Healthsport, Inc.
Form 10-Q
November 16, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2009

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________ to __________

Commission File Number: 000-23100

HEALTHSPORT, INC.
(Exact name of registrant as specified in its charter)

Delaware	**22-2649848**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6429 Independence Avenue Woodland Hills, CA	**91367**
(Address of principal executive offices)	(Zip Code)

(818) 593-4880
(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 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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

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 September 30, 2009, 55,802,753 shares of the issuer s common stock, par value $0.0001 per share, were outstanding.

HealthSport, Inc.
Quarterly Report on Form 10-Q
For the Period Ended September 30, 2009
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EXPLANATORY NOTE

In this report, unless the context indicates otherwise, the terms HealthSport, Company, we, us, and our r HealthSport, Inc., a Delaware corporation, and its wholly-owned subsidiaries: Enlyten, Inc. (**Enlyten**); InnoZen, Inc. (**InnoZen**) and InnoZen s majority owned subsidiary Pacific Manufacturing Group LLC (**PMG**) until its sale on December 30, 2008; Health Strip Solutions, LLC (**Health Strip**); and HealthSport Nutraceutical Products, Inc. (**Nutraceutical**).

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

Certain statements in this report, including information incorporated by reference, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995.

Forward-looking statements reflect our current views about future events and financial performance based on certain assumptions. They include opinions, forecasts, intentions, plans, goals, projections, guidance, expectations, beliefs or other statements that are not statements of historical fact. Words such as may, will, should, could, would, plans, believes, anticipates, intends, estimates, approximates, predicts, or projects, and similar ex identify a statement as a forward-looking statement. Any statements that refer to projections of our future financial performance, anticipated trends in our business, our goals, strategies, focus and plans, and other characterizations of future events or circumstances, including statements expressing general optimism about future operating results and the development of our products, are forward-looking statements. Forward-looking statements in this report may include statements about our ability to:

- maintain operating costs and implement our current business plan;
- obtain future financing or funds when needed;
- effectively launch new products
- develop and obtain a diverse and loyal customer base;
- protect our intellectual property rights and avoid infringing on the rights of others;
- attract and retain a qualified employee base;
- respond to new technology developments before our competitors;
- successfully complete acquisitions, strategic partnerships, and other significant transactions; and
- develop and execute a successful business strategy.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements. Forward-looking statements are subject to certain events, risks, and uncertainties that may be outside of our control. When considering forward-looking statements, you should carefully review the risks, uncertainties and other cautionary statements in this report as they identify certain important factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. These factors include, among others, the risks described under Item 1A and elsewhere in this report and in our 2008 Annual Report, as well as in other reports and documents we file with the SEC.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

HEALTHSPORT, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

	September 30, 2009 (unaudited)	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 25,443	$ 433,573
Accounts receivable (less allowance of $2,000 in 2009 and 2008)	97,257	486,967
Inventory	256,043	585,746
Prepaid expenses and other assets	237,863	293,318
Total current assets	616,606	1,799,604
Property and equipment, net	719,951	756,086
Non-current accounts receivable	200,294	225,000
Goodwill	6,276,948	10,276,948
Patent costs and other intangible assets, net	17,824,169	18,621,760
Other assets	80,010	137,170
Total assets	$ 25,717,978	$ 31,816,568
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,494,014	$ 1,462,148
Accrued expenses	400,664	900,837
Current portion of capital lease obligation	69,108	64,465
Current portion of convertible promissory notes, Note 6	1,182,500	1,268,000
Deferred revenue	588,401	832,256
Derivative Liability	648,987	
Total current liabilities	4,383,674	4,527,706
Convertible promissory notes, Note 6	356,596	277,450
Capital lease obligation	221,840	274,727
Total liabilities	4,962,110	5,079,883
Commitments and contingencies, Note 7		
Stockholders equity:		
Preferred stock: $2.75 par value; authorized 2,000,000 shares; no shares issued and outstanding		
Common stock: $.0001 par value; authorized 500,000,000 shares; 55,802,753 and 49,366,120 shares issued and outstanding at	5,580	4,937

September 30, 2009 and December 31, 2008, respectively				
Additional paid-in capital		67,851,041		69,241,594
Accumulated deficit		(47,100,753)		(42,509,846)
Total stockholders equity		20,755,868		26,736,685
Total liabilities and stockholders equity	$	25,717,978	$	31,816,568

See accompanying notes to condensed consolidated financial statements.

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HEALTHSPORT, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Operations (Unaudited)

	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Revenue				
Product sales	$ 61,931	$ 580,224	$ 2,215,181	$ 812,317
License fees, royalties and services	29,692	18,750	107,192	56,250
Total revenues	91,623	598,974	2,322,373	868,567
Costs and expenses				
Cost of product sold and manufacturing costs	269,233	463,267	2,075,570	1,097,667
General and administrative expense	675,631	645,317	1,714,748	2,181,818
Marketing and selling expense	10,672	358,530	220,820	1,056,087
Asset impairment			4,000,000	648,600
Inventory obsolescence	112,000		262,000	274,840
Non-cash compensation expense	171,148	351,747	466,726	2,033,325
Depreciation and amortization expense	330,944	294,982	1,000,027	1,053,313
Research and development costs	24,931	30,106	69,140	169,217
Total costs and expenses	1,594,559	2,143,949	9,809,031	8,514,867
Net loss from operations	(1,502,936)	(1,544,975)	(7,486,658)	(7,646,300)
Other income (expense):				
Interest income	6	406	304	1,175
Settlement income	3,850		444,181	
Change in fair value of derivative liability	372,063		2,732,608	
Miscellaneous income	10,822		19,728	5,584
Interest expense	(181,792)	(16,795)	(301,071)	(36,960)
Other income (expense)	204,949	(16,389)	2,895,750	(30,201)
Net loss before income taxes and minority interest	(1,297,987)	(1,561,364)	(4,590,908)	(7,676,501)
Provision for income taxes				
Net loss before minority interest	(1,297,987)	(1,561,364)	(4,590,908)	(7,676,501)
Minority interest		36,416		88,842
Net loss	$ (1,297,987)	$ (1,524,948)	$ (4,590,908)	$ (7,587,659)

Net loss per share, basic and diluted	$ (0.02)	$ (0.03)	$ (0.09)	$ (0.17)
Weighted average shares outstanding, basic and diluted	54,747,503	45,318,180	52,274,767	44,531,864

See accompanying notes to condensed consolidated financial statements.

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HEALTHSPORT, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows (Unaudited)

	For the nine months ended September 30, 2009	September 30, 2008
Cash flows from operating activities		
Net loss	$ (4,590,908)	$ (7,587,659)
Adjustment to reconcile net loss to net cash used in operating activities:		
Minority interest		(88,842)
Amortization of non-cash stock compensation	466,726	1,811,575
Amortization of loan discount	129,254	
Depreciation and amortization	1,000,027	1,053,313
Common stock issued for services	314,000	221,750
Inventory obsolescence reserve	262,000	274,840
Asset impairment	4,000,000	648,600
Gain on debt settlement	(444,181)	
Change in fair value of derivative liability	(2,732,608)	
Change in other assets and liabilities:		
Accounts receivable	389,710	136,471
Inventory	67,703	333,153
Prepaid expenses and other assets	129,342	242,337
Accounts payable	138,478	804,179
Accrued expenses	26,560	526,857
Deferred revenue	(243,855)	
Net cash used in operating activities	(1,087,752)	(1,623,426)
Cash flows from investing activities		
Patent costs incurred	(53,468)	
Acquisition of property and equipment	(108,666)	(389,022)
Net cash used in investing activities	(162,134)	(389,022)
Cash flows from financing activities		
Collect stock subscription receivable		22,500
Funding from joint venture partner		990,000
Proceeds from loans	90,000	545,000
Capital lease payments	(48,244)	(161,504)
Sale of common stock	800,000	660,000
Net cash provided by financing activities	841,756	2,055,996
Net increase (decrease) in cash and cash equivalents	(408,130)	43,548
Cash and cash equivalents, beginning of period	433,573	167,323

Cash and cash equivalents, end of period	$ 25,443	$ 210,871
Supplemental cash flow information		
Cash paid for interest and income taxes:		
Interest	$ 167,639	$ 7,733
Income taxes		
Non-cash investing and financing activities:		
Reclassification of derivative liability	3,252,341	
Common stock issued for notes payable and accrued interest	222,756	
Common stock issued for rent payable	62,762	
Stock subscription receivable		500

See accompanying notes to condensed consolidated financial statements.

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HealthSport, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1: ORGANIZATION AND NATURE OF BUSINESS

Principles of Consolidation

The condensed consolidated financial statements include the accounts of HealthSport, Inc., a Delaware corporation, and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Financial Statement Preparation

The condensed consolidated financial statements included in this report have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for interim reporting and include all adjustments (consisting only of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation. These condensed consolidated financial statements have not been audited.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to such rules and regulations for interim reporting. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008. The financial data for the interim periods presented may not necessarily reflect the results to be anticipated for the complete year.

In preparing the accompanying unaudited condensed consolidated financial statements, the Company has reviewed, as determined necessary by the Company s management, events that have occurred after September 30, 2009, up until the issuance of the financial statements, which occurred on November 16, 2009.

Reclassification

Certain reclassifications of the amounts presented for the comparative period have been made to conform to the current presentation.

Estimates

In preparing financial statements in conformity with generally accepted accounting principles, management makes estimates and assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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Nature of Business

We are a company specializing in the development and manufacture of proprietary, edible thin film products containing nutraceutical and pharmaceutical actives. Our thin film, which is similar in size and shape to a postage stamp, dissolves rapidly and utilizes patent pending bi-layer technology and other novel processes, including proprietary micro-encapsulation methods to mask the taste of actives in the film products. The result of this superior technology is higher quality, more stable products that support a platform capable of carrying larger product volumes and a more diverse array of active ingredients. We believe these qualities render our thin film effective, easy to use and suited for a multitude of consumer products in both the dietary supplement and pharmaceutical arenas.

We currently manufacture and distribute a number of nutritional supplement products formulated to contain electrolytes, vitamins, melatonin, caffeine, and other supplements. We are also currently conducting research and development related to future potential products that will contain over-the-counter and prescription drug actives.

Recent Accounting Pronouncements

On January 1, 2009, we adopted changes issued by the FASB to accounting for business combinations. While retaining the fundamental requirements of accounting for business combinations, including that the purchase method be used for all business combinations and for an acquirer to be identified for each business combination, these changes define the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control instead of the date that the consideration is transferred. These changes require an acquirer in a business combination, including business combinations achieved in stages (step acquisition), to recognize the assets acquired, liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. This guidance also requires the recognition of assets acquired and liabilities assumed arising from certain contractual contingencies as of the acquisition date, measured at their acquisition-date fair values. Additionally, these changes require acquisition-related costs to be expensed in the period in which the costs are incurred and the services are received instead of including such costs as part of the acquisition price. We have not engaged in any acquisitions since this new guidance was issued, so there has been no impact to our consolidated financial statements.

On January 1, 2009, we adopted changes issued by the FASB to accounting for intangible assets. These changes amend the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset in order to improve the consistency between the useful life of a recognized intangible asset outside of a business combination and the period of expected cash flows used to measure the fair value of an intangible asset in a business combination. The adoption of these changes did not have a material impact on our consolidated results of operations, financial position or cash flows, and the required disclosures regarding our intangible assets.

On January 1, 2009, we adopted changes issued by the FASB to consolidation accounting and reporting that establish accounting and reporting for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This guidance defines a non-controlling interest, previously called a minority interest, as the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent. These changes require, among other items, that a non-controlling interest be included in the consolidated balance sheet within equity separate from the parent s equity; consolidated net income to be reported at amounts inclusive of both the parent s and non-controlling interest s shares and, separately, the amounts

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of consolidated net income attributable to the parent and non-controlling interest all on the consolidated statement of operations; and if a subsidiary is deconsolidated, any retained non-controlling equity investment in the former subsidiary be measured at fair value and a gain or loss be recognized in net income based on such fair value. The adoption of these changes had no impact on our consolidated financial statements.

On January 1, 2009, we adopted changes issued by the FASB to fair value accounting and reporting as it relates to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the consolidated financial statements on at least an annual basis. These changes define fair value, establish a framework for measuring fair value in GAAP, and expand disclosures about fair value measurements. This guidance applies to other GAAP that require or permit fair value measurements and is to be applied prospectively with limited exceptions. The adoption of these changes, as it relates to nonfinancial assets and nonfinancial liabilities, had no impact on our consolidated financial statements. These provisions will be applied at such time a fair value measurement of a nonfinancial asset or nonfinancial liability is required, which may result in a fair value that is materially different than would have been calculated prior to the adoption of these changes.

On April 1, 2009 we adopted changes issued by the FASB in June 2008 to provide guidance in determining whether certain financial instruments (or embedded feature) are considered to be indexed to an entity s own stock. Existing guidance under GAAP considers certain financial instruments to be outside the scope of derivative accounting, specifying that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company s own stock and (b) classified in stockholders equity in the statement of financial position would not be considered a derivative financial instrument. These changes provide a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an entity s own stock and thus able to qualify for the derivative accounting scope exception. These changes did not have any impact on our consolidated financial statements.

In June 2009, the FASB issued guidance that establishes the FASB Accounting Standards Codification (the **Codification**) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). Use of the new Codification is effective for interim and annual periods ending after September 15, 2009. The Company has used the new Codification in reference to GAAP in this quarterly report on Form 10-Q and such use has not impacted the consolidated results of the Company.

In June 2009, the FASB amended U.S. GAAP with respect to the accounting for transfers of financial assets. These amendments, among other things, clarified that the objective of U.S. GAAP is to determine whether a transferor and all of the entities included in the transferor s financial statements being presented have surrendered control over transferred financial assets; limited the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented and/or when the transferor has continuing involvement with the transferred financial asset; and removed the concept of a qualifying special-purpose entity. The Company will be required to adopt these amendments effective January 1, 2010, and is currently evaluating the potential impact, if any, on its consolidated financial statements.

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In June 2009, the FASB issued changes to the accounting for variable interest entities. These changes require an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity; to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity; to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity; to add an additional reconsideration event for determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity s economic performance; and to require enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise s involvement in a variable interest entity. These changes become effective for us beginning on January 1, 2010. The adoption of this change is not expected to have a material impact on our consolidated financial statements.

On June 30, 2009, we adopted changes issued by the FASB to fair value disclosures of financial instruments. These changes require a publicly traded company to include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. Such disclosures include the fair value of all financial instruments, for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position; the related carrying amount of these financial instruments; and the method(s) and significant assumptions used to estimate the fair value. Other than the required disclosures, the adoption of these changes had no impact on our consolidated financial statements.

On June 30, 2009, we adopted changes issued by the FASB to fair value accounting. These changes provide additional guidance for estimating fair value when the volume and level of activity for an asset or liability have significantly decreased and includes guidance for identifying circumstances that indicate a transaction is not orderly. This guidance is necessary to maintain the overall objective of fair value measurements, which is, that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The adoption of these changes had no impact on our consolidated financial statements.

On June 30, 2009, we adopted changes issued by the FASB to the recognition and presentation of other-than-temporary impairments. These changes amend existing other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities. The adoption of these changes had no impact on our consolidated statements.

On July 1, 2009, we adopted changes issued by the FASB to accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued, otherwise known as subsequent events. Specifically, these changes set forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The adoption of these changes had no impact on our consolidated financial statements as management already followed a similar approach prior to the adoption of this new guidance. We have evaluated subsequent events through November 16, 2009, the filing date of this quarterly report, and there is no material impact on to our consolidated financial statements.

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In August 2009, the FASB issued Accounting Standards Update No. 2009-05, Measuring Liabilities at Fair Value (ASU 2009-05). ASU 2009-05 amends the Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification by providing additional guidance clarifying the measurement of liabilities at fair value. The update reaffirms that fair value is based on an orderly transaction between market participants, even though liabilities are infrequently transferred due to contractual or other legal restrictions. However, identical liabilities traded in the active market should be used when available. When quoted prices are not available, the quoted price of the identical liability traded as an asset, quoted prices for similar liabilities or similar liabilities traded as an asset, or another valuation approach should be used. This update also clarifies that restrictions preventing the transfer of a liability should not be considered as a separate input or adjustment in the measurement of fair value. We will adopt the provisions of this update for fair value measurements of liabilities effective October 1, 2009, which we do not expect to have a material impact on our condensed consolidated financial statements.

NOTE 2: DISPOSITION

On February 1, 2008 HealthSport and InnoZen executed a Limited Liability Company Operating Agreement (**LLC Agreement**) with Migami, Inc. (**Migami**) for the formation of PMG. Among other things, the LLC Agreement called for Migami to contribute $3,000,000 in cash to PMG for its intended 48% ownership and InnoZen licensed its technology to PMG for its 52% ownership. PMG was formed to build a world-wide regulatory compliant manufacturing facility with cutting edge innovation and stringent quality control, which will be cGMP compliant. Migami was scheduled to contribute $3,000,000 for its 48% interest in PMG. However, Migami was able to make only $990,000 of the required capital contributions. This resulted in substantial delays in completing the manufacturing facility. Production commenced in January 2009, although all operations have not yet been relocated to this facility. As a result of the delays in funding, Migami breached the LLC Agreement and forfeited all rights under that agreement. With Migami in breach of its obligation, PMG was unable to obtain the necessary capital to complete construction and incurring monthly operating losses. Consequently, Innozen elected to sell its interest in PMG for nominal consideration on December 30, 2008 and recognized a book gain of $869,453 on the transaction. The gain was the difference between the Company s share of the PMG loss which was included in the consolidated financial statements and its investment. Subsequently, operations related to the manufacturing facility have continued in InnoZen. Accordingly, no separate disclosure of PMG is included as the operations would have been included in InnoZen if PMG had not been formed.

NOTE 3: INVENTORY

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

	2009	2008
Raw materials	$ 136,032	$ 173,980
Work in progress	227,988	286,711
Finished goods	40,404	125,055
	404,424	585,746
Reserve for obsolescence	(148,381)	
Total Inventory	$ 256,043	$ 585,746

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NOTE 4: ASSET IMPAIRMENT

The Company accounts for goodwill in accordance with FASB codification guidance on accounting for goodwill and intangible assets, which prohibits the amortization of goodwill and intangible assets with indefinite useful lives and requires these assets to be reviewed for impairment at least annually. A charge to earnings is required for any identified impairments. This charge to earnings is to be recorded in the period in which the events causing the impairment occurred. The Company tests goodwill for impairment using the two-step process prescribed under the FASB codification guidance. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any.

Due to a significant reduction in business volume and a decline in the quoted market price of the Company s stock in the second quarter of 2009, management determined that the fair value of the Company had declined. Based on management s analysis, the fair value of the Company is no longer in excess of the carrying value of the underlying net assets, including goodwill. Accordingly, the Company recorded an impairment charge of $4,000,000 in the quarter ending June 30, 2009.

NOTE 5: DERIVATIVE LIABILITY

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level Input:	**Input Definition:**
Level I	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level II	Inputs, other than quoted prices included in Level I, that are observable for the asset or liability through corroboration with market data at the measurement date.
Level III	Unobservable inputs that reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date.

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The following table summarizes fair value measurements by level at September 30, 2009 for assets and liabilities measured at fair value on a recurring basis:

	Level I	Level II	Level III	Total
Cash and cash equivalents	$ 25,443	$	$	$ 25,443
Derivatives liability			$ (648,987)	$ (648,987)

We have issued convertible secured notes in 2008. The convertible notes require us to record the value of the conversion feature as a liability, at fair value, pursuant to FASB accounting rules, including provisions in the notes that protect the holders from declines in the Company s stock price, which is considered outside the control of the Company. The derivative liabilities are marked-to-market each reporting period and changes in fair value are recorded as a non-operating gain or loss in our statement of operations, until they are completely settled. The fair value of the conversion feature is determined each reporting period using the Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility, interest rates and expected term. The assumptions used in valuing the derivative liability during 2009 were as follows: