

APPLIED DNA SCIENCES INC  
Form 10QSB  
August 14, 2008

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

FORM 10-QSB

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2008

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the Transition Period From To

Commission file number 002-90539

APPLIED DNA SCIENCES, INC.  
(Name of small business issuer in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

59-2262718  
(I.R.S. Employer  
Identification Number)

25 Health Sciences Drive, Suite 113  
Stony Brook, New York  
(Address of Principal Executive  
Offices)

11790  
(Zip Code)

(631) 444-6861  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the last 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares of Common Stock, \$0.001 par value, outstanding on August 13, 2008, was 200,391,959 shares.

Transitional Small Business Disclosure Format (Check one)

Yes

No

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APPLIED DNA SCIENCES, INC  
QUARTERLY REPORT ON FORM 10-QSB FOR THE  
QUARTERLY PERIOD ENDING JUNE 30,2008

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

APPLIED DNA SCIENCES, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

|  | (unaudited)      |                       |
|--|------------------|-----------------------|
|  | June 30,<br>2008 | September 30,<br>2007 |
| <b>ASSETS</b>  |                  |                       |
| Current assets:  |                  |                       |
| Cash   | \$ 585,152       | \$ 25,185             |
| Accounts Receivable  | 89,483           | -                     |
| Prepaid expenses   | 114,583          | 101,000               |
| Restricted cash  | -                | 399,920               |
| Total current assets   | 789,218          | 526,105               |
| Property, plant and equipment-net of accumulated depreciation of \$129,641 and \$82,825, respectively                      | 81,221           | 105,537               |
| Other assets:  |                  |                       |
| Deposits   | 8,322            | 13,822                |
| Capitalized finance costs-net of accumulated amortization of \$329,584 and 7,997, respectively                             | 225,416          | 29,503                |
| Intangible assets:   |                  |                       |
| Patients, net of accumulated amortization of \$30,388 and \$25,445, respectively (Note B)                                  | 3,868            | 8,812                 |
| Intellectual property, net of accumulated amortization and write off of \$7,975,735 and \$7,702,891, respectively (Note B) | 1,455,165        | 1,728,009             |
| Total Assets   | \$ 2,563,210     | \$ 2,411,788          |
| <b>LIABILITIES AND DEFICIENCY IN STOCKHOLDERS' EQUITY</b>  |                  |                       |
| Current liabilities:   |                  |                       |
| Accounts payable and accrued liabilities   | \$ 12,778,317    | \$ 13,215,975         |
| Convertible notes payable, net of unamortized discount (Note D)  | 3,168,920        | 740,405               |
| Other current liabilities  | -                | 399,920               |
| Deferred revenue   | 60,000           | -                     |
| Total current liabilities  | 16,007,237       | 14,356,300            |
| Commitments and contingencies (Note H)   |                  |                       |
| Deficiency in Stockholders' Equity- (Note F)   |                  |                       |
| Preferred stock, par value \$0.0001 per share; 10,000,000 shares authorized; 60,000 issued and outstanding                 | 6                | 6                     |
| Common stock, par value \$0.001 per share; 410,000,000 shares authorized; 197,104,480 and 180,281,661 issued and           | 197,104          | 180,281               |

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outstanding as of June 30, 2008 and September 30, 2007, respectively

|  |               |               |
|--|---------------|---------------|
| Additional paid in capital                               | 131,919,396   | 128,448,584   |
| Accumulated deficit                                      | (145,560,533) | (140,573,383) |
| Total deficiency in stockholders' equity                 | (13,444,027)  | (11,944,512)  |
| Total liabilities and Deficiency in Stockholders' Equity | \$ 2,563,210  | \$ 2,411,788  |

See the accompanying notes to the unaudited condensed consolidated financial statements

**APPLIED DNA SCIENCES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF LOSSES**  
(unaudited)

|  | For the Three Months Ended |              | For the Nine Months Ended June |                |
|--|----------------------------|--------------|--------------------------------|----------------|
|  | June 30,                   |              | 30,                            |                |
|  | 2008                       | 2007         | 2008                           | 2007           |
| Sales  | \$ 252,691                 | \$ -         | \$ 583,595                     | \$ -           |
| Cost of sales  | (50,489)                   | -            | (124,493)                      | -              |
| Gross Profit   | 202,202                    | -            | 459,102                        | -              |
| Operating expenses:  |                            |              |                                |                |
| Selling, general and administrative                                | 951,828                    | 1,968,642    | 3,365,880                      | 6,012,028      |
| Research and development   | 19,816                     | 25,504       | 112,042                        | 94,289         |
| Depreciation and amortization                                      | 109,555                    | 108,357      | 324,603                        | 324,594        |
| Total operating expenses   | 1,081,199                  | 2,102,503    | 3,802,525                      | 6,430,911      |
| <b>NET LOSS FROM OPERATIONS</b>                                    | (878,997)                  | (2,102,503)  | (3,343,423)                    | (6,430,911)    |
| Net gain in revaluation of debt derivative and warrant liabilities | -                          | 4,431,421    | -                              | 142,131        |
| Other income   | -                          | -            | -                              | 977            |
| Interest expense-net   | (649,722)                  | (520,963)    | (1,643,727)                    | (1,945,702)    |
| Net (loss)/income before provision for income taxes                | (1,528,719)                | 1,807,954    | (4,987,150)                    | (8,233,506)    |
| Income taxes (benefit)   | -                          | -            | -                              | -              |
| <b>NET (LOSS) INCOME</b>   | \$ 1,528,719)              | \$ 1,807,954 | \$ (4,987,150)                 | \$ (8,233,506) |
| Net income (loss) per share-basic                                  | \$ 0.01)                   | \$ 0.01      | \$ (0.03)                      | \$ (0.07)      |
| Net loss per share- assuming fully diluted - Note A                |                            | \$ (0.02)    |                                |                |
| Weighted average shares outstanding-                               |                            |              |                                |                |
| Basic  | 192,749,058                | 132,310,413  | 188,818,049                    | 124,844,409    |
| Fully diluted  |                            | 170,056,948  |                                |                |

See the accompanying notes to the unaudited condensed consolidated financial statements

APPLIED DNA SCIENCES, INC  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
(unaudited)

|   | Nine Months Ended June<br>30, |                |
|---|-------------------------------|----------------|
|   | 2008                          | 2007           |
| <b>Cash flows from operating activities:</b>                                  |                               |                |
| Net loss  | \$ (4,987,150)                | \$ (8,233,506) |
| <b>Adjustments to reconcile net loss to net used in operating activities:</b> |                               |                |
| Depreciation and amortization   | 324,603                       | 324,594        |
| Income attributable to repricing of warrants and debt derivatives             | -                             | (142,131)      |
| Amortization of capitalized financing costs                                   | 321,587                       | 1,005,975      |
| Amortization of debt discount attributable to convertible debentures          | 1,375,876                     | 1,590,612      |
| Common stock issued in exchange for services rendered                         | 1,040,000                     | -              |
| <b>Change in assets and liabilities:</b>                                      |                               |                |
| Decrease (increase) in accounts receivable                                    | (89,483)                      | 9,631          |
| Decrease (increase) in prepaid expenses and deposits                          | (8,083)                       | (32,208)       |
| Decrease (increase) in other assets   | -                             | 8,419          |
| Increase (decrease) in accounts payable and accrued liabilities               | (387,383)                     | 3,811,641      |
| Increase (decrease) in deferred revenue                                       | 60,000                        | -              |
| Net cash used in operating activities   | (2,350,033)                   | (1,656,973)    |
| <b>Cash flows from investing activities:</b>                                  |                               |                |
| Decrease in restricted cash held in escrow                                    | 399,920                       | -              |
| Acquisition of property and equipment, net                                    | (22,500)                      | (11,039)       |
| Net cash provided by (used in) investing activities                           | 377,420                       | (11,039)       |
| <b>Cash flows from financing activities:</b>                                  |                               |                |
| Proceeds from issuance of convertible notes                                   | 2,532,580                     | 477,500        |
| Net cash provided by financing activities                                     | 2,532,580                     | 477,500        |
| Net increase in cash and cash equivalents                                     | 559,967                       | (1,190,512)    |
| Cash and cash equivalents at beginning of period                              | 25,185                        | 1,225,304      |
| Cash and cash equivalents at end of period                                    | \$ 585,152                    | \$ 34,792      |
| <b>Supplemental Disclosures of Cash Flow Information:</b>                     |                               |                |
| Cash paid during period for interest  | -                             | -              |
| Cash paid during period for taxes   | -                             | -              |
| <b>Non-cash transactions:</b>   |                               |                |
| Common stock issued for services  | \$ 1,040,000                  | -              |
| Common stock issued in exchange for previously incurred debt                  | \$ 600,275                    | \$ 4,361,200   |

See the accompanying notes to the unaudited condensed consolidated financial statements

APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

NOTE A — SUMMARY OF ACCOUNTING POLICIES

General

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-QSB, and therefore, do not include all the information necessary for a fair presentation of financial position, results of operations and cash flows in conformity with generally accepted accounting principles.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended June 30, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2008. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated September 30, 2007 financial statements and footnotes thereto included in the Company's SEC Form 10-KSB.

Business and Basis of Presentation

On September 16, 2002, Applied DNA Sciences, Inc. (the "Company") was incorporated under the laws of the State of Nevada. During the year ended September 30, 2007, the Company transitioned from a development stage enterprise to an operating company. The Company is principally devoted to developing DNA embedded biotechnology security solutions in the United States. To date, the Company has generated minimum sales revenues from its services and products; it has incurred expenses and has sustained losses. Consequently, its operations are subject to all the risks inherent in the establishment of a new business enterprise. For the period from inception through June 30, 2008, the Company has accumulated losses of \$145,560,533.

The consolidated financial statements include the accounts of the Company, and its wholly-owned subsidiaries Applied DNA Operations Management, Inc., APDN (B.V.I.), Inc. and Applied DNA Sciences Europe Limited. Significant inter-company transactions have been eliminated in consolidation.

Estimates

The preparation of the financial statement in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Revenue Recognition

Revenues are derived from research, development, qualification and production testing for certain commercial products. Revenue from fixed price testing contracts is generally recorded upon completion of the contracts, which are generally short-term, or upon completion of identifiable contractual tasks. At the time the Company enters into a contract that includes multiple tasks, the Company estimates the amount of actual labor and other costs that will be required to complete each task based on historical experience. Revenues are recognized which provide for a profit margin relative to the testing performed. Revenue relative to each task and from contracts which are time and materials based is recorded as effort is expended. Billings in excess of amounts earned are deferred. Any anticipated losses on contracts are charged to income when identified. To the extent management does not accurately forecast the level of effort required to complete a contract, or individual tasks within a contract, and the Company is unable to negotiate additional billings with a customer for cost over-runs, the Company may incur losses on individual



contracts. All selling, general and administrative costs are treated as period costs and expensed as incurred.

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APPLIED DNA SCIENCES, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2008  
 (unaudited)

## NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

## Revenue Recognition (continued)

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, REVENUE RECOGNITION ("SAB104"), which superseded Staff Accounting Bulletin No. 101, REVENUE RECOGNITION IN FINANCIAL STATEMENTS ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. At June 30, 2008 the Company's deferred revenue was \$60,000.

SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), MULTIPLE DELIVERABLE REVENUE ARRANGEMENTS. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. The effect of implementing EITF 00-21 on the Company's financial position and results of operations was not significant.

## Cash Equivalents

For the purpose of the accompanying financial statements, all highly liquid investments with a maturity of three months or less are considered to be cash equivalents.

## Income Taxes

The Company has adopted Financial Accounting Standard No. 109 (SFAS 109) which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statement or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Temporary differences between taxable income reported for financial reporting purposes and income tax purposes are insignificant.

## Property and Equipment

Property and equipment are stated at cost and depreciated over their estimated useful lives of 3 to 5 years using the straight line method. At June 30, 2008 and September 30, 2007 property and equipment consist of:

|                    | June 30,<br>2008 | September<br>30, 2007 |
|--------------------|------------------|-----------------------|
| Computer equipment | \$ 27,404        | \$ 27,404             |
| Lab equipment      | 77,473           | 54,973                |
| Furniture          | 105,985          | 105,985               |
|                    | 210,862          | 188,362               |

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|                          |           |            |
|--------------------------|-----------|------------|
| Accumulated Depreciation | (129,641) | (82,825)   |
| Net                      | \$ 81,221 | \$ 105,537 |

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APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

## NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

## Net income (loss) per share

The following reconciliation of net income and share amounts used in the computation of income (loss) per share for the three months ended June 30, 2007:

|   | Three Months Ended<br>June 30, 2007 |
|---|-------------------------------------|
| Net income used in computing basic net income per share                         | \$ 1,807,954                        |
| Impact of assumed assumptions:  |                                     |
| Fair value of warrants relating to convertible debt charged to interest expense | -                                   |
| Impact of equity classified as liability:                                       |                                     |
| Gain on warrant liability marked to fair value                                  | (4,431,421)                         |
| Net loss in computing diluted net loss per share:                               | \$ (2,623,467)                      |

The Company has adopted Statement of Financial Accounting Standard No. 128, "Earnings Per Share," specifying the computation, presentation and disclosure requirements of earnings per share information. The weighted average shares outstanding used in the basic net income per share computations for the three months ended June 30, 2007 was 132,310,413. In determining the number of shares used in computing diluted loss per share, the Company added approximately 37,746,535 for the three months ended June 30, 2007. Basic earnings per share have been calculated based upon the weighted average number of common shares outstanding. Stock options and warrants have been excluded as common stock equivalents in the diluted earnings per share because they are either antidilutive, or their effect is not material. Fully diluted shares outstanding were 254,201,883 and 162,590,944 for the nine months ended June 30, 2008 and 2007, respectively.

## Stock Based Compensation

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS 123." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the year ended September 30, 2006 and for the subsequent periods. The Company issued employee unvested employee options as stock-based compensation during the year ended September 30, 2006 and therefore has no unrecognized stock compensation related liabilities ended September 30, 2006. For the year ended September 30, 2007, the Company did not issue any stock based compensation.

APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

On January 1, 2006, we adopted the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 123, Accounting for Stock Based Compensation, to account for compensation costs under our stock option plans. We previously utilized the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (as amended) ("APB 25"). Under the intrinsic value method prescribed by APB 25, no compensation costs were recognized for our employee stock options because the option exercise price equaled the market price on the date of the grant. Prior to January 1, 2006 we only disclosed the pro forma effects on net income and earnings per share as if the fair value recognition provisions of SFAS 123(R) had been utilized.

In adopting SFAS No. 123(R), the Company elected to use the modified prospective method to account for the transition from the intrinsic value method to the fair value recognition method. Under the modified prospective method, compensation cost is recognized from the adoption date forward for all new stock options granted and for any outstanding unvested awards as if the fair value method had been applied to those awards as of the date of the grant. In the nine month period ended June 30, 2008, the Company granted employee stock options. For information on the employee stock options granted on June 17, 2008, please see "Note G – Stock Options and Warrants – Amendment to the 2005 Incentive Stock Plan and Recent Equity Award Grants" below.

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents and trade receivables. The Company places its cash and temporary cash investments with high credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit. The Company periodically reviews its trade receivables in determining its allowance for doubtful accounts. At June 30, 2008, allowance for doubtful receivable was \$0.

Research and Development

The Company accounts for research and development costs in accordance with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 2 ("SFAS 2"), "Accounting for Research and Development Costs. Under SFAS 2, all research and development costs must be charged to expense as incurred. Accordingly, internal research and development costs are expensed as incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved. Company-sponsored research and development costs related to both present and future products are expensed in the period incurred. The Company incurred research and development expenses of \$19,816 and \$112,042 for the three and nine month periods ended June 30, 2008, respectively, and \$25,504 and \$94,289 for the three and nine month periods ended June 30, 2007, respectively.

Reclassifications

Certain reclassifications have been made in prior year's financial statements to conform to classifications used in the current year.

Advertising

The Company follows the policy of charging the costs of advertising to expense as incurred. The Company charged to operations \$35,643 and \$47,007 for the three and nine month periods ended June 30, 2008, respectively, and \$-0- and \$12,568 as advertising costs for the three and nine month periods ended June 30, 2007.

#### Intangible Assets

The Company amortized its intangible assets using the straight-line method over their estimated period of benefit. The estimated useful life for patents is five years while intellectual property uses a seven year useful life.

APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

We periodically evaluate the recoverability of intangible assets and take into account events or circumstances that warrant revised estimates of useful lives or that indicate that impairment exists. All of our intangible assets are subject to amortization.

Restricted cash / other current liabilities

Restricted cash is comprised of funds deposited into an escrow account pending consummation of the placement of convertible debt as of December 31, 2007. The related obligation is recorded as other current liabilities until consummation.

Derivative Financial Instruments

The Company's derivative financial instruments consisted of embedded derivatives related to the 10% secured convertible promissory notes issued in 2006. These embedded derivatives included certain conversion features, variable interest features, call options and default provisions. The accounting treatment of derivative financial instruments required that the Company record the derivatives and related warrants at their fair values as of the inception date of the note (estimated at \$2,419,719) and at fair value as of each subsequent balance sheet date. In addition, under the provisions of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," as a result of entering into the notes, the Company was required to classify all other non-employee stock options and warrants as derivative liabilities and mark them to market at each reporting date. Any change in fair value was recorded as non-operating, non-cash income or expense at each reporting date. If the fair value of the derivatives is higher at the subsequent balance sheet date, the Company recorded a non-operating, non-cash charge. If the fair value of the derivatives is lower at the subsequent balance sheet date, the Company recorded non-operating, non-cash income. Conversion-related derivatives were valued using the Binomial Option Pricing Model with the following assumptions: dividend yield of 0%; annual volatility of 111% to 112%; and risk free interest rate of 4.96% to 5.15% as well as probability analysis related to trading volume restrictions. The remaining derivatives were valued using discounted cash flows and probability analysis. The derivatives were classified as long-term liabilities.

In December 2006, the FASB issued FSP EITF 00-19-2, Accounting for Registration Payment Arrangements ("FSP 00-19-2") which addresses accounting for registration payment arrangements. FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. FSP 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years.

In September 2007, the Company exchanged common stock for the remaining Secured Convertible Promissory Notes that contained embedded derivatives such as certain conversion features, variable interest features, call options and default provisions as described above. As a result, the Company reclassified the warrant liabilities recorded in

conjunction with the convertible promissory notes to equity as of the conversion date of the related debt. Additionally, the Company has an accumulative accrual of \$12,023,888 in liquidating damages in relationship to the previously outstanding convertible promissory notes and related warrants.

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APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

New Accounting Pronouncements

In December 2006, the FASB issued FSP EITF 00-19-2, "Accounting for Registration Payment Arrangements" ("FSP 00-19 -2") which addresses accounting for registration payment arrangements. FSP 00-19 -2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with SFAS No. 5, "Accounting for Contingencies". FSP 00-19 -2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years. The Company adopted FSP 00-19-2 in the preparation of the financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115" ("SFAS No. 159"). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of SFAS No. 159 apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities" applies to all entities with available-for-sale and trading securities. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provision of SFAS No. 157, "Fair Value Measurements". The adoption of SFAS No. 159 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS No. 141(R)"), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. SFAS No. 141R is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008. Earlier adoption is prohibited and the Company is currently evaluating the effect, if any, that the adoption will have on its consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51" ("SFAS No. 160"), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. SFAS No. 160 is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008. Earlier adoption is prohibited and the Company is currently evaluating the effect, if any that the adoption will have on its consolidated financial position, results of operations or cash flows.

In June 2007, the Accounting Standards Executive Committee issued Statement of Position 07-1, "Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies" ("SOP 07-1"). SOP 07-1 provides guidance for determining

whether an entity is within the scope of the AICPA Audit and Accounting Guide Investment Companies (the “Audit Guide”). SOP 07-1 was originally determined to be effective for fiscal years beginning on or after December 15, 2007; however, on February 6, 2008, FASB issued a final Staff Position indefinitely deferring the effective date and prohibiting early adoption of SOP 07-1 while addressing implementation issues.

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NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

In June 2007, the FASB ratified the consensus in EITF Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services to be Used in Future Research and Development Activities" (EITF 07-3), which requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development (R&D) activities be deferred and amortized over the period that the goods are delivered or the related services are performed, subject to an assessment of recoverability. EITF 07-3 will be effective for fiscal years beginning after December 15, 2007. The Company does not expect that the adoption of EITF 07-3 will have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB ratified the consensus in EITF Issue No. 07-1, "Accounting for Collaborative Arrangements" (EITF 07-1). EITF 07-1 defines collaborative arrangements and requires collaborators to present the result of activities for which they act as the principal on a gross basis and report any payments received from (made to) the other collaborators based on other applicable authoritative accounting literature, and in the absence of other applicable authoritative literature, on a reasonable, rational and consistent accounting policy is to be elected. EITF 07-1 also provides for disclosures regarding the nature and purpose of the arrangement, the entity's rights and obligations, the accounting policy for the arrangement and the income statement classification and amounts arising from the agreement. EITF 07-1 will be effective for fiscal years beginning after December 15, 2008, which will be the Company's September 30, 2010, and will be applied as a change in accounting principle retrospectively for all collaborative arrangements existing as of the effective date. The Company has not yet evaluated the potential impact of adopting EITF 07-1 on our consolidated financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment to FASB Statement No. 133" ("SFAS No. 161"). SFAS No. 161 is intended to improve financial standards for derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. Entities are required to provide enhanced disclosures about: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early adoption encouraged. The Company is currently evaluating the impact, if any, that SFAS No. 161 will have on our consolidated financial position, results of operations or cash flows.

In April 2008, the FASB issued FSP No. FAS 142-3, "Determination of the Useful Life of Intangible Assets". This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets". The Company is required to adopt FSP 142-3 on September 1, 2009; earlier adoption is prohibited. The guidance in FSP 142-3 for determining the useful life of a recognized intangible asset shall be applied prospectively to intangible assets acquired after adoption, and the disclosure requirements shall be applied prospectively to all intangible assets recognized as of, and subsequent to, adoption. The Company is currently evaluating the impact of FSP 142-3 on our consolidated financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS No. 162"). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days

following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." The Company does not expect the adoption of SFAS No. 162 to have a material effect on our consolidated financial position, results of operations or cash flows.

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## NOTE A — SUMMARY OF ACCOUNTING POLICIES (continued)

In May 2008, the FASB issued FSP Accounting Principles Board ("APB") 14-1 "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) " ("FSP APB 14-1"). FSP APB 14-1 requires the issuer of certain convertible debt instruments that may be settled in cash (or other assets) on conversion to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. FSP APB 14-1 is effective for fiscal years beginning after December 15, 2008 on a retroactive basis. The Company is currently evaluating the potential impact, if any, of the adoption of FSP APB 14-1 on our consolidated financial position, results of operations or cash flows.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the SEC did not, or are not believed by management to, have a material impact on the Company's present or future consolidated financial statements.

## NOTE B - ACQUISITION OF INTANGIBLE ASSETS

The Company has adopted SFAS No. 142, Goodwill and Other Intangible Assets, whereby the Company periodically tests its intangible assets for impairment. On an annual basis, and when there is reason to suspect that their values have been diminished or impaired, these assets are tested for impairment, and write-downs will be included in results from operations.

The identifiable intangible assets acquired and their carrying value at June 30, 2008 is:

|   |              |
|---|--------------|
| Trade secrets and developed technologies (Weighted average life of 7 years) | \$ 9,430,900 |
| Patents (Weighted average life of 5 years )                                 | 34,257       |
| Total Amortized identifiable intangible assets-Gross carrying value:        | \$ 9,465,157 |
| Less:   |              |
| Accumulated Amortization  | (2,351,113)  |
| Impairment (See below)  | (5,655,011)  |
| Net:  | \$ 1,459,033 |
| Residual value:   | \$ 0         |

During the year ended September 30, 2006 the Company management performed an evaluation of its intangible assets (intellectual property) for purposes of determining the implied fair value of the assets at September 30, 2006. The test indicated that the recorded remaining book value of its intellectual property exceeded its fair value for the year ended September 30, 2006, as determined by discounted cash flows. As a result, upon completion of the assessment, management recorded a non-cash impairment charge of \$5,655,011, net of tax, or \$0.05 per share during the year ended September 30, 2006 to reduce the carrying value of the patents to \$2,091,800. Considerable management judgment is necessary to estimate the fair value. Accordingly, actual results could vary significantly from management's estimates.

Total amortization expense charged to operations for the three and nine month periods ended June 30, 2008 was \$93,482 and \$277,787, respectively, and \$92,661 and \$277,983 for the three and nine month periods ended June 30,

2007, respectively.

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## NOTE C – ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at June 30, 2008 are as follows:

|   |               |
|---|---------------|
| Accounts payable  | \$ 402,748    |
| Accrued consulting fees   | 82,500        |
| Accrued interest payable  | 243,178       |
| Accrued penalties relating to registration rights liquidating damages | 12,023,888    |
| Other accrued expenses  | 26,003        |
| Total   | \$ 12,778,317 |

## Registration Rights Liquidated Damages

In private placements in November and December, 2003, December, 2004, and January and February, 2005, the Company issued secured convertible promissory notes and warrants to purchase the Company's common stock. Pursuant to the terms of a registration rights agreement, the Company agreed to file a registration statement to be declared effective by the SEC for the common stock underlying the notes and warrants in order to permit public resale thereof. The registration rights agreement provided for the payment of liquidated damages if the stipulated registration deadlines were not met. The liquidated damages are equal to 3.5% per month of the face amount of the notes, which equals \$367,885, with no limitations. During the three month period ended June 30, 2008, the SEC declared effective the Company's registration statement with respect to the common stock underlying the notes and warrants. The Company has accrued \$12,023,888 as of June 30, 2008 to account for late effectiveness of the registration statement.

## NOTE D – PRIVATE PLACEMENT OF CONVERTIBLE NOTES

Convertible notes payable as of June 30, 2008 are as follows:

|  |            |
|--|------------|
| 10% Secured Convertible Notes Payable, related party, dated July 30, 2007, net of unamortized debt discount of \$4,103 (see below)       | \$ 195,897 |
| 10% Secured Convertible Notes Payable, dated August 8, 2007, net of unamortized debt discount of \$3,394 (see below)                     | 96,606     |
| 10% Secured Convertible Notes Payable, related party, dated September 28, 2007, net of unamortized debt discount of \$44,911 (see below) | 255,089    |
| 10% Secured Convertible Notes Payable, dated October 4, 2007, net of unamortized debt discount of \$76,559 (see below)                   | 473,441    |
| 10% Secured Convertible Notes Payable, dated October 30, 2007, net of unamortized debt discount of \$121,543 (see below)                 | 478,457    |
| 10% Secured Convertible Notes Payable, dated November 29, 2007, net of unamortized debt discount of \$220,857 (see below)                | 779,143    |
| 10% Secured Convertible Notes Payable dated December 20, 2007, net of unamortized debt discount of \$94,937 (see below)                  | 355,063    |
| 10% Secured Convertible Notes Payable dated January 17, 2008, net of unamortized debt discount of \$115,252 (see below)                  | 334,748    |
| 10% Secured Convertible Notes Payable dated March 4, 2008, net of unamortized debt discount of \$112,230 (see below)                     | 137,770    |
|  | 62,706     |

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10% Secured Convertible Note Payable dated May 7, 2008, net of unamortized debt discount of \$37,294 (see below)

|                       |             |
|-----------------------|-------------|
|                       | 3,168,920   |
| Less: current portion | (3,168,920) |
|                       | \$ -        |

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Note dated April 23, 2007

On April 23, 2007, the Company issued a \$100,000 related party convertible promissory note due April 23, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, at \$0.50 per share. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.15 per share. The Company has granted the noteholder a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$13,333 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note's maturity period (one year) as interest expense.

In connection with the issuance of the note, the Company issued a non-detachable warrant granting the holder the right to acquire 200,000 shares of the Company's common stock at \$0.50 per share. The warrant expires five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrant in the amount of \$40,840 to additional paid in capital and a discount against the note. The Company valued the warrant in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.55%, a dividend yield of 0%, and volatility of 207.45%. The debt discount attributed to the value of the warrant issued is amortized over the note's maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$13,333) and warrant (\$40,840) to debt discount, aggregating \$54,173, which will be amortized to interest expense over the term of the note. Amortization of \$3,265 and \$30,426 was recorded for the three and nine month periods ended June 30, 2008.

On April 23, 2008, the note and accrued interest of \$10,000 automatically converted into 733,334 shares of the Company's common stock.

10% Secured Convertible Promissory Notes dated June 27, 2007

On June 27, 2007, the Company issued \$150,000 principal amount convertible promissory notes due June 27, 2007 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holders, at \$0.50 per share. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.15 per share. The Company has granted the noteholders a security interest in all the Company's assets.

In connection with the issuance of the notes, the Company issued warrants granting the holders the right to acquire 300,000 shares of the Company's common stock at \$0.50 per share.



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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

On June 27, 2008, the notes and accrued interest of \$15,000 converted into 1,100,000 shares of the Company's common stock.

10% Secured Convertible Promissory Note dated June 30, 2007

On June 30, 2007, the Company issued a \$250,000 principal amount related party convertible promissory note due June 30, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, at \$0.50 per share. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.087732076 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. The Company has granted the noteholder a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$63,454 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note's maturity period (one year) as interest expense.

In connection with the issuance of the note, the Company issued a non-detachable warrant granting the holder the right to acquire 500,000 shares of the Company's common stock at \$0.50 per share. The warrant expires five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$38,900 to additional paid in capital and a discount against the note. The Company valued the warrant in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.92%, a dividend yield of 0%, and volatility of 123.8%. The debt discount attributed to the value of the warrant issued is amortized over the note's maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$63,454) and warrant (\$38,900) to debt discount, aggregating \$102,354, which will be amortized to interest expense over the term of the note. Amortization of \$25,238 and \$76,555 was recorded for the three and nine month periods ended June 30, 2008.

On June 30, 2008, the note and accrued interest of \$25,000 automatically converted into 3,134,543 shares of the Company's common stock.

10% Secured Convertible Promissory Note dated July 30, 2007

On July 30, 2007, the Company issued a \$200,000 principal amount related party convertible promissory note due July 30, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, at \$0.50 per share. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.102568072 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. The Company has granted the noteholder a

security interest in all the Company's assets.

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Note dated July 30, 2007 (continued)

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios (“EITF 98-5”), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$33,991 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note’s maturity period (one year) as interest expense.

In connection with the issuance of the note, the Company issued a non-detachable warrant granting the holder the right to acquire 400,000 shares of the Company’s common stock at \$0.50 per share. The warrant expires five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments (“EITF – 0027”), the Company recognized the value attributable to the warrant in the amount of \$15,920 to additional paid in capital and a discount against the note. The Company valued the warrant in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.64%, a dividend yield of 0%, and volatility of 72.84%. The debt discount attributed to the value of the warrant issued is amortized over the note’s maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$33,991) and warrant (\$15,920) to debt discount, aggregating \$49,911, which will be amortized to interest expense over the term of the note. Amortization of \$12,444 and \$37,467 was recorded for the three and nine month periods ended June 30, 2008.

On July 30, 2008, the note and accrued interest of \$10,000 automatically converted into 2,144,917 shares of the Company’s common stock.

10% Secured Convertible Promissory Note dated August 8, 2007

On August 8, 2007, the Company issued a \$100,000 principal amount convertible promissory note due August 8, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder’s option, at \$0.50 per share. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.096274883 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. The Company has granted the noteholder a security interest in all the Company’s assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios (“EITF 98-5”), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$24,643 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note’s maturity period (one year) as interest expense.



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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Note dated August 8, 2007 (continued)

In connection with the issuance of the note, the Company issued a non-detachable warrant granting the holder the right to acquire 200,000 shares of the Company's common stock at \$0.50 per share. The warrant expires five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrant in the amount of \$7,960 to additional paid in capital and a discount against the note. The Company valued the warrant in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.69%, a dividend yield of 0%, and volatility of 92.71%. The debt discount attributed to the value of the warrant issued is amortized over the note's maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$24,643) and warrant (\$7,960) to debt discount, aggregating \$32,603, which will be amortized to interest expense over the term of the note. Amortization of \$8,128 and \$24,475 was recorded for the three and nine month periods ended June 30, 2008.

On August 8, 2008, the note and accrued interest of \$10,000 automatically converted into 1,142,562 shares of the Company's common stock.

10% Secured Convertible Promissory Note dated September 28, 2007

On September 28, 2007, the Company issued a \$300,000 principal amount related party convertible promissory note due September 28, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, at \$0.50 per share. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.066429851 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. The Company has granted the noteholder a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$151,604 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note's maturity period (one year) as interest expense.

In connection with the issuance of the note, the Company issued a non-detachable warrant granting the holder the right to acquire 600,000 shares of the Company's common stock at \$0.50 per share. The warrant expires five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$32,580 to additional paid in capital and a discount against the note. The Company valued the warrant in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.23%, a dividend yield of 0%, and volatility of 102.39%. The debt

discount attributed to the value of the warrant issued is amortized over the note's maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$151,604) and warrant (\$32,580) to debt discount, aggregating \$184,184, which will be amortized to interest expense over the term of the note. Amortization of \$45,920 and \$138,264 was recorded for the three and nine month periods ended June 30, 2008.



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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated October 4, 2007

On October 4, 2007, the Company issued \$500,000 principal amount convertible promissory notes due October 4, 2008 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holders, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.069328632 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.069328632 per share.

In addition, on October 4, 2007, the Company issued a \$50,000 principal amount convertible promissory note due October 4, 2008 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.079232722 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.079232722 per share. The Company has granted the noteholder a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$234,308 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes' maturity period (one year) as interest expense.

In connection with the issuance of the notes, the Company issued non-detachable warrants granting the holders the right to acquire 1,100,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$59,840 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.22%, a dividend yield of 0%, and volatility of 103.81%. The debt discount attributed to the value of the warrants issued is amortized over the notes' maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$234,308) and warrants (\$59,840) to debt discount, aggregating \$294,148, which will be amortized to interest expense over the term of the notes. Amortization of \$73,336 and \$217,589 was recorded for the three and nine month periods ended June 30, 2008.

10% Secured Convertible Promissory Notes dated October 30, 2007

On October 30, 2007, the Company issued \$550,000 principal amount convertible promissory notes due October 30, 2008 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holders, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.104750019 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.104750019 per share.

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated October 30, 2007 (continued)

In addition, on October 30, 2007, the Company issued two \$50,000 principal amount convertible promissory notes due October 30, 2008 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holder, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.119714308 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.119714308 per share. The Company has granted the noteholders a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$271,838 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes' maturity period (one year) as interest expense.

In connection with the issuance of the notes, the Company issued non-detachable warrants granting the holders the right to acquire 1,300,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$126,100 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 3.85%, a dividend yield of 0%, and volatility of 108.66%. The debt discount attributed to the value of the warrants issued is amortized over the notes' maturity period (one year) as interest expense.

On November 19, 2007, a noteholder elected to convert a \$50,000 principal amount promissory note and accrued interest of \$274 into 479,942 shares of the Company's common stock.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$271,838) and warrants (\$126,100) to debt discount, aggregating \$397,938, which will be amortized to interest expense over the term of the notes. Amortization of \$91,409 and \$276,394 was recorded for the three and nine month periods ended June 30, 2008 inclusive of the write off of the unamortized debt discount relating to the converted note described above.

10% Secured Convertible Promissory Notes dated November 29, 2007

On November 29, 2007, the Company issued \$1,000,000 principal amount convertible promissory notes due November 29, 2008 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holders, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.094431519, which is equal to a 30% discount to the average volume, weighted average price of our common stock

for the ten trading days prior to issuance per share. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.094431519 per share. The Company has granted the noteholders a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$376,659 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes' maturity period (one year) as interest expense.

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated November 29, 2007 (continued)

In connection with the issuance of the notes the Company issued non-detachable warrants granting the holders the right to acquire 2,000,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$157,200 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 3.42%, a dividend yield of 0%, and volatility of 106.15%. The debt discount attributed to the value of the warrants issued is amortized over the notes' maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$376,659) and warrants (\$157,200) to debt discount, aggregating \$533,859, which will be amortized to interest expense over the term of the notes. Amortization of \$133,099 and \$313,002 was recorded for the three and nine month periods ended June 30, 2008.

10% Secured Convertible Promissory Notes dated December 20, 2007

On December 20, 2007, the Company issued \$450,000 principal amount convertible promissory notes due December 20, 2008 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the option of the holders, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.074766323 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.074766323 per share. The Company has granted the noteholders a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$151,875 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes' maturity period (one year) as interest expense.

In connection with the issuance of the notes, the Company issued non-detachable warrants granting the holders the right to acquire 900,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$49,590 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 3.45%, a dividend yield of 0%, and volatility of 104.51%. The debt discount attributed to the value of the warrants issued is amortized over the notes' maturity period (one year) as interest

expense.

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated December 20, 2007 (continued)

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$151,875) and warrants (\$49,590) to debt discount, aggregating \$201,465, which will be amortized to interest expense over the term of the notes. Amortization of \$50,228 and \$106,528 was recorded for the three and nine month periods ended June 30, 2008.

10% Secured Convertible Promissory Notes dated January 17, 2008

On January 17, 2008, the Company issued \$450,000 principal amount convertible promissory notes due January 17, 2009 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder's option, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.073512803 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.073512803 per share. The Company has granted the noteholders a security interest in all the Company's assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$162,095 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes' maturity period (one year) as interest expense.

In connection with the placement of the notes the Company issued non-detachable warrants granting the holders the right to acquire 900,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$48,240 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 2.90%, a dividend yield of 0%, and volatility of 102.72%. The debt discount attributed to the value of the warrants issued is amortized over the notes' maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$162,095) and warrants (\$48,240) to debt discount, aggregating \$210,335, which will be amortized to interest expense over the term of the notes. Amortization of \$52,440 and \$95,083 was recorded for the three and nine month periods ended June 30, 2008.

10% Secured Convertible Promissory Notes dated March 4, 2008

On March 4, 2008, the Company issued \$250,000 principal amount convertible promissory notes due March 4, 2009 with interest at 10% per annum due upon maturity. The notes are convertible at any time prior to maturity, at the holder option of the holders, into shares of our common stock at a price equal to the greater of (i) 50% of the average

price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.125875423 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the notes, including any accrued and unpaid interest, are convertible at \$0.125875423 per share. The Company has granted the noteholders a security interest in all the Company's assets.



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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated March 4, 2008 (continued)

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios (“EITF 98-5”), the Company recognized an embedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$107,496 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the notes. The debt discount attributed to the beneficial conversion feature is amortized over the notes’ maturity period (one year) as interest expense.

In connection with the placement of the notes the Company issued non-detachable warrants granting the holders the right to acquire 500,000 shares of the Company’s common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments (“EITF – 0027”), the Company recognized the value attributable to the warrants in the amount of \$58,350 to additional paid in capital and a discount against the notes. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 2.53%, a dividend yield of 0%, and volatility of 106.37%. The debt discount attributed to the value of the warrants issued is amortized over the notes’ maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$107,496) and warrants (\$58,350) to debt discount, aggregating \$165,846, which will be amortized to interest expense over the term of the notes. Amortization of \$41,348 and \$53,616 was recorded for the three and nine month periods ended June 30, 2008.

10% Secured Convertible Promissory Note dated May 7, 2008

On May 7, 2008, the Company issued a \$100,000 convertible promissory note due May 7, 2009 with interest at 10% per annum due upon maturity. The note is convertible at any time prior to maturity, at the holder’s option, into shares of our common stock at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion or (ii) at \$0.079849085 per share, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. At maturity, the note, including any accrued and unpaid interest, is convertible at \$0.079849085 per share. The Company has granted the noteholder a security interest in all the Company’s assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios (“EITF 98-5”), the Company recognized an embedded beneficial conversion feature present in the note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$37,760 of the proceeds, which is equal to the intrinsic value of the embedded beneficial conversion feature, to additional paid-in capital and a discount against the note. The debt discount attributed to the beneficial conversion feature is amortized over the note’s maturity period (one year) as interest expense.

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NOTE D — PRIVATE PLACEMENT OF CONVERTIBLE NOTES (continued)

10% Secured Convertible Promissory Notes dated May 7, 2008 (continued)

In connection with the placement of the note the Company issued non-detachable warrants granting the holders the right to acquire 200,000 shares of the Company's common stock at \$0.50 per share. The warrants expire five years from the issuance. In accordance with Emerging Issues Task Force Issue 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$6,010 to additional paid in capital and a discount against the note. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 3.09%, a dividend yield of 0%, and volatility of 101.74%. The debt discount attributed to the value of the warrants issued is amortized over the note's maturity period (one year) as interest expense.

The Company recorded the intrinsic value of the embedded beneficial conversion feature (\$37,760) and warrants (\$6,010) to debt discount, aggregating \$43,770, which will be amortized to interest expense over the term of the Notes. Amortization of \$6,476 was recorded for the three and nine month periods ended June 30, 2008.

NOTE E - RELATED PARTY TRANSACTIONS

The Company's current and former officers and shareholders have advanced funds to the Company for travel related and working capital purposes. No formal repayment terms or arrangements existed. There were no advances due at June 30, 2008.

During the years ended September 30, 2007 and 2006, the Company's Chief Executive Officer, or entities controlled by the Company's Chief Executive Officer, had advanced funds to the Company in the form of convertible promissory notes for working capital purposes (see Note D).

During the three and nine month periods ended June 30, 2008, the Company had sales of \$87,943 and \$156,461 (or 34.8% and 26.8% of total sales), respectively, to an entity whereby the Company's Chief Executive Officer is the President.

NOTE F - CAPITAL STOCK

The Company is authorized to issue 410,000,000 shares of common stock, with a \$0.001 par value per share as the result of a shareholder meeting conducted on May 16, 2007. Prior to the May 16, 2007 share increase, the Company was authorized to issue 250,000,000 shares of common stock with a \$0.001 par value per share. In addition, the Company is authorized to issue 10,000,000 shares of preferred stock with a \$0.0001 par value per share. The preferred stock is convertible at the option of the holder into common stock at the rate of twenty-five (25) shares of common for every one share of preferred at the option of the holder.

Preferred and Common Stock Transactions During the Three Months Ended June 30, 2008:

During the three months ended June 30, 2008, the Company issued 4,967,877 shares of common stock in exchange for convertible notes and accrued interest.



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## NOTE G - STOCK OPTIONS AND WARRANTS

## Warrants

The following table summarizes the changes in warrants outstanding and the related prices for the shares of the Company's common stock issued to non-employees of the Company. These warrants were granted in lieu of cash compensation for services performed or financing expenses in connection with the sale of the Company's common stock.

| Exercise Prices | Number Outstanding | Warrants                                       |    | Weighted Average Exercise Price | Weighted Average Exercisable | Exercisable                     |                                 |
|-----------------|--------------------|--|----|---------------------------------|------------------------------|---------------------------------|---------------------------------|
|                 |                    | Outstanding Remaining Contractual Life (Years) |    |                                 |                              | Weighted Average Exercise Price | Weighted Average Exercise Price |
| \$0.09          | 16,400,000         | 3.17   | \$ | 0.09                            | 16,400,000                   | \$                              | 0.09                            |
| \$0.10          | 105,464            | 1.04   | \$ | 0.10                            | 105,464                      | \$                              | 0.10                            |
| \$0.20          | 5,000              | 0.38   | \$ | 0.20                            | 5,000                        | \$                              | 0.20                            |
| \$0.50          | 25,550,000         | 3.24   | \$ | 0.50                            | 25,550,000                   | \$                              | 0.50                            |
| \$0.60          | 8,226,000          | 1.02   | \$ | 0.60                            | 8,226,000                    | \$                              | 0.60                            |
| \$0.70          | 200,000            | 0.53   | \$ | 0.70                            | 200,000                      | \$                              | 0.70                            |
| \$0.75          | 14,797,000         | 1.60   | \$ | 0.75                            | 14,797,000                   | \$                              | 0.75                            |
|                 | 65,283,464         |  |    |                                 | 65,283,464                   |                                 |                                 |

Transactions involving warrants are summarized as follows:

|                                   | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|------------------|----------------------------------|
| Balance, September 30, 2006       | 72,369,464       | 0.48                             |
| Granted                           | 11,200,000       | 0.18                             |
| Exercised                         | -                | -                                |
| Canceled or expired               | (1,135,000)      | (0.70)                           |
| Outstanding at September 30, 2007 | 82,434,464       | 0.43                             |
| Granted                           | 6,900,000        | 0.50                             |
| Exercised                         | (2,500,000)      | (0.09)                           |
| Canceled or expired               | (21,551,000)     | (0.39)                           |
| Balance, June 30, 2008            | 65,283,464       | \$ 0.47                          |

## Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to employees of the Company under a non-qualified employee stock option plan:

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## NOTE G - STOCK OPTIONS AND WARRANTS (continued)

| Options Outstanding |                    |   | Options Exercisable             |                    |                                 |
|---------------------|--------------------|---|---------------------------------|--------------------|---------------------------------|
| Exercise Prices     | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$ 0.68             | 3,660,000          | 3.25  | \$ 0.68                         | 3,660,000          | \$ 0.68                         |
| 0.09                | 2,000,000          | 3.41  | 0.09                            | 2,000,000          | 0.09                            |
|                     | 5,660,000          |   |                                 | 5,660,000          | 0.47                            |

Transactions involving stock options issued to employees are summarized as follows:

|                                   | Number of Shares | Weighted Average Exercise Price Per Share |
|-----------------------------------|------------------|---|
| Outstanding at October 1, 2006    | 5,660,000        | \$ 0.47                                   |
| Granted                           | -                | -   |
| Exercised                         | -                | -   |
| Cancelled or expired              | -                | -   |
| Outstanding at September 30, 2007 | 5,660,000        | \$ 0.47                                   |
| Granted                           | -                | -   |
| Exercised                         | -                | -   |
| Canceled or expired               | -                | -   |
| Outstanding at June 30, 2008      | 5,660,000        | \$ 0.47                                   |

## Amendment to the 2005 Incentive Stock Plan and Recent Equity Award Grants

On June 17, 2008, the Board of Directors adopted an amendment to the 2005 Incentive Stock Plan that will increase the total number of shares of common stock issuable pursuant to the 2005 Incentive Stock Plan from a total of 20,000,000 shares to a total of 100,000,000 shares, which is subject to approval by our stockholders at the 2008 annual meeting of stockholders. In connection with the share increase amendment, the Board of Directors granted options to purchase a total of 37,750,000 shares to certain key employees and non-employee directors under the 2005 Incentive Stock Plan, including 17,000,000, 5,000,000 and 7,000,000 to James A. Hayward, Kurt H. Jensen and Ming-Hwa Liang, respectively, and 500,000 to each of Yacov Shamash and Sanford R. Simon. The options granted to our key employees and non-employee directors vested with respect to 25% of the underlying shares on the date of grant and the remaining will vest ratably each anniversary thereafter until fully vested on the third anniversary of the date of grant.

The effectiveness of the share increase amendment and the exercise of these stock options by the key employees and non-employee directors are subject to approval by our stockholders at the 2008 annual meeting of stockholders.

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NOTE H- COMMITMENTS AND CONTINGENCIES

Operating Lease Commitments

The Company leases office space under operating lease in Stony Brook, New York for its corporate use from an entity controlled by significant former shareholder, expiring in October 2008. In November 2005, the Company vacated the Los Angeles facility to relocated to the new Stony Brook New York address. Total lease rental expense for the three and nine month periods ended on June 30, 2008 was \$20,387 and \$57,808, respectively.

Employment and Consulting Agreements

The Company has consulting agreements with outside contractors, certain of whom are also Company stockholders. The Agreements are generally month to month.

Litigation

In January 2006, a former employee of the Company filed a complaint alleging wrongful termination against the Company. The former employee is seeking \$230,000 in damages. The Company believes that it has meritorious defenses to the plaintiff's claims and intends to vigorously defend itself against the Plaintiff's claims. Management believes the ultimate outcome of this matter will not have a material adverse effect on the Company's consolidated financial position or results of operations or liquidity.

On April 23, 2008, a consultant filed a complaint related to a claim for breach of contract. In March 2005, the Company entered into a consulting agreement which provided for, among other things, a payment of \$6,000 per month for a period of 24 months, or an aggregate of \$144,000. In addition, the consulting agreement provided for the issuance of a five-year warrant to purchase 250,000 shares of the Company's common stock with an exercise price of \$.75. The consultant asserts that the Company owes it 17 payments of \$6,000, or an aggregate of \$102,000, plus accrued interest thereon, and a warrant to purchase 250,000 shares of our common stock. This matter is in the early stages. We intend to vigorously defend against the claims asserted against us. Management believes the ultimate outcome of this matter will not have a material adverse effect on the Company's consolidated financial position, results of operations or liquidity.

The Company is subject to other legal proceedings and claims, which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters should not have a material adverse effect on its financial position, results of operations or liquidity.

Registration of Company's Shares of Common Stock

In connection with the private placement of our convertible promissory notes and warrants to certain investors during the fiscal quarters ended December 31, 2003, December 31, 2004, March 31, 2005, March 31, 2006 and June 30, 2006, pursuant to a registration rights agreement the Company agreed to file a registration statement to register the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants and to have the registration statement declared effective by the SEC. The registration rights agreement provided for the payment of liquidated damages if a registration statement was not declared effective by the SEC within 120 days of the private placement of the convertible promissory notes. The liquidated damages are equal to 3.5% per month of the aggregate proceeds, with no limitations. The liquidated damages may be paid in cash or our common stock, at our

option. Although the promissory notes and warrants do not provide for net-cash settlement, the existence of liquidated damages provides for a defacto net-cash settlement option. Therefore, the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants subject to the liquidated damages provisions of the registration rights agreement does not meet the tests required for shareholders' equity classification in the past, and accordingly has been reflected between liabilities and equity in our previous consolidated balance sheet.



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NOTE H- COMMITMENTS AND CONTINGENCIES (continued)

As of September 30, 2007, the Company did not have a registration statement declared effective relating to the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants. In accordance with EITF 00-19-2, the Company evaluated the likelihood of having the registration statement declared effective by the SEC. As of September 30, 2007, the Company determined it was probable that it will be required to remit payments to these investors because of our failure to have the registration statement declared effective and the Company estimated that the obligation to make additional payments would continue for nine months from September 30, 2007, at which time the Company estimated that the registration statement would have been declared effective. Although the Company was unable to estimate the exact amount of time needed to have the registration statement declared effective, it believed that an additional nine months would be required to complete the SEC's comment and review process and have the registration statement declared effective. In accordance with SFAS No. 5, Accounting For Contingencies, the Company accrued nine months of additional liquidated damages, or \$3,310,965, as a charge to operations during the year ended September 30, 2007.

As a result of not having our registration statement declared effective, the Company recorded an aggregate liability of \$11,750,941 as of September 30, 2007 and an increase of \$7,725,585 as compared to September 30, 2006, in order to account for the potential liquidated damages accruing until the registration statement is declared effective by the SEC. This increase, which was charged to operations as a selling, general and administrative expense, in fiscal 2007, is comprised of \$8,439,976 of current and prior years' stipulated contractual obligations, plus the additional accrual of \$3,310,965 described previously to account for the potential liquidated damages until the expected effectiveness of the registration statement is achieved.

In developing the best estimate for the accrual of additional liquidating damages, the Company took into account a number of factors and information, including, but not limited to, the following:

- advice of legal counsel and other advisors;
- its experience in addressing comments raised by the SEC in past registration statements;
- the limited number of matters needed to be addressed by the Company to achieve effectiveness;
- its limited resources in connection with responding to SEC comments; and
- the intent to achieve effectiveness of the registration statement as soon as practicable.

Estimates of potential future damages are based on our assumptions and projections and actual results and outcomes could differ significantly.

In September 2007, the Company issued common stock upon conversion of the final convertible promissory note that contained embedded derivatives, such as certain conversion features, variable interest features, call options and default provisions.

At June 30, 2008, the Company has an accumulative accrual of \$12,023,888 of liquidated damages in connection with certain previously outstanding convertible promissory notes and related warrants, which is included in accounts payable and accrued liabilities. Any increases to the accrued liabilities will be charged to operations as a selling,

general and administrative expense. Any decreases will be included in other income (expenses). During the three month period ended June 30, 2008, the SEC declared effective the Company's registration statement (see Note C).

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NOTE H- COMMITMENTS AND CONTINGENCIES (continued)

Matters Voluntarily Reported to the SEC and Securities Act Violations

We previously disclosed that we were investigating the circumstances surrounding certain issuances of 8,550,000 shares to employees and consultants in July 2005, and engaged outside counsel to conduct this investigation. We have voluntarily reported our current findings from the investigation to the SEC, and we have agreed to provide the SEC with further information arising from the investigation. We believe that the issuance of 8,000,000 shares to employees in July 2005 was effectuated by both our former President and our former Chief Financial Officer/Chief Operating Officer without approval of the Board of Directors. These former officers received a total of 3,000,000 of these shares. In addition, it appears that the 8,000,000 shares issued in July 2005, as well as an additional 550,000 shares issued to employees and consultants in March, May and August 2005, were improperly issued without a restrictive legend stating that the shares could not be resold legally except in compliance with the Securities Act of 1933, as amended. The members of our management who effectuated the stock issuances that are being examined in the investigation no longer work for us. In the event that any of the exemptions from registration with respect to the issuance of the Company's common stock under federal and applicable state securities laws were not available, the Company may be subject to claims by federal and state regulators for any such violations. In addition, if any purchaser of the Company's common stock were to prevail in a suit resulting from a violation of federal or applicable state securities laws, the Company could be liable to return the amount paid for such securities with interest thereon, less the amount of any income received thereon, upon tender of such securities, or for damages if the purchaser no longer owns the securities. As of the date of these financial statements, the Company is not aware of any alleged specific violation or the likelihood of any claim. There can be no assurance that litigation asserting such claims will not be initiated, or that the Company would prevail in any such litigation.

The Company is unable to predict the extent of its ultimate liability with respect to any and all future securities matters. The costs and other effects of any future litigation, government investigations, legal and administrative cases and proceedings, settlements, judgments and investigations, claims and changes in this matter could have a material adverse effect on the Company's financial condition and operating results

NOTE I - GOING CONCERN

The accompanying unaudited condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the accompanying unaudited condensed consolidated financial statements during the nine month period ended June 30, 2008, the Company incurred a loss of \$4,987,150. These factors among others may indicate that the Company will be unable to continue as a going concern for a reasonable period of time.

The Company's existence is dependent upon management's ability to develop profitable operations. Management is devoting substantially all of its efforts to developing DNA embedded biotechnology security solutions in the United States and Europe and there can be no assurance that the Company's efforts will be successful and no assurance can be given that management's actions will result in profitable operations or the resolution of its liquidity problems. The accompanying statements do not include any adjustments that might result should the Company be unable to continue as a going concern.

In order to improve the Company's liquidity, the Company's management is actively pursuing additional equity financing through discussions with investment bankers and private investors. There can be no assurance the Company

will be successful in its effort to secure additional equity financing.

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APPLIED DNA SCIENCES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2008  
(unaudited)

NOTE J – SUBSEQUENT EVENTS

On August 8, 2008, the Company issued 1,142,562 shares of common stock upon the automatic conversion of a secured convertible promissory note.

In July 2008, the Company issued an aggregate of \$150,000 10% secured convertible promissory notes with an automatic conversion one year from issuance at a weighted average conversion price of \$0.054948300, which is equal to a 30% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. Additionally, the notes are convertible into shares of the Company's common stock at any time, at the option of the noteholder, prior to the automatic conversion date, at the greater of (i) 50% of the average price of the Company's common stock for the ten trading days prior to the date of the notice of conversion and (ii) the automatic conversion price.

In connection with the issuance of the notes, the Company issued warrants to purchase 300,000 shares of its common stock for cash or on a cashless basis at \$0.50 per share exercisable over four years with certain redemption features.

Additionally, in conjunction with the private placement of the above described notes, the Company paid an aggregate of \$22,500 to its exclusive placement agent.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion should be read in conjunction with our Consolidated Financial Statements and Notes thereto, included elsewhere within this report. This quarterly report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Exchange Act of 1934, as amended (the "Exchange Act"), including statements using terminology such as "can", "may", "believe", "designated to", "will", "expect", "plan", "anticipate", "estimate", "potential" or "continue", or the negative thereof or other comparable terminology regarding beliefs, plans, expectations or intentions regarding the future. You should read statements that contain these words carefully because they:

discuss our future expectations;

contain projections of our future results of operations or of our financial condition; and

state other "forward-looking" information.

We believe it is important to communicate our expectations. However, forward looking statements involve risks and uncertainties and our actual results and the timing of certain events could differ materially from those discussed in forward-looking statements as a result of certain factors, including those set forth under "Risk Factors," "Business" and elsewhere in this report. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to us as of the date thereof, and we assume no obligations to update any forward-looking statement or risk factor, unless we are required to do so by law.

### Introduction

We provide botanical DNA encryption, embedment and authentication solutions that can help protect companies, governments and consumers from counterfeiting, fraud, piracy, product diversion, identity theft, and unauthorized intrusion into physical locations and databases. Our SigNature Program provides a secure, accurate and cost-effective means for our customers to incorporate our SigNature DNA Markers in, and then quickly and reliably authenticate and identify, a broad range of items such as artwork and collectibles, fine wine, consumer products, digital media, financial instruments, identity cards and other official documents. Having the ability to reliably authenticate and identify counterfeit versions of such items enables companies and governments to detect, deter, interdict and prosecute counterfeiting enterprises and individuals.

Our SigNature Program enables our customers to cost-effectively:

give assurance to manufacturers, suppliers, distributors, retailers and end-users that their products are authentic and can be forensically authenticated;

integrate our SigNature DNA Markers with existing security solutions such as barcodes, radio frequency identification (RFID) tags, holograms, microchips and other securities measures; and

add value to the "bottom-line" by helping to diminish product diversion and counterfeiting.

Counterfeit and diverted products continue to pose a significant and growing problem with consumer packaged goods, especially for prestige and established brands worldwide. Piracy, identity theft and forged documents and items are also highly prevalent in vertical markets such as digital media, fine art, luxury goods, and alcoholic beverages. Key aspects of our strategy include:

continuing to improve and customize our solution to meet our current and potential customers' needs;

continuing to develop and enhance our existing DNA marker authentication technologies;  
expanding our customer base both domestically and abroad by targeting high volume markets; and  
augmenting our competitive position through strategic acquisitions and alliances.

We have also begun to develop and manufacture DermalRx, an ingredient for use in skin care products, which allows for exfoliation without the irritation or inflammation associated with chemical peeling.

## Plan of Operations

### General

We expect to generate revenues principally from sales of our SigNature Program. We are currently attempting to develop business in six target markets: art and collectibles, fine wine, consumer products, digital recording media, pharmaceuticals, and homeland security driven programs. We intend to pursue both domestic and international sales opportunities in each of these vertical markets.

We believe that our existing capital resources will enable us to fund our operations until approximately November 2008. We believe we may be required to seek additional capital to sustain or expand our prototype and sample manufacturing, and sales and marketing activities, and to otherwise continue our business operations beyond that date. We have no commitments for any future funding, and may not be able to obtain additional financing or grants on terms acceptable to us, if at all, in the future. If we are unable to obtain additional capital this would restrict our ability to grow and may require us to curtail or discontinue our business operations. Additionally, while a reduction in our business operations may prolong our ability to operate, that reduction would harm our ability to implement our business strategy. If we can obtain any equity financing, it may involve substantial dilution to our then existing shareholders.

### Product Research and Development

We anticipate spending approximately \$50,000 for product research and development activities during the next twelve (12) months.

### Acquisition of Plant and Equipment and Other Assets

We do not anticipate the sale of any material property, plant or equipment during the next 12 months. We do anticipate spending approximately \$100,000 on the acquisition of leasehold improvements during the next 12 months. We believe our current leased space is adequate to manage our growth, if any, over the next 2 to 3 years.

### Number of Employees

We currently have seven employees and three part-time employees. The company expects to increase its staffing dedicated to sales, product prototyping, manufacturing of DNA markers and forensic authentication services. Expenses related to travel, marketing, salaries, and general overhead will be increased as necessary to support our growth in revenue. In order for us to attract and retain quality personnel, we anticipate we will have to offer competitive salaries to future employees. We anticipate that it may become desirable to add additional full and or part time employees to discharge certain critical functions during the next 12 months. This projected increase in personnel is dependent upon our ability to generate revenues and obtain sources of financing. There is no guarantee that we will be successful in raising the funds required or generating revenues sufficient to fund the projected increase in the number of employees. As we continue to expand, we will incur additional costs for personnel.

### Critical Accounting Policies

Financial Reporting Release No. 60, published by the Securities and Exchange Commission (“SEC”), recommends that all companies include a discussion of critical accounting policies used in the preparation of their financial statements. While all these significant accounting policies impact our financial condition and results of operations, we view certain of these policies as critical. Policies determined to be critical are those policies that have the most significant impact on our consolidated financial statements and require management to use a greater degree of judgment and estimates. Actual results may differ from those estimates.



We believe that given current facts and circumstances, it is unlikely that applying any other reasonable judgments or estimate methodologies would cause a material effect on our consolidated results of operations, financial position or liquidity for the periods presented in this report.

The accounting policies identified as critical are as follows:

Equity issued with registration rights ;

Revenue recognition;

Allowance for doubtful accounts;

Warrant liability; and

Fair value of intangible assets.

### Equity Issued with Registration Rights

In connection with the private placement of our convertible promissory notes and warrants to certain investors during the fiscal quarters ended December 31, 2003, December 31, 2004, March 31, 2005, March 31, 2006 and June 30, 2006, pursuant to a registration rights agreement we agreed to file a registration statement to register the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants and to have the registration statement declared effective by the SEC. The registration rights agreement provided for the payment of liquidated damages if a registration statement was not declared effective by the SEC within 120 days of the private placement of the convertible promissory notes. The liquidated damages are equal to 3.5% per month of the aggregate proceeds, with no limitations. The liquidated damages may be paid in cash or our common stock, at our option. Although the promissory notes and warrants do not provide for net-cash settlement, the existence of liquidated damages provides for a defacto net-cash settlement option. Therefore, the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants subject to the liquidated damages provisions of the registration rights agreement does not meet the tests required for shareholders' equity classification in the past, and accordingly has been reflected between liabilities and equity in our previous consolidated balance sheet.

As of September 30, 2007, we did not have a registration statement declared effective relating to the common stock issuable upon the conversion of the promissory notes and the exercise of the warrants. In accordance with EITF 00-19-2, we evaluated the likelihood of having the registration statement declared effective by the SEC. As of September 30, 2007, we determined it was probable that we will be required to remit payments to these investors because of our failure to have the registration statement declared effective and we estimated that the obligation to make additional payments would continue for nine months from September 30, 2007, at which time we estimated that the registration statement would have been declared effective. Although we were unable to estimate the exact amount of time needed to have the registration statement declared effective, we believed that an additional nine months would be required to complete the SEC's comment and review process and have the registration statement declared effective. In accordance with SFAS No. 5, Accounting For Contingencies, we accrued nine months of additional liquidated damages, or \$3,310,965, as a charge to operations during the year ended September 30, 2007.

As a result of not having our registration statement declared effective, we recorded an aggregate liability of \$11,750,941 as of September 30, 2007 and an increase of \$7,725,585 as compared to September 30, 2006, in order to account for the potential liquidated damages accruing until the registration statement is declared effective by the SEC. This increase, which was charged to operations as a selling, general and administrative expense, in fiscal 2007, is comprised of \$8,439,976 of current and prior years' stipulated contractual obligations, plus the additional accrual of \$3,310,965 described previously to account for the potential liquidated damages until the expected effectiveness of the registration statement is achieved.

In developing the best estimate for the accrual of additional liquidating damages, we took into account a number of factors and information, including, but not limited to, the following:

- advice of our legal counsel and other advisors;
- our experience in addressing comments raised by the SEC in past registration statements;
- the limited number of matters needed to be addressed by the Company to achieve effectiveness;
- our limited resources in connection with responding to SEC comments; and
- the intent to achieve effectiveness of the registration statement as soon as practicable.;

Estimates of potential future damages are based on our assumptions and projections and actual results and outcomes could differ significantly.

In September 2007, we issued common stock upon conversion of the final convertible promissory note that contained embedded derivatives, such as certain conversion features, variable interest features, call options and default provisions.

At June 30, 2008, we have an accumulative accrual of \$12,023,888 of liquidated damages in connection with certain previously outstanding convertible promissory notes and related warrants, which is included in accounts payable and accrued liabilities. Any increases to the accrued liabilities will be charged to operations as a selling, general and administrative expense. Any decreases will be included in other income (expenses).

## Revenue Recognition

Revenues are derived from rendering professional, scientific and technical services to our customers in connection with authentication of raw materials used in certain commercial products, such as cotton. In addition, we sell our products, including Signature DNA Markers and DermalRx, to customers in the biotechnology, personal care and consumer products industries.

Our contracts for services have different terms and depending on the scope, deliverables and complexity of the engagement, we are frequently required to make judgments and estimates with respect to recognizing revenues.

We examine each contract and consider the appropriate revenue recognition in accordance with SAB 104 and Emerging Issue Task Force, or EITF, 00-21, Revenue Recognition with Multiple Deliverables, or EITF 00-21. Revenue from fixed price single task consulting contracts is generally recorded upon completion of the contracts, which are generally short-term, or upon completion of identifiable contractual tasks. We consider amounts to be earned once evidence of an arrangement has been obtained, services are delivered, fees are fixed or determinable, and collectibility is reasonably assured.

At the time we enter into a contract that includes multiple tasks, we estimate the amount of actual labor and other costs that will be required to complete each task based on historical experience. Since we have limited operating history, we have based our estimates of labor and other costs upon the following factors:

- results of previous services rendered in connection with providing potential customers with a proof of concept in connection with the specific application of our products and services

- time records of personnel and contractors assigned to the identifiable contractual tasks; and

- specific identification of other direct costs (e.g. supplies, materials etc.) consumed in connection with completing the identifiable tasks.

We believe these estimates are reasonable, reliable and dependable as they are based on our expertise in extracting DNA, applying our SigNature DNA Marker to various products as well as recovering our SigNature DNA Marker after it has been applied.

Revenues from the achievement of contractual milestones, if deemed substantive, are recognized as revenue when the milestones are achieved, and milestone payments are due and collectible. Revenue relative to each task and from contracts which are time and materials based is recorded as effort is expended. Billings in excess of amounts earned are deferred. Any anticipated losses on contracts are charged to income when identified. Milestones are based upon contractually agreed upon terms between us and our customers. To the extent we do not accurately forecast the level of effort required to complete a contract, or individual tasks within a contract, and we are unable to negotiate additional billings with a customer for cost over-runs, we may incur losses on individual contracts. All selling, general and administrative costs are treated as period costs and expensed as incurred.

While each contract is different, we generally provide the following general deliverables:

- written or oral reports as to the authenticity of the product;

- written or oral reports as to the presence of our SigNature DNA Marker;

- written or oral reports as to the status of a particular feasibility study; and

delivery of our Signature DNA Markers.

Since our transition to an operating company in fiscal 2007, we have earned and received \$705,515 in payments from various contracts and purchase orders with an average gross profit margin of \$557,949.

#### Allowance for Uncollectible Receivables

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. The Company uses a combination of write-off history, aging analysis and any specific known troubled accounts in determining the allowance. If the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

#### Warrant Liability

In connection with the placement of certain debt instruments, as described above, we issued freestanding warrants. Although the terms of the warrants do not provide for net-cash settlement, in certain circumstances, physical or net-share settlement is deemed to not be within our control and, accordingly, we were required to account for these freestanding warrants as a derivative financial instrument liability, rather than as shareholders' equity.

The warrant liability is initially measured and recorded at its fair value, and is then re-valued at each reporting date, with changes in the fair value reported as non-cash charges or credits to earnings. For warrant-based derivative financial instruments, the Black-Scholes option pricing model is used to value the warrant liability.

The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is re-assessed at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

In December 2006, the FASB issued FSP EITF 00-19-2, Accounting for Registration Payment Arrangements ("FSP 00-19-2") which addresses accounting for registration payment arrangements. FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. FSP 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years.

As described above, as of September 30, 2007, we exchanged common stock for the previously issued Convertible Promissory Notes that contained certain embedded derivative financial instruments. As a result, the Company reclassified the warrant liabilities recorded in conjunction with the convertible promissory notes to equity as of the conversion date of the remaining note. We do not use derivative instruments to hedge exposures to cash flow, market, or foreign currency risks.

We do not use derivative instruments to hedge exposures to cash flow, market, or foreign currency risks.

#### Fair Value of Intangible Assets

We have adopted SFAS No. 142, Goodwill and Other Intangible Assets, whereby we periodically test our intangible assets for impairment. On an annual basis, and when there is reason to suspect that their values have been diminished or impaired, these assets are tested for impairment, and write-downs will be included in results from operations. During the years ended September 30, 2007 and 2006, our management performed an evaluation of the Company's intangible assets (intellectual property) for purposes of determining the implied fair value of the assets at September 30, 2007 and 2006, respectively. The test indicated that the recorded remaining book value of its intellectual property exceeded its fair value for the year ended September 30, 2006, as determined by discounted cash flows. As a result, upon completion of the assessment, management recorded a non-cash impairment charge of \$5,655,011, net of tax, or \$0.05 per share during the year ended September 30, 2006 to reduce the carrying value of the patents to \$2,091,800. Considerable management judgment is necessary to estimate the fair value. Accordingly, actual results could vary significantly from management's estimates.

The identifiable intangible assets acquired and their carrying value at June 30, 2008 are:

|   |              |
|---|--------------|
| Trade secrets and developed technologies (Weighted average life of 7 years) | \$ 9,430,900 |
| Patents (Weighted average life of 5 years )                                 | 34,257       |
| Total Amortized identifiable intangible assets-Gross carrying value:        | \$ 9,465,157 |
| Less:   |              |

|                          |              |
|--------------------------|--------------|
| Accumulated Amortization | (2,351,113)  |
| Impairment (See below)   | (5,655,011)  |
| Net:                     | \$ 1,459,033 |
| Residual value:          | \$ 0         |

Total amortization expense charged to operations for the three and nine month periods ended June 30, 2008 was \$93,482 and \$277,787, respectively, and, \$92,661 and \$277,983 for the three and nine month periods ended June 30, 2007, respectively.

Estimated amortization expense as of June 30, 2008 is as follows:

|                     |    |           |
|---------------------|----|-----------|
| 2008                | \$ | 93,483    |
| 2009                |    | 365,124   |
| 2010                |    | 363,791   |
| 2011                |    | 363,791   |
| 2012 and thereafter |    | 272,844   |
| Total               | \$ | 1,459,033 |

#### Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period. The most significant estimates relate to the estimation of percentage of completion on uncompleted contracts, valuation of inventory, allowance for doubtful accounts and estimated life of customer lists. Actual results could differ from those estimates.

#### Three Months Ended June 30, 2008 Compared With Three Months Ended June 30, 2007

##### Revenues

During the year ended September 30, 2007, we transitioned from a development stage enterprise to an operating company. For the three months ended June 30, 2008, we generated \$252,691 in revenues from operations and our cost of sales for the three months ended June 30, 2008 was \$50,489, netting us a gross profit of \$202,202. For the three months ended June 30, 2007, we had no revenues or cost of sales.

##### Costs and Expenses

##### Selling, General and Administrative

Selling, general and administrative expenses decreased from \$1,968,642 for the three months ended June 30, 2007 to \$951,828 for the three months ended June 30, 2008. The decrease of \$1,016,814, or 52%, is primarily attributable to a decrease in cost incurred in connection with professional services.

##### Research and Development

In the nine months ended June 30, 2008, research and development expenses increased by \$17,753 to \$112,042 from \$94,289 for the same period in 2007.

##### Depreciation and Amortization

Depreciation and amortization expenses for the nine months ended June 30, 2008 did not change materially from the same period in 2007, an increase of \$9 to \$324,603 to \$324,594.

##### Total Operating Expenses

Total operating expenses decreased to \$1,081,199 from \$2,102,503, or a decrease of \$1,021,304 primarily attributable to a decrease in costs incurred in connection with professional services.



Other Income/Loss

Gain on reevaluation of debt derivative and warrant liability decreased by \$4,431,421 from a gain of \$4,431,421 for the three months ended June 30, 2007 to \$0 for the three months ended June 30, 2008. In September 2007, we exchanged common stock for the remaining Secured Convertible Promissory Notes that contained embedded derivatives. As a result, we reclassified the warrant liabilities recorded in conjunction with the convertible promissory notes to equity as of the conversion date of the related debt.

Interest Expenses

Interest expense for the three months ended June 30, 2008 increased by \$128,759 to \$649,722 from \$520,963 in the same period of 2007. The increase in interest expense was due to an increase in outstanding debt.

## Net Income (loss)

Net loss for the three months ended June 30, 2008 increased to \$1,528,719 from a net income of \$1,807,954 in the prior period primarily attributable to the gain in change in warrant liability in 2007

## Nine Months Ended June 30, 2008 Compared With Nine Months Ended June 30, 2007

### Revenues

For the nine months ended June 30, 2008, we generated \$583,595 in revenues from operations and our cost of sales for the nine months ended June 30, 2008 was \$124,493, netting us a gross profit of \$459,102. For the nine months ended June 30, 2007, we had no revenues or cost of sales.

### Costs and Expenses

#### Selling, General and Administrative

Selling, general and administrative expenses decreased from \$6,012,028 for the nine months ended June 30, 2007 to \$3,365,880 for the nine months ended June 30, 2008. The decrease of \$2,646,148, or 44%, is primarily attributable to a decrease in cost incurred in connection with professional services.

#### Depreciation

Depreciation expenses for the nine months ended June 30, 2008 did not change materially from the same period in 2007 (an increase of \$9).

#### Research and Development

In the nine months ended June 30, 2008, research expenses increased by \$17,753 from \$94,289 to \$112,042 for the period compared to the same period in 2007.

#### Total Operating Expenses

Total operating expenses decreased to \$3,802,525 from \$6,430,911, or a decrease of \$2,628,386 primarily attributable to a decrease in costs incurred in connection with professional services.

#### Other Income/Loss

Gain on reevaluation of debt derivative and warrant liability decreased by \$142,131 from a gain of \$142,131 for the nine months ended June 30, 2007 to \$0 for the nine months ended June 30, 2008. In September 2007, we exchanged common stock for the remaining Secured Convertible Promissory Notes that contained embedded derivatives. As a result, we reclassified the warrant liabilities recorded in conjunction with the convertible promissory notes to equity as of the conversion date of the related debt.

#### Interest Expenses

Interest expense for the nine months ended June 30, 2008 decreased by \$301,975 to \$1,643,727 from \$1,945,702 in the same period of 2007. The decrease in interest expense was due to the lower year to date debt as compared to 2007.

## Net Income (loss)

Net loss for the nine months ended June 30, 2008 decreased to \$4,987,150 from a net loss of \$8,233,506 in the prior period primarily attributable to reduced professional and other related fees from 2007.

## Liquidity and Capital Resources

Our liquidity needs consist of our working capital requirements, indebtedness payments and research and development expenditure funding. Historically, we have financed our operations through the sale of equity and convertible debt as well as borrowings from various credit sources.

Substantially all of the real property used in our business is leased under operating lease agreements.

As of June 30, 2008, we had a working capital deficit of approximately \$15,218,019. For the nine month period ended June 30, 2008, we generated a net cash flow deficit from operating activities of \$2,350,033 consisting primarily of year to date losses of \$4,987,150. Non-cash adjustments included \$2,022,066 in depreciation and amortization charges and common stock issued for services provided of \$1,040,000. Additionally, we had a net increase in current assets of \$97,566 and a net decrease in current liabilities of \$327,383. Cash provided in investing activities totaled \$377,420, which was utilized for acquisition of property and equipment of \$22,500 and reduction in cash held in escrow of \$399,920. We met our cash flow needs by issuance of convertible notes of \$2,532,580, net, for the three months ended June 30, 2008.

We expect capital expenditures to be less than \$200,000 in fiscal 2008. Our primary investments will be in laboratory equipment to support prototyping and our authentication services.

## Debt and Equity Financing Transactions

## Fiscal 2006

In fiscal 2006, we completed three private placements of convertible debt and associated warrants. On November 3, 2005, we issued and sold a promissory note in the principal amount of \$550,000 to Allied International Fund, Inc. ("Allied"). Allied in turn financed a portion of the making of this loan by borrowing \$450,000 from certain persons, including \$100,000 from Dr. Hayward, a director, our President and Chief Executive Officer. The terms of the promissory note provided that we issue upon the funding of the note warrants to purchase 5,000,000 shares of our common stock at an exercise price of \$0.50 per share to certain persons designated by Allied. On November 9, 2005, we issued nine warrants to Allied and eight other persons to purchase an aggregate of 5,500,000 shares of our common stock at an exercise price of \$0.50 per share. These warrants included a warrant to purchase 1,100,000 shares that was issued to Dr. Hayward, a director, our President and Chief Executive Officer. We paid \$55,000 in cash to VC Arjent, Ltd. for its services as the placement agent with respect to this placement. All principal and accrued but unpaid interest under the promissory note was paid in full shortly after the closing of and from the proceeds of a private placement we completed on March 8, 2006. On March 8, 2006, we issued and sold an aggregate of 30 units consisting of (i) a \$50,000 principal amount secured convertible promissory note bearing interest at 10% per annum and convertible at \$0.50 per share, and (ii) a warrant to purchase 100,000 shares of our common stock at an exercise price of \$0.50 per share, for aggregate gross proceeds of \$1.5 million. The units were sold pursuant to subscription agreements by and between each of the purchasers and Applied DNA Operations Management, Inc., a Nevada corporation and our wholly owned subsidiary (our "Subsidiary"). The \$2.050 million in gross proceeds from these first two offerings were held by our Subsidiary for our benefit and used to fund commissions, fees and expenses associated with the placements, to repay the outstanding promissory note described above plus accrued interest thereunder, to fund financing fees, consultants and public reporting costs, salaries and wages, research and development, facility costs as well as general working capital needs. On March 24, 2006, we commenced an offering (the "Offshore Offering") of up to 140 units, at a price of \$50,000 per unit, for a maximum offering of \$7 million for sale to "accredited investors" who are not "U.S. persons." The units being sold as part of the Offshore Offering consisted of (i) a \$50,000 principal amount secured convertible promissory note, and (ii) a warrant to purchase 100,000 shares of our common stock at a price of \$0.50 per share. On May 2, 2006, we closed on the first tranche of the Offshore Offering in which we sold 20 units for aggregate gross proceeds of \$1,000,000. We paid Arjent Limited \$375,000 in commissions, fees and expenses from these gross proceeds. On June 15, 2006, we completed the second tranche of the Offshore Offering in which we sold 59 units for aggregate gross proceeds of \$2,950,000. We paid Arjent Limited \$442,500 in commissions, fees and expenses from these gross proceeds. Additionally, on July 10, 2006 we issued 2.4 million shares of our common stock to Arjent Limited at \$0.001 per share as partial consideration for its services in connection with the Offshore Offering.

## Fiscal 2007

In fiscal 2007, we issued sold an aggregate principal amount of \$850,000 in secured convertible promissory notes bearing interest at 10% per annum and warrants to purchase an aggregate of 1,700,000 shares of our common stock to Dr. James A. Hayward, a director, the Chairman of the Board of Directors, our President and Chief Executive Officer, as follows:

On April 23, 2007, we issued and sold a \$100,000 principal amount secured promissory note bearing interest at a rate of 10% per annum and a warrant to purchase 200,000 shares of our common stock. The promissory note and accrued but unpaid interest thereon converted on April 22, 2008 at a conversion price of \$0.15 into 733,334 shares of our common stock. The warrant is exercisable for a four-year period commencing on April 23, 2008, and expiring on April 22, 2012, at a price of \$0.50 per share. The warrant may be redeemed at our option at a redemption price of \$0.001 upon the earlier of (i) April 22, 2010, and (ii) the date our common stock has traded on The Over the Counter Bulletin Board at or above \$1.00 per share for 20 consecutive trading days.



On June 30, 2007, we issued and sold a \$250,000 principal amount secured promissory note bearing interest at a rate of 10% per annum and a warrant to purchase 500,000 shares of our common stock. The promissory note and accrued but unpaid interest thereon converted on June 30, 2008 at a conversion price of \$0.087732076 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, into 3,134,543 shares of our common stock. The warrant is exercisable for a four-year period commencing on June 30, 2008, and expiring on June 29, 2012, at a price of \$0.50 per share.

On July 30, 2007, we issued and sold a \$200,000 principal amount secured promissory note bearing interest at a rate of 10% per annum and a warrant to purchase 400,000 shares of our common stock. The promissory note and accrued but unpaid interest thereon converted on July 30, 2008 at a conversion price of \$0.102568072 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, into 2,144,917 shares of our common stock. The warrant is exercisable for a four-year period commencing on July 30, 2008, and expiring on July 29, 2012, at a price of \$0.50 per share.

On September 28, 2007, we issued and sold a \$300,000 principal amount secured promissory note bearing interest at a rate of 10% per annum and a warrant to purchase 600,000 shares of our common stock. The promissory note and accrued but unpaid interest thereon are convertible into shares of our common stock at a price of \$0.50 per share by the holder of the promissory note at any time from September 28, 2007 through September 27, 2008, and shall automatically convert on September 28, 2008 at a conversion price of \$0.066429851 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance. The warrant is exercisable for a four-year period commencing on September 28, 2008, and expiring on September 27, 2012, at a price of \$0.50 per share.

In addition, on June 27, 2007, we completed a private placement offering of convertible debt and associated warrants in which we issued and sold to certain investors an aggregate of 3 units of our securities, each unit consisting of (i) a \$50,000 Principal Amount of 10% Secured Convertible Promissory Note and (ii) warrants to purchase 100,000 shares of our common stock. The notes and accrued but unpaid interest thereon converted at \$0.15 per share on June 27, 2008 into an aggregate of 1,100,000 shares of our common stock. The warrants are exercisable for a four year period commencing on June 27, 2008, and expiring on June 26, 2012, at a price of \$0.50 per share. On August 8, 2007, we issued and sold a \$100,000 principal amount secured promissory note bearing interest at a rate of 10% per annum and a warrant to purchase 200,000 shares of our common stock to an "accredited investor," as defined in regulations promulgated under the Securities Act. The promissory note and accrued but unpaid interest thereon converted on August 8, 2008 at a conversion price of \$0.096274883 per share, which is equal to a 20% discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, into 1,142,562 shares of our common stock. The warrant is exercisable for a four-year period commencing on August 8, 2008, and expiring on August 7, 2012, at a price of \$0.50 per share.

#### Fiscal 2008

In the nine months ended June 30, 2008, we sold an aggregate of thirty-four and a half units at a price of \$100,000 per unit for sale to "accredited investors," as defined in regulations promulgated under the Securities Act, for aggregate gross proceeds of \$3,450,000. Each unit consists of (i) a \$100,000 Principal Amount 10% Secured Convertible Promissory Note and (ii) a warrant to purchase 200,000 shares of our common stock. The promissory notes and accrued but unpaid interest thereon automatically convert one year after issuance at a conversion price equal to a discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, and are convertible into shares of our common stock at the option of the holder at any time prior to such automatic conversion at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion and (ii) the automatic conversion price. In addition, any time prior to conversion, we have the irrevocable right to repay the unpaid principal and accrued but unpaid interest under the notes on three days notice. The promissory notes bear interest at the rate of 10% per annum and are due and

payable in full on the one year anniversary of their issuance. The warrants are exercisable for cash or on a cashless basis for a period of four years commencing one year after issuance at a price of \$0.50 per share. Each warrant may be redeemed at our option at a redemption price of \$0.01 upon the earlier of (i) three years after the issuance, and (ii) the date our common stock has traded on The Over the Counter Bulletin Board at or above \$1.00 per share for 20 consecutive trading days.

From July 1, 2008 through August 14, 2008, we sold one and a half units at a price of \$100,000 per unit for sale to “accredited investors,” as defined in regulations promulgated under the Securities Act, for aggregate gross proceeds of \$150,000. Each unit consists of (i) a \$100,000 Principal Amount 10% Secured Convertible Promissory Note and (ii) a warrant to purchase 200,000 shares of our common stock. The promissory notes and accrued but unpaid interest thereon automatically convert one year after issuance at a conversion price equal to a discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, and are convertible into shares of our common stock at the option of the holder at any time prior to such automatic conversion at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion and (ii) the automatic conversion price. In addition, any time prior to conversion, we have the irrevocable right to repay the unpaid principal and accrued but unpaid interest under the notes on three days notice. The promissory notes bear interest at the rate of 10% per annum and are due and payable in full on the one year anniversary of their issuance. The warrants are exercisable for cash or on a cashless basis for a period of four years commencing one year after issuance at a price of \$0.50 per share. Each warrant may be redeemed at our option at a redemption price of \$0.01 upon the earlier of (i) three years after the issuance, and (ii) the date our common stock has traded on The Over the Counter Bulletin Board at or above \$1.00 per share for 20 consecutive trading days.

We claim an exemption from the registration requirements of the Securities Act for the private placement of the units described above pursuant to Section 4(2) of the Securities Act because each of the units was made in a sale by the issuer not involving a public offering.

We presently do not have any available credit, bank financing or other external sources of liquidity. Due to our brief history and historical operating losses, our operations have not been a source of liquidity. We will need to obtain additional capital in order to expand operations and become profitable. We intend to pursue the building of a re-seller network outside the United States, and if successful, the re-seller agreements would constitute a source of liquidity and capital over time. In order to obtain capital, we may need to sell additional shares of our common stock or borrow funds from private lenders. There can be no assurance that we will be successful in obtaining additional funding and execution of re-seller agreements outside the United States.

We currently require additional financing in order to meet our current and projected cash flow deficits from operations and development. We have sufficient funds to conduct our operations for approximately three months. We presently do not have any available credit, bank financing or other readily available external sources of liquidity. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock, a downturn in the U.S. or global stock and debt markets and other reasons could make it more difficult to obtain financing through the issuance of equity securities or borrowing. Further, if we issue additional equity or convertible debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, this could have a material adverse effect on our business, results of operations liquidity and financial condition.

Our registered independent certified public accountants have stated in their report dated January 14, 2008, that we have incurred operating losses in the last two years, and that we are dependent upon management's ability to develop profitable operations. These factors among others may raise substantial doubt about our ability to continue as a going concern.



#### Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

#### Inflation

The effect of inflation on our revenue and operating results was not significant.

#### Going Concern

The accompanying unaudited condensed consolidated financial statements included in this filing have been prepared in conformity with generally accepted accounting principles that contemplate our continuance as a going concern. Our auditors, in their report dated January 14, 2008, have expressed substantial doubt about our ability to continue as going concern. Our cash position may be inadequate to pay all of the costs associated with the testing, production and marketing of our products. Management intends to use borrowings and the sale of equity or convertible debt to mitigate the effects of its cash position, however no assurance can be given that debt or equity financing, if and when required will be available. The accompanying unaudited condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets and classification of liabilities that might be necessary should we be unable to continue existence.

## RISK FACTORS

Because of the following factors, as well as other variables affecting our operating results and financial condition, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

### Risks Relating To Our Business:

We have a short operating history, a relatively new business model, and have not produced significant revenues. This makes it difficult to evaluate our future prospects and increases the risk that we will not be successful.

We have a short operating history with our current business model, which involves the marketing, sale and distribution of botanical products and services, which are based on technologies that we acquired in July 12, 2005 from Biowell Technology, Inc. ("Bio") second calendar quarter of 2006, which was insignificant. Prior to the July 12, 2005 acquisition, our operations consisted principally of providing services to Biowell. As a result, we have a very limited operating history for you to evaluate in assessing our future prospects. Our operations since inception have not produced significant revenues, and may not produce significant revenues in the future. Our ability to obtain additional financing and may require us to reduce or discontinue our operations. If we create revenues in the future, we will derive all such revenues from the sale of botanical DNA encryption, encapsulation, embedment and authentication products. We must consider our business and prospects in light of the risks and difficulties we will encounter as an early-stage company in a new and rapidly evolving industry. We may not be able to successfully address these risks and difficulties, which could significantly harm our business, operating results, and financial condition.

We have a history of losses which may continue, and which may harm our ability to obtain financing and continue our operations.

We incurred net losses of \$13.3 million for the year ended September 30, 2007 and \$2.4 million for the year ended September 30, 2006. For the nine months ended June 30, 2008, we incurred a net loss of \$4,987,150. These net losses have principally been the result of the various costs associated with our selling, general and administrative expenses as we commenced operations, acquired, developed and validated technologies, began marketing activities, and our interest expense on notes and warrants we issued to obtain financing. Our operations are subject to the risks and competition inherent in a company that moved from the development stage to an operating company. We may not generate sufficient revenues from operations to achieve or sustain profitability on a quarterly, annual or any other basis in the future. Our revenues and profits, if any, will depend upon various factors, including whether our existing products and services or any new products and services we develop will achieve any level of market acceptance. If we continue to incur losses, our accumulated deficit will continue to increase, which might significantly impair our ability to obtain additional financing. As a result, our business, results of operations and financial condition would be significantly harmed, and we may be required to reduce or terminate our operations.

If we are unable to obtain additional financing our business operations will be harmed or discontinued, and if we do obtain additional financing our shareholders may suffer substantial dilution.

We believe that our existing capital resources will enable us to fund our operations until approximately November 2008. We believe we will be able to sustain or expand our prototype and sample manufacturing, and sales and marketing activities, and to otherwise continue our business operations, but we have no commitments for any future funding, and may not be able to obtain additional financing or grants on terms acceptable to us, if we are unable to raise capital this would restrict our ability to grow and may require us to curtail or discontinue our business operations. Additionally, if we are unable to obtain additional financing, that reduction would harm our ability to implement our business strategy. If we can obtain any additional financing from existing shareholders.

Our independent auditors have expressed substantial doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.

In their report dated January 14, 2008, our independent auditors stated that our financial statements for the year ended September 30, 2007 were prepared assuming that we would continue as a going concern, and that they have substantial doubt about our ability to continue as a going concern. Our auditors' doubts are based on our incurring net losses of \$13.3 million for the year ended September 30, 2007. We continue to experience net operating losses. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including by the sale of our securities, obtaining loans from financial institutions, or obtaining grants from various organizations or governments, where possible. Our continued net operating losses and our auditors' doubts increase the difficulty of our meeting such goals and our efforts to continue as a going concern may not prove successful.

If our existing products and services are not accepted by potential customers or we fail to introduce new products and services, our business, results of operations and financial condition will be harmed.

There has been limited or no market acceptance of our botanical DNA encryption, encapsulation, embedment and authentication products and services to date. Some of the factors that will affect whether we achieve market acceptance of our solutions include:

- availability, quality and price relative to competitive solutions;
- customers' opinions of the solutions' utility;
- ease of use;
- consistency with prior practices;
- scientists' opinions of the solutions' usefulness;
- citation of the solutions in published research; and
- general trends in anti-counterfeit and security solutions' research.

The expenses or losses associated with the continued lack of market acceptance of our solutions will harm our business, operating results and financial condition.

The expenses or losses associated with the continued lack of market acceptance of our solutions will harm our business, operating results and financial condition.

Rapid technological changes and frequent new product introductions are typical for the markets we serve. Our future success may depend in part on continuous, timely development and introduction of new products that address evolving market requirements. We believe successful new product introductions may provide a significant competitive advantage because customers invest their time in selecting and learning to use new products, and are often reluctant to switch products. To the extent we fail to introduce new and innovative products, we may lose any market share we then have to our competitors, which will be difficult or impossible to regain. Any inability, for technological or other reasons, to successfully develop and introduce new products could reduce our growth rate or damage our business. We may experience delays in the development and introduction of products. We may not keep pace with the rapid rate of change in anti-counterfeiting and security products' research, and any new products acquired or developed by us may not meet the requirements of the marketplace or achieve market acceptance.

If we are unable to retain the services of Drs. Hayward or Liang we may not be able to continue our operations.

Our success depends to a significant extent upon the continued service of Dr. James A. Hayward, one of our directors, our President and Chief Executive Officer; and Dr. Benjamin Liang, our Secretary and Strategic Technology Development Officer. We do not have employment agreements with Drs. Hayward or Liang. Loss of the services of Drs. Hayward or Liang could significantly harm our business, results of operations and financial condition. We do not

maintain key-man insurance on the lives of Drs. Hayward or Liang.

The markets for our SigNature program are very competitive, and we may be unable to continue to compete effectively in this industry in the future.

The principal markets for our SigNature Program are intensely competitive. We compete with many existing suppliers and new competitors continue to enter the market. Many of our competitors, both in the United States and elsewhere, are major pharmaceutical, chemical and biotechnology companies, or have strategic alliances with such companies, and many of them have substantially greater capital resources, marketing experience, research and development staff, and facilities than we do. Any of these companies could succeed in developing products that are more effective than the products that we have or may develop and may be more successful than us in producing and marketing their existing products. Some of our competitors that operate in the anti-counterfeiting and fraud prevention markets include: Authentix, Collectors Universe Inc., Data Dot Technology, Digimarc Corp., DNA Technologies, Inc., ID Global, Informium AG, Inksure Technologies, Kodak, L-1 Identity Solutions, Manakoa, OpSec Security Group, SmartWater Technology, Inc., Sun Chemical Corp, and Tracetag.

We expect this competition to continue and intensify in the future. Competition in our markets is primarily driven by:

product performance, features and liability;  
price;  
timing of product introductions;  
ability to develop, maintain and protect proprietary products and technologies;  
sales and distribution capabilities;  
technical support and service;  
brand loyalty;  
applications support; and  
breadth of product line.

If a competitor develops superior technology or cost-effective alternatives to our products, our business, financial condition and results of operations could be significantly harmed.

We need to expand our sales, marketing and support organizations and our distribution arrangements to increase market acceptance of our products and services.

We currently have few sales, marketing, customer service and support personnel and will need to increase our staff to generate a greater volume of sales and to support any new customers or the expanding needs of existing customers. The employment market for sales, marketing, customer service and support personnel in our industry is very competitive, and we may not be able to hire the kind and number of sales, marketing, customer service and support personnel we are targeting. Our inability to hire qualified sales, marketing, customer service and support personnel may harm our business, operating results and financial condition. We do not currently have any arrangements with any distributors and we may not be able to enter into arrangements with qualified distributors on acceptable terms or at all. If we are not able to develop greater distribution capacity, we may not be able to generate sufficient revenue to support our operations.

A manufacturer's inability or willingness to produce our goods on time and to our specifications could result in lost revenue and net losses.

Though we manufacture prototypes, samples and some of our own products, we currently do not own or operate any significant manufacturing facilities and depend upon independent third parties for the manufacture of some of our products to our specifications. The inability of a manufacturer to ship orders of such products in a timely manner or to meet our quality standards could cause us to miss the delivery date requirements of our customers for those items, which could result in cancellation of orders, refusal to accept deliveries or a reduction in purchase prices, any of which could harm our business by resulting in decreased revenues or net losses upon sales of products, if any sales could be made.

If we need to replace manufacturers, our expenses could increase, resulting in smaller profit margins.

We compete with other companies for the production capacity of our manufacturers and import quota capacity. Some of these competitors have greater financial and other resources than we have, and thus may have an advantage in the competition for production and import quota capacity. If we experience a significant increase in demand, or if our existing manufacturers must be replaced, we will need to establish new relationships with another or multiple manufacturers. We cannot assure you that this additional third party manufacturing capacity will be available when required on terms that are acceptable to us or terms similar to those we have with our existing manufacturers, either from a production standpoint or a financial standpoint. We do not have long-term contracts with our manufacturers, and our manufacturers do not produce our products exclusively. Should we be forced to replace our manufacturers, we may experience an adverse financial impact, or an adverse operational impact, such as being forced to pay

increased costs for such replacement manufacturing or delays upon distribution and delivery of our products to our customers, which could cause us to lose customers or lose revenues because of late shipments.

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If a manufacturer fails to use acceptable labor practices, we might have delays in shipments or face joint liability for violations, resulting in decreased revenue and increased expenses.

While we require our independent manufacturers to operate in compliance with applicable laws and regulations, we have no control over their ultimate actions. While our internal and vendor operating guidelines promote ethical business practices and our staff and buying agents periodically visit and monitor the operations of our independent manufacturers, we do not control these manufacturers or their labor practices. The violation of labor or other laws by our independent manufacturers, or by one of our licensing partners, or the divergence of an independent manufacturer's or licensing partner's labor practices from those generally accepted as ethical in the United States, could interrupt, or otherwise disrupt the shipment of finished products to us or damage our reputation. Any of these, in turn, could have a material adverse effect on our financial condition and results of operations, such as the loss of potential revenue and incurring additional expenses.

Failure to license new technologies could impair sales of our existing products or any new product development we undertake in the future.

To generate broad product lines, it is advantageous to sometimes license technologies from third parties rather than depend exclusively on the development efforts of our own employees. As a result, we believe our ability to license new technologies from third parties is and will continue to be important to our ability to offer new products. In addition, from time to time we are notified or become aware of patents held by third parties that are related to technologies we are selling or may sell in the future. After a review of these patents, we may decide to seek a license for these technologies from these third parties. There can be no assurance that we will be able to successfully identify new technologies developed by others. Even if we are able to identify new technologies of interest, we may not be able to negotiate a license on favorable terms, or at all. If we lose the rights to patented technology, we may need to discontinue selling certain products or redesign our products, and we may lose a competitive advantage. Potential competitors could license technologies that we fail to license and potentially erode our market share for certain products. Intellectual property licenses would typically subject us to various commercialization, sublicensing, minimum payment, and other obligations. If we fail to comply with these requirements, we could lose important rights under a license. In addition, certain rights granted under the license could be lost for reasons beyond our control, and we may not receive significant indemnification from a licensor against third party claims of intellectual property infringement.

Our failure to manage our growth in operations and acquisitions of new product lines and new businesses could harm our business.

Any growth in our operations, if any, will place a significant strain on our current management resources. To manage such growth, we would need to improve our:

operations and financial systems;  
procedures and controls; and  
training and management of our employees.

Our future growth, if any, may be attributable to acquisitions of new product lines and new businesses. Future acquisitions, if successfully consummated, would likely create increased working capital requirements, which would likely precede by several months any material contribution of an acquisition to our net income. Our failure to manage growth or future acquisitions successfully could seriously harm our operating results. Also, acquisition costs could cause our quarterly operating results to vary significantly. Furthermore, our stockholders would be diluted if we financed the acquisitions by incurring convertible debt or issuing securities.

Although we currently only have operations within the United States, if we were to acquire an international operation;

we would face additional risks, including:

difficulties in staffing, managing and integrating international operations due to language, cultural or other differences;

different or conflicting regulatory or legal requirements;  
foreign currency fluctuations; and  
diversion of significant time and attention of our management.



Failure to attract and retain qualified scientific, production and managerial personnel could harm our business.

Recruiting and retaining qualified scientific and production personnel to perform and manage prototype, sample, and product manufacturing and business development personnel to conduct business development are critical to our success. In addition, our desired growth and expansion into areas and activities requiring additional expertise, such as clinical testing, government approvals, production, and marketing will require the addition of new management personnel and the development of additional expertise by existing management personnel. Because the industry in which we compete is very competitive, we face significant challenges attracting and retaining a qualified personnel base. Although we believe we have been and will be able to attract and retain these personnel, we may not be able to continue to successfully attract qualified personnel. The failure to attract and retain these personnel or, alternatively, to develop this expertise internally would harm our business since our ability to conduct business development and manufacturing will be reduced or eliminated, resulting in lower revenues. We generally do not enter into employment agreements requiring our employees to continue in our employment for any period of time.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services and brand.

Our patents, trademarks, trade secrets, copyrights and all of our other intellectual property rights are important assets for us. There are events that are outside of our control that pose a threat to our intellectual property rights as well as to our products and services. For example, effective intellectual property protection may not be available in every country in which our products and services are distributed. The efforts we have taken to protect our proprietary rights may not be sufficient or effective. Any significant impairment of our intellectual property rights could harm our business or our ability to compete. Protecting our intellectual property rights is costly and time consuming. Any increase in the unauthorized use of our intellectual property could make it more expensive to do business and harm our operating results. Although we seek to obtain patent protection for our innovations, it is possible we may not be able to protect some of these innovations. Given the costs of obtaining patent protection, we may choose not to protect certain innovations that later turn out to be important. There is always the possibility that the scope of the protection gained from one of our issued patents will be insufficient or deemed invalid or unenforceable. We also seek to maintain certain intellectual property as trade secrets. The secrecy could be compromised by third parties, or intentionally or accidentally by our employees, which would cause us to lose the competitive advantage resulting from these trade secrets.

Intellectual property litigation could harm our business.

Litigation regarding patents and other intellectual property rights is extensive in the biotechnology industry. In the event of an intellectual property dispute, we may be forced to litigate. This litigation could involve proceedings instituted by the U.S. Patent and Trademark Office or the International Trade Commission, as well as proceedings brought directly by affected third parties. Intellectual property litigation can be extremely expensive, and these expenses, as well as the consequences should we not prevail, could seriously harm our business.

If a third party claims an intellectual property right to technology we use, we might need to discontinue an important product or product line, alter our products and processes, pay license fees or cease our affected business activities. Although we might under these circumstances attempt to obtain a license to this intellectual property, we may not be able to do so on favorable terms, or at all. Furthermore, a third party may claim that we are using inventions covered by the third party's patent rights and may go to court to stop us from engaging in our normal operations and activities, including making or selling our product candidates. These lawsuits are costly and could affect our results of operations and divert the attention of managerial and technical personnel. A court may decide that we are infringing the third party's patents and would order us to stop the activities covered by the patents. In addition, a court may order us to pay the other party damages for having violated the other party's patents. The biotechnology industry has produced a proliferation of patents, and it is not always clear to industry participants, including us, which

patents cover various types of products or methods of use. The coverage of patents is subject to interpretation by the courts, and the interpretation is not always uniform. If we are sued for patent infringement, we would need to demonstrate that our products or methods of use either do not infringe the patent claims of the relevant patent and/or that the patent claims are invalid, and we may not be able to do this. Proving invalidity, in particular, is difficult since it requires a showing of clear and convincing evidence to overcome the presumption of validity enjoyed by issued patents.

Because some patent applications in the United States may be maintained in secrecy until the patents are issued, because patent applications in the United States and many foreign jurisdictions are typically not published until eighteen months after filing, and because publications in the scientific literature often lag behind actual discoveries, we cannot be certain that others have not filed patent applications for technology covered by our or our licensor's issued patents or pending applications or that we or our licensors were the first to invent the technology. Our competitors may have filed, and may in the future file, patent applications covering technology similar to ours. Any such patent application may have priority over our or our licensors' patent applications and could further require us to obtain rights to issued patents covering such technologies. If another party has filed a United States patent application on inventions similar to ours, we may have to participate in an interference proceeding declared by the United States Patent and Trademark Office to determine priority of invention in the United States. The costs of these proceedings could be substantial, and it is possible that such efforts would be unsuccessful, resulting in a loss of our United States patent position with respect to such inventions.

Some of our competitors may be able to sustain the costs of complex patent litigation more effectively than we can because they have substantially greater resources. In addition, any uncertainties resulting from the initiation and continuation of any litigation could have a material adverse effect on our ability to raise the funds necessary to continue our operations.

Accidents related to hazardous materials could adversely affect our business.

Some of our operations require the controlled use of hazardous materials. Although we believe our safety procedures comply with the standards prescribed by federal, state, local and foreign regulations, the risk of accidental contamination of property or injury to individuals from these materials cannot be completely eliminated. In the event of an accident, we could be liable for any damages that result, which could seriously damage our business and results of operations.

Potential product liability claims could affect our earnings and financial condition.

We face a potential risk of liability claims based on our products and services, and we have faced such claims in the past. Though we have product liability insurance coverage which we believe is adequate, we may not be able to maintain this insurance at reasonable cost and on reasonable terms. We also cannot assure that this insurance, if obtained, will be adequate to protect us against a product liability claim, should one arise. In the event that a product liability claim is successfully brought against us, it could result in a significant decrease in our liquidity or assets, which could result in the reduction or termination of our business.

Litigation generally could affect our financial condition and results of operations.

We generally may be subject to claims made by and required to respond to litigation brought by customers, former employees, former officers and directors, former distributors and sales representatives, and vendors and service providers. We have faced such claims and litigation in the past and we cannot assure that we will not be subject to claims in the future. In the event that a claim is successfully brought against us, considering our lack of material revenue and the losses our business has incurred for the period from our inception to June 30, 2008, this could result in a significant decrease in our liquidity or assets, which could result in the reduction or termination of our business.

We were obligated to pay liquidated damages as a result of our failure to have our registration statement declared effective prior to June 15, 2005, and any payment of liquidated damages will either result in depletion of our limited working capital or issuance of shares of common stock which would cause dilution to our existing shareholders.

Pursuant to the terms of a registration rights agreement with respect to common stock underlying convertible notes and warrants we issued in private placements in November and December, 2003, December, 2004, and January and February, 2005, if we did not have a registration statement registering the shares underlying these convertible notes and warrants declared effective on or before June 15, 2005, we are obligated to pay liquidated damages in the amount of 3.5% per month of the face amount of the notes, which equals \$367,885, until the registration statement is declared effective. At our option, these liquidated damages can be paid in cash or unregistered shares of our common stock. To date we have decided to pay certain of these liquidated damages in common stock, although any future payments of liquidated damages may, at our option, be made in cash. If we decide to pay such liquidated damages in cash, we would be required to use our limited working capital and potentially raise additional funds. If we decide to pay the liquidated damages in shares of common stock, the number of shares issued would depend on our stock price at the time that payment is due. Based on the closing market prices of \$0.66, \$0.58, \$0.70, \$0.49, \$0.32 and \$0.20 for our common stock on July 15, 2005, August 15, 2005, September 15, 2005, October 17, 2005, November 15, 2005 and December 15, 2005, respectively, we issued a total of 3,807,375 shares of common stock in liquidated damages from August, 2005 to January, 2006 to persons who invested in the January and February, 2005 private placements. The issuance of shares upon any payment by us of further liquidated damages will have the effect of further diluting the proportionate equity interest and voting power of holders of our common stock, including

investors in this offering.

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We paid liquidated damages in the form of common stock only for the period from June 15, 2005 to December 15, 2005, and only to persons who invested in the January and February, 2005 private placements. We believe that we have no enforceable obligation to pay liquidated damages to holders of any shares we agreed to register under the registration rights agreement for periods after the first anniversary of the date of issuance of such shares, since they were eligible for resale under Rule 144 of the Securities Act during such periods, and such liquidated damages are grossly inconsistent with actual damages to such persons. Nonetheless, as of June 30, 2008 we have accrued approximately \$12.0 million in penalties representing further liquidated damages associated with our failure to have the registration statement declared effective by the deadline, and have included this amount in accounts payable and accrued expenses.

Matter voluntarily reported to the Securities and Exchange Commission

During the months of March, May, July and August 2005, we issued a total of 8,550,000 shares of our common stock to certain employees and consultants pursuant to the 2005 Incentive Stock Plan. We engaged our outside counsel to conduct an investigation of the circumstances surrounding the issuance of these shares. On April 26, 2006, we voluntarily reported the findings from this investigation to the SEC, and agreed to provide the SEC with further information arising from the investigation. We believe that the issuance of 8,000,000 shares to employees in July 2005 was effectuated by both our former President and our former Chief Financial Officer/Chief Operating Officer without approval of our board of directors. These former officers received a total of 3,000,000 of these shares. In addition, it appears that the 8,000,000 shares issued in July 2005, as well as an additional 550,000 shares issued to employees and consultants in March, May and August 2005, were improperly issued without a restrictive legend stating that the shares could not be resold legally except in compliance with the Securities Act, as amended. The members of the Company's management who effectuated the stock issuances no longer work for the Company. These shares were not registered under the Securities Act, or the securities laws of any state, and we believe that certain of these shares may have been sold on the open market, though we have been unable to determine the magnitude of such sales. Since our voluntary report of the findings of our internal investigation to the SEC on April 26, 2006, we have received no communication from the SEC or any third party with respect to this matter. If violations of securities laws occurred in connection with the resale of certain of these shares, the employees and consultants or persons who purchased shares from them may have rights to have their purchase rescinded or other claims against us for violation of securities laws, which could harm our business, results of operations, and financial condition.

Risks Relating to Our Common Stock:

There are a large number of shares underlying our options and warrants that may be available for future sale and the sale of these shares may depress the market price of our common stock and will cause immediate and substantial dilution to our existing stockholders.

As of August 13 2008, we had 200,391,959 shares of common stock issued and outstanding and outstanding options and warrants to purchase 71,243,464 shares of common stock. All of the shares issuable upon exercise of our options and warrants may be sold without restriction. The sale of these shares may adversely affect the market price of our common stock. The issuance of shares upon exercise of options and warrants will cause immediate and substantial dilution to the interests of other stockholders since the selling stockholders may convert and sell the full amount issuable on exercise.

If we fail to remain current on our reporting requirements, we could be removed from the OTC bulletin board which would limit the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market.

Companies trading on The Over The Counter Bulletin Board (the "OTC Bulletin Board"), such as us, must be reporting issuers under Section 12 or Section 15(d) of the Securities Exchange Act, and must be current in their reports under

Section 13, in order to maintain price quotation privileges on the OTC Bulletin Board. If we fail to remain current on our reporting requirements, we could be removed from the OTC Bulletin Board. As a result, the market liquidity for our securities could be severely adversely affected by limiting the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market. Prior to May 2001, we were delinquent in our reporting requirements, having failed to file our quarterly and annual reports for the years ended 1998 – 2000 (except the quarterly reports for the first two quarters of 1999). We have been current in our reporting requirements for the last six years, however, there can be no assurance that in the future we will always be current in our reporting requirements.

We may not be able to implement section 404 of the Sarbanes Oxley Act of 2002 on a timely basis.

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act, adopted rules generally requiring each public company to include a report of management on the company's internal controls over financial reporting in its annual report on Form 10-K that contains an assessment by management of the effectiveness of the company's internal controls over financial reporting. This requirement will first apply to our annual report on Form 10-K for the fiscal year ending September 30, 2008. Under current rules, commencing with our annual report for the fiscal year ending September 30, 2010 our independent registered accounting firm must attest to and report on management's assessment of the effectiveness of our internal controls over financial reporting.

We have not yet developed a Section 404 implementation plan. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. How companies should be implementing these new requirements including internal control reforms to comply with Section 404's requirements and how independent auditors will apply these requirements and test companies' internal controls, is still reasonably uncertain.

We expect that we will need to hire and/or engage additional personnel and incur incremental costs in order to complete the work required by Section 404. We may not be able to complete a Section 404 plan on a timely basis. Additionally, upon completion of a Section 404 plan, we may not be able to conclude that our internal controls are effective, or in the event that we conclude that our internal controls are effective, our independent accountants may disagree with our assessment and may issue a report that is qualified. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations.

Our common stock is subject to the "penny stock" rules of the SEC and the trading market in our securities is limited, which makes transactions in our stock cumbersome and may reduce the value of an investment in our stock.

The SEC has adopted Rule 15g-9 which establishes the definition of a "penny stock," for the purposes relevant to us, as any equity security that has a market price of less than \$5.00 per share or with an exercise price of less than \$5.00 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, the rules require:

that a broker or dealer approve a person's account for transactions in penny stocks; and the broker or dealer receive from the investor a written agreement to the transaction, setting forth the identity and quantity of the penny stock to be purchased.

In order to approve a person's account for transactions in penny stocks, the broker or dealer must:

obtain financial information and investment experience objectives of the person; and make a reasonable determination that the transactions in penny stocks are suitable for that person and the person has sufficient knowledge and experience in financial matters to be capable of evaluating the risks of transactions in penny stocks.

The broker or dealer must also deliver, prior to any transaction in a penny stock, a disclosure schedule prescribed by the SEC relating to the penny stock market, which, in highlight form:

sets forth the basis on which the broker or dealer made the suitability determination; and that the broker or dealer received a signed, written agreement from the investor prior to the transaction.

Generally, brokers may be less willing to execute transactions in securities subject to the "penny stock" rules. This may make it more difficult for investors to dispose of our common stock and cause a decline in the market value of our stock.

Disclosure also has to be made about the risks of investing in penny stocks in both public offerings and in secondary trading and about the commissions payable to both the broker-dealer and the registered representative, current quotations for the securities and the rights and remedies available to an investor in cases of fraud in penny stock transactions. Finally, monthly statements have to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks.



### ITEM 3. CONTROLS AND PROCEDURES

a) **Evaluation of Disclosure Controls and Procedures:** As of June 30, 2008, our management carried out an evaluation, under the supervision of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's system of disclosure controls and procedures pursuant to the Exchange Act and Rules 13a-15(e) and 15d-15(e) promulgated thereunder. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were not effective, as of the date of their evaluation, for the purposes of recording, processing, summarizing and timely reporting material information required to be disclosed in reports filed under the Exchange Act.

As previously disclosed in our Current Reports on Form 8-K, filed on May 18, 2006 and October 2, 2006, as a result of comments raised by the SEC, we determined that accounting errors were made in connection with:

- accounting for and disclosing the fair value of warrants and options to acquire our common stock issued to non-employees as a current period expense;

- accounting for and disclosing the fair value of shares issued to a former Director in exchange for previously incurred debt;

- accounting for and disclosing the fair value of warrants issued to note holders and consultants having registration rights; and

- accounting for and disclosing the revaluation for warrant liabilities as of each reporting period.

Based on the impact of the aforementioned accounting errors, we determined to restate our consolidated financial statements as of September 30, 2005 and for the year ended September 30, 2005 and the quarterly unaudited data for the first three quarters of 2006 and all of 2005.

b) **Changes in internal control over financial reporting:** There were no changes in internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially effect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. Except as described below, we are currently not aware of any such legal proceedings that we believe will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

Paul Reep v. Applied DNA Sciences, Inc. et al. (Los Angeles Superior Court Case No. BC345702):

Plaintiff Paul Reep, a former employee, commenced this action against us on January 10, 2006. Mr. Reep asserted causes of action for breach of contract, breach of an oral agreement, negligent misrepresentation, interference with prospective business advantages, defamation, fraud, accounting and constructive trust, and unjust enrichment. The relief sought includes declaratory relief, unspecified compensatory damages, unpaid salary, unspecified penalties under the California Labor Code, interest, punitive damages and attorneys' fees. We successfully moved the court to indefinitely stay all proceedings in this matter in light of a forum selection clause designating Nevada state courts as the proper forum. We then agreed with Reep to consolidate this action with another matter pending in Los Angeles County Superior Court, captioned Applied DNA Sciences, Inc. v. Paul Reep, Case No. BC367661. Once this matter was consolidated with our affirmative lawsuit against Reep, we filed a demurrer to the first amended complaint. That demurrer resulted in several causes of action being dismissed. Reep then filed a Second Amended Complaint which asserts claims for breach of written and oral contracts, fraud, declaratory relief, violation of California's Labor Code and defamation. We answered the Second Amended Complaint in November 2007 and denied all of the material allegations. Since that time, we have deposed Reep on two occasions and propounded various written discovery. Based on the information obtained through the discovery process, we moved for summary judgment regarding all of Reep's remaining claims. The motion for summary judgment came on for hearing on June 19, 2008 before Judge Solner, and was granted in its entirety. We are now waiting for the Court to enter the proposed order that disposes of Reep's claims. We have also had communications with Reep's counsel whereby the parties have provisionally agreed for Reep to waive any appellate rights he may have relating to this lawsuit in exchange for our agreement to dismiss our affirmative lawsuit against Reep (see below). A written agreement setting forth the final resolution of both matters is expected to be executed shortly.

Applied DNA Sciences, Inc. v. Paul Reep et al. (Los Angeles County Superior Court Case No. BC 367661):

We filed this action against the defendants, Paul Reep, Adrian Butash, John Barnett, Chanty Cheang, Jaime Cardona, Peter Brocklesby, Cheri Lu Brocklesby and Angela Wiggins on or about March 9, 2007. In this matter, we have asked the court to make a judicial determination that the defendants were unjustly enriched and breached fiduciary duties owed to the company. We resolved our claims against all of the defendants except Reep and Peter and Cheri Lu Brocklesby. Default was entered against Peter and Cheri Lu Brocklesby for failing to respond to the complaint, and the company has since submitted documentation requesting that a default judgment be issued against both of these individuals. That request is still being considered by the Court. After the resolution of the claims involving the other defendants, we agreed with Reep that this case should be consolidated with Paul Reep v. Applied DNA Sciences, Inc. et al, Los Angeles Superior Court Case No. BC345702. The trial in the consolidated matter was set for July 22, 2008; however, on June 19, 2008, we prevailed in our motion for summary judgment in the matter captioned Paul Reep v. Applied DNA Sciences, Inc. et al, Los Angeles Superior Court Case No. BC345702 (see above). After the decision granting our motion for summary judgment was announced, we had communications with Reep's counsel whereby the parties provisionally agreed for Reep to waive any appellate rights he may have relating to Case No. BC 345702 in exchange for our agreement to dismiss our affirmative lawsuit against Mr. Reep. A written agreement setting forth the final resolution of both matters is expected to be executed shortly. The Court has set a status conference for

August 27, 2008 at 9:00 a.m. in the event this case is not resolved. We intend to vigorously prosecute our claims against Reep should the case not be resolved upon the terms provisionally agreed upon.

Douglas A. Falkner v. Applied DNA Sciences, Inc./N.C. Industrial Commission File No. 585698:

Plaintiff Douglas Falkner ("Falkner") filed a worker's compensation claim in North Carolina for an alleged work-related neck injury that he alleges occurred on January 14, 2004. Falkner worked as Business Development and Operations Manager at our sole East Coast office at the time of the alleged injury. Plaintiff Falkner was the only employee employed by us in North Carolina at the time of the alleged injury and we have employed no other employees in North Carolina at any other time. The claim has been denied and is being defended on several grounds, including the lack of both personal and subject matter jurisdiction. Specifically, we contend that we did not employ the requisite minimum number of employees in North Carolina at the time of the alleged injury and that the company is therefore not subject to the North Carolina Workers' Compensation Act. The claim was originally set for hearing in January 2007, but was continued to allow the parties to engage in further discovery.

Douglas A. Falkner v. Applied DNA Sciences, Inc. (Los Angeles County Superior Court Case No. BC 386557):

Falkner commenced this action asserting counts for breach of contract under his employment agreements dated March 10, 2003 and June 16, 2003 and wrongful discharge in violation of public policy. The relief sought includes unspecified compensatory damages, unspecified exemplary and punitive damages, and attorneys' fees. This matter is in the early stages of discovery. We intend to vigorously defend against the claims asserted against us.

Intervex, Inc. v. Applied DNA Sciences, Inc. (Supreme Court of the State of New York Index No.08-601219):

Intervex, Inc., or Intervex, the plaintiff, filed a complaint on or about April 23, 2008 related to a claim for breach of contract. In March 2005, we entered into a consulting agreement with Intervex, which provided for, among other things, a payment of \$6,000 per month for a period of 24 months, or an aggregate of \$144,000. In addition, the consulting agreement provided for the issuance by us to Intervex of a five-year warrant to purchase 250,000 shares of our common stock with an exercise price of \$.75. Intervex asserts that we owe it 17 payments of \$6,000, or an aggregate of \$102,000, plus accrued interest thereon, and a warrant to purchase 250,000 shares of our common stock. We have counterclaimed for compensatory and punitive damages, restitution, attorneys' fees and costs, interest and other relief the court deems proper. This matter is in the early stages of discovery. We intend to vigorously defend against the claims asserted against us.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

### Sales of Unregistered Securities

In the fiscal quarter ended June 30, 2008, we sold one unit at a price of \$100,000 to an “accredited investor,” as defined in regulations promulgated under the Securities Act. The unit consists of (i) a \$100,000 Principal Amount 10% Secured Convertible Promissory Note and (ii) a warrant to purchase 200,000 shares of our common stock. The promissory note and accrued but unpaid interest thereon automatically convert one year after issuance at a conversion price equal to a discount to the average volume, weighted average price of our common stock for the ten trading days prior to issuance, and are convertible into shares of our common stock at the option of the holder at any time prior to such automatic conversion at a price equal to the greater of (i) 50% of the average price of our common stock for the ten trading days prior to the date of the notice of conversion and (ii) the automatic conversion price. In addition, any time prior to conversion, we have the irrevocable right to repay the unpaid principal and accrued but unpaid interest under the note on three days notice. The promissory note bears interest at the rate of 10% per annum and is due and payable in full on the one year anniversary of its issuance. The warrant is exercisable for cash or on a cashless basis for a period of four years commencing one year after issuance at a price of \$0.50 per share. The warrant may be redeemed at our option at a redemption price of \$0.01 upon the earlier of (i) three years after the issuance and (ii) the date our common stock has traded on The Over the Counter Bulletin Board at or above \$1.00 per share for 20 consecutive trading days.

In conjunction with the private placement of the unit, we paid an aggregate of \$15,000 to the placement agent.

We claim an exemption from the registration requirements of the Securities Act for the private placement of the units pursuant to Section 4(2) of the Securities Act because the unit was sold by the issuer not involving a public offering.

For additional information concerning our sales of unregistered securities during the period covered by this report and subsequent to the period covered by this report, please refer to Note D and Note J respectively, to our Consolidated Financial Statements in Part I, Item 1 of this report, which are incorporated herein by reference.

## 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

Exhibit Description

- 2.1 Articles of Merger of Foreign and Domestic Corporations, filed December 19, 1998 with the Nevada Secretary of State, filed as an exhibit to the annual report on Form 10-KSB filed with the Commission on December 29, 2003 and incorporated herein by reference.
- 3.1 Articles of Incorporation of DCC Acquisition Corporation, filed April 20, 1998 with the Nevada Secretary of State, filed as an exhibit to the annual report on Form 10-KSB filed with the Commission on December 29, 2003 and incorporated herein by reference.
- 3.2 Articles of Amendment of Articles of Incorporation of DCC Acquisition Corp. changing corporation name to ProHealth Medical Technologies, Inc.
- 3.3 Certificate of Designations, Powers, preferences and Rights of the Founders' Series of Convertible Preferred Stock, filed as an exhibit to the annual report on Form 10-KSB filed with the Commission on December 29, 2003 and incorporated herein by reference.
- 3.4 Articles of Amendment of Articles of Incorporation of Applied DNA Sciences, Inc. increasing the par value of the company's common stock, filed on December 3, 2003 with the Nevada Secretary of State, filed as an exhibit to the annual report on Form 10-KSB filed with the Commission on December 29, 2003 and incorporated herein by reference.
- 3.5 Articles of Amendment of Articles of Incorporation of Applied DNA Sciences, Inc. increasing the number of authorized shares of the company's common stock, filed on May 17, 2007 with the Nevada Secretary of State, filed as an exhibit to Amendment No. 9 to Form SB-2 dated April 21, 2008 to the Registration Statement on Form S-1 filed with the Commission on April 21, 2008 and incorporated herein by reference.
- 3.6 By-Laws of Applied DNA Sciences, Inc., filed as an exhibit to the annual report on Form 10-KSB filed with the Commission on December 29, 2003 and incorporated herein by reference.
- 4.1 Registration Rights Agreement, dated January 28, 2005, between the Company and Vertical Capital Partners, Inc., on behalf of the investors, filed as an exhibit to the current report on Form 8-K filed with the Commission on January 28, 2005 and incorporated herein by reference.

10.1

Amendment to Engagement Letter, dated December 20, 2007, by and between Applied DNA Sciences, Inc. and ARjENT Limited, filed as an exhibit to the current report on Form 8-K filed with the Commission on December 28, 2007 and incorporated herein by reference

- 10.2 Form of Subscription Agreement by and among Applied DNA Sciences, Inc. and the investors named on the signature pages thereto, previously filed as Exhibit 10.1 to our Current Report on Form 8-K on October 11, 2007 and incorporated herein by reference.
- 10.3 Form of 10% Secured Convertible Promissory Note of Applied DNA Sciences, Inc., previously filed as Exhibit 10.2 to our Current Report on Form 8-K on October 11, 2007 and incorporated herein by reference.
- 10.4 Form of Warrant Agreement of Applied DNA Sciences, Inc., previously filed as Exhibit 10.3 to our Current Report on Form 8-K on October 11, 2007 and incorporated herein by reference.
- 10.5 Form of Employee Stock Option Agreement under The Applied DNA Sciences, Inc. 2005 Incentive Stock Plan of Applied DNA Sciences, Inc. (filed herewith).
- 10.6 Form of Director Stock Option Agreement under The Applied DNA Sciences, Inc. 2005 Incentive Stock Plan of Applied DNA Sciences, Inc. (filed herewith)
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14 and Rule 15d 14(a), promulgated under the Securities and Exchange Act of 1934, as amended

- 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)
- 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)

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SIGNATURES

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

APPLIED DNA SCIENCES,  
INC.

Date: August 14, 2008

By: /s/ JAMES A.  
HAYWARD  
James A. Hayward  
Chief Executive Officer