INSMED INC
Form 10-Q
August 04, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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FORM 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from _____ to _____

INSMED INCORPORATED
(Exact Name of Registrant as Specified in Its Charter)

Virginia
(State or Other Jurisdiction of Incorporation)

0-30739	54-1972729
(Commission File Number)	(IRS Employer Identification No.)

8720 Stony Point Parkway, Suite 200, Richmond, Virginia	23235
(Address of Principal Executive Offices)	(Zip Code)

(804) 565-3000
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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: þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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: o No o

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

Large accelerated filer	o	Accelerated filer	þ
Non-accelerated filer	o	Smaller reporting company	o

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

As of August 1, 2010, the latest practicable date, there were 130,295,819 shares of Insmed Incorporated common stock outstanding.

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INSMED INCORPORATED

FORM 10-Q
For the Quarterly Period Ended June 30, 2010

PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

PART I
FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

INSMED INCORPORATED
Consolidated Balance Sheets
(in thousands, except share and per share data)

	June 30, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$11,316	$12,740
Short-term investments	113,472	109,441
Income tax receivable	-	2,023
Accounts receivable, net	190	245
Prepaid expenses	341	159
Total current assets	125,319	124,608
Long-term assets:		
Certificate of deposit	2,085	2,085
Deferred financing costs, net	-	2
Total long-term assets	2,085	2,087
Total assets	$127,404	$126,695
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$912	$312
Accrued project costs & other	1,150	1,150
Payroll liabilities	386	580
Interest payable	-	1
Deferred rent	132	132
Deferred revenue	438	398
Convertible debt	-	231
Debt discount	-	(23)
Net convertible debt	-	208
Total liabilities	3,018	2,781
Stockholders' equity:		
Common stock; $.01 par value; authorized shares 500,000,000; issued and outstanding shares, 130,295,819 in 2009 and 122,494,010 in 2008	1,303	1,302
Additional paid-in capital	350,372	350,243
Accumulated deficit	(228,336)	(228,076)

Accumulated other comprehensive income:		
Unrealized gain on investment	1,047	445
Net stockholders' equity	124,386	123,914
Total liabilities and stockholders' equity	$127,404	$126,695

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

INSMED INCORPORATED
Consolidated Statements of Operations
(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Royalties	$-	$30	$2	$58
Grant revenue	-	272	-	544
Other expanded access program income, net	1,864	2,738	3,791	4,808
Total revenues	1,864	3,040	3,793	5,410
Operating expenses:				
Research and development	893	1,472	1,535	7,340
Selling, general and administrative	1,884	2,874	3,422	6,323
Total expenses	2,777	4,346	4,957	13,663
Operating loss	(913)	(1,306)	(1,164)	(8,253)
Investment income	538	112	935	135
Interest expense	-	(420)	(28)	(662)
Gain on sale of asset, net	-	13	-	127,768
Income (loss) before taxes	(375)	(1,601)	(257)	118,988
Income tax expense	3	-	3	2,794
Net (loss) income	$(378)	$(1,601)	$(260)	$116,194
Basic net (loss) income per share	$(0.00)	$(0.01)	$(0.00)	$0.93
Shares used in computing basic net (loss) income per share	130,249	126,178	130,228	124,360
Diluted net (loss) income per share	$(0.00)	$(0.01)	$(0.00)	$0.93
Shares used in computing diluted net (loss) income per share	130,249	126,178	130,228	124,606

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

INSMED INCORPORATED
Consolidated Statements of Cash Flows
(in thousands)

	Six Months Ended June 30,	
	2010	2009
Operating activities		
Net income	$(260)	$116,194
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	25	601
Stock based compensation expense	129	1,922
Gain on sale of asset, net	-	(127,768)
Changes in operating assets and liabilities:		
Accounts receivable	55	(89)
Income tax receivable	2,023	-
Prepaid expenses	(182)	(71)
Accounts payable	600	(566)
Accrued project costs & other	-	(266)
Payroll liabilities	(194)	582
Income tax liability	-	1,250
Deferred rent	-	(65)
Deferred revenue	40	(32)
Restricted stock unit liability	-	(113)
Asset retirement obligation	-	(2,217)
Interest payable	(1)	(10)
Net cash provided by (used in) operating activities	2,235	(10,648)
Investing activities		
Cash received from asset sale	-	127,768
Sales of short-term investments	69,239	-
Purchases of short-term investments	(72,668)	(87,763)
Net cash provided by (used in) investing activities	(3,429)	40,005
Financing activities		
Proceeds from issuance of common stock	-	580
Repayment of convertible notes	(231)	(785)
Certificate of deposits	-	10
Warrants converted into shares	-	3,493
Other	1	31
Net cash provided by (used in) financing activities	(230)	3,329
Increase (decrease) in cash and cash equivalents	(1,424)	32,686
Cash and cash equivalents at beginning of period	12,740	2,397
Cash and cash equivalents at end of period	$11,316	$35,083

Supplemental information		
Cash paid for interest	$-	$62
Cash paid for taxes	3	-

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

Insmed Incorporated
Notes to Consolidated Financial Statements
(Unaudited)

1. Basis of Presentation, Current Development and Liquidity

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") and applicable Securities and Exchange Commission regulations for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly these financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. It is presumed that users of this interim financial information have read or have access to the audited consolidated financial statements contained in the Annual Report on Form 10-K of Insmed Incorporated ("Insmed", the "Company", "us" "we" or "our"), for the fiscal year ended December 31, 2009. In the opinion of c management, all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for the full year.

We are a biopharmaceutical company with expertise in recombinant protein drug development. Our corporate office is located in Richmond, Virginia.

On March 31, 2009, we completed the sale of our follow-on biologics ("FOB") platform to Merck & Co., Inc. ("Merck") for an aggregate purchase price of $130 million. As part of this transaction, Merck assumed the lease of our Boulder, Colorado-based manufacturing facility (which was also used to manufacture IPLEX™) and acquired ownership of all the equipment in the building. In addition, Merck offered positions to employees at the Boulder facility. After fees, taxes and other expenses related to the transaction, we received total net proceeds of approximately $127 million. In the fourth quarter of 2009 we recorded a $2 million tax refund receivable which increased the after tax proceeds on the sale from $125 million, as reported in the first quarter of 2009, to the $127 million reported in our full year results. The $2.0 million reduction in taxes results from the beneficial impact of revised tax laws, which came into effect in the fourth quarter of 2009, and allowed the Company to utilize more of its net operating losses ("NOLs") than previously able under former tax law to reduce the amount of taxes paid on the gain on sale of its FOB business to Merck in March 2009. The Company received the full tax refund in April 2010. We retained our Richmond, VA corporate office, which houses our Clinical, Regulatory, Finance, and Administrative functions, in support of the continuing IPLEX™ program.

Until the sale of our follow-on biologics platform, we pursued a dual path strategy involving entry into the follow-on biologics arena (also known as biosimilars, biogenerics and biologics) and advancing our proprietary protein platform into niche markets with unmet needs. Following the sale of our follow-on biologics assets, we have engaged the services of RBC Capital Markets to act as financial advisor in evaluating other options for use of these proceeds from the sale of our FOB business to Merck. These options could include acquisitions of complementary businesses or technologies, product licensing or mergers, and could also include share repurchase or the distribution of a portion of the proceeds to shareholders if we do not find attractive acquisition or licensing opportunities. In parallel, we also intend to continue to focus on our proprietary protein platform and our product, the FDA-approved IPLEX™, which is in various stages of development for a number of serious medical conditions. Based on a comprehensive market analysis, our current resource allocation strategy for IPLEX™ is focused on Amyotrophic Lateral Sclerosis ("ALS"), also known as Lou Gehrig's disease and Retinopathy of Prematurity ("ROP"), the latter under a Material Transfer Agreement with Premacure AB in Sweden.

On June 15, 2009, we announced that Geoffrey Allan, Ph.D., resigned as our President, Chief Executive Officer and Chairman of the Board due to a health condition. Dr. Allan had held these positions since our Company was formed in 1999. Mel Sharoky, M.D., one of our directors, assumed the role of Chairman of the Board. Pending the completion of the Strategic Review Process, we have decided not to hire a new President and Chief Executive Officer.

In June 2009, we announced results from our exploratory U.S. Phase II clinical trial evaluating IPLEX™ in patients with myotonic muscular dystrophy ("MMD"). The trial explored measures of endurance, muscle function and strength, cognitive function, gastrointestinal function, general health, pain, quality of life, insulin sensitivity, lipid metabolism, and safety and tolerability of IPLEX™ . The results of the trial indicated that IPLEX™ did not exhibit a statistically significant improvement in the functional measure of endurance by the six-minute walk test, muscle function, strength, cognitive function, general health, pain, or quality of life in any of the tests utilized in this study. IPLEX™ did, however, demonstrate improvements in standard measures of insulin sensitivity and reductions in fasting glucose, fasting insulin, cholesterol and triglycerides, which is consistent with the expected metabolic profile of insulin-like growth factor. Pending the completion of the Strategic Review Process, we have decided not to conduct further clinical trials focused on MMD patients.

Following the transfer of our Boulder, Colorado manufacturing facility to Merck, we no longer have the capability to manufacture IPLEX™, which is an extremely complicated drug to produce. Any agreement with a third party to undertake the manufacture of IPLEX™ would not result in production of additional quantities of IPLEX™ for at least 12 to 18 months. We are not actively exploring any third party manufacturing arrangements for IPLEX™ at this time. Since we no longer have a facility to manufacture IPLEX™, we announced in July 2009 that we would conserve our limited inventory of IPLEX™ on hand for the treatment of existing patients, would cease the supply of IPLEX™ to any new patients, and would not initiate further clinical trials with IPLEX™ (including a Phase II clinical trial for ALS patients in the U.S. discussed with the U.S. Food and Drug Administration (“FDA”) in early 2009). We plan, however, to continue to collect and analyze data for the ROP and ALS indications.

There are approximately 40 patients who currently receive IPLEX™, 8 in the U.S. and the remainder around the rest of the world. Most of the patients receive IPLEX™ pursuant to a court-ordered Expanded Access Program (EAP) for ALS in Italy, pursuant to which we have received most of our operating revenues in the form of cost recovery charges. The 8 U.S. patients are being treated for ALS under single patient Investigational New Drug applications approved by the U.S. Food and Drug Administration (“FDA”). We believe that we have sufficient IPLEX™ inventory to supply these existing patients into approximately the second quarter of 2011 at which time our primary source of operating revenues will cease.

The use of IPLEX™ in ROP is being conducted by Premacure AB in Sweden under a Phase 2 trial and we were recently informed by Premacure that the trial dosed its first patient in June 2010. We have supplied Premacure with sufficient IPLEX™ to complete the Phase 2 trial which Premacure is conducting and paying for.

Until the gain generated by the sale of our FOB platform to Merck, we had not been profitable. We accumulated deficits of approximately $230 million through December 31, 2009. Following the sale of our FOB assets to Merck, we operated on a cash neutral basis as a result of revenues on our Expanded Access Program and interest on the net proceeds of the sale of our FOB assets, offsetting our ongoing base costs. Moving forward our major source of income will continue to be the cost recovery charges for our Expanded Access Program and our major expenses will be related to due diligence for the ongoing corporate Strategic Review Process together with some research and development expenses. In general, our expenditures may increase as development of our product candidates progresses. However, there will be fluctuations from period to period caused by differences in project costs incurred at each stage of development.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries, Insmed Therapeutic Proteins, Incorporated, Insmed Pharmaceuticals, Incorporated and Celtrix Pharmaceuticals, Incorporated. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents and Short-Term Investments

We consider investments with maturities of three months or less when purchased to be cash equivalents. Short-term investments are classified as available for sale and consist primarily of mutual funds, government agency bonds and treasury securities. The cost of the specific security sold is used to compute the gain or loss on the sale of short-term investments.

Revenue Recognition

Revenue from our Expanded Access Program in Italy is recognized when the drugs have been provided to program patients and collectibility is assured. Royalties previously paid to Tercica and Genentech are shown net against Expanded Access Program revenue. Grant revenue is recognized once payment has been received. Shipping and handling costs charged to customers are included in revenue.

Research and Development

Research and development costs are expensed as incurred. Research and development expenses consist primarily of salaries and related expenses, cost to develop and manufacture drug candidates, patent protection costs, amounts paid to contract research organizations, hospitals and laboratories for the provision of services and materials for drug development and clinical trials. We do not have separate accounting policies for internal or external research and development and we do not conduct any research and development for others. Our expenses related to clinical trials are based on estimates of the services received and efforts expended pursuant to contracts with first party organizations that conduct and manage clinical trials on our behalf. These contracts set forth the scope of work to be completed at a fixed fee or amount per patient enrolled. Payments under these contracts depend on performance criteria such as the successful enrollment of patients or the completion of clinical trial milestones. Expenses are accrued based on contracted amounts applied to the level of patient enrollment and to activity according to the clinical trial protocol.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The relevant accounting for income taxes also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion of the deferred tax asset will not be realized. In evaluating the need for a valuation allowance, we take into account various factors, including the expected level of future taxable income and available tax planning strategies. If actual results differ from the assumptions made in the evaluation of our valuation allowance, we record a change in valuation allowance through income tax expense in the period such determination is made.

Net Income Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	(in thousands except per share data)			
Numerator:				
Net income for basic and diluted earnings per share	$(378)	$(1,601)	$(260)	$116,194
Denominator:				
Weighted average shares for basic earnings per share	130,249	126,178	130,228	124,360
Effect of dilutive securities:				
Warrants	-	-	-	26
Stock options and restricted stock	0	0	0	220
Denominator for diluted earnings per share	130,249	126,178	130,228	124,606
Basic earnings per share	$(0.00)	$(0.01)	$(0.00)	$0.93
Diluted earnings per share	$(0.00)	$(0.01)	$(0.00)	$0.93

Basic net loss per share is computed based upon the weighted average number of common shares outstanding during the year. For the three months ended June 30, 2009 and 2010 and the six months ended 2010, the Company's diluted net loss per share is the same as its basic net loss per share because all stock options, warrants, and other potentially dilutive securities are antidilutive and, therefore, excluded from the calculation of diluted net loss per share. Shares excluded from the calculation of diluted shares totaled 3.8 million for 2010 and 11.2 million for 2009 for the three months ended and 3.3 million for 2010 and 7.5 million for 2009 for the six months ended because they were antidilutive.

Segment Information

We currently operate in one business segment, which is the development and commercialization of pharmaceutical products for the treatment of metabolic and endocrine diseases. We are managed and operated as one business. A single management team that reports to the Chairman of the Board comprehensively manages the entire business. We do not operate separate lines of business with respect to our products or product candidates. Accordingly, we do not have separately reportable segments.

3. Equity Compensation Plan Information

As of June 30, 2010, we had two equity compensation plans under which we grant stock options and shares of non-vested stock. We are currently granting stock-based awards from our Amended and Restated 2000 Stock Incentive Plan (the "2000 Plan") and our Amended and Restated 2000 Employee Stock Purchase Plan (the "2000 ESPP"). Both the 2000 Plan and the 2000 ESPP are administered by the Compensation Committee of the Board of Directors.

The 2000 Plan was originally adopted by the Board and approved by our shareholders in 2000. Its original ten-year term was extended to March 15, 2015 when the plan was last amended. Under the terms of the 2000 Plan, we are authorized to grant a variety of incentive awards based on our common stock, including stock options (both incentive options and non-qualified options), performance shares and other stock awards. The 2000 Plan currently provides for the issuance of a maximum of 9,250,000 (adjusted for stock splits) shares of common stock. These shares are reserved for awards to all participants in the 2000 Plan, including non-employee directors.

The 2000 ESPP was adopted by the Board on April 5, 2000 and approved by our shareholders on the same date. It was amended by the Board to increase the number of shares available for issuance, and such amendment was approved by our shareholders on May 11, 2005. The 2000 ESPP was subsequently amended and restated by action of the Board on October 4, 2006 and the amendment and restatement was approved by our shareholders on December 14, 2006. Under the terms of the 2000 ESPP, eligible employees have the opportunity to purchase our common stock through stock options granted to them. An option gives its holder the right to purchase shares of our common stock at the lesser of 85% of the fair market value of a share of common stock at the beginning of each offer period or 85% of the fair market value of a share of common stock on the date the purchase is made, up to a maximum value of $25,000 per year. The 2000 ESPP provides for the issuance of a maximum of 1,500,000 shares of our common stock to participating employees.

The following table presents information as of June 30, 2010, with respect to the 2000 Plan and the 2000 ESPP.

Plan Category (1)	Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity Compensation Plans Approved by Shareholders:			
Amended and Restated 2000 Stock Incentive Plan (2)	2,202,750	$ 2.03	2,044,385
Amended and Restated 2000 Employee Stock Purchase Plan	—	—	365,380
Total:	2,202,750	$ 2.03	2,409,765

(1) We do not have any equity compensation plans that have not been approved by our shareholders.

(2) To the extent that stock options or stock appreciation rights granted under the 2000 Plan terminate, expire, or are canceled, forfeited, exchanged or surrendered without having been exercised, or if any shares of restricted stock are forfeited, the shares of common stock underlying such grants will again become available for purposes of the 2000 Plan.

A summary of the status of our stock options as of June 30, 2010, and changes for the six months then ended is presented below:

Description	2010	Average Exercise Price	Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Options outstanding at January 1, 2010	2,592,750	$2.30		

Granted	-	-		
Exercised	-	-		
Cancelled	(390,000)	3.86		
Options outstanding at June 30, 2010	2,202,750	2.03	2.43	$15,020
Exercisable at June 30, 2010	2,097,750	$2.06	2.31	$15,020

The fair value of options granted is generally estimated at the date of grant using a Black-Scholes-Merton option-pricing model. No options were granted during the six month period ended June 30, 2010. Stock-based compensation expense related to stock options was $34,774 and $128,506 for the six months ended June 30, 2010 and 2009, respectively.

As of June 30, 2010, there were 4,080,991 shares reserved for issuance for all outstanding warrants, options and restricted stock.

Restricted Stock and Restricted Stock Units

In May 2008, under the 2000 Plan, we began granting Restricted Stock (“RS”) and Restricted Stock Units (“RSU’s”) to eligible employees, including our executives. Each RS and RSU represents a right to receive one share of our common stock or an equivalent cash payment upon the completion of a specific period of continued service or our achievement of certain performance metrics. Shares of RS are valued at the market price of our common stock on the date of grant and RSU’s are valued based on the market price on the date of settlement. RSU’s are classified as liabilities, as they are settled with a cash payment for each unit vested, equal to the fair market value of our common stock on the vesting date. We recognize noncash compensation expense for the fair values of these RS and RSU’s on a straight-line basis over the requisite vesting period of these awards.

The weighted-average grant date fair value of RS and RSU’s granted during the six months ended June 30, 2010 was $0.88. As of June 30, 2010, there were 202,704 RS awards outstanding to our Board of Directors and 100,000 RS awards to our Chief Scientific Officer who was hired in March 2010; the remaining unrecognized stock-based compensation expense relating to these awards is $208,525 and will be recognized over the next twelve months in accordance with their vesting schedule.

Below is a table of RS and RSU activity for the six months ended June 30, 2010.

	Number of Shares Restricted Stock
Outstanding at January 1, 2010	87,720
Granted	302,704
Vested	87,720
Outstanding at June 30, 2010	302,704

4. Convertible Debt Financings

On March 15, 2005, we entered into several purchase agreements with a group of institutional investors, pursuant to which we issued and sold to such investors certain 5.5% convertible notes in the aggregate principal amount of $35,000,000, which convert into a certain number of shares of our common stock (the “2005 Notes”) as well as warrants to purchase, in the aggregate, approximately 14,864,883 shares of our common stock, at an exercise price of $1.36 per share (the “2005 Warrants”).

As of September 1, 2005, the holders of the 2005 Notes began to receive interest payments at a rate of 5.5% per annum, and such interest payments were payable quarterly until March 1, 2010. As of March 1, 2008, the 2005 Notes matured and beginning on March 1, 2008, the holders of the 2005 Notes were entitled to receive nine quarterly installments of $552,778 in the aggregate each quarter. Any outstanding 2005 Notes were repaid in cash or converted into shares of our common stock by March 1, 2010. Subject to the terms of the 2005 Note purchase agreements, the holders of the 2005 Notes may convert such notes into shares of our common stock at a conversion price of $1.295 per share (as adjusted in accordance with certain adjustments for stock splits, dividends and the like) at any time prior to the close of business on March 1, 2010. Between April 1, 2005 and March 1, 2010, we received notices from certain holders of the 2005 Notes electing to voluntarily convert approximately $31,312,000 principal amount of such notes into approximately 24,185,181 shares of our common stock at the conversion rate of one share of common stock for each $1.295 in principal amount of the 2005 Notes. The final payment to our Convertible Note holders was made on March 1, 2010. As of June 30, 2010, we no longer had any outstanding debt related to these notes. The 2005 Warrants associated with these notes expired on March 15, 2010.

5. Income Taxes

The Company is subject to U.S. federal and state income taxes. Our loss carryforwards are subject to audit in any tax year in which those losses are carried and applied, notwithstanding the year of origin. The Company's policy is to recognize interest accrued related to unrecognized tax benefits and penalties in income tax expense. The Company has recorded no such expense.

At June 30, 2010, the Company had net operating loss ("NOL") carryforwards for income tax purposes of approximately $172 million, expiring in various years beginning in 2010. The deferred tax assets of approximately $74 million at June 30, 2010, arise primarily due to NOL carryforwards for income tax purposes. The Company projects that it will be able to utilize a portion of these NOL carryforwards and deferred tax assets in 2010, however presently all deferred tax assets have been fully offset by a valuation allowance. The Company has never been audited by the Internal Revenue Service.

6. Fair Value Measurements

We categorize financial assets and liabilities measured and reported at fair value in the financial statements on a recurring basis based upon the level of judgments associated with the inputs used to measure their fair value. Hierarchical levels, which are directly related to the amount of subjectivity associated with the inputs used to determine the fair value of financial assets and liabilities are as follows:

- Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.
- Level 2 – Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the assets or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.
- Level 3 – Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

Each major category of financial assets and liabilities measured at fair value on a recurring basis are categorized in the tables below based upon the lowest level of significant input to the valuations. The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Financial instruments in Level 1 generally include U.S. treasuries and mutual funds listed in active markets. Financial instruments in Level 2 generally include government agency bonds listed in secondary markets.

Assets and liabilities measured at fair value are summarized below (in thousands):

Fair Value Measurements at Reporting Date Using