

XCORPOREAL, INC.
Form 10QSB
May 11, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB**

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

For the quarterly period ended March 31, 2007

Commission file number 001-31608

XCORPOREAL, INC.

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

Delaware

98-0349685

(State or other jurisdiction of incorporation or
organization)

(IRS Employer Identification Number)

11150 Santa Monica Blvd., Suite 340, Los Angeles, California 90025

(Address of principal executive offices)

(310) 424-5668

(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

Class

Outstanding as of May 9, 2007

Common Stock, \$0.0001 par value

14,200,050 shares

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

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XCORPOREAL, INC.
(a Development Stage Company)
BALANCE SHEETS

	March 31, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current		
Cash and cash equivalents	\$ 444,075	\$ 27,440,987
Marketable securities, at fair value	24,623,290	
Restricted cash	75,000	
Prepays	133,202	70,850
Other current assets	1,265	19,378
Total current assets	25,276,832	27,531,215
Property and equipment, net	37,869	3,328
Other assets	13,031	1,000
Total Assets	25,327,732	27,535,543
LIABILITIES		
Current		
Accounts payable	492,940	143,606
Accrued placement agent fees		1,348,470
Accrued professional fees	312,208	312,208
Accrued other liabilities	583,276	204,522
Other current liabilities	115,400	124,676
Total Current Liabilities	1,503,824	2,133,482
Commitments and contingencies		
STOCKHOLDERS EQUITY		
Preferred Stock, \$0.001 par value, 10,000,000 shares authorized, none outstanding		
Common Stock, \$0.0001 par value, 40,000,000 shares authorized, 14,200,050 outstanding on March 31, 2007 and December 31, 2006	1,420	1,420
Additional paid-in capital	33,221,109	29,924,410
Deficit accumulated during the development stage	(9,398,621)	(4,523,769)
Total Stockholders Equity	23,823,908	25,402,061

Total Liabilities & Stockholders Equity	\$ 25,327,732	\$ 27,535,543
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See accompanying notes to the interim financial statements

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XCORPOREAL, INC.
(a Development Stage Company)
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,		May 4, 2001 (Date of Inception) to March 31, 2007
	2007	2006	
Operating Expenses:			
Selling, general and administrative	\$ 4,041,634	\$ 6,203	\$ 7,360,286
Research and development	1,143,563		2,430,885
Depreciation and amortization	1,521		1,616
Loss before Other Income and Income Tax	(5,186,718)	(6,203)	(9,792,787)
Interest Income	311,866		394,166
Loss before income taxes	(4,874,852)	(6,203)	(9,398,621)
Income taxes			
Net Loss	\$ (4,874,852)	\$ (6,203)	\$ (9,398,621)
Basic and diluted loss per share	\$ (0.34)	\$ (0.00)	
Weighted average number of shares outstanding	14,200,050	3,820,000	
See accompanying notes to the interim financial statements			

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XCORPOREAL, INC.
(a Development Stage Company)
STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended		May 4, 2001
	March 31,		(Date
	2007	2006	of Inception) to
			March 31,
			2007
Cash flows used in operating activities			
Net Loss for the Period	\$ (4,874,852)	\$ (6,203)	\$ (9,398,621)
Adjustments to reconcile net loss to net cash used in operating activities:			
Non-employee Stock Based Compensation	2,657,635		4,820,246
Stock Based Compensation	639,064		903,315
Depreciation and amortization	1,521		1,616
Net Change in assets and liabilities:			
Prepaid Expenses	(62,352)		(133,202)
Other Current Assets	18,113		(1,265)
Other Assets	(12,031)		(13,031)
Accounts Payable and Accrued Liabilities	(620,382)	2,702	1,388,424
Other Current Liabilities	(9,276)		115,400
Net Cash Used in Operating Activities	(2,262,560)	(3,501)	(2,317,118)
Cash Flows from Investing Activities			
Capital Expenditures	(36,062)		(39,485)
Restricted Cash	(75,000)		(75,000)
Purchase of marketable securities	(24,623,290)		(24,623,290)
Net Cash Used in Investing Activities	(24,734,352)		(24,737,775)
Cash Flows from Financing Activities			
Capital Stock issued in Private Placement for \$29,400,351 in cash; fees of \$2,058,024			27,434,348
Advances from related party		3,540	64,620
Net Cash Provided by Financing Activities		3,540	27,498,968
Increase/(decrease) in cash during the period	(26,996,912)	39	444,075
Cash, beginning of the period	27,440,987		
Cash, end of the period	\$ 444,075	\$ 39	\$ 444,075

Supplemental disclosure of cash flow information; cash paid
for:

Interest	\$	\$	\$
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Income taxes	\$	\$	\$
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See accompanying notes to the interim financial statements

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XCORPOREAL, INC.
(a Development Stage Company)
STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIENCY)
For the Period May 4, 2001 (Inception) to March 31, 2007
(Unaudited)

	Common Stock		Additional	Deficit	
	Shares	Amount	Paid-in	Accumulated	Total
			Capital	During	
				Development	
				Stage	
Common stock issued for cash at \$0.01 per share	2,500,000	\$ 250	\$ 24,750		\$ 25,000
Net Loss for the year ended December 31, 2001				\$ (40,255)	(40,255)
Balance as of December 31, 2001	2,500,000	250	24,750	(40,255)	(15,255)
Common stock issued for cash at \$0.05 per share	1,320,000	132	65,868		66,000
Net Loss for the year ended December 31, 2002				(31,249)	(31,249)
Balance as of December 31, 2002	3,820,000	382	90,618	(71,504)	19,496
Net Loss for the year ended December 31, 2003				(12,962)	(12,962)
Balance as of December 31, 2003	3,820,000	382	90,618	(84,466)	6,534
Net Loss for the year ended December 31, 2004				(23,338)	(23,338)
Balance as of December 31, 2004	3,820,000	382	90,618	(107,804)	(16,804)
Net Loss for the year ended December 31, 2005				(35,753)	(35,753)
Balance as of December 31, 2005	3,820,000	382	90,618	(143,557)	(52,557)
Common stock issued for a licence rights	9,600,000	960	40		1,000
Capital stock cancelled	(3,420,000)	(342)	342		
Warrants granted for consulting fees			2,162,611		2,162,611
Forgiveness of debt			64,620		64,620
Common stock issued for cash at \$7.00, net of placement fees of \$2,058,024	4,200,050	420	27,341,928		27,342,348

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Stock-based compensation expense			264,251		264,251
Net loss for the period				(4,380,212)	(4,380,212)
Balance as of December 31, 2006	14,200,050	1,420	29,924,410	(4,523,769)	25,402,061
Warrants granted for consulting services			2,657,635		2,657,635
Stock-based compensation expense			639,064		639,064
Net loss for the period				(4,874,852)	(4,874,852)
Balance as of March 31, 2007	14,200,050	\$ 1,420	\$ 33,221,109	\$ (9,398,621)	\$ 23,823,908

See accompanying notes to the interim financial statements

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XCORPOREAL, INC.
(a Development Stage Company)
NOTES TO THE INTERIM FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)

Note 1 Interim Reporting

While information presented in the accompanying interim financial statements is unaudited, it includes all adjustments, which are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows for the interim period presented. All adjustments are of a normal recurring nature. It is suggested that these interim financial statements be read in conjunction with our December 31, 2006 financial statements.

The results of operations for the period ended March 31, 2007, are not necessarily indicative of the results that can be expected for the year ended December 31, 2007.

Note 2 Nature and Continuance of Operations

We were incorporated in the State of Nevada as Pacific Spirit Inc. on May 4, 2001 to engage in the acquisition, exploration and development of natural resource properties. On August 31, 2006, we changed our name to Xcorporeal, Inc. and thereafter acquired the rights to our Wearable Artificial Kidney, congestive heart failure treatment products, and other medical devices. As a result, we transitioned to a development stage company focused on researching, developing and commercializing technology and products related to the treatment of kidney failure and congestive heart failure.

On October 13, 2006, Xcorporeal, Inc., a Nevada corporation (Xcorporeal Nevada), consummated a merger with and into its newly-formed, wholly-owned subsidiary, Xcorporeal Merger Corporation, a Delaware corporation (Xcorporeal Delaware) for the purpose of changing our domicile from Nevada to Delaware. Each outstanding share of Xcorporeal Nevada common stock, par value \$0.001 per share, was automatically converted into one share of Xcorporeal Delaware common stock, par value \$0.0001 per share. The change in par value has been applied retroactively. As a result of the reincorporation, the total number of common stock authorized changed from 100,000,000 shares to 40,000,000 common shares; the total number of preferred stock authorized remained at 10,000,000 shares, resulting in a total number of capital stock authorized of 50,000,000 shares.

Note 3 Development Stage Company

We were previously a pre-exploration stage company as defined in the Statement of Financial Accounting Standards (SFAS) No. 7 and the Securities and Exchange Act Guide No. 7. Effective with the execution of the license agreement on August 31, 2006, we are a development stage company, devoting substantially all of our efforts to the research, development and commercialization of kidney and congestive heart failure treatment technologies.

Risks and Uncertainties We operate in an industry that is subject to intense competition, government regulation and rapid technological change. Our operations are subject to significant risk and uncertainties including financial, operational, technological, regulatory and other risks associated with a development stage company, including the potential risk of business failure.

Note 4 Cash Equivalents and Marketable Securities

We invest available cash in short-term commercial paper, certificates of deposit and high grade variable rate securities. Liquid investments with an original maturity of three months or less when purchased are considered to be cash equivalents.

Investments, including auction rate securities and certificates of deposit, with maturity dates greater than three months when purchased, which have readily determined fair values, are classified as available-for-sale investments and reflected in current assets as marketable securities at fair market value. Auction rate securities are recorded at par value, which equals fair market value, as the rate on such securities resets generally every 7, 28 or 35 days.

Restricted cash represents deposits secured as collateral for a bank credit card program.

Table of Contents**Note 5 Property and Equipment**

Property and equipment consist of the following at March 31, 2007:

Property and equipment	\$ 39,450
Accumulated depreciation	(1,581)
Property and equipment, net	\$ 37,869

Depreciation expense for the three months ended March 31, 2007 and 2006 was \$1,486 and \$0, respectively.

Note 6 Interest Income

Interest income of \$311,866 reported for the three months ended March 31, 2007 is a result of the interest earned on our cash raised from our private placement during the fourth quarter of 2006.

Note 7 Mineral Property

By a lease agreement effective June 1, 2001 and amended June 25, 2002, November 25, 2002, January 9, 2004 and April 11, 2005, we were granted the exclusive right to explore and mine the Del Oro and NP Claims located in Pershing County of the State of Nevada. The term of this lease was for 30 years, renewable for an additional 30 years so long as the conditions of the lease are met. We were required to pay minimum advanced royalties payments on each January 9 of \$50,000. We did not make the payment which triggered an event of default under the lease. On March 10, 2006, we received a termination notice and the lease was subsequently terminated.

Note 8 Related Party Transaction

We were charged the following by a former director:

	Three months ended March 31, 2007	2006	May 2, 2001 (Date of Inception) to March 31, 2007
Administrative services	\$	\$1,500	\$12,000

Note 9 License Agreement

On August 31, 2006, we entered into a Contribution Agreement with a company whose sole managing member is our current Chairman. We issued 9,600,000 shares of common stock in exchange for (a) the right, title, and interest to the name Xcorporeal and related trademarks and domain names, and (b) the right to enter into the Merger Agreement and License Agreement with National Quality Care, Inc. (NQCI) dated September 1, 2006 pursuant to which we obtained the exclusive rights to the technology relating to our congestive heart failure treatment, kidney failure treatment, and other medical devices. We were a shell corporation prior to the transaction. We valued the License Agreement at the carry-over basis of \$1,000. As consideration for being granted the License, we agreed to pay a minimum annual royalty of \$250,000, or 7% of net sales. We recorded \$145,833 in royalty expenses covering the minimum royalties from commencement of the License Agreement through March 31, 2007. The first minimum royalty payment is due by December 1, 2007. The License Agreement expires in 2105.

Note 10 Terminated Merger Agreement

On September 1, 2006, we entered into a Merger Agreement with our licensor, NQCI, which contemplated that we would either (i) acquire it as a wholly owned subsidiary pursuant to a triangular merger, or (ii) issue shares of our common stock in consideration of the assignment of the licensed technology. The Merger Agreement expired by its own terms on December 31, 2006. In addition, on December 29, 2006, NQCI served written notice that it was terminating the Merger Agreement, and on January 2, 2007, we consented to the termination. Accordingly, the Merger Agreement is now terminated. We will not be proceeding with any merger with NQCI. The termination of the Merger Agreement had no effect on the License Agreement, the Contribution Agreement, or the shares we issued to CNL.

Table of Contents**Note 11 Stock Options and Warrants*****Incentive Compensation Plan***

On October 13, 2006, after the effectiveness of the Nevada reincorporation, we adopted the Xcorporeal, Inc. 2006 Incentive Compensation Plan and the related form of option agreement. The plan authorizes the grant of stock options, restricted stock, restricted stock units and stock appreciation rights. Effective February 28, 2007, there are 3,900,000 shares of common stock reserved for issuance pursuant to the plan (subject to adjustment in accordance with the provisions of the plan). The plan will continue in effect for a term of up to ten years

Stock Options to Employees, Officer and Directors

The Compensation Committee of our Board of Directors determines the terms of the options granted, including the exercise price, the number of shares subject to option, and the vesting period. Options generally vest over five years and have a maximum life of ten years. On February 27, 2007, we granted options to purchase an aggregate of 650,000 shares of our common stock under the 2006 Incentive Compensation Plan to employees. The options vest ratably over 5 years, are exercisable at \$7.00 per share, the fair market value of our common stock on the grant date, and expire in 2017.

We reported \$639,064 in stock-based compensation expense for the three month period ended March 31, 2007. No stock-based compensation expense was reported for the three month period ended March 31, 2006.

All compensation expense for stock options granted have been determined under the fair value method using the Black-Scholes option-pricing model with the following assumptions:

	Three months ended March 31, 2007
Expected dividend yield	0.00%
Expected volatility	110%
Risk-free interest rate	4.46%
Expected terms in years	6.5 years

Warrants and Stock Options to Non-Employees

On February 27, 2007, we issued stock options and warrants to purchase an aggregate of 835,000 shares of common stock whereby 435,000 vested immediately on the grant date and 400,000 vest ratably over 5 years to consultants in exchange for consulting services. These stock options and warrants are exercisable at \$7.00 per share, the fair market value of our common stock on the grant date, and expire between 2012 and 2017. The resulting fair value of such stock options and warrants was \$5.3 million, of which \$2.7 million was expensed in the accompanying unaudited interim financial statements for the first quarter ended March 31, 2007. No such expense was reported for the three month period ended March 31, 2006.

Compensation for options granted to non-employees has been determined in accordance with SFAS No. 123 and EITF 96-18, Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. Accordingly, compensation is determined using the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured.

For options and warrants issued as compensation to non-employees for services that are fully vested and non-forfeitable at the time of issuance, the estimated value is recorded in equity and expensed when the services are performed and benefit is received as provided by Financial Accounting and Standards Board (FASB) Emerging Issues Task Force No. 96-18 Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring Or In Conjunction With Selling Goods Or Services.

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All charges for warrants granted have been determined under the fair value method using the Black-Scholes option-pricing model with the following assumptions:

	Three months ended March 31, 2007
Expected dividend yield	0.00%
Expected volatility	135%
Risk-free interest rate	4.50 - 4.65%
Expected terms in years	5.0-10.0 years

The following table shows the change in unamortized compensation expense for stock options and warrants issued to employees, officers, directors and non-employees during the quarter ended March 31, 2007:

	Stock Options and Warrants Outstanding	Unamortized Compensation Expense
January 1, 2007	2,054,221	\$ 10,002,154
Granted in the period	1,485,000	9,253,316
Expensed in the period		(3,296,699)
March 31, 2007	3,539,221	\$ 15,958,771

Amendment of the 2006 Incentive Compensation Plan

On February 27, 2007, our board of directors approved an amendment to the 2006 Incentive Compensation Plan to increase the number of shares of common stock reserved for issuance under the plan from 2,000,000 to 3,900,000. The amendment was previously approved by our stockholders.

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ITEM 2. Management's Discussion and Analysis or Plan of Operation.

The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes, and the other financial information included in this report.

Forward-Looking Statements

The forward-looking comments contained in this report involve risks and uncertainties. Our actual results may differ materially from those discussed here due to factors such as, among others, limited operating history, difficulty in developing, exploiting and protecting proprietary technologies, results of clinical studies, intense competition and substantial regulation in the healthcare industry. Additional factors that could cause or contribute to such differences can be found in the following discussion and in the **Risks Factors** set forth below.

Plan of Operation

Overview

We are a medical device company actively researching and developing an *extra-corporeal* platform to perform functions of various human organs. Our prototype systems apply modern electronics and engineering principals to reduce the size, cost and power requirements of conventional extracorporeal therapies including kidney dialysis. Our platform may also improve the quality of therapy delivered ultimately leading to better patient outcomes and reduced healthcare costs.

License Agreement

On September 1, 2006, we entered into the License Agreement pursuant to which we obtained exclusive rights to our technology relating to the treatment of kidney failure, congestive heart failure and other medical devices, with no geographic restrictions, that will last for a period of ninety-nine years or until the expiration of its proprietary rights in each item of intellectual property, if earlier. As consideration for granting the license, we agreed to reimburse designated costs and expenses of our licensor, and pay a minimum royalty of 7% of net sales, with an annual minimum royalty of \$250,000. As a result, we have become a developmental stage company focused on researching, developing, and commercializing technology and products related to the treatment of kidney failure and congestive heart failure.

Description of Business

For the coming year we plan to test and develop the technology for our *extra-corporeal* platform and other medical devices. In its simplest configuration, our product platform can be used as an ultrafiltration machine which will remove a predetermined amount of water from a patient's blood stream. Removal of excess water by ultrafiltration has been shown to be an effective therapy for management of fluid overload under physician supervision. We can also add additional components to our platform to configure a full dialysis machine, which can remove metabolic waste (urea, creatinine) and toxins from the blood. Dialysis has been shown to be an effective therapy for treatment of kidney failure.

We will also plan our Validation and Verification strategy including bench testing, clinical testing, and regulatory strategy in the US and abroad. The products we plan to bring to market include:

Portable kidney dialysis for use in the clinic, hospital, or at home

Wearable Artificial Kidney (WAK) for chronic treatment of End Stage Renal Disease (ESRD)

Portable ultrafiltration for management of fluid overload under physician supervision

Wearable Ultrafiltration Device (WUD) for chronic treatment of fluid overload under physician supervision.

Product Applications

Our Wearable Artificial Kidney (WAK) is a breakthrough technology for the chronic treatment of End Stage Renal Disease (ESRD). We have successfully demonstrated a prototype system that weighs less than 6 kg., is battery operated, and can be worn by

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an ambulatory patient. Our miniature, wearable device will enable continuous (24 x 7) renal replacement therapy on a chronic basis at home. Continuous therapy has previously been shown to reduce mortality, reduce morbidity, and improve quality of life in ESRD patients. Our WAK is the first practical device to provide continuous, chronic therapy, because:

Reduced size, weight, and power consumption allows us to deploy a wearable package so that the treatment does not interfere with normal activities of daily life.

Reduced fluid requirements make the WAK easy to use for consumers and reduce utility requirements (water, electricity) at home.

Novel vascular access makes the WAK safe and effective for home use.

Packaged differently, the same attributes (portability, size, weight, fluid and power reduction) make the WAK a very attractive alternative to conventional Continuous Renal Replacement Therapy (CRRT) machines for hospitalized patients. Our miniature system can also be configured to treat fluid overload under physician supervision.

Research and Development

R&D Team

We acquired the exclusive license to our platform technology on September 1, 2006, and have commenced planning and implementing our research and development efforts. We have recruited an experienced scientific team to execute our research and development plan. The goals of our research and development efforts will include:

Improving the chemicals used in the dialysis process. The current chemicals have been used for decades. We believe new chemicals that last longer and can be used in smaller quantities would further reduce the cost and weight of our product.

Developing software to allow physicians to customize the function of the device to meet the specific dialysis needs of each patient.

Adapting the *extra-corporeal* platform technology underlying our Wearable Artificial Kidney to other medical uses. We believe our technology is a platform for a number of other devices that can be used to treat other diseases and will offer substantive value propositions for patients and healthcare providers.

Expanding our recruiting and retaining an experienced team of scientists and engineers.

Clinical Studies

The feasibility of the WAK prototype was demonstrated in a porcine model during 2004 and 2005. The feasibility of the WAK prototype for treatment of fluid overload in humans was demonstrated by the treatment of six volunteers in Vicenza, Italy in July and August 2006. We demonstrated the feasibility of the WAK prototype for dialysis treatment in humans by the treatment of eight volunteers in London in March 2007. We are planning additional clinical trials over the next few years, culminating in a pivotal study to support a regulatory submission.

We incurred approximately \$1.1 million and \$1.3 million in research and development expenses for the three months ended March 31, 2007 and the year ended December 31, 2006, respectively. We expect our research and development expenses to increase as a result of additional headcount in the areas of product development and quality assurance and regulatory affairs, a higher level of third-party consulting activity and other related expenses.

Management's Discussion and Analysis

Results of Operations for the three months ended March 31, 2007

We have not generated any revenues since inception. We incurred net loss of \$4.9 million for the three months ended March 31, 2007, compared to a net loss of \$6,203 for the three months ended March 31, 2006. The increase in net loss was primarily due to (i) research, development and other expenses related to advancing our kidney and congestive heart failure treatment technologies, (ii)

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stock compensation expense related to options and warrants granted to directors, officer, employees and consultants, and (iii) legal and audit fees. At March 31, 2007, we had positive working capital of \$23.8 million compared to positive working capital of \$25.4 million for beginning of the year.

Liquidity and Capital Resources

We expect to incur operating losses and negative cash flows for the foreseeable future. During the fourth quarter of 2006 we raised approximately \$27.3 million (net of placement fees of \$2.1 million) through a private placement. Our ability to execute on our current business plan is dependent upon our ability to develop and market our products, and, ultimately, to generate revenue.

At March 31, 2007 we had cash, cash equivalents and marketable securities of approximately \$25,142,365. We are expending cash at a rate of approximately \$0.8 million per month, and at present rates can satisfy our cash requirements for approximately three years. At present rates, we will not have to raise additional funds in the next twelve months.

Off-Balance Sheet Arrangements

As of March 31, 2007, we had no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, results of operations or cash flows.

Legal Proceedings

We are involved in an arbitration against National Quality Care, Inc. concerning our License Agreement, as described in our most recent annual report. From time to time, we may be involved in litigation relating to claims arising out of our operations in the normal course of business. As of the date of this report we are not currently involved in any legal proceeding that we believe would have a material adverse effect on our business, financial condition or operating results.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. Generally accepted accounting principles require management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. We base our estimates on experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that may not be readily apparent from other sources. Our actual results may differ from those estimates.

We consider our critical accounting policies to be those that involve significant uncertainties, require judgments or estimates that are more difficult for management to determine or that may produce materially different results when using different assumptions. We consider the following accounting policies to be critical:

Marketable Securities

We classify investments with maturity dates greater than three months when purchased as marketable securities. Investments, including auction rate securities and certificates of deposit, with maturity dates greater than three months when purchased and which have readily determined fair values are classified as available-for-sale investments and reflected in current assets as marketable securities at fair market value. Auction rate securities are recorded at cost, which equals fair market value, as the rate on such securities generally resets every 7, 28 or 35 days. Our investment policy requires that all investments be investment grade quality and no more than ten percent of our portfolio may be invested in any one security or with one institution.

Identifiable Intangibles

Certain costs associated with obtaining and licensing patents and trademarks are capitalized as incurred and are amortized on a straight-line basis over the shorter of their estimated useful lives or their legal lives of 17 to 20 years. Amortization of such costs begins once the patent or trademark has been issued. We evaluate the recoverability of our patent costs and trademarks quarterly based on estimated undiscounted future cash flows.

Table of Contents*Stock-Based Compensation*

Statements of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)) and Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 107 (SAB 107) require the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. We have applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Recent Accounting Pronouncements

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140* (SFAS 156). The provisions of SFAS 156 are effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. We have adopted SFAS 156 in January 2007. There was no impact on our results of operations and financial position upon adoption.

In July 2006, the FASB released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. This statement is effective for fiscal years beginning after December 15, 2006. We have adopted FIN 48 in January 2007. There was no impact on our results of operations and financial position upon adoption.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are required to adopt the provision of SFAS 157, as applicable, beginning in fiscal year 2008. We are currently in the process of evaluating the expected effect of SFAS 157 on our results of operations and financial position.

In February 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 159). SFAS No. 159 permits an entity to choose to measure many financial instruments and certain items at fair value. The objective of this standard is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reporting earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 permits all entities to choose to measure eligible items at fair value at specified election dates. Entities will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, which for us would be our fiscal year beginning January 1, 2008. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply to provision of FASB Statement No. 157, *Fair Value Measurements*. We are currently evaluating the impact that the adoption of SFAS No. 159 will have on our consolidated financial statements.

In December 2006, the FASB issued FSP 00-19-2, *Accounting for Registration Payment Arrangements* (FSP 00-19-2) which addresses accounting for registration payment arrangements. FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*. FSP 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment. FSP 00-19-2 is effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that

are entered into or modified subsequent to December 21, 2006. For registration payment arrangement and related financial instruments entered into prior to December 21, 2006, FSP 00-19-2 is effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those financial years. Companies are required to report transition through a cumulative-effect adjustment to the opening balance of retained earnings as of the first interim period for the fiscal year in which FSP 00-19-2 is adopted. We have early adopted FSP 00-19-2 in 2006. There was no impact on our financial statements upon adoption.

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In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. (SAB) 108 (Topic 1N), *Considering the Effects of Prior Year Misstatement when Quantifying Misstatements in Current Year Financial Statements*, . SAB No. 108 requires SEC registrants (i) to quantify misstatements using a combined approach that considers both the balance-sheet and income-statement approaches, (ii) to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors, and (iii) to adjust their financial statements if the new combined approach results in a conclusion that an error is material. SAB No. 108 is effective for fiscal years ending after November 15, 2006, which for us was our fiscal year ended December 31, 2006. The adoption of SAB No. 108 did not have any effect on our financial position and results of operations.

ITEM 3. Controls and Procedures.

We conducted an evaluation, under the supervision and with the participation of our President and Chief Operating Officer (principal executive officer) and Chief Financial Officer (principal financial officer), of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of March 31, 2007. Based upon this evaluation, our President and Chief Operating Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that required material information is included in this quarterly report for the period ended March 31, 2007.

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting

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PART II OTHER INFORMATION

ITEM 1. Legal Proceedings.

Not applicable.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On February 27, 2007, we issued to 10 consultants a total of 835,000 stock options and warrants to purchase our common stock with an exercise price of \$7.00 per share in exchange for consulting services. These securities were issued without registration pursuant to the exemption afforded by Section 4(2) of the Securities Act of 1933, as a transaction by us not involving any public offering.

ITEM 3. Defaults Upon Senior Securities

Not applicable.

ITEM 4. Submission of Matters to a Vote of Security Holders.

Not applicable.

ITEM 5. Other Information.

Not applicable.

ITEM 6. Exhibits.

No. Description of Exhibit

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 11, 2007

By: /s/ ROBERT S. STEFANOVICH
Robert S. Stefanovich
Interim Chief Financial Officer
(Principal Financial Officer and Principal
Accounting Officer)