

INTERLEUKIN GENETICS INC
Form 10-Q
November 07, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2007

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

For the transition period from July 1, 2007 to September 30, 2007

Commission File Number: 001-32715

INTERLEUKIN GENETICS, INC.

(Exact name of registrant in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

135 Beaver Street, Waltham, MA

(Address of principal executive offices)

94-3123681

(I.R.S. Employer Identification No.)

02452

(Zip Code)

Registrant's Telephone Number: (781) 398-0700

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

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

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

Class
Common Stock, par value \$0.001 per share

Outstanding at October 31, 2007
27,639,120

TABLE OF CONTENTS

| | Page |
|---|------|
| <u>PART I FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements of Interleukin Genetics, Inc. and Subsidiaries</u> | |
| <u>Consolidated Balance Sheets as of September 30, 2007 (Unaudited) and December 31, 2006 (Audited)</u> | 3 |
| <u>Consolidated Statements of Operations (Unaudited)</u> | 4 |
| <u>Consolidated Statements of Stockholders' Equity (Unaudited)</u> | 5 |
| <u>Consolidated Statements of Cash Flows (Unaudited)</u> | 6 |
| <u>Notes to Interim Consolidated Financial Statements (Unaudited)</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 24 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 31 |
| <u>Item 4. Controls and Procedures</u> | 32 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 33 |
| <u>Item 1A. Risk Factors</u> | 33 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 33 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 33 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 33 |
| <u>Item 5. Other Information</u> | 33 |
| <u>Item 6. Exhibits</u> | 33 |
| <u>Signatures</u> | 34 |
| <u>Exhibit Index</u> | 35 |

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | September 30, 2007 (Unaudited) | December 31, 2006 (Audited) |
|--|--------------------------------------|-----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 8,058,276 | \$ 10,082,919 |
| Accounts receivable from related party | 103,137 | 199,395 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$6,696 and \$28,000 at September 30, 2007 and December 31, 2006, respectively | 1,031,751 | 769,053 |
| Inventory | 970,921 | 1,504,154 |
| Prepaid expenses and other current assets | 304,266 | 435,592 |
| Total current assets | 10,468,351 | 12,991,113 |
| Fixed assets, net | 650,087 | 875,934 |
| Intangible assets, net | 7,624,065 | 8,726,820 |
| Other assets | 53,333 | 36,418 |
| Total Assets | \$ 18,795,836 | \$ 22,630,285 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,127,584 | \$ 948,421 |
| Accrued expenses | 1,953,164 | 2,119,729 |
| Deferred receipts | 1,275,276 | 1,277,132 |
| Commitments for funded research and development projects | 92,056 | 165,556 |
| Due to seller under the asset purchase agreement | 744,053 | 744,053 |
| Convertible debt, net of discount of \$115,468 at September 30, 2007 and \$461,874 at December 31, 2006 | 2,479,868 | 2,133,462 |
| Total current liabilities | 7,672,001 | 7,388,353 |
| Contingent acquisition consideration | 1,466,741 | 1,449,001 |
| Deferred tax liability | 19,000 | 7,000 |
| Total liabilities | 9,157,742 | 8,844,354 |
| Stockholders equity: | | |
| Convertible preferred stock \$0.001 par value 6,000,000 shares authorized; 5,000,000 shares of Series A issued and outstanding at September 30, 2007 and December 31, 2006; aggregate liquidation preference of \$18,000,000 at September 30, 2007 | 5,000 | 5,000 |
| Common stock \$0.001 par value 100,000,000 shares authorized; 27,639,120 and 27,406,984 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively | 27,639 | 27,407 |
| Additional paid-in capital | 82,466,249 | 81,896,060 |
| Accumulated deficit | (72,860,794) | (68,142,536) |
| Total stockholders equity | 9,638,094 | 13,785,931 |
| Total liabilities and stockholders equity | \$ 18,795,836 | \$ 22,630,285 |

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

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------------------|---------------------------------|------------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| Revenue from related party | \$ 757,904 | \$ 649,106 | \$ 2,191,228 | \$ 2,209,564 |
| Revenue from others | 1,803,381 | 685,825 | 5,197,802 | 702,281 |
| Total revenue | 2,561,285 | 1,334,931 | 7,389,030 | 2,911,845 |
| Operating expenses: | | | | |
| Cost of genetic testing services | 211,953 | 331,836 | 721,090 | 937,770 |
| Cost of consumer products sold | 995,769 | 675,101 | 2,882,072 | 675,101 |
| Research and development | 785,942 | 721,731 | 2,246,340 | 2,382,390 |
| Selling, general and administrative | 1,163,531 | 1,196,263 | 4,821,032 | 2,702,517 |
| Amortization of intangibles | 413,209 | 145,322 | 1,236,074 | 193,830 |
| Total operating expenses | 3,570,404 | 3,070,253 | 11,906,608 | 6,891,608 |
| Loss from operations | (1,009,119) | (1,735,322) | (4,517,578) | (3,979,763) |
| Other income (expense): | | | | |
| Interest income | 108,116 | 77,652 | 340,762 | 149,845 |
| Interest expense | (61,187) | (60,510) | (183,036) | (169,984) |
| Amortization of note discount | (115,469) | (115,469) | (346,406) | (346,407) |
| Total other expense | (68,540) | (98,327) | (188,680) | (366,546) |
| Net loss before income taxes | (1,077,659) | (1,833,649) | (4,706,258) | (4,346,309) |
| Provision for income taxes | (4,000) | | (12,000) | |
| Net loss | \$ (1,081,659) | \$ (1,833,649) | \$ (4,718,258) | \$ (4,346,309) |
| Basic and diluted net loss per common share | \$ (0.04) | \$ (0.07) | \$ (0.17) | \$ (0.18) |
| Weighted average common shares outstanding | 27,637,303 | 25,745,809 | 27,576,940 | 24,658,213 |

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

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2007
(Unaudited)

| | Convertible Preferred Stock | | Common Stock | | Additional | Accumulated | Total |
|--|-----------------------------|-------------------|-------------------|-------------------|----------------------|-------------------------|----------------------|
| | Shares | \$0.001 par value | Shares | \$0.001 par value | Paid-in Capital | Deficit | |
| Balance as of December 31, 2006 (Audited) | 5,000,000 | \$ 5,000 | 27,406,984 | \$ 27,407 | \$ 81,896,060 | \$ (68,142,536) | \$ 13,785,931 |
| Net loss | | | | | | (4,718,258) | (4,718,258) |
| Common stock issued: | | | | | | | |
| Exercise of stock options | | | 194,917 | 195 | 347,215 | | 347,410 |
| Employee stock purchase plan | | | 5,707 | 6 | 14,860 | | 14,866 |
| Common stock issued to employees | | | 7,000 | 7 | (7) | | |
| Restricted stock issued to employees | | | 12,500 | 12 | (12) | | |
| Rights offering, net of issuance costs | | | 12,012 | 12 | 52,670 | | 52,682 |
| Stock-based compensation expense | | | | | 155,463 | | 155,463 |
| Balance as of September 30, 2007 | 5,000,000 | \$ 5,000 | 27,639,120 | \$ 27,639 | \$ 82,466,249 | \$ (72,860,794) | \$ 9,638,094 |

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

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | For the Nine Months Ended | |
|--|----------------------------------|---------------------|
| | September 30, | |
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (4,718,258) | \$ (4,346,309) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization of fixed assets | 250,256 | 241,708 |
| Amortization of intangible assets | 1,217,369 | 155,838 |
| Amortization of note discount | 346,406 | 346,405 |
| Income taxes | 12,000 | |
| Stock-based and other compensation expense | 156,193 | 713,506 |
| Changes in operating assets and liabilities, excluding the effects of the acquisition: | | |
| Accounts receivable, net | (166,440) | (101,619) |
| Inventory | 533,233 | 235,423 |
| Prepaid expenses and other current assets | 114,411 | (153,022) |
| Accounts payable | 179,163 | 4,745 |
| Accrued expenses | (166,563) | (207,316) |
| Deferred receipts | (1,857) | (298,223) |
| Commitments for funded R&D | (73,500) | (169,113) |
| Net cash used in operating activities | (2,317,587) | (3,577,977) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of fixed assets | (25,137) | (146,297) |
| Increase in other assets | (114,617) | (111,248) |
| Acquisition of the assets and business of the Alan James Group, LLC, including transaction costs paid of \$530,087 | 17,740 | (7,561,344) |
| Cash used in investing activities | (122,014) | (7,818,889) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from investment by Alticor | | 17,014,665 |
| Proceeds from exercises of warrants and stock options | 347,410 | 822,513 |
| Proceeds from employee stock purchase plan | 14,866 | 31,631 |
| Proceeds from rights offering, net of issuance costs | 52,682 | |
| Principal payments of capital lease obligations | | (2,977) |
| Net cash provided by financing activities | 414,958 | 17,865,832 |
| Net (decrease) increase in cash and cash equivalents | (2,024,643) | 6,468,966 |
| Cash and cash equivalents, beginning of period | 10,082,919 | 3,415,174 |
| Cash and cash equivalents, end of period | \$ 8,058,276 | \$ 9,884,140 |
| Supplemental disclosures of cash flow information: | | |
| <i>Non-cash investing and financing activities:</i> | | |
| Deferred receipt reclassified to equity | \$ | \$ 1,274,210 |
| <i>Interest paid:</i> | | |
| Cash paid for interest | \$ 183,036 | \$ 169,984 |

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

INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 Basis of Presentation

The consolidated financial statements include the accounts of Interleukin Genetics, Inc. (the Company), and its wholly-owned subsidiaries, as of September 30, 2007 and have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting 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 notes required by generally accepted accounting principles for complete financial statements. All intercompany accounts and transactions have been eliminated. These unaudited interim consolidated financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, as amended. Operating results for the three months and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

Note 2 Acquisition

In August 2006, the Company acquired the assets and business of the Alan James Group, LLC (the Alan James Group). The acquired business primarily develops, markets and sells nutritional products and OTCeicals and engages in related activities. Interleukin and the Alan James Group have complementary capabilities in genetic testing services and preventive healthcare products distribution. By combining these capabilities, the Company is positioned to expand its science-based solutions portfolio, commercialize its products and services and offer a broad selection of innovative, preventive and personalized products to its customers. The initial purchase price consisted of the payment of \$7,031,257 in cash and the obligation to place in escrow \$250,000 and 88,055 shares of the Company's Common Stock valued at \$500,000, or \$5.6873 per share (based on the volume-weighted average closing stock price for the 20 consecutive trading days ending August 15, 2006). The seller has agreed that the Company may apply the \$250,000 cash and the 88,055 shares that were to be placed in escrow against certain post-closing claims. As a result, management believes the Company is no longer obligated, effective July 2007, for payment of the \$250,000 and 88,055 common stock shares that were to be placed in escrow. The Company is also responsible for paying additional contingent consideration of up to \$1,500,000 in cash and up to 1,628,833 shares of Common Stock over the next three years upon achievement of certain earnings milestones by the acquired business. The acquisition was accounted for as a purchase in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS No. 141). Accordingly, the consolidated financial statements include the results of the acquired company's operations since the acquisition date, August 17, 2006.

The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The estimated fair value of the assets acquired and liabilities assumed exceeded the initial payments by approximately \$2.2 million resulting in negative goodwill. Pursuant to SFAS No. 141, the Company recorded as a liability, contingent consideration up to the amount of negative goodwill. If and when contingent payments become due, the Company will apply the contingent payments against the liability. Contingent payments in excess of \$2.2 million, if any, will be recorded as goodwill.

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

The components of the purchase price allocation are as follows:

| Purchase Price: | |
|---------------------------------------|--------------|
| Cash | \$ 7,031,257 |
| Transaction costs | 632,260 |
| | \$ 7,663,517 |
| Allocation: | |
| Accounts Receivable | \$ 1,479,837 |
| Inventory | 2,000,000 |
| Other current assets | 108,611 |
| Property and equipment | 110,144 |
| Acquired intangible assets | 8,800,000 |
| Accounts payable and accrued expenses | (2,618,334) |
| Contingent acquisition costs | (2,216,741) |
| | \$ 7,663,517 |

Acquired intangible assets are as follows:

| Identified Intangible Assets | Estimated Fair Value | Estimated Remaining Useful Life |
|---------------------------------------|-----------------------------|--|
| Retailer Relationships | \$ 5,200,000 | 5 years |
| Indefinite Lived Trademarks | 1,000,000 | N/A |
| Definite Lived Trademarks | 1,100,000 | 5 years |
| Non-Compete Agreements | 200,000 | 4 years |
| OTCceutical Formulations | 1,300,000 | 5 years |
| Total Fair Value of Intangible Assets | \$ 8,800,000 | |

For tax purposes, the fair value of the non-current tangible and intangible assets will be reduced pro rata to the extent of the contingent liability with a resultant reduction in amortization for tax purposes. If, and when, the contingent liability is paid, the tax basis of the non-current tangible assets will be increased pro rata in the amount of the contingent payment up to the non-current assets fair value at the date of acquisition. The unamortized tax basis will be amortized over the assets remaining useful life.

Had the acquisition of the Alan James Group been completed at the beginning of 2006, the Company's pro forma results would have been as follows:

| | For the Three Months Ended September 30, 2006 | For the Nine Months Ended September 30, 2006 |
|---|--|---|
| Revenue | \$ 2,485,119 | \$ 7,921,702 |
| Net loss | \$ (1,616,880) | \$ (6,000,198) |
| Basic and diluted net loss per common share | \$ (0.06) | \$ (0.23) |

Note 3 Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Interleukin Genetics, Inc., and its wholly-owned subsidiaries, Interleukin Genetics Laboratory Services, Inc. and AJG Brands, Inc. doing business as the Alan James Group. All intercompany accounts and transactions have been eliminated. Results of AJG Brands, Inc. are included in operations since August 17, 2006, the date of acquisition.

Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reported periods. Actual results could differ from those estimates. The Company's most critical accounting policies are in areas of its strategic alliance with Alticor, revenue recognition, allowance for sales returns, trade promotions, accounts receivable, inventory, stock-based compensation, income taxes, long-lived assets, intangible assets, beneficial conversion feature of convertible instruments and below market interest rate on debt. These critical accounting policies are more fully discussed in these notes to the consolidated financial statements.

Strategic Alliance with Alticor

In a private placement on March 5, 2003, the Company entered into a Stock Purchase Agreement with Alticor, pursuant to which Alticor purchased from the Company 5,000,000 shares of the Company's Series A Preferred Stock, \$0.001 per share, for \$7,000,000 in cash and an additional \$2,000,000 in cash paid upon the Company reaching a milestone pursuant to the terms of the Stock Purchase Agreement. The Series A Preferred Stock issued in the private placement was initially convertible into 28,157,683 shares of the Company's Common Stock at the purchaser's discretion. Pursuant to the terms of the Stock Purchase Agreement, Alticor also agreed to refinance, in the form of convertible debt, certain of the Company's indebtedness in the form of previously issued promissory notes that were held by Alticor and certain individuals. This amounted to \$2,595,336 in debt refinanced and was initially convertible into 5,219,903 shares of the Company's Common Stock. Concurrent with the closing of the Stock Purchase Agreement, the Company entered into a research agreement with Alticor that would provide additional funding of \$5,000,000 to be paid quarterly over a two-year period.

In accordance with Emerging Issues Task Force (EITF) No. 01-1, the terms of both the agreement for goods or services provided and the convertible instruments should be evaluated to determine whether their separately stated pricing is equal to the fair value of the goods or services provided and the convertible instruments. If that is not the case, the terms of the respective transactions should be adjusted. The convertible instruments should be recognized at fair value with a corresponding increase or decrease in the sales price of the goods or services.

On March 5, 2003, the Company was obligated to issue up to 33,377,586 shares of its common stock underlying the convertible preferred stock and the convertible debt issued. Based on the last reported trade price of \$0.71 per common share of the Company's common stock on March 5, 2003, the convertible instruments had a fair value of \$23,698,086 on the date of issuance. Based on the fair value of the convertible instruments and the guidance provided by EITF 01-1, the Company recognized the fair value of the convertible instruments, to the extent of proceeds received, with a corresponding decrease to the sales price of the goods and services provided. At March 5, 2003, the Company treated the \$5,000,000 committed research funding as an equity investment rather than revenue and any costs of performing the research services under the agreement were classified as research and development expenses. Any subsequent proceeds that the Company received from Alticor that were linked to the March 2003 transaction, were considered equity rather than revenue to the extent of the fair value of the convertible instruments at March 5, 2003. In June 2004, the Company entered into another research agreement with Alticor for potential funding up to \$2,200,000 and in March 2005, the Company entered into two more agreements to provide additional funding of \$5,057,651 over two years beginning April 1, 2005. In addition, since March 5, 2003, the Company received various purchase orders from Alticor valued at \$501,800 to conduct genotyping test for research purposes. These purchase orders, together with the research agreements entered into in June 2004 and March 2005, were deemed to be linked to the March 2003

transaction, and, accordingly, were treated as equity rather than revenue. As of December 31, 2006, proceeds received from Alticor, which were recorded as consideration for the fair value of the convertible instruments issued in March 2003, amounted to \$23,698,086.

In March 2007, the Company entered into an agreement, effective January 1, 2007, to expand the research being performed under its current agreements with Alticor through 2007. The research agreement is expected to provide the Company with \$2.3 million during 2007, on a time and material basis. The Company recorded revenue associated with this agreement in accordance with its revenue recognition policy.

Revenue Recognition

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectibility is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test. To the extent that tests have been prepaid but results have not yet been reported, recognition of all related revenue is deferred. As of September 30, 2007 and December 31, 2006, deferred receipts includes \$12,250, and \$0, respectively, for tests that have been prepaid but results have not yet been reported.

Revenue from product sales is recognized when there is persuasive evidence of an arrangement, delivery has occurred and title and risk of loss have transferred to the customer, the sales price is determinable and collectibility is reasonably assured. The Company has no consignment sales. Product revenue is reduced for allowances and adjustments, including returns, discontinued items, discounts, trade promotions and slotting fees.

Revenue from contract research and development is recognized over the term of the contract as the Company performs its obligations under that contract.

Allowance for Sales Returns

The Company's recognition of revenue from sales to retailers is impacted by giving them rights to return damaged and outdated products as well as the fact that as a practical business matter, the Company's sales force, along with its customers, are constantly working to ensure profitability of its products within retailers by rotating slow moving items out of stores and replacing those products with what the Company and the retailer expect will be more profitable, faster selling items. For product sales the Company believes it can reasonably and reliably estimate future returns, it recognizes revenue at the time of sale. For product sales which it cannot estimate future returns, particularly new products, the Company defers revenue recognition until the return privilege has substantially expired or the amount of future returns can be reasonably estimated. As of September 30, 2007 and December 31, 2006, the Company has deferred \$91,748, and \$59,949, respectively, of revenue for sales in which it cannot reasonably and reliably estimate future returns.

The Company analyzes sales returns in accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists*. The Company is able to make reasonable and reliable estimates based on its history. The Company also monitors the buying patterns of the end-users of its products based on sales data received. The Company reviews its estimated product returns based on expected data communicated by its customers. The Company also monitors the levels of inventory at its largest customers to avoid excessive customer stocking of merchandise. The Company believes it has sufficient interaction and knowledge of its customers and of the industry trends and conditions to adjust the accrual for returns when necessary. The Company believes that this analysis creates appropriate estimates of expected future returns. There is no guarantee that future returns will not increase to, or exceed, the levels experienced in the past.

Furthermore, the possibility exists that should the Company lose a major account, it may agree to accept a substantial amount of returns.

Trade Promotions

The Company uses objective procedures for estimating its allowance for trade promotions. The allowance for trade promotions offered to customers is based on contracted terms or other arrangements agreed in advance.

Accounts Receivable

Trade accounts receivable are stated at their estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offers its customers a 2% cash discount if payment is made within 30 days of invoice date. As of September 30, 2007 and December 31, 2006, the Company has reduced trade accounts receivable by \$19,198 and \$9,327, respectively, for anticipated discounts taken. A provision is made for estimated bad debts based on management's estimate of the amount of possible credit losses in the Company's existing accounts receivable. As of September 30, 2007 and December 31, 2006, the Company has provided an allowance for uncollectible accounts of \$6,696 and \$28,000, respectively.

Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the specific identification method. Management periodically evaluates inventory to identify items that are slow moving or have excess quantities. Management also considers whether certain items are carried at values that exceed the ultimate sales price less selling costs. Where such items are identified, management adjusts the carrying value to lower of cost or market.

Inventory on hand primarily consisted of the following at September 30, 2007 and December 31, 2006:

| | 2007 | 2006 |
|----------------|------------|--------------|
| Raw materials | \$ 126,263 | \$ 17,375 |
| Finished goods | 844,658 | 1,486,779 |
| Total | \$ 970,921 | \$ 1,504,154 |

Stock-Based Compensation

The Company accounts for its stock-based compensation expense in accordance with SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R) using the modified prospective basis. SFAS No. 123R addresses all forms of share-based payment (SBP) awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R requires the Company to expense SBP awards with compensation cost for SBP transactions measured at fair value. SFAS No. 123R applies to new equity awards and to equity awards modified, repurchased or canceled after the effective date, January 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the effective date shall be recognized as the requisite service is rendered on or after the effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated from the pro forma disclosures under SFAS No. 123. Additionally, common stock purchased pursuant to its employee stock purchase plan is expensed based upon the fair market value in excess of purchase price.

Income Taxes

The preparation of its consolidated financial statements requires the Company to estimate its income taxes in each of the jurisdictions in which it operates, including those outside the United States, which may be subject to certain risks that ordinarily would not be expected in the United States. The income tax accounting process involves estimating its actual current exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in the recognition of deferred tax assets and liabilities. The Company must then record a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized.

Significant management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets. The Company has recorded a full valuation allowance against its deferred tax assets of \$20.7 million as of September 30, 2007, due to uncertainties related to its ability to utilize these assets. The valuation allowance is based on management's estimates of taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or management adjusts these estimates in future periods, the Company may need to adjust its valuation allowance, which could materially impact its financial position and results of operations.

Long-Lived Assets

The Company applies the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144). SFAS No. 144 requires that the Company evaluate its long-lived assets for impairment whenever events or changes in circumstances indicate that carrying amounts of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted net cash flows expected to be generated by the asset. Any write-downs, based on fair value, are to be treated as permanent reductions in the carrying amount of the assets. The Company believes that no impairment exists related to the Company's long-lived assets at September 30, 2007.

Intangible Assets

Purchase accounting requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair market value of the assets purchased and liabilities assumed. The Company accounted for its acquisitions using the purchase method of accounting. Values were assigned to goodwill and intangible assets based on third-party independent valuations, as well as management's forecasts and projections that include assumptions related to future revenue and cash flows generated from the acquired assets.

The Company applies the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires impairment tests be periodically repeated and on an interim basis, if certain conditions exist, with impaired assets written down to fair value. The Company believes that no impairment exists related to the Company's intangible assets at September 30, 2007.

Beneficial Conversion Feature of Convertible Instruments

Based on EITF No. 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments* (EITF No. 00-27), which provides guidance on the calculation of a beneficial conversion feature of a convertible instrument, the Company has determined that the convertible debt issued on March 5, 2003 contained a beneficial conversion feature.

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

Based on the effective conversion price of the convertible debt of \$0.2875 and the market value per share of \$0.71 at March 5, 2003, the intrinsic value was calculated to be \$2,205,522; however in accordance with EITF No. 00-27, the amount of the discount allocated to the beneficial conversion feature is limited to the amount of the proceeds allocated to the instrument. The beneficial conversion feature resulted in a discount of the convertible debt of \$1,500,609 at March 5, 2003. The amount of the discount allocated to the beneficial conversion feature of the convertible debt is amortized from the date of issuance to the earlier of the maturity or conversion date. Therefore, the Company charged \$77,619 for each of the three months ended September 30, 2007 and 2006 and \$232,853 for each of the nine months ended September 30, 2007 and 2006 to amortization of note discount.

Below Market Interest Rate

The convertible debt has a stated interest rate of prime plus 1%. However, the promissory notes, refinanced with the convertible debt, originally had a stated interest rate of 15%. Therefore, the Company determined the fair value of the convertible debt, using an interest rate comparable to that of the refinanced promissory notes, at \$1,863,553. The resulting discount of \$731,783 is amortized from the date of issuance to the earlier of maturity or conversion date. Therefore, the Company charged \$37,850 to amortization of note discount for the three months ended September 30, 2007 and 2006 and \$113,553 for each of the nine months ended September 30, 2007 and 2006.

Basic and Diluted Net Loss per Common Share

The Company applies SFAS No. 128, *Earnings per Share* (SFAS No. 128), which establishes standards for computing and presenting earnings per share. Basic and diluted net loss per share was determined by dividing net loss applicable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted loss per share is the same as basic loss per share for all the periods presented, as the effect of the potential common stock equivalents is antidilutive due to the loss in each period. Potential common stock equivalents excluded from the calculation of diluted net loss per share consists of stock options, warrants, convertible preferred stock, and convertible debt as described in the table below:

| | As of September 30, | |
|-----------------------------|---------------------|------------|
| | 2007 | 2006 |
| Options outstanding | 1,459,475 | 2,118,750 |
| Warrants outstanding | 400,000 | 400,000 |
| Convertible preferred stock | 28,160,200 | 28,160,200 |
| Convertible debt | 4,060,288 | 4,060,288 |
| Total | 34,079,963 | 34,739,238 |

Reclassifications

Certain items in the 2006 financials have been reclassified to conform to the 2007 presentation.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (an interpretation of FASB Statement No. 109) (FIN 48), which is effective for fiscal years beginning after December 15, 2006. FIN 48 prescribes how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that a company has taken or expects to take on a tax return. In January 2007, the Company adopted FIN 48 and determined that the adoption of FIN 48 has no material effect on the financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 was issued to provide consistency and comparability in determining fair value measurements and to provide for expanded disclosures about fair value measurements. The definition of fair value maintains the exchange price notion in earlier definitions of fair value but focuses on the exit price of the asset or liability. The exit price is the price that would be received to sell the asset or paid to transfer the liability adjusted for certain inherent risks and restrictions. Expanded disclosures are also required about the use of fair value to measure assets and liabilities. The effective date is for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has not yet determined the impact, if any, of adopting this statement on its financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115*, which is effective for fiscal years beginning after November 15, 2007. The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The Company has not yet determined the impact, if any, of adopting this statement on its financial position, results of operations and cash flows.

In July 2007, the Emerging Issues Task Force (EITF) issued EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to be Used in Future Research and Development Activities* (EITF 07-3). EITF 07-3 clarifies the accounting for nonrefundable advance payments for goods or services that will be used or rendered for research and development activities. EITF 07-3 states that such payments should be capitalized and recognized as an expense as the goods are delivered or the related services are performed. If an entity does not expect the goods to be delivered or the services rendered, the capitalized advance payment should be charged to expense. EITF 07-3 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the effect of EITF 07-3 on its financial statements but does not expect the adoption of EITF 07-3 to have a material effect on the Company's financial position or results of operations.

Note 4 Strategic Alliance with Alticor Inc.

On March 5, 2003, the Company entered into a broad strategic alliance with several affiliates of the Alticor family of companies to develop and market novel nutritional and skin care products. The alliance utilizes Interleukin Genetics' intellectual property and expertise in genomics to develop personalized consumer products.

The alliance initially included an equity investment, a multi-year research and development agreement, a licensing agreement with royalties on marketed products, the deferment of outstanding loan repayment and the refinancing of bridge financing obligations. The major elements of the initial alliance were:

- The purchase by Alticor of \$7,000,000 of equity in the form of 5 million shares of Series A Preferred Stock for \$1.40 per share. These were convertible into 28,157,683 shares of common stock at a stated conversion price equal to \$0.2486 per share. On March 11, 2004, upon achievement of a defined milestone, Alticor contributed an additional \$2,000,000 to the Company for a total equity funding of \$9,000,000 and a new stated conversion price of \$0.3196 per share, or 28,160,200 shares of common stock.
- The right of the Series A holders to nominate and elect four directors to a five person board.
- A research and development agreement (Research Agreement I) providing the Company with funding of \$5.0 million, payable over the twenty-four month period from April 2003 through March 2005, to conduct certain research projects with a royalty on resulting products.

- Credit facilities in favor of the Company, as follows:
- \$1,500,000 working capital credit line to initiate selected research agreements with third party entities approved by the board of directors of the Company;
- \$2,000,000 refinancing of notes previously held by Alticor, extending the maturity date and reducing the interest rate; and
- \$595,336 refinancing on July 1, 2003 of bridge financing notes previously held by third parties, extending the maturity date and reducing the interest rate.

As of September 30, 2007, there was \$2,595,336 outstanding under the terms of these credit facilities.

On June 17, 2004, the Company entered into another research agreement (Research Agreement II), valued at \$2.2 million, as amended, with Alticor to conduct research into the development of a test to identify individuals with specific genetic variations that affect how people gain and maintain weight. During the first phase of the agreement, the Company received \$1,380,000 in research funding over a period of six months beginning on July 1, 2004. If Alticor determines, in its sole discretion, that it has a reasonable likelihood of commercializing weight management nutritional products, the Company will be eligible to receive, during the second phase of the agreement, an additional \$820,000 in funding over a six-month period. No funding related to this agreement was received during the three months ended September 30, 2007 and 2006 and the Company is not anticipating any additional funding under this agreement.

On March 5, 2005, the Company entered into an agreement with Alticor to expand the research being performed under Research Agreement I (Research Agreement III) to provide additional funding of \$2,716,151 over the two years beginning April 1, 2005. Also on March 5, 2005, the Company entered into an additional research agreement (Research Agreement IV) with Alticor for exploratory research valued at \$2,341,500 over a two-year period commencing April 1, 2005. These research agreements provided the Company with a total of \$5.0 million during the two years ending March 2007. The Company received \$0 and \$1,767,305 in funding related to these agreements during the nine months ended September 30, 2007 and 2006, respectively.

Also on April 18, 2005, Alticor paid the Company \$2.0 million as a non-refundable advance payment for genetic risk assessment tests to be processed under the terms of the Distribution Agreement, which expired on March 22, 2006. On February 23, 2006, the Company entered into two new purchase agreements with Alticor. The two new purchase agreements cover two genetic health assessment tests that Interleukin Genetics developed on behalf of Alticor. These are: 1) the heart health genetic test, which analyzes DNA variations in the Interleukin-1A and 1B genes to identify whether an individual may have a predisposition for chronically elevated measures of inflammation and an increased risk for heart disease; and 2) the general nutrition genetic test, which analyzes DNA variations in two genes that affect Vitamin B metabolism and four genes that are involved in responding to oxidative stress. The purchase agreement for the heart health genetic test provides for sales of these tests to Alticor through March 2008. Both parties agreed that \$600,000 of the \$2.0 million prepayment received pursuant to the Distribution Agreement would be applied to purchases made under the purchase agreement for the heart health genetic tests from March 23, 2006 through December 31, 2006 to the extent tests are processed. Of the remaining \$1.4 million prepayment, \$125,790 was recognized as revenue for tests processed during the remaining term of the Distribution Agreement and the balance of \$1,274,210 has been reclassified from deferred receipts to equity. The general nutrition genetic test purchase agreement term is through January 2008.

On June 30, 2006, the Company entered into an agreement with Alticor to perform association studies on composite genotypes to skin inflammatory response. The agreement provided \$94,000 of funding, all of which was received in 2006. As of September 30, 2007 and December 31, 2006, \$94,000 was included in deferred receipts on the accompanying consolidated balance sheets.

On August 17, 2006, Alticor purchased from the Company an aggregate of 2,750,037 shares of Common Stock for an aggregate purchase price of \$15,615,537, or \$5.6783 per share (based on the volume-weighted average closing stock price for the 20 consecutive trading days ending August 15, 2006). In addition, Alticor also agreed to extend to the Company a credit line of \$14,384,463 of working capital borrowings at any time until August 17, 2008. The Company incurred \$83,707 of issuance costs associated with this private placement. As a condition of the financing, the Company initiated a rights offering of 2,533,234 shares of its Common Stock to existing stockholders (other than Alticor) at a per share price of \$5.6783. The costs, incurred as a result of the rights offering were \$66,356 and these costs have been netted against the proceeds received from the financing.

On March 29, 2007, the Company entered into an agreement, effective January 1, 2007, to expand the research being performed under its current agreements with Alticor through 2007. The research agreement is expected to provide the Company with \$2.3 million during 2007, on a time and material basis.

Note 5 Debt

On March 5, 2003 as part of its strategic alliance with Alticor Inc., the Company was granted credit facilities as follows:

- \$1,500,000 working capital credit line to initiate selected research agreements with third party entities approved by the board of directors of Interleukin;
- \$2,000,000 refinancing of notes previously held by Alticor, extending the maturity date and reducing the interest rate; and
- \$595,336 refinancing on July 1, 2003 of bridge financing notes previously held by third parties, extending the maturity date and reducing the interest rate.

There was \$2,595,336 outstanding under the terms of these credit facilities, net of unamortized discount of \$115,468 and \$461,874 at September 30, 2007 and December 31, 2006, respectively. The credit facilities will mature in December 2007, bear interest at 1% over the prime rate (7.75% at September 30, 2007), are collateralized by a security interest in the Company's intellectual property (except intellectual property related to periodontal disease and sepsis), and are convertible at the election of Alticor into shares of common stock at a conversion price equal to \$0.6392 per share.

On February 23, 2006, these credit facilities with Alticor were amended to provide the Company with access to an additional \$2.0 million of working capital borrowing at any time prior to April 1, 2007. Any amounts borrowed would bear interest at prime plus 1%, require quarterly interest payments and be due five years from the date of borrowing issuance. In addition, the restrictions on the existing \$1.5 million line of credit were removed so that it could be used for general working capital purposes. These credit facilities expired unexercised on April 1, 2007.

On August 17, 2006, these credit facilities with Alticor were further amended to provide the Company with access to an additional \$14.4 million of working capital borrowings at any time prior to August 17, 2008. Any amounts borrowed will bear interest at prime plus 1%, require quarterly interest payments and be due on August 16, 2011. The principal amount of any borrowing under this credit facility is convertible at Alticor's election into a maximum of 2,533,234 shares of Common Stock, reflecting a conversion price of \$5.6783 per share. As a condition of this financing, the Company initiated a rights offering of 2,533,234 shares of its Common Stock to existing stockholders (other than Alticor) at a per share price of \$5.6783. Any proceeds received from the rights offering will reduce the availability under the credit facility. As a result of the rights offering, the availability under the credit facility has been reduced by \$68,208, leaving approximately \$14.3 million available. No amounts are outstanding under these credit facilities as of September 30, 2007.

Note 6 Commitments and Contingencies*Purchase Price of the Alan James Group*

The Company is responsible for paying additional consideration to the sellers of the Alan James Group of up to \$1,500,000 in cash and up to 1,628,833 shares of the Company's Common Stock over the next three years upon achievement of certain earnings milestones by the Alan James Group. As of September 30, 2007, no milestones have been achieved.

Operating Leases

The Company leases its offices and laboratory space under non-cancelable operating leases expiring at various dates through March 2009. The Company also leases certain office equipment under lease obligations, all of which are classified as operating leases. Future minimum lease commitments under lease agreements with initial or remaining terms of one year or more at September 30, 2007, are as follows:

| Year Ending December 31, | |
|---------------------------------|------------|
| 2007 | \$ 142,752 |
| 2008 | 564,575 |
| 2009 | 172,853 |
| | \$ 880,179 |

Acquisition of Data Bases

In connection with the research agreement with Alticor dated March 5, 2003, the Company is obligated to purchase two clinical databases. As of June 30, 2004, the Company determined that this obligation met the criteria of SFAS No. 5, *Accounting for Contingencies*, and estimated the cost of these two databases at \$450,000. Accordingly, the Company recorded a liability and charged research and development expenses of \$450,000 at that time. As of September 30, 2007, the Company had expenditures of \$357,944 associated with the acquisition of these databases. The Company believes that the acquisition of the databases will not exceed the amount that the Company has estimated, however actual amounts could differ.

Sponsored Research Agreements

In connection with the research agreement with Alticor dated March 5, 2005, the Company entered into a sponsored research agreement with Yonsei University to conduct a clinical study. The sponsored research agreement is for an amount of \$499,882 and is payable upon achievement of certain milestones. As of September 30, 2007, Yonsei University had achieved milestones valued at \$183,000. The remaining commitment on this agreement is \$316,882. When, and if, Yonsei University completes the other milestones associated with this sponsored research agreement, the Company will record these costs as research and development expenses.

In connection with both the research agreement with Alticor dated March 5, 2005 and March 29, 2007, the Company entered into a sponsored research agreement with SOGO Clinical Pharmacology Co., LTD (SOGO) to conduct a clinical study. The sponsored research agreement is for an amount of ¥26,346,600, or approximately \$224,000 (based on the exchange rate on March 30, 2007 of 117.56 ¥ to 1 US\$) and is payable upon achievement of certain milestones. As of September 30, 2007, SOGO had achieved milestones valued at ¥18,442,620 or \$158,007 based on actual payment in US dollars. The remaining commitment on this agreement is ¥7,903,980, or approximately \$67,028 (based on the exchange rate on September 30, 2007 of 117.92 ¥ to 1 US\$). When, and if, SOGO completes the other milestones associated with this sponsored research agreement, the Company will record these costs as research and development expenses.

Off-Balance Sheet Arrangements

The Company has no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, results of operations and cash flows.

Employment Agreements

The Company has entered into employment agreements with certain key employees of the Company. These agreements expire at various dates through August 17, 2009. As of September 30, 2007, the remaining commitments under these agreements, based on continued employment, was as follows:

| Year Ending December 31, | Base Salary | Car Allowance | Stock Award (# of shares) |
|---------------------------------|--------------------|----------------------|----------------------------------|
| 2007 | \$ 131,250 | \$ 3,600 | |
| 2008 | 525,000 | 14,400 | 12,500 |
| 2009 | 131,250 | 3,600 | 12,500 |
| | \$ 787,500 | \$ 21,600 | 25,000 |

On June 28, 2007, the Company decided to terminate the employment of two of these employees effective as of July 2, 2007, subject only to their earlier resignation. On July 2, 2007, Timothy J. Richerson submitted his resignation as Chief Executive Officer of the Company, taking effect on July 31, 2007 and David A. Finkelstein resigned as Chief Strategy Officer of the Company, taking effect on July 2, 2007. Under the terms of the employment agreements, these former employees may be entitled to separation pay of up to \$600,000. Accordingly, the Company recorded this potential liability as of June 30, 2007 and is included in accrued expenses on the accompanying balance sheet.

Note 7 Capital Stock

Authorized Common and Preferred Stock

At September 30, 2007, the Company had authorized 6,000,000 shares of Series A Preferred stock of which 5,000,000 shares were issued and outstanding. At September 30, 2007, the Company had authorized 100,000,000 shares of \$0.001 par value common stock of which 68,810,929 shares were outstanding or reserved for issuance. Of those, 27,639,120 shares were outstanding; 28,160,200 shares were reserved for the conversion of the Series A Preferred to common stock; 4,060,288 shares were reserved for the conversion of approximately \$2.6 million of debt; 3,965,340 shares were reserved for the exercise of authorized or outstanding stock options; 400,000 shares were reserved for the exercise of outstanding warrants to purchase common stock; 435,926 shares were reserved for the exercise of rights held under the Employee Stock Purchase Plan; 2,521,222 shares were reserved for the issuance upon the conversion of convertible notes and 1,628,833 shares were reserved for issuance upon the achievement of certain milestones as additional consideration for the acquisition of the Alan James Group.

Series A Preferred Stock

On March 5, 2003, the Company entered into a Purchase Agreement with Alticor, pursuant to which Alticor purchased from the Company Series A Preferred Stock for \$7,000,000 in cash on that date, and an additional \$2,000,000 in cash that was paid as a result of the Company achieving a certain milestone, on March 11, 2004.

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

The Series A Preferred Stock accrues dividends at the rate of 8% of the original purchase price per year, payable only when, as and if declared by the Board of Directors and are non-cumulative. To date, no dividends have been declared on these shares. If the Company declares a distribution, with certain exceptions, payable in securities of other persons, evidences of indebtedness issued by the Company or other persons, assets (excluding cash dividends) or options or rights to purchase any such securities or evidences of indebtedness, then, in each such case the holders of the Series A Preferred Stock shall be entitled to a proportionate share of any such distribution as though the holders of the Series A Preferred Stock were the holders of the number of shares of our Common Stock into which their respective shares of Series A Preferred Stock are convertible as of the record date fixed for the determination of the holders of our Common Stock entitled to receive such distribution.

In the event of any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, the holders of the Series A Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of the Company's assets or surplus funds to the holders of its Common Stock by reason of their ownership thereof, the amount of two times the then-effective purchase price per share, as adjusted for any stock dividends, combinations or splits with respect to such shares, plus all declared but unpaid dividends on such share for each share of Series A Preferred Stock then held by them. The liquidation preference at September 30, 2007 was \$18,000,000. After receiving this amount, the holders of the Series A Preferred Stock shall participate on an as-converted basis with the holders of common stock in any of the remaining assets.

Each share of Series A Preferred Stock is convertible at any time at the option of the holder into a number of shares of the Company's common stock determined by dividing the then-effective purchase price (\$1.80, and subject to further adjustment) by the conversion price in effect on the date the certificate is surrendered for conversion. As of September 30, 2007, the Series A Preferred Stock is convertible into 28,160,200 shares of Common Stock reflecting a conversion price of \$.3196 per share.

Each holder of Series A Preferred Stock is entitled to vote its shares of Series A Preferred Stock on an as-converted basis with the holders of Common Stock as a single class on all matters submitted to a vote of the stockholders, except as otherwise required by applicable law. This means that each share of Series A Preferred Stock will be entitled to a number of votes equal to the number of shares of Common Stock into which it is convertible on the applicable record date.

Note 8 Stock-Based Compensation Arrangements

Stock-based compensation arrangements consisted of the following as of September 30, 2007: three share-based compensation plans, restricted stock awards; an employee stock purchase plan; and employee compensation agreements. Total compensation cost that has been charged against income for stock-based compensation arrangements is as follows:

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Stock option grants beginning of period | \$ 35,033 | \$ 119,062 | \$ 145,536 | \$ 364,067 |
| Stock-based arrangements awarded during the period: | | | | |
| Stock option grants | | | | |
| Restricted stock issued | | 63,901 | | 147,980 |
| Unrestricted stock issued: | | | | |
| Employee stock purchase plan | 330 | 3,696 | 2,636 | 7,621 |
| Employment agreements | 1,750 | 161,494 | 7,291 | 193,838 |
| | \$ 37,113 | \$ 348,153 | \$ 155,463 | \$ 713,506 |

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

Stock option grants prior to January 1, 2006

The weighted-average grant-date fair value of unvested employee stock options granted prior to January 1, 2006 was \$2.65 per share, as determined using the Black-Scholes option pricing model. No employee stock options were granted after December 31, 2005. For purposes of determining the stock-based compensation expense for grant awards issued prior to January 1, 2006 and for pro forma disclosure required by SFAS 123, the Black-Scholes option pricing model was used with the following weighted-average assumptions:

| | 2005 | | 2004 | | 2003 | |
|-------------------------|---------|---|---------|---|---------|---|
| Risk-free interest rate | 5.00 | % | 4.00 | % | 4.00 | % |
| Expected life | 7 years | | 7 years | | 7 years | |
| Expected volatility | 70 | % | 80 | % | 80 | % |

Using these assumptions, the weighted average grant date fair value of options granted in 2005, 2004 and 2003 was \$2.29, \$2.97 and \$2.69, respectively.

Restricted Stock Awards

During the three and nine months ended September 30, 2007, the Company did not grant any restricted stock awards. During the three and nine months ended September 30, 2006, the Company granted restricted stock awards to employees of zero shares and 33,385 shares, respectively. These awards vested at various dates through 2007 assuming continued employment with the Company and the holders of these awards participate fully in the rewards of stock ownership of the Company, including voting and dividend rights. The employees were not required to pay any consideration to the Company for these restricted stock awards. The recognition of compensation expense for these types of awards did not change as a result of adopting SFAS No. 123R on January 1, 2006. The Company measured the fair value of the shares based on the last reported price at which the Company's common stock traded on the date of the grant and compensation cost was recognized over the remaining service period.

The following table details restricted stock activity for the nine months ended September 30, 2007 and 2006:

| | 2007 | | 2006 | |
|--------------------------------------|---------------------|--|---------------------|--|
| | Number of Shares | Weighted Avg Grant Date Fair Value | Number of Shares | Weighted Avg Grant Date Fair Value |
| Outstanding, beginning of the period | | \$ | | \$ |
| Granted | | | 33,385 | 6.85 |
| Lapsed | | | (8,380) | 6.94 |
| Canceled | | | (625) | 5.25 |
| Outstanding, end of the period | | \$ | 24,380 | \$ 6.86 |

Employee Stock Purchase Plan

Purchases made under the Company's Employee Stock Purchase Plan are now deemed to be compensatory under SFAS No. 123R because employees may purchase stock at a price equal to 85% of the fair market value of the Company's common stock on either the first day or the last day of a calendar quarter, whichever is lower. During the three and nine months ended September 30, 2007, employees purchased 1,837 and 5,707 shares of common stock at a weighted-average purchase price of \$1.01 and \$2.60, while the weighted-average fair market value was \$1.19 and \$3.07 per share. During the three and nine months ended September 30, 2006, employees purchased 2,632 and 6,513 shares of common stock at a weighted-average purchase price of \$4.89 and \$4.86, while the weighted-average fair market value was \$6.03 and \$6.03 per share.

Employment Agreements

During the year ended December 31, 2006, the Company entered into employment agreements with certain key employees of the Company. These agreements provided for the issuance of up to 122,500 shares of the Company's common stock at various dates through 2009 assuming continued employment with the Company. The employees are not required to pay any consideration to the Company for these stock awards. As of September 30, 2007, 47,500 shares of the Company's common stock have been issued pursuant to these agreements. The recognition of compensation expense for these types of awards did not change as a result of adopting SFAS No. 123R on January 1, 2006. The Company measures the fair value of the shares, prior to issuance, based on the last reported price at which the Company's common stock traded for the reporting period and compensation cost is recognized ratably over the employment period required to earn the stock award. At time of issuance, the Company will measure the fair value of the shares based on the last reported price at which the Company's common stock traded on the date of the issuance and will record a cumulative adjustment, if any.

On June 28, 2007, the Company terminated the employment of two of these key employees effective as of July 2, 2007. Accordingly, 50,000 shares of the Company's common stock for these stock awards have been cancelled.

A summary of compensation cost included in the statement of operations is as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Cost of revenue | \$ 6,526 | \$ 10,098 | \$ 19,466 | \$ 25,565 |
| Research and development expenses | 20,156 | 73,269 | 110,304 | 220,231 |
| Selling, general and administrative expenses | 10,431 | 264,786 | 25,713 | 467,710 |
| Total | \$ 37,113 | \$ 348,153 | \$ 155,463 | \$ 713,506 |

Note 9 Segment Information

The Company follows SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS No. 131), which establishes standards for reporting information about operating segments in annual and interim financial statements, and requires that companies report financial and descriptive information about its reportable segments based on a management approach. SFAS No. 131 also establishes standards for related disclosures about products and services, geographic areas and major customers. As a result of the acquisition of the assets and business of the Alan James Group in August 2006, the Company has two reportable segments: Personalized Health and Consumer Products.

Interleukin Genetics, Inc. develops genetic tests and performs testing services that can help individuals improve and maintain their health through preventive measures. AJG Brands, Inc., doing business as the Alan James Group, develops, markets and sells nutritional products and OTCeuticals and related activities. The Company's principal operations and markets are located in the United States.

The accounting policies of each of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based on revenue and earnings before interest, taxes, depreciation and amortization (EBITDA). Common costs not directly attributable to a segment are included in the Personalized Health segment. These costs include corporate costs such as legal, audit, tax and other professional fees.

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

The following is a summary of the Company's operations by operating segment:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2007 | 2006 | 2007 | 2006 |
| Personalized Health (including common costs not directly attributable to a segment): | | | | |
| Revenue | \$ 768,597 | \$ 660,206 | \$ 2,215,476 | \$ 2,237,120 |
| Net loss before interest, taxes, depreciation and amortization of \$237,907 and \$194,492 for the three months ended September 30, 2007 and 2006, respectively, and \$476,601 and \$643,991 for the nine months ended September 30, 2007 and 2006, respectively | \$ (792,787) | \$ (1,200,613) | \$ (3,458,881) | \$ (3,263,774) |
| Consumer Products: | | | | |
| Revenue (since August 17, 2006, date of acquisition) | \$ 1,792,688 | \$ 674,725 | \$ 5,173,555 | \$ 674,725 |
| Net income (loss) before interest, taxes, depreciation and amortization of \$414,059 and \$120,101 for the three months ended September 30, 2007 and 2006, respectively, and \$1,210,409 and \$120,101 for the nine months ended September 30, 2007 and 2006, respectively | \$ 363,094 | \$ (318,443) | \$ 427,634 | \$ (318,443) |
| Consolidated: | | | | |
| Total revenue | \$ 2,561,285 | \$ 1,334,931 | \$ 7,389,031 | \$ 2,911,845 |
| EBITDA | \$ (429,693) | \$ (1,471,034) | \$ (3,031,247) | \$ (3,544,225) |
| Interest, net | 46,929 | (17,142) | 157,726 | (20,139) |
| Taxes | (4,000) | | (12,000) | |
| Depreciation | (166,217) | (84,682) | (250,256) | (241,708) |
| Amortization | (528,678) | (260,791) | (1,582,480) | (540,237) |
| Net loss | \$ (1,081,659) | \$ (1,833,649) | \$ (4,718,258) | \$ (4,346,309) |

The Company has no operations outside of the United States. For the three and nine months ended September 30, 2007 and 2006, the Company had minimal royalty income derived from distributors outside the United States, minimal expenses derived from research partners outside the United States and minimal assets outside of the United States. The Company does not believe this risk is material and does not use derivative financial instruments to manage foreign currency fluctuation risk.

Note 10 Industry Risk and Concentration

The Company develops genetic risk assessment tests under contract, performs research for its own benefit and provides research services to a collaborative partner. As of September 30, 2007, the Company has commercially introduced three genetic tests, two of which are sold exclusively through its strategic partner Alticor, and is in various stages of development for several others. Commercial success of the Company's genetic risk assessment tests will depend on their acceptance as scientifically credible and cost-effective by consumers and the marketing success of its collaborative partner.

Research in the field of disease predisposing genes and genetic markers is intense and highly competitive. The Company has many competitors in the United States and abroad that have considerably greater financial, technical, marketing, and other resources available. If the Company does not discover

disease predisposing genes or genetic markers and develop risk assessment tests and launch such services or products before its competitors, then the potential for significant revenues may be reduced or eliminated.

The market for health supplement products is competitive and other companies sell products similar to those sold by the Company. The Company's sales and margins may be influenced by competitor actions or other factors, such as the cost of product, contract terms and general market conditions.

For the three and nine months ended September 30, 2007, approximately 51% and 48%, respectively, of the consumer products revenue was from a single customer. As of September 30, 2007 and December 31, 2006, approximately 47% and 47% of the trade accounts receivable was from that same customer.

The majority of the Company's consumer products were sourced from three suppliers. The Company pays a contracted rate per completed unit for each product. The suppliers are responsible for procuring raw materials and packaging finished products. If the Company is unable to maintain the relationship with these suppliers, it will need to find an alternative.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited Consolidated Financial Statements and the notes thereto included elsewhere in this document.

Forward-Looking Statements

This report on Form 10-Q and the documents incorporated by reference within this document contain certain forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended. Statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Words or phrases such as may, will, could, should, potential, continue, expect, intend, plan, estimate, anticipate, believe, similar words or expressions or the negatives of such words or expressions are intended to identify forward-looking statements. We base these statements on our beliefs as well as assumptions we made using information currently available to us. Such statements are subject to risks, uncertainties and assumptions, including those identified in Risk Factors elsewhere in this report, as well as other matters not yet known to us or not currently considered material by us. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected. Given these risks and uncertainties, prospective investors are cautioned not to place undue reliance on such forward-looking statements. Forward-looking statements do not guarantee future performance and should not be considered as statements of fact. All information set forth in this Form 10-Q is as of the date of this Form 10-Q. Unless required by law we accept no responsibility to update this information.

General Overview

We are a company focused on developing, acquiring, and commercializing personalized health products that can help individuals improve and maintain their health through preventive measures. We use functional genomics to help in the development of genetic risk assessment tests based on genetic variations in people. Since August 17, 2006, we have been developing and marketing nutritional and OTCeutical products. We have commercialized genetic tests for periodontal disease risk assessment, cardiovascular risk assessment, and general nutrition assessment. In addition, our Alan James Group subsidiary sells nutritional product brands, including Ginkoba, Ginsana, and Venastat through the nation's largest food, drug and mass retailers. Our current development programs focus on osteoporosis and weight management genetic risk assessment tests, as well as our new proprietary OTCeuticals for distribution through the Alan James Group. We expect that these programs may lead to the personalized selection of nutritional and therapeutic products, and provide consumers and healthcare professionals with better preventive product alternatives.

Critical Accounting Policies and Estimates

Critical accounting policies and estimates are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our most critical accounting policies and estimates upon which our financial condition depends, and which involve the most complex or subjective decisions or assessments are the following:

Strategic Alliance with Alticor:

We account for our strategic alliance with Alticor in accordance with Emerging Issues Task Force (EITF) No. 01-1, Accounting for Convertible Instruments Granted or Issued to a Nonemployee for Goods

or Services or a Combination of Goods or Services and Cash (EITF No. 01-1). Under EITF No. 01-1, the proceeds received from Alticor in connection with the March 5, 2003 transaction must first be allocated to the fair value of the convertible instruments issued. As of March 5, 2003, the fair value of the convertible instruments issued was \$23.7 million; therefore proceeds received from Alticor in connection with the March 5, 2003 transaction, up to \$23.7 million, have been recorded as equity.

Revenue Recognition:

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectibility is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test.

Revenue from product sales is recognized when there is persuasive evidence of an arrangement, delivery has occurred and title and risk of loss have transferred to the customer, the sales price is determinable and collectibility is reasonably assured. We have no consignment sales. Product revenue is reduced for allowances and adjustments, including returns, discontinued items, discounts, trade promotions and slotting fees.

Revenue from contract research and development is recognized over the term of the contract as the Company performs its obligations under that contract.

Allowance for Sales Returns:

Our recognition of revenue from sales to retailers is impacted by giving them rights to return damaged and outdated products as well as the fact that as a practical business matter, our sales force, along with our customers, is constantly working to ensure profitability of our products within retailers by rotating slow moving items out of stores and replacing those products with what we and the retailer expect will be more profitable, faster selling items. For product sales we believe we can reasonably and reliably estimate future returns, we recognize revenue at the time of sale. For product sales which we cannot estimate future returns, particularly new products, we defer revenue recognition until the return privilege has substantially expired or the amount of future returns can be reasonably estimated.

We analyze sales returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists*. We are able to make reasonable and reliable estimates based on our 2 plus years of history. We also monitor the buying patterns of the end-users of our products based on sales data received. We review our estimated product returns based on expected data communicated by our customers. We also monitor the levels of inventory at our largest customers to avoid excessive customer stocking of merchandise. We believe we have sufficient interaction and knowledge of our customers and of the industry trends and conditions to adjust the accrual for returns when necessary. We believe that this analysis creates appropriate estimates of expected future returns. There is no guarantee that future returns will not increase to, or exceed, the levels experienced in the past. Furthermore, the possibility exists that should we lose a major account, we may agree to accept a substantial amount of returns.

Trade Promotions:

We use objective procedures for estimating our allowance for trade promotions. The allowance for trade promotions offered to customers is based on contracted terms or other arrangements agreed in advance.

Inventory:

We value our inventory at the lower of cost or market. We monitor our inventory and analyze it on a regular basis. Cycle counts are taken periodically to verify inventory levels. In addition, we analyze the movement of items within our inventory in an effort to determine the likelihood that inventory will be sold or used before expiration dates are reached. We provide an allowance against that portion of inventory that we believe is unlikely to be sold or used before expiration dates are reached.

Stock-based compensation:

We account for our stock-based compensation expense in accordance with SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R) using the modified prospective basis. SFAS No. 123R addresses all forms of share-based payment (SBP) awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R requires us to expense SBP awards with compensation cost for SBP transactions measured at fair value. SFAS No. 123R applies to new equity awards and to equity awards modified, repurchased or canceled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the effective date shall be recognized as the requisite service is rendered on or after the effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated from the pro forma disclosures under SFAS No. 123. Additionally, common stock purchased pursuant to our employee stock purchase plan is expensed based upon the fair market value in excess of purchase price.

Intangible Assets:

Purchase accounting requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair market value of the assets purchased and liabilities assumed. We have accounted for our acquisitions using the purchase method of accounting. Values were assigned to intangible assets based on third-party independent valuations, as well as management's forecasts and projections that include assumptions related to future revenue and cash flows generated from the acquired assets.

Income taxes:

The preparation of our consolidated financial statements requires us to estimate our income taxes in each of the jurisdictions in which we operate, including those outside the United States, which may be subject to certain risks that ordinarily would not be expected in the United States. The income tax accounting process involves estimating our actual current exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in the recognition of deferred tax assets and liabilities. We must then record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against deferred tax assets. We have recorded a full valuation allowance against our deferred tax assets of \$20.7 million as of September 30, 2007, due to uncertainties related to our ability to utilize these assets. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to adjust our valuation allowance which could materially impact our financial position and results of operations.

Recent Accounting Pronouncements:

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (an interpretation of FASB Statement No. 109) (FIN 48), which is effective for fiscal years beginning after December 15, 2006. FIN 48 prescribes how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that a company has taken or expects to take on a tax return. In January 2007, the Company adopted FIN 48 and determined that the adoption of FIN 48 has no material effect on the financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*, SFAS No. 157 was issued to provide consistency and comparability in determining fair value measurements and to provide for expanded disclosures about fair measurements. The definition about of fair value maintains the exchange price notion in earlier definitions of fair value but focuses on the exit price of the asset or liability. The exit price is the price that would be received to sell the asset or paid to transfer the liability adjusted for certain inherent risks and restrictions. Expanded disclosures are also required about the use of fair value to measure assets and liabilities. The effective date is for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We have not yet determined the impact, if any, of adopting this statement on its financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115*, which is effective for fiscal years beginning after November 15, 2007. The statement permits entities to choose to measure many financial instruments and certain other items at fair value. We have not yet determined the impact, if any, of adopting this statement on its financial position, results of operations and cash flows.

In July 2007, the Emerging Issues Task Force (EITF) issued EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to be Used in Future Research and Development Activities* (EITF 07-3). EITF 07-3 clarifies the accounting for nonrefundable advance payments for goods or services that will be used or rendered for research and development activities. EITF 07-3 states that such payments should be capitalized and recognized as an expense as the goods are delivered or the related services are performed. If an entity does not expect the goods to be delivered or the services rendered, the capitalized advance payment should be charged to expense. EITF 07-3 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the effect of EITF 07-3 on its financial statements but does not expect the adoption of EITF 07-3 to have a material effect on the Company's financial position or results of operations.

Results of Operations***Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006***

Revenue for the three months ended September 30, 2007 was \$2.6 million compared to \$1.3 million for the three months ended September 30, 2006, an increase of \$1.2 million or 92%. The increase was due to incremental revenue of \$1.1 million from our consumer products segment acquired in August 2006 which sells branded nutritional products (primarily to large retail outlets) and an increase of \$107,000 from our personalized health segment. Revenue from our segments consisted of the following:

| | Three Months Ended September 30, | | | |
|-----------------------------------|---|--------------|------------------|-----------------|
| | 2007 | 2006 | \$ Change | % Change |
| Personalized health: | | | | |
| Genetic Testing | \$ 157,645 | \$ 654,482 | \$ (496,837) | (76)% |
| Contract research and development | 609,234 | | 609,234 | |
| Other | 1,718 | 5,724 | (4,006) | (70)% |
| Segment total | 768,597 | 660,206 | 108,391 | (16)% |
| Consumer products | 1,792,688 | 674,725 | 1,117,963 | 166 % |
| Total | \$ 2,561,285 | \$ 1,334,931 | \$ 1,226,354 | 92 % |

Cost of genetic testing services revenue was \$212,000 for the three months ended September 30, 2007 compared to \$332,000 for the three months ended September 30, 2006. Gross profit from genetic testing services was \$(54,000), or (35%) of revenue, for the three months ended September 30, 2007 compared to \$323,000, or 50% of revenue, for the three months ended September 30, 2006. Cost of genetic testing services revenue includes fixed overhead costs associated with laboratory operations, therefore, lower test volumes result in lower gross profit.

Cost of consumer products revenue was \$996,000 for the three months ended September 30, 2007, resulting in gross profit of \$797,000, or 45%, from these products compared to cost of consumer products revenue of \$675,000 for the same period in 2006, resulting in on no gross profit from these products. This was primarily the result of the sale of inventory during the period that had been acquired at fair value on the date of acquisition, August 17, 2006. Most of the inventory acquired was sold during 2006.

Research and development expenses were \$786,000 for the three months ended September 30, 2007 compared to \$721,000 for the three months ended September 30, 2006, an increase of \$65,000 or 9%. Funded research and development expenses were \$510,000 for the three months ended September 30, 2007 compared to \$424,000 for the three months ended September 30, 2006, an increase of \$86,000 or 17%. In March 2003, we entered into a research agreement with Alticor to develop genetic tests and software to assess personalized risk and develop and use screening technologies to validate the effectiveness of the nutrigenomic consumables Alticor is developing. In March 2005 and in March 2007, we entered into new agreements with Alticor to continue the research being performed. Direct expenses associated with these agreements were \$499,000 and \$392,000 for the three months ended September 30, 2007 and 2006, respectively. In September 2004, we entered into another research agreement with Alticor to conduct research into the development of a test to identify individuals with specific genetic variations that affect how people gain and maintain weight. This project was completed during 2006. Direct expenses associated with this agreement were \$32,000 for the three months ended September 30, 2006. In June 2006, we entered into another research agreement with Alticor to perform association studies on composite genotypes to skin inflammatory response. Direct expenses associated with this agreement were \$11,000 for the three months ended September 30, 2007. Other research and development expenses, including overhead costs associated with research and development activities, were \$276,000 for the three months

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

ended September 30, 2007 compared to \$262,000 for the three months ended September 30, 2006, an increase of \$14,000 or 5%.

Selling, general and administrative expenses were \$1.2 million for the three months ended September 30, 2007 compared to \$1.2 million for the three months ended September 30, 2006. As a result of the departure of the CEO and the CSO, salary expenses for the period ended September 30, 2007 were \$150,000 lower than during the same period in the prior year. Strategic marketing and recruitment expenses for the period ended September 30, 2007 were \$86,000 and \$81,000 higher than during the same period in the prior year respectively.

Amortization of intangible assets was \$413,000 for the three months ended September 30, 2007 compared to \$145,000 during the same period in the prior year. This increase was primarily attributable to amortization expense associated with acquisition-related intangible assets.

Interest income was \$108,000 for the three months ended September 30, 2007 compared to \$78,000 for the three months ended September 30, 2006. The increase of 39% is primarily the result of an increase in our cash balances being maintained in interest bearing accounts coupled with an increase in the prevailing interest rates. Interest expense remained flat at \$61,000 for the three months ended September 30, 2007 and for the same period in 2006.

We recorded amortization of note discount of \$115,000 for each of the three months ended September 30, 2007 and 2006. Of the \$115,000 expense, \$78,000 is due to the amortization of the \$1.5 million of discount resulting from the beneficial conversion feature of the convertible debt issued in March 2003 and \$37,000 is due to the amortization of the \$732,000 of discount associated with the below market stated interest rate.

Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006

Revenue for the nine months ended September 30, 2007 was \$7.4 million compared to \$2.9 million for the nine months ended September 30, 2006, an increase of \$4.5 million or 154%. The increase was due to incremental revenue of \$4.4 million from our consumer products segment acquired in August 2006 which sells branded nutritional products (primarily to large retail outlets) partially offset by a decrease of \$23,000 from our personalized health segment. Revenue from our segments consisted of the following:

| | Nine Months Ended September 30, | | | |
|-----------------------------------|--|---------------------|---------------------|-----------------|
| | 2007 | 2006 | \$ Change | % Change |
| Personalized health: | | | | |
| Genetic Testing | \$ 648,910 | \$ 2,219,145 | \$ (1,570,235) | (71)% |
| Contract research and development | 1,558,205 | | 1,558,205 | |
| Other | 8,360 | 17,975 | (9,615) | (53)% |
| Segment total | 2,215,475 | 2,237,120 | (21,645) | (1)% |
| Consumer products | 5,173,555 | 674,725 | 4,498,830 | 667 % |
| Total | \$ 7,389,030 | \$ 2,911,845 | \$ 4,477,185 | 154 % |

Cost of genetic testing services revenue was \$721,000 for the nine months ended September 30, 2007 compared to \$938,000 for the nine months ended September 30, 2006. Gross profit from genetic testing services was \$(72,000), or (12%) of revenue, for the nine months ended September 30, 2007 compared to \$1.3 million, or 58% of revenue, for the nine months ended September 30, 2006. Cost of genetic testing services revenue includes fixed overhead costs associated with laboratory operations, therefore, lower test volumes result in lower gross profit.

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

Cost of consumer products revenue was \$2.9 million for the nine months ended September 30, 2007, resulting in gross profit of \$2.3million, or 45%, from these products compared to cost of consumer products revenue of \$675,000 for the same period in 2006, resulting in on no gross profit from these products. This was primarily the result of the sale of inventory during the period that had been acquired at fair value at the date of acquisition, August 17, 2006. Most of the inventory acquired was sold during 2006.

Research and development expenses were \$2.2 million for the nine months ended September 30, 2007 compared to \$2.3 million for the nine months ended September 30, 2006, a decrease of \$100,000, or 5%. Funded research and development expenses were \$1.2 million for the nine months ended September 30, 2007 compared to \$1.3 million for the nine months ended September 30, 2006, a decrease of \$100,000 or _9%. In March 2003, we entered into a research agreement with Alticor to develop genetic tests and software to assess personalized risk and develop and use screening technologies to validate the effectiveness of the nutrigenomic consumables Alticor is developing. In March 2005 and in March 2007, we entered into new agreements with Alticor to continue the research being performed. Direct expenses associated with these agreements were \$1.1 million and \$944,000 for the nine months ended September 30, 2007 and 2006, respectively. In June 2004, we entered into another research agreement with Alticor to conduct research into the development of a test to identify individuals with specific genetic variations that affect how people gain and maintain weight. This project was completed during 2006. Direct expenses associated with this agreement were \$346,000 for the nine months ended September 30, 2006. In June 2006, we entered into another research agreement with Alticor to perform association studies on composite genotypes to skin inflammatory response. Direct expenses associated with this agreement were \$34,000 for the nine months ended September 30, 2007. Other research and development expenses, including overhead costs associated with research and development activities, were \$1.1 million for the nine months ended September 30, 2007 compared to \$965,000 for the nine months ended September 30, 2006, a decrease of 135,000 or 13%.

Selling, general and administrative expenses were \$4.8 million for the nine months ended September 30, 2007 compared to \$2.7 million for the nine months ended September 30, 2006, an increase of \$2.1 million or 68%. This increase was attributable to costs of \$1.1 million incurred by the Alan James Group for the nine months ended September 30, 2007, the recording of a one-time charge of \$600,000 associated with the termination of certain employees and professional costs incurred during the nine months ended September 30, 2007 in connection with the integration of the Alan James Group.

Amortization of intangible assets was \$1.2 million for the nine months ended September 30, 2007 compared to \$194,000 during the same period in the prior year. This increase was primarily attributable to amortization expense associated with acquisition-related intangible assets.

Interest income was \$341,000 for the nine months ended September 30, 2007 compared to \$150,000 for the nine months ended September 30, 2006. The increase of 128% is primarily the result of an increase in our cash balances being maintained in interest bearing accounts coupled with an increase in the prevailing interest rates. Interest expense of \$183,000 was incurred during the nine months ended September 30, 2007, compared to \$170,000 for the same period in 2006. The increase of 8% is primarily due to the increase in the prevailing interest rate over the two periods from 8.25% in 2006 to 9.25% in 2007.

We recorded amortization of note discount of \$346,000 for each of the nine months ended September 30, 2007 and 2006. Of the \$346,000 expense, \$233,000 is due to the amortization of the \$1.5 million of discount resulting from the beneficial conversion feature of the convertible debt issued in March 2003 and \$113,000 is due to the amortization of the \$732,000 of discount associated with the below market stated interest rate.

Liquidity and Capital Resources

Cash and cash available under our credit facilities are key financial performance indicators for us. As of September 30, 2007, we had cash and cash equivalents of \$8.1 million and borrowings available under our credit facilities of \$14.3 million for a total of \$22 million. Net cash used in operating activities was \$2.4 million and \$3.6 million for the nine months ended September 30, 2007 and 2006, respectively.

Cash used in investing activities was \$122,000 for the nine months ended September 30, 2007 and \$7.8 million for the same period in 2006. Cash was used primarily for the purchase of equipment and capitalized patent costs in 2007. In 2006, we acquired the assets and business of the Alan James Group. We paid initial consideration at the closing consisting of \$7.0 million in cash and the obligation to place in escrow \$250,000 and 88,055 shares of common stock. We are also responsible for paying additional contingent consideration of up to \$1.5 million in cash and 1,628,833 shares of Common Stock through 2009 upon achievement of certain earnings milestones by the Alan James business. Capital additions were \$258,000 for the nine months ended September 30, 2006.

Cash provided by financing activities was \$415,000 for the nine months ended September 30, 2007 compared to \$17.9 million for the nine months ended September 30, 2006. During the nine months ended September 30, 2007, we received \$362,000 from the exercise of stock options and stock purchases through the employee stock purchase plan and \$53,000 from our rights offering completed in January 2007. As a condition of our financing completed in August 2006, we initiated a rights offering of 2,533,234 shares of our common stock to our stockholders (other than Alticor) at a per share price of \$5.6783. An aggregate of 12,012 shares were sold in the offering. During the nine months ended September 30, 2006, we received \$17.0 million from our strategic alliance with Alticor and \$855,000 from the exercise of stock options, warrants and stock purchases through the employee stock purchase plan. These amounts were offset by \$3,000 of payments of our capital lease obligations. We currently do not have any commitments for any material capital expenditures.

A summary of our contractual obligations as of September 30, 2007 is included in the table below:

| Contractual Obligations | Payments Due By Period | | | | |
|-----------------------------|------------------------|---------------------|-------------------|-----------|----------------------|
| | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Long-Term Debt Obligations | \$ 2,595,336 | \$ 2,595,336 | \$ | \$ | \$ |
| Operating Lease Obligations | 880,179 | 566,459 | 313,720 | | |
| TOTAL | \$ 3,475,515 | \$ 3,161,795 | \$ 313,720 | \$ | \$ |

Based on our current operating and capital expenditure forecasts, we believe that the combination of funds currently available, funds to be generated from operations and our available lines of credit will be adequate to finance our ongoing operations for at least the next twelve months.

Effects of Inflation

We believe that inflation and changing prices over the past three years have not had a significant impact on our net revenue or on our income from continuing operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

Interest Rate Risk

We are exposed to market risk from changes in interest rates primarily through our financing activities. Interest on our notes payable accrues at a rate equal to the prime rate of interest plus 1% per annum. Our ability to carry out our business plan or our ability to finance future working capital requirements may be impacted if the cost of carrying debt fluctuates to the point where it becomes a burden on our resources.

Foreign Currency Risk

Some of our sales occur outside the United States and are transacted in foreign currencies. Accordingly, we are subject to exposure from adverse movements in foreign currency exchange rates. At this time we do not believe this risk is material and we do not currently use derivative financial instruments to manage foreign currency fluctuation risk. However, if foreign sales increase and the risk of foreign currency exchange rate fluctuation increases, we may in the future consider utilizing derivative instruments to mitigate these risks.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Our principal executive officer and principal financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q, have concluded that, based on such evaluation, our disclosure controls and procedures were adequate and effective to ensure that material information relating to us, including our consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

(b) *Changes in Internal Control Over Financial Reporting.* As of December 31, 2006, management and our independent accountants have identified as a material weakness in our internal control over financial reporting the fact that we did not perform sufficient analysis on our historical sales return data by customer to appropriately document our basis for estimating future returns on a timely basis. In addition, the Alan James Group did not obtain information from our customers regarding the levels of inventory subject to rights of return on a timely basis. This limited our ability to reasonably and reliably estimate future returns on a timely basis.

In an effort to remediate the identified material weakness, management has implemented since December 31, 2006, or is in the process of implementing, improvements to its process of estimating product returns. These include, among others, the following:

- Tracking actual returns data by customer on a monthly basis,
- Obtaining information from our largest customer regarding levels of inventory subject to returns on a monthly basis, and
- Obtaining information from our larger customers regarding levels of inventory subject to returns on a quarterly basis.

No other change in internal control over financial reporting occurred during the quarter ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

In August 2006, the Company acquired the assets and business of the Alan James Group, a group of four commonly owned limited liability companies owned by Timothy J. Richerson and David A. Finkelstein. In connection with the acquisition, Richerson was hired as the company's Chief Executive Officer and Finkelstein as the Company's Chief Strategy Officer. The Company's Board of Directors determined on June 28, 2007, and informed Richerson and Finkelstein on July 2, 2007 that their employment would be terminated immediately, subject only to their earlier resignations. On July 2, 2007, both Richerson and Finkelstein submitted their resignations. Since that time, Richerson and Finkelstein have asserted various claims against the Company and its affiliates relating to the sale of their business to the Company and the Company has asserted various claims against Richerson and Finkelstein relating to the condition of their business when the Company acquired it. This dispute has not yet resulted in formal litigation and the Company intends to seek a resolution consistent with the best interests of the Company. However, the Company believes that the claims raised by Richerson and Finkelstein are without merit and if necessary the Company intends to vigorously assert its rights and defend its position.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006, as amended, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

Not applicable.

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.

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q.

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: November 7, 2007

INTERLEUKIN GENETICS, INC.

By:

/s/ THOMAS R. CURRAN, JR.
Thomas R. Curran, Jr.
Interim Chief Executive Officer
(Principal Executive Officer &
Principal Financial Officer)

34

EXHIBIT INDEX

Exhibit

| Number | Exhibit |
|---------------|--|
| 31.1* | Certification by Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification by Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Filed herewith.

35
