Patient Safety Technologies, Inc
Form 10-Q
August 16, 2010

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

FORM 10-Q

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

COMMISSION FILE NUMBER: 001-09727

PATIENT SAFETY TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

Delaware	13-3419202
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

5 Caufield Place, Suite 102, Newtown, PA 18940
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (215) 579-7789

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 x No ¨

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 ¨ 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:

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if smaller reporting company)	Smaller Reporting Company x

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

The number of outstanding shares of the registrant's common stock, par value $0.33 per share, as of August 13, 2010 was 23,456,063.

PATIENT SAFETY TECHNOLOGIES, INC.

FORM 10-Q FOR THE QUARTER
ENDED JUNE 30, 2010

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements in this quarterly report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. You can sometimes identify forward-looking statements by our use of forward-looking words like “may,” “should,” “expects,” “intends,” “plans,” “anticipates,” “believes,” “estimates,” “seeks,” “predicts,” “potential,” or “continue” o of these terms and other similar expressions. Our forward-looking statements relate to future events or our future performance and include, but are not limited to, plans, objectives, expectations and intentions. Other statements contained in this report that are not historical facts are also forward-looking statements.

We claim the protection of the safe harbor contained in the Private Securities Litigation Reform Act of 1995. Although we believe that the plans, objectives, expectations and intentions reflected in or suggested by our forward-looking statements are reasonable, those statements are based only on the current beliefs and assumptions of our management and on information currently available to us and, therefore, they involve uncertainties and risks as to what may happen in the future. Accordingly, we cannot guarantee that our plans, objectives, expectations or intentions will be achieved. Our actual results, performance (financial or operating) or achievements could differ from those expressed in or implied by any forward-looking statement in this report as a result of many known and unknown factors, many of which are beyond our ability to predict or control. These factors include, but are not limited to, those described under the caption “Risk Factors” in our annual report on Form 10-K for the year ended December 31, 2009 filed on March 31, 2010 and amended on April 30, 2010, including without limitation the following:

- our need for additional financing to support our business;
- the early stage of adoption of our Safety-Sponge® System and the need to expand adoption of our Safety-Sponge® System;
- any failure of our new management team and Board of Directors to operate effectively;
- our reliance on third-party manufacturers, some of whom are sole-source suppliers, and on our exclusive distributor; and
- any inability to successfully protect our intellectual property portfolio.

The risks included in our filings are not exhaustive, and additional factors could adversely affect our business and financial performance. We operate in a competitive and rapidly changing environment. New risk factors emerge from time to time, and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

All written and oral forward-looking statements attributable to us are expressly qualified in their entirety by these cautionary statements.

Our forward-looking statements speak only as of the date they are made and should not be relied upon as representing our plans, objectives, expectations and intentions as of any subsequent date. Although we may elect to update or revise forward-looking statements at some time in the future, we specifically disclaim any obligation to do so, even if our plans, objectives, expectations or intentions change.

HELPFUL INFORMATION

As used throughout this quarterly report on Form 10-Q, the terms the “Company,” “the registrant,” “we,” “us,” and “our” mean Patient Safety Technologies, Inc., a Delaware corporation, together with its consolidated subsidiary, SurgiCount Medical Inc., a California Corporation, unless the context otherwise requires.

Unless otherwise indicated, all statements presented in this quarterly report on Form 10-Q regarding cumulative number of surgical sponges used and numbers of procedures are internal estimates only.

Safety-Sponge®, SurgiCounter™ and Citadel™, among others, are registered or unregistered trademarks of Patient Safety Technologies, Inc. (including its subsidiary).

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PATIENT SAFETY TECHNOLOGIES, INC.
Condensed Consolidated Balance Sheets

	June 30, 2010 (Unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 4,591,755	$ 3,446,726
Restricted cash	651,223	—
Accounts receivable	532,798	906,136
Inventories, net	1,179,826	565,823
Prepaid expenses	122,445	207,598
Total current assets	7,078,047	5,126,283
Property and equipment, net	873,131	744,646
Goodwill	1,832,027	1,832,027
Patents, net	2,951,554	3,114,025
Long-term investment	666,667	666,667
Other assets	42,671	43,246
Total assets	$ 13,444,097	$ 11,526,894
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities		
Accounts payable	$ 1,726,325	$ 2,043,166
Convertible note	1,424,558	1,424,558
Capital lease-current portion	—	19,330
Warrant derivative liability	996,388	3,666,336
Deferred revenue	6,416,818	8,099,144
Accrued liabilities	1,334,277	1,242,876
Total current liabilities	11,898,366	16,495,410
Capital lease, less current portion	—	58,274
Deferred tax liability	740,622	805,768
Total liabilities	12,638,988	17,359,452
Commitments and contingencies (Note 20)		
Stockholders' equity:		
Series A preferred stock, $1.00 par value, cumulative 7% dividend: 1,000,000 shares authorized; 10,950 issued and outstanding at June 30, 2010 and December 31, 2009; (Liquidation preference of $1.2 million at June 30, 2010 and December 31, 2009)	10,950	10,950
	60,067	–

Series B convertible preferred stock, $1.00 par value, cumulative 7% dividend: 150,000 shares authorized; 60,067 issued and outstanding at June 30, 2010 and 0 issued and outstanding at December 31, 2009; (Liquidation preference of $6.0 million at June 30, 2010 and $0 at December 31, 2009)		
Common stock, $0.33 par value: 100,000,000 shares authorized; 23,456,063 shares issued and outstanding at June 30, 2010 and December 31, 2009	7,740,501	7,740,501
Additional paid-in capital	51,113,594	44,834,321
Accumulated deficit	(58,120,003)	(58,418,330)
Total stockholders' equity (deficit)	805,109	(5,832,558)
Total liabilities and stockholders' equity (deficit)	$ 13,444,097	$ 11,526,894

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

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PATIENT SAFETY TECHNOLOGIES, INC.
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenues	$ 3,765,517	$ 1,027,605	$ 6,130,337	$ 1,963,605
Cost of revenue	1,790,360	618,562	2,879,248	1,167,562
Gross profit	1,975,157	409,043	3,251,089	796,043
Operating expenses:				
Research and development	97,972	85,581	131,302	198,581
Sales and marketing	828,445	553,225	1,822,562	1,202,225
General and administrative	2,076,776	1,359,848	3,728,638	3,910,848
Total operating expenses	3,003,193	1,998,654	5,682,502	5,311,654
Operating loss	(1,028,036)	(1,589,611)	(2,431,413)	(4,515,611)
Other income (expense)				
Interest expense	(796)	(219,733)	(13,042)	(439,733)
Gain (loss) on change in fair value of warrant derivative liability	951,210	(2,155,119)	2,669,949	(2,570,119)
Other income (expense)	(5,075)	—	52,782	—
Total other income (expense)	945,339	(2,374,852)	2,709,689	(3,009,852)
Income (loss) before income taxes	(82,697)	(3,964,463)	278,276	(7,525,463)
Income tax benefit	32,573	30,719	65,146	64,719
Net income (loss)	50,124	(3,933,744)	343,422	(7,460,744)
Preferred dividends	(25,932)	(19,325)	(45,095)	(38,325)
Net income (loss) applicable to common shareholders	$ (76,056)	$ (3,953,069)	$ 298,327	$ (7,499,069)
Income (loss) per common share				
Basic	$ (0.00)	$ (0.23)	$ 0.01	$ (0.44)
Diluted	$ (0.00)	$ (0.23)	$ 0.01	$ (0.44)
Weighted average common shares outstanding:				
Basic	23,456,063	17,197,872	23,456,063	17,197,872
Diluted	23,456,063	17,197,872	24,895,607	17,197,872

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

PATIENT SAFETY TECHNOLOGIES, INC.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Operating activities:		
Net income (loss)	$ 343,422	$ (7,460,744)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation	277,779	170,360
Amortization of patents	162,471	162,471
Amortization of debt discount	—	247,124
Stock based compensation	804,525	571,782
Gain on reduction of contingent tax liability	(427,700)	—
Loss on abandonment of lease	371,942	—
Loss on capital lease write-off	3,917	—
Non-cash expense related to issuance of additional warrants	—	1,297,200
Non-cash interest	—	61,000
(Gain) loss on change in fair value of warrant derivative liability	(2,669,949)	2,569,000
Change in deferred tax liability	(65,146)	(64,319)
Inventory valuation allowance	—	106,059
Changes in operating assets and liabilities:		
Accounts receivable	373,338	230,352
Inventories	(614,003)	(563,059)
Prepaid expenses	85,153	(32,243)
Other assets	575	7,826
Accounts payable	683,158	860,630
Accrued liabilities	147,158	(155,410)
Deferred revenue	(1,682,326)	—
Net cash used in operating activities	(2,205,686)	(1,991,971)
Investing activities:		
Purchase of property and equipment	(472,226)	(14,768)
Net cash used in investing activities	(472,226)	(14,768)
Financing activities:		
Proceeds from issuance of notes payable	—	2,000,000
Proceeds from issuance of convertible preferred stock	5,000,000	—
Payments for stock issuance costs	(471,955)	
Capital lease principle payments	(15,556)	—
Payments of preferred dividends	(38,325)	(38,325)
Transfer to restricted cash in connection with tax escrow account	(651,223)	—
Net cash provided by financing activities	3,822,941	1,961,675
Net increase (decrease) in cash and cash equivalents	1,145,029	(45,064)
Cash and cash equivalents at beginning of period	3,446,726	296,185
Cash and cash equivalents at end of period	$ 4,591,755	$ 251,121

Supplemental disclosures of cash flow information:				
Cash paid during the period for interest	$	—	$	36,000
Cash paid during the period for taxes	$	16,113	$	—
Non cash investing and financing activities:				
Issuance of convertible preferred stock for accounts payable	$	1,000,000	$	—
Dividends accrued	$	45,028	$	38,325
Reduction of fixed assets based on write-off of capital lease	$	62,048	$	—
Reclassification of accrued interest to notes payable	$	—	$	94,000
Debt discount recorded in connection with issuance of notes payable	$	—	$	1,311,311
Reclassification of warrant equities to derivative liability	$	—	$	4,240,000

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

1. DESCRIPTION OF BUSINESS

Patient Safety Technologies, Inc. is a Delaware corporation, and its operations are conducted through its wholly-owned operating subsidiary, SurgiCount Medical, Inc. (“SurgiCount”), a California corporation. References to the "Company" include references Patient Safety Technologies, Inc. and SurgiCount, unless the context otherwise requires.

The Company’s operating focus is the development, marketing and sales of products and services focused in the medical patient safety markets. The SurgiCount Safety-Sponge® System is a patented system of bar-coded surgical sponges, SurgiCounter™ scanners, and software applications integrated to form a comprehensive counting and documentation system. This system is designed to reduce the number of retained surgical sponges unintentionally left inside of patients during surgical procedures by allowing faster and more accurate counting of surgical sponges.

2. LIQUIDITY AND GOING CONCERN

The accompanying condensed consolidated interim financial statements have been prepared assuming that the Company will continue as a going concern. At June 30, 2010, the Company has an accumulated deficit of $58,120,003 and a working capital deficit of $4,820,319. For the six month period ended June 30, 2010, the Company incurred an operating loss of $2,431,413 and generated negative cash flow from operating activities of $2,205,686. The most recent report dated March 31, 2010 by the Company’s independent registered public accounting firm on our consolidated financial statements as of and for the years ended December 31, 2009 and 2008 includes an explanatory paragraph in which our independent registered public accounting firm states that the significant recurring net losses through December 31, 2009 and the significant working capital deficit as of December 31, 2009 raise substantial doubt about the Company’s ability to continue as a going concern.

Management believes existing cash resources, as augmented by the Company’s June 2010 financing, combined with projected cash flow from operations, will be sufficient to fund the Company’s working capital requirements into the first quarter of 2011and in order to continue to operate as a going concern it will be necessary to raise additional funds. The Company believes that it will be able to obtain such financing and that, if necessary, additional cost-cutting measures could be implemented to extend the Company’s ability to operate its core business even if financing is not timely available. However, no assurances can be made that the Company will be successful in obtaining a sufficient amount of financing on acceptable terms (or any financing) to continue to fund its operations or that it will achieve profitable operations and positive cash flow. In addition, no assurance can be made that any additional cost cutting measures, if implemented, would materially extend the Company’s ability to operate without procuring additional financing. The accompanying condensed consolidated interim financial statements do not include any adjustments that might result from the outcome of this uncertainty.

3. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated interim financial statements have been prepared in accordance with the instructions to Form 10-Q and applicable sections of Regulation S-X and do not include all the information and disclosures required by accounting principles generally accepted in the United States of America. The condensed consolidated interim financial information is unaudited but reflects all normal adjustments that are, in the opinion of management, necessary to make the financial statements not misleading. The condensed consolidated balance sheet as of December 31, 2009 was derived from the Company’s audited financial statements. The condensed consolidated interim financial statements should be read in conjunction with the consolidated financial statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009. Results of the three and six months ended June

30, 2010 are not necessarily indicative of the results to be expected for the full year ending December 31, 2010.

Principles of Consolidation

The accompanying condensed consolidated interim financial statements for 2010 include the accounts of the Company and its subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The condensed consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of these financial statements 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 dates of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. These estimates and assumptions include, but are not limited to, assessing the following: the valuation of accounts receivable and inventory, impairment of goodwill and other intangible assets, the fair value of stock-based compensation and derivative liabilities, valuation allowance related to deferred tax assets, warranty obligations, provisions for returns and allowances and the determination of assurance of the collection of revenue arrangements.

Reclassifications

Certain prior year amounts have been reclassified to conform to the 2010 presentation. These reclassifications had no effect on previously reported results of operations or accumulated deficit.

Revenue Recognition

The Company recognizes revenue from the sale of products to end-users and distributors when persuasive evidence of a sale exists, the product is complete, tested and has been shipped which coincides with transfer of title and risk of loss, the sales price is fixed and determinable, collection of the resulting receivable is reasonably assured, there are no material contingencies and the Company does not have significant obligations for future performance. When collectability is not reasonably assured, the Company defers the revenue until cash payment is received. Provisions for estimated future product returns and allowances are recorded in the period of the sale based on the historical and anticipated future rate of returns. The Company records shipping and handling costs charged to customers as revenue and shipping and handling costs to cost of revenue as incurred. Revenue is recorded net of any discounts or trade-in allowances given to the buyer.

- Hardware Cost Reimbursement Revenues: Beginning with the third quarter of 2009, the Company modified its business model and began to offer its SurgiCounter™ scanners and related hardware and software to all hospitals at no cost when they adopt its Safety-Sponge® System. Prior to the third quarter of 2009, the Company's business model included the sale of its SurgiCounter™ scanners and related hardware and software used in its Safety-Sponge® System to most hospitals that adopted the Company's system. Under the supply and distribution agreement with Cardinal Health entered into in November 2009, the Company is reimbursed an agreed upon percentage of the cost of the scanners provided by the Company to hospitals that receive their surgical sponges and towels through Cardinal Health. Reimbursements received from Cardinal Health are initially deferred and are recognized as revenue on a pro-rata basis over the life of the specific hospital contract. Because the Company no longer engages primarily in direct SurgiCounter™ scanner and related hardware sales, except in certain customer specific situations, it generally anticipates only recognizing revenues associated with its SurgiCounter™ scanners in connection with reimbursement arrangements under its agreement with Cardinal Health.

- Hardware, Software and Maintenance Agreement Revenues: Because the software included in the Company's SurgiCounter™ scanner is not incidental to the product being sold, the sale of the software falls within the scope of Accounting Standards Codification ("ASC") ASC 985-605, formerly Statement of Position ("SOP") 97-2. The SurgiCounter™ scanner is considered to be a software-related element, as defined in ASC 985-605, because the software is essential to the functionality of the scanner, and the maintenance agreement, which provides for product support including unspecified product upgrades and enhancements developed by the Company during the period covered by the agreement, is considered to be post-contract customer support ("PCS") as defined in ASC 985-605.

These items are considered to be separate deliverables within a multiple-element arrangement, and based on the fact that there is vendor specific objective evidence for the non-delivered element the total price of this arrangement is allocated to each respective deliverable based on the residual fair value of each element, and recognized as revenue as each element is delivered. For the hardware and software elements, delivery is generally considered to be at the time of shipment where terms are FOB shipping point. In the event that terms of the sale are FOB customer, the delivery is considered to occur at the time that delivery to the customer has been completed. Delivery with respect to the initial one-year maintenance agreement is considered to occur on a monthly basis over the term of the one-year period, and revenues related to this element are recognized on a pro-rata basis during this period.

- Surgical Sponge Revenues: The surgical products (sponges and towels) used in the Company’s Safety-Sponge® System are sold separately from the hardware and software described above, and those products are not considered to be part of a multiple-element arrangement. Accordingly, revenues related to the sale of products used in the Company’s Safety-Sponge® System are recognized in accordance with ASC 605-25 that addresses revenue recognition for multiple-element arrangements. Generally revenues from the sale of surgical products used in the Safety-Sponge® System are recognized upon shipment as most surgical products used in the Safety-Sponge® System are sold FOB shipping point. In the event that terms of the sale are FOB customer, revenue is recognized at the time delivery to the customer has been completed. Advanced payments are classified as deferred revenue and recognized as product is shipped to the customer.

Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2009-13, Multiple Deliverable Revenue Arrangements, which addresses the accounting for multiple deliverable arrangements to enable vendors to account for products and services (deliverables) separately rather than as a combined unit. The amendments in ASU 2009-13 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The impact of this accounting update on the Company’s consolidated financial statements has not been evaluated.

In October 2009, the FASB issued ASU 2009-14, Certain Revenue Arrangements That Include Software Elements, which changes the accounting model for revenue arrangements that include both tangible products and software elements that are “essential to the functionality,” and scopes these products out of current software revenue guidance. The new guidance will include factors to help companies determine what software elements are considered “essential to the functionality.” The amendments included in ASU 2009-14 are effective prospectively for revenue arrangements entered into or materially modified in the fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The impact of this accounting update on the Company’s consolidated financial statements has not been evaluated.

In January 2010, the FASB issued ASU 2010-06, “Fair Value Measurements and Disclosures (Topic 20): Improving Disclosures about Fair Value Measurements.” This ASU provides clarification regarding existing disclosures and requires additional disclosures regarding fair value measurements. Specifically, the guidance now requires reporting entities to disclose the amounts of significant transfers between levels and the reasons for the transfers. In addition, the reconciliation should present separate information about purchases, sales, issuances and settlements. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value. The new standard was effective for reporting periods beginning after December 15, 2009 except for disclosures about purchases, sales, issuances and settlements which is not effective until reporting periods beginning after December 15, 2010. There were no transfers into or out of Level 1 or Level 2 of the fair value hierarchy during the six months ended June 30, 2010. Adoption of the not yet effective section of this guidance is not expected to have a material impact on our Consolidated Financial Statements.

4. RESTRICTED CASH

Restricted cash at June 30, 2010 consists of cash held in an escrow account pursuant to the Tax Escrow Agreement which was established during the quarter ended June 30, 2010 in connection with the Convertible Preferred Stock financing transaction (See Note 20). Cash held in the escrow account is invested in the escrow agent’s insured money market account and any income earned on such funds is added to the balance held in escrow. In accordance with the terms of the Tax Escrow Agreement, funds held in the escrow account may be released to pay tax claims by federal or state taxing authorities, or in the event that the Company’s estimated contingent tax liability, as reflected in its periodic reporting on either Form 10-Q or 10-K, is reduced for reasons other than actual payment of tax claims, subject to compliance with specific provisions of the agreement. During the quarter ended June 30, 2010 the contingent tax liability was reduced by $427,700 based primarily on the expiration of the federal statute of limitations relating to certain 2006 income. Based on this reduction in the contingent tax liability, the Company expects that $427,700 will be released from the escrow account during the quarter ending September 30, 2010.

5. EARNINGS (LOSS) PER COMMON SHARE

Earnings (loss) per common share is determined by dividing the earnings (loss) applicable to common shareholders by the weighted average number of common shares outstanding. The Company complies with FASB Accounting Standards Codification (“ASC”) 260-10 Earnings Per Share (previously SFAS No. 128, Earnings per Share), which requires dual presentation of basic and diluted earnings (loss) per share on the face of the condensed consolidated statements of operations. Basic loss per common share excludes dilution and is computed by dividing loss attributable to common stockholders by the weighted-average common shares outstanding for the period. Diluted earnings per common share reflects the potential dilution that could occur if convertible preferred stock or notes, options and warrants were to be exercised or converted or otherwise resulted in the issuance of common stock that then shared in the earnings of the entity.

For the three and six months ended June 30, 2010, the shares associated with the convertible note plus only the warrants and options that have a conversion/exercise price in excess of the average stock price during the three and six month periods ending June 30, 2010, respectively, are included in calculating diluted earnings per share. Because the effects of outstanding options, warrants and the convertible note that have conversion/exercise prices in excess of the average stock price during the three and six month periods ended June 30, 2010, are anti-dilutive, shares of common stock underlying these instruments as shown below have been excluded from the computation of loss per common share for the three and six months ended June 30, 2009, respectively.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Basic				
Income (loss) available to common stockholders	$ (76,056)	$ (3,953,069)	$ 298,327	$ (7,499,069)
Weighted average common shares outstanding (basic)	23,456,063	17,197,872	23,456,063	17,197,872
Basic income (loss) per common share	$ (0.00)	$ (0.23)	$ 0.01	$ (0.44)
Diluted				
Income (loss) available to common stockholders	$ (76,056)	$ (3,953,069)	$ 298,327	$ (7,499,069)
Weighted average common shares outstanding	23,456,063	17,197,872	23,456,063	17,197,872
Assumed issuance of restricted stock	—	—	75,000	—
Assumed exercise of options	—	—	695,335	—
Assumed exercise of warrants	—	—	169,209	—
Assumed conversion of debt	—	—	500,000	—
Common and potential common shares	23,456,063	17,197,872	24,895,607	17,197,872
Diluted income (loss) per common share	$ (0.00)	$ (0.23)	$ 0.01	$ (0.44)
Potentially dilutive securities outstanding at period end excluded from diluted computation as they were anti-dilutive	8,241,917	19,742,109	7,933,917	19,530,756

6. INVENTORY

Inventory consists of the following:

	June 30, 2010	December 31, 2009
Finished goods	$ 1,348,822	$ 734,819
Reserve for obsolescence	(168,996)	(168,996)
Total inventory, net	$ 1,179,826	$ 565,823

7. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	June 30, 2010	December 31, 2009
Computer software and equipment	$ 1,100,003	$ 1,097,181
Furniture and equipment	226,586	298,333
Hardware for customer use	858,409	394,861
Property and equipment, gross	2,184,998	1,790,375
Less: accumulated depreciation	(1,311,867)	(1,045,729)
Property and equipment, net	$ 873,131	$ 744,646

At June 30, 2010, based on the Company's decision to close the Newtown, PA office, the Company wrote off the remaining capital lease of $65,963 pertaining to office furniture acquired as part of the Newtown, PA sublease. Depreciation expense for the three and six months ended June 30, 2010 was $135,548 and $277,779, respectively. Depreciation expense for the three and six months ended June 30, 2009 was $84,769 and $170,360, respectively.

8. GOODWILL AND PATENTS

The Company recorded goodwill in the amount of $1,700,000 in connection with its acquisition of SurgiCount in February 2005. During the year ended December 31, 2007, cumulative gross revenues of SurgiCount exceeded $1,000,000 and as such the Company issued 100,000 shares of common stock, valued at approximately $145,000 to the SurgiCount founders, as contingent consideration, which was recorded as additional goodwill. In addition, in connection with the SurgiCount acquisition, the Company recorded patents acquired that were valued at $4,700,000.

The Company performs its annual impairment analysis of goodwill in the fourth quarter of each year according to the provisions of ASC 350 Valuation Analysis (formerly SFAS 142, Goodwill and Other Intangible Assets). This statement requires that the Company perform a two-step impairment test on goodwill. In the first step, the Company compares the fair value of each reporting unit to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to the reporting unit, goodwill is not impaired and the Company is not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then the Company must perform the second step of the impairment testing to determine the implied fair value of the reporting unit's goodwill. The implied fair value of goodwill is calculated by deducting the fair value of all tangible and intangible assets of the reporting unit, excluding goodwill, from the fair value of the reporting unit as determined in the first step. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference would be recorded.

During 2009, the Company conducted its annual test for impairment at year-end and determined goodwill was not impaired.

Patents, net, consists of the following:

		June 30, 2010		December 31, 2009
Patents	$	4,684,576	$	4,684,576
Accumulated amortization		(1,733,022)		(1,570,551)
Patents, net	$	2,951,554	$	3,114,025

The patents are subject to amortization over their estimated useful life of 14.4 years. Amortization expense for the three and six months ended June 30, 2010 and 2009 was $81,235 and $162,471, respectively.

9. LONG-TERM INVESTMENTS

Long-term investments consists of the following:

		June 30, 2010		December 31, 2009
Alacra, Inc.	$	666,667	$	666,667
Total	$	666,667	$	666,667

At June 30, 2010 and December 31, 2009, the Company had an investment in shares of Series F convertible preferred stock of Alacra, Inc. (“Alacra”), a global provider of business and financial information in New York, recorded at its cost of $666,667. The Company has the right, to the extent that Alacra has sufficient available capital, to have the Series F convertible preferred stock redeemed by Alacra for face value beginning on December 31, 2006. During the year ended December 31, 2007, Alacra redeemed one-third of the Series F convertible preferred stock.

10. CONVERTIBLE NOTE PAYABLE

Effective June 1, 2007, the Company restructured the entire unpaid principal and interest under promissory notes issued to Ault Glazer Capital Partners, LLC (“Ault Glazer”), into a new Convertible Secured Promissory Note (the "AG Capital Partners Convertible Note") in the principal amount of $2.5 million. The AG Capital Partners Convertible Note bears interest at the rate of 7% per annum and is due on the earlier of December 31, 2010, or the occurrence of an event of default.

On September 5, 2008, the Company entered into an Amendment and Early Conversion of the Secured Convertible Promissory Note (the “Amendment”) to modify the terms of the AG Capital Partners Convertible Note. Under the Amendment, the Company agreed to pay Ault Glazer $450,000 in cash and, contingent upon satisfaction of certain conditions by Ault Glazer, convert the remaining balance of the convertible secured note into 1,300,000 shares of the Company’s common stock. One condition was that Ault Glazer transfers certain leases from the Company’s name into its name. The Company made the $450,000 cash payment on September 5, 2008.

On September 12, 2008, the parties executed an Agreement for the Advancement of Common Stock Prior to Close of the Amendment and Early Conversion of Secured Convertible Promissory Note, dated September 5, 2008 (the “Advancement”). Pursuant to the Advancement, the Company agreed to issue 300,000 shares of the Company’s common stock to Ault Glazer on September 12, 2008, in advance of the satisfaction of the conditions for conversion in the Amendment, with the understanding that Ault Glazer would satisfy the conditions stated in the Amendment prior to September 19, 2008.

Ault Glazer failed to satisfy the conditions by the September 19, 2008 deadline. Although the conditions remained unsatisfied, the Company made two additional issuances of shares to Ault Glazer pursuant to the Amendment as follows: the Company issued another 250,000 shares on October 10, 2008 and another 250,000 shares on November 6, 2008. As of June 30, 2010 and December 31, 2009, there remain 500,000 shares issuable to Ault Glazer upon Ault Glazer meeting the conditions of the Amendment.

During the three and six months ended June 30, 2010 and the year ended December 31, 2009, in light of the failure to satisfy the conditions of the Amendment and the Advancement, the Company did not accrue interest expense on the AG Capital Partners Convertible Note.

11. ACCRUED LIABILITIES

Accrued liabilities consists of the following:

	June 30, 2010	December 31, 2009
Accrued lease liability	$ 7,547	$ 7,547
Accrued dividends on preferred stock	114,976	114,976
Accrued severance	370,981	47,449
Accrued office lease	371,942	—
Accrued director's fees	—	162,500
Contingent tax liability	223,523	740,726
Accrued commissions	—	13,200
Accrued financing expenses	88,000	—
Other	157,308	156,478
Total accrued liabilities	$ 1,334,277	$ 1,242,876

12. DEFERRED REVENUE

Deferred revenue consists of the following:

	June 30, 2010	December 31, 2009
Cardinal Health advance payment on purchase order	$ 6,117,324	$ 8,000,000
Scanner reimbursement revenue	295,328	99,144
Maintenance agreements	4,166	—
Total	$ 6,416,818	$ 8,099,144

On November 19, 2009, the Company entered into a new Supply and Distribution Agreement with Cardinal Health (which replaced the parties' previous distribution agreement). This agreement has a five-year term and names Cardinal Heath as the exclusive distributor in the United States, Puerto Rico and Canada of current products used in the Company's Safety-Sponge® System. In connection with the execution of this agreement, Cardinal Health issued a $10,000,000 purchase order for products used in the Company's Safety-Sponge® System, calling for deliveries over the 12-month period ending November 2010, paid the Company $8,000,000 upon execution of the agreement as partial pre-payment for such products, and agreed to pay up to $2,000,000 directly to the Company's supplier upon delivery of invoices for product delivered under the purchase order. As of June 30, 2010, the Company shipped $3,396,870 of product covered under the $10,000,000 purchase order from Cardinal Health and Cardinal Health has directly paid our supplier $1,514,194.

Prior to the third quarter of 2009, the Company's business model included the sale of its SurgiCounter™ scanners and related software used in the Company's Safety-Sponge® System to most hospitals that adopted its system. Beginning with the third quarter of 2009, the Company modified its business model and began to offer to provide its SurgiCounter™ scanners and related hardware and software to all hospitals at no cost when they adopt its Safety-Sponge® System. Under the new supply and distribution agreement with Cardinal Health entered into in November 2009, the Company is reimbursed an agreed upon percentage of the cost of the scanners provided by the Company to hospitals that receive their surgical sponges and towels through Cardinal. Reimbursements received from Cardinal are initially deferred and are recognized as revenue on a pro-rata basis over the life of the specific hospital contract. Because the Company no longer engages primarily in direct SurgiCounter™ scanner and related hardware sales, except in certain customer specific situations, it generally anticipates only recognizing revenues associated with its SurgiCounter™ scanners in connection with reimbursement arrangements under its agreement with Cardinal Health.

13. SERIES B CONVERTIBLE PREFERRED STOCK

On June 24, 2010 the Company entered into a Convertible Preferred Stock Purchase Agreement with several accredited investors, as defined under Rule 501(a) of the Securities Act of 1933, as amended. The accredited investors included A Plus International, Inc. and Catalysis Partners, LLC. Wenchen (Wayne) Lin, a member of the Company's Board of Directors, is a founder and significant beneficial owner of A Plus International, Inc and John P. Francis, a member of the Company's Board of Directors, has voting and investment control over securities held by Francis Capital Management, LLC, which acts as the investment manager for Catalysis Partners, LLC. Pursuant to the Convertible Preferred Stock Purchase Agreement, the Company issued an aggregate of 60,000 shares of its Series B Convertible Preferred Stock ("Series B Preferred"), at a purchase price of $100 per share, or $6,000,000 in the aggregate, payable in cash or as a reduction of indebtedness or a combination of both. The Company authorized 150,000 shares of Series B Preferred, with a par value of $1.00 per share. Holders of the Series B Preferred are entitled to receive quarterly cumulative dividends at a rate of 7.00% per annum, beginning on July 1, 2010. All dividends due on or prior to December 31, 2011 are payable in kind in the form of additional shares of Series B Preferred, and all dividends payable after December 31, 2011 are payable solely in cash.

14. STOCKHOLDERS' EQUITY:

The following table summarizes changes in components of stockholders' equity during the six months ended June 30, 2010:

	Preferred Stock Series A		Convertible Preferred Stock Series B		Common Stock Issued		Paid – In	Accumulated	Total Stockholders' Equity
	Shares	Amount	Shares	Amount	Shares	Amount	Capital	Deficit	(Deficit)
BALANCES, December 31, 2009	10,950	$ 10,950	–	–	23,456,063	$ 7,740,501	$ 44,834,321	$ (58,418,330)	$ (5,832,558)
Preferred dividends	—	—	67	67	—	—	6,703	(45,095)	(38,325)
Issuance of convertible preferred stock, net of transaction costs	—	—	60,000	60,000	—	—	5,468,045	—	5,528,045
Stock-based compensation	—	—	—	—	—	—	804,525		804,525
Net income	—	—			—	—	—	343,422	343,422
BALANCES, June 30, 2010	10,950	$ 10,950	60,067	$ 60,067	23,456,063	$ 7,740,501	$ 51,113,594	$ (58,120,003)	$ 805,109

15. WARRANTS AND WARRANT DERIVATIVE LIABILITY

The following table summarizes warrants to purchase common stock activity for the period ended June 30, 2010:

	Amount	Range of Exercise Price
Warrants outstanding December 31, 2009	8,064,978	$0.75 – 6.05
Issued	—	
Cancelled/Expired	(515,125)	$1.25 – 6.05
Warrants outstanding June 30, 2010	7,549,853	$0.75 – 4.50

At June 30, 2010, stock purchase warrants will expire as follows:

	# of Warrants		Range of Exercise Price
2010	—		—
2011	2,301,419	$	0.75 – 4.50*
2012	818,000	$	2.00
2013	1,786,267	$	0.75 – 1.40*
2014	1,890,000	$	1.82 – 4.00
2015	754,167	$	1.25
Total	7,549,853	$	0.75 – 4.50

* Includes warrants that contain anti-dilution rights if the Company grants or issues securities for less than the exercise price.

Warrant Derivative Liability

At June 30, 2010, a total of 2,567,686 warrants are classified as a derivative liability pursuant to guidance codified in FASB ASC 815-40, Derivatives and Hedging, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (previously EITF 07-5).

At June 30, 2010, the estimated fair value of these warrants, based on a Black-Scholes option pricing model was $996,388, which is included in current liabilities in the accompanying condensed consolidated balance sheet. Based on the change in fair value of the warrant derivative liability, the Company recorded non-cash income of $951,210 and $2,669,948 for the three and six months ended June 30, 2010, respectively. The warrant fair values at June 30, 2010 were determined using the Black-Scholes valuation model using the closing price stock price at each date, volatility rate of 112-118%, risk free interest rates of 0.53-1.69%, and contractual lives equal to the remaining term of the warrants expiring as of each measurement date.

16. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy

Fair value is defined in ASC 820 as the price that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are to be considered from the perspective of a market participant that holds the assets or owes the liability. ASC 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices in active markets for identical or similar assets and liabilities.

Level 2: Quoted prices for identical or similar assets and liabilities in markets that are not active or observable inputs other than quoted prices in active markets for identical or similar assets and liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Financial Instruments Measured at Fair Value on a Recurring Basis

ASC 820 requires disclosure of the level within the fair value hierarchy used by the Company to value financial assets and liabilities that are measured at fair value on a recurring basis. At June 30, 2010, the Company had outstanding warrants to purchase common shares of its stock that are classified as warrant derivative liabilities with a fair value of $996,388. The warrants are valued using Level 3 inputs because there are significant unobservable inputs associated with them (See Note 15).

The table below sets forth a summary of changes in the fair value of the Company’s warrant derivative liability for the period ended June 30, 2010:

	January 1, 2010	Gain on change in fair value included in earnings	June 30, 2010
Warrant Derivative Liability	$ (3,666,336)	$ 2,669,948	$ (996,388)

Other Financial Instruments

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities and deferred revenue approximate their respective fair values because of the short-term nature of these financial instruments.

The fair value of the Company's convertible debt is estimated to be $330,000 and $950,000 at June 30, 2010 and December 31, 2009, respectively, which is less than the carrying value of $1,424,558 at each of these dates. As described in Note 10, the current terms of the agreements relating to the convertible debt provide for the full settlement of the outstanding balance of the debt. Accordingly, the fair values noted above were estimated based on market value of 500,000 shares of the Company’s common stock at June 30, 2010 and December 31, 2009.

The fair value of long-term investments reported using the cost method for which there are no quoted market prices has not been determined as a reasonable estimate of fair value could not be made without incurring excessive costs (See Note 9).

17. STOCK COMPENSATION

In September 2005, the Board of Directors of the Company approved the Amended and Restated 2005 Stock Option and Restricted Stock Plan (the “2005 SOP”) and the Company’s stockholders approved the 2005 SOP in November 2005. The 2005 SOP reserves 2,000,000 shares of common stock for grants of incentive stock options, nonqualified stock options, warrants and restricted stock awards to employees, non–employee directors and consultants performing services for the Company. The Company has stopped granting stock options under the 2005 SOP.

On March 11, 2009, the Board of Directors of the Company approved the 2009 Stock Option Plan (the “2009 SOP”), and the Company’s stockholders approved the 2009 SOP August 6, 2009. An aggregate of 3,000,000 shares of common stock have been reserved under the 2009 SOP for grants of incentive stock options, nonqualified stock options, warrants and restricted stock awards to employees, non–employee directors and consultants performing services for the Company.

Options granted under the 2005 SOP and 2009 SOP have an exercise price equal to or greater than the fair market value of the underlying common stock at the date of grant and become exercisable based on a vesting schedule determined at the date of grant. The options generally expire 10 years from the date of grant. Restricted stock awards granted under the 2005 SOP and 2009 SOP are subject to a vesting period determined at the date of grant.

In June 2010, the Company entered into a Release and Separation Agreement with the Company’s former CEO and former members of the board of directors pursuant to which their respective stock option grants were modified. In connection with these modifications, the Company recorded incremental stock based compensation expense, based on the change in fair value of the modified options, of $147,082 during the quarter ended June 30, 2010. In addition, based on the continued vesting of certain of the modified stock options that were modified, the Company expects to record additional stock based compensation expense totaling approximately $112,000 ratably over the next 12 months.

All options that the Company granted during the six months ended June 30, 2010 were granted at the per share fair market value on the grant date. Vesting of options differs based on the terms of each option. The Company utilized the Black-Scholes option pricing model and the assumptions used for each period are as follows:

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Weighted average risk free interest rate	2.76%	2.42%
Weighted average life (in years)	6.0 years	5.99 years
Volatility	123%	149%
Expected dividend yield	0%	0%
Weighted average grant-date fair value per share of options granted	$ 1.39	$ 0.91

A summary of stock option activity for the six months ended June 30, 2010 is presented below:

Outstanding Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (1)
Balance at December 31, 2009(2)	5,821,000	$ 1.37	6.10	$ 4,301,385
Options Granted	680,000	$ 1.39	9.58	
Exercised	—	—	—	
Forfeited	(1,603,333)	$ 1.09		
Cancelled	—	—		
Balance at June 30, 2010	4,897,667	$ 1.47	6.60	
Vested and exercisable as of June 30, 2010	2,550,062	$ 1.66	5.89	—
Unvested as of June 30, 2010	2,347,605	$ 1.25	7.37	$ —

1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the closing stock prices of $0.66 and $1.90 of the Company's common stock at June 30, 2010 and December 31, 2009, respectively.

2) Includes 3,150,000 non-qualified options that were issued outside the 2005 and 2009 stock option plans.

The total grant date fair value of stock options granted during the three and six months ended June 30, 2010 was $0 and $833,579, respectively. For the three and six months ended June 30, 2010, stock based compensation was $447,409 and $735,575, respectively, that included $54,750 for 75,000 shares of restricted stock authorized but not issued to a consultant. For the three and six months ended June 30, 2009, stock based compensation was $346,737 and $571,782, respectively.

As of June 30, 2010, there was $1,683,718 of unrecognized compensation costs related to outstanding employee stock options. This amount is expected to be recognized over a weighted average period of 2.98 years. To the extent the forfeiture rate is different from what the Company anticipated; stock-based compensation related to these awards will be different from the Company's expectations.

18. RELATED PARTY TRANSACTIONS

A Plus International, Inc.

During the three and six months ended June 30, 2010 the Company recognized cost of revenues of $1,709,839 and $2,740,910 in connection with the manufacture of surgical products used in the Safety-Sponge® System by A Plus International or A Plus. At June 30, 2010, the Company’s accounts payable included $1,380,749 owed to A Plus in connection with the purchase of surgical products used in the Safety-Sponge® System, $13,656 of which will be paid directly to A Plus by Cardinal Health pursuant to the new Supply and Distribution Agreement dated November 19, 2009. Wenchen Lin, a Director and significant beneficial owner of the Company is a founder and significant owner of A Plus. On June 24, 2010, A Plus converted $1,000,000 of accounts payable owed to A Plus into 10,000 shares of Series B Convertible Preferred Stock (see Note 13).

Francis Capital Management

On June 24, 2010, Catalysis Partners, LLC, invested $1,000,000 in the Series B Convertible Preferred Stock transaction (see Note 13). John P. Francis, a member of our Board of Directors, has voting and investment control over securities held by Francis Capital Management, LLC, which acts as the investment manager for Catalysis Partners, LLC.

Release and Separation Agreements

In connection with the Series B Convertible Preferred Stock financing (see Note 13), Steven H. Kane, the Company's former CEO, resigned as a Director, President and Chief Executive Officer, and Howard E. Chase, Loren McFarland, Eugene A Bauer, MD, and William M. Hitchcock also resigned as members of our Board of Directors (the "Board") and received certain severance benefits.

In connection with Mr. Kane's resignation, we entered into a Separation Agreement and Mutual General Release with Steven Kane (the "Kane Release"). Under the Kane Release, Mr. Kane will receive, subject to compliance with its terms, 12 months of salary and health payments, and waived his rights to any bonus payment, or payment for excise taxes. The Kane Release also provided for the payment to Mr. Kane, in cash, of an aggregate $234,573 as payment in full for all accrued Director Fees and salary, accrued vacation, and accrued severance benefits of $349,113 as of June 30, 2010 as provided in his employment agreement. The Kane Release contains other provisions, including provisions relating to stock options and other matters.

In connection with the resignation of Messrs. Chase, McFarland, Hitchcock and Dr. Bauer as members of our Board, effective as of June 24, 2010, we entered into a Separation Agreement and Mutual General Release with such individuals (the "Director Release"). The Director Release provided for the payment, in cash, of the following unpaid Director's fees not previously approved by the Compensation Committee: $83,488 to Mr. Chase, $64,912 to Mr. McFarland, $10,025 to Mr. Hitchcock and $10,025 to Dr. Bauer. The Director Release contains other provisions, including provisions relating to stock options and other matters.

19. MAJOR CUSTOMERS, SUPPLIERS, SEGMENT AND RELATED INFORMATION

Major Customers

During the three and six months ended June 30, 2010, due to its exclusive distribution agreement with Cardinal Health, the Company had one customer that represented in excess of 97% and 98% of total revenues, respectively, compared with 89% and 80% for the same respective periods in 2009. No other single customer accounted for more than 10% of total revenues in either period.

Suppliers

The Company relies primarily on a third-party supplier, A Plus, to supply all the surgical sponges and towels used in its Safety-Sponge® System. The Company also relies on a number of third parties to manufacture certain other components of its Safety-Sponge® System. If A Plus or any of the Company's other third-party manufacturers cannot, or will not, manufacture its products in the required volumes, on a cost-effective basis, in a timely manner, or at all, the Company will have to secure additional manufacturing capacity. Any interruption or delay in manufacturing could have a material adverse effect on the Company's business and operating results.

Furthermore, all products obtained from A Plus are manufactured in China. As such, the supply of product from A Plus is subject to various political, economic, and other risks and uncertainties inherent in importing products from this country, including among other risks, export/import duties, quotas and embargoes; domestic and international customs and tariffs; changing taxation policies; foreign exchange restrictions; and political conditions and governmental regulations.

Segment and Related Information

The Company presents its business as one reportable segment due to the similarity in nature of products marketed, financial performance measures, methods of distribution and customer markets. The Company's chief operating decision making officer reviews financial information on the Company's products on a consolidated basis. All revenues earned during the three and six months ended June 30, 2010 relate to customers based in the United States.

The following table summarizes revenues by product line.

Three Months Ended June 30,	2010	2009
Revenues:		
Surgical sponges and towels	$ 3,733,098	$ 992,735
Scanners and related products	32,419	34,870
Total revenues	$ 3,765,517	$ 1,027,605

Six Months Ended June 30,	2010	2009
Revenues:		
Surgical sponges and towels	$ 6,072,585	$ 1,723,084
Scanners and related products	57,752	240,521
Total revenues	$ 6,130,337	$ 1,963,605

20. COMMITMENTS AND CONTINGENCIES

Operating and Capital Leases

In November 2007, the Company entered into a 36 month lease agreement for approximately 4,000 square feet of office space in Temecula, CA which expires December 31, 2010. Monthly lease payments for the remaining lease term of this lease are $9,757. In December 2009, the Company entered into a 40 month sublease agreement for office space in Newtown, PA which expires in April 2013, at a fixed monthly total lease payment for the entire term of the lease of $11,576. In connection with the Newtown, PA office sublease, the Company acquired certain office furniture valued at $100,000 from the building landlord for a nominal one-time payment. Accordingly, a portion of the total monthly lease payment for this facility has been allocated to the acquisition of this furniture and recorded as a capital lease at December 31, 2009.

In June 2010, the Company made the decision to close the Newtown, PA corporate office. Per FASB Accounting Standards Codification 420, Exit or Disposal Cost Obligations, the Company expensed the net present value of the remaining lease obligation along with an accrual for utilities through April 2013. The Company did not offset the lease accrual by any potential sublease, since it is unlikely that a tenant will be found during the remaining sublease term due to local commercial real estate market conditions. This assumption will be reviewed at the end of each quarter and any adjustments to the calculation will be made as needed. Accordingly, the Company wrote-off the remaining capital lease asset and capital lease obligation which was recorded when the Company acquired office furniture for a nominal one-time payment in December 2009.

Contingent Tax Liability

In the process of preparing the Company's federal tax returns for prior years, the Company's management found there had been errors in reporting income to the recipients and the respective taxing authorities, related to stock grants made to certain employees and consultants. In addition, the Company determined that required tax withholding relating to these stock grants had not been made, reported or remitted, as required in 2006 and 2007. Due to the Company's failure to properly report this income and withhold/remit required amounts, the Company may be held liable for the amounts that should have been withheld, plus related penalties and interest. The Company has estimated its contingent liability based on the estimated required federal and state withholding amounts, the employee and employer portion of social security taxes as well as the possible penalties and interest associated with the error, and has submitted documentation to the Internal Revenue Service reporting the previously unreported income. Although the Company's liability may ultimately be reduced based either on the expiration of applicable statutes of limitations, or if it can prove that the taxes due on this income were paid on a timely basis by some or all of the recipients, the estimated liability including estimated interest and penalties, originally accrued by the Company was based on the assumption that it will be liable for the entire amounts due to the uncertainty with respect to whether or not the recipients made such payments.

On June 24, 2010, in connection with the Series B Convertible Preferred Stock Purchase Agreement, the Company entered into a Tax Escrow Agreement and transferred $651,223 into a tax escrow account. The Tax Escrow Agreement was entered into by and among the Company, Marc L. Rose, the Company's Chief Financial Officer, as representative of the present and former members of the Company's Board of Directors and U.S. Bank National Association, a national banking association, in its capacity as escrow agent. Under the Tax Escrow Agreement, the escrow agent is required to use the escrowed funds to pay specified tax claims to taxing authorities and/or to release escrowed funds to the extent the Company's tax reserve for the contingent tax liability has been reduced, subject to compliance with certain procedures.

During the quarter ended June 30, 2010, the Company reduced the tax escrow account by $427,700 based on the expiration of the statue of limitations during the quarter for certain amounts relating the tax year 2006. The Company anticipates receiving the $427,700 from the escrow account in the third quarter of 2010. As of June 30, 2010, the remaining contingent tax liability, which is included in accrued liabilities, is $223,523.

Legal Proceedings

On October 15, 2001, Jeffrey A. Leve and Jeffrey Leve Family Partnership, L.P. filed a lawsuit against the Company, Sunshine Wireless, LLC, and four other defendants affiliated with Winstar Communications, Inc. This lawsuit alleged that the Winstar defendants conspired to commit fraud and breached their fiduciary duty to the plaintiffs in connection with the acquisition of the plaintiff's radio production and distribution business. The complaint further alleged that the Company and Sunshine joined the alleged conspiracy. On February 25, 2003, the case against the Company and Sunshine was dismissed. However, on October 19, 2004, Jeffrey A. Leve and Jeffrey Leve Family Partnership, L.P. exercised their right to appeal. On June 1, 2005, the United States Court of Appeals for the Second Circuit affirmed the February 25, 2003 judgment of the district court dismissing the claims against the Company.

On July 28, 2005, Jeffrey A. Leve and Jeffrey Leve Family Partnership, L.P. filed another lawsuit against the Company, Sunshine Wireless LLC and four other defendants affiliated with Winstar Communications to collect a federal default judgment of $5 million entered against two entities, Winstar Radio Networks, LLC and Winstar Global Media, Inc., by attempting to enforce the judgment against the Company and others under the doctrine of de facto merger. The action was tried before the Los Angeles County Superior Court in 2008. On August 5, 2009, the Superior Court issued a statement of decision in the Company's favor, and on October 8, 2009, the Superior Court entered judgment in the Company's favor, and judged plaintiffs' responsible for $2,708.70 of the Company's court costs. On November 6, 2009, the plaintiff filed a notice of appeal in the Superior Court of the State of California, County of Los Angeles Central District. The Company has engaged appellate counsel, believes the plaintiff's case is without merit and intends to continue to defend the case vigorously. As loss is not deemed to be probable, no accruals have been made as of June 30, 2010.

21. SUBSEQUENT EVENTS

On August 9, 2010, the Company entered into an employment agreement and appointed John A. Hamilton as Chief Operating Officer and Vice President of the Company.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated interim financial statements and the related notes thereto appearing elsewhere in this quarterly report on Form 10-Q and our audited consolidated financial statements and related notes thereto and the description of our business appearing in our annual report on Form 10-K for the year ended December 31, 2009. This discussion contains forward-looking statements that involve risks and uncertainties. See "Cautionary Note Regarding Forward-Looking Statements." Known and unknown risks, uncertainties and other factors could cause our actual results to differ materially from those projected in any forward-looking statements. In evaluating these statements, you should specifically consider various factors, including, but not limited to, those set forth under the caption "Risk Factors" in our annual report on Form 10-K for the year ended December 31, 2009.

Overview

We focus on the development, marketing and sales of products and services in the medical patient safety markets. Our proprietary Safety-Sponge® System is a patented system of bar-coded surgical sponges, SurgiCounter™ scanners, and software applications integrated to form a comprehensive counting and documentation system. This system is designed to eliminate the possibility of retained surgical sponges being unintentionally left inside of patients during surgical procedures by allowing faster and more accurate counting of surgical sponges. At June 30, 2010, we reached a milestone of having had a cumulative total of an estimated 32,500,000 sponges used in 1,300,000 procedures without a single undetected sponge left inside a surgical patient. We sell our Safety-Sponge® System to hospitals through our direct sales force, but rely on an exclusive distributor for the ongoing supply of our proprietary surgical sponge products to hospitals that have adopted our system. Our business model consists of selling our unique surgical sponge products, which are manufactured for us by an exclusive supplier, on a recurring basis to those hospitals that have adopted our Safety-Sponge® System. One of the ways in which we differentiate our products from other competing products is by working closely with hospital personnel through education and implementation services. We currently sell our Safety-Sponge® System only in the United States and we had revenues of $3,765,517 and $6,130,337 for the three and six months ended June 30, 2010, which included $2,322,361 and $3,396,870, respectively, shipped to Cardinal Health under the First Forward Order which does not necessarily represent sales of that product to end user hospitals (see "Factors Affecting Future Results —Cardinal Health Supply Agreement").

Sources of Revenues and Expenses

Revenues

Surgical Sponge Revenues. We generate revenues primarily from the sale of surgical sponges used in our Safety-Sponge® System to our exclusive distributor, who then sells directly and through sub-distributors to hospitals that have adopted our Safety-Sponge® System. We expect hospitals that adopt our Safety-Sponge® System to commit to its use and thus provide a recurring source of revenues from ongoing sales of surgical sponges and other products used in our system. We recognize revenues from the sale of surgical sponges upon shipment to our distributor because most of our surgical sponge sales are to our distributor, FOB shipping point. Note that because of the way our sales cycle works there is a gap between the time we begin incurring costs associated with our new customer arrangements and when we begin generating revenues from such arrangements.

Hardware, Software and Maintenance Agreement Revenues. We also generate revenues from the sale of related hardware and software to hospitals that have adopted our Safety-Sponge® System. The sale of our Safety-Sponge® System includes hardware (the SurgiCounter™ scanners and certain related hardware), our proprietary file management software (Citadel™) and an initial one-year maintenance agreement (which may be renewed). All of these items are considered to be separate deliverables within a multiple-element arrangement and, accordingly, we allocate the total price of this arrangement among each respective deliverable, and recognize revenue as each element is delivered. For the hardware and software elements of our Safety-Sponge® System, we recognize revenues on delivery, which is the time of shipment (if terms are FOB shipping point) or upon receipt by the customer (if terms are FOB destination). Delivery with respect to our initial one-year maintenance agreements is considered to occur on a monthly basis over the term of the one-year period; we recognize revenues related to this element on a pro-rata basis during this period. Because of the change in our business model discussed below under "—Factors Affecting Future Results," we do not expect these sales to represent a significant portion of our revenues going forward.

Prior to the third quarter of 2009, our business model included the sale of our SurgiCounter™ scanners and related software used in our Safety-Sponge® System to most hospitals that adopted our system. Beginning with the third quarter of 2009, we modified our business model and began to provide our SurgiCounter™ scanners and related software to all hospitals at no cost when they adopt our Safety-Sponge® System. Because we no longer engage primarily in direct SurgiCounter™ scanner sales, we generally anticipate only recognizing revenues associated with our SurgiCounter™ scanners in connection with reimbursement arrangements under our agreement with Cardinal Health. Therefore, we do not expect that our SurgiCounter™ scanners and related hardware will represent a sizable source of future revenues for us. Deferred scanner revenue associated with the reimbursement from Cardinal Health, will be recognized over the life of the specific hospital contract.

Cost of revenues

Our cost of revenues consists primarily of our direct product costs for surgical sponges and products from our exclusive third-party manufacturer. We also include a reserve expense for obsolete and slow moving inventory in cost of revenues. In addition, when we provide scanners to hospitals for their use (rather than sell), we include only the depreciation expense of the scanners in cost of revenues (not the full product cost). We estimate the useful life of the scanners to be three years. However, should we sell the scanners to hospitals, our cost of revenues include the full product cost when shipped.

Research and development expenses

Our research and development expenses consist of costs associated with the design, development, testing and enhancement of our products. We also include salaries and related employee benefits, research-related overhead expenses and fees paid to external service providers in our research and development expenses.

Sales and marketing expenses

Our sales and marketing expenses consist primarily of salaries and related employee benefits, sales commissions and support costs, professional service fees, travel, education, trade show and marketing costs.

General and administrative expenses

Our general and administrative expenses consist primarily of salaries and related employee benefits, professional service fees, expenses related to being a public entity, and depreciation and amortization expense.

Total other income (expense)

Our total other income (expense) primarily reflects changes in the fair value of warrants classified as derivative liabilities. Under applicable accounting rules (discussed below under "—Critical Accounting Policies—Warrant Derivative Liability"), we are required to make estimates of the fair value of our warrants each quarter, and to record the change in fair value each period in our statement of operations. As a result, changes in our stock price from period to period result in other income (when our stock price decreases) or other expense (when our stock price increases) on our income statement.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures in the financial statements. Critical accounting policies are those accounting policies that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. While we base our estimates and judgments on our experience and on various other factors that we believe to be reasonable under the circumstances, actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies used in the preparation of our financial statements require significant judgments and estimates. For additional information relating to these and other accounting policies, see Note 3 to our condensed consolidated interim financial statements, appearing elsewhere in this quarterly report on Form 10-Q.

Warrant Derivative Liability

Under applicable accounting guidance, an evaluation of outstanding warrants is made to determine whether warrants issued are required to be classified as either equity or a liability. Because certain warrants we have issued in connection with past financings contain certain provisions that may result in an adjustment to their exercise price, we classify them as derivative liabilities, and accordingly, we are then required to estimate the fair value of such warrants, at the end of each fiscal quarter. We use the Black-Scholes option pricing model to estimate such fair value, which requires the use of numerous assumptions, including, among others, expected life (turnover), volatility of the underlying equity security, a risk-free interest rate and expected dividends. The use of different values by management in connection with these assumptions in the Black Scholes option pricing model could produce substantially different results. Because we record changes in the fair value of warrants classified as derivative liabi