INTERLEUKIN GENETICS INC
Form 10-Q
May 14, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2009

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 001-32715

INTERLEUKIN GENETICS, INC.

(Exact name of registrant in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**94-3123681** (I.R.S. Employer Identification No.)
135 Beaver Street, Waltham, MA (Address of principal executive offices)	**02452** (Zip Code)

Registrant s Telephone Number: **(781) 398-0700**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark whether each registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES o NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o
Non-Accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at April 30, 2009
Common Stock, par value $0.001 per share	**32,010,837**

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2009	December 31, 2008
	(Unaudited)	(Audited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,746,523	$ 4,952,481
Accounts receivable from related party	36,388	35,167
Trade accounts receivable, net of allowances for doubtful accounts of $6,696 at March 31, 2009 and December 31, 2008	945,165	720,914
Inventory	1,037,288	828,120
Deferred tax asset	57,800	58,000
Prepaid expenses and other current assets	374,812	271,602
Total current assets	4,197,976	6,866,284
Fixed assets, net	929,702	474,035
Intangible assets, net	4,392,604	4,759,153
Other assets	54,916	54,916
Total assets	$ 9,575,198	$ 12,154,388
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 855,169	$ 1,332,258
Accrued expenses	2,150,327	1,820,544
Deferred receipts	429,814	482,103
State taxes payable		10,000
Accrued expenses related to funded research and development projects	22,055	22,056
Total current liabilities	3,457,365	3,666,961
Long Term Debt	4,000,000	4,000,000
Deferred tax liability	10,000	5,000
Total liabilities	7,467,365	7,671,961
Stockholders equity:		
Convertible preferred stock, $0.001 par value 6,000,000 shares authorized; 5,000,000 shares of Series A issued and outstanding at March 31, 2009 and December 31, 2008; aggregate liquidation preference of $18,000,000 at March 31, 2009	5,000	5,000
Common stock, $0.001 par value 100,000,000 shares authorized; 31,969,887 and 31,799,381 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively	31,970	31,799

Additional paid-in capital	85,539,656	85,458,334
Accumulated deficit	(83,468,793)	(81,012,706)
Total stockholders equity	2,107,833	4,482,427
Total liabilities and stockholders equity	$ 9,575,198	$ 12,154,388

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

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INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Revenue:		
Revenue from related party	$ 334,538	$ 640,616
Revenue from others	1,560,457	2,013,907
Total revenue	1,894,995	2,654,523
Cost of revenue	1,042,699	1,335,972
Gross profit	852,296	1,318,551
Operating Expenses:		
Research and development	881,556	813,371
Selling, general and administrative	2,034,938	2,083,235
Amortization of intangible assets	337,551	330,184
Total operating expenses	3,254,045	3,226,790
Loss from operations	(2,401,749)	(1,908,239)
Other income (expense):		
Interest income	8,216	63,552
Interest expense	(32,055)	(11,865)
Loss on sale of fixed asset	(12,499)	
Total other income (expense)	(36,338)	51,687
Net loss before income taxes	(2,438,087)	(1,856,552)
Provision for income taxes	(18,000)	(18,550)
Net loss	$ (2,456,087)	$ (1,875,102)
Basic and diluted net loss per common share	$ (0.08)	$ (0.06)
Weighted average common shares outstanding	31,855,981	30,832,121

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

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INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the Three Months Ended March 31, 2009

(Unaudited)

	Convertible Preferred Stock		Common Stock		Additional		
	Shares	$0.001 par value	Shares	$0.001 par value	Paid-in Capital	Accumulated Deficit	Total
Balance as of December 31, 2008 (Audited)	5,000,000	$ 5,000	31,799,381	$ 31,799	$ 85,458,334	$ (81,012,706)	$ 4,482,427
Net loss						(2,456,087)	(2,456,087)
Common stock issued:							
Purchase stock			126,500	126	34,028		34,154
Employee stock purchase plan			31,506	32	5,325		5,357
Restricted stock awards			12,500	13	(13)		
Stock-based compensation expense					41,982		41,982
Balance as of March 31, 2009	5,000,000	$ 5,000	31,969,887	$ 31,970	$ 85,539,656	$ (83,468,793)	$ 2,107,833

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

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INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Three Months Ended March 31,	
	2009	**2008**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,456,087)	$ (1,875,102)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	428,565	402,238
Stock-based compensation expense	41,982	38,437
Loss on sale of fixed asset	12,499	
Changes in operating assets and liabilities:		
Accounts receivable, net	(225,472)	(256,111)
Inventory	(209,169)	(1,822)
Prepaid expenses and other current assets	(103,210)	(53,069)
Accounts payable	(477,089)	349,700
Accrued expenses	329,782	(828,679)
State Taxes Payable	(10,000)	(19,705)
Deferred revenue	(52,289)	(237,013)
Accrued expenses related to funded R&D		(23,000)
Deferred tax provision	5,200	(3,000)
Net cash used in operating activities	(2,715,288)	(2,507,126)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital additions	(559,179)	(9,199)
Increase in other assets	28,998	(59,268)
Settlement of claims relating to the acquisition of the assets and business of the Alan James Group, LLC		(600,000)
Net cash used in investing activities	(530,181)	(668,467)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	34,154	
Proceeds from exercises of rights offering, stock warrants, options and employee stock purchase plan	5,357	1,590
Net cash provided by financing activities	39,511	1,590
Net decrease in cash and cash equivalents	(3,205,958)	(3,174,003)
Cash and cash equivalents, beginning of period	4,952,481	7,646,468
Cash and cash equivalents, end of period	$ 1,746,523	$ 4,472,465
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	$	$ 67,500
Cash paid for interest	$ 50,411	$ 11,865

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

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INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

The condensed consolidated financial statements include the accounts of Interleukin Genetics, Inc. (the Company), and its wholly-owned subsidiaries, as of March 31, 2009 and have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. All intercompany accounts and transactions have been eliminated. These unaudited condensed consolidated financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008. Operating results for the three months ended March 31, 2009 are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

Note 2 Settlement of acquisition contingency

On March 25, 2008, The Company entered into an agreement with the former owners of the Alan James Group regarding the acquisition of the assets and business of the Alan James Group. Under the agreement, the former owners agreed to release the Company from any further obligations under the Asset Purchase Agreement, relating to the acquisition of the assets and business of the Alan James Group on August 17, 2006. The former owners agreed that no further amounts are or will become due under the Purchase Agreement (including its earn-out provisions).

In addition, on March 25, 2008, the Company agreed to pay a total of $1,200,000. This agreement resolved all remaining issues associated with the Company s August 2006 acquisition of that business including contingent consideration and compensation arrangements with the sellers/former management. The $1,200,000 due to sellers was recorded as a current liability at December 31, 2007. The Company applied $600,000 of the settlement cost against the previously accrued separation expense that was recorded on September 30, 2007 and the remaining $600,000 was applied against the $2,130,374 aggregate total of contingent liabilities and amounts due under escrow recorded as part of the original acquisition. The remaining contingent liabilities and amounts due under escrow balance of $1,530,374 was eliminated as no longer due and applied as a reduction in the balances on a pro rata basis of the intangible assets recorded as part of the original acquisition, including the effect of term reduction on the non-compete agreements.

If the amount initially recognized as if it was a liability exceeds the fair value of the consideration issued or issuable, that excess shall be allocated as a pro rata reduction of the amounts assigned to assets acquired in accordance with SFAS No. 141. The intangible balances as of December 31, 2007 reflect the resolution of the contingency resulting from the acquisition of the assets and business of the Alan James Group.

Note 3 Significant Accounting Policies

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Interleukin Genetics, Inc., and its wholly owned subsidiaries, Interleukin Genetics Laboratory Services, Inc. and AJG Brands, Inc. doing business as the Alan James Group. All intercompany accounts and transactions have been eliminated.

Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reported periods. Actual results could differ from those estimates. The Company s most critical accounting policies are in areas of its strategic alliance with Alticor, revenue recognition, allowance for sales returns, trade promotions, accounts receivable, inventory, stock-based compensation, income taxes, long-lived assets. These critical accounting policies are more fully discussed in these notes to the consolidated financial statements.

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Revenue Recognition

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectability is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test. To the extent that tests have been prepaid but results have not yet been reported, recognition of all related revenue is deferred. As of March 31, 2009 and December 31, 2008, the Company has deferred receipts of $32,400 and $80,000, respectively, for tests that have been prepaid but results have not yet been reported.

Revenue from product sales is recognized when there is persuasive evidence of an arrangement, delivery has occurred and title and risk of loss have transferred to the customer, the sales price is determinable and collectability is reasonably assured. The Company has no consignment sales. Product revenue is reduced for allowances and adjustments, including returns, discontinued items, discounts, trade promotions and slotting fees.

Revenue from contract research and development is recognized over the term of the contract as the Company performs its obligations under that contract (including revenue from Alticor, a related party).

Allowance for Sales Returns

The Company s revenue is affected by retailers right to return products. For product sales for which the Company believes it can reasonably and reliably estimate future returns, it recognizes revenue at the time of sale. For product sales for which the Company cannot reasonably and reliably estimate future returns, such as new products, the Company defers revenue recognition until the return privilege has substantially expired or the amount of future returns can be reasonably and reliably estimated. As of March 31, 2009 and December 31, 2008, the Company has deferred $77,308 and $78,627, respectively, of revenue for sales for which it cannot reasonably and reliably estimate future returns.

The Company analyzes sales returns in accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists.* The Company is able to make reasonable and reliable estimates based on its history. The Company also monitors the buying patterns of the end-users of its products based on sales data received. The Company reviews its estimated product returns based on expected sales data communicated by its customers. The Company also monitors the levels of inventory at its largest customers to avoid excessive customer stocking of merchandise. The Company believes it has sufficient interaction with and knowledge of its customers, industry trends and industry conditions to adjust the accrual for returns when necessary. If the Company loses a major account, it may agree to accept a substantial amount of returns.

Trade Promotions

The Company uses objective procedures for estimating its allowance for trade promotions. The allowance for trade promotions offered to customers is based on contracted terms or other arrangements agreed in advance, as well as historical experience. The Company may adjust its estimate based on these factors to more accurately reflect trade promotion costs.

Accounts Receivable

Trade accounts receivable are stated at their estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offers its Consumer Product Segment customers a 2% cash discount if payment is made within 30 days of the invoice date, however, most customers take the discount regardless of when payment occurs. As of March 31, 2009 and December 31, 2008, the Company has reduced trade accounts receivable by $16,524 and $13,364, respectively, for discounts anticipated to be taken. The Company provides for an allowance for estimated bad debts based on management s estimate of the amount of probable credit losses in the Company s existing accounts receivable. As of March 31, 2009 and December 31, 2008, the Company has provided an allowance for uncollectible accounts of $6,696.

Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the invoice price from our vendors. Management periodically evaluates inventory to identify items that are slow moving or have excess quantities. Management also considers whether certain items are carried at values that exceed the ultimate sales price less selling costs. Where such items are identified, management adjusts the carrying value to the lower of cost or market.

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Inventory on hand primarily consisted of the following at March 31, 2009 and December 31, 2008:

	2009	2008
Raw materials	$ 96,447	$ 93,544
Finished goods	940,841	734,576
Total	$ 1,037,288	$ 828,120

Stock-Based Compensation

The Company accounts for its stock-based compensation expense in accordance with SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R) which requires companies to recognize compensation expenses for all share-based payments to employees at fair value. SFAS No. 123R addresses all forms of share-based payment (SBP) awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R requires the Company to expense SBP awards with compensation cost for SBP transactions measured at fair value. SFAS No. 123R applies to new equity awards and to equity awards modified, repurchased or canceled after the effective date, January 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the effective date shall be recognized as the requisite service is rendered on or after the effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated from the pro forma disclosures under SFAS No. 123. Additionally, the Company records an expense for the amount that the fair market value exceeds the purchase cost for common stock purchased pursuant to its employee stock purchase plan.

Income Taxes

The preparation of its consolidated financial statements requires the Company to estimate its income taxes in each of the jurisdictions in which it operates, including those outside the United States, which may be subject to certain risks that ordinarily would not be expected in the United States. The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires the recognition of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized.

Significant management judgment is required in determining the Company s provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets. The Company has recorded a full valuation allowance against its deferred tax assets of $25.3 million as of March 31, 2009, due to uncertainties related to its ability to utilize these assets. The valuation allowance is based on management s estimates of taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or management adjusts these estimates in future periods, the Company may need to adjust its valuation allowance, which could materially impact its financial position and results of operations.

The Company complies with the provisions of the Financial Accounting Standards Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transitions. The Company reviews all material tax positions for all years open to statute to determine whether it is more likely than not that the positions taken would be sustained based on the technical merits of those positions. The Company did not recognize any adjustments for uncertain tax positions during the three months ended March 31, 2009.

Research and Development

Research and development costs are expensed as incurred.

Advertising Expense

Advertising costs are expensed as incurred. During the three months ended March 31, 2009 and 2008 advertising expense was $153,341 and $274,713, respectively.

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Basic and Diluted Net Loss per Common Share

The Company applies SFAS No. 128, *Earnings per Share*, which establishes standards for computing and presenting earnings per share. Basic and diluted net loss per share was determined by dividing net loss applicable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is the same as basic net loss per share for all the periods presented, as the effect of the potential common stock equivalents is anti-dilutive due to the loss in each period. Potential common stock equivalents excluded from the calculation of diluted net loss per share consists of stock options, warrants, convertible preferred stock and convertible debt as described in the table below:

	As of March 31,	
	2009	**2008**
Options outstanding	2,225,667	1,866,073
Warrants outstanding	400,000	400,000
Convertible preferred stock	28,160,200	28,160,200
Convertible debt	704,436	931,377
Total	31,490,303	31,357,650

Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. During the three months ended March 31, 2009, and 2008, there were no items other than net loss included in the comprehensive loss.

Fair Value of Financial Instruments

The Company, using available market information, has determined the estimated fair values of financial instruments. The stated values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term nature of these instruments. The carrying amounts of borrowings under short-term agreements approximate their fair value as the rates applicable to the financial instruments reflect changes in overall market interest rates.

Cash Equivalents

Cash and cash equivalents consist of amounts on deposit in checking and savings accounts with banks and other financial institutions. Short-term investments primarily consist of bank money market funds which have short-term maturities of less than ninety days and are carried at cost which approximates fair value.

Fixed Assets

Fixed assets are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over estimated useful lives of three to five years. Leasehold improvements are amortized over the estimated useful life of the asset, or the remaining term of the lease, whichever is shorter.

Long-Lived Assets

The Company applies the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). SFAS No. 144 requires that the Company evaluate its long-lived assets for impairment whenever events or changes in circumstances indicate that carrying amounts of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted net cash flows expected to be generated by the asset. Any write-downs, based on fair value, are to be treated as permanent reductions in the carrying amount of the assets. The Company believes that no impairment exists related to the Company s long-lived assets at March 31, 2009.

Intangible Assets

Purchase accounting requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair market value of the assets purchased and liabilities assumed. Prior to 2009, the Company accounted for its acquisitions using the purchase method of accounting. Values were assigned to goodwill and intangible assets based on

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third-party independent valuations, as well as management s forecasts and projections that include assumptions related to future revenue and cash flows generated from the acquired assets.

The Company applies the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires impairment tests be periodically repeated and on an interim basis, if certain conditions exist, with impaired assets written down to fair value. An analysis performed by management on December 31, 2007, determined that the indefinite lived trademarks had a current fair market value of $764,000. Management adjusted the book value of the indefinite lived trademarks to reflect this $236,000 impairment in value. See Note 2 for adjustments of intangible assets related to the settlement effective March 25, 2008.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . SFAS 157 defines fair value, establishes a U.S. GAAP framework for measuring fair value, and expands financial statement disclosures about fair value measurements. We adopted SFAS No. 157 on January 1, 2008 for financial assets and liabilities. The adoption of this standard had no material impact on our results of operations or financial condition. In February 2008, the FASB issued FASB Staff Position (FSP) 157-2, Effective Date of FASB Statement No. 157 , which permits a one-year deferral in applying the measurement provisions of SFAS 157 to non-financial assets and non-financial liabilities (non-financial terms) that are not recognized or disclosed at fair value in an entity s financial statements on a recurring basis (at least annually). Therefore, if the change in fair value of a non-financial item is not required to be recognized or disclosed in the financial statements on an annual basis or more frequently, the effective date of application of SFAS 157 was deferred until fiscal years beginning after November 15, 2008. The adoption of this standard as of January 1, 2009 had no material effect on our results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115*, which is effective for fiscal years beginning after November 15, 2007. The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The Company adopted SFAS 159 on January 1, 2008. The Company has not elected to account for any of its assets or liabilities using the fair value option under SFAS 159 and accordingly, the adoption of SFAS 159 did not have a material effect on the Company s financial position or results of operations.

In July 2007, the Emerging Issues Task Force (EITF) issued EITF 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to be Used in Future Research and Development Activities (EITF 07-3). EITF 07-3 clarifies the accounting for nonrefundable advance payments for goods or services that will be used or rendered for research and development activities. EITF 07-3 states that such payments should be capitalized and recognized as an expense as the goods are delivered or the related services are performed. If an entity does not expect the goods to be delivered or the services rendered, the capitalized advance payment should be charged to expense. EITF 07-3 is effective for fiscal years beginning after December 15, 2007. The Company adopted EITF 07-3 on January 1, 2008. The adoption of EITF 07-3 did not have a material effect on the Company s financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations Statement 141R, a replacement of SFAS No. 141. SFAS 141R is effective for fiscal years beginning on or after December 15, 2008 and applies to all business combinations. SFAS 141R provides that, upon initially obtaining control, an acquirer shall recognize 100% of the fair values of acquired assets, including goodwill, and assumed liabilities, with only limited exceptions, even if the acquirer has not acquired 100% of its target. Additionally, SFAS 141R changes current practice, in part, as follows: (1) contingent consideration arrangements will be fairly valued at the acquisition date and included on that basis in the purchase price consideration; (2) transaction costs will be expensed as incurred, rather than capitalized as part of the purchase price; (3) pre-acquisition contingencies, such as legal issues, will generally have to be accounted for in purchase accounting at fair value; and (4) in order to accrue for a restructuring plan in purchase accounting, the requirements in SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met at the acquisition date. The adoption of this standard as of January 1, 2009 had no material effect on our results of operations or financial condition although the new standard could materially change the accounting for business combinations consummated subsequent to that date.

In December 2007, the FASB issued Statement of Financial Accounting Standards SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*, an Amendment of ARB 51 . SFAS 160 establishes new accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 will require entities to classify noncontrolling interests as a component of stockholders equity and will require subsequent changes in ownership interest in a subsidiary to be accounted for as an equity transaction. Additionally, SFAS 160 will

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require entities to recognize a gain or loss upon the loss of control of a subsidiary and to remeasure any ownership interest retained at fair value on that date. This statement also requires expanded disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective on a prospective basis for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, except for the presentation and disclosure requirements, which are required to be applied retrospectively. Early adoption is not permitted. The adoption of SFAS 160 as of January 1, 2009 did not have a material effect on the Company s financial position or results of operations.

In December 2007, the FASB ratified a consensus opinion reached by the EITF on EITF Issue 07-1, Accounting for Collaborative Arrangements (EITF 07-1). The guidance in EITF 07-1 defines collaborative arrangements and establishes presentation and disclosure requirements for transactions within a collaborative arrangement (both with third parties and between participants in the arrangement). The consensus in EITF 07-1 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2008. The consensus requires retrospective application to all collaborative arrangements existing as of the effective date, unless retrospective application is impracticable. The impracticability evaluation and exception should be performed on an arrangement-by-arrangement basis. The adoption of EITF 07-1 did not have a significant effect on our financial statements.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142). The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of FSP 142-3 on January 1, 2009 did not have a material effect on the Company s financial position or results of operations.

In November 2008, the FASB issued EITF Issue No. 08-7, *Accounting for Defensive Intangible Assets,* or EITF 08-7. EITF 08-7 seeks to clarify how to account for defensive intangible assets, or those intangible assets acquired in a business combination that an entity does not intend to actively use but does intend to prevent others from using, subsequent to initial measurement. EITF 08-7 is effective for all intangible assets acquired during the first fiscal year beginning on or after December 15, 2008. Early adoption is not permitted. The impact of the adoption of EITF 08-7 will be dependent upon the type and structure of future transactions that the Company consummates.

Note 4 Strategic Alliance with Alticor Inc.

Since March 2003, the Company has maintained a broad strategic alliance with several affiliates of the Alticor family of companies to develop and market novel nutritional and skin care products. The alliance initially included an equity investment, a multi-year research and development agreement, a licensing agreement with royalties on marketed products, the deferment of outstanding loan repayment and the refinancing of bridge financing obligations. The alliance continues to evolve and recent events under the alliance are described in this Note 4.

On February 25, 2008, the Company entered into research agreement (RA8) with an affiliate of Alticor, effective January 1, 2008, to expand the research being performed under its current agreements with Alticor through 2008. The Company received $1,200,000 during 2008 under the research agreement, on a time and materials basis. Additionally, in 2008 the Company recognized as revenue approximately $800,000 of previously deferred revenue. The Company recognized $203,686 in the three months ended March 31, 2009 and $537,013 in the three months ended March 31, 2008 from this agreement. In addition to the $800,000 of deferred revenue recognized under RA8, $168,254 of funds previously paid to the Company by Alticor under research agreement 3 (RA3) and research agreement 4 (RA4), for which no work has been performed, will not need to be repaid to Alticor by the Company. Since the Company performed no prior services relating to the $168,254 received from Alticor, and the Company is not required to perform any future services relating to these funds, the Company has determined that the funds should be classified as additional paid-in capital and are recorded as such on the Company s balance sheet as such as of March 31, 2009.

On January 31, 2009, the Company entered into an amendment to the RA8. The amendment extends the term from a maximum of six months to eight months terminating on September 30, 2009. The Company received an additional $200,316 on March 31, 2009 under the terms of the amendment to complete ongoing research. The $200,316 is recognized as deferred revenue on the Company s Balance Sheet of March 31, 2009.

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Note 5 Debt

On August 17, 2006, a new credit facility with Alticor was extended to provide the Company with access to an additional $14,400,000 of working capital borrowings at any time prior to August 17, 2008. Any amounts borrowed will bear interest at prime, require quarterly interest payments and will mature on August 16, 2011. The principal amount of any borrowing under this credit facility is convertible at Alticor s election into a maximum of 2,533,234 shares of common stock, reflecting a conversion price of $5.6783 per share. As a condition of this financing, the Company initiated a rights offering of 2,533,234 shares of its common stock to existing stockholders (other than Alticor) at a per share price of $5.6783. The proceeds received from the rights offering reduced the availability under the credit facility. As a result of the rights offering, the availability under the credit facility has been reduced by $68,208, leaving approximately $14,316,255 available.

On June 10, 2008, the Company borrowed $4,000,000 under the credit facility which is the amount outstanding at March 31, 2009 leaving $10,316,255 of available credit. On August 12, 2008, this credit facility was extended to permit borrowing at any time prior to March 31, 2009.

On June 11, 2008, pursuant to the terms of the notes, Pyxis Innovations Inc., an affiliate of Alticor (Pyxis), converted the indebtedness due on June 30, 2008, representing an aggregate principal amount of $595,336 and accrued interest of $7,450, into 943,032 shares of the Company s common stock.

On March 11, 2009, the Company entered into an amended and restated note purchase agreement, dated as of March 10, 2009, with Pyxis, to extend the availability of the existing credit facility from March 31, 2009 until March 31, 2010. All such borrowing under this credit facility becomes due on August 16, 2011 and is convertible into shares of common stock at a conversion price equal to $5.68 per share.

Note 6 Commitments and Contingencies

Acquisition of Databases

In connection with the research agreement with Alticor dated March 5, 2003, the Company is obligated to purchase two clinical databases. As of June 30, 2004, the Company determined that this obligation met the criteria for accrual of SFAS No. 5, *Accounting for Contingencies,* and estimated the cost of these two databases at $450,000. Accordingly, the Company recorded a liability and charged research and development expenses of $450,000 at that time. As of March 31, 2009 and 2008, the Company had cumulative expenditures of $427,944 and $380,944, respectively, associated with the acquisition of these databases. The Company believes that the acquisition of the databases will not exceed the amount that the Company has estimated, however actual amounts could differ.

Sponsored Research Agreements

In connection with the research agreement with Alticor dated March 5, 2005, the Company entered into a sponsored research agreement with Yonsei University to conduct a clinical study. The sponsored research agreement was originally for an amount of $499,882. This amount has been renegotiated to $412,288 and is payable upon achievement of certain milestones. As of March 31, 2009 and 2008, Yonsei University had achieved milestones valued at $412,288 and $316,000 respectively. The milestones are fully paid by the Company as of March 31, 2009.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on its financial condition, results of operations or cash flows.

Note 7 Capital Stock

Authorized Preferred and Common Stock

At March 31, 2009, the Company had authorized 6,000,000 shares of $0.001 par value Series A Preferred Stock, of which 5,000,000 were issued and outstanding. At March 31, 2009, the Company had authorized 100,000,000 shares of $0.001 par value common stock of which 66,931,082 shares were outstanding or reserved for issuance. Of those, 31,969,887 shares were outstanding; 28,160,200 shares were reserved for the conversion of Series A Preferred to common stock; 704,436 shares were reserved for the conversion of the $4,000,000 of debt outstanding under the credit facility with Pyxis; 3,489,095 shares were reserved for the exercise of authorized and outstanding stock options; 400,000 shares were reserved for the exercise of outstanding warrants to purchase common stock at an exercise price of $2.50 per share which are exercisable

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currently until the expiration date of August 9, 2012; 390,678 shares were reserved for the exercise of rights held under the Employee Stock Purchase Plan; 1,816,786 shares were reserved for the issuance upon the conversion of convertible notes that may be issued to Pyxis under the existing credit facility.

Series A Preferred Stock

On March 5, 2003, the Company entered into a Stock Purchase Agreement with Alticor, pursuant to which Alticor purchased from the Company 5,000,000 shares of Series A Preferred Stock for $7,000,000 in cash on that date, and an additional $2,000,000 in cash that was paid, as a result of the Company achieving a certain milestone, on March 11, 2004.

The Series A Preferred Stock accrues dividends at the rate of 8% of the original purchase price per year, payable only when, as and if declared by the Board of Directors and are non-cumulative. To date, no dividends have been declared on these shares. If the Company declares a distribution, with certain exceptions, payable in securities of other persons, evidences of indebtedness issued by the Company or other persons, assets (excluding cash dividends) or options or rights to purchase any such securities or evidences of indebtedness, then, in each such case the holders of the Series A Preferred Stock shall be entitled to a proportionate share of any such distribution as though the holders of the Series A Preferred Stock were the holders of the number of shares of Common Stock into which their respective shares of Series A Preferred Stock are convertible as of the record date fixed for the determination of the holders of Common Stock entitled to receive such distribution.

In the event of any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, the holders of the Series A Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of the Company s assets or surplus funds to the holders of its Common Stock by reason of their ownership thereof, the amount of two times the then-effective purchase price per share, as adjusted for any stock dividends, combinations or splits with respect to such shares, plus all declared but unpaid dividends on such share for each share of Series A Preferred Stock then held by them. The liquidation preference at March 31, 2009 was $18,000,000. After receiving this amount, the holders of the Series A Preferred Stock are entitled to participate on an as-converted basis with the holders of Common Stock in any of the remaining assets.

Each share of Series A Preferred Stock is convertible at any time at the option of the holder into a number of shares of the Company s Common Stock determined by dividing the then-effective purchase price ($1.80, and subject to further adjustment) by the conversion price in effect on the date the certificate is surrendered for conversion. As of March 31, 2009, the Series A Preferred Stock was convertible into 28,160,200 shares of Common Stock reflecting a current conversion price of $0.3196 per share.

Each holder of Series A Preferred Stock is entitled to vote its shares of Series A Preferred Stock on an as-converted basis with the holders of Common Stock as a single class on all matters submitted to a vote of the stockholders, except as otherwise required by applicable law. This means that each share of Series A Preferred Stock will be entitled to a number of votes equal to the number of shares of Common Stock into which it is convertible on the applicable record date.

Note 8 Stock-Based Compensation Arrangements

Stock-based compensation arrangements consisted of the following as of March 31, 2009: three share-based compensation plans, restricted stock awards; an employee stock purchase plan; and employee compensation agreements. Total compensation cost that has been charged against income for stock-based compensation arrangements is as follows:

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Stock option grants beginning of period	$ 38,984	$ 21,743
Stock-based arrangements during the period:		
Stock option grants	428	16,421
Unrestricted stock issued:		
Employee stock purchase plan	945	273
Employment Agreements	1,625	
	$ 41,982	$ 38,437

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Stock option grants

The following table details all stock option activity for the three months ended March 31, 2009 and 2008:

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008