

STEMCELLS INC
Form 10-Q
October 31, 2006

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

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

**For the quarter ended: September 30, 2006 Commission File Number: 0-19871
STEMCELLS, INC.**

(Exact name of registrant as specified in its charter)

DELAWARE

94-3078125

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
identification No)

3155 PORTER DRIVE
PALO ALTO, CA 94304

(Address of principal executive offices including zip code)

(650) 475-3100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter periods 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 large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

At October 30, 2006, there were 77,809,096 shares of Common Stock, \$.01 par value, issued and outstanding.

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****STEMCELLS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 55,440,550	\$ 34,540,908
Receivables	445,368	201,919
Other current assets	1,107,032	386,966
Total current assets	56,992,950	35,129,793
Marketable securities	1,041,527	3,720,794
Property, plant and equipment, net	3,803,441	3,282,588
Other assets, net	2,615,172	2,705,513
Total assets	\$ 64,453,090	\$ 44,838,688
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 592,476	\$ 637,122
Accrued expenses	906,830	1,483,300
Accrued wind-down expenses, current portion	950,079	1,118,796
Deferred revenue, current portion	20,709	
Capital lease obligations, current portion		54,676
Bonds payable, current portion	238,333	254,167
Total current liabilities	2,708,427	3,548,061
Bonds payable, less current maturities	1,177,915	1,351,250
Deposits and other long-term liabilities	495,242	522,866
Accrued wind-down expenses, non-current portion	5,926,763	6,186,930
Deferred rent	1,007,336	853,997
Deferred revenue, non-current portion	227,565	
Total liabilities	11,543,248	12,463,104
Stockholders' equity:		
Common stock, \$.01 par value; 125,000,000 shares authorized; 77,803,368 and 65,396,022 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	778,033	653,960
Additional paid in capital	254,157,840	217,919,336
Accumulated deficit	(198,989,259)	(185,943,565)
Accumulated other comprehensive loss	(3,036,772)	(254,147)

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Total stockholders' equity	52,909,842	32,375,584
Total liabilities and stockholders' equity	\$ 64,453,090	\$ 44,838,688

See accompanying notes to condensed consolidated financial statements.

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STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Revenue:				
Revenue from grants and licensing agreements	\$ 18,321	\$ 91,255	\$ 80,406	\$ 163,345
Total revenue	18,321	91,255	80,406	163,345
Operating expenses:				
Research and development	3,523,078	2,336,562	9,402,472	5,924,591
General and administrative	1,889,512	1,549,443	4,979,349	4,009,187
Wind-down expenses	168,168	297,184	499,186	2,015,384
Total operating expenses	5,580,758	4,183,189	14,881,007	11,949,162
Loss from operations	(5,562,437)	(4,091,934)	(14,800,601)	(11,785,817)
Other income (expense):				
License and settlement agreement, net		3,747,601	103,359	3,747,601
Interest income	735,652	301,255	1,779,016	790,407
Interest expense	(34,062)	(42,021)	(111,159)	(133,777)
Other income (expense)	(2,362)	(8,594)	(16,309)	(29,226)
Total other income (expense)	699,228	3,998,241	1,754,907	4,375,005
Net loss	(\$ 4,863,209)	(\$ 93,693)	(\$ 13,045,694)	(\$ 7,410,812)
Net loss per share basic and diluted	(\$ 0.06)	(\$ 0.00)	(\$ 0.18)	(\$ 0.12)
Weighted average shares used to compute net loss per share basic and diluted	77,779,257	64,179,563	73,487,670	63,226,214
See accompanying notes to condensed consolidated financial statements.				

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STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Nine months ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net loss	(\$13,045,694)	(\$7,410,812)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	790,949	834,135
Amortization of deferred compensation		354,624
Stock-based compensation expense	1,812,962	550,649
Loss on disposal of fixed assets	1,197	1,377
Income from license and settlement agreement	(103,359)	(3,974,883)
Changes in operating assets and liabilities:		
Accrued interest receivable	(119,147)	(31,215)
Receivables	(124,302)	60,517
Other current assets	(720,066)	(237,840)
Other assets	106,271	52,947
Accounts payable and accrued expenses	(621,116)	(670,512)
Accrued wind-down expenses	(428,884)	1,192,125
Deposits received (refunded)	(27,624)	(95,173)
Deferred rent	153,339	186,517
Deferred revenue	248,274	
Net cash used in operating activities	(12,077,200)	(9,187,544)
Cash flows from investing activities:		
Purchase of property, plant and equipment	(1,230,554)	(696,793)
Acquisition of other assets	(88,375)	(80,000)
Net cash used in investing activities	(1,318,929)	(776,793)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	123,186	343,165
Proceeds from the exercise of warrants	994,896	3,753,123
Proceeds from issuance of common stock	33,421,534	
Repayments of capital lease obligations	(54,676)	(39,232)
Repayment of debt obligations	(189,169)	(181,667)
Net cash provided by financing activities	34,295,771	3,875,389
Increase (decrease) in cash and cash equivalents	20,899,642	(6,088,948)
Cash and cash equivalents, beginning of period	34,540,908	41,059,532
Cash and cash equivalents, end of period	\$ 55,440,550	\$ 34,970,584

Supplemental disclosure of cash flow information:

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Interest paid	\$	111,159	\$	133,777
Stock issued for licensing agreements	\$	10,000(1)		

(1) Under terms of a license agreement with the California Institute of Technology (Cal Tech), annual fees of \$5,000 were due on each of two patents to which StemCells holds a license from Cal Tech, payable in cash or stock at the Company's choice. The Company elected to pay the fees in stock and issued 3,848 unregistered shares to Cal Tech.

See accompanying notes to condensed consolidated financial statements

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**Notes to Condensed Consolidated Financial Statements
(Unaudited) September 30, 2006 and 2005**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The terms StemCells, the Company, our, we and us as used in this report refer to StemCells, Inc. The accompanying unaudited, condensed consolidated financial statements have been prepared by the Company in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 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, the accompanying financial statements include all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. Results of operations for the nine months ended September 30, 2006, are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2006.

The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required for complete financial statements in accordance with accounting principles generally accepted in the United States of America. For the complete financial statements, refer to the audited financial statements and footnotes thereto as of December 31, 2005, included on Form 10-K.

The Company has incurred significant operating losses and negative cash flows since inception. It has not achieved profitability and may not be able to realize sufficient revenues to achieve or sustain profitability in the future. The Company has limited capital resources and it will need to raise additional capital from time to time to sustain its product development efforts, acquisition of technologies and intellectual property rights, preclinical and clinical testing of anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, general and administrative expenses and other working capital requirements. To fund its operations, the Company relies on cash balances, proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, and on government grants and collaborative arrangements. The Company cannot be certain that such funding will be available when needed. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Actual results could differ from these estimates. Significant estimates include the following:

Accrued wind-down expenses (Note 4).

The grant date fair value of share-based awards recognized as compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004) *Share-Based Payment* (SFAS 123R). See *Stock-Based Compensation* below.

Marketable securities

In accordance with Statement of Financial Accounting Standards (SFAS) No. 115 *Accounting for Certain Investments in Debt and Equity Securities*, the Company has classified the Company's short-term investments as available-for-sale marketable securities in the accompanying consolidated financial statements. The marketable securities are stated at fair market value, with unrealized gains and losses reported in other comprehensive income. Management

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reviews securities with unrealized losses for other than temporary impairment. A decline in the fair value of securities that is deemed other than temporary is charged to earnings when so deemed.

Reclassification

Certain reclassifications of prior year amounts have been made to conform to current year presentation. Patent related expenses of \$189,980 and \$529,244 for the three and nine-month period ended September 30, 2005 have been reclassified from research and development expense to general and administrative expense on the consolidated statements of operations for that period to conform with current year presentation.

Net Loss Per Share

The Company has computed net loss per common share according to the Statement of Financial Accounting Standards No. 128 *Earnings Per Share*, which requires disclosure of basic and diluted earnings per share. Basic earnings per share excludes any dilutive effects of options, warrants and convertible securities, and is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share includes the impact of potentially dilutive securities and is computed using the weighted average of common and diluted equivalent stock options, warrants and convertible securities outstanding during the period. Stock options, warrants and convertible securities that are anti-dilutive are excluded from the calculation of diluted loss per common share.

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net loss applicable to common stockholders	(\$4,863,209)	(\$93,693)	(\$13,045,694)	(\$7,410,812)
Weighted average shares used in computing net loss per share applicable to common stockholders, basic and diluted.	77,779,257	64,179,563	73,487,670	63,226,214
Net loss per share applicable to common stockholders, basic and diluted.	(\$0.06)	(\$0.00)	(\$0.18)	(\$0.12)

The Company has excluded outstanding stock options and warrants from the calculation of diluted loss per common share because all such securities are anti-dilutive for all applicable periods presented. These outstanding securities consist of the following potential common shares:

	Outstanding at September 30,	
	2006	2005
Outstanding options	8,989,671	6,641,401
Outstanding warrants	1,930,658	3,341,212
Total	10,920,329	9,982,613

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123R. SFAS 123R requires all share-based payments to employees, or to non-employee directors as compensation for service on the Board of Directors, to be recognized as compensation expense in the consolidated financial statements based on the fair values of such payments. The Company maintains shareholder approved stock-based compensation plans, pursuant to which it grants stock-based compensation to its employees, and to non-employee directors for Board service. These grants are primarily in the form of options that allow a grantee to purchase a fixed number of shares of the Company's common stock at a fixed exercise price equal to the market price of the shares at the date of the grant (qualified stock option grants). The options may vest on a single date or in tranches over a period of time,

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but normally they do not vest unless the grantee is still employed by or a director of the Company on the vesting date. The compensation expense for these grants will be recognized over the requisite service period which is typically the period over which the stock-based compensation awards vest. The Company made no modifications to outstanding options with respect to vesting periods or exercise prices prior to adopting SFAS 123R. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 (SAB 107), which provides guidance on the implementation of SFAS 123R. The Company applied the principles of SAB 107 in conjunction with its adoption of SFAS 123R.

The Company adopted SFAS 123R effective January 1, 2006, using the modified-prospective transition method. Under this transition method, compensation expense will be recognized based on the grant date fair value estimated in accordance with the provisions of SFAS 123R for all new grants effective January 1, 2006, and for options granted prior to but not vested as of December 31, 2005. Prior periods were not restated to reflect the impact of adopting the new standard and therefore do not include compensation expense related to qualified stock option grants for those periods. In accordance with SFAS 123R, the Company recognized stock option related compensation expense of approximately \$696,000 and \$1,604,000 for the three and nine month periods ended September 30, 2006. All options granted in the three and nine month period ended September 30, 2006 were qualified stock options and the related compensation expense was recognized on a straight line basis over the vesting period of each grant net of estimated forfeitures. The Company's estimated forfeiture rates are based on its historical experience within separate groups of employees. The estimated fair value of the options granted during 2006 and prior years was calculated using a Black Scholes Merton option pricing model (Black Scholes model). The following summarizes the assumptions used in the Black Scholes model as applied in the first three quarters of 2006:

	First Quarter 2006	Second Quarter 2006	Third Quarter 2006
Risk free interest rate ⁽¹⁾	4.72%	5.08%	4.68%
Volatility ⁽²⁾	119.5%	110.8%	106.6%
Dividend yield ⁽³⁾	0%	0%	0%
Expected term (years until exercise) ⁽⁴⁾	6.25	6.25	6.25

(1) The risk-free interest rate is based on US Treasury debt securities with maturities close to the expected term of the option.

(2) Expected volatility is based on historical volatility of the Company's stock factoring in daily share price observations. In computing

expected volatility, the length of the historical period used is equal to the length of the expected term of the option.

- (3) No cash dividends have been declared on the Company's common stock since the Company's inception, and the Company currently does not anticipate paying cash dividends over the expected term of the option.

- (4) The expected term is equal to the average of the contractual life of the stock option and its vesting period.

At September 30, 2006, approximately \$7,310,000 of unrecognized compensation expense related to stock options is expected to be recognized over a weighted average period of approximately 1.7 years. The resulting effect on net loss and net loss per share attributable to common stockholders is not likely to be representative of the effects in future periods, due to changes in forfeiture rates, additional grants and subsequent periods of vesting.

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Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. In accordance with APB 25, the Company recognized no compensation expense for qualified stock option grants, as the options were granted at fair market price of the underlying shares on the date of the grant. For options issued with an exercise price less than the fair market value of the shares at the date of grant, the Company recognized the difference between the exercise price and fair market value as compensation expense in accordance with APB 25. Prior to January 1, 2006, the Company provided pro forma disclosure amounts in accordance with Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation*, (SFAS 123) as amended by Statement of Financial Accounting Standards No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure*, (SFAS 148). As compensation expense was disclosed but not recognized in periods prior to January 1, 2006, no cumulative adjustment for forfeitures was recorded in 2006. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation in the prior three and nine-month periods ended September 30, 2005:

	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net loss as reported	(\$93,693)	(\$7,410,812)
Add: Stock-based employee/director compensation expense included in reported net loss		
Deduct: Total stock-based employee/director compensation expense under the fair value based method for all awards	(507,833)	(746,525)
Net loss pro forma	(\$601,526)	(\$8,157,337)
Basic and diluted net loss per share as reported	(\$0.00)	(\$0.12)
Basic and diluted net loss per share pro forma	(\$0.01)	(\$0.13)
Shares used in basic and diluted loss per share amounts	64,179,563	63,226,214

The Company accounts for stock options granted to non-employees in accordance with SFAS 123 and Emerging Issues Task Force (EITF) 96-18 *Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring, Or In Conjunction With Selling, Goods Or Services*, and accordingly, recognizes as expense the estimated fair value of such options as calculated using the Black Scholes model. The fair value is re-measured at each reporting date during the service period and is amortized over the vesting period of each option or the recipient's contractual arrangement, if shorter. No stock options were issued to non-employees during the three and nine month period ending September 30, 2006, other than options granted to non-employee members of the Board of Directors for service as Board members.

Stock Appreciation Rights

In July 2006, the Company, pursuant to the 2006 Equity Incentive Plan, granted cash-settled Stock Appreciation Rights (SARs) to certain employees. The SARs give the holder the right, upon exercise, to the difference between the price per share of the Company's common stock at the time of exercise and the exercise price of the SAR. The exercise price of the SARs is equal to the market price of the Company's common shares at the date of grant. The SARs will vest on the same schedule as the Company's qualified options issued to employees, i.e., 25% on the first anniversary of the grant date and then 1/48th every month thereafter. The Company will recognize compensation expense for the SARs over the requisite service period which is typically the period over which the awards vest. Since the vesting schedule of the SARs is identical to the vesting schedule of options granted this period, the Company's fair value calculation of the SARs issued using the Black Scholes model were based on the same assumptions used in calculating compensation expense for stock options granted this period. The

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fair value of the share-based compensation liability for the cost of the requisite service that has been rendered at the reporting date is re-measured at each reporting date through the date of settlement. The following table presents the activity of the Company's SARs awards for the nine month periods ended September 30, 2006 and 2005.

	2006	Weighted Average Exercise Price	2005	Weighted Average Exercise Price
	SARs		SARs	
	2006		2005	
Outstanding at January 1				
Granted	1,564,599	\$ 2.00		
Exercised				
Canceled				
Outstanding at September 30	1,564,599	\$ 2.00		

SARs exercisable at September 30

At September 30, 2006, approximately \$2,100,000 of unrecognized compensation expense related to SARs is expected to be recognized over a weighted average period of approximately 2 years. The resulting effect on net loss and net loss per share attributable to common stockholders is not likely to be representative of the effects in future periods, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting.

Revenue Recognition

Revenues from collaborative agreements and grants are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the collaborative agreement. The Company currently recognizes revenues resulting from the licensing and use of our technology and intellectual property. Such licensing agreements may contain multiple elements, such as upfront fees, payments related to the achievement of particular milestones and royalties. Revenue from upfront fees for licensing agreements that contain multiple elements are deferred and recognized on a straight-line basis over the term of the agreement, fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned.

Recent Accounting Pronouncements

The Company is currently evaluating the following recent accounting pronouncements:

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (an Interpretation of FASB Statement No. 109) (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on subsequent derecognition of tax positions, financial statement classification, recognition of interest and penalties, accounting in interim periods, and disclosure and transition requirements. FIN 48 is effective for the Company's fiscal year beginning January 1, 2007, with early adoption permitted. The Company is currently evaluating the impact, if any, of the adoption of FIN 48 on its consolidated financial statements.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after

November 15, 2007, and for interim periods within those fiscal years. The Company is currently evaluating the

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requirements of SFAS 157; however, it does not believe that its adoption will have a material effect on its consolidated financial statements.

In September 2006, the Staff of the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB No.108). SAB No. 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of determining whether the current year's financial statements are materially misstated. SAB No. 108 is effective for the Company's fiscal year beginning January 1, 2007. The Company is currently evaluating the requirements of SAB No. 108; however, it does not believe that its adoption will have a material effect on its consolidated financial statements.

NOTE 2. RENEURON LICENSE AND SETTLEMENT AGREEMENT

In July 2005, the Company entered into a license and settlement agreement with ReNeuron Limited, a wholly owned subsidiary of ReNeuron Group plc, a publicly listed UK corporation (collectively referred to as "ReNeuron"). As part of the agreement, the Company granted ReNeuron a license that allows ReNeuron to exploit their c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. In return for the license, StemCells received a 7.5% fully-diluted equity interest in ReNeuron, subject to certain anti-dilution provisions, and a cross-license to the exclusive use of ReNeuron's technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either StemCells or ReNeuron might have had against the other in connection with any putative infringement of certain of each party's patent rights prior to the effective date of the agreement. The agreement is Exhibit 10.71 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. An amendment to the agreement was entered on April 3, 2006, a copy of which was attached as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006. On June 29, 2006, ReNeuron issued additional shares of common stock, of which StemCells was entitled to 439,071 shares because of the anti-dilution provisions within the agreement and net of shares due to Neurospheres Ltd., an Alberta corporation from which StemCells has licensed some of the patent rights that are the subject of the agreement with ReNeuron. The Company recorded approximately \$103,000 as other income for the additional shares. The fair market value of the Company's holdings in ReNeuron common stock as of December 31, 2005 (8,835,766 shares) and September 30, 2006 (9,274,837 shares) was approximately \$3,721,000 and \$1,042,000 respectively. Changes in market value as a result of changes in market price per share or the exchange rate between the US dollar and the British pound are accounted for under other comprehensive loss if deemed temporary, as in this case, and are not recorded as other income or loss until the shares are disposed of and a gain or loss realized. The unrealized loss as of September 30, 2006, is approximately \$3,037,000. A decline in the fair value of securities that is deemed other than temporary would be charged to earnings.

NOTE 3. LEASES

The Company had undertaken direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling \$5,000,000 to finance the construction of a pilot manufacturing facility related to its former encapsulated cell technology. The related leases are structured such that lease payments will fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. Interest rates vary with the respective bonds' maturities, ranging currently from 8.1% to 9.5%. The outstanding principal at September 30, 2006 was approximately \$1,416,000. The bonds contain certain restrictive covenants, which limit among other things, the payment of cash dividends and the sale of the related assets.

The Company entered into a fifteen-year lease for a laboratory facility in connection with a sale and leaseback arrangement in 1997. The lease has escalating rent payments and accordingly, the Company is recognizing rent expense on a straight-line basis. At December 31, 2005 and September 30, 2006, the Company had deferred rent liability for this facility of approximately \$1,208,000 and \$1,231,000 respectively; the deferred rent liability is presented as part of the wind-down accrual.

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Although the Company previously discontinued activities relating to encapsulated cell technology, the Company remains obligated under the leases for the pilot manufacturing facility and the laboratory facility. The Company has succeeded in subleasing the pilot manufacturing facility and part of the laboratory facility. The aggregate income received by the Company is significantly less than the Company's aggregate obligations under the leases, and the Company's continued receipt of rental income is dependent on the financial ability of the occupants to comply with their obligations under the subleases. The Company continues to seek to sublet the vacant portions of the Rhode Island facilities, to assign or sell its interests in all of these properties, or to otherwise arrange for the termination of its obligations under the lease obligations on these facilities. There can be no assurance, however, that the Company will be able to dispose of these properties in a reasonable time, if at all, or to terminate its lease obligations without the payment of substantial consideration.

As of February 1, 2001, the Company entered into a 5-year lease for 40,000 square feet of an approximately 68,000 square foot facility located in the Stanford Research Park in Palo Alto, CA. The facility includes space for animals, laboratories and offices. On December 19, 2002 the Company negotiated an amendment to the lease, which resulted in reducing the average annual rent over the remaining term of the lease from approximately \$3.7 million to \$2.0 million. As part of the amendment the Company issued a letter of credit on January 2, 2003 for \$503,079, which was an addition to the letter of credit in the amount of \$275,000 issued at commencement of the lease, to serve as a deposit for the duration of the lease. The Company negotiated an amendment to the lease effective April 1, 2005, which extends the term of the lease through March 31, 2010, includes an immediate reduction in the rent per square foot, and provides for an expansion of the leased premises by approximately 28,000 additional square feet effective July 1, 2006. In addition, the Company sublet some of the additional space for the period from April 1, 2005 through June 30, 2006. The average annual rent due from the Company under its lease for the period commencing April 1, 2005 to March 31, 2010 is approximately \$2 million before subtenant income. The lease has escalating rent payments, which the Company is recognizing on a straight-line basis. At September 30, 2006, the Company had deferred rent liability for this facility of approximately \$1,007,000. At September 30, 2006 the Company has a space-sharing agreement covering in total approximately 11,000 square feet of this facility. The Company receives the amount of base rent plus the proportionate share of the operating expenses that it pays for such space over the term of these agreements.

NOTE 4. RELOCATION TO CALIFORNIA FROM RHODE ISLAND

In October 1999, the Company relocated to California from Rhode Island and established a wind down reserve for the estimated lease payments and operating costs of the Rhode Island facilities through an expected disposal date of June 30, 2000. The Company did not fully sublet the Rhode Island facilities in 2000. Even though the Company intends to dispose of the facility at the earliest possible time, the Company's management cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, the Company periodically re-evaluates and adjusts the reserve. The Company considers various factors such as the Company's lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy. At December 31, 2005 the reserve was approximately \$6,098,000. For the three and nine-month period ended September 30, 2006, the Company incurred approximately \$368,000 and \$950,000 respectively in operating expenses, which was recorded against the reserve. After evaluating the afore-mentioned factors the Company re-valued the reserve to \$5,647,000 at September 30, 2006 by recording an additional \$156,000, \$175,100 and \$168,000 at March 31, 2006, June 30, 2006 and September 30, 2006 respectively, as wind-down expenses.

Wind-down reserve

	January to March 31, 2006	April to June 30, 2006	July to September 30, 2006	January to September 30, 2006	January to December 31, 2005
Accrued wind-down reserve at beginning of period	\$6,098,000	5,970,000	5,847,000	\$6,098,000	\$ 4,350,000

Less actual expenses recorded against estimated reserve during the period	(284,000)	(298,000)	(368,000)	(950,000)	(1,079,000)
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	January to March 31, 2006	April to June 30, 2006	July to September 30, 2006	January to September 30, 2006	January to December 31, 2005
Additional expense recorded to revise estimated reserve at period-end	156,000	175,000	168,000	499,000	2,827,000
Revised reserve at period-end	5,970,000	5,847,000	5,647,000	5,647,000	6,098,000
Add deferred rent at period end (See Note 3)	1,215,000	1,223,000	1,230,000	1,230,000	1,208,000
Total accrued wind-down expenses at period-end (current and non current portion)	\$7,185,000	\$7,070,000	\$6,877,000	\$6,877,000	\$7,306,000