

INTERLEUKIN GENETICS INC  
Form 10-Q  
November 12, 2009  
[Table of Contents](#)

# 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, 2009

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-32715

## INTERLEUKIN GENETICS, INC.

(Exact name of registrant in its charter)

**Delaware**  
(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)

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

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 each registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-Accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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	Outstanding at October 29, 2009
Common Stock, par value \$0.001 per share	32,102,435

Table of Contents

INTERLEUKIN GENETICS, INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2009

Table of Contents

	Page
<b>PART I FINANCIAL INFORMATION</b>	
<u>Item 1. Financial Statements of Interleukin Genetics, Inc. and Subsidiaries</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2009 (Unaudited) and December 31, 2008</u>	3
<u>Condensed Consolidated Statements of Operations (Unaudited)</u>	4
<u>Condensed Consolidated Statements of Stockholders' (Deficit) Equity (Unaudited)</u>	5
<u>Condensed Consolidated Statements of Cash Flows (Unaudited)</u>	6
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	27
<u>Item 4. Controls and Procedures</u>	27
<b>PART II OTHER INFORMATION</b>	
<u>Item 1. Legal Proceedings</u>	28
<u>Item 1A. Risk Factors</u>	28
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
<u>Item 3. Defaults Upon Senior Securities</u>	28
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	28
<u>Item 5. Other Information</u>	28
<u>Item 6. Exhibits</u>	29
<u>Signatures</u>	30

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	September 30, 2009		December 31, 2008	
	(Unaudited)		(Audited)	
<b>ASSETS</b>				
<b>Current assets:</b>				
Cash and cash equivalents	\$	1,421,621	\$	4,952,481
Accounts receivable from related party		36,410		35,167
Trade accounts receivable		10,978		8,219
Inventory		95,913		
Prepaid expenses and other current assets		242,884		162,834
Current assets of discontinued operations		53,247		1,707,583
<b>Total current assets</b>		<b>1,861,053</b>		<b>6,866,284</b>
<b>Fixed assets, net</b>		<b>850,865</b>		<b>435,480</b>
<b>Intangible assets, net</b>		<b>774,354</b>		<b>889,941</b>
<b>Other assets</b>		<b>238,001</b>		<b>38,001</b>
<b>Other assets of discontinued operations</b>				<b>3,924,682</b>
<b>Total assets</b>	\$	<b>3,724,273</b>	\$	<b>12,154,388</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>				
<b>Current liabilities:</b>				
Accounts payable	\$	725,262	\$	884,421
Accrued expenses		425,463		197,023
Deferred revenue		77,820		403,475
Accrued expenses related to funded research and development projects		22,056		22,056
Liabilities of discontinued operations		1,431,293		2,159,986
<b>Total current liabilities</b>		<b>2,681,894</b>		<b>3,666,961</b>
<b>Convertible long term debt</b>		<b>5,000,000</b>		<b>4,000,000</b>
<b>Deferred tax liability</b>				<b>5,000</b>
<b>Total liabilities</b>		<b>7,681,894</b>		<b>7,671,961</b>
<b>Stockholders (deficit) equity:</b>				
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, 2009 and December 31, 2008; aggregate liquidation preference of \$18,000,000 at September 30, 2009		5,000		5,000
Common stock, \$0.001 par value 100,000,000 shares authorized; 32,079,833 and 31,799,381 shares issued and outstanding at September 30, 2009 and December 31, 2008,		32,080		31,799

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

respectively				
Additional paid-in capital		85,729,881		85,458,334
Accumulated deficit		(89,724,582)		(81,012,706)
Total stockholders (deficit) equity		(3,957,621)		4,482,427
<b>Total liabilities and stockholders (deficit) equity</b>	\$	3,724,273	\$	12,154,388

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

Table of Contents

## INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
<b>Revenue:</b>				
Revenue from related party	\$ 286,146	\$ 533,310	\$ 826,423	\$ 1,666,949
Revenue from others	36,736	12,284	66,916	42,136
<b>Total revenue</b>	<b>322,882</b>	<b>545,594</b>	<b>893,339</b>	<b>1,709,085</b>
<b>Cost of revenue</b>	<b>305,303</b>	<b>235,795</b>	<b>912,150</b>	<b>679,037</b>
<b>Gross profit (loss)</b>	<b>17,579</b>	<b>309,799</b>	<b>(18,811)</b>	<b>1,030,048</b>
<b>Operating expenses:</b>				
Research and development	873,195	933,003	2,628,943	2,455,230
Selling, general and administrative	1,660,235	1,196,580	4,473,860	3,864,216
Amortization of intangibles	28,863	26,271	86,590	70,611
Total operating expenses	2,562,293	2,155,854	7,189,393	6,390,057
<b>Loss from operations</b>	<b>(2,544,714)</b>	<b>(1,846,055)</b>	<b>(7,208,204)</b>	<b>(5,360,009)</b>
<b>Other income (expense):</b>				
Interest income	740	38,591	9,905	130,498
Interest expense	(40,959)	(50,411)	(108,363)	(79,842)
Total other income (expense)	(40,219)	(11,820)	(98,458)	50,656
<b>Net loss from continuing operations before income taxes</b>	<b>(2,584,933)</b>	<b>(1,857,875)</b>	<b>(7,306,662)</b>	<b>(5,309,353)</b>
Benefit for income taxes		37,000		31,000
<b>Net loss from continuing operations</b>	<b>\$ (2,584,933)</b>	<b>\$ (1,820,875)</b>	<b>\$ (7,306,662)</b>	<b>\$ (5,278,353)</b>
Discontinued operations:				
Profit(loss) from discontinued operations, net of income taxes	40,661	179,026	(59,012)	95,057
Loss on sale of discontinued operations including impairment charge of \$3,251,838 in 2009			(1,346,202)	
<b>Profit(loss) on discontinued operations</b>	<b>\$ 40,661</b>	<b>\$ 179,026</b>	<b>\$ (1,405,214)</b>	<b>\$ 95,057</b>
<b>Net loss</b>	<b>\$ (2,544,272)</b>	<b>\$ (1,641,849)</b>	<b>\$ (8,711,876)</b>	<b>\$ (5,183,296)</b>
<b>Basic and diluted net (loss) income per common share from:</b>				
<b>Continuing operations</b>	<b>\$ (0.08)</b>	<b>\$ (0.06)</b>	<b>\$ (0.23)</b>	<b>\$ (0.17)</b>
<b>Discontinued operations</b>		<b>0.01</b>	<b>(0.04)</b>	
<b>Net loss</b>	<b>\$ (0.08)</b>	<b>\$ (0.05)</b>	<b>\$ (0.27)</b>	<b>\$ (0.17)</b>
<b>Weighted average common shares outstanding, basic and diluted</b>	<b>32,059,258</b>	<b>31,792,999</b>	<b>31,975,953</b>	<b>31,204,196</b>

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



Table of Contents

## INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS (DEFICIT) EQUITY

For the Nine Months Ended September 30, 2009

(Unaudited)

	Convertible Preferred Stock			Common Stock			Additional		Accumulated		Total	
	Shares		\$0.001 par value	Shares		\$0.001 par value	Paid-in Capital		Deficit			
<b>Balance as of December 31, 2008 (Audited)</b>	5,000,000	\$	5,000	31,799,381	\$	31,799	\$	85,458,334	\$	(81,012,706)	\$	4,482,427
Net loss										(8,711,876)		(8,711,876)
Common stock issued:												
Stock grants				126,500		126		34,030				34,156
Exercise of stock option				15,000		15		3,885				3,900
Employee stock purchase plan				126,452		127		24,759				24,886
Restricted stock awards				12,500		13		(13)				
Stock-based compensation expense								208,886				208,886
<b>Balance as of September 30, 2009</b>	5,000,000	\$	5,000	32,079,833	\$	32,080	\$	85,729,881	\$	(89,724,582)	\$	(3,957,621)

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



Table of Contents**INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>For the Nine Months Ended Sept. 30,</b>			
	<b>2009</b>		<b>2008</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>				
Net loss	\$	(8,711,876)	\$	(5,183,296)
Loss on disposal of discontinued operations		1,346,202		
Net loss from discontinued operations		59,012		(95,057)
Net loss from continuing operations		(7,306,662)		(5,278,353)
Adjustments to reconcile net loss from continued operations to net cash used in operating activities:				
Depreciation and amortization		380,208		275,389
Stock-based compensation expense		170,109		119,595
Changes in operating assets and liabilities, net of business sold:				
Accounts receivable, net		(4,002)		16,974
Inventory		(95,913)		
Prepaid expenses and other current assets		(80,050)		52,097
Accounts payable		(159,159)		(84,355)
Accrued expenses		228,440		(382,674)
Deferred revenue		(325,654)		(493,009)
Accrued expenses related to funded research and development				(70,000)
Deferred tax provision				(31,000)
Cash provided on sale of Alan James Group business		4,372,292		
Net cash used in operating activities of discontinuing operations		(1,093,403)		1,060,127
Net cash used in operating activities		(3,913,794)		(4,815,209)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>				
Capital additions		(709,005)		(107,143)
Other assets		28,997		(222,297)
Settlement of claims relating to the acquisition of the assets and business of the Alan James Group, LLC				(600,000)
Net cash used in investing activities		(680,008)		(929,440)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>				
Proceeds from issuance of notes payable		1,000,000		4,000,000
Proceeds from exercises of rights offering, stock warrants, options and employee stock purchase plan		62,942		13,029
Net cash provided by financing activities		1,062,942		4,013,029
Net decrease in cash and cash equivalents		(3,530,860)		(1,731,620)
Cash and cash equivalents, beginning of period		4,952,481		7,646,468
<b>Cash and cash equivalents, end of period</b>	\$	1,421,621	\$	5,914,848
<b>Supplemental disclosures of cash flow information:</b>				

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

Cash paid for income taxes	\$	61,300	\$	
Cash paid for interest	\$	108,363	\$	30,488
<b>Supplemental disclosures of non-cash investing activities:</b>				
Receivable for discontinued operations	\$	200,000	\$	

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

Table of Contents

**INTERLEUKIN GENETICS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Basis of Presentation**

The condensed consolidated financial statements include the accounts of Interleukin Genetics, Inc. (the Company), and its wholly-owned subsidiaries, as of September 30, 2009 and have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. All intercompany accounts and transactions have been eliminated. These unaudited condensed 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, 2008. Operating results for the nine months ended September 30, 2009 include results from continuing operations. Prior to the opening of business on July 1, 2009 the Company and its wholly-owned subsidiary AJG Brands, Inc. sold substantially all of the Alan James Group Business and assets of AJG Brands, Inc. Operating results for AJG Brands, Inc. are reflected in discontinued operations. Operating results are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

**Note 2 Settlement of acquisition contingency**

On March 25, 2008, the Company entered into an agreement with the former owners of the Alan James Group regarding the acquisition of the assets and business of the Alan James Group. Under the agreement, the former owners agreed to release the Company from any further obligations under the Asset Purchase Agreement, relating to the acquisition of the assets and business of the Alan James Group on August 17, 2006. The former owners agreed that no further amounts are or will become due under the Purchase Agreement (including its earn-out provisions).

In addition, on March 25, 2008, the Company agreed to pay a total of \$1,200,000. This agreement resolved all remaining issues associated with the Company's August 2006 acquisition of that business including contingent consideration and compensation arrangements with the sellers/former management. The Company applied \$600,000 of the settlement cost against the previously accrued separation expense that was recorded on September 30, 2007 and the remaining \$600,000 was applied against the \$2,130,374 aggregate total of contingent liabilities and amounts due under escrow recorded as part of the original acquisition. The remaining contingent liabilities and amounts due under escrow balance of \$1,530,374 was eliminated as no longer due and applied as a reduction in the balances on a pro rata basis of the intangible assets recorded as part of the original acquisition, including the effect of term reduction on the non-compete agreements.

**Note 3 Discontinued Operations**

Prior to the opening of business on July 1, 2009, the Company and its wholly-owned subsidiary, AJG Brands, Inc. entered into an asset purchase agreement with Nutraceutical Corporation and Pep Products, Inc., a wholly-owned subsidiary of Nutraceutical Corporation, pursuant to which substantially all of the Alan James Group business and assets of AJG Brands, Inc. were sold to Pep Products, Inc. for an aggregate sale price of

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

\$4,572,292. The proceeds consist of a \$200,000 holdback reflected in other assets and \$4,372,292 received on July 1, 2009. The assets sold consisted primarily of accounts receivable, inventories, property and equipment and other assets related to the business, which primarily develops, markets and sells nutritional supplements and related products into retail consumer channels. The buyer did not assume accounts payable and accrued liabilities. Subsequent to the closing, AJG Brands, Inc. s name was changed to Interleukin Brands, Inc. ( IBI ). The assets remaining in IBI consist primarily of certain remaining accounts receivable and inventory. All remaining accounts receivable and inventory has been fully reserved for. Liabilities of discontinued operations primarily consist of accruals for inventory in the retail channel with the right of return.

At June 30, 2009 the Company recognized a loss on the sale of discontinued operations of \$1,346,202. This includes a gain on the sale of net tangible assets of \$2,579,879, direct costs of the disposition of \$674,243 and a loss from the permanent impairment of all remaining AJG Brands, Inc. s intangible assets in the amount of \$3,251,838.

AJG Brands, Inc. s sales reported in discontinued operations for the three months and nine months ended September 30, 2009 were \$0 and \$3,580,169, respectively, and for the three months and nine months ended September 30, 2008 were \$1,626,001 and \$5,593,267, respectively.

Table of Contents

The following is a summary of the net assets sold at the close of business on June 30, 2009.

Accounts receivable	\$	1,114,835
Inventories		783,512
Property and equipment, net		21,073
Other assets		72,993
Net tangible assets sold from discontinued operations	\$	1,992,413

**Note 4 Significant Accounting Policies***Principles of Consolidation*

The condensed consolidated financial statements include the accounts of Interleukin Genetics, Inc., and its wholly-owned subsidiaries, Interleukin Genetics Laboratory Services, Inc. and Interleukin Brands, Inc., formerly AJG Brands, Inc. doing business as the Alan James Group. All intercompany accounts and transactions have been eliminated. In 2008 the Company has separately disclosed the operating portion of cash flows attributable to discontinued operations, which in prior periods were reported in a combined basis as a single amount.

*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 (see Note 5), revenue recognition, allowance for sales returns, trade promotions, accounts receivable, inventory, stock-based compensation, income taxes, and long-lived assets. These critical accounting policies are more fully discussed in these notes to the consolidated financial statements.

*Revenue Recognition*

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectability is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test. To the extent that tests have been prepaid but results have not yet been reported, recognition of all related revenue is deferred. As of September 30, 2009 and December 31, 2008, the Company has deferred revenue of \$23,200 and \$80,000, 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 collectability is reasonably assured. The Company has no consignment

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

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 (including revenue from Alticor, a related party).

### *Allowance for Sales Returns*

We analyze sales returns in accordance with the provisions of Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 605, *Revenue Recognition*. We are able to make reasonable and reliable estimates based on the buying patterns of the end-users of its products based on sales data received. We believe we have sufficient interaction with and knowledge of our customers, industry trends and industry conditions to adjust the accrual for returns when necessary.

At September 30, 2009, we have fully reserved for any potential sales returns and discontinued items applicable to the non-acquired accounts resulting from our sale of substantially all of the assets of the Alan James Group business. The

Table of Contents

reserve of approximately \$1.3 million is deemed to be adequate and no additional amounts were added at September 30, 2009.

*Trade Promotions*

Pursuant to the asset purchase agreement in connection with the Company's sale of substantially all of the Alan James Group business and assets, the Company fully accrued for the approximately \$150,000 of agreed upon trade promotions implemented prior to June 30, 2009. At September 30, 2009 the balance of trade promotions estimated to be due in the future was \$128,000.

*Accounts Receivable*

Pursuant to the asset purchase agreement in connection with the Company's sale of substantially all of the Alan James Group business and assets the Company retained non acquired accounts receivable in the amount of \$180,605 which was fully reserved for as uncollectible at June 30, 2009. At September 30, 2009 the balance in non acquired accounts receivable was \$64,179 and is fully reserved for in the Company's financial statements. Prior to the acquisition trade accounts receivable were stated at their estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offered its Consumer Product customers a 2% cash discount if payment was made within 30 days of the invoice date, however, most customers took the discount regardless of when payment occurred. At December 31, 2008, the Company has reduced trade accounts receivable by \$13,364 for discounts anticipated to be taken and had provided an allowance for uncollectible accounts of \$6,696.

*Inventory*

Inventory is stated at the lower of cost or market. Cost is determined using the invoice price from our vendors. 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 the lower of cost or market.

Inventory on hand includes items not acquired as part of the sale of substantially all of the assets and business of AJG Brands, Inc. and product inventory related to our Inherent Health brand of genetic tests.

The inventory reserve at September 30, 2009 consists entirely of the non acquired inventory in connection with the Company's sale of substantially all of the Alan James Group business and assets

Inventory primarily consisted of the following at September 30, 2009 and December 31, 2008:

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

	2009		2008	
Raw materials	\$	31,791	\$	130,108
Finished goods		166,798		701,081
Inventory reserve		(102,676)		
Total inventory, net	\$	95,913	\$	831,189

*Stock-Based Compensation*

We account for our stock-based compensation expense in accordance with FASB ASC 718, *Compensation - Stock Compensation*. The standard 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. We expense SBP awards with compensation cost for SBP transactions measured at fair value. 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. Common stock purchased pursuant to our employee stock purchase plan will be 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



Table of Contents

ordinarily would not be expected in the United States. The Company accounts for income taxes in accordance with FASB ASC 740, *Income Taxes*, which requires the recognition of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized.

Significant management judgment is required in determining the Company's provision 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 \$25.4 million as of September 30, 2009, due to uncertainties related to its ability to utilize these assets. The valuation allowance is based on management's estimates of taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or management adjusts these estimates in future periods, the Company may need to adjust its valuation allowance, which could materially impact its financial position and results of operations.

Due to recent changes in Massachusetts corporate income tax regulations, the Company will be filing on a combined basis with Alticor affiliated entities on a go-forward basis and, as a result, net operating losses will be fully utilized at September 30, 2009. The combined filing will have no impact on the Company's financial statements due to the full valuation allowance that offsets any deferred tax assets.

The Company reviews its recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. The Company reviews all material tax positions for all years open to statute to determine whether it is more likely than not that the positions taken would be sustained based on the technical merits of those positions. The Company did not recognize any adjustments for uncertain tax positions during the nine months ended September 30, 2009.

*Research and Development*

Research and development costs are expensed as incurred.

*Advertising Expense*

Advertising costs are expensed as incurred. During the nine months ended September 30, 2009 and 2008 advertising expense was \$887,400 and \$471,752, respectively.

*Basic and Diluted Net Loss per Common Share*

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

The Company applies the provisions of FASB ASC 260, *Earnings per Share*, which establishes standards for computing and presenting earnings per share. Basic and diluted net loss per share was determined by dividing net loss applicable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is the same as basic net loss per share for all the periods presented, as the effect of the potential common stock equivalents is anti-dilutive due to the loss in each period. Potential common stock equivalents excluded from the calculation of diluted net loss per share consists of stock options, warrants, convertible preferred stock and convertible debt as described in the table below:

	As of September 30,	
	2009	2008
Options outstanding	2,106,917	2,014,073
Warrants outstanding	400,000	400,000
Convertible preferred stock	28,160,200	28,160,200
Convertible debt	880,545	704,436
<b>Total</b>	<b>31,547,662</b>	<b>31,278,709</b>

### *Comprehensive Income (Loss)*

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. During the nine months ended September 30, 2009, and 2008, there were no items other than net loss included in the comprehensive loss.

Table of Contents

*Fair Value of Financial Instruments*

The Company, using available market information, has determined the estimated fair values of financial instruments. The stated values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term nature of these instruments. The carrying amounts of borrowings under short and long term agreements approximate their fair value as the rates applicable to the financial instruments reflect changes in overall market interest rates.

*Cash and Cash Equivalents*

Cash and cash equivalents consist of amounts on deposit in checking and savings accounts with banks and other financial institutions. Short-term investments primarily consist of bank money market funds which have short-term maturities of less than ninety days and are carried at cost which approximates fair value.

*Fixed Assets*

Fixed assets are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over estimated useful lives of three to five years. Leasehold improvements are amortized over the estimated useful life of the asset, or the remaining term of the lease, whichever is shorter.

*Long-Lived Assets*

The Company evaluates 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, 2009.

*Intangible Assets*

The Company performs impairment tests on an interim basis, if certain conditions exist, with impaired assets written down to fair value. See Note 2 for adjustments of intangible assets related to the settlement effective March 25, 2008. The Company determined that due to the sale of substantially all of the Alan James Group business and assets of its wholly-owned subsidiary, AJG Brands, Inc., prior to the opening of business on July 1, 2009, the remaining \$3,251,838 of intangible assets became permanently impaired and was expensed.

*Recent Accounting Pronouncements*

Since January 1, 2008, the Company has applied the provisions of FASB ASC 820, *Fair Value Measurements and Disclosures* for financial assets and liabilities. The standard had no material impact on our results of operations or financial condition. There is a one-year deferral in applying the measurement provisions to non-financial assets and non-financial liabilities (non-financial terms) that are not recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually). Therefore, if the change in fair value of a non-financial item is not required to be recognized or disclosed in the financial statements on an annual basis or more frequently, the effective date of application was deferred until fiscal years beginning after November 15, 2008. The adoption of this standard as of January 1, 2009 had no material effect on our results of operations or financial condition.

Since January 1, 2008 the Company has applied the provisions of FASB ASC 825, *Financial Instruments*. The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The Company has not elected to account for any of its assets or liabilities using the fair value option and accordingly, the adoption did not have a material effect on the Company's financial position or results of operations.

Since January 1, 2009 the Company has applied the provisions of FASB ASC 805, *Business Combinations*. The Company, upon initially obtaining control in a transaction, shall recognize 100% of the fair values of acquired assets, including goodwill, and assumed liabilities, with only limited exceptions, even if the Company has not acquired 100% of the acquiree. The adoption of this standard had no material effect on the Company's results of operations or financial condition, although it could have a material impact on future acquisitions.

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

### Table of Contents

Since January 1, 2009, The Company has applied the provisions of FASB ASC 810, *Consolidation*. The standard establishes new accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary and will require entities to classify noncontrolling interests as a component of stockholders' equity as well as require subsequent changes in ownership interest in a subsidiary to be accounted for as an equity transaction. Additionally, the standard will require entities to recognize a gain or loss upon the loss of control of a subsidiary and to remeasure any ownership interest retained at fair value on that date. This statement also requires expanded disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. The standard did not have a material effect on the Company's financial position or results of operations.

Since January 1, 2009 the Company has applied the provisions of FASB ASC 808, *Collaborative Arrangements*. The guidance defines collaborative arrangements and establishes presentation and disclosure requirements for transactions within a collaborative arrangement (both with third parties and between participants in the arrangement) and requires retrospective application to all collaborative arrangements existing as of the effective date, unless retrospective application is impracticable. The impracticability evaluation and exception should be performed on an arrangement-by-arrangement basis. The adoption did not have a significant effect on the Company's financial statements.

Since June 30, 2009 the Company has applied the provisions of FASB ASC 855, *Subsequent Events*, which established general standards of accounting for and disclosures of events that occur after the balance sheet date but before the financial statements are issued or available to be used. The Company evaluated its September 30, 2009 financial statements for subsequent events through November 12, 2009, the date the financial statements were available to be issued. The Company is not aware of any subsequent events which would require recognition or disclosure in the financial statements beyond the \$2.0 million borrowing on November 9, 2009 disclosed in note 12.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140* (SFAS No. 166). In SFAS No. 166, the FASB improves the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. SFAS No. 166 shall be effective as of the first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. Adoption of the Standard will not have a material effect on the Company's consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*. In SFAS No. 167, the FASB replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative, requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity, and requires additional disclosures about an enterprise's involvement in variable interest entities. SFAS No. 167 shall be effective as of the first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited. The Company's adoption of SFAS No. 167 will not have a material effect on its consolidated financial statements.

Since September 30, 2009 the Company has applied the provisions of FASB ASC 105, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. The Standard is now the single source of authoritative nongovernmental U.S. generally accepted accounting principles or GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), EITF, and related accounting literature. The Standard reorganizes the thousands of GAAP pronouncements into roughly 90 accounting topics and displays them using a consistent structure. Also included is relevant Securities and Exchange Commission guidance organized using the same topical structure in separate sections. The Standard did not have a material impact on the Company's financial statements. However, the Standard changed the Company's references to GAAP in its consolidated financial statements.

**Note 5 Strategic Alliance with Alticor Inc.**

Since March 2003, the Company has maintained 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 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 alliance continues to evolve and recent events under the alliance are described in this Note 5.

Table of Contents

On February 25, 2008, the Company entered into a research agreement (RA8) with an affiliate of Alticor, effective January 1, 2008, to expand the research being performed under its current agreements with Alticor through 2008. The Company received \$1,200,000 during 2008 under the research agreement, on a time and materials basis. Additionally, in 2008 the Company recognized as revenue approximately \$800,000 of previously deferred revenue. The Company recognized \$198,203 in the three months ended September 30, 2009 and \$441,467 in the three months ended September 30, 2008 from this agreement. In addition to the \$800,000 of deferred revenue recognized under RA8, \$168,254 of funds previously paid to the Company by Alticor under research agreement 3 (RA3) and research agreement 4 (RA4), for which no work has been performed, will not need to be repaid to Alticor by the Company. Since the Company performed no prior services relating to the \$168,254 received from Alticor, and the Company is not required to perform any future services relating to these funds, the Company has determined that the funds should be classified as additional paid-in capital and are recorded as such on the Company's balance sheet as of September 30, 2009.

On January 31, 2009, the Company entered into an amendment to the RA8. The amendment extends the term from a maximum of six months to eight months, terminating on September 30, 2009. The Company received an additional \$200,316 on March 31, 2009 under the terms of the amendment to complete ongoing research, which was recognized as deferred revenue on the Company's balance sheet as of March 31, 2009. At September 30, 2009, there was a balance of \$2,857 in deferred revenue under RA8.

**Note 6 Convertible Debt**

On August 17, 2006, our existing credit facility with Pyxis Innovations Inc., an affiliate of Alticor (Pyxis), was amended to provide the Company with access to an additional \$14,400,000 of working capital borrowings at any time prior to August 17, 2008. Any amounts borrowed bear interest at prime, require quarterly interest payments and will mature on August 16, 2011. The principal amount of any borrowing under this credit facility is convertible at Pyxis' election into a maximum of 2,533,234 shares of common stock, reflecting a conversion price of \$5.6783 per share.

This credit facility has been extended several times, most recently on August 10, 2009 to permit borrowings at anytime prior to January 1, 2011. As of September 30, 2009, there was \$5,000,000 in principal outstanding under the credit facility. On November 9, 2009 the Company borrowed \$2,000,000 leaving \$7,316,255 of available credit and \$7,000,000 in principal outstanding under the credit facility (see note 12).

**Note 7 Commitments and Contingencies**

*Off-Balance Sheet Arrangements*

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

**Note 8 Capital Stock**

*Authorized Preferred and Common Stock*

At September 30, 2009, the Company had authorized 6,000,000 shares of \$0.001 par value Series A Preferred Stock, of which 5,000,000 were issued and outstanding. At September 30, 2009, the Company had authorized 100,000,000 shares of \$0.001 par value common stock of which 66,931,082 shares were outstanding or reserved for issuance. Of those, 32,079,833 shares were outstanding; 28,160,200 shares were reserved for the conversion of Series A Preferred to common stock; 880,545 shares were reserved for the conversion of the \$5,000,000 of debt outstanding under the credit facility with Pyxis; 3,474,095 shares were reserved for the potential exercise of authorized and outstanding stock options; 400,000 shares were reserved for the exercise of outstanding warrants to purchase common stock at an exercise price of \$2.50 per share which are exercisable currently until the expiration date of August 9, 2012; 295,732 shares were reserved for the potential exercise of rights held under the Employee Stock Purchase Plan; and 1,640,677 shares were reserved for the issuance upon the conversion of convertible notes that may be issued to Pyxis under the existing credit facility.



Table of Contents

*Series A Preferred Stock*

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 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.

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 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 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, 2009 was \$18,000,000. After receiving this amount, the holders of the Series A Preferred Stock are entitled to participate on an as-converted basis with the holders of Common Stock in any of the remaining assets.

Each share of Series A 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, 2009, the Series A Preferred Stock was convertible into 28,160,200 shares of Common Stock reflecting a current conversion price of \$0.3196 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 9 Stock-Based Compensation Arrangements**

Stock-based compensation arrangements consisted of the following as of September 30, 2009: 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:

Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

	Three Months Ended Sept. 30,				Nine Months Ended Sept. 30,			
	2009		2008		2009		2008	
Stock option grants beginning of period	\$	53,543	\$	7,250	\$	197,206	\$	31,342
Stock-based arrangements during the period:								
Stock option grants		3,837		32,381		5,721		78,364
Restricted stock issued:								
Employee stock purchase plan		2,160		704		4,334		977
Employment agreements				1,813		1,625		13,469
	\$	59,540	\$	42,148	\$	208,886	\$	124,152

*Stock option grants*

The following table details stock option activity for the nine months ended September 30, 2009 and 2008:

Table of Contents

	Nine Months Ended September 30, 2009			Nine Months Ended September 30, 2008		
	Shares		Weighted Avg Exercise Price	Shares		Weighted Avg Exercise Price
Outstanding, beginning of period	2,100,917		\$ 2.33	1,366,406		\$ 3.11
Granted	138,500		0.26	752,500		1.17
Exercised	(15,000)		0.26			
Canceled	(47,900)		1.04	(29,833)		1.93
Expired	(69,600)		1.35	(75,000)		2.48
Outstanding, end of period	2,106,917		\$ 2.27	2,014,073		\$ 2.43
Exercisable, end of period	1,487,117		\$ 2.83	1,350,073		\$ 3.01

The Company's share-based payments that result in compensation expense consist of stock option grants and shares issued under the Employee Stock Purchase Plan. During the nine-month period ended September 30, 2009, the Company granted stock options under the 2000 Employee Stock Compensation Plan and the 2004 Employee, Director & Consultant Stock Plan. At September 30, 2009, the Company had an aggregate of 1,367,178 shares of Common Stock available for grant; including 88,232 shares under the 2000 Employee Stock Compensation Plan and 1,278,946 under the 2004 Employee, Director & Consultant Stock Plan. Each of these plans expires ten years from the date the plan was approved.

It is the Company's policy to grant stock options with an exercise price equal to the fair market value of the Company's common stock at the grant date, and stock options to employees generally vest over five years based upon continuous service. Historically, the majority of the Company's stock options have been granted in connection with the employee's start date with the Company. In addition, the Company may grant stock options in recognition of promotion and/or performance.

For purposes of determining the stock-based compensation expense for stock option awards, the Black-Scholes option-pricing model was used with the following weighted-average assumptions:

	2009
Risk-free interest rate	2.56%
Expected life	6.50 years
Expected volatility	87.1%

*Employee Stock Purchase Plan*

Purchases made under the Company's Employee Stock Purchase Plan are deemed to be compensatory 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 nine months ended September 30, 2009 and 2008, employees purchased 126,452 and 5,620 shares, respectively, of common stock at a weighted-average purchase price of \$0.20 and \$0.99, respectively, while the weighted-average fair value was \$0.23 and

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

\$1.17 per share, respectively, resulting in compensation expense of \$4,334 and \$977, respectively.

### *Employment Agreements*

On March 13, 2009 Lewis Bender received a cash bonus of \$102,850 pursuant to his employment agreement and elected to receive \$29,700 in 110,000 shares of our common stock. On March 13, 2009 Eliot Lurier received a cash bonus of \$43,695 pursuant to his employment agreement and elected to receive \$4,455 in 16,500 shares of our common stock. During the nine months ended September 30, 2009, 12,500 shares of restricted stock vested pursuant to an employment agreement with Dr. Kornman. 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.

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

### Table of Contents

A summary of stock compensation cost included in the statement of operations for the three and nine months ended September 30, 2009 and 2008 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Continuing operations:				
Cost of revenue	1,972	4,755	6,204	17,566
Research and development expenses	3,964	6,342	27,773	25,118
Selling, general and administrative expenses	19,605	28,772	136,132	76,911
Total continuing operations	25,541	39,869	170,109	119,595
Discontinued operations	33,999	2,279	38,777	4,557
Total	59,540	42,148	208,886	124,152

### *Restricted Stock Awards*

Holders of restricted stock awards participate fully in the rewards of stock ownership of the Company, including voting and dividend rights. Recipients of restricted stock awards are generally not required to pay any consideration to the Company for these restricted stock awards. The Company measures 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 is recognized over the remaining service period. During each of the nine months ended September 30, 2009 and 2008 the Company granted restricted stock awards of 12,500 shares under an employment agreement dated March 31, 2006.

### **Note 10 Segment Information**

The Company applies the provisions of FASB ASC 280, *Segment Reporting*, 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 their reportable segments based on management's approach. The standard also establishes 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 and until prior to the opening of business on July 1, 2009 when substantially all of the assets and business were sold, the Company had two reportable segments: Personalized Health and Consumer Products.

Beginning in the third quarter the Company has one segment remaining, the genetic test business, which was formerly defined as the Personalized Health segment and is reflected as continuing operations. The Company develops genetic tests for sale into the emerging personalized health market and performs testing services that can help individuals improve and maintain their health through preventive measures. The Company's principal operations and markets are located in the United States. The Company has no operations outside of the United States. For the nine months ended September 30, 2009 and 2008, 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 the United States. The Company does not believe that foreign currency exchange rate risk is material and does not use derivative financial instruments to manage foreign currency fluctuation risk.

**Note 11 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, 2009, the Company has introduced four genetic risk assessment tests commercially. Two of the tests are branded and sold through the Company's strategic partner Alticor. Commercial success of the Company's genetic risk assessment tests will depend on their success as scientifically credible and cost-effective by consumers and the marketing success of the Company and 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.

Table of Contents

Prior to the sale of substantially all of the Alan James Group business and assets of the Company's wholly-owned subsidiary, AJG Brands, Inc., for the nine months ended September 30, 2009 and 2008, approximately 52.1% and 50.9%, respectively, of the Company's consumer products revenue was from a single customer. As of September 30, 2009 and December 31, 2008, approximately 0% and 60.6% respectively, of the trade accounts receivables were from that same customer.

Prior to the sale of substantially all of the Alan James Group business and assets of the Company's wholly-owned subsidiary, AJG Brands, Inc., the majority of the Company's consumer products were sourced from three suppliers. The Company paid a contracted rate per completed unit for each product. The suppliers were responsible for procuring raw materials and packaging finished products.

Our significant customer, Alticor, which is our principal shareholder, represented approximately 88.6% of our revenues from continuing operations in the three months ended September 30, 2009.

The Company fully reserved in its financial statements for all non-acquired inventory and accounts receivable as a result of the Alan James Group transaction.

**Note 12 Subsequent Event**

On November 9, 2009, we drew down \$2.0 million under our existing convertible credit facility with Pyxis, an affiliate of Alticor Inc., and issued a convertible promissory note to Pyxis in that amount. A description of the credit facility is set forth in Note 6 of the Notes to our Condensed Consolidated Financial Statements. The principal amount of the note is due and payable on August 16, 2011. The note bears interest at a variable rate equal to the prime rate and the interest is payable quarterly. Prior to the maturity date, any portion or the entire outstanding principal and any accrued but unpaid interest under the note is convertible at Pyxis's election into shares of our common stock at a price of \$5.6783 per share. Immediately following the issuance of the note on November 9, 2009, the note was convertible into an aggregate of 352,218 shares of our common stock, we had \$7.0 million outstanding under the credit facility and we had \$7.3 million available to us to borrow under the credit facility.

Table of Contents

**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 our unaudited condensed consolidated financial statements and the notes thereto included elsewhere in this document.*

**General Overview and Trends**

We are a genetics-focused personalized health company that develops preventive consumer products and genetic tests for sale to the emerging personalized health market. Our vision is to build a leading personalized health and wellness company using the science of applied genetics to empower people to understand the genetic components of their health, to provide physicians guidance on patient care and to provide drug developers and other companies the tools necessary to create new, innovative therapeutic and other products.

During the three months ended September 30, 2009 we continued with the launch of our new Inherent Health brand of genetic tests and related programs, which began at the end of the second quarter of 2009, including the first-of-its-kind test for weight management that identifies an individual's genetic tendencies for weight gain and metabolism. In addition, the brand launch offers customers a full suite of affordable, easy-to-use and meaningful genetic tests in heart health, bone health which we expect to launch in the fourth quarter, nutritional needs, as well as PST®, the periodontal disease risk assessment test. To support the launch, we implemented a fully functional web presence with e-commerce capabilities. Genetic tests may be purchased through the website. A nationwide advertising campaign consisting of television, print and internet media was started in the third quarter of 2009, which we anticipated would allow us to better understand the proper media mix for this brand. A third party support and call center was put in place in advance of the advertising campaign. We anticipated the initial phase of advertising to cost approximately \$1.0 million. The nationwide advertising campaign ran for two weeks and cost approximately \$0.8 million. The media campaign provided strategic direction to our product marketing efforts. Distribution of our tests and related technology in the short term will focus on:

- partnering with large national and international companies for the sale and distribution of our genetic test products
  
- partnering with biotechnology companies in the area of drug discovery
  
- health care professional partnerships

In addition, we will continue to offer our products through our e-commerce web site.

On September 23, 2009 we announced top line positive results from a retrospective clinical study on weight management using patients who participated in a diet study previously reported in the Journal of The American Medical Association. Our study demonstrated that individuals following diets matched to their genotype, as determined by our weight management genetic test, showed statistically significant greater weight



## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

loss and other benefits at all time points (2, 6 and 12 months) when compared to individuals on diets not matched to their genotype (6.2% versus 2.4%  $p < 0.013$  at 12 months).

Prior to the opening of business on July 1, 2009 we sold substantially all of the Alan James Group business and assets of our wholly-owned subsidiary AJG Brands, Inc. to Pep Products, Inc., a subsidiary of Nutraceutical Corporation, for approximately \$4.6 million in cash. The proceeds consist of a \$0.2 million holdback reflected in other assets and \$4.4 million cash due which was received on July 1, 2009. The assets sold consisted primarily of accounts receivable, inventories, property and equipment and other assets related to the business. The buyer did not assume accounts payable and accrued liabilities. Subsequent to the closing, AJG Brands, Inc.'s name was changed to Interleukin Brands, Inc. ( IBI ). The assets remaining in IBI consist primarily of certain remaining accounts receivable and inventory. IBI will remain as a wholly-owned subsidiary of Interleukin until all remaining accounts receivable and inventory is settled or liquidated at which time we will determine whether to keep the subsidiary active. We expect this to occur in the next twelve months. We have fully reserved for all non-acquired inventory and accounts receivable assets in our financial statements. As a requirement of the transaction, we are prohibited from continuing to operate in a business competitive to the one previously conducted by AJG Brands, Inc., which primarily developed, marketed and sold nutritional supplements and related products into retail consumer channels. The sale of substantially all of the Alan James Group business and assets, which previously comprised the Consumer Products segment of our business, will allow us to focus our resources and attention exclusively on our genetic test business by developing new and selling our existing genetics tests to the growing personalized health market. During the three months ended September 30, 2009 we did not receive any revenue from the Alan James Group reflected in discontinued operations. We expect to continue to incur expenses as the remaining assets and liabilities are disposed of. We are now focusing on

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

### Table of Contents

genetic test development and commercialization which was formerly defined as our Personalized Health segment and is reflected as continuing operations.

On April 6, 2009, we entered into a licensing agreement with LABEC Pharma, S.L. to market and sell our Heart Health genetic test throughout Spain and Portugal. As part of the agreement, the test will be marketed by LABEC Pharma and the tests will be processed at our Clinical Laboratory Improvement Act of 1988 (CLIA) certified laboratory at our Corporate Headquarters in Waltham, Massachusetts. We will receive royalties and commercial milestone payments. We have submitted the necessary documents to LABEC who will be filing the CE mark application with the European regulatory authorities.

Our genetic test business contributes toward our overall mission of developing tests and products that can help individuals improve and maintain their health through preventive measures. We plan to pursue this by:

- developing genetic risk assessment tests for use in multiple indications, countries and various demographics; and
- processing genetic risk assessment tests in our CLIA-certified lab or in those of sublicensees.

In 2006, sales of our genetic test products began under marketing and other business arrangements with Alticor. Alticor is a significant customer, representing virtually all of our genetic test revenues and contract research revenue and over 89% of consolidated revenues in the three month ended September 30, 2009. With the launch of our Inherent Health brand of genetic tests and related programs in June 2009, we would expect that revenues from Alticor may represent a smaller percentage of our revenues in the future, although we can provide no assurance that the launch of our own brand of genetic tests will be commercially successful.

We have traditionally spent approximately \$3-4 million annually on research and development. We expect to complete our research agreements with Alticor in 2009 and dedicate more of our resources to our own product development efforts. We expect our research & development expenses to decrease as we focus on our own development efforts. Our current development programs focus on obesity, heart disease, osteoporosis, osteoarthritis, skin aging, sports nutrition and weight management genetic risk assessment tests. We expect that these programs will also lead to the personalized selection of nutritional and therapeutic products and provide consumers and healthcare professionals with better preventive product alternatives. As a result of the launch of our Inherent Health Brand of genetic tests, we expect corporate selling, general, marketing and administrative expenses associated with our genetic test products to increase in the remainder of 2009 and beyond. We currently have \$9.3 million of borrowings available under our credit line with Pyxis Innovations, Inc., an affiliate of Alticor ( Pyxis ), which permits borrowing any time prior to January 1, 2011. We expect to be able to fund our operations through at least the next twelve months with revenue from product sales, borrowings from our credit facility and the cash proceeds from the sale of substantially all of the Alan James Group business and assets.

On February 25, 2008, we entered into our most recent research agreement, known as RA8, with Access Business Group International LLC (ABG), a subsidiary of Alticor. RA8 encompasses four primary areas: osteoporosis, cardiovascular disease, nutrigenomics, and dermagenomics. On January 31, 2009, the Company entered into an amendment to RA8, which extends the term from a maximum of six months to eight months terminating on September 30, 2009. We received an additional \$200,316 on March 31, 2009 per the amendment to complete ongoing research. See financial statement footnote 5 for a discussion of our strategic alliance with Alticor. As of September 30, 2009, we have completed the

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

clinical studies under RA8 which aim to correlate SNP gene variations to the risk of osteoporosis or cardiovascular disease in Asian populations. Other studies conducted in North American populations identified genetic factors that influence athletic performance (nutrigenomics) and skin health, such as wrinkles, elasticity, aging (dermagenomics), for the purpose of developing products to enhance healthy aging. Under the terms of RA8, ABG paid us \$1.2 million during 2008 for the research. In addition, we recognized approximately \$800,000 of revenue which was unused from prior research agreements with Alticor and its subsidiaries.

In the genetic test business, competition is in flux and the markets and customer base are not well established. Adoption of new technologies by consumers requires substantial market development and customer education. Historically, we have focused on our relationship with our primary customer, Alticor, a significant direct marketing company, in order to assist us in developing the market for our products and educating our potential customers. Our challenge in 2009 and beyond will be to develop the market for our own personalized health products. We have begun to allocate considerable resources to our own brand of consumer products, including the June 2009 launch of our new Inherent Health Brand of genetic tests and related programs. Due to the early stage of these initiatives, we cannot predict with certainty fluctuations we may

Table of Contents

experience in our test revenues or whether revenues derived from Alticor related to the heart health and general nutrition genetic tests will be sustained in future periods.

**Liquidity and Capital Resources**

As of September 30, 2009, we had cash and cash equivalents of \$1.4 million and borrowings available under our credit facility of \$9.3 million, which permits borrowing at any time prior to January 1, 2011. On November 9, 2009 we borrowed an additional \$2.0 million leaving \$7.3 million of available credit. In connection with the closing of the sale of substantially all of the Alan James Group business and assets of AJG Brands, Inc., prior to the opening of business on July 1, 2009, we received \$4.4 million of cash proceeds on July 1, 2009.

Cash used in continuing operations was \$7.2 million for the nine months ended September 30, 2009, as compared to \$5.9 million for the nine months ended September 30, 2008. Cash used in operations is primarily impacted by operating results and changes in working capital, particularly the timing of the collection of receivables, inventory levels and the timing of payments to suppliers. A significant use of cash in the nine months ended September 30, 2008 was a payment of \$1.2 million, relating to the settlement of purchase obligations with the Alan James Group, \$0.6 million of which had been accrued prior to 2008 and is reflected as being paid in net cash used in continuing operation activities in the nine months ended September 30, 2008. The remaining \$0.6 million is reflected in net cash used in investing activities of our continuing operations as described below. The increase of \$1.3 million of cash used in continuing operations is primarily attributable to closing costs related to the sale of substantially all of the Alan James Group business and assets of AJG Brands, Inc., as well as costs of advertising, media and product development costs related to the launch of our Inherent Health brand of genetic tests.

Cash used in investing activities of our continuing operations was \$0.7 million for the nine months ended September 30, 2009, compared to \$0.9 million for the nine months ended September 30, 2008. The most significant use of cash in investing activities during the nine months ended September 30, 2008 was the settlement of claims related to the acquisition of the assets and business of the Alan James Group as described above. As a result of the settlement, we paid additional consideration of \$0.6 million. Capital additions were \$0.7 million for the nine months ended September 30, 2009, compared to \$0.1 million for the nine months ended September 30, 2008. The increase in capital additions primarily consists of new commercial laboratory equipment installed and validated in the first nine months of 2009, which allows for high volume processing of genetic test samples.

Cash provided by financing activities of our continuing operations was \$1.1 million for the nine months ended September 30, 2009, compared to \$4.0 million for the nine months ended September 30, 2008. On May 29, 2009, we received proceeds from the issuance of a note payable in the amount of \$1.0 million under our existing credit facility with Pyxis. On June 10, 2008 we received \$4.0 million under the same credit facility. We received approximately \$63,000 and \$13,000, respectively from the exercise of stock options and stock purchases through the employee stock purchase plan for the nine months ended September 30, 2009 and September 30, 2008.

On December 23, 2008, we were notified of our failure to comply with the NYSE Amex, LLC's, hereinafter referred to as the Exchange, continued listing standards under section 1003 of the Exchange's Company Guide. Specifically, the Exchange noted our failure to comply with section 1003(a)(iii) of the Company Guide because our stockholders' equity was less than \$6,000,000 and we had losses from continuing operations and net losses in our five most recent fiscal years. The notice was based on a review by the Exchange of publicly available information, including our Quarterly Report on Form 10-Q for the quarter ended September 30, 2008. As of December 31, 2008, our stockholders equity was \$4.5 million. On January 27, 2009, we submitted a plan to the exchange to meet the continued listing requirements. The plan consists of several elements, but is primarily focused on increasing the sales of our products and services and raising additional equity capital. On March 27, 2009, we were notified that the Exchange found our plan to regain compliance with the continued listing standards to be

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

unacceptable. We filed an appeal for an oral hearing and submitted a revised plan to the Exchange. On May 11, 2009, the Exchange notified us that the Exchange accepted our redrafted plan of compliance, without a hearing, and granted us an extension until December 31, 2009 to regain compliance with the continued listing standards. The Exchange will periodically review our progress toward regaining compliance. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards by December 31, 2009 could result in delisting from the Exchange, which could significantly impact our ability to raise additional capital.

We currently do not have any commitments for any additional material capital purchases.

Prior to June 30, 2009, we generated operating cash by sales of consumer products and subsequent to that date we continue to generate cash from the sale of genetic tests, royalties, and reimbursements for funded research. Subsequent to

Table of Contents

June 30, 2009, pursuant to the asset purchase agreement with the Alan James Group, we are prohibited from continuing to operate in a business competitive to the one previously conducted by AJG Brands, Inc., which primarily developed, marketed and sold nutritional supplements and related products into retail consumer channel. The amount of operating cash we generate is not currently sufficient to continue to fund and grow our operations. In addition to funds generated by our operations, we have a \$14.3 million credit facility with Pyxis, under which we had \$9.3 million in borrowings available as of September 30, 2009. On November 9, 2009 we borrowed an additional \$2.0 million leaving borrowings available of \$7.3 million under the credit facility. Clinical studies and other research and development activities may require cash outflows that depend on the timing of activities.

We believe that our cash on hand and availability under our line of credit with Pyxis will be sufficient to fund our operations and meet our overall strategic plan for at least the next twelve months. We will need to raise additional capital, if market conditions permit, to continue investment in new product development, to improve our distribution channels, to maintain our listing on the NYSE Amex, LLC, and other aspects of our overall strategic plan. The current status of the financial markets may adversely affect our ability to raise additional capital.

We have no financial covenants as part of our credit facility with Pyxis. We currently have \$5.0 million outstanding under the credit facility, which is reflected as long term debt on our balance sheet and is convertible, at the option of Pyxis into shares of our common stock at a price of \$5.6783 per share. We anticipate drawing down additional funds available under our credit facility in the foreseeable future.

Table of Contents**Results of Operations (000 s)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
<b>Continuing operations</b>				
Revenue:				
Genetic testing	\$ 119,309	\$ 102,782	\$ 352,130	\$ 295,527
Contract research and development	198,203	441,467	520,935	1,380,759
Other	5,370	1,345	20,274	32,799
Total revenue from continuing operations	322,882	545,594	893,339	1,709,085
Cost of revenue	\$ 305,303	\$ 235,795	\$ 912,150	\$ 679,037
Gross profit (loss)	\$ 17,579	\$ 309,799	\$ (18,811)	\$ 1,030,048
Expenses:				
Research and development	873,195	933,003	2,628,943	2,455,230
Selling, general and administrative	1,660,235	1,196,580	4,473,860	3,864,216
Amortization of intangibles	28,863	26,271	86,590	70,611
Other expense (income)	40,219	11,820	98,458	(50,656)
Total expenses	\$ 2,602,512	\$ 2,167,674	\$ 7,287,851	\$ 6,339,401
Net loss from continuing operations before income taxes	\$ (2,584,933)	\$ (1,857,875)	\$ (7,306,662)	\$ (5,309,353)
Benefit for income taxes		37,000		31,000
Net loss from continuing operations	\$ (2,584,933)	\$ (1,820,875)	\$ (7,306,662)	\$ (5,278,353)
<b>Discontinued operations</b>				
Consumer product revenue	\$	\$ 1,626,000	\$ 3,580,169	\$ 5,593,267
Cost of revenue		764,469	1,892,815	2,963,675
Gross profit	\$	\$ 861,531	\$ 1,687,354	\$ 2,629,592
Expenses:				
Selling, general and administrative	83,215	365,821	1,187,368	1,586,920
Amortization of intangibles		308,684	617,375	926,058
Other expenses	(123,876)		1,234,825	1,057
Total expenses	\$ (40,661)	\$ 674,505	\$ 3,039,568	\$ 2,514,035
Net profit (loss) from discontinued operations before income taxes	\$ 40,661	\$ 187,026	\$ (1,352,214)	\$ 115,557
Provision for income taxes		(8,000)	(53,000)	(20,500)
Net profit (loss) from discontinued operations	\$ 40,661	\$ 179,026	\$ (1,405,214)	\$ 95,057
<b>Combined continuing and discontinued operations</b>				
Total revenue	\$ 322,882	\$ 2,171,594	\$ 4,473,508	\$ 7,302,352
Cost of revenue	305,303	1,000,264	2,804,965	3,642,712
Gross profit	\$ 17,579	\$ 1,171,330	\$ 1,668,543	\$ 3,659,640
Expenses:				
Research and development	873,195	933,003	2,628,943	2,455,230
Selling, general and administrative	1,743,450	1,562,401	5,661,228	5,451,136
Amortization of intangibles	28,863	334,955	703,965	996,669
Other (income) expense	(83,657)	11,820	1,333,283	(49,599)
Total expenses	\$ 2,561,851	\$ 2,842,179	\$ 10,327,419	\$ 8,853,436
Net loss before income taxes	\$ (2,544,272)	\$ (1,670,849)	\$ (8,658,876)	\$ (5,193,796)
Benefit (provision) for income taxes		29,000	(53,000)	10,500
Net loss	\$ (2,544,272)	\$ (1,641,849)	\$ (8,711,876)	\$ (5,183,296)

Table of Contents

*Three Months Ended September 30, 2009 and September 30, 2008*

**Continuing operations**

Total revenue from continuing operations for the three months ended September 30, 2009 was \$0.3 million, compared to \$0.5 million for the three months ended September 30, 2008. The decrease of \$0.2 million, or 40.8%, is primarily attributable to a decrease in contract research revenue, offset by increases in genetic test and royalty revenue. Contract research revenue was \$0.2 million in the three months ended September 30, 2009, compared to \$0.4 million in the three months ended September 30, 2008. The decrease of \$0.2 million, or 55.1%, is primarily attributable to the completion and timing of our reimbursable research projects. Genetic testing revenue increased to \$0.12 million, or 16.1%, in the three months ended September 30, 2009, compared to \$0.10 million in the three months ended September 30, 2008. The increase is primarily attributable to the launch of our Inherent Health Brand of genetic tests, which commenced in June 2009. Genetic testing revenue is derived from tests sold and processed, which is driven by consumer demand. Contract research revenue is recognized when Alticor sponsored research expenses are incurred.

We have one significant customer, Alticor, which is our principal shareholder, represented approximately 88.6% and 97.7%, respectively, of our revenues from continuing operations in the three months ended September 30, 2009 and 2008.

Cost of revenue from continuing operations for the three months ended September 30, 2009 was \$0.3 million or 94.6% of its revenue, compared to \$0.2 million, or 43.2% of its revenue, for the three months ended September 30, 2008. The significant increase in the cost of revenue as a percentage of revenue is primarily attributable to increased fixed costs associated with our genetic testing laboratory notwithstanding changes in our revenue. Fixed costs were impacted during the three months ended September 30, 2009 by costs associated with the installation of new high volume genetic testing equipment, which we expect to be absorbed with changes in volume of tests performed. Increased costs associated with this equipment are recognized in the third quarter of 2009, where no such costs were recognized in the third quarter of 2008. The equipment will allow for higher volume processing.

Gross margin from continuing operations for the three months ended September 30, 2009, was \$18,000, or 5.4%, compared to \$0.3 million, or 56.8%, for the three months ended September 30, 2008. The significant decrease in gross margin is primarily attributable to increased fixed costs associated with our genetic testing laboratory and a decrease in contract research revenue.

Research and development expenses from continuing operations were \$0.87 million for the three months ended September 30, 2009, compared to \$0.93 million for the three months ended September 30, 2008. The slight decrease from 2008 to 2009 is primarily attributable to increased expenses for patent and separation costs which were offset by lower consulting and clinical trial expenses as compared to the three months ended September 30, 2008.

Selling, general and administrative expenses from our continuing operations were \$1.7 million for the three months ended September 30, 2009, compared to \$1.2 million for the three months ended September 30, 2008. The increase of \$0.5 million is primarily attributable to the product development and advertising costs associated with our new Inherent Health Brand of genetic tests offset by decreased expenses relating to administrative support consultants.



## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

Interest expense from continuing operations was \$41,000 for the three months ended September 30, 2009, as compared to \$50,000 for the three months ended September 30, 2008. The decrease in interest expense of \$9,000 is primarily attributable to lower interest rate associated with borrowings on our credit facility with Pyxis.

Interest income from continuing operations was \$700 for the three months ended September 30, 2009 as compared to \$39,000 for the three months ended September 30, 2008. The decrease in interest income of \$38,000 is primarily attributable to the decrease in our cash balances as well as lower interest being earned on available cash balances. The current financial market conditions have significantly reduced the interest rate we are able to earn on our cash and cash equivalent balances.

### *Nine Months Ended September 30, 2009 and September 30, 2008*

#### **Continuing operations**

Total revenue from our continuing operations for the nine months ended September 30, 2009 was \$0.9 million, compared to \$1.7 million for the nine months ended September 30, 2008. The decrease of \$0.8 million or 47.7% is

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

### Table of Contents

attributable to a decrease in contract research revenue and royalty revenue offset by an increase in genetic test revenue. Contract research revenue decreased \$0.9 million primarily due to the completion of sponsored projects with reimbursable research expenses. Genetic testing revenue increased to \$0.4 million, or 19.2% in the nine months ended September 30, 2009, compared to \$0.3 million in the nine months ended September 30, 2008 primarily attributable to the launch of our Inherent Health Brand of genetic tests, which commenced in June 2009.

Alticor represented approximately 92.5% and 97.5%, respectively of our revenues from continuing operations in the nine months ended September 30, 2009 and 2008.

Cost of revenue from continuing operations for the nine months ended September 30, 2009 was \$0.9 million, or 102.1% of its revenue, compared to \$0.7 million, or 39.7% of its revenue, for the nine months ended September 30, 2008. The significant increase in the cost of revenue as a percentage of revenue is primarily attributable to increased fixed costs associated with our genetic testing laboratory notwithstanding decreases in our revenue.

Gross margin from continuing operations for the nine months ended September 30, 2009 was a loss of \$19,000, or 2.1% of its revenue, compared to a profit of \$1.0 million, or 60.3% of its revenue, in the nine months ended September 30, 2008. The decrease in gross margin of \$1.0 million, or 101.8%, is primarily attributable to a reduction in contract research revenue and royalty revenue offset by an increase in genetic testing revenue for the nine months ended September 30, 2009, compared to the nine months ended September 30, 2008. Fixed costs increased during the nine months ended September 30, 2009 due to the purchase and installation of new high volume genetic testing equipment, which we expect to be absorbed with changes in volume of tests performed. The equipment will allow for higher volume processing. No such costs were recognized in the nine months ended September 30, 2008.

Research and development expenses from continuing operations were \$2.6 million for the nine months ended September 30, 2009, compared to \$2.5 million for the nine months ended September 30, 2008. The increase of \$0.1 million is primarily attributable to increased separation costs, clinical trial expenses related to our research agreements with Alticor and increased expenses related to our patent portfolio, which was offset by a decrease in consulting expenses.

Selling, general and administrative expenses from continuing operations were \$4.5 million for the nine months ended September 30, 2009 compared to \$3.9 million for the nine months ended September 30, 2008. The increase of \$0.6 million is primarily attributable to increased product development and advertising expenses for our Inherent Health Brand of genetic test and increased headcount, offset by decreased expenses relating to administrative support consultants.

Interest expense from continuing operations was \$108,000 for the nine months ended September 30, 2009, as compared to \$80,000 for the nine months ended September 30, 2008. The increase in interest expense of \$28,000 is primarily attributable to interest expense associated with borrowings on our credit facility with Pyxis.

Interest income from continuing operations was \$10,000 for the nine months ended September 30, 2009, as compared to \$130,000 for the nine months ended September 30, 2008. The decrease in interest income of \$120,000 is primarily attributable to the decrease in cash balance with lower interest being earned on available cash balances. The current financial market conditions have significantly reduced the interest rate we are able to earn on our cash and cash equivalent balances.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements. The preparation of these financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires us to (i) make judgments, assumptions and estimates that affect the reported amounts of assets, liabilities, revenue and expenses; and (ii) disclose contingent assets and liabilities. A critical accounting estimate is an assumption that could have a material effect on our consolidated financial statements if another, also reasonable, amount were used or a change in the estimates is reasonably likely from period to period. We base our accounting estimates on historical experience and other factors that we consider reasonable under the circumstances. However, actual results may differ from these estimates. To the extent there are material differences between our estimates and the actual results, our future financial condition and results of operations will be affected. 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:

Table of Contents

*Revenue Recognition:*

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectability is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test. To the extent that tests have been prepaid but results have not yet been reported, recognition of all related revenue is deferred. As of September 30, 2009 and December 31, 2008, the Company has deferred revenue of \$23,200 and \$80,000, 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 collectability 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 (including revenue from Alticor, a related party).

*Allowance for Sales Returns:*

We analyze sales returns in accordance with the provisions of FASB ASC 605, *Revenue Recognition*. We are able to make reasonable and reliable estimates based on the buying patterns of the end-users of its products based on sales data received. We believe we have sufficient interaction with and knowledge of our customers, industry trends and industry conditions to adjust the accrual for returns when necessary.

At September 30, 2009, we have fully reserved for any potential sales returns and discontinued items applicable to the non-acquired accounts resulting from our sale of substantially all of the assets of the Alan James Group business. The reserve of approximately \$1.3 million is deemed to be adequate and no additional amounts were added at September 30, 2009.

*Trade Promotions:*

Pursuant to the asset purchase agreement in connection with the Company's sale of substantially all of the Alan James Group business and assets, the Company fully accrued for the approximately \$150,000 of agreed upon trade promotions implemented prior to June 30, 2009. At September 30, 2009 the balance of trade promotions estimated to be due in the future was \$128,000.

*Accounts Receivable*

Pursuant to the asset purchase agreement in connection with the Company's sale of substantially all of the Alan James Group business and assets the Company retained non acquired accounts receivable in the amount of \$180,605 which was fully reserved for as uncollectible at June 30, 2009. At September 30, 2009 the balance in non acquired accounts receivable was \$64,179 and is fully reserved for in the Company's financial statements. Prior to the acquisition trade accounts receivable were stated at their estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offered its Consumer Product customers a 2% cash discount if payment is made within 30 days of the invoice date, however, most customers take the discount regardless of when payment occurs. At December 31, 2008, the Company has reduced trade accounts receivable by \$13,364 for discounts anticipated to be taken and had provided an allowance for uncollectible accounts of \$6,696.

*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. An adverse change in any of these factors may result in the need for additional inventory allowance.

Table of Contents

*Stock-based compensation:*

We account for our stock-based compensation expense in accordance with FASB ASC 718, *Compensation - Stock Compensation*. The standard 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. We expense SBP awards with compensation cost for SBP transactions measured at fair value. 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. Common stock purchased pursuant to our employee stock purchase plan will be expensed based upon the fair market value in excess of purchase price.

*Cash Equivalents*

Cash and cash equivalents consist of amounts on deposit in checking and savings accounts with banks and other financial institutions. Short-term investments primarily consist of bank money market funds which have short-term maturities of less than ninety days and are carried at cost which approximates fair value.

*Fixed Assets*

Fixed assets are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over estimated useful lives of three to five years. Leasehold improvements are amortized over the estimated useful life of the asset, or the remaining term of the lease, whichever is shorter.

*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. We determined that due to the sale of substantially all of the Alan James Group business and assets of its wholly-owned subsidiary, AJG Brands, Inc., prior to the opening of business on July 1, 2009, \$3,251,838 of intangible assets became permanently impaired and were expensed.

*Income taxes:*

## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

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. We account for income taxes in accordance with FASB ASC 740, *Income Taxes*, which requires the recognition of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. We 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 \$25.4 million as of September 30, 2009, due to uncertainties related to our ability to utilize these assets. The valuation allowance is based on management's estimates of taxable income by jurisdiction in which we operate 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, we may need to adjust our valuation allowance, which could materially impact our financial position and results of operations.

Due to recent changes in the Massachusetts corporate income tax regulations, we will be filing on a combined basis with our other affiliated entities on a go-forward basis and as a result, net operating losses will be fully utilized at September 30, 2009. The combined filing will have no impact on our financial statements due to the full valuation allowance that offsets any deferred tax assets.

Table of Contents

In addition, the standard 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. At September 30, 2009, we reviewed all material tax positions for all years open to statute and for all tax jurisdictions open to statute to determine whether it was more likely than not that the positions taken would be sustained based upon the technical merits of those positions. These provisions had no impact on our financial statements.

*Contingencies:*

Estimated losses from contingencies are accrued by management based upon the likelihood of a loss and the ability to reasonably estimate the amount of the loss. Estimating potential losses, or even a range of losses, is difficult and involves a great deal of judgment. Management relies primarily on assessments made by its external legal counsel to make our determination as to whether a loss contingency arising from litigation should be recorded or disclosed. Should the resolution of a contingency result in a loss that we did not accrue because management did not believe a loss was probable or capable of being reasonably estimated, then this loss would result in a charge to income in the period the contingency was resolved.

**Recent Accounting Pronouncements**

Please see our discussion of *Recent Accounting Pronouncements* in Note 4. Significant Accounting Policies contained in the Notes to Condensed Consolidated Financial Statements elsewhere in this Form 10-Q.

**Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

As of September 30, 2009, the only financial instruments we carried were cash and cash equivalents denominated in U.S. Dollars. We believe the market risk arising from holding these financial instruments is not material. While we recognize that the interest rates these instruments bear are currently at historically low levels, we believe it is most prudent to maintain these relatively low risk positions during this time of unprecedented volatility and uncertainty across the global financial markets.

Some of our sales and some of our costs 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***



## Edgar Filing: INTERLEUKIN GENETICS INC - Form 10-Q

(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 15(d)-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 information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Control Over Financial Reporting.* No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f)) occurred during the quarter ended September 30, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**PART II OTHER INFORMATION**

**Item 1.** Legal Proceedings.

Not applicable.

**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, 2008 and Part II, Item 1A. Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, 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 that we face. In addition, risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. Except for the addition of the following risk factor, there have been no material changes in or additions to the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2008 and our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009.

***SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS***

This Quarterly Report on Form 10-Q and, in particular, our Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Part I Item 2 contain or incorporate a number of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this Quarterly Report on Form 10-Q will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially.

Without limiting the foregoing, the words believes, anticipates, plans, expects and similar expressions are intended to identify forward-looking statements. There are a number of factors that could cause actual events or results to differ materially from those indicated by such forward-looking statements, many of which are beyond our control, including the factors set forth under Item 1A. Risk Factors of our 2008 Annual Report on Form 10-K. In addition, the forward-looking statements contained herein represent our estimate only as of the date of this filing and should not be relied upon as representing our estimate as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements.

**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.

On November 9, 2009, we drew down \$2.0 million under our existing convertible credit facility with Pyxis, an affiliate of Alticor Inc., and issued a convertible promissory note to Pyxis in that amount. A description of the credit facility is set forth in Note 6 of the Notes to our Condensed Consolidated Financial Statements (Unaudited), contained in this Quarterly Report on Form 10-Q, which description is incorporated into this Item 5 by reference. The promissory note issued to Pyxis was in the form of promissory note filed with the Securities and Exchange Commission as Exhibit 10.4 to our Current Report on Form 8-K/A (File No. 001-32715) on October 31, 2006. The principal amount of the note is due and payable on August 16, 2011. The note bears interest at a variable rate equal to the prime rate and the interest is payable quarterly. Prior to the maturity date, any portion or the entire outstanding principal and any accrued but unpaid interest under the note is convertible at Pyxis's election into shares of our common stock at a price of \$5.6783 per share. Immediately following the issuance of the note on November 9, 2009, the note was convertible into an aggregate of 352,218 shares of our

Table of Contents

common stock, we had \$7.0 million outstanding under the credit facility and we had \$7.3 million available to us to borrow under the credit facility.

**Item 6.** Exhibits.

<b>Exhibit Number</b>	<b>Exhibit</b>
10.1	First Amendment dated August 10, 2009 to Amended and Restated Note Purchase Agreement, dated March 10, 2009 by and between the Company and Pyxis Innovations, Inc. (incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the Quarter ended June 30, 2009 (File No. 001-32715))
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.

**Table of Contents**

**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.

INTERLEUKIN GENETICS, INC.

Date: November 12, 2009

By:

/s/ Lewis H. Bender  
Lewis H. Bender  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 12, 2009

By:

/s/ ELIOT M. LURIER  
Eliot M. Lurier  
Chief Financial Officer  
(Principal Financial Officer)