INTERLEUKIN GENETICS INC
Form 10-Q
November 14, 2013

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 September 30, 2013

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

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 x NO ¨

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 ¨	Accelerated filer ¨
Non-Accelerated filer ¨ (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 ¨ 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 October 31, 2013
Common Stock, par value $0.001 per share	**122,417,090**

INTERLEUKIN GENETICS, INC.

FORM 10-Q
FOR THE QUARTER ENDED September 30, 2013

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Smaller Reporting Company Scaled Disclosure

Pursuant to Item 10(f) of Regulation S-K promulgated under the Securities Act of 1933, as amended, as indicated herein, we have elected to comply with the scaled disclosure requirements applicable to "smaller reporting companies".

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

INTERLEUKIN GENETICS, INC.

CONDENSED BALANCE SHEETS

	September 30, 2013 (Unaudited)		December 31, 2012	
ASSETS				
Current assets:				
Cash and cash equivalents	$	8,743,509	$	1,225,426
Accounts receivable from related party		2,275		552,572
Trade accounts receivable		15,875		47,560
Inventory		132,556		158,238
Prepaid expenses		556,987		417,772
Other current assets		38,001		
Total current assets		9,489,203		2,401,568
Fixed assets, net		321,245		126,946
Intangible assets, net		317,182		399,131
Other assets				38,001
Total assets	$	10,127,630	$	2,965,646
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)				
Current liabilities:				
Accounts payable	$	1,107,336	$	479,182
Accrued expenses		191,323		165,745
Deferred revenue		1,793,184		1,628,264
Total current liabilities		3,091,843		2,273,191
Convertible debt				14,316,255
Total liabilities		3,091,843		16,589,446
Commitments and contingencies (Note 7)				
Stockholders' equity (deficit):				
Convertible preferred stock, $0.001 par value 6,000,000 shares authorized; 0 and 5,500,000 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively; aggregate liquidation preference of $24,000,000 at December 31, 2012				5,500
Common stock, $0.001 par value 300,000,000 and 150,000,000 shares authorized at September 30, 2013 and December 31, 2012, respectively; 122,417,090 and 36,761,864 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively		122,417		36,762
Additional paid-in capital		119,763,983		94,030,603
Accumulated deficit		(112,850,613)		(107,696,665)
Total stockholders' equity (deficit)		7,035,787		(13,623,800)
Total liabilities and stockholders' equity (deficit)	$	10,127,630	$	2,965,646

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

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INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue:				
Genetic testing	$ 411,557	$ 383,064	$ 1,744,342	$ 1,837,781
Other	7,484	36,947	14,220	59,550
Total revenue	419,041	420,011	1,758,562	1,897,331
Cost of revenue	362,769	271,430	1,242,757	1,040,764
Gross profit	56,272	148,581	515,805	856,567
Operating expenses:				
Research and development	161,353	245,736	509,509	1,009,449
Selling, general and administrative	2,035,179	1,044,567	4,610,737	3,357,327
Amortization of intangibles	27,317	28,863	81,950	86,590
Total operating expenses	2,223,849	1,319,166	5,202,196	4,453,366
Loss from operations	(2,167,577)	(1,170,585)	(4,686,391)	(3,596,799)
Other income (expense):				
Interest income	2,488	1,637	4,628	3,240
Interest expense	(10,968)	(117,276)	(472,185)	(337,206)
Total other income (expense)	(8,480)	(115,639)	(467,557)	(333,966)
Loss before income taxes	(2,176,057)	(1,286,224)	(5,153,948)	(3,930,765)
Benefit for income taxes				
Net loss	$ (2,176,057)	$ (1,286,224)	$ (5,153,948)	$ (3,930,765)
Basic and diluted net loss per common share	$ (0.02)	$ (0.03)	$ (0.06)	$ (0.11)
Weighted average common shares outstanding, basic and diluted	122,277,324	36,756,864	79,666,229	36,753,942

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

INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

For the Nine Months Ended September 30, 2013 and 2012

(Unaudited)

	Convertible Preferred Stock		Common Stock		Additional Paid-in	Accumulated	
	Shares	Amount	Shares	Amount	Capital	Deficit	Total
Balance as of December 31, 2011	5,000,000	$ 5,000	36,709,706	$ 36,710	$ 91,111,640	$ (102,576,581)	$ (11,423,231)
Net loss						(3,930,765)	(3,930,765)
Private placement of preferred stock, net of offering costs of $386,030	500,000	500			2,613,470		2,613,970
Warrants issued in connection with private placement of preferred stock					104,907		104,907
Common stock issued:							
Employee stock purchase plan			52,158	52	8,758		8,810
Stock-based compensation expense					170,875		170,875
Balance as of September 30, 2012	5,500,000	$ 5,500	36,761,864	$ 36,762	$ 94,009,650	$ (106,507,346)	$ (12,455,434)
Balance as of December 31, 2012	5,500,000	$ 5,500	36,761,864	$ 36,762	$ 94,030,603	$ (107,696,665)	$ (13,623,800)
Net loss						(5,153,948)	(5,153,948)
Private placement of common stock, net of offering costs of $1,735,000			43,715,847	43,716	11,265,204		11,308,920
Conversion of preferred stock	(5,500,000)	(5,500)	39,089,161	39,089	(33,589)		
Conversion of convertible debt			2,521,222	2,521	14,313,734		14,316,255
Common stock issued:							
			252,000	252	80,268		80,520

Exercise of stock options					
Cancellation of restricted stock	(2,500)	(2)	2		
Employee stock purchase plan	79,496	79	23,153		23,232
Stock-based compensation expense			84,608		84,608
Balance as of September 30, 2013	122,417,090	$ 122,417	$ 119,763,983	$(112,850,613)	$7,035,787

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

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INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months Ended September 30, 2013		2012	
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss	$	(5,153,948)	$	(3,930,765)
Adjustments to reconcile loss to net cash used in operating activities:				
Depreciation and amortization		161,302		225,299
Stock-based compensation expense		84,608		170,875
Change in fair value of warrants		297,547		
Changes in operating assets and liabilities:				
Accounts receivable		31,685		(1,442)
Receivable from related party		550,297		(5,926)
Inventory		25,682		43,213
Prepaid expenses and other current assets		(139,215)		(48,400)
Accounts payable		688,154		(76,230)
Accrued expenses		25,578		198,896
Deferred revenue		164,920		146,472
Net cash used in operating activities		(3,323,390)		(3,278,008)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital additions		(273,653)		(5,000)
Net cash used in investing activities		(273,653)		(5,000)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from issuance of notes payable				1,316,255
Proceeds from private placement of preferred stock				3,000,000
Proceeds from private placement of common stock		12,000,000		
Private placement offering costs		(988,626)		(281,123)
Proceeds from exercises of employee stock options		80,520		
Proceeds from employee stock purchase plan		23,232		8,810
Net cash provided by financing activities		11,115,126		4,043,942
Net increase in cash and cash equivalents		7,518,083		760,934
Cash and cash equivalents, beginning of period		1,225,426		1,728,222
Cash and cash equivalents, end of period	$	8,743,509	$	2,489,156
Supplemental disclosures of cash flow information:				
Cash paid for interest	$	219,914	$	319,478
Supplemental disclosures of non-cash financing activities:				
Warrants issued in connection with private placements	$		$	104,907
Conversion of debt to common stock	$	14,316,255	$	
Interest related to fair value of warrants market adjustment	$	297,547	$	

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

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INTERLEUKIN GENETICS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
September 30, 2013
(UNAUDITED)

Note 1 Basis of Presentation

Interleukin Genetics, Inc. ("the Company") develops genetic tests for sale into the emerging personalized health market and performs testing services that can help individuals improve and maintain their health through preventive or therapeutic measures. The Company's principal operations and markets are located in the United States.

The accompanying condensed financial statements include the accounts of the Company as of September 30, 2013 and December 31, 2012 and for the three and nine months ended September 30, 2013 and 2012.

The financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. These unaudited condensed 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, 2012. Operating results are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

For information regarding our critical accounting policies and estimates, please refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates" contained in our Annual Report on Form 10-K for the year ended December 31, 2012 and Note 3 to our condensed financial statements contained herein.

Note 2 Operating Matters and Liquidity

The Company has experienced net operating losses since its inception through September 30, 2013. The Company had net losses of $5.1 million and $5.0 million for the years ended December 31, 2012 and 2011, respectively, and $5.2 million for the nine months ended September 30, 2013, contributing to an accumulated deficit of $112.9 million as of September 30, 2013.

The Company continues to take steps to reduce genetic test processing costs. Cost savings are achieved through test process improvements and the subleasing of underutilized rental space. Management believes that the current laboratory space is adequate to process high volumes of genetic tests.

As more fully discussed in Note 8 herein, on May 17, 2013, the Company entered into a Common Stock Purchase Agreement with various accredited investors, pursuant to which the Company sold an aggregate of 43,715,847 shares of its common stock in a private placement transaction, at a price of $0.2745 per share for gross proceeds of $12,000,000. The investors also received warrants to purchase up to an aggregate of 32,786,885 shares of common stock at an exercise price of $0.2745 per share. The warrants are exercisable as to 63% of the shares immediately and as to 37% of the shares following receipt of shareholder approval, which occurred on August 9, 2013, of an increase in the number of authorized shares of common stock from 150,000,000 to 300,000,000, and have a term of seven years from the date they became exercisable.

The Company's financial statements have been prepared assuming that it will continue as a going concern which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company expects to incur additional losses in 2013 and, accordingly, is dependent on the recent financing and potential revenue to fund its operations in the commercial launch of the PST® test with Renaissance Health Services Corporation (“RHSC”), the parent corporation of eight Delta Dental member companies operating in their eight respective states. The Company currently believes RHSC may begin offering dental plans that incorporate our genetic PST® test for plan years beginning in 2014. The timing of any revenues that we may receive under this agreement is dependent upon the timing of the offering of such plans, which timing is very uncertain at this time, and is contingent upon a number of factors, including RHSC’s affiliates’ ability to develop such plans and to develop a viable market for such plans. The Company currently expects the launch of the PST genetic test with RHSC will occur in a phased approach. The Company expects RHSC in early 2014 to partner with smaller group plans. In the latter half of 2014 and 2015, RHSC is expected to offer dental plans that incorporate our genetic test to a broader group of employer customers. The Company expects to have the cash resources necessary, for at least the next twelve months, to support the launch of the PST genetic test in dental offices in collaboration with RHSC.

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Note 3 Significant Accounting Policies

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 September 30, 2013 and December 31, 2012, the Company had deferred genetic test revenue of $1.8 million and $1.6 million, respectively. Included in deferred revenue at September 30, 2013 are $733,000 in customer payments in excess of one year old. Management continues to evaluate steps it may take in resolving these older payments.

Sales Commission

The Company accounts for sales commissions due to Amway Global under the Merchant Channel and Partner Agreement in accordance with SEC Staff Accounting Bulletin ("SAB") 104. Commissions are recorded as an expense at the time they become due which is at the point of sale. The cost of commissions was $318,000 and $576,000 for the nine months ended September 30, 2013 and 2012, respectively.

Accounts Receivable

Accounts receivable is stated at estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offers its commercial genetic test customers a 2% cash discount if payment is made by bank wire transfer within 10 days of the invoice date. No accounts receivable reserve is required at September 30, 2013 as all accounts receivable are expected to be collected.

Inventory

Inventory is carried at lower of cost (first-in, first-out method) or market and no inventory reserve is deemed necessary at September 30, 2013. As the Company does not manufacture any products, no overhead costs are included in inventory. When a kit is sold, the corresponding cost of the kit is recorded as cost of goods sold and removed from inventory.

Inventory consisted of the following at September 30, 2013 and December 31, 2012:

	September 30, 2013	December 31, 2012
Raw materials	$ 122,961	$ 154,485
Finished goods	9,595	3,753
Total inventory, net	$ 132,556	$ 158,238

Income Taxes

The Company accounts for income taxes in accordance with FASB ASC 740, *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 (benefit) 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 approximately $28.4 million as of September 30, 2013, 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.

Due to changes in Massachusetts corporate income tax regulations enacted in 2009, the Company began filing a combined tax return with certain Alticor affiliated entities, referred to herein as “the unitary group”. The law requires corporations with net operating loss carryforwards to go back to each year in which the loss was generated and recompute the loss as if it occurred on a consolidated basis. The Company was required to include data from the newly formed unitary group as if the unitary group was in place during the loss years. As a result, the losses generated by the Company were significantly reduced through this required computation. Due to a change in common ownership, the Company is no longer qualified to join in a combined filing of the unitary group as of June 29, 2012. Accordingly, the Company will cease filing combined Massachusetts tax returns with the unitary group. The Company estimates that the combined and separate filings will have no impact on the Company's financial condition, results of operations and cash flows.

On January 2, 2013, President Obama signed The American Taxpayer Relief Act of 2012 (H.R. 8) legislation which extended many of the tax provisions that expired in 2011 or 2012. For financial reporting purposes, the tax impact of this legislation is taken into account in the quarter in which the legislation is enacted by Congress and signed into law by the President. Since President Obama signed the bill on January 2, 2013, the financial reporting for these legislative changes occurred in the 1st quarter, 2013. Therefore, for 2012, no deferred tax asset with respect to the federal R&D tax credit was recorded. In the 1st quarter 2013, the full deferred tax asset for the 2012 federal R&D tax credit has been recorded as a discrete item. The total impact to 2013 is a deferred tax asset of approximately $60,000 which is fully reserved.

As a result of the Company’s change in its capital structure during the quarter ending June 30, 2013, the Company may have undergone an IRC section 382 ownership change which would limit its ability to realize the benefit of its tax attributes (i.e., federal/state net operating losses and research and development credits) during their respective carry forward periods. Furthermore, pursuant to the change in capital structure, the Company realized cancellation of indebtedness income under IRC section 108(e)(8), which reduced the Company’s federal net operating loss carry-forward pursuant to IRC section 108(b)(2)(A), due to the fact that the Company’s liabilities exceeded the fair market value of its assets. Accordingly, the Company had a reduction in its deferred tax asset and a corresponding reduction in its valuation allowance for the quarter ending June 30, 2013. The cancellation of indebtedness income resulted from a shareholder’s conversion of debt of approximately $14.3 million into common stock of the Company prior to an additional investment by an unrelated investor.

The Company reviews its recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. 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 as of and during the nine months ended September 30, 2013. However, if the Company incurred interest and penalties they would be recorded in general and administrative expenses.

Research and Development

Research and development costs are expensed as incurred.

Basic and Diluted Net Loss per Common Share

The Company applies the provisions of FASB ASC 260, *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 are as follows:

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	As of September 30,	
	2013	2012
Options outstanding	1,603,150	1,830,767
Warrants outstanding	37,269,125	2,187,158
Convertible preferred stock		39,089,161
Convertible debt		2,521,222
Total	38,872,275	45,628,308

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 fair value of warrants is calculated using the Black-Scholes pricing model.

Cash and Cash Equivalents

The Company maintains its cash and cash equivalents with domestic financial institutions that the Company believes to be of high credit standing. Cash and cash equivalents are available on demand and are generally in excess of FDIC insurance limits.

Recent Accounting Pronouncements

No recently issued updates or other guidance issued by the FASB through the issuance of these financial statements are expected to have a material impact on the Company's financial reporting.

Note 4 Related Party Transactions

Since March 2003, the Company has maintained a broad strategic alliance with several affiliates of the Alticor Inc. family of companies, a related party, 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.

On October 20, 2009, the Company entered into a Merchant Network and Channel Partner Agreement with Amway Corp., d/b/a/ Amway Global ("Amway Global"), a subsidiary of Alticor Inc. Pursuant to this Agreement, Amway Global sells the Company's Inherent Health® brand of genetic tests through its e-commerce website via a hyperlink to our e-commerce site. We paid Amway Global $318,000 and $576,000 in commissions for the nine months ended September 30, 2013 and 2012, respectively, representing a percentage of net sales to their customers. The Company expenses commissions owed to Amway Global at the point of sale with the customer.

On September 14, 2012, the Company received a purchase order from Access Business Group, LLC ("ABG"), an affiliate of Pyxis Innovations, Inc. ("Pyxis"), the Company's largest stockholder and a subsidiary of Alticor. The order consists of kits of the Company's Weight Management genetic test to be included in a promotional product bundle to be offered by ABG to the Amway sales channel in 2013. The total amount of the order was $1.0 million. The Company shipped $0.5 million in December 2012 and the balance in the first quarter of 2013. ABG placed an additional order for $327,000. All other amounts have been paid on these orders. The Company continues to receive additional orders from ABG for this program. During the nine months ended September 30, 2013, approximately 47% of our revenue came from tests processed through this program.

On September 21, 2012, the Company entered into a License Agreement with Access Business Group International LLC ("ABGI"), an affiliate of Pyxis. Pursuant to the License Agreement, the Company has granted ABGI and its affiliates a non-exclusive license to use the technology related to Interleukin's Weight Management genetic test and to sell the Weight Management test in Europe, Russia and South Africa (the "Territories"). ABGI, or a laboratory designated by ABGI, will be responsible for processing the tests, and the Company will receive a royalty for each test sold, which royalty will increase if certain pending patent applications are issued. The License Agreement has an initial term of five years from the date of first commercial sale of the Weight Management test under the agreement. Thereafter, the term will automatically renew for additional one-year periods unless at least 60 days prior notice is delivered by either party. To date, no license fees have been earned from this agreement.

In connection with the execution of the License Agreement, the Company and ABGI also entered into a Professional Services Agreement (the "PSA") pursuant to which the Company has agreed to provide services to ABGI in connection with its sale and processing of the tests within the Territories. Services will be provided pursuant to a statement of work to be entered into from time to time between the parties. Such statements of work will also specify the fees to be paid by ABGI to Interleukin for such services. The PSA has no set term and may be terminated by either party, subject to certain conditions. To date, the Company has earned $5,250 in fees from this agreement.

During the nine months ended September 30, 2013 and 2012, approximately 38% and 65%, respectively, of our revenue came from sales through our Merchant Network and Channel Partner Agreement with Amway Global, a subsidiary of Alticor, and 47% and 0%, respectively, of our revenue came from sales through ABG's promotional product bundle program.

On February 25, 2013, the Company entered into a Preferred Participation Agreement with RHSC, for itself and on behalf of certain of its affiliates and subsidiaries. RHSC is a related party through its affiliation with Delta Dental of Michigan, Inc. ("DDMI"), a stockholder of the Company. Pursuant to this agreement, affiliates of RHSC agreed to reimburse the Company a fixed price for each PST® genetic test that the Company processed for a customer of affiliates of RHSC. In addition, if during the term of the agreement the Company offered the PST® test to any other person or party for a lower price, such lower price would then be applicable to tests processed for a customer of such affiliates of RHSC for the remainder of the term of the agreement. The pricing arrangement was subject to the satisfaction of certain milestones, including that (1) within a specified timeframe, RHSC affiliates were to develop and offer dental benefit plans for which a significant portion of such affiliate's clients are eligible that provided for use of the PST® test and reimbursement of the test at the agreed upon price (each such plan, hereinafter referred to as a "Reimbursed Dental Plan") and (2) prior to a specified date, RHSC affiliates were to have sold policies for Reimbursed Dental Plans for the year beginning January 1, 2014. The Company agreed that for a one year period beginning on the date on which RHSC affiliates first offered a Reimbursed Dental Plan, it would make the PST® test available solely to RHSC affiliates and not to any other third party or person. This agreement had a term of three years beginning on February 25, 2013.

On November 1, 2013, the Company entered into an Amended and Restated Preferred Participation Agreement with RHSC, for itself and on behalf of certain of its affiliates and subsidiaries. Pursuant to this agreement, affiliates of RHSC have agreed to reimburse the Company a fixed price for each PST® genetic test that the Company processes for a customer of affiliates of RHSC. In addition, if during the term of the agreement the Company offers the PST® test to any other person or party for a lower price, such lower price shall then be applicable to tests processed for a customer of such affiliates of RHSC for the remainder of the term of the agreement. RHSC and its affiliates will continue to receive the preferred pricing (or any lower market price during the term) only for so long as affiliates of RHSC continue to: (a) work to develop and to offer Reimbursed Dental Plans for which a significant portion of employees of RHSC's affiliates' customers are eligible; and (b) exercise their commercially-reasonable best efforts to maximize the number of customers that offer a Reimbursed Dental Plan. In addition, under the terms of the amended agreement, the Company is no longer obligated to make the PST® test available solely to RHSC affiliates and not to any other third party or person. This amended agreement has a term of three years beginning February 25, 2013, unless terminated earlier (1) upon the mutual written agreement of us and RHSC, (2) if either party becomes the subject of bankruptcy, insolvency, liquidation or other similar proceedings, or (3) in the event of an uncured breach of the amended agreement by either party.

The timing of any revenues that the Company may receive under the amended agreement with RHSC is dependent upon the timing of the offering of Reimbursed Dental Plans, which timing is very uncertain at this time and is dependent on a viable market developing for such plans. The Company currently expects the launch of the PST genetic test with RHSC will occur in a phased approach. The Company expects RHSC in early 2014 to partner with smaller group plans. In the latter half of 2014 and in 2015, RHSC is expected to offer dental plans that incorporate our genetic test to a broader group of employer customers. The Company does not expect to receive any significant revenues under this agreement until the fourth quarter of 2014 or early in 2015, at the earliest, and the timing of any such revenues may be substantially later. We may never receive significant revenues under this agreement.

Note 5 Convertible Debt

On August 17, 2006, our credit facility with Pyxis was amended to provide the Company with access to approximately $14.3 million of additional working capital borrowings. Any amounts borrowed thereunder accrued interest at the prime rate and required quarterly interest payments. The principal amount of any borrowing under this credit facility was convertible at Pyxis' election into a maximum of 2,521,222 shares of common stock, reflecting a conversion price of $5.6783 per share.

This credit facility had been modified several times, including on November 29, 2012, to extend the due date to March 31, 2014.

Immediately prior to the closing of the private placement of common stock on May 17, 2013, Pyxis converted all of the principal amount of debt outstanding into 2,521,222 shares of common stock. Accordingly, there is no convertible debt outstanding at September 30, 2013.

Note 6 Intangible Assets

Intangible assets at September 30, 2013 and December 31, 2012 consisted of the following:

	September 30, 2013		December 31, 2012	
Patent costs	$	1,154,523	$	1,154,523
Less Accumulated amortization		(837,341)		(755,392)
Total	$	317,182	$	399,131

Patent amortization expense was $81,950 and $86,590 for the nine months ended September 30, 2013 and 2012, respectively.

Patent costs which are amortized on a straight-line basis over a 10-year life, are scheduled to amortize as follows:

<u>Year ending December 31,</u>

2013 (remaining three months)	$27,317
2014	94,100
2015	77,656
2016	61,119
Thereafter	56,990
	$317,182

Note 7 Commitments and Contingencies

Operating Lease

The Company leases its office and laboratory space under a non-cancelable operating lease expiring on March 31, 2014. In May 2010, the Company completed a sublease of approximately 6,000 square feet of underutilized office and laboratory space which successfully reduced our total space operating costs. The sublease also expires on March 31, 2014. Rent expense, net of the benefit of the sublease, was $246,000 and $253,000 for the nine months ended September 30, 2013 and 2012, respectively. The Company has not executed its renewal option and plans to negotiate for an extension of its current office and laboratory space.

Note 8 Capital Stock

Authorized Preferred and Common Stock

At September 30, 2013, the Company had authorized 6,000,000 shares of $0.001 par value preferred stock. The Company had authorized 300,000,000 shares of $0.001 par value common stock of which 171,352,369 shares were outstanding or reserved for issuance. Of those, 122,417,090 shares were outstanding; 10,995,650 shares were reserved for the potential exercise of outstanding stock options and for shares of common stock available for future grants under our stock plan; 670,504 shares were reserved for the potential exercise of rights held under the Employee Stock

Purchase Plan; 1,750,000 shares were reserved for the exercise of outstanding warrants to purchase common stock at an exercise price of $1.30 per share which are exercisable currently until March 5, 2015; 437,158 shares were reserved for the exercise of outstanding warrants to purchase common stock at an exercise price of $0.2745 per share which are exercisable currently until June 29, 2017; and 35,081,967 shares were reserved for the exercise of outstanding warrants to purchase common stock at an exercise price of $0.2745 per share. The warrants are exercisable as to 63% of the shares immediately and as to 37% of the shares following receipt of shareholder approval, which occurred on August 9, 2013, of an increase in the number of authorized shares of common stock from 150,000,000 to 300,000,000, and have a term of seven years from the date they became exercisable.

On June 29, 2012, the Company entered into an agreement with Pyxis to exchange the 5,000,000 shares of Series A Convertible Preferred Stock held by Pyxis for 5,000,000 shares of Series A-1 Convertible Preferred Stock (the "Series A-1 Preferred Stock") and filed a new Certificate of Designation, Preferences and Rights of Preferred Stock with the State of Delaware for the Series A-1 Preferred Stock and Series B Convertible Preferred Stock (the "Series B Preferred Stock" and, with the Series A-1 Preferred Stock, the "Preferred Stock"). Concurrently therewith, the Company completed a financing with Delta Dental of Michigan, Inc. ("DDMI") pursuant to which DDMI purchased 500,000 shares of Series B Preferred Stock for gross proceeds of $3,000,000. Net proceeds to the Company after fees and expenses were approximately $2.7 million. In addition, fully vested warrants to purchase 437,158 shares of common stock at an exercise price of $0.2745 per share were issued to the placement agent in the transaction. These warrants expire in five years. For purposes of determining the fair value of these warrants, the Black-Scholes pricing model was used with the following assumptions:

Risk-free interest rate	1	%
Expected life	5 years	
Expected volatility	142.36	%
Dividend yield	0	%

Using these assumptions, the fair value of the warrants is $104,907.

In the event of any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, the holders of the Preferred Stock were entitled to receive on a *pari passu* basis, 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 shares for each share of Preferred Stock then held by them. The liquidation preference for the Preferred Stock at May 17, 2013, prior to the financing, was $24,000,000 in the aggregate, reflecting a liquidation preference of $18,000,000 for the Series A-1 Preferred Stock and $6,000,000 for the Series B Preferred Stock. After receiving this amount, the holders of the Preferred Stock were 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-1 Preferred Stock was 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 adjustment) by the conversion price in effect on the date the certificate was surrendered for conversion. The Series A-1 Preferred Stock was convertible into 28,160,200 shares of common stock reflecting a conversion price of $0.3196 per share. Each share of Series B Preferred Stock was 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 ($6.00, and subject to adjustment) by the conversion price in effect on the date the certificate was surrendered for conversion. The Series B Preferred Stock was convertible into 10,928,961 shares of common stock reflecting a conversion price of $0.2745 per share. All shares of Preferred Stock were converted to common stock on May 17, 2013 in connection with the private placement described below, resulting in the issuance of 39,089,161 shares of common stock. As of September 30, 2013 no shares of preferred stock are issued and outstanding.

Each holder of Preferred Stock was entitled to vote its shares of 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 Preferred Stock was entitled to a number of votes equal to the number of shares of common stock into which was convertible on the applicable record date.

On May 17, 2013, the Company entered into a Common Stock Purchase Agreement with various accredited investors ("the "Purchasers"), pursuant to which the Company sold securities to the Purchasers in a private placement transaction. The Company sold an aggregate of 43,715,847 shares of its common stock, at a price of $0.2745 per share for gross proceeds of $12,000,000. The Purchasers also received warrants to purchase up to an aggregate of 32,786,885 shares of Common Stock at an exercise price of $0.2745 per share (the "Warrants"). The Warrants were exercisable as to 63% of the shares immediately and as to 37% of the shares following receipt of shareholder approval of a share authorization increase and have a term of seven years from the date they become exercisable. For Warrants that were exercisable upon shareholder approval of an increase in the Company's authorized shares of common stock, the Company recorded a non-current liability at June 30, 2013 based on the allocation of the relative fair values of the common stock and Warrants issued in the private placement. In addition, the Company recognized non-cash interest expense of $286,579 representing the increase in the fair value of the warrant liability from the date of issuance to June 30, 2013. On August 9, 2013, the Company's shareholders' approved an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of common stock from 150,000,000 to 300,000,000 shares. Following the shareholder approval of the increase in authorized shares on August 9, 2013 the Company filed a certificate of amendment with the Delaware Secretary of State, which provided for adequate authorized shares for all potential common stock equivalents issued pursuant to the financing on May 17, 2013. As a result, the warrant liability reflected as a non-current liability, in the June 30, 2013 balance sheet was reclassified to shareholders' equity at its fair value as of August 9, 2013. The fair value of the warrant liability increased $11,000 from June 30, 2013 to August 9, 2013, and was recorded as an increase to interest expense in the statement of operations for the three months ended September 30, 2013.

For its services in this transaction, the placement agent received cash compensation in the amount of approximately $780,000 and the placement agent and an affiliate received warrants to purchase an aggregate of 2,295,082 shares of common stock, at an exercise price of $0.2745 per share (the "Placement Agent Warrants"). The Placement Agent Warrants became exercisable on August 9, 2013, following shareholder approval of an increase in the Company's authorized shares of common stock and expire August 9, 2020. The cash compensation and the fair value of the warrants were recorded as issuance costs resulting in a reduction to shareholders' equity.

For purposes of determining the fair value of the warrants exercisable upon shareholder approval of an increase in the Company's authorized shares, the Black-Scholes pricing model was used with the following assumptions:

	May 17, 2013		June 30, 2013		August 9, 2013	
Risk-free interest rate	1.35	%	1.58	%	2.53	%
Expected life	4 years		4 years		4 years	
Expected volatility	144.63	%	145.62	%	146.19	%
Dividend Yield	0	%	0	%	0	%

Using these assumptions, the fair value of the warrants is $5,072,129 on May 17, 2013, $5,358,708 on June 30, 2013 and $5,369,676 on August 9, 2013.

In connection with this private placement, all preferred stockholders converted their shares of Preferred Stock to common stock in accordance with the terms noted above resulting in the issuance of 39,089,161 shares of common stock.

In addition, pursuant to the Common Stock Purchase Agreement, each Purchaser has the right, at any time and from time to time following the date of shareholder approval of the increase in the number of authorized shares of common stock from 150,000,000 shares to 300,000,000 shares (which occurred on August 9, 2013) and on or before June 30, 2014, to purchase at one or more subsequent closings its pro rata share of up to an aggregate of $5,000,000 of additional shares of common stock and warrants on the same terms and conditions as those set forth above. If, prior to June 30, 2014, investors have not purchased their entire pro rata share of such additional investment of $5,000,000, those who have purchased their entire pro rata share of the additional investment, will be entitled to purchase the unsold portion of the additional investment.

Registration Rights Agreement

On May 17, 2013, the Company also entered into a Registration Rights Agreement with the Purchasers, Pyxis, DDMI and the placement agent, pursuant to which the Company is required to file a registration statement on Form S-1 within 45 days to cover the resale of (i) the shares sold to the Purchasers and the shares of common stock underlying the Warrants, (ii) the shares of common stock issued to Pyxis upon conversion of the Series A-1 Preferred Stock and the convertible debt, (iii) the shares of common stock issued to DDMI upon the conversion of the Series B Preferred Stock, and (iv) the shares of common stock underlying the Placement Agent Warrants. The Company filed the registration statement on July 1, 2013, and it was declared effective on August 9, 2013.

In addition, within 45 days following June 30, 2014, the Company will be required to file a registration statement to cover the resale of (i) any shares of common stock sold to the Purchasers pursuant to the additional investment and the shares of common stock underlying any warrants issued to Purchasers pursuant to such additional investment, and (ii) shares of common stock underlying any additional warrants issued to the placement agent in connection with the additional investment.

Note 9 Stock-Based Compensation Arrangements

Total stock-based compensation is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012