

NANOBAC PHARMACEUTICALS INC  
Form 10QSB  
May 16, 2005

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

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**FORM 10-QSB  
QUARTERLY REPORT**

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

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For the Quarter Period Ended  
**March 31, 2005**

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**Nanobac Pharmaceuticals, Incorporated**  
(Exact name of registrant as specified in its charter)

**Florida**  
(State or Other Jurisdiction of  
Incorporation)

**0-24696**  
(Commission File Number)

**59-3248917**  
(I.R.S. Employer Identification  
Number)

**2727 W. Dr. Martin Luther King Jr. Blvd, Suite 850, Tampa, Florida 33607**  
(Address of Principal Executive Office) (Zip Code)

**(813) 264-2241**  
(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 a shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act):

Yes  No

The number of shares issued and outstanding of the Registrant's Common Stock, no par value, as of May 12, 2005 was 189,006,760.

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**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**

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NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES  
CONDENSED CONSOLIDATED  
BALANCE SHEETS

(UNAUDITED)

	(Unaudited) March 31, 2005	December 31, 2004
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 13,579	\$ 17,908
Account receivable	16,729	3,395
Inventory	74,431	70,571
Prepaid expenses	28,807	23,649
Total current assets	133,546	115,523
<b>FIXED ASSETS</b> , less accumulated depreciation of \$94,998	145,665	124,995
<b>OTHER ASSETS</b>		
Security deposits	67,758	68,054
Intangible assets, less accumulated amortization of \$1,009,431		
		5,583,612
		5,760,342
Goodwill		
		3,615,393
		3,615,393
<b>Total other assets</b>		
		9,266,763
		9,443,789
<b>TOTAL ASSETS</b>		
\$		9,545,974
\$		9,684,307
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		

**CURRENT LIABILITIES**

Accounts payable

\$	629,319
----	---------

\$	645,491
----	---------

Accrued compensation

422,067

50,611

Accrued expenses

317,043

335,861

Short-term note payable

77,207

62,379

Other liabilities

18,185

16,423

Stockholder loans

646,846

194,068

**Total current liabilities**

2,110,667

1,304,833

**LONG-TERM LIABILITIES**

Accrued compensation

	--
	350,000
Stock settlement liability	
	2,496,154
	1,918,630
<b>Total liabilities</b>	
	4,606,821
	3,573,463
<b>COMMITMENTS AND CONTINGENCY (Note 9)</b>	
	--
	--
<b>STOCKHOLDERS' EQUITY</b>	
Common stock, no par value, 250,000,000 shares authorized, 189,006,760 shares issued and outstanding at March 31, 2005 and 187,240,093 shares issued and outstanding at December 31, 2004	
	16,307,050
	16,296,550
Preferred stock, no par value, 1,000,000 shares authorized, no shares issued and outstanding	
	--
	--
Additional paid-in capital	
	3,514,328
	3,539,328
Accumulated deficit	

)	(13,837,581
)	(13,049,568
Accumulated other comprehensive loss	
)	(1,044,644
)	(675,466
<b>Total stockholders' equity</b>	
	4,939,153
	6,110,844
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	
\$	9,545,974
\$	9,684,307

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

## NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED  
STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months ended March 31, 2005	Three Months ended March 31, 2004
<b>REVENUE</b>	\$ 151,865	\$ 32,385
<b>COST OF REVENUE</b>	43,838	7,189
<b>GROSS PROFIT</b>	108,027	25,196
<b>OPERATING EXPENSES</b>		
Sales, general and administrative	275,786	3,384,425
Research and development	411,294	628,325
Depreciation and amortization	188,252	158,113
<b>Total Operating Expenses</b>	875,332	4,170,863
<b>OPERATING LOSS</b>	(767,305)	(4,145,667)
<b>OTHER INCOME (EXPENSES)</b>		
Interest expense	(5,193)	(82,967)
Other, net	(15,515)	6,662
<b>LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>		
		(788,013)
)		
		(4,221,972)
)		
<b>PROVISION FOR INCOME TAXES</b>		
		--
		--
<b>LOSS FROM CONTINUING OPERATIONS</b>		
		(788,013)
)		
		(4,221,972)

)

**DISCONTINUED OPERATIONS:**

Loss from discontinued operations (no applicable income taxes)

--

(57,268

)

**NET LOSS**

\$

(788,013

)

\$

(4,279,240

)

**LOSS PER COMMON SHARE (BASIC AND DILUTED):**

Continuing operations

\$

0.00

\$

(0.03

)

Discontinued operations

0.00

0.00

Net loss

\$

0.00

\$

(0.03

)

**WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING**

Basic and Diluted

188,394,671



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

## NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED  
STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)  
(UNAUDITED)

	Common Shares	Stock Value	Additional Paid-in Capital	Accumulated Deficit	Other Comprehensive Loss	Accumulated Other Comprehensive Loss	Total
<b>Balance, December 31, 2004</b>	<b>187,240,093</b>	<b>\$ 16,296,550</b>	<b>\$ 3,539,328</b>	<b>\$ (13,049,568)</b>		<b>\$ (675,466)</b>	<b>\$ 6,110,844</b>
Stock issued for services	100,000	10,500	--	--		--	10,500
Sale of common stock	1,666,667	--	(25,000)	--		--	(25,000)
Comprehensive loss:							
Net loss	--	--	--	(788,013)	\$ (788,013)	--	(788,013)
Foreign currency translation adjustment							--
							--
							--
							--
							8,346
							8,346
							8,346
Derivative loss							(377,524)
)							(377,524)
)							(377,524)
)							(377,524)

Comprehensive loss

) (1,157,191

**Balance, March 31, 2005**

	<b>189,006,760</b>
\$	<b>16,307,050</b>
\$	<b>3,514,328</b>
\$	<b>(13,837,581</b>
)	
\$	<b>(1,044,644</b>
)	
\$	<b>4,939,153</b>

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

## NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED  
STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	Three Months ended March 31, 2005	Three Months ended March 31, 2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Loss	\$ (788,013)	\$ (4,279,240)
Adjustments to reconcile net loss to cash flows from operating activities:		
Depreciation and amortization		188,252
		158,113
Charges from common stock issuances		10,500
		2,562,750
Interest expense added to stockholder loan		3,895
		82,500
Net (increase) decrease in assets:		
Stock issued for services		
Accounts receivable		(13,334)
)		
		(11,189)
)		
Inventory		(3,860)
)		
		489
Other assets		(5,158)

)	
)	(13,967
Net increase (decrease) in liabilities:	
Accounts payable	
)	(16,172
)	(19,439
Accrued compensation	
	21,456
	189,309
Accrued expenses	
)	(18,818
	55,898
Deferred revenue	
	1,762
	--
Total adjustments	
	168,523
	3,004,464
<b>Net cash flows from operating activities</b>	
)	(619,490
)	(1,274,776
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
Acquisition of fixed assets	
	(33,866

)		
)		(8,952)
Cash received from exercise of stock option in subsidiary		--
		200,000
<b>Net cash flows from investing activities</b>		
)		(33,866)
		191,048
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from issuance of common stock and stock subscription agreements, net of expenses		
		175,000
		--
Proceeds from stockholder loans, net		
		448,883
		1,186,113
Proceeds (payments) of notes payable, net		
		14,828
)		(70,000)
<b>Net cash flows from financing activities</b>		
		638,711
		1,116,113
<b>Effect of exchange rate changes</b>		
		10,316
		3,644

Net change in cash	(4,329)
)	36,029
Cash balance, beginning of period	17,908
	49,755
<b>Cash balance, end of period</b>	
\$	13,579
\$	85,784
<b>Supplemental disclosures of cash flow information:</b>	
Cash paid for interest expense	
\$	1,298
\$	467
<b>Supplemental schedule of non-cash investing and financing activities:</b>	
Common stock issued in acquisition	
\$	--
\$	4,267,500
Capital contribution associated with sale of subsidiary to affiliate	
Reduction in stockholder loan	
\$	--
\$	250,000

Assumption of accounts payable and accrued expenses

\$

--

\$

499,327

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

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**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**1. Nature of operations and summary of significant accounting polices**

**Nature of business**

Nanobac Pharmaceuticals, Incorporated and subsidiaries, ("Nanobac", the "Company", or "NNBP") trades under the symbol "NNBP."

NNBP's primary business is the study and development of therapeutic and diagnostic technologies related to nanobacterium sanguineum ("Nanobacteria"). Nanobacteria are believed to be small, slowly growing nano-particles that can be found in human blood, kidney stones and arterial wall plaques.

**Basis of Presentation**

In the opinion of management, the accompanying financial statements include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with generally accepted accounting principles. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results for a full year.

The financial statements for the period ended March 31, 2005 and notes thereto should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 2004 for the Company as filed in the annual report on Form 10-KSB, which information is included herein by reference.

**Liquidity and Management Plans**

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred recurring losses and has a working capital deficiency at March 31, 2005. The Company is dependent on continued financing from outside investors including additional shareholder loans. All of these matters raise substantial doubt about the ability of the Company to continue as a going concern. Management believes that the Company will need to raise additional capital in order to launch new clinical trials, fund research and development for new treatment areas, and general working capital requirements. Capital may be raised through further sales of equity securities, which may result in dilution of the position of current shareholders.

There can be no assurances that NNBP will be successful in obtaining debt or equity financing in order to achieve its financial objectives and continue as a going concern. The financial statements do not include any adjustments to the carrying amount of assets and the amounts and classifications of liabilities that might result from an adverse outcome of this uncertainty.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**1. Nature of operations and summary of significant accounting polices (continued)**

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All material intercompany transactions and balances have been eliminated in consolidation.

**Revenue Recognition**

Revenue is recognized when the Company's products are shipped and title has passed or when diagnostic results are provided to the customer. Revenue is recorded net of reserves for estimated discounts and incentives.

**Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Financial instruments**

The carrying value of the Company's financial instruments, including cash, accounts receivable, accounts payable, short-term note payable and stockholder loans approximate their fair market values.

**Inventory**

Inventory is stated at the lower of cost or market. Cost is determined in a manner which approximates the first-in, first-out (FIFO) method. Inventory consists of raw materials for currently marketed products and materials and processing costs for antibodies and antigens used in our Finland laboratory. Inventory is shown net of applicable reserves and allowances. Shipping costs are expensed as incurred and are included in cost of revenue.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**1. Nature of operations and summary of significant accounting polices (continued)**

**Fixed Assets**

Fixed assets consist of furniture, fixtures, computers and lab equipment and are recorded at cost. Fixed assets are depreciated using the straight-line method over the estimated useful lives of three to seven years.

**Intangible assets and goodwill**

Intangible assets are recorded at cost, less accumulated amortization. Amortization of intangible assets is provided over the following estimated useful lives on a straight-line basis:

Patents 12 years  
Product rights 5 years

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), and Statement of Financial Accounting Standards, No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), the Company reviews its non-amortizable long-lived assets, including intangible assets and goodwill for impairment annually, or sooner whenever events or changes in circumstances indicate the carrying amounts of such assets may not be recoverable. Other depreciable or amortizable assets are reviewed when indications of impairment exist.

**Research and development expenses**

Research and development expenses are comprised of the following types of costs incurred in performing R&D activities: salaries and benefits, allocated overhead and occupancy costs, clinical trial and related clinical manufacturing costs, contract services, and other outside costs. Research and development costs are expensed as incurred.

**Income taxes**

The Company records its federal and state tax liability in accordance with Financial Accounting Standards Board Statement No. 109 "Accounting for Income Taxes". Deferred taxes are recorded for temporary differences between the recognition of income and expenses for tax and financial reporting purposes, using current tax rates. Deferred assets and liabilities represent the future tax consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**1. Nature of operations and summary of significant accounting polices (continued)**

**Derivative financial instruments**

The Company accounts for derivative financial instruments indexed to and potentially settled in, its own stock in accordance with Emerging Issues Task Force 00-19, which provides that if the number of shares deliverable in a transaction is indeterminable, that said shares be presented as a liability in the balance sheet. Further, the liability is to be measured at fair value until such time as the obligation is settled. The shares issued in connection with the 2004 Subscription Agreement transactions discussed in Note 5 are derivative transactions and as such have been presented in the accompanying balance sheets as liabilities and accumulated other comprehensive loss. The accumulated other comprehensive loss component represents the difference in the share value as issued and the value of said shares at the balance sheet date based on the trading value of the stock at March 31, 2005. At settlement, accumulated other comprehensive loss will be charged to retained earnings as a constructive dividend.

**Accumulated other comprehensive loss**

Accumulated other comprehensive loss at March 31, 2005 consists the following:

Derivative financial instruments (see above)	(\$1,021,154)
Cumulative foreign currency translation adjustment related to our Finland subsidiary	(23,490)
	(\$1,044,644)

Accumulated other comprehensive loss has no applicable income tax effect.

**Net loss per share**

Net loss per share represents the net loss attributable to common stockholders divided by the weighted average number of common shares outstanding during the period. The effect of incremental shares from common stock equivalents is not included in the calculation of net loss per share as the inclusion of such common stock equivalents would be anti-dilutive. Accordingly, fully dilutive shares outstanding equal basic shares outstanding as of and for the periods ended March 31, 2005 and 2004.

**Reclassifications**

Certain prior year amounts have been reclassified to conform to the current year presentation.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

## 2. Acquisitions

### Nanobac OY

Nanobac OY is a Finnish company that performs similar nanobacterial research to that of the Company. On November 11, 2003, NNBP completed the acquisition of 65% of Nanobac OY when a final cash payment was made and the Company exercised the conversion option in acquired convertible promissory notes.

During January through March 2004, NNBP acquired the remaining 35% of Nanobac OY from two individuals who are currently employees of the Company ("OY Minority Shareholders"). The purchase price was (a) 5 million shares of NNBP's common stock, (b) 5 million warrants convertible into NNBP's common stock at \$.005 per share and (c) cash consideration of 15,000 Euros. Total consideration to the OY Minority Stockholders is valued at \$4.3 million.

The total consideration to date for OY is \$5.1 million, which included cash payments, the fair value of NNBP common stock issued, as well as direct transaction costs. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed as of the acquisition date:

Current assets	\$ 37,534
Fixed assets	29,286
Identifiable intangible assets	5,243,048
Other assets	4,731
Current liabilities	(11,884)
Advances from Nanobac	(228,119)
	<b>\$ 5,074,596</b>

Acquired identifiable intangible assets consist of patents for the detection and treatment of Nanobacteria. The allocation of the purchase price was based, in part, on third-party valuations of the fair values of identifiable intangible assets. Amortization of this asset commenced as of the acquisition date.

In addition, as part of the above agreement, the OY Minority Shareholders agreed to employment agreements with NNBP. These agreements included \$500,000 of signing bonuses of which \$150,000 was paid in 2004 and the remaining \$350,000 (earned upon certain triggering events that occurred in 2004) is payable two years from the agreement dates (January and March 2006) and is included in current liabilities at March 31, 2005.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**2. Acquisitions (continued)****Proforma**

The following unaudited table compares NNBP's reported operating results to pro forma information prepared on the basis that the acquisitions had taken place at the beginning of the period for the three months ended March 31, 2004:

<b>As Reported</b>	
Revenue	\$ 32,385
Net loss	\$ (4,279,240)
Basic loss per share	\$ (0.03)
Diluted loss per share	\$ (0.03)
<b>Proforma</b>	
Revenue	\$ 32,385
Net loss	\$ (4,308,246)
Basic loss per share	\$ (0.03)
Diluted loss per share	\$ (0.03)

In management's opinion, the unaudited pro forma combined results of operations are not indicative of the actual results that would have occurred had the acquisitions been consummated at the beginning of each period presented or of future operations of the combined companies under the ownership and management of NNBP.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

### 3. Discontinued Operations

During March 2004, the Company sold its HealthCentrics business unit an affiliate of the Company's CEO for consideration of \$250,000 (a reduction in amounts otherwise owed to the affiliate). The Company's gain on disposal was \$749,326, which is accounted for as a capital contribution given the related party nature of the arrangement. Summary operating results for the discontinued operations for the three months ended March 31, 2004 are as follows:

	2004
Revenue	\$ 5,301
	(\$
Loss before income taxes	57,268)
Provision for income taxes	--
	(\$
Net loss	57,268)

### 4. Income taxes

NNBP has accumulated a net operating loss carryforward of approximately \$8.3 million for income tax purposes, which can be used to offset future taxable income through 2024.

Estimated future tax benefit	\$ 3,930,000
Valuation allowance	(3,930,000)
Estimated future tax benefit	\$ --

### 5. Stockholders' deficit

#### Preferred stock:

The holder(s) of preferred shares are entitled to receive non-cumulative dividends not to exceed \$.10 per share when and as declared by the Board of Directors. In the event of any liquidation, dissolution or winding down of the company, either voluntary or involuntary, the holder(s) of each preferred share shall be entitled to be paid on an amount equal to \$4.00 per share. In the event that the Company authorizes the redemption of all or any preferred shares, the redemption price shall be \$4.30 per share. The preferred shares are convertible at any time into common at the ratio of 44.11 common shares to one preferred share. Holders of preferred shares have a right to cast eight votes per preferred share and the right to elect fifty percent of the authorized members of the board of directors.

**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**5. Stockholders' deficit (continued)**

**Common stock:**

From August 2004 through February 2005, the Company entered into Subscription Agreements with three unaffiliated investors. Under the terms of the Subscription Agreements, the Company received cash of \$852,500 (net of \$122,500 of expenses) through March 31, 2005. The Company is to receive additional cash of \$975,000 within five days of registering the common shares and warrants issued as a result of the Subscription Agreements. The number of common shares to be issued is equal to the amount received divided by the lesser of \$.12 or 52% of the average closing bid price of the Company's common stock on the five trading days immediately prior to the date on which the registration statement is declared effective ("Fixed Price"). In addition, the Subscription Agreements provide for the issuance of warrants equal to the number of common shares issued. Fifty percent (50%) of the warrants are exercisable at 110% of the Fixed Price and the remaining 50% of the warrants are exercisable at 150% of the Fixed Price. Unexercised warrants will expire December 31, 2008. The Company has agreed to use its best efforts to promptly register the common shares and warrants.

During December 2004, the Company entered into a Subscription Agreement with an affiliate of the Company's Chief Executive Officer. Under the terms of the Subscription Agreement, the Company received cash of \$500,000 during the year ended December 31, 2004. The Company is to receive additional cash of \$500,000 within five days of registering the common shares and warrants issued as a result of the Subscription Agreement. All other terms of the Subscription Agreement are substantially the same as the Subscription Agreements to the unaffiliated investors described in the preceding paragraph. This amount is classified as Stock Settlement Liability at March 31, 2005.

As a result of the above Subscription Agreements, the Company has issued 12,291,667 shares of common shares, which represents the minimum number of shares to be issued under the Subscription Agreements in exchange for cash received through March 31, 2005. If the price of the Company's stock is less than \$0.23 per share when the Company's registration statement is declared effective, the Company will be required to issue additional shares under the above Subscription Agreements equal to a price of 52% of the average closing bid price of the Company's common stock on the five trading days immediately prior to the date on which the registration statement is declared effective. The ultimate number of shares to be issued is indeterminate as the number of shares is dependent on NNBP's closing bid price when a registration statement is declared effective. As a result, the \$1,475,000 of cash received under the Subscription Agreements through March 31, 2005 is classified as Stock Settlement Liability at March 31, 2005.

At March 31, 2005 the Company measured the value of the shares to be issued under the Subscription Agreements based on the Company's closing bid price at March 31, 2005 compared to the actual shares issued. As a result of this measurement, an additional \$643,630 Stock Settlement Liability was recorded as of March 31, 2005 with a charge to other comprehensive loss.



**NANOBAC PHARMACEUTICALS, INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2005**  
**(UNAUDITED)**

**5. Stockholders' deficit (continued)**

**Warrants:**

As of March 31, 2005, in connection with the OY acquisition, 5,000,000 warrants were outstanding with an exercise price of \$.005 per common share and an expiration date of August 31, 2009 (see Note 2).

At the finalization of the Subscription Agreements described above, management estimates between 18 million to 44 million warrants will be issued with an estimated weighted average exercise price of \$.07 to \$.16 per common share and an expiration date of five years from the date of issuance. The ultimate number of warrants to be issued and the related exercise price is indeterminate as the number of shares is dependent on NNBP's closing bid price when a registration statement is declared effective.

**6. Related Party Transactions:**

Stockholder Loan

An affiliate of the Chief Executive Officer has loaned NNBP approximately \$647,000 as of March 31, 2005. These loans had interest at 5% and were due on demand. Interest expense for the above loans for the three months ended March 31, 2005 was approximately \$4,000. During April 2005, an affiliate of the Chief Executive Officer loaned an additional \$750,000 to the Company under the same terms as the above loan.

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

### Business

Nanobac Pharmaceuticals, Incorporated and its subsidiaries (which may be referred to as “Nanobac”, “the Company”, “NNBP”, “we”, “us”, or “our”) is a research-based lifescience company.

Our research is focused on investigating the role of Nanobacterium sanguineum, (“Nanobacteria”) in human diseases. Researchers at Nanobac have discovered a novel nano-sized particle that we believe is responsible for a majority of diseases associated with soft tissue calcification or plaque. While calcification is a normal process for building healthy bones and teeth, calcification also plays a role in other conditions related to diseases, such as strokes and heart attacks. We believe that blood-borne nanobacteria forms slow-growing calcified colonies in arteries and organs, much as coral reefs are formed. Calcification of blood vessels typically involves the heart’s coronary arteries in atherosclerosis. It also occurs in arteries more generally throughout the body in arteriosclerosis, or hardening of the arteries. Kidney stones are calcifications within the urinary tracts. In addition, pathologic or soft tissue calcifications are observed in many other diseases such as, prostatitis (a painful inflammation of the prostate gland), and Polycystic Kidney Disease (growths of cysts in the kidneys). Research has shown the presence of Nanobacteria in the parts of the body affected by these diseases.

Our objective is to gain a better understanding of the role Nanobacteria plays in diseases associated with soft tissue calcification (or the build up of calcified deposits within the body), and to develop new methods to detect and treat diseases associated with nanobacterial infection. At the same time, we intend to expand the sales of our Dietary Supplements and In Vitro Diagnostic products. Our business is comprised of three areas:

- Dietary Supplements
- In Vitro Diagnostics
- Bio-Medical Research - Pharmaceutical Drug Discovery

We believe these three areas will fuel each other. Our research will lead to a better understanding of Nanobacteria and its role in disease. This in turn will enable us to develop better diagnostic tests to detect the presence of Nanobacteria. The development of new and more effective methods to diagnose nanobacterial infection and diseases involving pathologic calcification should increase the demand for our dietary supplements and for new drugs that we may bring to the market alone or in partnership. Likewise, as more effective therapies come to market, diagnostic test ordering tends to increase.

While there remains significant work ahead, we are encouraged by the progress being made in the study of Nanobacteria and the increasing level of acceptance in the medical community that there may be a relationship between the nano-particles we call Nanobacteria and the progression of certain diseases involving pathologic calcification. Our continuing research and development efforts, along with our efforts in obtaining recognition by various regulatory agencies (e.g. the FDA and similar agencies throughout the world), will require significant additional amounts of financing over the next several years.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Current Developments**- Recently we signed a collaborative agreement with the Mayo Foundation for Medical Education and Research to conduct research relating to the prevalence and treatment of nanobacteria in specific disease populations. The parties will evaluate the role of nanobacteria through four studies utilizing diagnostic test kits developed by Nanobac.

We continue with our collaborative efforts with scientists at NASA researching the effects of Nanobacteria in the formation of kidney stones under conditions simulating space flight. We also signed a collaborative agreement with Iowa State University to work with the Department of Geological and Atmospheric Sciences to explore novel methodologies for detecting calcified nano-particles which may be related to nanobacteria.

**Intellectual Property** - We are attempting to protect the intellectual property rights to our discoveries including our treatment therapies and our diagnostic methods by obtaining patents. We currently have one issued patent and multiple patent applications for treatment therapies including the combination of EDTA and tetracycline to treat nanobacteria infections and the formula mix and treatment regimen for Nanobac Supplements, We also have one issued patent and multiple patent applications related to our diagnostic products We are attempting to further protect our intellectual property rights by obtaining additional patents in unique areas of research with respect to the role of Nanobacteria in pathologic calcification. These efforts are ongoing and will require significant additional infusions of financing to complete. It is also anticipated that additional patents will be sought in the future as our research and development efforts yield new discoveries.

**Change of Name** - During April 2004, we announced a name change from Nanobac Pharmaceuticals, Incorporated to Nanobac Life Sciences, Inc. to become effective upon approval by the shareholders.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Results of Operations**

The following table presents the percentage of period-over-period dollar change for the line items in our Condensed Consolidated Statements of Operations for the three month period ended March 31, 2005. These comparisons of financial results are not necessarily indicative of future results.

		<b>Quarter ended March</b>		
	2005	2004	% Change	
Revenue	\$ 151,865	\$ 32,385	369%	
Cost of revenue	43,838	7,189	510%	
Gross Profit	108,027	25,196	329%	
Gross Profit percentage	71%	78%		
Selling, general and administrative	356,038	3,534,425	-90%	
Research and development	331,042	478,325	-31%	
Depreciation and amortization	188,252	158,113	19%	
Operating loss	(767,305)	(4,145,667)	-81%	
Other income (Expense)	(20,708)	(76,305)	-73%	
Loss from continuing operations	(788,013)	(4,221,972)	-81%	
Discontinued Operations	0	(57,268)	-100%	
Net loss	(\$788,013)	(\$4,279,240)	-82%	

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Revenue**

Revenue for the three months ended March 31, 2005 and 2004 is summarized as follows:

	<b>Quarter ended March</b>	
	2005	2004
Nanobac Supplement	\$ 125,128	\$ 0
License revenue	0	16,875
Diagnostic Products	26,737	15,510
	<b>\$ 151,865</b>	<b>\$ 32,385</b>

During February 2004, we initiated the license of a new product to a third party. Effective June 2004, the above license agreement was cancelled and we initiated sales of this product directly to customers under the name of Nanobac Supplement. Since the introduction of our new product, our revenue has increased on a quarterly basis as follows:

Quarter 1 - 2004	\$ 32,385
Quarter 2 - 2004	73,564
Quarter 3 - 2004	118,141
Quarter 4 - 2004	134,271
Quarter 1 - 2005	151,865

We intend to continue to expand our sales through increased marketing efforts, accelerating our research and developing new products for better patient acceptance

**Cost of revenue**

Cost of revenue consists of direct materials, testing services (for diagnostic products) and shipping. As a percentage of revenue, cost of revenue was 29% for the three months ended March 31, 2005 compared to approximately 22% for the three months ended March 31, 2004. The lower cost of revenue in 2004 was due to the 2004 license revenue having no direct costs. During June 2004, this licensing agreement was terminated and we initiated sales of Nanobac Supplement directly to customers, which has resulted in higher revenue and cost of revenue.

**Gross Profit**

Gross profit as a percentage of revenue was 71%, respectively for the three months ended March 31, 2005 compared to 78% for the three months ended March 31, 2004. The decrease in gross profit percentage is attributable to the 2004 license revenue having no costs. We anticipate our future gross profit as a percentage of revenue to be 65% to 75% based on our current product mix and pricing strategy.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Selling, General and Administrative**

Approximately 70% of selling, general and administrative ("SG&A") expenses are comprised of payroll, travel and professional fees. The majority of professional fees are related to public company expenses for audit, legal and investor relations. Other significant SG&A expenses include facility rental and insurance.

SG&A expenses for the three months ended March 31, 2004 include a \$2.6 million charge for stock issued as part of the Plan of Reorganization as confirmed by the Bankruptcy Court. SG&A expenses, excluding the above charges, are summarized as follows:

	<b>Quarter ended March</b>	
	2005	2004
SG&A as reported	\$ 275,786	\$ 3,384,425
Less charge for stock issuance		(2,562,750)
SG&A expenses net of charge for stock issuance	\$ 275,786	\$ 821,675

SG&A expenses decreased approximately \$545,000 for the three months ended March 31, 2005 compared to the three months ended March 31, 2004. In particular, professional fees were reduced by approximately \$350,000 and travel expenses were reduced \$130,000 for the three months ended March 31, 2005 compared to the same period in 2004.

The reduction in SG&A expenses is consistent with the results for the prior two quarters ended September 30, 2004 and December 31, 2004 as management made a significant effort to reduce the level of SG&A expenses.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Research and Development**

For the three months ended March 31, 2005 and 2004 research and development ("R&D") expenses consisted of the following types of expenses:

	Quarter ended March	
	2005	2004
U.S. Payroll and medical directors	60%	34%
Finland payroll and laboratory	20%	9%
Research studies	2%	27%
Signing bonuses	0%	24%
Other	18%	6%
<b>Total R&amp;D</b>	<b>100%</b>	<b>100%</b>

Other R&D expenses include professional fees related to development of patents and other office expenses.

R&D expenses for the three months ended March 31, 2005 of approximately \$411,000 represents a \$217,000 decrease compared to R&D expenses of approximately \$628,000 for the three months ended March 31, 2004. The majority of this decrease is related to \$150,000 of signing bonuses incurred in the first quarter of 2004 with the execution of employment agreements for key scientific personnel. The remaining decrease is due to no significant research studies being conducted during the three months ended March 31, 2005.

We anticipate increasing R&D expenses during the next several months.

**Depreciation and amortization**

Approximately 95% of depreciation and amortization are related to the amortization of Product Rights and Patents acquired in the June 2003 acquisition of LABS and the November 2003 acquisition of OY.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Other income (Expense)**

Other income for the three months ended March 31, 2005 and 2004 is summarized as follows:

	2005	2004
Interest expense		
Stockholder loan	(\$3,895)	(\$82,500)
Other	(1,298)	(467)
Foreign exchange gain (loss)	(10,717)	6,307
Other, net	(4,798)	355
	(\$20,708)	(\$76,305)

Foreign currency gain results from exchange rate changes between the U.S. dollar and the Euro on intercompany advances between our U.S. subsidiary and our Finland subsidiary.

**Loss from Continuing Operations**

The increase in the loss is primarily attributable to the \$206,000 of additional R&D expenses and \$368,000 of additional intangible asset amortization expenses.

Loss from continuing operations for the three months ended March 31, 2005 was \$788,000 compared to \$4.2 million for the three months ended March 31, 2004. Excluding non-cash items for stock issuances and amortization and depreciation, the loss from continuing operations for the three months ended March 31, 2005 and 2004 was as follows:

	2005	2004	Change
Loss from continuing operations	(\$788,013)	(\$4,221,972)	\$ 3,433,959
Depreciation and amortization	188,252	158,113	30,139
Charges for stock issuances	0	2,562,750	(2,562,750)
Loss from continuing operations excluding non-cash items			
)			(\$599,761)
)			(\$1,501,109)
\$			901,348

The loss from continuing operations excluding the above non-cash items decreased \$901,000 for the three months ended March 31, 2005 compared to the three months ended March 31, 2004. This decrease reflects (a) increased gross



profit of \$83,000; (b) \$545,000 decrease in SG&A expenses; (c) \$150,000 signing bonuses incurred in the first quarter of 2004 and (d) \$67,000 reduction in other R&D expenses (primarily research studies).

We are experiencing significant losses as we conduct research and development related to nanobacteria and launch our products and services. We believe it will take significant time before we will earn meaningful revenue to offset our expenses and there is no assurance that we will be able to accomplish this goal. As a result of the losses, we are dependent on affiliates of our CEO and other investors to provide sufficient cash sources to fund our operations.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)****Discontinued Operations**

During March 2004, our HealthCentrics business unit was sold to an affiliate of the CEO for consideration of \$250,000 plus assumption of net liabilities of approximately \$499,000. Our gain on disposal of approximately \$749,000 is accounted for as a capital contribution given the related party nature of the arrangement.

As a result of our decision to dispose of the HealthCentrics business unit, the operations of HealthCentrics are retroactively removed from continuing operations and disclosed as a single line item on the statements of operations. The loss from discontinued operations for the three months ended March 31, 2004 is summarized as follows:

	2004
Revenue	\$ 5,301
Cost of revenue	9,208
Gross profit (loss)	(3,907)
Selling, general & administrative	53,361
Research and development	--
Net loss	(\$57,268)

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Liquidity and Capital Resources**

Since the United States Bankruptcy Court confirmed a plan of reorganization that allowed the Company to emerge from Chapter 11 during calendar 2002, the Company has financed its activities primarily through loans made by entities affiliated with our current Chief Executive Officer (referred to herein as "the Affiliated Entities"). These loans were made as funding was needed and were extremely advantageous to the Company in that the amounts were funded as the Company needed financial infusions and allowed the Company to avoid the costs and distractions of attempting to raise these amounts from unrelated parties. It is unrealistic to believe that unrelated parties would have offered terms as generous as those obtained from the Affiliated Entities, and it is also unlikely that any financing could have been obtained under any terms without the financing of the Affiliated Entities. From time to time the Affiliated Entities have agreed to allow a portion of the loan balances to be converted into shares of the Company's common stock. There is no obligation on the part of the Affiliated Entities to make additional loans to the Company. The Affiliated Entities are also under no obligation to convert any portion of the loan balances owed to it into additional shares of the Company's stock.

As of March 31, 2005, we had total assets of \$9.5 million of which only \$133,000 were current assets. At March 31, 2005, we had total current liabilities of \$2.1 million and a working capital deficit of \$2.0 million.

Net cash used in operations for the three months ended March 31, 2005 was \$619,000 for the three months ended March 31, 2005. The negative cash flow from operations reflects the \$788,000 net loss for the period offset by the non-cash charge of \$188,000 for depreciation and amortization.

Net cash used by investing activities for the three months ended March 31, 2004 was \$34,000 for the purchase of fixed assets.

Net cash provided by financing activities for the three months ended March 31, 2005 was \$639,000, which is attributable to stockholder loans of \$449,000, common stock subscriptions of \$175,000 (net of expenses of \$25,000) and an increase in notes payable of \$15,000.

We are dependent on raising additional funding necessary to implement our business plan. Should we not be successful in raising cash from our CEO and other investors, we are unlikely to continue as a going concern.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Recent Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs." The statement amends Accounting Research Bulletin ("ARB") No. 43, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. ARB No. 43 previously stated that these costs must be "so abnormal as to require treatment as current-period charges." SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal." In addition, this statement requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted for fiscal years beginning after the issue date of the statement. The adoption of SFAS No. 151 is not expected to have any significant impact on our current financial condition or results of operations.

In December 2004, the FASB revised its SFAS No. 123 ("SFAS No. 123R"), "Accounting for Stock Based Compensation." The revision establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services, particularly transactions in which an entity obtains employee services in share-based payment transactions. The revised statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost is to be recognized over the period during which the employee is required to provide service in exchange for the award. Changes in fair value during the requisite service period are to be recognized as compensation cost over that period. In addition, the revised statement amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash flow rather than as a reduction of taxes paid. The provisions of the revised statement are effective for financial statements issued for the first interim or annual reporting period beginning after June 15, 2005, with early adoption encouraged. The adoption of SFAS No. 123 is not expected to have any significant impact on our current financial condition or results of operations.

**Critical accounting policies**

*Use of estimates* - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Forward Looking Statements**

Our disclosure and analysis in this Form 10-QSB contains some forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995 (“the Act”), that set forth anticipated results based on our plans and assumptions. From time to time, we also provide forward-looking statements in other materials we release to the public as well as oral forward-looking statements. Such statements give our current expectations or forecasts of future events; they do not relate strictly to historical and current facts. We have tried wherever possible to identify such statements by using words such as “anticipate”, “estimate”, “expect”, “project”, “intend”, “plan”, “believe”, “will” and expressions in connection with any discussion of future operating or financial performance.

In light of the important factors that can materially affect results, including those set forth above and elsewhere in this report, the inclusion of forward-looking information herein should not be regarded as a representation by us or any other person that our objectives or plans will be achieved. We may encounter competitive, technological, financial and business challenges making it more difficult than expected to continue to market our products and services; competitive conditions within our industry may change adversely; we may be unable to retain existing key management and research personnel; our forecasts may not accurately anticipate market demand; and there may be other material adverse changes in our operations or business. Certain important factors affecting the forward looking statements made herein include, but are not limited to (i) accurately forecasting capital expenditures; (ii) obtaining new sources of external financing; (iii) serving as the nexus for nanobacteria research and (iv) conducting successful clinical trials supporting Dr. Kajander’s theories that the human body does not recognize nanobacteria as harmful, and accordingly, nanobacteria could be the cause of pathological disease causing calcification found in multiple diseases. Assumptions relating to budgeting, marketing, product development and other management decisions are subjective in many respects and thus susceptible to interpretations and periodic revisions based on actual experience and business developments, the impact of which may cause the Company to alter its capital expenditure or other budgets, which may in turn affect the Company's financial position and results of operations.

### **Risk Factors**

#### **Trends, Risks and Uncertainties**

We have sought to identify what we believe to be the most significant risks to our business. However, we cannot predict whether, or to what extent, any of such risks may be realized nor can we guarantee that we have identified all possible risks that might arise. You should not consider the risks and assumptions identified in this report to be a complete discussion of all potential risks and uncertainties affecting the Company. Investors should carefully consider all risk factors before making an investment decision with respect to our Common Stock.

#### **Cautionary Factors that may affect Future Results**

We provide the following cautionary discussion of risks, uncertainties and possible inaccurate assumptions relevant to our business and our products. These are factors that we think could cause our actual results to differ materially from expected results. Other factors besides those listed here could adversely affect us.

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Risk Factors (continued)**

**We require additional financing in order to continue in business as a going concern, the availability of which is uncertain. We may be forced by business and economic conditions to accept financing terms which will require us to issue our securities at a discount, which could result in further dilution to our existing stockholders.**

As discussed under the heading, "Management's Discussion and Analysis - Liquidity and Capital Resources," we require additional financing to fund our operations. There can be no assurance that additional financing will be available to us when needed or, if available, that it can be obtained on commercially reasonable terms. In addition, any additional equity financing may involve substantial dilution to our stockholders. If we fail to raise sufficient financing to meet our immediate cash needs, we will be forced to scale down or perhaps even cease the operation of our business, which may result in the loss of some or all of your investment in our common stock.

In addition, in seeking debt or equity private placement financing, we may be forced by business and economic conditions to accept terms which will require us to issue our securities at a discount from the prevailing market price or face amount, which could result in further dilution to our existing stockholders.

### **Liquidity and Working Capital Risks; Need for Additional Capital to Finance Growth and Capital Requirements**

Throughout 2005 and 2004, affiliates of our Chief Executive Officer have provided our capital needs through loans and capital contributions. While these affiliates continue to provide for the majority of our cash requirements, they are under no obligation to continue such financing and/or strategic guidance. In the event these affiliates should discontinue their support, we may have difficulty in continuing our operations. In such an event, shareholders could lose their investment in its entirety. Historically, these affiliates have provided capital to us on a demand debt basis after which they may agree to convert debt into shares of our common stock. If, in the future we require additional capital, these affiliates might contribute some or all of our requirements. We anticipate that as a part of any such loan, these affiliates would have rights to convert into additional shares of our common stock. In such an event and to the degree of which we require these affiliates' support, shareholders may experience dilution. At present, we do not maintain key man insurance for our CEO.

In addition to the financial support we may receive from affiliates of our CEO, we may continue to seek to raise capital from public or private equity or debt sources to provide working capital to meet our general and administrative costs until net revenues make the business self-sustaining. We cannot guarantee that we will be able to raise any such capital on terms acceptable to us or at all. Such financing may be upon terms that are dilutive or potentially dilutive to our stockholders. If alternative sources of financing are required, but are insufficient or unavailable, we will be required to modify our growth and operating plans in accordance with the extent of available funding.

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Risk Factors (continued)**

**We have a history of operating losses and fluctuating operating results, which raise substantial doubt about our ability to continue as a going concern.**

Since inception through March 31, 2005, we have incurred aggregate losses of \$13.8 million. There is no assurance that we will operate profitably or will generate positive cash flow in the future. In addition, our operating results in the future may be subject to significant fluctuations due to many factors not within our control, such as the unpredictability of when customers will order products, the size of customers' orders, the demand for our products, and the level of competition and general economic conditions.

Although we are confident that revenues will increase, we also expect an increase in research and development costs and operating costs. Consequently, we expect to incur operating losses and negative cash flow until our products gain market acceptance sufficient to generate a commercially viable and sustainable level of sales, and/or additional products are developed and commercially released and sales of such products made so that we are operating in a profitable manner.

### **Potential Incorrect Conclusions on the Detection and Eradication of Nanobacteria**

Most of our future revenue is based on our ability to detect and eradicate Nanobacteria. If it is ultimately proved that our diagnostic methodologies and treatment regimens as covered by our patents are ineffective or based upon incorrect scientific conclusions, our existing patents and product lines may lose most or all of their value. Further, if we are unsuccessful in leveraging our diagnostic and therapeutic products to detect and treat nanobacterial diseases, we may not generate sufficient revenue to offset our expenses.

### **Development and Commercialization of Pharmaceutical and Nutraceutical Products**

Pharmaceutical and nutraceutical research and development is highly speculative and involves a high and significant degree of risk. The marketability of any product developed by us will be affected by numerous factors beyond our control, including:

- the discovery of unexpected toxicities or lack of sufficient efficacy of products which make them unattractive or unsuitable for human use;
- preliminary results as seen in animal and/or limited human testing may not be substantiated in larger controlled clinical trials;
  - manufacturing costs or other factors may make manufacturing of products impractical and non-competitive;
  - proprietary rights of third parties or competing products or technologies may preclude commercialization; and
    - requisite regulatory approvals for the commercial distribution of products may not be obtained.

Other factors may become apparent during the course of research, up-scaling or manufacturing which may result in the discontinuation of research and other critical projects.

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Risk Factors (continued)**

#### **Acceptance of Products in the Marketplace is Uncertain.**

Our future financial performance will depend, at least in part, upon the introduction and customer acceptance of our proposed treatments and products. Our treatments and products may not achieve market acceptance, and such adverse marketing results could materially harm the Company.

#### **Limited Operating History Anticipated Losses; Uncertainty of Future Results**

We have a limited operating history upon which an evaluation of our Company and our prospects can be based. Our prospects must be evaluated with a view to the risks encountered by companies in early stages of development, particularly in light of the uncertainties relating to the new and evolving lifescience research which we intend to develop and market, and the acceptance of our business model. We will be incurring costs to: (i) perform research studies to prove the effectiveness of our pharmaceutical products, (ii) further develop and market our products; (iii) establish distribution relationships; and (iv) build an organization. To the extent that such expenses are not subsequently followed by commensurate revenues, our business, results of operations and financial condition will be materially adversely affected. We, therefore, cannot insure that we will be able to immediately generate sufficient revenues. We expect negative cash flow from operations to continue for at least the next 12 months as we continue to develop and market our business. If cash generated by operations is insufficient to satisfy our liquidity, we may be required to sell additional equity or debt securities. The sale of additional equity or convertible debt securities would result in additional dilution to our stockholders. Our initial operations may not be profitable, since time will be required to build our business to the point that our revenues will be sufficient to cover our total operating costs and expenses. Our reaching a sufficient level of sales revenues will depend upon a large number of factors, including availability of sufficient working capital, the number of customers we are able to attract and the costs of continuing development of our product line.

#### **Federal Food and Drug Administration**

Some or all of our products may be governed by rules and regulations established by the United States Food and Drug Administration ("FDA"). Changes in FDA regulations and the enforcement thereof may affect our lifescience business. Furthermore, we may not be successful in filing and obtaining approval of our 510K or PMA filings with the FDA for our Nano-Capture Antigen and Nano-Sero IgG ELISA assays.

#### **Data Obtained Through Clinical Trials.**

Data obtained from pre-clinical studies and clinical trials do not necessarily predict results that will be obtained from later pre-clinical studies and clinical trials. Moreover, pre-clinical and clinical data is susceptible to varying interpretations, which could delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry have suffered significant setbacks in advanced clinical trials, even after experiencing promising results in earlier trials. The failure to adequately demonstrate the safety and/or effectiveness of an intended product under development could delay or prevent regulatory clearance of the potential drug or treatment, resulting in delays to commercialization, and could materially harm the business.



## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Risk Factors (continued)**

#### **Competitors in the Nutraceutical and Pharmaceutical Industry May Develop Competing Technologies**

We have a number of competitors, some of whom are better able to commercialize their products, which could render our products obsolete or uncompetitive prior to recovering our expenses. We anticipate that we will face increased competition in the future as new products enter the market and advanced technologies become available.

#### **Regulations may Inhibit our Ability to Sell Nanobac Supplements**

Codex is a joint body comprising government representatives and non-governmental organizations, jointly managed by the United Nation's (U.N.) Food and Agriculture Organization (FAO) and the World Health Organization (WHO) of the U.N. The Codex Committee on Nutrition and Foods for Special Dietary Uses (CCNFSDU) has been attempting to develop international guidelines for vitamins and minerals since 1991. In November 2004, these guidelines were finalized and a vote to ratify will take place in July, 2005.

There is a school of thought within the dietary supplement community that buying vitamins and other dietary supplements will be severely limited by this CODEX. Passage of the above guidelines may inhibit our ability to sell Nanobac Supplement outside of the United States. We do not believe that the passage will impact United State revenue as the U.S. draft position states that "The United States supports consumer choice and access to dietary supplements that are safe and are labelled in a truthful and non-misleading manner." Further, the CODEX Draft notes that the Codex Guidelines for Vitamin and Mineral Supplements will not adversely affect the availability of safe and truthfully labelled supplement products in the U.S. marketplace or to U.S. consumers. If our interpretation is not correct passage of the international guidelines may inhibit the sales of Nanobac Supplement inside and outside of the United States

#### **Risk of Third Party Lawsuits.**

We are exposed to potential product liability risks that are inherent in the testing, manufacturing and marketing of pharmaceutical products. We cannot assure potential investors that such claims will not be asserted against the Company. A successful liability claim or series of claims brought against us could have a material adverse effect on our financial condition. In addition, we may be sued by third parties who claim that our products and treatments infringe upon the intellectual property rights of others or that we have misappropriated trade secrets of others. This risk is exacerbated by the fact that the validity and breadth of claims covered in medical technology patents and the breadth and scope of trade secret protection involve complex legal and factual questions for which important legal principles are unresolved. Any litigation or claims against us, whether or not valid, could result in substantial costs, could place a significant strain on our financial resources, and could harm our reputation.

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

### **Risk Factors (continued)**

#### **Government Regulation**

Healthcare in general and the pharmaceuticals industry in particular are highly regulated markets, subject to both federal and a multitude of state regulations and guidelines. The majority of our business is still in clinical research applications and is governed by the medical community. There can be no assurance that changes to state or federal laws will not materially restrict our ability to sell our products or develop new product lines.

#### **Intellectual Property Rights**

We have a family of patents encompassing the detection and eradication of nanobacteria. There are risks inherent in any intellectual property rights in that they may be challenged as being invalid or not original. Additionally, other parties may abuse such intellectual rights, causing the Company to defend its rights.

#### **Dependency upon Key Technical and Scientific Personnel Who May Terminate Employment at Any Time.**

Our success will depend to a significant degree upon the continued services of key technical and scientific personnel, including but not limited to E. Olavi Kajander, MD, PhD. In addition, our success may depend on our ability to attract and retain other highly skilled personnel. Competition for qualified personnel is intense, and the process of hiring and integrating such qualified personnel is often lengthy. We may be unable to recruit personnel on a timely basis, if at all. All of the Company's management and other employees may voluntarily terminate their employment with us at any time. The loss of the services of key personnel, or the inability to attract and retain additional qualified personnel, could result in delays to development, loss of sales, and/or diversion of management resources that could have a material adverse affect on the Company.

#### **Competition**

The markets in which we compete include successful and well-capitalized competitors that vary in size and scope. Principal competitors include Pfizer, Merck and other pharmaceutical companies having unique treatments for cardiovascular disease. All of these competitors are more established, benefit from greater name recognition and have substantially greater resources than us. Moreover, we could face additional competition as other established and emerging companies enter the market and new products and technologies are introduced. Increased competition could result in price reductions, fewer customer subscriptions, reduced gross margins and loss of market share, any of which could materially adversely affect our business, financial condition and operating results. In addition, current and potential competitors may make strategic acquisitions or establish cooperative relationships among themselves or with third-parties, thereby increasing the ability of their products to address the needs of our prospective consumers. While we believe we can differentiate our product from these current and future competitors, focusing on the products' functionality, flexibility, adaptability and features, there can be no assurance that we will be able to compete successfully against current and future competitors. The failure to effectively compete would have a material adverse effect upon our business, financial condition and operating results.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Risk Factors (continued)**

**Lack of Independent Directors**

We cannot guarantee our Board of Directors will have a majority of independent directors in the future. In the absence of a majority of independent directors, our executive officers, who are also principal stockholders and directors, could establish policies and enter into transactions without independent review and approval thereof. This could present the potential for a conflict of interest between the Company's stockholders and the controlling officers and/or directors.

**Limitation of Liability and Indemnification of Officers and Directors**

Our officers and directors are required to exercise good faith and high integrity in our management affairs. Our Articles of Incorporation and By Laws provide, however, that our officers and directors shall have no liability to our shareholders for losses sustained or liabilities incurred which arise from any transaction in their respective managerial capacities unless they violated their duty of loyalty, did not act in good faith, engaged in intentional misconduct or knowingly violated the law, approved an improper dividend or stock repurchase, or derived an improper benefit from the transaction. Our Articles and By-Laws also provide for the indemnification by us of the officers and directors against any losses or liabilities they may incur as a result of the manner in which they operate our business or conduct the internal affairs, provided that in connection with these activities they act in good faith and in a manner they reasonably believe to be in, or not opposed to, the best interests of the Company, and their conduct does not constitute gross negligence, misconduct or breach of fiduciary obligations.

**Continued Control by Current Officers and Directors**

The present officers and directors control approximately 50% of the outstanding shares of Common Stock, and are in a position to elect all of our Directors and otherwise control the Company, including, without limitation, authorizing the sale of equity or debt securities of the Company, the appointment of officers, and the determination of officer's salaries. Shareholders have no cumulative voting rights.

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Limited Market Due To Penny Stock**

NNBP's stock differs from many stocks, in that it is a "penny stock." The Securities and Exchange Commission has adopted a number of rules to regulate penny stocks. These rules include, but are not limited to, Rules 3a51-1, 15g-1, 15g-2, 15g-3, 15g-4, 15g-5, 15g-6 and 15g-7 under the Securities and Exchange Act of 1934, as amended. Because our securities constitute penny stock within the meaning of the rules, the rules would apply to us and our securities. The rules may further affect the ability of owners of our stock to sell their securities in any market that may develop for them. There may be a limited market for penny stocks, due to the regulatory burdens on broker-dealers. The market among dealers may not be active. Investors in penny stock often are unable to sell stock back to the dealer that sold them the stock. The mark-ups or commissions charged by the broker-dealers may be greater than any profit a seller may make. Because of large dealer spreads, investors may be unable to sell the stock immediately back to the dealer at the same price the dealer sold the stock to the investor. In some cases, the stock may fall quickly in value. Investors may be unable to reap any profit from any sale of the stock, if they can sell it at all. Stockholders should be aware that, according to the Securities and Exchange Commission Release No. 34- 29093, the market for penny stocks has suffered in recent years from patterns of fraud and abuse. These patterns include: - Control of the market for the security by one or a few broker-dealers that are often related to the promoter or issuer; - Manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases; - "Boiler room" practices involving high pressure sales tactics and unrealistic price projections by inexperienced sales persons; - Excessive and undisclosed bid-ask differentials and markups by selling broker-dealers; and - The wholesale dumping of the same securities by promoters and broker- dealers after prices have been manipulated to a desired level, along with the inevitable collapse of those prices with consequent investor losses. Furthermore, the penny stock designation may adversely affect the development of any public market for NNBP's shares of common stock or, if such a market develops, its continuation. Broker-dealers are required to personally determine whether an investment in penny stock is suitable for customers. Penny stocks are securities (i) with a price of less than five dollars per share; (ii) that are not traded on a "recognized" national exchange; (iii) whose prices are not quoted on the NASDAQ automated quotation system (NASDAQ-listed stocks must still meet requirement (i) above); or (iv) of an issuer with net tangible assets less than \$2,000,000 (if the issuer has been in continuous operation for at least three years) or \$5,000,000 (if in continuous operation for less than three years), or with average annual revenues of less than \$6,000,000 for the last three years. Section 15(g) of the Exchange Act, and Rule 15g-2 of the Commission require broker-dealers dealing in penny stocks to provide potential investors with a document disclosing the risks of penny stocks and to obtain a manually signed and dated written receipt of the document before effecting any transaction in a penny stock for the investor's account. Potential investors in NNBP's common stock are urged to obtain and read such disclosure carefully before purchasing any shares that are deemed to be "penny stock." Rule 15g-9 of the Commission requires broker-dealers in penny stocks to approve the account of any investor for transactions in such stocks before selling any penny stock to that investor. This procedure requires the broker-dealer to (i) obtain from the investor information concerning his or her financial situation, investment experience and investment objectives; (ii) reasonably determine, based on that information, that transactions in penny stocks are suitable for the investor and that the investor has sufficient knowledge and experience as to be reasonably capable of evaluating the risks of penny stock transactions; (iii) provide the investor with a written statement setting forth the basis on which the broker-dealer made the determination in (ii) above; and (iv) receive a signed and dated copy of such statement from the investor, confirming that it accurately reflects the investor's financial situation, investment experience and investment objectives. Compliance with these requirements may make it more difficult for NNBP's stockholders to resell their shares to third parties or to otherwise dispose of them.

### **Item 3: Quantitative and Qualitative Disclosures About Market Risk**

While most of our operations are conducted in the United States, we also operate a laboratory in Kuopio Finland. We face two risks related to foreign currency exchange: translation risk and transaction risk. Amounts invested in our Finland operations are translated into US Dollars at the exchange rates in effect at the balance sheet date. Since the functional currency of our Finland subsidiary is the local currency, foreign currency translation of the balance sheet is reflected as a component of stockholders' equity and does not impact operating results.

Our Finland subsidiary collects revenue and pays expenses in Euros, mitigating transaction risk. Revenues and expenses in Euros translate into varying amounts of US Dollars depending upon whether the US Dollar weakens or strengthens against the Euro. Therefore, changes in exchange rates may negatively affect the Company's consolidated revenues and expenses (as expressed in US Dollars) from foreign operations.

Currency transaction gains or losses are incurred on our US Subsidiary's intercompany advance to our Finland Subsidiary. We recognize a gain on the intercompany advance as the US Dollar weakens against the Euro and we recognize a loss when the US Dollar strengthens against the Euro.

The Company has not entered into a material amount of foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange rates.

### **Item 4: Controls and Procedures**

#### ***Disclosure controls and procedures***

Under the supervision and with the participation of our management, including our Chief Executive Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures within 90 days of the filing date of this report, and, based on this evaluation, our Chief Executive Officer has concluded that these controls and procedures are effective.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Item 4: Controls and Procedures (continued)**

***Section 404 of the Sarbanes-Oxley Act of 2002***

Section 404 of the Sarbanes-Oxley Act of 2002 requires our report on Form 10-KSB for 2006 to include a report of management on internal control over financial reporting. Internal control over financial reporting, as defined under these rules, is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

In our report, we will be required, among other things, to assess the effectiveness of our internal control over financial reporting. The report must also disclose any material weaknesses in internal control over financial reporting identified by management, and if there are any material weaknesses, we must conclude that our internal control over financial reporting was not effective. A material weakness, under the applicable rules, is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In conducting our ongoing assessment of its internal control over financial reporting to prepare for compliance with the requirements under Section 404 of the Sarbanes-Oxley Act, we have identified a lack of segregation of duties to be a potential material weakness in internal controls. Lack of segregation of duties is inherent to our company due to the small number of employees. Our assessment is still in process to determine if this situation is actually a material weakness or if there are any other material weaknesses.

***Changes in internal controls***

There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

**PART II - OTHER INFORMATION**

**Item 1: Legal Proceedings**

Except as described below, we know of no material, active or pending legal proceedings against us, nor are we involved as a plaintiff in any material proceedings or pending litigation. There are no proceedings in which any of our directors, officers or affiliates, or any registered or beneficial shareholders are an adverse party or have a material interest adverse to us.

On September 24, 2004 a civil action was filed in United States District Court - Southern District of California by World Health Products, LLC ("World Health") broadly alleging that the Company, together with a customer of the Company ("Customer"), has infringed on its Patent Number 5,602,180 related to the sale of suppositories included in the Company's supplement product. World Health alleged additional complaints against the Customer to which the Company is not liable. During February 2005, World Health dropped the Company from their lawsuit as their tests of our suppositories determined that World Health's patents were not being infringed upon.

**Item 2: Unregistered Sales of Equity Securities and Use of Proceeds**

From August 2004 through February 2005, we executed Subscription Agreements with three unaffiliated investors and one affiliated investor. These investors paid us 50% of the subscription price at execution and the remaining 50% is due within five days from the date that a registration statement is declared effective for the common shares that are being issued. In exchange for the cash consideration, we are to issue these investors shares of our common stock equal to the amount paid divided by the lesser of (a) \$0.12 or (b) fifty-two percent of the average closing bid price for our common stock for the five days immediately prior to the date on which a registration statement is declared effective (“The Fixed Price”). In addition, each of these investors will receive an equivalent number of warrants with expiration dates of five years from the date of issuance. One half of these warrants will be priced at 120% of the Fixed Price and the remainder will be priced at 150% of the Fixed Price. The minimum number of shares and warrants that will be issued under these Subscription Agreements (assuming a Fixed Price of \$0.12 per share) is as follows:

	Number of Shares	Per Share	Proceeds
Common Stock:			
Unaffiliated Investors	16,250,000	\$ 0.12	\$ 1,950,000
Affiliates	8,333,333	\$ 0.12	\$ 1,000,000
	24,583,333		\$ 2,950,000
	Number of Warrants	Exercise Price	
Warrants:			
Unaffiliated Investors	8,125,000	\$ 0.132	
Unaffiliated Investors	8,125,000	\$ 0.180	
Affiliates	4,166,667	\$ 0.132	
Affiliates	4,166,666	\$ 0.180	
	24,583,333		

As of December 31, 2004, 10,625,000 shares had been issued under the above Subscription Agreements. The actual number of shares and warrants that ultimately will be issued under these Subscription Agreements may be substantially higher due to the variability of the Fixed Price. Based on our recent traded price of \$0.09 to \$0.14 per share, approximately twice as many shares and warrants would be issued as described above.

Each of these investors received their shares in reliance upon Section 4(2) of the Securities Act of 1933, because each of the holders was knowledgeable, sophisticated and had access to comprehensive information about us. At all relevant times we were a reporting company under the Securities Exchange Act of 1934 and there was readily available adequate current public information with respect to the Company.

A success fee was awarded to a broker for completing the transaction to one of the above unaffiliated investors in the form of 5-year warrants equal to 20% of the value of the transaction. These warrants have exercise prices equal to \$0.16 to \$0.22 per share for transactions completed to date. Future warrants issued under this agreement will have an exercise price equal to NNBP’s stock price on the date of closing. We estimate that approximately 2.2 million warrants will be issued to this broker.

**Item 3: Defaults upon Senior Securities**

None.

**Item 4: Submission of Matters to a Vote of Security Holders**

None.

**Item 5: Other Information**

None

**Item 6: Exhibits and Reports on Form 8-K**

(a) The following exhibits are filed as part of this report:

Exhibit 31.1 - Certification to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer

Exhibit 31.2 - Certification to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer

Exhibit 32.1 - Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer

Exhibit 32.2 - Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer

(b) Reports on Form 8-K

None



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**NANOBACK PHARMACEUTICALS, INCORPORATED**

Date: May 12, 2005

By: /s/ John D. Stanton

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John D. Stanton  
Chief Executive Officer

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**Nanobac Pharmaceuticals, Incorporated**

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