

Patient Safety Technologies, Inc  
Form 10-Q  
November 19, 2008

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

---

**FORM 10-Q**

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

**OR**

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 001-09727

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

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**13-3419202**  
(I.R.S. Employer Identification Number)

**43460 Ridge Park Drive, Suite 140, Temecula, CA 92590**  
(Address of principal executive offices) (Zip Code)

**Registrant's telephone number, including areacode: (951) 587-6201**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

Edgar Filing: Patient Safety Technologies, Inc - Form 10-Q

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

There were 17,172,872 shares of the registrant's common stock outstanding as of November 14, 2008.

---

**PATIENT SAFETY TECHNOLOGIES, INC.**

**FORM 10-Q FOR THE QUARTER  
ENDED SEPTEMBER 30, 2008**

**TABLE OF CONTENTS**

	<u>Page</u>
<b>PART I - FINANCIAL INFORMATION</b>	
Item 1.	1
	16
Item 2.	25
Item 3.	25
Item 4T.	25
<b>PART II - OTHER INFORMATION</b>	
Item 1.	26
Item 1A.	26
Item 2.	26
Item 3.	26
Item 4.	27
Item 5.	27
Item 6	27
<b>SIGNATURES</b>	<b>28</b>

**"SAFE HARBOR" STATEMENT UNDER  
THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

We believe that it is important to communicate our plans and expectations about the future to our stockholders and to the public. Some of the statements in this report are forward-looking statements about our plans and expectations of what may happen in the future, including in particular the statements about our plans and expectations in Part I of this report under the heading "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations." Statements that are not historical facts are forward-looking statements. These forward-looking statements are made pursuant to the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995. You can sometimes identify forward-looking statements by our use of forward-looking words like "may," "should," "expects," "intends," "plans," "anticipates," "believes," "estimates," "predicts," "potential," or "continue" or the negative of these terms similar expressions.

Although we believe that the plans and expectations reflected in or suggested by our forward-looking statements are reasonable, those statements are based only on the current beliefs and assumptions of our management and on information currently available to us and, therefore, they involve uncertainties and risks as to what may happen in the future. Accordingly, we cannot guarantee you that our plans and expectations will be achieved. Our actual results and stockholder values could be very different from and worse than those expressed in or implied by any forward-looking statement in this report as a result of many known and unknown factors, many of which are beyond our ability to predict or control. These factors include, but are not limited to, those contained in Part II of this report under "Item 1A. Risk Factors." All written and oral forward-looking statements attributable to us are expressly qualified in their entirety by these cautionary statements.

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

---

**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements.**

**PATIENT SAFETY TECHNOLOGIES, INC. AND SUBSIDIARY**  
**Condensed Consolidated Balance Sheets (Unaudited)**  
(In thousands, except par value)

	September 30, 2008	December 31, 2007
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 1,038	\$ 405
Accounts receivable	325	72
Inventories	35	—
Prepaid expenses	309	105
<b>Total current assets</b>	<b>1,707</b>	<b>582</b>
Restricted certificate of deposit	87	87
Notes receivable	154	154
Property and equipment, net	721	663
Assets held for sale, net	90	406
Goodwill	1,832	1,832
Patents, net	3,520	3,764
Long-term investment	667	667
Other assets	29	19
<b>Total assets</b>	<b>\$ 8,807</b>	<b>\$ 8,174</b>
<b>Liabilities and Stockholders' (Deficit) Equity</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 603	\$ 709
Current portion of long term debt	2,946	1,172
Accrued liabilities	3,303	521
<b>Total current liabilities</b>	<b>6,852</b>	<b>2,402</b>
Long-term debt, less current portion	—	2,531
Deferred tax liabilities	1,403	1,499
<b>Total liabilities</b>	<b>8,255</b>	<b>6,431</b>
<b>Stockholders' equity:</b>		
Convertible preferred stock, \$1.00 par value, cumulative 7% dividend: 1,000 shares authorized; 11 issued and outstanding at September 30, 2008 and December 31, 2007 (Liquidation preference of \$1.2 million at September 30, 2008 and December 31, 2007	11	11
Common stock, \$0.33 par value: 25,000 shares authorized; 16,673 shares issued and outstanding at September 30, 2008; 12,055 shares issued and outstanding at December 31, 2007	5,502	3,978
Additional paid-in capital	35,408	34,320

Edgar Filing: Patient Safety Technologies, Inc - Form 10-Q

Accumulated deficit	(40,369)	(36,567)
<b>Total stockholders' (deficit) equity</b>	552	1,743
<b>Total liabilities and stockholders' equity</b>	\$ 8,807	\$ 8,174

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

1

---

**PATIENT SAFETY TECHNOLOGIES, INC. AND SUBSIDIARY**  
**Condensed Consolidated Statements of Operations (Unaudited)**  
(In thousands, except per share data)

	For The Three Months Ended September 30,		For The Nine Months Ended September 30,	
	2008	2007	2008	2007
<b>Revenues</b>	\$ 880	\$ 213	\$ 1,937	\$ 834
<b>Cost of revenue</b>	622	112	1,342	514
<b>Gross profit</b>	258	101	595	320
<b>Operating expenses:</b>				
Research and development	87	39	168	91
Sales and marketing	662	418	1,796	1,090
General and administrative	958	764	3,680	2,790
Total operating expenses	1,707	1,221	5,644	3,971
<b>Operating loss</b>	(1,449)	(1,120)	(5,049)	(3,651)
<b>Other income (expenses):</b>				
Interest expense	(79)	(810)	(254)	(1,414)
Change in fair value of warrant liability	1,683	—	1,515	—
Realized gain (loss) assets held for sale, net	—	—	(25)	22
Unrealized loss on assets held for sale, net	—	—	(65)	—
Other income	36	—	35	—
Total other income (expense)	1,640	(810)	1,206	(1,392)
<b>Income (loss) from continuing operations before income taxes</b>	191	(1,931)	(3,843)	(5,043)
Income tax provision	33	29	98	88
<b>Income (loss) from continuing operations</b>	224	(1,901)	(3,744)	(4,955)
<b>Loss from discontinued operations</b>	—	(19)	—	(166)
<b>Net income (loss)</b>	224	(1,920)	(3,745)	(5,121)
<b>Preferred dividends</b>	(19)	(19)	(57)	(57)
<b>Net income (loss) applicable to common shareholders</b>	\$ 205	\$ (1,940)	\$ (3,802)	\$ (5,178)
<b>Basic net income (loss) per common share</b>				
<b>Continuing operations</b>	\$ 0.01	\$ (0.18)	\$ (0.28)	\$ (0.53)
<b>Discontinued operations</b>	\$ —	\$ (0.00)	\$ —	\$ (0.02)
<b>Net income (loss)</b>	\$ 0.01	\$ (0.18)	\$ (0.28)	\$ (0.55)

**Diluted net income (loss) per  
common share**

<b>Continuing operations</b>	\$	0.01	\$	(0.18)	\$	(0.28)	\$	(0.53)
<b>Discontinued operations</b>	\$	0	\$	0.00	\$	—	\$	(0.02)
<b>Net income (loss)</b>	\$	0.01	\$	(0.18)	\$	(0.28)	\$	(0.55)

**Weighted average common shares  
outstanding:**

Basic	15,615	10,626	13,588	9,501
Diluted	29,005	19,788	26,978	18,663

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



**PATIENT SAFETY TECHNOLOGIES, INC. AND SUBSIDIARY**  
**Condensed Consolidated Statements of Cash Flows (Unaudited)**  
(In thousands)

	<b>For The Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities:</b>		
Net loss	\$ (3,745)	\$ (5,121)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	261	133
Amortization of patents	244	244
Non-cash interest	145	1,045
Non-cash payments	568	—
Realized loss on assets held for sale, net	25	—
Realized loss (gain) on sale of property and equipment	—	(33)
Unrealized loss on assets held for sale, net	65	—
Stock-based compensation to employees and directors	1,229	900
Change in fair value of warrant derivative liability	(1,515)	—
Income tax benefit	(98)	(86)
Changes in operating assets and liabilities:		
Accounts receivable	(253)	2
Inventories	(35)	15
Prepaid expenses	30	402
Other current assets	(10)	—
Assets held for sale, net	—	22
Accounts payable	(105)	(453)
Accrued liabilities	151	345
Net cash used in operating activities	(3,043)	(2,585)
<b>Investing activities:</b>		
Purchase of property and equipment	(319)	(387)
Proceeds from sale of property and equipment	—	43
Proceeds from sale of assets held for sale, net	226	3,178
Net cash provided by (used in) investing activities	(93)	2,834
<b>Financing activities:</b>		
Proceeds from issuance of common stock and warrants	3,877	3,051
Proceeds from notes payable	500	100
Payments and decrease on notes payable	(551)	(3,301)
Payments of preferred dividends	(57)	(19)
Net cash provided by (used in) financing activities	3,769	(169)
Net increase in cash and cash equivalents	633	80
Cash and cash equivalents at beginning of period	405	4
Cash and cash equivalents at end of period	\$ 1,038	\$ 84
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for interest	\$ 49	\$ 222
<b>Non cash investing and financing activities:</b>		

Edgar Filing: Patient Safety Technologies, Inc - Form 10-Q

Issuance of common stock in payment of accrued liabilities	\$	185	\$	—
Dividends accrued	\$	—	\$	38
Issuance of common stock in connection with contingent payment with Surgicount acquisition	\$	—	\$	75
Issuance of common stock in payment of notes payable, accrued and prepaid interest	\$	859	\$	580
Issuance of common stock for inventory	\$	700	\$	500
Payment of accrued liability with long-term investments	\$	—	\$	11
Reclassification of accrued interest to notes payable, less current portion - net	\$	—	\$	349
Reclassification of additional paid in capital to warrant derivative liability	\$	4,350	\$	—

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

**Patient Safety Technologies, Inc. and Subsidiary**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

**1. DESCRIPTION OF BUSINESS**

Patient Safety Technologies, Inc. ("*PST*" or the "*Company*") is a Delaware corporation. The Company's operations are conducted at its wholly-owned operating subsidiary, SurgiCount Medical, Inc. ("*SurgiCount*"), a California corporation.

The Company's primary focus is development, manufacturing and distribution of products and services focused primarily in the health care and medical products field, particularly the patient safety markets. SurgiCount is a developer and manufacturer of patient safety products and services. The SurgiCount Safety-Sponge System is a patented turn-key array of modified surgical sponges, line-of-sight scanning SurgiCounters, and printPAD printers integrated together to form a comprehensive counting and documentation system.

Until June 29, 2007, the Company also operated a car wash through Automotive Services Group, Inc. ("*Automotive Services Group*"), which held the Company's investment in Automotive Services Group, LLC ("*ASG*"), its wholly-owned subsidiary. As discussed in Note 4, during 2007 the Company completed the sale of the assets held in ASG. In addition, the Company holds other unrelated investments including an investment in real estate and in a financial services company, which it is in the process of liquidating as part of a strategic plan adopted during 2006 to dispose of all of the Company's non patient safety related assets.

**2. LIQUIDITY AND GOING CONCERN**

The accompanying unaudited consolidated interim financial statements have been prepared assuming that the Company will continue as a going concern. At September 30, 2008, the Company has an accumulated deficit of approximately \$40.4 million and a working capital deficit of approximately \$5.1 million. For the nine months ended September 30, 2008, the Company incurred a loss of approximately \$3.8 million and has used approximately \$3.0 million in cash in its operations. Further, the Company has just begun to generate a material amount of revenues from sales of the Company's patient safety products. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The Company has relied on liquidating investments and short-term debt financings to fund a large portion of its operations. In order to ensure the continued viability of the Company, additional financing must be obtained and profitable operations must be achieved in order to repay the existing short-term debt and to provide a sufficient source of operating capital. No assurances can be made that the Company will be successful obtaining a sufficient amount of additional financing to continue to fund its operations or that the Company will achieve profitable operations and positive cash flow from its patient safety products. The consolidated interim financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**3. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 8-03 of Regulation S-X and do not include all the information and disclosures required by accounting principles generally accepted in the United States of America. The consolidated interim financial information is unaudited but reflects all normal adjustments that are, in the opinion of management, necessary to provide a fair statement of results for the interim periods presented. The consolidated interim financial statements should be read in conjunction with the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Results of the nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year ending December 31, 2008.



## Revenue Recognition

The Company complies with SEC Staff Accounting Bulletin (“**SAB**”) 101, *Revenue Recognition in Financial Statements*, amended by SAB 104, *Revenue Recognition*. Revenues from sales of the Safety-Sponge™ System are recorded upon shipment.

## Goodwill and Intangible Assets

In accordance with SFAS No. 142, *Goodwill and Intangible Assets*, goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the Company’s fourth fiscal quarter or more frequently if indicators of impairment exist. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company’s reporting units with each respective reporting unit’s carrying amount, including goodwill. The fair value of reporting units is generally determined using the income approach. If the carrying amount of a reporting unit exceeds the reporting unit’s fair value, the second step of the goodwill impairment test is performed to determine the amount of any impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the reporting unit’s goodwill with the carrying amount of that goodwill.

## Long-Lived Assets

The Company evaluates long-lived assets for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which requires impairment evaluation on long-lived assets used in operations when indicators of impairment are present. Reviews are performed to determine whether the carrying value of an asset is impaired, based on a comparison to undiscounted expected future cash flows. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using discounted expected future cash flows and a discount rate based upon the Company’s weighted average cost of capital adjusted for risks associated with the related operations. Impairment is based on the excess of the carrying amount over the fair value of those assets.

## Stock-Based Compensation

The Company accounts for stock-based compensation pursuant to SFAS No. 123(R), *Share-Based Payment*. During the three and nine months ended September 30, 2008, the Company recorded total stock-based compensation expense of \$185 thousand and \$1.2 million, respectively, related to issuances to the Company’s employees and directors. The total amount of stock-based compensation for the nine months ended September 30, 2008 of \$1.2 million included expenses related to restricted stock grants valued at \$35 thousand and stock \$572 thousand, respectively. During the three and nine months ended September 30, 2007, the Company had stock-based compensation expense, from issuances to the Company’s employees and directors, included in reported net loss of \$207 thousand and \$843 thousand, respectively. The total amount of stock-based compensation for the nine months ended September 30, 2007, of \$843 thousand, included expenses relate to restricted stock grants of \$421 thousand and stock options of \$422 thousand.

During the three and nine months ended September 30, 2008, the Company had stock-based compensation expense from issuances of warrants to employees, directors and consultants of the Company included in reported net loss of nil and \$532 thousand, respectively. During the three and nine months ended September 30, 2007, the Company had stock-based compensation expense from issuances of restricted stock and warrants to consultants of the Company of nil and \$57 thousand, respectively.

A summary of stock option activity for the nine months ended September 30, 2008 is presented below (*in thousand, except per share data*):



	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Outstanding Options Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
<b>December 31, 2007</b>	<b>1</b>	<b>1,650</b>	<b>\$ 3.49</b>	<b>8.43</b>	
Grants	(550)	550	\$ 1.25	9.70	
Cancellations	793	(793)	\$ 4.07	7.60	
<b>September 30, 2008</b>	<b>244</b>	<b>1,407</b>	<b>\$ 2.28</b>	<b>8.71</b>	<b>\$ —</b>
Options exercisable at:					
December 31, 2007		783	\$ 4.40	7.83	\$ —
September 30, 2008		962	\$ 2.65	8.49	\$ —

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between our closing stock price on September 30, 2008 and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. There have not been any options exercised during the nine months ended September 30, 2008 or year ended December 31, 2007.

All options that the Company granted during the nine months ended September 30, 2008 and 2007 were granted at the per share fair market value on the grant date. Vesting of options differs based on the terms of each option. The Company utilized the Black-Scholes option pricing model and the assumptions used for each period are as follows:

	Nine Months ended September 30,	
	2008	2007
Weighted average risk free interest rate	3.50%	4.50%
Weighted average life (in years)	5.00	5.00
Volatility	106%	98 - 100%
Expected dividend yield	0%	0%
Weighted average grant-date fair value per share of options granted	\$ 0.93	\$ 1.22

A summary of the changes in the Company's nonvested options during the nine months ended September 30, 2008 is as follows:

Nonvested Shares	Shares	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2007	867	\$ 1.75
Granted	550	\$ 1.40
Vested	(566)	\$ 1.56
Cancelled and forfeited	(407)	\$ 2.23
Nonvested at September 30, 2008	445	\$ 1.12





As of September 30, 2008, total unrecognized compensation costs related to unvested stock options was \$283 thousand. Which is expected to be recognized over a weighted average period of 1.37 years.

### Beneficial Conversion Feature of Convertible Notes Payable

The convertible feature of certain notes payable provides for a rate of conversion that is below market value. Such feature is normally characterized as a Beneficial Conversion Feature (“**BCF**”). Pursuant to EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratio*, EITF No. 00-27, *Application of EITF Issue No. 98-5 To Certain Convertible Instruments* and APB 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, the estimated fair value of the BCF is recorded in the consolidated financial statements as a discount from the face amount of the notes. Such discounts are amortized to accretion of convertible debt discount over the term of the notes (or conversion of the notes, if sooner).

### Warrant Derivative Liability

The Company accounts for warrants issued in connection with financing arrangements in accordance with EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock (“EITF 00-19”)*. Pursuant to EITF 00-19, an evaluation of specifically identified conditions is made to determine whether warrants issued are required to be classified as either equity or a liability. If the classification required under EITF 00-19 changes as a result of events during a reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. In the event that this evaluation results in a partial reclassification, our policy is to first reclassify warrants with the latest date of issuance. The estimated fair value of warrants classified as derivative liabilities is determined using the Black-Scholes option pricing model. The fair value of warrants classified as derivative liabilities is adjusted for changes in fair value at each reporting period, and the corresponding non-cash gain or loss is recorded in current period earnings. There is no limit on the number of times a contract may be reclassified.

### Earnings (Loss) per Common Share

Earnings (loss) per common share is based on the weighted average number of common shares outstanding. The Company complies with SFAS No. 128, *Earnings Per Share*, which requires dual presentation of basic and diluted earnings per share on the face of the consolidated statements of operations. Basic loss per common share excludes dilution and is computed by dividing loss available to common stockholders by the weighted-average common shares outstanding for the period. Diluted loss per common share reflects the potential dilution that could occur if convertible preferred stock or debentures, options and warrants were to be exercised or converted or otherwise resulted in the issuance of common stock that then shared in the earnings of the entity.

The following sets forth the number of shares of common stock underlying outstanding options, warrants, convertible preferred stock and convertible debt as of September 30, 2008 and 2007 (*in thousands*):

	September 30, 2008	September 30, 2007
Warrants	10,680	4,758
Stock options	1,407	1,491
Convertible promissory notes	1,057	2,667
Convertible preferred stock	246	246
	13,390	9,162

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. The actual results may differ from management's estimates.

7

---

## Reclassifications

Certain prior year amounts have been reclassified to conform to the 2008 presentation. These reclassifications had no effect on previously reported results of operations or accumulated deficit.

## Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board known as FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. SFAS 157 does not require new fair value measurements but rather defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company adopted SFAS 157 on January 1, 2008 and in connection with its adoption, there was no impact on the Company's consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment to FASB Statement No. 115*. This statement permits companies to choose to measure many financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement of accounting for financial instruments. The fair value option established by this statement permits all entities to measure eligible items at fair value at specified election dates with the resulting unrealized gains and losses, if any, reported in earnings. The Company adopted SFAS 159 on January 1, 2008 and in connection with its adoption, there was no impact on the Company's consolidated financial statements.

Staff Accounting Bulletin 110 issued by the SEC was effective for the Company beginning in the first quarter of 2008. SAB 110 amends the SEC's views discussed in Staff Accounting Bulletin 107 regarding the use of the simplified method in developing estimates of the expected lives of share options in accordance with SFAS No. 123(R), *Share-Based Payment*. The Company will continue to use the simplified method until we have the historical data necessary to provide reasonable estimates of expected lives in accordance with SAB 107, as amended by SAB 110.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), *Business Combinations*. This statement requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS 141(R) also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. The Company will implement SFAS No. 141(R) on January 1, 2009 and will apply prospectively to business combinations completed on or after that date. The Company does not expect that the adoption of this standard will have a material impact on our financial position or results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB 51*. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also established reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owner. The Company will implement SFAS No. 160 on January 1, 2009. As of September 30, 2008, the Company did not have any minority interests. Therefore, the

Company does not expect the adoption of this standard to have a material impact on our income statement, financial position or cash flows.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The standard requires additional quantitative disclosures (provided in tabular form) and qualitative disclosures for derivative instruments. The required disclosures include how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows; relative volume of derivative activity; the objectives and strategies for using derivative instruments; the accounting treatment for those derivative instruments formally designated as the hedging instrument in a hedge relationship; and the existence and nature of credit-related contingent features for derivatives. SFAS No. 161 does not change the accounting treatment for derivative instruments. SFAS No. 161 is effective for the Company in the first quarter of fiscal year 2009. The Company does not expect that the adoption of this standard will have a material impact on our financial position or results of operations.

In May 2008, the FASB issued FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. FSP APB 14-1 requires recognition of both the liability and equity components of convertible debt instruments with cash settlement features. The debt component is required to be recognized at the fair value of a similar instrument that does not have an associated equity component. The equity component is recognized as the difference between the proceeds from the issuance of the note and the fair value of the liability. FSP APB 14-1 also requires an accretion of the resulting debt discount over the expected life of the debt. Retrospective application to all periods presented is required and a cumulative-effect adjustment is recognized as of the beginning of the first period presented. This standard is effective for us in the first quarter of fiscal year 2009. We are currently evaluating the impact of FSP APB 14-1.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Policies*, which reorganizes the GAAP hierarchy. The purpose of the new standard is to improve financial reporting by providing a consistent framework for determining what accounting principles should be used when preparing the U.S. GAAP financial statements. The standard is effective 60 days after the SEC's approval of the PCAOB's amendments to AU Section 411. The adoption of SFAS 162 will not have an impact on our financial position or results of operations.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, which requires entities to apply the two-class method of computing basic and diluted earnings per share for participating securities that include awards that accrue cash dividends (whether paid or unpaid) any time common shareholders received dividends and those dividends do not need to be returned to the entity if the employee forfeits the award. FSP EITF 03-6-1 will be effective for the Company on January 1, 2009 and will require retroactive disclosure. We are currently evaluating the impact of adopting FSP EITF 03-6-1 on our consolidated financial position, cash flows and results of operations.

#### 4. DISCONTINUED OPERATIONS

As part of a strategic plan to dispose of all the Company's non-patient safety related assets, during the fourth quarter of 2006 the Company began marketing for sale the assets of ASG, located in Alabama. The Company completed the sale of one operating car wash on June 29, 2007 and the remaining two parcels of undeveloped land during the nine months ended September 30, 2007. The assets of ASG met the "held for sale" and "discontinued operations" criteria in accordance with SFAS 144.

The following sets forth the discontinued operations for the nine months ended September 30, 2008 and 2007 related to the held for sale assets of Automotive Services Group (*in thousands*):

	Nine Months Ended September	
	30,	
	2008	2007
Operating revenues	\$ —	\$ 309
Operating expenses	—	(262)
Depreciation and amortization	—	(22)
Interest expense	—	(201)
Gain on sale of assets	—	10
Loss from discontinued operations	\$ —	\$ (166)

**Assets held for sale**

Assets held for sale as of September 30, 2008 consist of a parcel of land located in Tennessee and has a book value of \$90 thousand. The land is currently in escrow and the Company expects the sale to be completed prior to year-end.

**5. PATENTS**

Patents, net, as of September 30, 2008 and December 31, 2007 are composed of patents (*in thousands*):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Patents	\$ 4,685	\$ 4,685
Accumulated amortization	(1,165)	(921)
	<b>\$ 3,520</b>	<b>\$ 3,764</b>

**6. LONG-TERM INVESTMENTS**

Long-term investments at September 30, 2008 and December 31, 2007 are comprised of the Company's investment in Alacra Corporation ("**Alacra**"). The investment represents 221 thousand shares of Series F convertible preferred stock of Alacra Corporation, recorded at its cost of \$667 thousand, and classified as an available-for-sale investment. The Company has the right, to the extent that Alacra has sufficient available capital, to have the Series F convertible preferred stock redeemed by Alacra for face value plus accrued dividends beginning on December 31, 2006. During the year ended December 31, 2007, Alacra redeemed one-third of the Series F convertible preferred stock. Alacra, based in New York, is a global provider of business and financial information.

**7. OTHER ASSETS**

At September 30, 2008 and December 31, 2007, the Company had other assets of approximately \$29 thousand and \$19 thousand respectively, consisting primarily of security deposits.

**8. NOTES PAYABLE**

Notes payable at September 30, 2008 and December 31, 2007 are comprised of the following (*in thousands*):

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Related Party Notes:		
Notes payable to Ault Glazer Capital Partners, LLC (a)	\$ 1,775	\$ 2,531
Notes payable to Herb Langsam (b)	600	600
Note payable to Catalysis Offshore, Ltd (c)	250	—
Note payable to Catalysis Partners, LLC (c)	250	—
Sub-total, Related Party Notes	2,875	3,131
Note payable to Charles Kalina III (d)	—	400
Other notes payable (e)	71	172
Total notes payable	2,946	3,703
Less: current portion	(2,946)	(1,172)
Notes payable - long-term portion	\$ —	\$ 2,531

Aggregate future required principal payments on these notes during the twelve month period subsequent to September 30, 2008 are \$2.9 million.

(a) Effective June 1, 2007, the entire unpaid principal and interest due under note payable agreements previously entered into with Ault Glazer Capital Partners, LLC (formerly AGB Acquisition Fund) (the "**Fund**") a related party, were restructured into a new Convertible Secured Promissory Note (the "**AG Partners Convertible Note**") in the principal amount of \$2.5 million. The Fund is controlled by Milton "Todd" Ault III, a former director of the Company and its former Chairman and Chief Executive Officer and Louis Glazer, a director of the Company, both of whom currently have a significant beneficial ownership interest in the Company's common and preferred stock. The AG Partners Convertible Note bears interest at the rate of 7% per annum and is due on the earlier of December 31, 2010, or the occurrence of an event of default. In the event that the average closing price of the Company's common stock is in excess of \$5.00 per share for thirty (30) consecutive trading days, the Company will have the right to redeem the promissory note in shares or in cash. In the event of redemption in shares, the principal is convertible into shares of the Company's common stock at a conversion price of \$2.50. The promissory note is secured by all of the Company's assets. Should the Company raise up to \$2 million in a new credit facility, including any replacement credit facilities, the Fund is required to subordinate its security interest in favor of the new credit facility. During the three and nine months ended September 30, 2008, the Company incurred interest expense of \$38 thousand and \$127 thousand, respectively, on the AG Partners Convertible Note. During the three and nine months ended September 30, 2007, the Company incurred interest expense of \$44 thousand and \$59 thousand, respectively, on the AG Partners Convertible Note.

In connection with the Ault Glazer Partners, LLC Note agreement, the Company issued 153,150 shares of its common stock in July 2008, with an agreed upon value of \$1.50 per share, to pay past due interest owed by the Company from the first and second quarter of 2008 and current interest owed for the third quarter of 2008 totaling approximately \$127 thousand, and to prepay future interest related to the outstanding note balance. The prepaid interest balance, which is included in prepaid expenses at September 30, 2008 is approximately \$103 thousand.

On September 5, 2008 an amendment was entered into between Ault Glazer Partners LLC and the Company. The Amendment and Early Conversion of Secured Convertible Promissory Note (the "**AG Amendment**") replaces the Secured Convertible Promissory Note, effective June 1, 2007 in the principal amount of \$2.5 million, described above. The terms of the AG Amendment stipulate the Company will pay the lender \$450 thousand in cash and convert the remaining balance of the note to 1.3 million shares of common stock upon satisfactory completion of certain conditions, as specified in the amendment. The lender is currently in possession of several pieces of office equipment that is leased under the Company's name. One of the stipulations of the amendment is to transfer the leases into the lenders' name. The equipment is not carried on the Company's book and does not pay the monthly lease payment. The lender may transfer or sell the Early Conversion Shares according to the following schedule: 400 thousand shares may be sold or transferred within the first 90 days after closing and up to 125 thousand shares may be sold or transferred during each calendar month beginning 90 days after closing. As of September 30, 2008 the Company has paid \$450 thousand in cash and issued 300 thousand shares of common stock as partial settlement under the AG Amendment. In November 2008, the Company issued 250 thousand additional shares of its common stock pursuant to the Amendment. The Company expects the remaining 750 thousand shares of common stock to be issued in 2009.

(b) On May 1, 2006, Herbert Langsam, a Class II Director of the Company, loaned the Company \$500 thousand. The loan is documented by a \$500 thousand Secured Promissory Note (the "**Langsam Note**") payable to the Herbert Langsam Irrevocable Trust. The Langsam Note accrues interest at the rate of 12% per annum and had a maturity date of November 1, 2006. This note was not repaid by the scheduled maturity and to date has not been extended, therefore the Langsam Note is recorded in current liabilities. Accordingly, the note is currently in default and therefore accruing interest at the rate of 16% per annum. Pursuant to the terms of a Security Agreement dated May 1, 2006, the Company granted the Herbert Langsam Revocable Trust a security interest in all of the Company's

assets as collateral for the satisfaction and performance of the Company's obligations pursuant to the Langsam Note.



On November 13, 2006, Mr. Langsam, loaned the Company an additional \$100 thousand. The loan is documented by a \$100 thousand Secured Promissory Note (the "**Second Langsam Note**") payable to the Herbert Langsam Irrevocable Trust. The Second Langsam Note accrues interest at the rate of 12% per annum and had a maturity date of May 13, 2007. The Company is in the process of restructuring the debt that is owed to Mr. Herbert Langsam. Mr. Langsam received warrants to purchase 50 thousand shares of the Company's common stock at an exercise price of \$1.25 per share as additional consideration for entering into the loan agreement. The Company recorded debt discount in the amount of \$17 thousand as the estimated value of the warrants. The debt discount was amortized as non-cash interest expense over the term of the debt using the effective interest method. During the nine months ended September 30, 2008 and 2007, interest expense of nil and \$12 thousand, respectively, was recorded from the debt discount amortization. Pursuant to the terms of a Security Agreement dated November 13, 2006, the Company granted the Herbert Langsam Revocable Trust a security interest in all of the Company's assets as collateral for the satisfaction and performance of the Company's obligations pursuant to the Second Langsam Note.

During the three and nine months ended September 30, 2008, the Company incurred interest expense, excluding amortization of debt discount, of \$24 thousand and \$72 thousand, respectively, on the Langsam Notes. During the three and nine months ended September 30, 2007, the Company incurred interest expense, excluding amortization of debt discount, of \$18 thousand and \$64 thousand, respectively. At September 30, 2008 and December 31, 2007 accrued interest on the Langsam Notes totaled \$186 thousand and \$138 thousand, respectively.

- (c) Between February 28, 2008 and March 20, 2008, Catalysis Offshore, Ltd. and Catalysis Partners, LLC (collectively "**Catalysis**"), related parties, each loaned \$250 thousand to the Company. As consideration for the loans, the Company issued Catalysis promissory notes in the aggregate principal amount of \$500 thousand (the "**Catalysis Notes**"). The Catalysis Notes accrue interest at the rate of 8% per annum and had maturity dates of May 31, 2008. The managing partner of Catalysis is Francis Capital Management, LLC ("**Francis Capital**"), an investment management firm. John Francis, a director of the Company and President of Francis Capital, has voting and investment control over the securities held by Catalysis. Francis Capital, including shares directly held by Catalysis, beneficially owns 1.3 million shares of the Company's common stock and warrants for purchase of 763 thousand shares of the Company's common stock. During the three and nine months ended September 30, 2008, the Company incurred interest expense of \$14 thousand and \$27 thousand, respectively, on the Catalysis Notes. At September 30, 2008 accrued interest on the Catalysis Notes totaled \$27 thousand.
- (d) On July 12, 2006 the Company, executed a Convertible Promissory Note in the principal amount of \$250 thousand in favor of Charles J. Kalina, III, an existing shareholder of the Company. On November 3, 2006 the balance due under the \$250 thousand Convertible Promissory Note was added to a new Convertible Promissory Note in the principal amount of \$400 thousand (the "**Kalina Note**"), pursuant to which the Company received proceeds of approximately \$150 thousand. The Kalina Note accrued interest at the rate of 12% per annum and was due on January 31, 2008. On May 20, 2008, the principal and accrued interest on the Kalina Note, in the aggregate amount of \$426 thousand, was exchanged for equity in the Company. Mr. Kalina received 341 thousand shares of the Company's common stock and a warrant to purchase 205 thousand shares of the Company's common stock at \$1.40 per share. During the three and nine months ended September 30, 2008, the Company incurred interest expense, excluding amortization of debt discount of \$12 thousand and \$34 thousand, respectively, on the Kalina Note. At December 31, 2007 accrued interest on the Kalina Note totaled \$8 thousand.
- (e) On November 1, 2006 we entered into a Convertible Promissory Note with Michael G. Sedlak in the principal amount of \$71 thousand (the "**Sedlak Note**"). The Sedlak Note, which was not paid by its scheduled maturity date, January 31, 2008, accrues interest at the rate of 12% per annum.

## 9. ACCRUED LIABILITIES

Accrued liabilities at September 30, 2008 and December 31, 2007 are comprised of the following (*in thousands*):

12

---

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
Accrued interest	\$ 213	\$ 169
Accrued dividends on preferred stock	134	134
Accrued salaries and director fees	123	212
Warrant derivative liability	2,825	—
Other	8	6
	\$ 3,303	\$ 521

## 10. EQUITY TRANSACTIONS

Between May 20, 2008 and June 19, 2008, the Company sold, in a private placement exempt from the registration requirements of the Securities Act, 2.1 million shares of the Company's common stock at \$1.25 price per share and issued five-year warrants to purchase 1.3 million shares of common stock at an exercise price of \$1.40 per share, pursuant to a Securities Purchase Agreement entered into with several accredited investors. The investors paid a total of \$1.5 million in cash, \$700 thousand in prepaid inventory, and agreed to the extinguishment of debt and accrued interest totaling \$426 thousand owed by the Company.

Between August 1, 2008 and August 30, 2008, the Company sold, in a private placement exempt from the registration requirements of the Securities Act, 2.0 million shares of the Company's common stock at \$1.25 price per share and issued five-year warrants to purchase 1.3 million shares of common stock at an exercise price of \$1.40 per share, pursuant to a Securities Purchase Agreement entered into with several accredited investors. The investors paid a total of \$2.4 million in cash, and agreed to extinguishment of existing accrued liabilities totaling \$83 thousand owed by the Company.

## 11. WARRANTS AND WARRANT DERIVATIVE LIABILITY

During the three and nine months ended September 30, 2008, a total of 1.3 million and 4.6 million warrants, at an average exercise price of \$1.39 per share were issued primarily in connection with the various subscription agreements entered into by the Company as well as payment for services and accrued interest. The warrants were valued using the Black-Scholes valuation model assuming expected dividend yield, risk-free interest rate, expected life and volatility of 0%, 3.50%, five years and 103% - 106%, respectively. Warrants granted during the year ended December 31, 2007 were valued using an expected dividend yield, risk-free interest rate, expected life and volatility of 0%, 4.50%, five years and 63% - 101%, respectively. As of September 30, 2008, a total of 10.7 million warrants, at exercise prices ranging from \$1.25 to \$6.05 remain outstanding. Of the 10.7 million warrants outstanding, 1.2 million warrants are unvested.

As discussed in Note 2, EITF 00-19 requires analysis of criteria which must be met in order to classify warrants issued in a Company's own stock as either equity or liabilities. Evaluation of these criteria as of September 30, 2008 resulted in the determination that certain outstanding warrants should be classified as derivative liabilities.

Based on this analysis, 5.3 million warrants have been classified as warrant derivative liabilities. As of September 30, 2008, the total fair value of the warrant derivative liabilities is \$2.8 million, which is included as a component of accrued liabilities. Based on the change in fair value of the warrant derivative liability, the Company recorded a non-cash gain of \$1.7 million and \$1.5 million during the three and nine months ended September 30, 2008, respectively.

## 12. FAIR VALUE MEASUREMENTS

We adopted SFAS 157 effective January 1, 2008 for financial assets and liabilities measured on a recurring basis. SFAS 157 defines fair value, establishes a framework for measuring fair value and generally accepted accounting principles and expands disclosures about fair value measurements. This standard applies in situations where other accounting pronouncements either permit or require fair value measurements. SFAS 157 does not require any new fair value measurements.

Fair value is defined in SFAS 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are to be considered from the perspective of a market participant that holds the assets or owes the liability. SFAS 157 also establishes a fair value hierarchy which required an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

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

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

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

At September 30, 2008 we had outstanding warrants to purchase common shares of our stock that are classified as warrant derivative liabilities with a fair value of \$2.8 million. The warrants are valued using Level 3 inputs because there are significant unobservable inputs associated with them.

### **13. RELATED PARTY TRANSACTIONS**

#### *Rent*

During the nine months ended September 30, 2007 the Company paid approximately \$26 thousand of the base rent on the corporate offices and The Ault Glazer Group, Inc. ("**Ault Glazer**") paid the remaining base rent based upon their respective usage of the facilities. Together, Milton "Todd" Ault III, our former Chairman and Chief Executive Officer of the Company, and Louis Glazer, a Class I Director of the Company, and Melanie Glazer, the former Manager of our real estate segment, (together, the "**Glazers**") own a controlling interest in the outstanding capital stock of Ault Glazer. As of September 30, 2008 and December 31, 2007, Ault Glazer, Mr. Ault and the Glazers had a significant beneficial ownership interest in the outstanding common and preferred stock of the Company.

#### *Notes Payable*

As of September 30, 2008 and December 31, 2007, the Company has notes payable agreements issued to related parties with aggregate outstanding principal balances of \$2.9 million and \$3.1 million, respectively (See Note 8).

#### *ASG*

During the period from June 29, 2007 to August 13, 2007, Automotive Services Group sold its express car wash and underlying real estate and a parcel of undeveloped land located in Birmingham, Alabama to Charles H. Dellaccio and Darrell Grimsley. Mr. Grimsley was the Chairman of the Board and Chief Executive Officer of Automotive Services Group.

#### *A Plus International, Inc.*

The Company recorded cost of goods sold of \$514 thousand and \$100 thousand for the three months ended September 30, 2008 and 2007, respectively, in connection with surgical sponges provided by A Plus. During the nine months ended September 30, 2008 and 2007, the Company recorded cost of goods sold of \$1.1 million and \$352 thousand,

respectively, in connection with surgical sponges provided by A Plus. As part of the May 2008 financing, the Company recorded \$700 thousand in prepaid expenses to be used against inventory ordered from A Plus. As of September 30, 2008 there was \$133 thousand remaining in prepaid expenses. Wenchen Lin, a director and significant beneficial owner of the Company is a founder and significant owner of A Plus.

*Health West Marketing Inc.*

During the three and nine months ended September 30, 2008, Health West Marketing Incorporated received payments for consulting services, of \$60 thousand and \$180 thousand, respectively, from A Plus International, Inc. William Adams the Company's Chief Executive Officer is the Chief Executive Officer and President of Health West Marketing Inc. For the three and nine months ended September 30, 2007, Health West Marketing Incorporated received payments for consulting services of \$60 thousand and \$180 thousand, respectively. The consulting arrangement between A Plus and Health West has been an ongoing agreement between the respective parties. The Company does not recognize this income or expense on their financial statements.

#### **14. COMMITMENTS AND CONTINGENCIES**

*Legal Proceedings*

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

On July 28, 2005, Jeffrey A. Leve and Jeffrey Leve Family Partnership, L.P. filed a new lawsuit (the "**new Leve Lawsuit**") against the Company, Sunshine Wireless, LLC ("**Sunshine**"), and four other defendants affiliated with Winstar Communications, Inc. ("**Winstar**"). The new Leve Lawsuit attempts to collect a federal default judgment of \$5.0 million entered against only two entities, i.e., Winstar Radio Networks, LLC and Winstar Global Media, Inc., by attempting to enforce the judgment against a number of additional entities who are not judgment debtors. Further, the new Leve Lawsuit attempts to enforce the plaintiffs default judgment against entities who were dismissed on the merits from the underlying action in which plaintiffs obtained their default judgment. An unfavorable outcome in the lawsuit may have a material adverse effect on the Company's business, financial condition and results of operations. The Company believes the lawsuit is without merit and intends to vigorously defend itself. These consolidated interim financial statements do not include any adjustments for the possible outcome of this uncertainty.

As of September 30, 2008 final arguments were being prepared by the respective parties. No decision has been rendered by the Court.

#### **15. SUBSEQUENT EVENTS**

On October 10, 2008, the Company's former principal accounting officer, tendered his resignation as Chief Financial Officer and Secretary of the Company and as an officer and director of the Company's subsidiary, SurgiCount Medical, Inc., effective October 13, 2008. The resignation arose from his desire to spend more time with his family and to pursue other career opportunities.

To fill the vacancy created by the resignation, Mary Lay was appointed Interim Chief Financial Officer and principal accounting officer, effective October 13, 2008.





## Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes thereto contained elsewhere in this Form 10-Q. This discussion contains forward-looking statements that involve risks and uncertainties. All statements regarding future events, our future financial performance and operating results, our business strategy and our financing plans are forward-looking statements. In many cases, you can identify forward-looking statements by terminology, such as “may,” “should,” “expects,” “intends,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” or “continue” or the negative of such terms and other comparable terminology. These statements are only predictions. Known and unknown risks, uncertainties and other factors could cause our actual results to differ materially from those projected in any forward-looking statements. In evaluating these statements, you should specifically consider various factors, including, but not limited to, those set forth in Part II of this report under “Item 1A. Risk Factors” and elsewhere in this report on Form 10-Q.*

*The following “Overview” section is a brief summary of the significant issues addressed in Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”). Investors should read the relevant sections of the MD&A for a complete discussion of the issues summarized below. The entire MD&A should be read in conjunction with Item 1 of Part I of this report, “Financial Statements.”*

### Overview

Patient Safety Technologies, Inc. (referred to in this report as the “**Company**,” “**we**,” “**us**,” and “**our**”) was incorporated on March 31, 1987, under the laws of the state of Delaware. Currently we conduct our operations through a single wholly-owned operating subsidiary: SurgiCount Medical, Inc. (“**SurgiCount**”), a California corporation. Beginning in July 2005 through August 2007, the Company’s wholly-owned subsidiary, Automotive Services Group, Inc., a Delaware corporation, held the Company’s investment in Automotive Services Group, LLC (“**ASG**”), its wholly-owned express car wash subsidiary. During the period from June 29, 2007 to August 13, 2007, Automotive Services Group sold all the assets held by ASG.

The Company is engaged in the acquisition of controlling interests in companies and research and development of products and services focused primarily in the health care and medical products field, particularly the patient safety markets. SurgiCount is a developer and manufacturer of patient safety products and services. In the past we also focused on the financial services and real estate industries. On October 2005 our Board of Directors authorized us to evaluate alternative strategies for the divestiture of our non-healthcare assets. As a result of our prior focus on the financial services and real estate industries, we continue to hold various other unrelated investments. We are in the process of liquidating these few remaining non-patient safety related assets (the “*non-core assets*”). The non-core assets are recorded on the Company’s balance sheet in “long-term investments” and “assets held for sale, net”.

### SurgiCount

SurgiCount, developer of the Safety-Sponge™ System, was acquired to enhance our ability to focus our efforts in the health care and medical products field, particularly the patient safety markets. SurgiCount’s Safety-Sponge System helps reduce the number of retained sponges and towels in patients during surgical procedures and allows for faster and more accurate counting of surgical sponges. The SurgiCount Safety-Sponge System is a patented turn-key array of modified surgical sponges, line-of-sight scanning SurgiCounters, and printPAD printers integrated together to form a comprehensive counting and documentation system. The Safety-Sponge System works much like a grocery store checkout process: Every surgical sponge and towel is affixed with a unique inseparable two-dimensional data matrix bar code and used with a SurgiCounter to scan and record the sponges during the initial and final counts. Because each sponge is identified with a unique code, a SurgiCounter will not allow the same sponge to be counted more than one time. When counts have been completed at the end of a procedure, the system will produce a printed report, or can be

modified to work with a hospital's paperless system. By scanning the surgical dressings in at the beginning of a surgical procedure and then scanning them out at the end of the procedure, the sponges can be counted faster and more accurately than traditional methods which require two medical personnel manually counting the used and un-used sponges. The Safety-Sponge System is the only FDA 510k approved computer assisted sponge counting system. SurgiCount is the first acquisition in our plan to become a leader in the patient safety market.

Our principal executive offices are located at 43460 Ridge Park Drive, Suite 140, Temecula, CA 92590. Our telephone number is (951) 587-6201. Our website is located at <http://www.patientsafetytechnologies.com>.

### **Critical accounting policies and estimates**

The below discussion and analysis of our financial condition and results of operations is based upon the accompanying financial statements. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Our most critical accounting policies relate to revenue recognition, valuation of warrant derivative liability, valuation of our intangible assets and stock based compensation and accounting for income taxes.

### **Warrant Derivative Liability**

The Company accounts for warrants issued in connection with financing arrangements in accordance with EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock ("EITF 00-19")*. Pursuant to EITF 00-19, an evaluation of specifically identified conditions is made to determine whether warrants issued are required to be classified as either equity or a liability. If the classification required under EITF 00-19 changes as a result of events during a reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. In the event that this evaluation results in a partial reclassification, our policy is to first reclassify warrants with the latest date of issuance. The estimated fair value of warrants classified as derivative liabilities is determined using the Black-Scholes option pricing model. The fair value of warrants classified as derivative liabilities is adjusted for changes in fair value at each reporting period, and the corresponding non-cash gain or loss is recorded in current period earnings. There is no limit on the number of times a contract may be reclassified.

### **Valuation of Intangible Assets**

We assess the impairment of intangible assets when events or changes in circumstances indicate that the carrying value of the assets or the asset grouping may not be recoverable. Factors that we consider in deciding when to perform an impairment review include significant under-performance of a product line in relation to expectations, significant negative industry or economic trends, and significant changes or planned changes in our use of the assets. Recoverability of intangible assets that will continue to be used in our operations is measured by comparing the carrying amount of the asset grouping to our estimate of the related total future net cash flows. If an asset grouping's carrying value is not recoverable through the related cash flows, the asset grouping is considered to be impaired. The impairment is measured by the difference between the asset grouping's carrying amount and its fair value, based on the best information available, including market prices or discounted cash flow analysis. Impairments of intangible assets are determined for groups of assets related to the lowest level of identifiable independent cash flows. Due to our limited operating history and the early stage of development of some of our intangible assets, we must make subjective judgments in determining the independent cash flows that can be related to specific asset groupings. To date we have not recognized impairments on any of our intangible assets related to the Safety Sponge™ System.

### **Stock-Based Compensation**

We have adopted the provisions of SFAS No. 123(R), *Share-Based Payment*. The fair value of each option grant, nonvested stock award and shares issued under the employee stock purchase plan were estimated on the date of grant using the Black-Scholes option pricing model and various inputs to the model. Expected volatilities were based on historical volatility of our stock. The expected term represents the period of time that grants and awards are expected

to be outstanding. The risk-free interest rate approximates the U.S. treasury rate corresponding to the expected term of the option, and dividends were assumed to be zero. These inputs are based on our assumptions, which include complex and subjective variables. Other reasonable assumptions could result in different fair values for our stock-based awards.

Stock-based compensation expense, as determined using the Black-Scholes option pricing model, is recognized on a straight line basis over the service period, net of estimated forfeitures. Forfeiture estimates are based on historical data. To the extent actual results or revised estimates differ from the estimates used, such amounts will be recorded as a cumulative adjustment in the period that estimates are revised.

### **New Accounting Pronouncements**

In September 2006, the FASB, issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. SFAS 157 does not require new fair value measurements but rather defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We adopted SFAS 157 on January 1, 2008 and in connection with its adoption, there was no impact on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment to FASB Statement No. 115*. This statement permits companies to choose to measure many financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement of accounting for financial instruments. The fair value option established by this statement permits all entities to measure eligible items at fair value at specified election dates with the resulting unrealized gains and losses, if any, reported in earnings. We adopted SFAS 159 on January 1, 2008 and in connection with its adoption, there was no impact on our consolidated financial statements.

Staff Accounting Bulletin 110 issued by the SEC was effective for us beginning in the first quarter of 2008. SAB 110 amends the SEC's views discussed in Staff Accounting Bulletin 107 regarding the use of the simplified method in developing estimates of the expected lives of share options in accordance with SFAS No. 123(R), *Share-Based Payment*. We will continue to use the simplified method until we have the historical data necessary to provide reasonable estimates of expected lives in accordance with SAB 107, as amended by SAB 110.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), *Business Combinations*. This statement requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS 141(R) also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. We will implement SFAS No. 141(R) on January 1, 2009 and will apply prospectively to business combinations completed on or after that date. The Company does not expect an impact on our financial position or results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB 51*. SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also established reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owner. We will implement SFAS No. 160 on January 1, 2009. As of May 20, 2009, we did not have any minority interests. Therefore, we do not expect the adoption of this standard will have a material impact on our income statement, financial position or cash flows.



In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The standard requires additional quantitative disclosures (provided in tabular form) and qualitative disclosures for derivative instruments. The required disclosures include how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows; relative volume of derivative activity; the objectives and strategies for using derivative instruments; the accounting treatment for those derivative instruments formally designated as the hedging instrument in a hedge relationship; and the existence and nature of credit-related contingent features for derivatives. SFAS No. 161 does not change the accounting treatment for derivative instruments. SFAS No. 161 is effective for us in the first quarter of fiscal year 2009. The Company does not expect that the adoption of this standard will have a material impact on our financial position or results of operations.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of Useful Life of Intangible Assets*. FSP FAS 14203 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS 142, "Goodwill and Other Intangible Assets." FSP FAS 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. Earlier adoption is not permitted. We do not expect FSP FAS 142-3 will have a material impact on our financial statements.

In May 2008, the FASB issued FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. FSP APB 14-1 requires recognition of both the liability and equity components of convertible debt instruments with cash settlement features. The debt component is required to be recognized at the fair value of a similar instrument that does not have an associated equity component. The equity component is recognized as the difference between the proceeds from the issuance of the note and the fair value of the liability. FSP APB 14-1 also requires an accretion of the resulting debt discount over the expected life of the debt. Retrospective application to all periods presented is required and a cumulative-effect adjustment is recognized as of the beginning of the first period presented. This standard is effective for us in the first quarter of fiscal year 2009. We are currently evaluating the impact of FSP APB 14-1.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Policies*, which reorganizes the GAAP hierarchy. The purpose of the new standard is to improve financial reporting by providing a consistent framework for determining what accounting principles should be used when preparing the U.S. GAAP financial statements. The standard is effective 60 days after the SEC's approval of the PCAOB's amendments to AU Section 411. The adoption of SFAS 162 will not have an impact on our financial position or results of operations.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, which requires entities to apply the two-class method of computing basic and diluted earnings per share for participating securities that include awards that accrue cash dividends (whether paid or unpaid) any time common shareholders received dividends and those dividends do not need to be returned to the entity if the employee forfeits the award. FSP EITF 03-6-1 will be effective for the Company on January 1, 2009 and will require retroactive disclosure. We are currently evaluating the impact of adopting FSP EITF 03-6-1 on our consolidated financial position, cash flows and results of operations.

## **Results of Operations**

### *Revenue and Expense Components*

The following is a description of the primary components of our revenues and expenses:

*Revenues.* We derive our revenue primarily from the sale of our SurgiCount sponges and the related hardware. Our revenues are generated by our direct sales force and independent distributors. Our products are ordered directly by the hospitals through our distributors and shipped and billed directly. Although hardware sales are not considered a recurring item, we expect that once an institution adopts our system, they will be committed to its use and therefore provide a recurring source of revenues for sales of the safety sponge



*Cost of revenues.* Cost of revenues consist of direct product costs billed from our contract manufacturer.

*Research and development.* Research and development expense consists of costs associated with the design, development, testing and enhancement of our products. Research and development costs also include salaries and related employee benefits, research-related overhead expenses and fees paid to external service providers.

*Sales and marketing.* Our sales and marketing expense consists primarily of salaries and related employee benefits, sales commissions and support cost, professional service fees, travel, education, trade show and marketing costs.

*General and administrative.* Our general and administrative expense consists primarily of salaries and related employee benefits, professional service fees, legal costs and expenses related to being a public entity.

*Total other income (expense).* Total other income (expense) includes interest income, interest expense, change in fair value of warrant liability, realized gain (loss) on assets held for sale and unrealized loss on assets held for sale.

### *Revenues*

We recognized revenues of \$880 thousand and \$213 thousand during the three months ended September 30, 2008 and 2007, respectively. Revenues during the three months ended September 30, 2008 consisted of sales from the Safety-Sponge of \$737 thousand and sales from hardware and supplies of \$142 thousand. Revenues during the three months ended September 30, 2007 consisted of sales from the Safety-Sponge of \$1.6 million and sales from hardware and supplies of \$314 thousand. Although hardware sales are not considered a recurring item, we expect that once an institution adopts our system, they will be committed to its use and therefore provide a recurring source of revenues for sales of the safety sponge.

We recognized revenues of \$1.9 million and \$834 thousand during the nine months ended September 30, 2008 and 2007, respectively. Revenues during the nine months ended September 30, 2008 consisted of sales from the Safety-Sponge of \$212 thousand and sales from hardware and supplies of \$1 thousand, respectively. Revenues during the nine months ended September 30, 2007 consisted of sales from the Safety-Sponge of \$710 thousand and sales from hardware and supplies of \$123 thousand.

We attribute a significant amount of the increase in sales generated by our Safety-Sponge System to increased product awareness and demand. The Safety-Sponge System is currently being evaluated by a large number of medical institutions, the adoption by any one of which would have a material impact on our revenues. We expect that small medical institutions which adopt the Safety-Sponge System will represent approximately \$100 thousand in annual revenue whereas the larger institutions could represent annual recurring revenues of \$600 thousand or more.

On November 14, 2006, SurgiCount entered into a Supply Agreement with Cardinal Health 200, Inc., a Delaware corporation. Pursuant to the agreement, Cardinal shall act as the exclusive distributor of SurgiCount's products in the United States, with the exception that SurgiCount may sell its products to one other hospital supply company, named in the agreement, solely for the sale and distribution to its hospital customers. The term of the agreement is 36 months, unless earlier terminated as set forth therein. Otherwise, the agreement automatically renews for successive 12 month periods. Although we cannot reasonably predict or estimate the financial impact of the agreement with Cardinal we believe it has and will continue to have a material impact on our results of operations due to the coordination of our sales efforts with Cardinal and their significant presence in the major medical institutions.

### *Cost of revenues*

Cost of revenues increased \$510 thousand, or 455% to \$622 thousand for the three months ended September 30, 2008 from \$112 thousand for the same period in 2007. This reflects an increase in sales of our Safety-Sponge™ System.



Cost of revenues increased \$828 thousand, or 161% to \$1.3 million for the nine months ended September 30, 2008 compared to \$514 thousand for the nine months ended September 30, 2007. This reflects an increase in sales of our Safety-Sponge™ System and an inventory write down for obsolete inventory returned from a distributor of \$87 thousand.

#### *Gross profit*

During the three months ended September 30, 2008, our gross profit increased \$157 thousand or 155%, to \$258 thousand from \$101 thousand for the same period in 2007. Our gross margin percentage was 29% for the three months ended September 30, 2008 compared to 47% for the same period in 2007. The decrease in gross margin percentage was primarily as a result of a write off for obsolete inventory and discounts provided in connection with hardware sales.

Our gross profit increased \$275 thousand or 86%, to \$595 thousand during the nine months ended September 30, 2008 from \$320 thousand for the same period in 2007. Our gross margin percentage was 31% compared to 38% for the same period in 2007. The decrease in gross margin was primarily as a result of a write off for obsolete inventory and discounts provided in connection with hardware sales.

#### *Research and development*

Research and development costs were \$87 thousand and \$39 thousand, for the three months ended September 30, 2008 and 2007, respectively. During the nine months ended September 30, 2008 we had research and development costs of \$168 thousand, compared to \$91 thousand for the same period last year. The increase is primarily due to an increase in software development costs associated with our system hardware.

#### *Sales and marketing*

We had sales and marketing expenses of \$662 thousand and \$418 thousand for the three months ended September 30, 2008 and 2007, respectively. For the nine months ended September 30, 2008 and 2007, respectively, we had sales and marketing expenses of \$1.8 million and \$1.1 million. The increase is primarily due to the addition of sales representatives in the field and the associated benefit costs and travel expenses.

#### *General and administrative*

General and administrative costs were \$959 thousand and \$765 thousand for the three months ended September 30, 2008 and 2007, respectively. Our general and administrative costs for the nine months ended September 30, 2008 were \$3.7 million compared to \$2.8 million for the same period in the prior year. The increase is primarily due to an increase in stock based compensation to employees, increased legal and audit fees as well as an increase in employee benefit costs.

#### *Total other income (expense), net*

Total other income increased to income of \$1.6 million from an expense of \$810 thousand for the three months ended September 30, 2008 and 2007 respectively. This increase was mainly due to a decrease in the fair market value of our warranty derivative liability resulting in a gain of \$1.7 million in the three months ended September 30, 2008 and a decrease of interest expense of \$731 thousand, as described below.

For the nine months ended September 30, 2008 other income (expense), net increased to income of \$1.2 million from an expense of \$1.4 million for the nine months ended September 30, 2007. This increase is mainly due to the decrease in the fair market value of our warranty derivative liability resulting in a gain of \$1.5 million, a decrease in interest

expense and a decrease in debt discount amortization associated with our short term financing as well as a realized loss on assets held for sale of \$25 thousand and an unrealized loss on assets held for sale of \$65 thousand, net.

*Interest expense*

We had interest expense of \$79 thousand and \$810 thousand for the three months ended September 30, 2008 and 2007, respectively. The decrease in interest expense for the three months ended September 30, 2008 when compared to September 30, 2007 is primarily attributable to the non-cash interest charges incurred in the 2007 period as a result of the debt discount amortization associated with our short-term debt financings. During the three months ended September 30, 2008 and 2007, we recorded nil and \$392 thousand, respectively, in non-cash interest charges. These charges resulted from the issuance of debt that either had conversion prices on the date of issuance that were below the fair market value of the underlying common stock or required the issuance of warrants to purchase shares of our common stock, which required us to record an expense based on the estimated fair value of the warrants.

We had interest expense of \$254 thousand and \$1.4 million for the nine months ended September 30, 2008 and 2007, respectively. The decrease in interest expense for the nine months ended September 30, 2008 when compared to September 30, 2007 is primarily attributable to the non-cash interest charges incurred in the 2007 period as a result of the debt discount amortization associated with our short-term debt financings. During the nine months ended September 30, 2008 and 2007, we recorded \$127 thousand and \$1.0 million, respectively, in non-cash interest charges. These charges resulted from the issuance of debt that either had conversion prices on the date of issuance that were below the fair market value of the underlying common stock or required the issuance of warrants to purchase shares of our common stock, which required us to record an expense based on the estimated fair value of the warrants.

*Realized gains (losses) on investments, net*

During the nine months ended September 30, 2008 we realized a net loss of \$25 thousand compared to a net gain of \$22 thousand during the nine months ended September 30, 2007. Realized loss during the nine months ended September 30, 2008 reflects the sale of approximately 8.5 acres of undeveloped land in Heber Springs, Arkansas. Realized gain of \$51 thousand during the nine months ended September 30, 2007 reflects the sale of our operating car wash for a gain of \$29 thousand, which is reported in our consolidated statements of operations in loss from discontinued operations, combined with the sale of certain non-operating assets for a gain of \$22 thousand.

*Loss from discontinued operations*

During the nine months ended September 30, 2007, we recorded a loss from our discontinued car wash segment of \$166 thousand. Consistent with our decision to focus our business exclusively on the patient safety medical products field, we completed the divestiture of ASG in August 2007. Thus, we did not incur a loss from the discontinued car wash segment during the three or nine months ended September 30, 2008.

**Financial Condition, Liquidity and Capital Resources**

Our cash and cash equivalents balance was \$1.0 million at September 30, 2008, versus \$405 thousand at December 31, 2007. Total current liabilities were \$6.9 million at September 30, 2008, versus \$2.4 million at December 31, 2007. As of September 30, 2008 we had a working capital deficit of approximately \$5.1 million. Since we continue to have recurring losses, we have relied upon private placements of equity and debt securities. Our existing cash and cash equivalents balance, combined with the proceeds received from our August 2008 equity financing, are not expected to be sufficient to meet our anticipated funding requirements during the next twelve months.

In order to ensure the continued viability of the Company, additional financing must be obtained and profitable operations must be achieved in order to repay the existing short-term debt and to provide a sufficient source of operating capital.

As of September 30, 2008, other than our office lease and employment agreements with key executive officers, we had no commitments other than the liabilities reflected in our consolidated financial statements.

Cash increased by \$632 thousand to \$1.0 million during the nine months ended September 30, 2008, compared to an increase of \$80 thousand during the nine months ended September 30, 2007, primarily as a result of financing activities during 2008 as described below.

*Operating activities*

Operating activities used \$3.0 million of cash during the nine months ended September 30, 2008, compared to \$2.6 million during the nine months ended September 30, 2007.

Operating activities for the nine months ended September 30, 2008, exclusive of changes in operating assets and liabilities, used \$2.8 million of cash, as the Company's net cash used in operating activities of \$3.0 million included non-cash charges for change in fair value of warrant derivative liability of \$1.5 million, depreciation and amortization of \$508 thousand and stock based compensation of \$1.2 million.

For the nine months ended September 30, 2007, operating activities, exclusive of changes in operating assets and liabilities, used \$2.9 million of cash, as the Company's net cash used in operating activities of \$2.6 million included non-cash charges for depreciation and amortization of \$377 thousand, debt discount of \$1.0 million and stock based compensation of \$900 thousand.

Changes in operating assets and liabilities provided cash of \$224 thousand during the nine months ended September 30, 2008, principally due to increases in accrued liabilities associated with the warrant derivative liability partially offset by increases in prepaid expenses and a decrease in accounts payable.

Changes in operating assets and liabilities used cash of \$333 thousand during the nine months ended September 30, 2007, principally due to decreases in the level of accounts payable which were partially offset by an increase in accrued liabilities and a decrease in prepaid expenses.

*Investing activities*

The principal factor in the \$93 thousand of cash used in investing activities during the nine months ended September 30, 2008 was capitalized costs of \$264 thousand, of which \$251 thousand related to the ongoing development of purchased software related to our Safety-Sponge System. This was offset by the sale of our undeveloped land in Alabama for \$226 thousand.

The principal factor in the \$1.3 million of cash provided by investing activities during the nine months ended September 30, 2007 was due to the sale of the express car wash and underlying real estate in Birmingham, Alabama for \$1.5 million. This was partially offset by capitalized costs of \$160 thousand related to the ongoing development of purchased software related to our Safety-Sponge System.

*Financing activities*

Cash provided by financing activities during the nine months ended September 30, 2008 of \$3.8 million resulted from the net proceeds from the issuance of common stock and warrants of \$3.9 million and short-term debt financings of \$500 thousand. The net proceeds from the issuance of securities was offset by the repayment of a promissory note of \$551 thousand and the payment of preferred dividends of \$57 thousand.

Cash used by financing activities during the nine months ended September 30, 2007 of \$169 thousand resulted primarily from repayment of promissory notes in the amount of \$3.3 million offset by net proceeds from the issuance of common stock and warrants of \$3.1 million.

**2008 Private Placements**

During the period May 20, 2008 to August 29, 2008, we sold to accredited investors in our private placements, as reflected below, \$5.1 million in equity securities.

23

---



Between May 20, 2008 and June 19, 2008, the Company entered into a securities purchase agreement with several accredited investors, in a private placement exempt from the registration requirements of the Securities Act. The Company issued and sold to these investors an aggregate of 2.1 million shares of its common stock and warrants to purchase an additional 1.3 million shares of its common stock.

Between August 1, 2008 and August 29, 2008, the Company entered into a securities purchase agreement with several accredited investors, in a private placement exempt from the registration requirements of the Securities Act. The Company issued and sold to these investors an aggregate of 2.0 million shares of its common stock and warrants to purchase an additional 1.3 million shares of its common stock.

### **2007 Private Placements**

During 2007 we sold to accredited investors in our private placements, as reflected below, \$5.3 million in equity securities.

Between January 29, 2007 and June 8, 2007, we entered into various subscription agreements with accredited investors in private placements exempt from the registration requirements of the Securities Act. We issued and sold to these accredited investors an aggregate of 3.0 million shares of our common stock and warrants to purchase an additional 1.4 million shares of our common stock.

On October 17, 2007, we entered into a securities purchase agreement with Francis Capital Management, LLC, an accredited investor, in a private placement exempt from the registration requirements of the Securities Act. We issued and sold to Francis Capital an aggregate of 1.3 million shares of our common stock and warrants to purchase an additional 763 thousand shares of our common stock.

### **Promissory Notes**

In addition to our private placements, we have also received a significant amount of funding from Ault Glazer Capital Partners, LLC (the "**Fund**"). AG Management is the managing member of the Fund. The managing member of AG Management is The Ault Glazer Group, Inc. ("**The AG Group**"). The Company's former Chairman and former Chief Executive Officer, Milton "Todd" Ault, III, is Chairman, Chief Executive Officer and President of The AG Group. At September 30, 2008 the outstanding principal balance of the loan that we entered into with the Fund was \$1.8 million.

At September 30, 2008 we had additional outstanding promissory notes in the aggregate principal amount of \$1.2 million. Between February 28, 2008 and March 20, 2008, Catalysis Offshore, Ltd. and Catalysis Partners, LLC (collectively "**Catalysis**"), which are parties related to one another, loaned us an aggregate of \$500 thousand. As consideration for the loans, we issued Catalysis promissory notes in the aggregate principal amount of \$500 thousand (the "**Catalysis Notes**"). The Catalysis Notes accrue interest at the rate of 8% per annum and has maturity dates of October 31, 2008. The other outstanding promissory notes were entered into during 2006.

### **Investments**

Our investments are illiquid, which will make it difficult to dispose of the securities quickly. Since we may be forced to liquidate some or all of the investments on an accelerated timeline, the proceeds of such liquidation may be significantly less than the value at which we acquired the investments. The following is a discussion of our most significant investments at September 30, 2008.

*Alacra Corporation*

At September 30, 2008, we had an investment in Alacra Corporation, valued at \$667 thousand, which represents 7.7% of our total assets. On April 20, 2000, we purchased \$1.0 million worth of Alacra Series F Convertible Preferred Stock. We have the right, subject to Alacra having the available cash, to have the preferred stock redeemed by Alacra over a period of three years for face value plus accrued dividends beginning on December 31, 2006. Pursuant to this right, in December 2006 we informed management of Alacra that we were exercising our right to put back one-third of our preferred stock. Alacra had a sufficient amount of cash to redeem our preferred stock and in December 2007 completed the initial redemption of one-third of our preferred stock. We received proceeds of \$333 thousand which accounted for the entire amount of the decrease in value of our Alacra investment. We continue to maintain our right to put back our remaining preferred stock to Alacra and expect an additional redemption of one-third of our preferred stock in December 2008.

### *Real Estate Investments*

At September 30, 2008, we had one real estate investment, valued at \$90 thousand. The real estate investment, consisting of 0.61 acres of undeveloped land in Springfield, Tennessee, is currently being marketed for sale. In March 2008, we completed the sale of approximately 8.5 acres of undeveloped land in Heber Springs, Arkansas for net proceeds of \$226 thousand, which resulted in a realized loss of \$25 thousand. In March 2008 we wrote down the value of our one remaining parcel in Springfield, Tennessee to \$90 thousand. We recognized an unrealized loss of \$90 thousand as a result of this write-down. We anticipate consummating the sale of the undeveloped land in Tennessee during the quarter ended December 31, 2008.

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

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this item.

### **Item 4T. Controls and Procedures.**

#### **Limitations on the Effectiveness of Controls**

We seek to improve and strengthen our control processes to ensure that all of our controls and procedures are adequate and effective. We believe that a control system, no matter how well designed and operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met. In reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. In addition, the design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. No evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company will be detected. As set forth below, our Chief Executive Officer and our Interim Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the objectives of our disclosure control system were met.

#### **Evaluation of Effectiveness of Disclosure Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our principal executive officer and interim chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, our chief executive officer and chief financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level discussed above.

## **Changes in Internal Control over Financial Reporting**

There were no changes in our internal controls over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the last quarter that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

As of the date this report was filed, there have been no material developments in the legal proceedings previously reported in our annual report on Form 10-K for the fiscal year ended December 31, 2007, which was filed with the Securities and Exchange Commission on April 15, 2008.

### **Item 1A. Risk Factors.**

There have been no material changes from risk factors previously disclosed in Item 1A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, which was filed with the SEC on April 15, 2008.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

Between August 1, 2008 and August 29, 2008, the Company entered into a securities purchase agreement with several accredited investors (the "*Investors*"), in a private placement exempt from the registration requirements of the Securities Act. The Company issued and sold to the Investors an aggregate of 2.0 million shares of its common stock and warrants to purchase an additional 1.3 million shares of its common stock. The warrants are exercisable for a period of five years at an exercise price equal to \$1.40 per share. These issuances resulted in aggregate gross proceeds to the Company of \$2.3 million in cash and the extinguishment of \$83 thousand in accrued liabilities. We are required to file a registration statement within 180 calendar days from August 4, 2008 (the "*Filing Date*") and to use our best efforts to cause the registration statement to become effective within 120 calendar days from the Filing Date or, in the event of a full review by the Securities and Exchange Commission, within 150 calendar days from the Filing Date (collectively the "*Effectiveness Date*"). We intend to use the net proceeds from this private placement transaction primarily for general corporate purposes and repayment of existing liabilities. These securities were sold in reliance upon the exemption provided by Section 4(2) of the Securities Act and the safe harbor of Rule 506 under Regulation D promulgated under the Securities Act. No advertising or general solicitation was employed in offering the securities, the sales were made to a limited number of persons, all of whom represented to the Company that they are accredited investors, and transfer of the securities is restricted in accordance with the requirements of the Securities Act.

### **Item 3. Defaults Upon Senior Securities.**

On May 1, 2006, the Company entered into a secured promissory note with Herbert Langsam, a Class II Director of the Company, in the principal amount of \$500 thousand. This note was due to be repaid on November 1, 2006. The Company is in the process of attempting to restructuring the debt that is owed to Mr. Herbert Langsam.

On November 13, 2006, the Company entered into a secured promissory note with Mr. Langsam in the principal amount of \$100 thousand. This note was due to be repaid on May 13, 2007. The Company is in the process of attempting to restructuring the debt that is owed to Mr. Herbert Langsam.

On November 1, 2006 the Company entered into a convertible promissory note with Michael G. Sedlak in the principal amount of \$71 thousand. This note was due to be repaid on January 31, 2008. The Company intends to pay this note in full prior to year-end.

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

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

Exhibit Number	Description
10.01	Form of Securities Purchase Agreement entered into May 20, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on June 2, 2008)
10.02	Form of Registration Rights Agreement entered into May 20, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on June 2, 2008)
10.03	Form of Warrant Agreement entered into May 20, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on June 2, 2008)
10.04	Form of Securities Purchase Agreement entered into August 1, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on August 14, 2008)
10.05	Form of Registration Rights Agreement entered into August 1, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on August 14, 2008)
10.06	Form of Warrant Agreement entered into August 1, 2008 between Patient Safety Technologies, Inc. and several accredited investors (Incorporated by reference to the Company's current report on Form 8-K filed with the Securities and Exchange Commission on August 14, 2008)
31.1*	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a)
31.2*	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a)
32.1*	Certification of Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code
32.2*	Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code

---

\* Filed herewith.

**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.

PATIENT SAFETY TECHNOLOGIES, INC.

Date: November 14, 2008

By: /s/ William Adams

\_\_\_\_\_  
William Adams  
Chief Executive Officer

Date: November 14, 2008

By: /s/ Mary A. Lay

\_\_\_\_\_  
Mary A. Lay  
Interim Chief Financial Officer and  
Principal Accounting Officer