GLOWPOINT INC
Form 10-Q
June 06, 2007

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2006.

or

¨ Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number: 0-25940

GLOWPOINT, INC.
(Exact Name of registrant as Specified in its Charter)

Delaware	**77-0312442**
(State or other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Number)

225 Long Avenue, Hillside, New Jersey 07205
(Address of Principal Executive Offices)

312-235-3888
(Issuer's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ¨ No x

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes ¨ No x

The number of shares outstanding of the registrant's Common Stock as of August 14, 2006 was 46,369,673.

GLOWPOINT, INC

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* The Condensed Consolidated Balance Sheet at December 31, 2005 has been derived from the audited consolidated financial statements filed as an exhibit to our Report on Form 8-K on February 27, 2007.

GLOWPOINT, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,858	$ 2,023
Accounts receivable, net of allowance for doubtful accounts of $147 and $145; respectively	2,316	2,171
Prepaid expenses and other current assets	487	510
Total current assets	6,661	4,704
Property and equipment, net	3,525	4,117
Other assets	663	216
Total assets	$ 10,849	$ 9,037
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	$ 2,278	$ 1,586
Accrued expenses	2,258	1,961
Accrued sales taxes and regulatory fees	3,723	3,063
Current portion of derivative financial instruments	4,636	1,246
Deferred revenue	300	374
Total current liabilities	13,195	8,230
Long term liabilities:		
Derivative financial instruments, less current portion	2,154	324
10% Convertible notes, net of discount of $3,270	3,013	—
Total long term liabilities	5,167	324
Total liabilities	18,362	8,554
Preferred stock, $.0001 par value; 5,000 shares authorized and redeemable; 0.120 Series B shares issued and outstanding, (stated value of $2,888; liquidation value of $3,560 and $3,388, respectively)	2,888	2,888
Stockholders' deficit:		
Common stock, $.0001 par value; 100,000 shares authorized; 46,410 and 46,086 shares issued and issuable; 46,370 and 46,046 shares outstanding, respectively	5	5
Additional paid-in capital	161,190	160,219
Accumulated deficit	(171,356)	(161,833)
Deferred compensation	—	(556)
	(10,161)	(2,165)
Less: Treasury stock, 40 shares at cost	(240)	(240)
Total stockholders' deficit	(10,401)	(2,405)
Total liabilities and stockholders' deficit	$ 10,849	$ 9,037

See accompanying notes to condensed consolidated financial statements.

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GLOWPOINT, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

(Unaudited)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Revenue	$ 9,702	$ 8,599	$ 4,981	$ 4,397
Cost of revenue	6,836	7,692	3,350	4,006
Gross margin	2,866	907	1,631	391
Operating expenses:				
Research and development	474	576	203	263
Sales and marketing	1,374	2,148	645	1,225
General and administrative	7,458	6,670	2,805	3,456
Total operating expense	9,306	9,394	3,653	4,944
Loss from operations	(6,440)	(8,487)	(2,022)	(4,553)
Other expense (income):				
Interest expense	2,415	1	777	1
Increase in fair value of derivative financial instruments	579	80	602	38
Amortization of deferred financing costs	129	—	129	—
Interest income	(41)	(33)	(37)	(30)
Gain on settlement with Gores	—	(379)	—	—
Total other expense (income), net	3,082	(331)	1,471	9
Net loss	(9,522)	(8,156)	(3,493)	(4,562)
Preferred stock dividends	(172)	(147)	(87)	(58)
Preferred stock deemed dividends	—	(1,282)	—	—
Net loss attributable to common stockholders	$ (9,694)	$ (9,585)	$ (3,580)	$ (4,620)
Net loss attributable to common stockholders per share:				
Basic and diluted	$ (0.21)	$ (0.23)	$ (0.08)	$ (0.10)
Weighted average number of common shares:				
Basic and diluted	46,127	42,612	46,207	46,046

See accompanying notes to condensed consolidated financial statements.

GLOWPOINT, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2006	2005
Cash flows from Operating Activities:		
Net loss	$ (9,522)	$ (8,156)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,013	1,147
Amortization of deferred financing costs	129	—
Other expense recognized for the increase in the estimated fair value of the derivative financial instruments	579	81
Accretion of discount on 10% Notes	369	—
Beneficial conversion feature for 10% Notes	1,768	—
Gain on settlement with Gores	—	(379)
Stock-based compensation	530	573
Loss on disposal of equipment	57	—
Increase (decrease) in cash attributable to changes in assets and liabilities:		
Accounts receivable	(145)	(299)
Prepaid expenses and other current assets	23	(294)
Other assets	205	2
Accounts payable	692	(394)
Accrued expenses, sales taxes and regulatory fees	1,104	516
Deferred revenue	(74)	243
Net cash used in operating activities	(3,272)	(6,960)
Cash flows from Investing Activities:		
Proceeds from discontinued operations, including escrowed cash	—	3,087
Purchases of property, equipment and leasehold improvements	(478)	(1,011)
Net cash (used in) provided by investing activities	(478)	2,076
Cash flows from Financing Activities:		
Proceeds from issuance of 10% Notes, net of financing costs of $595	5,585	—
Proceeds from issuance of common stock and warrants	—	9,389
Proceeds from exercise of warrants and options, net	—	74
Payments on capital lease obligations	—	(35)
Net cash provided by financing activities	5,585	9,428
Increase in cash and cash equivalents	1,835	4,544
Cash and cash equivalents at beginning of period	2,023	4,497
Cash and cash equivalents at end of period	$ 3,858	$ 9,041
Supplement disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ —	$ 1
Non-cash investing and financing activities:		
Preferred stock dividends	$ 172	$ 147
Deferred financing costs for 10% Notes incurred by issuance of placement agent warrants	296	—
Additional 10% Notes issued as payment for interest	103	—

Preferred stock deemed dividends	—	1,282
Conversion of Series B convertible preferred stock to common stock	—	2,000
Equity issued as consideration for accrued preferred stock dividends	—	183

See accompanying notes to condensed consolidated financial statements.

GLOWPOINT, INC.
NOTES TO RESTATED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006

(Unaudited)

Note 1 – Basis of Presentation

The Business

Glowpoint, Inc. ("Glowpoint" or "we" or "us"), a Delaware corporation, is a premiere broadcast-quality, IP (Internet Protocol)-based managed video services provider. We offer a vast array of managed video services, including video application services, managed network services, IP and ISDN videoconferencing services, multi-point conferencing (bridging), technology hosting and management, and professional services. We provide these services to a wide variety of companies, from large enterprises and governmental entities to small and medium-sized businesses. Glowpoint is exclusively focused on high quality two-way video communications and has been supporting millions of video calls since its launch in 2000. We have bundled some of our managed services to offer video communication solutions for broadcast/media content acquisition and for video call center applications. Recently, with the advent of HD (High Definition) Telepresence solutions, we have combined various components of our features and services into a comprehensive “white glove” service offering that can support any of the telepresence solutions on the market today.

Liquidity and Going Concern

Our condensed consolidated financial statements have been prepared assuming we will continue as a going concern. We have incurred recurring operating losses and negative operating cash flows since our inception including a net loss attributable to common stockholders of $9,694,000 for the six months ended June 30, 2006. At June 30, 2006, we had a working capital deficit of $6,534,000. We had $3,858,000 in cash and cash equivalents at June 30, 2006. We had net cash used in operations of $3,272,000 for the six months ended June 30, 2006. Additionally, the 10% Senior Secured Convertible Notes (see Note 5) mature in September 2007. These factors raise substantial doubt as to our ability to continue as a going concern. In March 2006 we implemented a corporate restructuring plan designed to reduce certain operating, sales and marketing and general and administrative costs (see Note 8). We raised capital in March and April 2006, but continue to sustain losses and negative operating cash flows. Assuming we realize all of the savings from our restructured operating activities, assuming we are able to negotiate favorable terms with the authorities regarding our sales and use taxes and regulatory fees and assuming we are able to renegotiate or refinance the 10% Senior Secured Convertible Notes , we believe that our available capital as of June 30, 2006 will enable us to continue as a going concern through June 30, 2007. There are no assurances, however that we will be able to raise additional capital as needed, or upon acceptable terms nor any assurances that we will be able renegotiate the terms and maturity date of the 10% Notes. If we are unable to renegotiate the maturity of the 10% Notes or issue new securities on favorable terms to repay them, it would have a material adverse effect on the Company. The accompanying financial statements do not include any adjustments that might result from this uncertainty.

Summary of Significant Accounting Policies

Quarterly Financial Information and Results of Operations

The financial statements as of June 30, 2006 and for the six and three months ended June 30, 2006 and 2005, are unaudited and, in the opinion of management, include all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position as of June 30, 2006, and the results of operations and cash flows for the six and three months ended June 30, 2006 and 2005. The results for the six and three months ended June 30, 2006 are not necessarily indicative of the results to be expected for the entire year. While management of the

Company believes that the disclosures presented are adequate to make the information not misleading, these consolidated financial statements should be read in conjunction with the consolidated financial statements and the footnotes thereto for the fiscal year ended December 31, 2005 as filed with the Securities and Exchange Commission as an exhibit to Form 8-K on February 27, 2007.

See “Note 2 - Basis of Presentation and Summary of Significant Accounting Policies” in the consolidated financial statements for the fiscal year ended December 31, 2005 as filed with the Securities and Exchange Commission as an exhibit to Form 8-K on February 27, 2007 for a discussion of the estimates and judgments necessary in the Company’s accounting for sales taxes and regulatory fees, concentration of credit risk, lives of property and equipment, income taxes and fair value of financial instruments. There have been no changes to our critical accounting policies in the six months ended June 30, 2006. Critical accounting policies and the significant estimates made in accordance with them are regularly discussed with our Audit Committee.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Glowpoint and our wholly owned subsidiaries, GP Communications LLC, AllComm Products Corporation and VTC Resources, Inc. All material inter-company balances and transactions have been eliminated in consolidation.

Reclassifications

Certain amounts from 2005 have been reclassified to conform to the 2006 presentation.

Use of Estimates

Preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual amounts could differ from the estimates made. We continually evaluate estimates used in the preparation of the consolidated financial statements for reasonableness. Appropriate adjustments, if any, to the estimates used are made prospectively based upon such periodic evaluation. The significant areas of estimation include determining the allowance for doubtful accounts, deferred tax valuation allowance, sales and use tax obligations, regulatory fees and related penalties and interest, the estimated life of customer relationships, the estimated lives of property and equipment and the fair value of derivative financial instruments.

Revenue Recognition

We recognize subscription revenue, when the related services have been performed. Revenues billed in advance are deferred until the revenue has been earned. Other service revenue, including amounts related to surcharges charged by our carriers, related to the Glowpoint managed network service and the multi-point video and audio bridging services are recognized as service is provided. As the non-refundable, upfront activation fees charged to the subscribers do not meet the criteria as a separate unit of accounting, they are deferred and recognized over the twenty-four month period estimated life of the customer relationship. Revenues derived from other sources are recognized when services are provided or events occur.

Long-Lived Assets

We evaluate impairment losses on long-lived assets used in operations, primarily fixed assets, when events and circumstances indicate that the carrying value of the assets might not be recoverable in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144 *“Accounting for the Impairment or Disposal of Long-Lived Assets”*. For purposes of evaluating the recoverability of long-lived assets, the undiscounted cash flows estimated to be generated by those assets are compared to the carrying amounts of those assets. If and when the carrying values of the assets exceed their fair values, the related assets will be written down to fair value. In the 2006 period, no impairment losses were indicated or recorded.

Derivative Financial Instruments

The Company’s objectives in using debt related financial instruments are to obtain the lowest cash cost source of funds within a targeted range of variable to fixed-rate debt obligations. Derivatives are recognized in the consolidated balance sheets at fair value based on the criteria specified in SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”. The estimated fair value of the derivative liabilities is calculated using the Black-Scholes formula where applicable and such estimates are revalued at each balance sheet date with changes in value recorded as other income or expense.

Related Party Transactions

The Company receives consulting and tax services from an accounting firm in which one of our directors is a partner. Management believes that such transactions are at arm's-length and for terms that would have been obtained from unaffiliated third parties. For the six and three months ended June 30, 2006 and 2005, we incurred fees for these services of $19,000, $10,000, $19,000 and $0, respectively.

Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, *"Accounting for Certain Hybrid Financial Instruments"*. SFAS No. 155 amends SFAS No. 133 and SFAS No. 140, and addresses issues raised in SFAS No. 133 Implementation Issue No. D1, *"Application of Statement 133 to Beneficial Interests in Securitized Financial Assets"*. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe it will be materially affected by the adoption of SFAS No. 155.

In June 2006, the FASB issued FASB Interpretation Number ("FIN") 48, *"Accounting for Uncertainty in Income Taxes—An interpretation of FASB Statement No. 109"*, regarding accounting for, and disclosure of, uncertain tax positions. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *"Accounting for Income Taxes."* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe its results of operations and financial position will be materially affected by the adoption of FIN No. 48.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 108, *"Considering the Effects on Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"*. SAB No. 108 requires registrants to quantify errors using both the income statement method (i.e. iron curtain method) and the rollover method and requires adjustment if either method indicates a material error. If a correction in the current year relating to prior year errors is material to the current year, then the prior year financial information needs to be corrected. A correction to the prior year results that are not material to those years would not require a "restatement process" where prior financials would be amended. SAB No. 108 is effective for fiscal years ending after November 15, 2006. We have adopted SAB No. 108 and it did not have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements"*, to define fair value, establish a framework for measuring fair value in accordance with generally accepted accounting principles, and expand disclosures about fair value measurements. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007, the beginning of the Company's 2008 fiscal year. The Company is assessing the impact the adoption of SFAS No. 157 will have on the Company's financial position and results of operations.

Note 2 - Stock-Based Compensation

We periodically grant stock options to employees and directors in accordance with the provisions of our stock option plans, with the exercise price of the stock options being set at the closing market price of the common stock on the date of grant. Effective January 1, 2006, the Company adopted Statement of Financial Standards No. 123R, *Share-Based Payment* ("SFAS No. 123R") which requires that compensation cost relating to share-based payment transactions be recognized as an expense in the financial statements and that measurement of that cost be based on the estimated fair value of the equity or liability instrument issued. Under SFAS No. 123R, the pro forma disclosures previously permitted under SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS No. 123") are no longer an alternative to financial statement recognition. SFAS No. 123R also requires that forfeitures be estimated and recorded over the vesting period of the instrument.

Prior to January 1, 2006, as permitted by SFAS No. 123, the Company accounted for share-based payments to employees using the intrinsic value method under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related interpretations. Under this method, compensation cost is measured as the amount by which the market price of the underlying stock

exceeds the exercise price of the stock option at the date at which both the number of options granted and the exercise price are known. As previously permitted by SFAS No. 123, the Company had elected to apply the intrinsic-value-based method of accounting under APB No. 25 described above, and adopted only the disclosure requirements of SFAS No. 123 which were similar in most respects to SFAS No. 123R, with the exception of option forfeitures, which, under SFAS No. 123, had been accounted for as they occurred.

The Company has adopted SFAS No. 123R using the modified prospective method which requires that share-based expense recognized includes: (a) share-based expense for all awards granted prior to, but not yet vested, as of the adoption date and (b) share-based expense for all awards granted subsequent to the adoption date. Since the modified prospective application method is being used, there is no cumulative effect adjustment upon the adoption of SFAS No. 123R, and the Company's December 31, 2005 financial statements do not reflect any restated amounts. No modifications were made to outstanding options prior to the adoption of SFAS No. 123R, and the Company did not change the quantity, type or payment arrangements of any share-based payments programs.

The Company uses the same valuation methodologies and assumptions in estimating the fair value of options under both SFAS No. 123R and the pro forma disclosures under SFAS No. 123.

Stock options or warrants issued in return for services rendered by non-employees are accounted for using the fair value based method. The following table illustrates the effect on net loss attributable to common shareholders and net loss per share for the six and three months ended June 30, 2005 if the fair value based method using the Black-Scholes model at the grant date had been applied to all awards: (in thousands except per share data):

		Six Months		Three Months
Net loss attributable to common stockholders, as reported	$	(9,585)	$	(4,620)
Add: stock-based employee compensation expense included in reported net loss.		311		156
Deduct: total stock-based employee compensation expense determined under the fair value based method		(847)		(408)
Pro forma net loss attributable to common stockholders	$	(10,121)	$	(4,872)
Net loss attributable to common stockholders per share:				
Basic and diluted - as reported herein	$	(0.23)	$	(0.10)
Basic and diluted - pro forma	$	(0.24)	$	(0.11)

The pro forma effect of applying SFAS No. 123R may not be representative of the effect on reported net income in future years because options vest over several years and varying amounts are generally made each year.

The weighted average fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions during the six and three months ended June 30, 2006 and 2005:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2006	2005	2006	2005
Risk free interest rate	4.8%	3.9%	4.9%	3.8%
Expected option lives	5 Years	5 Years	5 Years	5 Years
Expected volatility	95.4%	109.5%	95.3%	108.6%
Estimated forfeiture rate	30%	20%	30%	20%
Expected dividend yields	None	None	None	None
Weighted average grant date fair value of options	$0.30	$1.39	$0.29	$1.13

Expected volatility was calculated using the historical volatility of the appropriate industry sector index. The expected term of the options is estimated based on the Company's historical exercise rate and forfeiture rates are estimated based on employment termination experience. The risk free interest rate is based on U.S. Treasury yields for securities in effect at the time of grants with terms approximating the term of the grants. The assumptions used in the Black-Scholes option valuation model are highly subjective, and can materially affect the resulting valuation.

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A summary of options granted, exercised, expired and forfeited under our plans and options outstanding as of and for the six months ended June 30, 2006 with respect to all outstanding options is as follows (options in thousands):

	Outstanding		Exercisable	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options outstanding, January 1, 2006	4,996	$ 2.51	3,613	$ 2.92
Granted	1,103	0.41		
Exercised	—	—		
Expired	(7)	4.37		
Forfeited	(681)	1.48		
Options outstanding, June 30, 2006	5,411	$ 2.51	3,865	$ 2.79

At June 30, 2006, there was $319,000 of total unrecognized compensation costs related to non-vested options granted prior to January 1, 2006 that are expected to be recognized over a weighted-average period of 0.93 years. The Company has recorded $530,000 and $233,000 related to its stock-based compensation in general and administrative expenses for the six and three months ended June 30, 2006, respectively. There was no income tax benefit recognized for stock-based compensation for the six and three months ended June 30, 2006. No compensation costs were capitalized as part of the cost of an asset.

The weighted average grant date fair value of 363,000 shares of restricted common stock granted during the six months ended June 30, 2006 was $0.32.

Note 3 - Loss Per Share

Basic loss per share is calculated by dividing net loss attributable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted loss per share for the six months and three months ended June 30, 2006 and 2005 is the same as basic loss per share. Potential shares of common stock associated with 20,943,000 and 14,428,000 outstanding options and warrants, 1,729,000 and 1,301,000 shares issuable upon the conversion of our Series B convertible preferred stock and 13,214,000 and 0 shares issuable upon conversion of the March and April 2006 Senior Secured Convertible 10% Notes as of June 30, 2006 and 2005, respectively, have been excluded from the calculation of diluted loss per share because the effects would be anti-dilutive.

Note 4 - Stockholders' Deficit

In January 2004, in exchange for the cancellation and termination of convertible debentures with an aggregate face value of $4,888,000 and forfeiture of any and all rights of collection, claim or demand under the debentures, we agreed to give the holders of the debentures: (i) an aggregate of 203.667 shares of series B convertible preferred stock; (ii) an aggregate of 250,000 shares of restricted common stock; and (iii) a reduction of the exercise price of the warrants issued pursuant to the original purchase agreement from $3.25 to $2.75. The investors have anti-dilution rights. As a result of subsequent financings, the conversion price of the Series B convertible preferred stock and the exercise price of the warrants have been adjusted to $1.67 and $1.85, respectively, as of June 30, 2006. We recognized deemed dividends of $115,000 in the six months ended June 30, 2005.

In February 2004, we raised net proceeds of $12,480,000 in a private placement of 6,100,000 shares of our common stock at $2.25 per share. The registration rights agreement for the February 2004 financing provides for liquidated damages of 3% of the aggregate purchase price for the first month and 1.5% for each subsequent month if we failed to register the common stock and the shares of common stock underlying the warrants or maintain the effectiveness of such registration. We account for the registration rights agreement as a separate freestanding instrument and account for the liquidated damages provision as a derivative liability subject to SFAS No. 133. The estimated fair value of the derivative liability is based on estimates of the probability and costs expected to be incurred and such estimates are revalued at each balance sheet date with changes in value recorded as other income or expense. Approximately $1,164,000 of the proceeds of the financing was attributed to the estimated fair value of the derivative liability. We estimated the fair value of the derivative liability to be $1,544,000 and $1,570,000 as of June 30, 2006 and December 31, 2005. We recognized income of $26,000 and $3,000 for the six and three months ended June 30, 2006, respectively, and other expense of $80,000 and $38,000 for the six and three months ended June 30, 2005, respectively.

In March 2005, we raised net proceeds of $9,376,000 in a private placement of 6,766,667 shares of our common stock at $1.50 per share. Investors in the private placement were also issued warrants to purchase 2,706,667 shares of common stock at an exercise price of $2.40 per share. The warrants expire five years after the closing date. The warrants are subject to certain anti-dilution protection. As a result of subsequent financings, the conversion price of these warrants has been adjusted to $1.79 as of June 30, 2006.

In March 2005, 83.333 shares of our outstanding Series B convertible preferred stock and accrued dividends of $183,000 were exchanged for 1,333,328 shares of our common stock and warrants to purchase 533,331 shares of our common stock with an excess aggregate fair value of $1,167,000. We recognized deemed dividends of $1,167,000 during the 2005 period in connection with the warrants and a reduced conversion price, which were offered as an inducement to convert.

Note 5 - 10% Senior Secured Convertible Notes

10% Senior Secured Convertible Notes and 10% Note Discount

In March and April 2006, we issued our 10% Senior Secured Convertible Notes (“10% Notes”) in a private placement to private investors. Activity for the 10% Notes and the related discount during the year ended, and as of June 30, 2006, follows (in thousands):

				Total
Principal of 10% Notes:				
March 2006 financing	$	5,665		
April 2006 financing		515		
Additional 10% Notes		103		
			$	6,283
Discount:				
Derivative financial instrument - Series A Warrants		(2,873)		
Reduction of exercise price and extension of expiration dates of warrants		(766)		
		(3,639)		
Accretion of discount		369		