XSUNX INC
Form 10-Q
February 14, 2014

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 Exchange Act of 1934

For The Quarterly Period Ended: December 31, 2013

[ ] Transition Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For The Transition Period From ___________ to _______________

Commission File Number: 000-29621

XSUNX, INC.

(Exact name of registrant as specified in its charter)

Colorado	84-1384159
(State of incorporation)	(I.R.S. Employer Identification No.)

65 Enterprise, Aliso Viejo, CA 92656

(Address of principal executive offices) (Zip Code)

Registrant's telephone number: (949) 330-8060

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, as amended, during the preceding twelve (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. Yesx No o

Indicate by check mark whether the 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

The number of shares of common stock issued and outstanding as of February 14, 2014 was 527,544,021.

TABLE OF CONTENTS

2

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

XSUNX, INC.

(A Development Stage Company)

BALANCE SHEETS

	December 31, 2013 (Unaudited)	September 30, 2013
ASSETS		
CURRENT ASSETS		
Cash	$ 45,077	$ 38,573
Inventory	$ 14,652	$ -
Prepaid expenses	51,351	16,117
Total Current Assets	111,080	54,690
PROPERTY & EQUIPMENT		
Office & miscellaneous equipment	35,853	35,853
Machinery & equipment	253,166	266,366
Leasehold improvements	-	17,500
	289,019	319,719
Less accumulated depreciation	(209,138)	(225,397)
Net Property & Equipment	79,881	94,322
OTHER ASSETS		
Security deposit	-	2,500
Total Other Assets	-	2,500
TOTAL ASSETS	$ 190,961	$ 151,512

LIABILITIES AND SHAREHOLDERS' DEFICIT

CURRENT LIABILITIES		
Accounts payable	$ 140,876	$ 147,629
Credit card payable	11,977	1,962
Accrued expenses	-	107
Accrued interest on notes payable	23,048	14,358
Derivative liability	659,785	705,118
Convertible promissory notes, net of $342,327 and $462,143 in discounts	186,047	74,964
Total Current Liabilities	1,021,733	944,138
TOTAL LIABILITIES	1,021,733	944,138
SHAREHOLDERS' DEFICIT		
Preferred stock 50,000,000 shares authorized, shares issued and outstanding designated as follows		
Preferred Stock Series A, $0.01 par value, 10,000 authorized 5,000 and 0 shares issued and outstanding, respectively	50	50
Common stock, no par value; 2,000,000,000 authorized common shares 517,321,256 and 429,043,441 shares issued and outstanding, respectively	30,193,820	29,175,261
Additional paid in capital	5,335,398	5,335,398
Paid in capital, common stock warrants	3,811,700	3,811,700
Deficit accumulated during the development stage	(40,171,740)	(39,115,035)
TOTAL SHAREHOLDERS' DEFICIT	(830,772)	(792,626)
TOTAL LIABILITIES AND SHAREHOLDERS' DEFICIT	$ 190,961	$ 151,512

The accompanying notes are an integral part of these financial statements

XSUNX, INC.

(A Development Stage Company)

STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended		From Inception February 25, 1997 through December 31, 2013
	December 31, 2013	December 31, 2012	
SALES	30,808	-	$ 45,688
COST OF GOODS SOLD	29,791	-	29,791
GROSS PROFIT	1,017	-	15,897
OPERATING EXPENSES			
Selling, general and administrative expenses	138,728	129,006	19,193,698
Research and development	2,566	15,000	3,714,564
Depreciation and amortization expense	4,618	14,652	769,087
TOTAL OPERATING EXPENSES	145,912	158,658	23,677,349
LOSS FROM OPERATIONS BEFORE OTHER INCOME/(EXPENSES)	(144,895)	(158,658)	(23,661,452)
OTHER INCOME/(EXPENSES)			
Interest income	-	-	445,537
Gain/(Loss) on sale of asset	(4,423)	-	20,000
Impairment of assets	-	-	(7,285,120)
Derivative financing cost	(237,178)	-	(558,757)
Write down of inventory asset	-	-	(1,177,000)
Gain on legal settlement	-	-	1,279,580
Loan and commitment fees	-	(8,966)	(7,096,690)
Forgiveness of debt	-	-	592,154
Gain/(Loss) on settlement of debt	(813,074)	(126,470)	(2,491,779)

Gain/(loss) on change in derivative liability	420,511	(92,468)	1,207,436
Other, non-operating	-	-	(5,215)
Penalties	(226)	-	(845)
Interest expense	(277,420)	(148,070)	(1,439,589)
TOTAL OTHER INCOME/(EXPENSES)	(911,810)	(375,974)	(16,510,288)
NET LOSS	$ (1,056,705)	$ (534,632)	$ (40,171,740)
BASIC AND DILUTED LOSS PER SHARE	$ (0.00)	$ (0.00)	
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC AND DILUTED	488,925,399	287,343,603	

The accompanying notes are an integral part of these financial statements

4

XSUNX, INC.

(A Development Stage Company)

STATEMENT OF SHAREHOLDERS DEFICIT

(Unaudited)

	Preferred Stock		Common Stock		Additional	Warrants	De Accu Stock Devel Paid-in
	Shares	Amount	Shares	Amount	Paid-in Capital		
Balance at September 30, 2013	5,000	$ 50	429,043,441	$ 29,175,261	$ 5,335,398	$ 3,811,700	$ (3
Issuance of common stock for conversion of notes and interest	-	-	88,277,815	1,018,559	-	-	
Net loss for the period ended December 31, 2013	-	-	-	-	-	-	(
Balance at December 31, 2013	5,000	$ 50	517,321,256	$ 30,193,820	$ 5,335,398	$ 3,811,700	$ (4

The accompanying notes are an integral part of these financial statements

5

XSUNX, INC.

(A Development Stage Company)

STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended December 31, 2013	Three Months Ended December 31, 2012	From Inception February 25,1997 through December 31, 2013
CASH FLOWS FROM OPERATING ACTIVITIES:			
	$	$	$
Net loss	(1,056,705)	(534,632)	(40,171,740)
Adjustment to reconcile net loss to net cash used in operating activities			
Depreciation & amortization	4,618	14,652	769,087
Common stock issued for services and other expenses	9,085	-	2,614,244
Stock option and warrant expense	-	-	4,085,890
Convertible notes issued for prepaids	48,000	-	48,000
Commitment fees	-	8,966	5,780,273
Asset impairment	-	-	7,285,120
Write down of inventory asset	-	-	1,177,000
Loss on conversion and settlement of debt	813,074	126,470	2,024,818
(Gain)/Loss on sale of asset	4,423	-	(20,000)
Financing cost associated with issuance of convertible notes	237,178	-	558,757
Contributed capital and services	-	-	97,035
Settlement of lease	-	-	59,784
(Gain)/Loss on change in derivative liability	(420,511)	96,768	(1,207,436)
Amortization of debt discount	257,816	126,270	1,103,440
Change in Assets and Liabilities:			
(Increase) Decrease in:			
Prepaid expenses	(35,234)	26,815	23,844
Inventory	(14,652)	-	(1,431,652)
Other assets	2,500	-	-
Increase (Decrease) in:			
Accounts payable	3,262	28,506	2,377,220
Accrued expenses	10,250	11,640	204,632
	(136,896)	(94,545)	(14,621,684)

NET CASH USED IN OPERATING ACTIVITIES			
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of manufacturing equipment and facilities in process	-	(29,615)	(5,909,913)
Payments on note receivable	-	-	(1,500,000)
Proceeds from sale of assets	5,400	-	274,500
Receipts on note receivable	-	-	1,500,000
Purchase of marketable prototype	-	-	(1,780,396)
Purchase of fixed assets	-	-	(630,708)
NET CASH PROVIDED/(USED) BY INVESTING ACTIVITIES	5,400	(29,615)	(8,046,517)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from warrant conversion	-	-	3,306,250
Proceeds from convertible promissory notes	138,000	117,500	6,759,000
Proceeds for issuance of common stock, net	-	-	12,648,028
NET CASH PROVIDED BY FINANCING ACTIVITIES	138,000	117,500	22,713,278
NET INCREASE (DECREASE) IN CASH	6,504	(6,660)	45,077
CASH, BEGINNING OF PERIOD	38,573	44,527	-
CASH, END OF PERIOD	$ 45,077	$ 37,867	$ 45,077
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION			
Interest paid	$ 163	$ 119	$ 121,510
Taxes paid	$ -	$ -	$ -

SUPPLEMENTAL DISCLOSURES OF NON CASH TRANSACTIONS

During the three months ended December 31, 2013, the Company issued 88,277,815 shares of common stock upon conversion of promissory notes for principal in the amount of

$196,400, plus $6,307 in accrued interest. During the three months ended December 31, 2012, the Company exchanged a demand note in the amount of $350,000 plus accrued

The accompanying notes are an integral part of these financial statements

XSUNX, INC.

(A Development Stage Company)

Notes to Financial Statements (Unaudited)

December 31, 2013

1.

Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all normal recurring adjustments considered necessary for a fair presentation have been included. Operating results for the three months ended December 31, 2013 are not necessarily indicative of the results that may be expected for the year ending September 30, 2014. For further information refer to the financial statements and footnotes thereto included in the Company's Form 10-K/A for the year ended September 30, 2013.

Going Concern

The accompanying unaudited financial statements have been prepared on a going concern basis of accounting, which contemplates continuity of operations, realization of assets and liabilities and commitments in the normal course of business. The accompanying financial statements do not reflect any adjustments that might result if the Company is unable to continue as a going concern. The Company does not generate significant revenue, and has negative cash flows from operations, which raise substantial doubt about the Company s ability to continue as a going concern. The ability of the Company to continue as a going concern and appropriateness of using the going concern basis is dependent upon, among other things, additional cash infusion. The Company has obtained funds from its shareholders since its inception through the period ended December 31, 2013. Management believes the existing shareholders and the prospective new investors will provide the additional cash needed to meet the Company s obligations as they become due, and will allow the development of its business.

2.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of XsunX, Inc. is presented to assist in understanding the Company s financial statements. The financial statements and notes are representations of the Company s management, which is responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Development Stage Activities and Operations

The Company has been in its initial stages of formation and for the three months ended December 31, 2013, had revenues of $30,808 associated with the initial sales efforts for its solar electric photovoltaic (PV) system installation services which the Company began to market in the period covered by this report. A development stage activity as one in which all efforts are devoted substantially to establishing a new business and even if planned principal operations have commenced, revenues are insignificant.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements. Significant estimates made in preparing these financial statements include the estimate of useful lives of property and equipment, the deferred tax valuation allowance, and the fair value of stock options. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and cash equivalents include cash in banks and money markets with an original maturity of three months or less.

Loss per Share Calculations

Loss per Share is the calculation of basic earnings per share and diluted earnings per share. Basic earnings per share are computed by dividing income available to common shareholders by the weighted-average number of common shares available. Diluted earnings per share is computed similar to basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The Company s diluted loss per share is the same as the basic loss per share for the three months ended December 31, 2013, as the inclusion of any potential shares would have had an anti-dilutive effect due to the Company generating a loss.

Revenue Recognition

The Company recognizes revenue when services are performed, and at the time of shipment of products, provided that evidence of an arrangement exists, title and risk of loss have passed to the customer, fees are fixed or determinable, and collection of the related receivable is reasonably assured. To date the Company has had minimal revenue and is still in the development stage.

Stock-Based Compensation

Share-based Payment applies to transactions in which an entity exchanges its equity instruments for goods or services and also applies to liabilities an entity may incur for goods or services that are to follow a fair value of those equity instruments. We are required to follow a fair value approach using an option-pricing model, such as the Black Scholes option valuation model, at the date of a stock option grant. The deferred compensation calculated under the fair value method would then be amortized over the respective vesting period of the stock option. This has not had a material impact on our results of operations.

Fair Value of Financial Instruments

Fair Value of Financial Instruments, requires disclosure of the fair value information, whether or not recognized in the balance sheet, where it is practicable to estimate that value. As of December 31, 2013, the balances reported for cash, prepaid expenses, accounts payable, accrued expenses, and derivative liability approximate the fair value because of their short maturities.

We adopted ASC Topic 820 (originally issued as SFAS 157, Fair Value Measurements) as of January 1, 2008 for financial instruments measured as fair value on a recurring basis. ASC Topic 820 defines fair value, established a framework for measuring fair value in accordance with accounting principles generally accepted in the United States and expands disclosures about fair value measurements.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 established a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). These tiers include:

.

Level 1, defined as observable inputs such as quoted prices for identical instruments in active markets;

.

Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable such as quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active; and

.

Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions, such as valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

We measure certain financial instruments at fair value on a recurring basis. Assets and liabilities measured at fair value on a recurring basis are as follows at December 31, 2013:

	Total	(Level 1)	(Level 2)	(Level 3)
Assets	$ -	$ -	$ -	$ -
Total assets measured at fair value	$ -	$ -	$ -	$ -
Liabilities				
Derivative Liability	$ 659,785	$ -	$ -	$ 659,785
Convertible Promissory Notes, net of discount	186,047	-	-	186,047
Total liabilities measured at fair value	$ 845,832	$ -	$ -	$ 845,832

Recently Adopted Accounting Pronouncements

Management reviewed accounting pronouncements issued during the three months ended December 31, 2013, and no pronouncements were adopted during the period.

3.

CAPITAL STOCK

At December 31, 2013, the Company s authorized stock consisted of 2,000,000,000 shares of common stock, with no par value. The Company is also authorized to issue 50,000,000 shares of preferred stock with a par value of $0.01 per share of which 10,000 shares have been designated as Series A Preferred Stock. The rights, preferences and privileges of the holders of the preferred stock are determined by the Board of Directors prior to issuance of such shares.

During the period ended December 31, 2013, the Company issued 88,277,815 shares of common stock upon conversion of convertible notes in the aggregate fair value of $1,018,559 at prices ranging between $0.0054 and $0.0017.

4.

STOCK OPTIONS AND WARRANTS

On January 5, 2007, the Board of Directors of XsunX resolved to establish the Company s 2007 Stock Option Plan (the Plan) to enable the Company to obtain and retain the services of the types of employees, consultants and directors who could contribute to the Company s long range success and to provide incentives which are linked directly to increases in share value which will inure to the benefit of all stockholders of the Company. Options granted under the Plan may be either Incentive Options or Nonqualified Options and shall be administered by the Company's Board of Directors ("Board"). Each Option shall be exercisable to the nearest whole share, in installments or otherwise, as the respective Option agreements may provide. Notwithstanding any other provision of the Plan or of any Option agreement, each Option shall expire on the date specified in the Option agreement. A total of 20,000,000 shares of common stock are authorized under the plan, and at December 31, 2013 9,500,000 options are issued and outstanding under the Plan.

The following tables set forth summary information, as of December 31, 2013, concerning securities authorized for issuance under all equity compensation plans and agreements as of December 31, 2013 is as follows:

Risk free interest rate	0.29% to 0.38%
Stock volatility factor	138.33% to 169.56%
Weighted average expected option life	2-3 years
Expected dividend yield	None

A summary of the Company s stock option activity and related information follows:

	For the period ended 12/31/2013	
	Number of Options	Weighted average exercise price
Outstanding, beginning of the period	9,500,000	$ 0.066
Granted	-	-
Exercised	-	-
Expired	-	-
Outstanding, end of the period	9,500,000	$ 0.066
Exercisable at the end of the period	8,500,000	$ 0.043
Weighted average fair value of options granted during the period		$ -

The weighted average remaining contractual life of options outstanding issued under the plan as of December 31, 2013 was as follows:

Exercisable Prices	Stock Options Outstanding	Stock Options Exercisable	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price of Options Outstanding	Weighted Average Exercise Price of Options Exercisable
$ 0.160	2,500,000	2,500,000	0.25 years	$ 0.16	$ 0.16
$ 0.014	500,000	500,000	1.36 years	$ 0.16	$ 0.16
$ 0.100	1,000,000	-	1.80 years	$ 0.16	$ 0.16
$ 0.014	4,000,000	4,000,000	2.22 years	$ 0.16	$ 0.16
$	1,500,000	1,500,000	3.03 years	$	$

0.045	9,500,000	8,500,000	0.16	0.16

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the financial statements of operations during the three months ended December 31, 2013, included compensation expense for the stock-based payment awards granted prior to, but not yet vested, as of December 31, 2013 based on the grant date fair value estimated, and compensation expense for the stock-based payment awards granted subsequent to December 31, 2013, based on the grant date fair value estimated. We account for forfeitures as they occur, and no options were forfeited during the period ended December 31, 2013. There was no stock-based compensation expense recognized in the statement of income during the three months ended December 31, 2013, and 2012.

5.

CONVERTIBLE PROMISSORY NOTES

As previously disclosed by XsunX, Inc. (the Company) in its Annual Report on Form 10-K for the year ended September 30, 2012, filed on January 11, 2013, the Company, in exchange for a promissory note (the Note) that had matured on September 30, 2012, issued in November 2012 a new unsecured 12% convertible promissory exchange note (the Exchange Note) for the remaining accrued principal and interest totaling $385,863. The Exchange Note had a maturity date of September 30, 2013. On September 30, 2013, the Exchange Note had an outstanding balance of $293,496, including accrued interest. Effective September 30, 2013, the Company and the Holder entered into an Extension and Amendment Agreement (Amendment Agreement), under which the Company issue an Amended and Restated 12% Promissory Note (the Amended Note.) The Amended Note provides for, among other things, an extension of the maturity date to September 30, 2014, and amended the conversion price to be 60% of the lowest volume weighted average price (VWAP) occurring during the twenty trading days preceding any conversion date by Holder. The balance of provisions remained substantially the same. No additional cash consideration was provided or exchanged. During the period ended December 31, 2013, the lender converted $90,000 in principal of the note, plus interest of $858, leaving a remaining principal balance of $203,496. Upon conversion the Company issued an aggregate of 41,299,127 shares common stock to the lender. As of December 31, 2013, the Company recognized interest expense of $9,001.

On November 7, 2012, the Company issued a 10% unsecured convertible promissory note (the Note) for the principal sum of up to $78,000 plus accrued interest on any advanced principal funds. On November 6, 2013, the lender advanced $28,000 to the Company under the note. As of December 31, 2013, the lender has advanced $78,000 under the Note to the Company, and the Note has a remaining principal balance of $28,000. The Note matures one year from each advance. The Note may be converted by the lender into shares of common stock of the Company at the lesser of $.0125 per share at fifty percent (50%) of the lowest trade price in the twenty five (25) trading days prior to the conversion of any outstanding funded principal or accrued interest under the Note. On November 1, 2013, the lender converted $25,000 in principal, plus $1,171 of accrued interest. Upon conversion the Company issued 14,954,989 shares of common stock to the lender. During the period ended December 31, 2013, the Company recognized interest expense of $641.

On December 13, 2012, the Company issued a 10% unsecured convertible promissory note (the Note) for the principal sum of up to $250,000 and accrued interest on any advanced principal funds. The consideration is $225,000 with an original issue discount of $25,000. Under the Note the Lender has advanced an aggregate principal sum of $215,000 to the Company, including $40,000 advanced to the Company on December 10, 2013. The Lender may only advance additional consideration to the Company subject to consent by the Company. The Company shall be required to repay only the consideration funded by the lender, and shall not have any interest or other rights extend to any unfunded portion of the Note. The Note matures one year from the date each advance under the Note. The Note may be converted by the Lender into shares of common stock of the Company at the lesser of $.025 per share or sixty percent (60%) of the lowest trade price in the twenty five (25) trading days prior to the conversion of any outstanding funded principal or accrued interest under the Note. During the period ended December 31, 2013, the lender converted $43,900 of the convertible note, plus original issued discount and interest of $5,556 leaving a remaining principal balance of $96,100, plus original issue discount and accrued interest of $12,788 for a total sum of $108,878. During the period ended December 31, 2013, the Company recognized interest expense of $7,222, which includes original issue discount of $4,444.

On October 16, 2013, and November 13, 2013, the Company issued securities purchase agreements to an unrelated third party providing for the sale of two 8% convertible promissory notes (the Convertible Notes) in the amount of $37,500 and $32,500 respectively. The Convertible Notes were issued to an existing holder under terms substantially similar to previous Convertible Notes. After one hundred and eighty days from the date consideration is provided to the Company, the Convertible Notes can be converted into shares of common stock at a conversion price of 60% of the average lowest three (3) closing bid prices for the common stock, during the ten (10) trading day period ending on the latest complete trading day prior to the conversion date. Each of the Convertible Notes mature nine months after the date of issuance. The Company has the right to redeem a portion or all amounts outstanding under the Convertible Notes prior to one hundred and eighty one days from issuance of the Convertible Notes under a variable redemption rate premium. During the period ended December 31, 2013, the lender converted a note in the principal amount of $37,500, plus $1,500 in accrued interest, leaving a remaining aggregate principal balance of $140,000. Upon conversion the Company issued an aggregate of 13,973,430 shares of voting common stock to the lender. The remaining Notes mature on April 11, 2014, May 22, 2014, July 18, 2014, and August 15, 2014. The Company has the right to redeem a portion or all amounts outstanding under the any Note prior to one hundred and eighty one days from issuance of the Note under a variable redemption rate premium. After one hundred and eighty days the holder may convert into shares of common stock at a variable conversion price of 60% multiplied by the market price of the average lowest three (3) trading prices for the common stock during the ten (10) trading days prior to the conversion date. During the period ended December 31, 2013, the Company recognized $2,578 in interest expense.

Issuance of Convertible Promissory Notes for Services to Related Party

On October 1, 2013, the Company issued a total of $48,000 in unsecured Convertible Promissory Notes (the Promissory Notes) in the amount of $12,000 each to Board members Joseph Grimes, Tom Anderson, Dr. Michael Russak, and Oz Fundlingsland (the Holders) in exchange for their services as directors during the fiscal year ending September 30, 2014. The Promissory Notes can be converted into shares of common stock by the Holder for $0.0045 per share. The Promissory Notes mature on October 1, 2015, and bear zero (0%) percent interest during the first 12 months from the date of issuance. If the Promissory Note is not paid in full by the Company, or through conversion by the Holder, on or before the first anniversary, a one-time interest charge of 10% shall be applied to any reaming principal sum. So long as any shares issuable under a conversion are subject to transfer and sale restrictions imposed pursuant to SEC Rule 144 of the Rules promulgated under the Securities Act of 1933, the Company shall, upon written request by Holder, file Form S-8, if applicable, with the U.S. Securities and Exchange commission to register the issued shares.

6. DERIVATIVE LIABILITIES

In June 2008, the FASB issued authoritative guidance on determining whether an instrument (or embedded feature) is indexed to an entity s own stock. Under the authoritative guidance, effective January 1, 2009, instruments which did not have fixed settlement provisions were deemed to be derivative instruments. As a result, certain convertible notes issued described in Notes 5 do not have fixed settlement provisions because their conversion prices may be lowered if the Company issues securities at lower prices in the future. The conversion feature has been characterized as derivative liabilities to be re-measured at the end of every reporting period with the change in value reported in the statement of operations.

At September 30, 2013, the outstanding fair value of the convertible notes accounted as derivative liabilities amounted to $705,118.

During the period ended December 31, 2013, as a result of aggregate total of convertible notes we issued that were accounted for as derivative liabilities, we determined that the fair value of the conversion feature of the convertible notes at issuance was $375,178, based upon a Black-Sholes calculation. We recorded the full value of the derivative as a liability at issuance with an offset to valuation discount, which will be amortized over the life of the notes. As the aggregate fair value of these liabilities of $375,178 exceeded the aggregate value of the notes, the excess of the liability over the total combined note value of $237,178 was considered as a cost of the debt and reported in the accompanying Statement of Operation as financing cost.

During the period ended December 31, 2013, approximately $196,400 in convertible notes were converted. As a result of the conversion of these notes, the Company recorded a gain in change in fair value of the derivative liability of $970,159 due to the extinguishment of the corresponding derivative liability. Furthermore, during the period ended December 31, 2013, the Company recognized a loss of $549,648 to account for the change in fair value of the derivative liabilities. At December 31, 2013, the fair value of the derivative liability was $659,785.

For purpose of determining the fair market value of the derivative liability for the embedded conversion, the Company used Black Scholes option valuation model. The significant assumptions used in the Black Scholes valuation of the derivative are as follows:

Risk free interest rate	Between 0.03% and 0.14%
Stock volatility factor	Between 106.82% and 409.17%
Months to Maturity	9 months to 1 year
Expected dividend yield	None

7.

SUBSEQUENT EVENTS

The following are items management has evaluated as subsequent events pursuant to the requirement of ASC Topic 855.

Between January 21, 2014 and January 28, 2014 the Company issued 5,322,765 shares of common stock at prices ranging from $0.0077 to $0.0068 upon conversion of the aggregate amount of $39,000 dollars of principal and accrued interest to the holder of 8% convertible notes. The shares were issued in a transaction exempt from regi