



INTERNATIONAL  
DISPENSING  
CORPORATION

QUARTERLY REPORT  
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## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis should be read in conjunction with the Company's financial statements and financial information included elsewhere herein.

### THE COMPANY AND ITS MISSION

International Dispensing Corporation ("IDC" or the "Company") was incorporated in the State of Delaware in October, 1995. A flexible packaging R&D company, the Company continues to follow the original vision on which it was founded: to create and market a cost-effective dispensing system that can keep aseptic liquid contents fresh and uncontaminated (shelf-stable) through the entire dispensing cycle (days, weeks, or months, depending on product) without recourse to refrigeration or preservatives. In recent years as the Company has broadened its scope over the supply chain and expanded its intellectual property, its official vision now reads: "Innovators of dispensing technologies for flexible packaging." Its official mission statement is: "To supply our customers innovative, cost effective dispensing solutions in an environmentally responsible manner, while delivering value to our shareholders."

### THE OPPORTUNITY

To understand the logic and opportunity behind the Company's business model, it is useful to discuss Tetra Pak®, the world's largest packaging company with 2012 revenues estimated at \$20 billion. Founded in 1950, Tetra Pak® pioneered the aseptic carton (invented in 1943), which can keep perishable liquid foods and beverages fresh for up to a year without refrigeration. Currently found on grocery shelves in 170 countries, Tetra Pak® aseptic cartons are pervasive in regions where the cold chain is nonexistent, or far less developed than in the United States, though the penetration of aseptic cartons in the United States is massive as well. Once an aseptic carton is opened, the contents are exposed to air and must be refrigerated and consumed within a short period of time, or otherwise spoil. This is why aseptic cartons are predominantly single-serve retail packages - one liter and smaller - and why aseptic foods and beverages have not made significant inroads in the foodservice market, where multiple servings require a bulk package that can easily and safely mete out product over an extended period of time.

IDC's dispensing tap, The Answer®, was created specifically to fill that need. Attached to a flexible bag or pouch, which is airtight when filled and collapses when product is dispensed, The Answer® takes the bag-in-box ("BIB") packaging format, primarily associated with highly-preserved, inexpensive wines, into a broad, almost endless range of liquid aseptic products. With The Answer®, aseptically processed beverages and liquid foods can be safely dispensed over time from a large-format package, three to twenty liters (and even larger if necessary), without relying on refrigeration and without compromising product integrity and safety. To IDC's knowledge, there is no other technology in the world besides The Answer® that can safely dispense aseptic products at ambient temperatures.

Aseptic processing represents a major advance over alternative forms of sterilization, providing consumers with a higher quality and better tasting product than conventional bottling and canning. Generally speaking, aseptic retains 1/3 more vitamins and nutrients than retort, hot-fill,

and other forms of processing. Rather than cook the product inside the package for 30 to 60 minutes, aseptic processing takes place outside the package. Product is heated at high temperatures for a short period, then immediately cooled before finally being filled into packages. Because it is a far gentler process, aseptic products retain more nutritional value, exhibit more natural texture, color, and taste, and consume less energy to produce. That, and the fact that aseptic packages can be shipped without refrigeration, accounts in large part for Tetra Pak®'s incredible global success. Because IDC's large-format aseptic package utilizes less packaging per fluid ounce of product, requires less energy to produce and fill, takes up less landfill, and does not require refrigeration even after "opening", it is a more ecological alternative to aseptic cartons. It also stands to reason that a bulk package, as filling speeds improve and volumes increase, will be more economical per serving than single serve.

Due primarily to Tetra Pak® (and its rival, SIC Combi-Bloc®) aseptic accounts for a significant portion of worldwide retail packaging, with estimated current year sales of 180 billion cartons generating approximately \$23 billion in annual revenue. However, in the growing sectors of foodservice and bulk retail, aseptic continues to under-perform, yielding market position to tubs, pails, large cans, bottles, jars, and many other types of non-sustainable, cumbersome packaging. The Company believes it has an "answer" - The Answer® - which can introduce aseptic liquids to foodservice the way Tetra Pak® introduced them to retail, in a package that is safe and conducive to repeated use. With over 50% of every food dollar spent for consumption away from home, the target market for The Answer® is vast to be sure, though due to the current fragmented nature of foodservice packaging (as well as eventual opportunities in bulk retail) it is difficult to quantify a market potential for the Company and its technologies with any accuracy other than to say that there is a very significant upside once a bulk aseptic package with dispensing capability (i.e. The Answer®) gets traction. It is not the Company's intention to compete with Tetra Pak® and SIC Combi-Bloc, but rather to take the aseptic concept to a large-format package, one that is beyond the reach of current Tetra Pak® and SIC Combi-Bloc filling platforms and whose end-use is impractical for an aseptic carton.

There are over 63,000 Tetra Pak® packaging machines and over 9,000 Tetra Pak® processing units in circulation in food processing plants around the world. In theory, virtually any of those processing plants could become a BIB supplier simply by investing in a BIB filler and connecting it to its aseptic processing system. In that respect, most of the downstream infrastructure that can support The Answer® is already in place, eliminating one significant barrier to entry.

However, a slew of upstream obstacles still remained for a visionary product ahead of its time. Since the creation of The Answer® in 2000, the Company has faced a myriad of challenges relating to: 1) manufacturing, 2) testing and validating, 3) building an industry infrastructure around its technology virtually from scratch, 4) working with a fragmented supply chain, and 5) educating the industry about its technology and signing major strategic partners--all of which has amounted to years of behind-the-scenes heavy lifting. It is not unlike some of the challenges that confronted Tetra Pak® in the 1950s, when it was introducing to a skeptical industry and public a revolutionary packaging system that could store milk (and other perishable products) safely for up to a year without refrigeration. This concept hardly gained acceptance overnight, but took almost two decades to gain traction. IDC is taking Tetra Pak®'s aseptic packaging concept to the next level, by introducing dispensing and multiple uses, an idea that is equally "outlandish".

## MANUFACTURING

While IDC continues to see itself as an intellectual property and R&D company, it has made the conscious decision to manufacture The Answer® rather than license it. The reasons for this are to maintain product integrity, guard manufacturing know-how, maximize margins, and benefit from economies of scale. The Company owns its own tooling and assembly equipment, which are housed, maintained, and run at Hoffer Plastics (“Hoffer”), IDC’s manufacturing partner. An award-winning fourth generation family business located in South Elgin, IL, Hoffer supplies molded and assembled parts to a number of Fortune 400 companies. Hoffer has proven to be an innovative and reliable partner for IDC, improving quality, reducing costs, making significant investments, and assisting in new product development. IDC and Hoffer have forged a tight working relationship, and Hoffer continues to treat IDC as a first tier customer -- testimony to its belief in the Company’s technology and vision. With Hoffer, IDC has developed a fully-automated assembly machine for The Answer’s® five parts with state-of-the-art quality control procedures to detect microscopic flaws; it has also reduced the cost of The Answer® by over 60% since its inception, with more reductions in sight as volume levels build. The Company believes that the technical know-how arising from the IDC/Hoffer relationship, along with years of extensive testing and validation, serves as additional protection of its intellectual property. It is IDC’s view (and the view of a current overseas customer) that the advantages of manufacturing in the U.S. greatly outweigh local manufacture, but in the event it becomes necessary for whatever reason to consider overseas production, the Company would expect to do so with Hoffer as a partner.

## TESTING, VALIDATION

Aseptic dispensing is a bold, revolutionary idea, one that some large companies have tried but abandoned. Failure of a single dispensing device can lead to serious illness and compromise brand equity, which is why the testing and validation process is so arduous and critical, especially in low-acid (e.g. dairy) applications. Although The Answer® has been in commercial use since 2001 with dairy products, it was for a refrigerated end-use. Establishing the technology as a true aseptic tap that can dispense low-acid products at ambient temperatures over time has been an ongoing process.

The Answer® was first tested and successfully validated by two FDA processing authorities – Siliker in 1999 and National Food Labs in 2003. Several potential customers recommended that the Company retain the Institute of Environmental Health (“IEH”) to conduct even more stringent sterility tests. The Company commissioned IEH in late 2006, prevailing on certain potential dairy customers to participate in establishing the testing protocols.

The tests demonstrated that The Answer® safely dispenses growth-promoting liquid at ambient conditions, at viscosities as high as that of a smoothie. Even when the nozzles were inoculated in unrealistic sabotage fashion with excessive levels of deadly bacteria, The Answer® provided a barrier for a minimum of three weeks of dispensing. Bags with no inoculation remained sterile for a much longer period, until the test was abandoned. Considering that most foodservice establishments will typically go through a bag of product in a day or two, or a week at most, the results were extremely positive. They inspired IEH to write a scientific paper, entitled “Sterility Testing of a Dispensing Valve for Aseptic Function in Food Service,” which it presented to the July 2007 conference of the International Association of Food Protection (“IAFP”). The leading body

on food safety, IAFP is comprised of scientists, academics, and FDA and USDA officials. The IEH paper was submitted for peer review, allowing leading scientists in the field to challenge its findings. In March 2008 the paper was published in the Journal of Food Protection (“JFP”). The IEH tests and JFP article triggered a number of articles in trade press publications. They have also helped the Company convince leading BIB and food and beverage companies to work with IDC.

An array of potential dairy customers have told the Company that they are convinced by the IEH testing that The Answer® works as advertised. However, because the government food code does not allow for the dispensing of dairy products at ambient temperatures (in the United States), certain potential customers, before they can proceed, need something in writing from the US government stating that The Answer® is suitable for ambient dispensing of dairy products. The largest opportunities here are for coffee creamers and coffee-based beverages served over ice. The Company has hired a seasoned consultant to navigate the U.S. regulatory authorities in order to gain the necessary government imprimatur. Recently, a federal regulatory agency approved in writing IDC’s proposed test-protocols (jointly developed by the Company and the agency), which represents a major step in clearing this final regulatory hurdle. The Company has selected a co-packer for the tests, which are expected to take place in Q2 2012. Assuming The Answer® passes the tests (a reasonable assumption given that the original IEH protocols were equally demanding), it is the Company’s expectation that a document amounting to a government non-objection will be granted. This promises to be a very significant event for the U.S. dairy industry, in the Company’s view. In the meantime, there are no regulatory barriers preventing The Answer® from dispensing unrefrigerated high-acid aseptic products (juice, sports drinks, etc.); from dispensing refrigerated aseptic dairy products in the United States; from shipping aseptic dairy products unrefrigerated prior to dispensing; from dispensing hot-filled products at room temperatures; or from dispensing low-acid or high-acid products at room temperatures outside the United States. In any case, the Company encourages potential customers to test their own products to their satisfaction.

In late 2011, PepsiCo conducted its own microbiological tests on The Answer®, filling bags in China and shipping them by sea to IEH in Seattle. Spouts were innocuated with bacteria and product was dispensed for 30 days to see if any bags breached. The test was a success.

## SUPPLY CHAIN & INFRASTRUCTURE

When The Answer® was first introduced to the industry in 2001, there were no BIB fillers anywhere in the world that could run it as a single-fitment. To run The Answer® over a BIB filling line, a second fitment on the package was required through which product could be filled. A second fitment adds significant cost to each bag, creating an uncompetitive situation and relegating The Answer® to niche status. Though The Answer® was always designed to exist as a single fitment—i.e. where it can be removed from the bag during the filling process and then snapped firmly and irretrievably back in place -- most of the existing fillers at the time could not be converted to run The Answer® as a single-fitment, and the ones that could required a sizeable investment on the part of the manufacturer to dismantle the machine and then rebuild it.

Another obstacle -- holding back not just The Answer® but BIB in general -- was the output of BIB filling machines. As a rule of thumb, standard BIB fillers could run 10 bags per minute for high-acid (e.g. juice) packages and 5 bags per minute for low-acid (e.g. milk) packages,

paltry compared to the filling speeds of plastic bottles, aseptic cartons, and other more established package formats.

For BIB to emerge as a mainstream packaging format of interest to major brands, and for it to capitalize on the economic and environmental benefits that should logically accrue from bulk aseptic packaging, the above mentioned machine issues have had to be addressed. Due in large part to the Company's efforts in moving an entire industry, a large percentage of the BIB fillers manufactured today are equipped to run The Answer® as a single-fitment. Since the issuance of IDC's 2010 Annual Report, roughly a dozen food and beverage companies have either installed BIB fillers or are in the process of procuring a BIB filler, almost always with the Company's guidance and assistance. In each case, the customer has stipulated that the filler be designed to run The Answer® as a single fitment. Such investments are indicative of growing interest in The Answer® and the bulk aseptic package it enables. They also provide IDC with more co-packing options to capitalize on opportunities.

Additionally, due in part to the Company's leadership in promoting the benefits of flexible packaging and The Answer®, filling speeds are on the rise. Conventional BIB machines are 15-20% faster than when The Answer® was first introduced, but other more attractive filling options have also emerged. Both Sealed Air Corporation and Fres-co, two packaging companies with whom IDC has forged solid working relationships, have developed aseptic form-fill-seal machines that can run pouches in the range of 20 to 25 per minute, or roughly double the output of conventional BIB filling equipment.

In April, 2010, the Company entered into a joint venture with two multinational companies to produce a proprietary aseptic system, one that represents a quantum advance over current industry standards. The system is expected to be completed and shipped to a customer in the US in mid 2012.

IDC's goal remains to sell The Answer® to a wide range of end users and make it the ubiquitous global standard for aseptic dispensing, and to that end it is working with virtually all the major BIB players while remaining strategically independent. Because the Company is endeavoring to make history and change paradigms – i.e. dispensing aseptic liquids out of a flexible package and keeping the remaining contents shelf-stable without relying on refrigeration or preservatives – the sales cycle has proven to be a long one for all the reasons explained above. However, the years it has taken IDC to invent, develop, and validate The Answer®, and to address all the infrastructure and supply chain issues, has a very positive flip side: Once you are established it is a very long and difficult process for anyone to unseat you. The behind-the-scenes progress the Company is making on all of these issues has, it believes, positioned it for success and will quicken the sales cycle considerably going forward.

In the process of working with all facets of the supply chain and interacting with customers, the Company continues to innovate and as opportunities present themselves. Not only has The Answer® spawned developments in filling equipment, but also dispensing equipment, new types of packaging, and derivative taps and fitments, all of which fill specific needs and have the potential of being game-changing in their respective sectors. As 2012 progresses, the Company expects that it will no longer be dependent on a sole product, The Answer®. Despite its current size, the Company sees itself as one of the premier innovation leaders in the BIB flexible packaging industry.

## SALES & MARKETING

On December 1, 2011, the Company and PepsiCo announced the signing of a multiyear global supply agreement for The Answer®. Under the agreement, PepsiCo will buy The Answer® taps for use in a wide variety of PepsiCo non-carbonated ready-to-drink beverages as well as syrups and concentrates. The agreement between IDC and PepsiCo will maximize exposure of the multi-serve aseptic package, and is expected to result in a number of product launches in regions around the world starting in 2012. For well over a year, the companies have been working closely to develop and commercialize The Answer® as a unique selling proposition and core PepsiCo branding opportunity. The companies see significant growth potential for such a package in both emerging and mature markets, in both foodservice and retail channels. The Company regards this agreement as a major milestone, not only for the volumes it is expected to generate but also in terms of visibility. PepsiCo, which offers the world's largest portfolio of billion-dollar food and beverage brands, including Tropicana and Gatorade, as well as hundreds of other respected household brand names, is regarded as an ideal partner for The Answer® to achieve its global potential.

Currently there are four PepsiCo projects underway, all involving internationally recognizable brand names, in the following regions: China, Europe, Mexico, Philippines (for shipment to the US) – all of which the Company has visited more than once to assist in production and supply chain issues beyond The Answer®. Each of these regions has dedicated production lines in place for its particular project. The Company cannot reveal more at this time, nor can it predict exact timing. While the pace of big companies can often frustrate fast-moving entrepreneurial concerns like IDC, the Company remains as confident as ever in the PepsiCo relationship and expects significant order activity to commence in 2012.

The initial PepsiCo launch of The Answer® was expected to occur in China in Q1 2012. However, due to PepsiCo's joint venture with the Chinese beverage giant Tingyi (publicly announced on November 4, 2011), the launch experienced a delay while both beverage companies awaited approval of the deal by the Chinese government. Due to the deal's magnitude and complexity, involving the shifting of assets, personnel, and responsibilities, new projects cannot effectively be pushed until government approval is formally granted. That approval occurred on March 29, 2012. Since then, PepsiCo and Tingyi have been involved in the integration process, which the Company has been told, will be completed no later than June 1. Exactly when business activity will occur remains uncertain, but PepsiCo has asked the Company to plan on a visit to China and possibly other countries in Asia in the very near future. Under the deal, Tingyi, China's largest tea manufacturer and beverage distributor with annual revenues of \$16.6 billion, will be PepsiCo's exclusive bottler and distributor in China. The joint venture with Tingyi will not only boost the manufacturing capacity available to PepsiCo, but also ensure that all its products receive wide distribution throughout the country, even in the remotest areas. Currently (according to public information), PepsiCo has a 5% market share of the Chinese beverage market; under the deal, the combined entity will represent a 20% market share and leapfrog Coca Cola as the largest beverage enterprise in China. The Company believes that the PepsiCo/Tingyi joint venture can enhance The Answer®'s market penetration in China and allow for significantly faster manufacturing ramp up. In addition, the Company hopes the PepsiCo China project will likely spread to neighboring Asian countries in the natural course of business.

The PepsiCo deal does not preclude the Company from pursuing other business, and the Company continues to work with a number of other potential customers, ranging from food processors to packaging companies to multinational brands to the military. Given the disruptive nature of IDC's technology, Management has always envisioned that IDC's success will occur in "tipping point" fashion, that one high-profile acceptance is likely to jump-start a stampede in a "me-too" industry. Generally speaking, until actual contracts are signed and/or IDC gets a customer's written permission to reveal information, the Company must be ruled by discretion. *Management's policy remains to build the Company's value for the long term rather than to hype the stock for the short term, and it will not make any announcement before its time nor do anything to jeopardize relationships with customers and strategic partners.*

Below are some of the additional opportunities, to the extent that the Company is at liberty to divulge information. It is by no means a complete list, as the landscape of opportunity continues to grow and fluctuate. It is impossible to list all the companies that have expressed interest in The Answer®, but below is a description of some of the opportunities on the Company's plate:

In April, 2010 the Company signed an agreement with two multinational companies to develop a proprietary aseptic system. Due to confidentiality agreements and overriding strategic concerns, the Company cannot divulge details, except to say that the project is expected to create another profit center for IDC apart from its fitments as well as provide a springboard to boost sales of The Answer®. Virtually all fountain products in fast-food restaurants, convenience stores, cafeterias, and stadiums are pumped from bags, so the opportunity for a new and superior aseptic system is far-reaching; moreover, the Company's strategic partners are strong, credible global players. The Company is on an equal footing with its partners in this venture and with its partners has exclusive global rights to this system – which it believes can improve the BIB economic model. The first prototype is expected to be shipped to a US customer in mid 2012 and fully operational in late 2012, at which time the Company and its partners will begin to market the system aggressively to the world. Though this project has taken longer than anticipated due to certain complexities and the magnitude of what is being achieved, the Company believes it has the potential to be as significant as PepsiCo.

Cold Star, Inc. ("Cold Star"), a leading distributor of bulk dairy dispensing systems throughout the United States and Canada, continues to order The Answer® taps at a consistent monthly rate. Products include coffee creamers and dairy-based coffee beverages, though Cold Star is in the process of expanding into juices and teas using The Answer® and increasing its geographic reach. The Company projects annual sales from Cold Star in the low millions of taps.

Protica, Inc., a maker of protein shots and energy drinks, continues to market a bulk package with The Answer® to health chains. Its one-gallon standup pouch of liquid protein under the Sunkist label was featured in 2011 on the cover of Sky Mall Magazine. Though the \$85 sticker price proved daunting to consumers despite the 30% savings per serving, Protica continues to market the pouch concept for less pricey applications to club stores. Moreover, the Sunkist package was named by the *Healthcare Packaging* Web Site to be the number one packaging innovation of 2011, attracting more viewers than any other featured story.

The Sunkist standup pouch is generating considerable interest from potential customers in other industries. A major beverage brand (other than PepsiCo) is working with the Company on a funded project for a standup with The Answer®. A number of other potential end-users have requested pouch samples equipped with IDC technology for their sales efforts. Initial product lines include juice, tea, spirits, sports drinks, wine, and even detergent. Once again, IDC is on the cutting edge of innovation, thinking outside the box -- in this case, outside the bag-in-box. Management has believed for years that a standup pouch equipped with IDC technology would be a more aesthetic, appealing alternative to the box, especially in retail, where newness, graphics, ergonomics, and environmental concerns are important to consumers. The Company is currently working with innovative pouch manufacturers to automate fitment application and pouch filling, as well as create novel designs.

As stated earlier, a growing number of food processors are entering the BIB (and standup pouch) arena, and are actively working with the Company to procure fillers that can run The Answer® as a single fitment. Co-packers in the United States and overseas, both high-acid and low-acid, are at various stages of entering the bulk aseptic market with the Company's assistance. The Company intends to release more specific information at the appropriate time, as it receives permission.

Since 2009, Hershey's has dispensed chocolate and white milk at its Chocolate World attraction in Hershey, PA. The next step, to market the Hershey's system to convenience stores, quick-serve restaurants, and other foodservice outlets across the country, is dependent on Hershey's qualifying a reliable aseptic dairy that can handle its volume and run The Answer® as a single fitment. The bags in Chocolate World are currently double fitment.

As stated throughout this report, the infrastructure/supply chain process is moving along, with more and more companies willing to invest in the Company's vision. While aseptic dairy producers are generally slower to act and more conservative than high-acid aseptic producers, the Company anticipates some high-volume, single-fitment dairy options will become viable in the coming months. Moreover, assuming that the Company is successful in getting regulatory approval for the ambient dispensing of dairy products, it has received several positive indications that the leading players in the dairy industry will clamor to adapt its technology. In the meantime, low-acid producers such as Cold Star continue to market The Answer® for a refrigerated end use.

During 2009 and 2010, the Company made three sponsored visits to Saudi Arabia, where leading packaging and beverage companies in the region expressed interest in The Answer®. A feasibility study was conducted to determine the opportunities in the MENA region (Middle East, North Africa), with promising results. However, because of the global agreement with PepsiCo which was recently signed the Company chose to put the Saudi joint venture on hold, believing that it is in the interest of both parties to enter the MENA region with a major customer rather than to develop a market from scratch. The Company intends to revisit this opportunity at the opportune time.

The Company has developed a lower cost dispensing tap to complement The Answer®, though development is only at the prototype/sampling stage. An aseptic producer of juice, tea, and lemonade ("JTL") for retail in the U.S. has expressed its intention to convert all its business this new dispensing technology once it is commercially available. The JTL products are meant to be dispensed from a refrigerator and therefore do not require the barrier properties of The Answer®.

The Company is currently in discussions with JTL and other interested parties to garner enough volume commitments to justify the investment in new tooling. The new tap has attributes that are of keen interest to certain beverage categories, and therefore has explosive potential in the Company's view, but until the decision is made to commit to production tooling the Company will not elaborate.

The above are some, but by no means all, of the opportunities on the Company's plate. Numerous other seeds have been planted, though Management is primarily focused on the most immediate opportunities in the belief that one major success will be followed by others. Creating a large-format aseptic package from scratch -- to be to large-format aseptic what TetraPak® is to small format -- is a Herculean task, but one with tremendous potential upside. That things have taken longer than expected is not unusual, and Management continues to take the long view and hold its vision.

## PUBLIC RELATIONS

Because BIB is associated with low-end, highly preserved wine and BIB taps are designed merely to evacuate product, the Company has worked on a PR front to differentiate its technology. Naming it The Answer® was the first step. IDC has also trademarked the tagline, "Don't call it a tap . . . call it The Answer™". Because the Company is in the process of changing how people look at BIB, it has trademarked a new and more descriptive name for the format -- Multiserve SafePak™. The Company believes "Bag-in-Box" is too pedestrian and doesn't do The Answer® justice. Moreover, as evidenced by Protica's Sunkist stand-up pouch, not all applications in the future will require a box; there is a trend toward various iterations of stand-up pouches and non-box alternatives. The Company hopes Multiserve SafePak™ will become the generic name for the large-format flexible category. Despite not advertising in trade magazines, the Company has benefited from numerous articles -- on the IEH test results, the JFP article, the Sunkist® pouch, and other developments -- all of which have given IDC impressive visibility for a company its size. The Company has also begun a website and logo re-design to reflect its progress.

## OVERHEAD & PERSONNEL

With most of the development, patenting, and testing behind it, the Company is endeavoring to buy itself as much time as possible with a projected annual overhead of \$1,200,000 in 2012. With the percolating business prospects described above, management believes it has the necessary resources to achieve positive cash flow. If success takes longer than expected, due to long lead times common in the industry and variables outside the Company's control, management believes it has the ability to raise additional funds from its current investor base or other investors, but will only do so with great care.

The Board named Gregory Abbott, IDC's founder, fundraiser, and Chairman, to serve as CEO. As the Company's largest shareholder, Mr. Abbott has agreed to work without salary, at least until the Company becomes cash flow positive, and for years did not charge the Company for his IDC-related expenses. Due to the large number of projects on the Company's plate and their technical complexity, the Company (in April, 2010) hired Gregory Wuttke, previously a part-time consultant for IDC. Prior to joining IDC full-time, Mr. Wuttke served for six years as director of

sales and marketing for the Morningstar Tomato Company, the world's largest and arguably most innovative tomato processor. Regarded as one of the foremost technical experts in the aseptic BIB industry, Mr. Wuttke also worked thirteen years for the Scholle Corporation (the world's largest bag-in-box company) and Tetra Pak (the world's largest packaging company). In addition to hiring Mr. Wuttke, the Company continues to utilize strategic consultants to assist in marketing, engineering, and regulatory issues. Most notable among these is Daniel Beard, who spent eight years at the Scholle Corporation (as a colleague of Mr. Wuttke) before becoming a premier consultant to the BIB and flexible packaging industries. Mr. Beard has worked for IDC since 2005, and though he has other consulting clients, IDC remains his primary and only permanent one. Because of Mr. Beard's close association with IDC, his outside consulting jobs only serve to bolster IDC's visibility and credibility.

## THE ANSWER® AND INDUSTRY TRENDS

Consumers worldwide are increasingly concerned about nutrition, wellness, and food safety. Organic has grown into a \$35 billion global industry, while preservatives and processed foods are coming under increased fire for their adverse health effects. Product recalls, contamination outbreaks, and safety violations have focused attention and concern on the issue of food safety, and it is a well-known fact that half of the world's food supply spoils before it is consumed, one of mankind's most acute environmental problems. A 2006 study conducted by Tetra Pak® cited the three most important deliverables that consumers want in the packaged foods they buy: 1) protection from spoilage before and after opening, 2) taste and product integrity, 3) safety barriers that eliminate the need for preservatives. The Answer® squarely addresses all of the above issues.

Wal-Mart's Sustainability Scorecard and other environmental initiatives are causing profound repercussions throughout the industry. In packaging conferences around the world, sustainability is a hot topic and some companies are making packaging decisions based on sustainability. With refrigeration accounting for six percent of the world's carbon footprint, the energy savings afforded by The Answer® offers a clear-cut Earth-friendly advantage. It stands to reason that because a bulk format uses less packaging material per fluid ounce of product, it must expend less energy in the package's life cycle. In order to test these assumptions with scientific accuracy, the Company commissioned Allied Development, the leader in packaging sustainability studies, to conduct a comprehensive report comparing the carbon footprint of IDC's Multiserve SafePak™ to those of milk jugs, aseptic cartons, and plastic bottles. When commissioning the study, the Company had no idea how it would turn out other than its own gut assumptions, and was warned in advance by Allied Development that the results may or may not be to the Company's liking – in other words, the study was truly independent. Measuring in scrupulous detail energy usage and greenhouse gas (GHG) emissions through each stage of the supply chain (including material transport, resin production, package manufacture, filling, and shipping) the study (released in November, 2008) found that IDC's Multiserve SafePak™ expended “significantly less energy and GHG” than the other formats tested. The study also verified that the Multiserve SafePak™ takes up significantly less landfill—1/2 that of milk jugs, 1/3 that of aseptic cartons, and 1/6 that of plastic bottles. Based on these results, the Company believes the Multiserve SafePak™ is, arguably, the most sustainable package in the marketplace. It is unlikely that a major brand will convert to the Multiserve SafePak™ on environmental factors alone, but as the BIB economics

improve via faster filling speeds and economies of scale, the signs point to the Multiserve SafePak™ as one of the packages of the future.

## INTELLECTUAL PROPERTY

The Answer® received initial United States patent protection in 2002, and additional US patent protection in 2004. Currently The Answer® has patent protection in Eurasia (nine countries including Russia, 2003), South Africa (2004), Australia (2004), New Zealand (2004), Mexico (2006), Canada (2007), Europe (UK, France, Italy, Germany, Spain, and the Netherlands, 2009), Hong Kong (2010) and Brazil (2011). A patent is currently pending in Japan.

Two versions of The Answer® that improve drip are currently pending in the United States, Europe, Eurasia, China, Hong Kong, Japan, Australia, New Zealand, Canada, Mexico, Brazil, South Africa, India, Israel, and Korea.

While the basic patent for The Answer® is effective until 2022, the Company is working to extend it through continued refinements. Further protection is provided by the manufacturing know-how gained by years of experience in the Hoffer collaboration. Because the stakes are so high regarding safety, and the economies of scale achieved by IDC are likely to be daunting for any possible competitor by the time 2022 rolls around, the barriers to entry go far beyond simple patent protection. Such was the case with Tetra Pak® when its patents expired.

Patent protection is expensive and the Company has carefully chosen countries based on population and likelihood of manufacture. In theory, a country like Albania (to use one example) could legally produce The Answer™ and sell it within Albania only, but based on the testing, validation, and manufacturing know-how necessary for safety, the country's small population (which cannot justify the requisite investment), and the country's lack of industry infrastructure, the likelihood of this happening is remote. The same can be said for virtually all the countries in which the Company has not sought patent protection.

A version of The Answer® that can dispense carbonated beverages from a flexible pouch within a rigid container is currently pending in the United States, though the Company is making no efforts at commercialization at this time. Nevertheless, the carbonated tap is part of IDC's IP portfolio.

The Answer® became a registered trademark in August 2010, and the Company has several trademark applications pending for federal registration, including DON'T CALL IT A TAP™; DON'T CALL IT A TAP...CALL IT THE ANSWER™; MULTISERVE SAFEPAK™; GREEN MACHINE™ (referring to dispensing equipment designed around The Answer® that can heat or cool room temperature product as it is dispensed); and THE TICKET™ (referring to a derivative tap of The Answer™ specifically designed around the dispensing of wines and refrigerated aseptic beverages).

The Company believes there may be Intellectual Property arising from its three-way partnership to develop an aseptic system, but can say nothing conclusive at this time.

In 2006, the Company was awarded a patent for its Blending Pump ("BP") technology, a water-driven dispenser that accurately extracts concentrates from a flexible bag or pouch and mixes

them with water or diluents to produce a finished beverage or chemical. The BP is scalable technology that enables users to customize mixing ratios far more minutely and precisely than anything currently existing, ranging from 4:1 to 1,000:1. The Company sees the BP primarily of use for sanitation applications in restaurants and hotels, an interesting complement to the food safety direction the Company has taken with The Answer®.

## LEGAL PROCEEDINGS

The Company may be involved in litigation and other legal proceedings from time to time in the ordinary course of business. The Company believes that the ultimate resolution of any current litigation will not have a material effect on the Company's financial position, results of operations or cash flows.

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No assurance can be given that any of the current or future introductions, discussions, negotiations, development projects or confidentiality agreements with potential customers, companies or partners will lead to additional sales, contracts, longer term partnerships or buyouts of the technology in the future. Additionally, the success of the Company may be subject to the availability of sufficient financing to meet its future cash requirements and the uncertainty of future product development, regulatory approval and market acceptance of proposed products. Other risk factors such as loss of key personnel, lack of manufacturing capabilities, difficulty in establishing new intellectual property rights and preserving and enforcing existing intellectual property rights, as well as product obsolescence due to the development of competing technologies could negatively impact the future results of the Company.

## RESULTS OF OPERATIONS

### Three Months Ended March 31, 2012 Compared to Three Months Ended March 31, 2011

Revenue – For the three months ended March 31, 2012, the Company had revenue from The Answer™ of \$107,071 compared to the \$95,844 of revenue generated for the three months ended March 31, 2011, an increase of \$11,227 or 11.7%. This increase in revenue is due to increased unit sales.

Gross Profit – For the three months ended March 31, 2012, the Company had a gross profit of \$2,907 compared to a gross profit of \$19,414 for the three months ended March 31, 2011, a decrease of \$16,507 or 85.0%. This is due primarily to a short-term increase in cost of goods sold while building and qualifying a new tool that had exceeded its useful life. Cost of goods sold unit pricing is back in line with historical levels as of Q2 2012.

Operating Expenses – For the three months ended March 31, 2012, the Company had total operating expenses of \$434,283 representing an increase of \$9,661 or 2.3%, compared to the three months ended March 31, 2011. This increase was primarily driven by an increase in patent fees as we move to an automated system for managing patent renewals.

Loss from Operations – For the three months ended March 31, 2012, the Company had a loss from operations of \$431,376 representing an increase in loss from operations of \$26,168 or

6.5% compared to the three months ended March 31, 2011. This increase in loss from operations was driven primarily by a decrease in gross profit and an increase in operating expenses as explained above.

Interest Expense – Interest expense for the three months ended March 31, 2012 was \$16,656 compared to \$16,542 for the three months ended March 31, 2011.

Net Loss – For the three months ended March 31, 2012, the Company had a net loss of \$448,032 representing an increase in net loss of \$26,282 or 6.2% compared to the three months ended March 31, 2011. The increase in net loss was driven primarily by an increase in operating expenses and a decrease in gross profit as explained above.

## FINANCIAL CONDITION AND LIQUIDITY

As reflected in the Company's financial statements, the Company has experienced continuing net losses and negative cash flows from operations through March 31, 2012. The Company's continuing existence is dependent upon its ability to obtain additional financing, to generate sufficient cash flows to meet its obligations on a timely basis and to achieve and maintain profitable operations. The Company is attempting to obtain additional contracts to bolster its cash flow. However, there can be no assurance that the Company will be successful in this regard.

In the first quarter of 2011, three investors purchased an aggregate of 1,357,144 shares of the Company's common stock for an aggregate purchase price of \$570,000 (\$.42 per share).

In the second quarter of 2011, five investors purchased an aggregate of 739,143 shares of the Company's common stock for an aggregate purchase price of \$310,440 (\$.42 per share).

In the third quarter of 2011, two individual investors and one investor group purchased an aggregate of 1,071,429 shares of the Company's common stock for an aggregate purchase price of \$450,000 (\$.42 per share).

In the fourth quarter of 2011, one individual investor purchased 595,238 shares for a purchase price of \$250,000 (\$.42 per share).

In the first quarter of 2012, one individual investor purchased 238,096 shares for a purchase price of \$100,000 (\$.42 per share).

The Company believes that it has sufficient capital and access to funding to continue operations through September 30, 2012. However, there is no assurance that the Company will raise sufficient capital or otherwise generate sufficient cash flows to enable the Company to continue as a going concern beyond such time. The accompanying financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

**INTERNATIONAL DISPENSING CORPORATION**

**BALANCE SHEETS**

March 31, 2012 (unaudited) AND DECEMBER 31, 2011

	<b>ASSETS</b>		
		March 31	December 31
		<u>2012</u>	<u>2011</u>
<b>CURRENT ASSETS:</b>			
Cash		\$ 281,726	\$ 534,527
Accounts receivable		3,101	-
Inventory		29,181	
Prepaid expenses		<u>33,029</u>	<u>39,318</u>
Total current assets		<u>347,037</u>	<u>573,845</u>
<b>PROPERTY AND EQUIPMENT:</b>			
Office equipment		81,672	83,127
Production equipment		<u>2,994,546</u>	<u>2,994,601</u>
		3,076,273	3,077,728
Less accumulated depreciation		<u>(2,494,585)</u>	<u>(2,434,082)</u>
Total property and equipment		<u>581,633</u>	<u>643,646</u>
<b>TOTAL ASSETS</b>		<u><b>\$ 928,670</b></u>	<u><b>\$ 1,217,491</b></u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>			
<b>CURRENT LIABILITIES:</b>			
Accounts payable and accrued expenses		\$ 540,582	\$ 580,589
Note payable to stockholders		500,000	500,000
Bank term loan		<u>125,000</u>	<u>-</u>
Total current liabilities		<u>1,165,582</u>	<u>1,080,589</u>
<b>LONG-TERM LIABILITIES:</b>			
Bank term loan		<u>361,110</u>	<u>500,000</u>
Total long term liabilities		<u>361,110</u>	<u>500,000</u>
Total liabilities		<u>1,526,692</u>	<u>1,580,589</u>
<b>STOCKHOLDERS' DEFICIT:</b>			
Common stock, \$.001 par value; 100,000,000 shares authorized; 79,563,163 and 79,325,067 shares issued and outstanding as of March 31, 2012, and December 31, 2011, respectively		79,563	79,325
Additional paid-in capital		34,143,278	33,930,407
Accumulated deficit		<u>(34,820,864)</u>	<u>(34,372,832)</u>
Total stockholders' deficit		<u>(598,023)</u>	<u>(363,100)</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		<u><b>\$ 928,670</b></u>	<u><b>\$ 1,217,491</b></u>

See accompanying notes

## INTERNATIONAL DISPENSING CORPORATION

### STATEMENTS OF OPERATIONS (unaudited) FOR THE THREE MONTHS ENDED MARCH 31, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
REVENUES	\$ 107,071	\$ 95,844
COST OF GOODS SOLD	<u>104,164</u>	<u>76,430</u>
GROSS PROFIT	<u>2,907</u>	<u>19,414</u>
OPERATING EXPENSES:		
General, administrative and selling expenses	372,270	361,992
Depreciation	<u>62,013</u>	<u>62,630</u>
Total operating expenses	<u>434,283</u>	<u>424,622</u>
LOSS FROM OPERATIONS	<u>(431,376)</u>	<u>(405,208)</u>
INTEREST EXPENSE	<u>(16,656)</u>	<u>(16,542)</u>
NET LOSS	<u>\$ (448,032)</u>	<u>\$ (421,750)</u>
NET LOSS PER COMMON SHARE (BASIC AND DILUTED)	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>
BASIC AND DILUTED WEIGHTED AVERAGE SHARES OUTSTANDING	<u>79,455,889</u>	<u>76,699,680</u>

See accompanying notes.

**INTERNATIONAL DISPENSING CORPORATION**

STATEMENTS OF CASH FLOWS (unaudited)  
FOR THE THREE MONTHS ENDED MARCH 31, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (448,032)	\$ (421,750)
Non-cash items:		
Depreciation	62,013	62,630
Stock-based compensation	113,109	90,762
Net changes in:		
Accounts receivable	(3,101)	83,574
Prepaid assets	6,290	2,775
Inventory	(29,181)	-
Accounts payable and accrued expenses	<u>(53,899)</u>	<u>(64,099)</u>
Net cash used in operating activities	<u>(352,801)</u>	<u>(246,108)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Additions to property and equipment	<u>-</u>	<u>(23,968)</u>
Net cash used in investing activities	<u>-</u>	<u>(23,968)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of common stock	<u>100,000</u>	<u>570,000</u>
Net cash provided by financing activities	<u>100,000</u>	<u>570,000</u>
<b>NET (DECREASE)/INCREASE IN CASH</b>	<b>(252,801)</b>	<b>299,924</b>
<b>CASH AT BEGINNING OF PERIOD</b>	<u>534,527</u>	<u>193,354</u>
<b>CASH AT END OF PERIOD</b>	<u><u>\$ 281,726</u></u>	<u><u>\$ 493,278</u></u>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	<u><u>\$ 4,190</u></u>	<u><u>\$ 4,213</u></u>

See accompanying notes.

**INTERNATIONAL DISPENSING CORPORATION**

**STATEMENTS OF CHANGES IN STOCKHOLDERS' (DEFICIT)/EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2012 (unaudited)  
AND THE YEAR ENDED DECEMBER 31, 2011**

	<u>Common Shares</u>	<u>Common Stock Amount</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Deficit</u>	<u>Total Stockholders' (Deficit)/Equity</u>
BALANCE AT JANUARY 1, 2011	75,562,113	\$75,562	\$31,933,978	\$(32,402,865)	\$ (393,325)
Stock-based compensation expense	-	-	419,752	-	419,752
Additional shares issued	3,762,954	3,763	1,576,677	-	1,580,440
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,969,967)</u>	<u>(1,969,967)</u>
BALANCE AT DECEMBER 31, 2011	79,325,067	\$79,325	\$33,930,407	\$(34,372,832)	\$ (363,100)
Stock-based compensation expense	-	-	113,109	-	113,109
Additional shares issued	238,096	238	99,762	-	100,000
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(448,032)</u>	<u>(448,032)</u>
BALANCE AT March 31, 2012	<u>79,563,163</u>	<u>\$79,563</u>	<u>\$34,143,278</u>	<u>\$(34,820,864)</u>	<u>\$ (598,023)</u>

See accompanying notes.

# INTERNATIONAL DISPENSING CORPORATION

## NOTES TO THE FINANCIAL STATEMENTS FOR THE THREE MONTHS ENDED MARCH 31, 2012 AND 2011 (unaudited)

### 1. THE COMPANY AND ORGANIZATION

International Dispensing Corporation ("IDC" or the "Company") was incorporated in the State of Delaware in October 1995. The Company designs and manufactures proprietary packaging and dispensing solutions for the flowable food, beverage, medical, pharmaceutical and chemical industries. IDC's business model offers companies proven market solutions that offer higher levels of product safety and product performance.

IDC's single focus is on the development of market solutions whose value may be optimized through a joint venture alliance, license agreement or sale of the technology. IDC's business plan is organized on five platforms.

- I. Identify emerging packaging and dispensing market trends in the flowable foods, beverages, medical, pharmaceutical and chemical industries.
- II. Design and incubate new packaging and dispensing technologies that delivers measurable improvements in product safety and product performance.
- III. Demonstrate that the new technology can be mass marketed and mass produced.
- IV. Deliver each new technology with the necessary patent and regulatory certifications completed.
- V. Partner with leading flexible packaging companies in joint venture alliances, license agreements or sale of the technology to maximize shareholder value.

The Company continues to be subject to a number of on-going risks through March 31, 2012. For example, the Company is subject to risks related to the availability of sufficient financing to meet its future cash requirements and the uncertainty of future product development, regulatory approval, and market acceptance of existing and proposed products. Additionally, other significant risk factors such as loss of key personnel, lack of manufacturing capabilities, difficulty in establishing new intellectual property rights and preserving and enforcing existing intellectual property rights, as well as product obsolescence due to the development of competing technologies could impact the future results of the Company.

### 2. GOING CONCERN

The Company's financial statements have been presented on the basis that it will continue as a going concern. The Company's activities have resulted in an accumulated deficit from inception to March 31, 2012, of \$34,820,864. Losses are continuing as efforts to market the

Company's products continue to develop. The Company's primary source of funds since inception has been from the sales of its common and preferred stock and to a lesser extent from the issuance of debt.

The Company's ability to continue as a going concern is dependent on its ability to obtain additional financing, to generate sufficient cash flows to meet its obligations on a timely basis, and ultimately to attain profitability.

As of March 31, 2012, the Company had negative net working capital of \$1,179,6556. The accompanying financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

### 3. SIGNIFICANT ACCOUNTING POLICIES

#### Cash

Cash consists of cash in banks.

#### Accounts Receivable

The Company's accounts receivable consist of amounts due from customers operating in the food and beverage industry throughout the United States. Collateral is generally not required. The Company does not have a history of significant uncollectible accounts. For the periods reported, the Company has performed a detailed review of the current status of the existing receivables and determined that an allowance for doubtful accounts is not necessary.

#### Property and Equipment

Office equipment and productive equipment are recorded at cost and are depreciated on a straight-line basis over their estimated useful lives, generally five years. Depreciation expense for the three months ended March 31, 2012 and 2011 was \$62,013 and \$62,630, respectively.

#### Impairment of Long-Lived Assets

The Company reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An asset is considered impaired if its carrying amount exceeds the future net undiscounted cash flows that the asset is expected to generate. If such asset is considered to be impaired, the impairment to be recognized is the amount by which the carrying amount of the asset, if any, exceeds its fair value determined using a discounted cash flow model.

#### Patents

Costs to develop patents are expensed when incurred.

### Revenue Recognition

Revenue is recognized upon shipping of the product to the customer. Terms are FOB the Company's loading dock.

### Income Taxes

The Company uses the liability method in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Management considers the likelihood of changes by taxing authorities in its filed income tax returns and recognizes a liability for or discloses potential changes that management believes are more likely than not to occur upon examination by tax authorities. Management has not identified any uncertain tax positions in filed income tax returns that require recognition or disclosure in the accompanying financial statements. The Company's income tax returns for the past three years are subject to examination by tax authorities, and may change upon examination.

### Net Loss per Share

Basic loss per share is computed by dividing net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted loss per share is determined using the weighted-average number of shares of common stock outstanding during the period adjusted for the dilutive effect of common stock equivalents related to preferred stock, outstanding stock options and deferred contingent common stock awards. Such incremental shares were antidilutive for the periods presented.

### Use of Estimates

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

### Stock-Based Compensation

Compensation cost for all stock-based awards is measured at fair value on date of grant and recognized over the service period for awards expected to vest. Such value is recognized as expense over the service period, net of estimated forfeitures. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. Management considers many factors when estimating expected forfeitures, including types of awards, employee class, and historical experience.

### Fair Value of Financial Instruments

The Company's financial instruments consist primarily of accounts receivable, accounts payable and accrued expenses, bank term loan, and notes payable to shareholders. In management's opinion, the carrying amounts of these financial instruments approximated their fair value at March 31, 2012 and December 31, 2011.

### Business Segments

The Company has determined that its current business and operations consist of one business segment.

### Advertising

The Company expenses advertising costs as incurred. Advertising expenses totaled \$12,448 and \$2,060 for the years ended March 31, 2012 and 2011, respectively.

## 4. PRIVATE PLACEMENTS OF STOCK

In the first quarter of 2011, three non-related investors purchased an aggregate of 1,357,144 shares of the Company's common stock for an aggregate purchase price of \$570,000 (\$.42 per share).

In the second quarter of 2011, five non-related investors purchased an aggregate of 739,143 shares of the Company's common stock for an aggregate purchase price of \$310,440 (\$.42 per share).

In the third quarter of 2011, two individual investors and one investor group purchased an aggregate of 1,071,429 shares of the Company's common stock for an aggregate purchase price of \$450,000 (\$.42 per share).

In the fourth quarter of 2011, one individual investor purchased 595,238 shares for a purchase price of \$250,000 (\$.42 per share).

In the first quarter of 2012, one individual investor purchased 238,096 shares for a purchase price of \$100,000 (\$.42 per share).

## 5. RELATED PARTY TRANSACTIONS

Gregory Abbott, Chairman & CEO, has continued to invest in the Company and in May 2009 he purchased 595,238 shares for a purchase price of \$250,000. Also in May 2009, the Company issued 350,000 shares to Mr. Abbott in reimbursement of amounts he paid ABI Marketing & Public Relations. This stock issuance was valued at \$.60 per share and charged to operating expense. In September 2010, Mr. Abbott made an equity investment of \$200,000 to purchase 476,191 shares.

## 6. INCOME TAXES

The Company's federal statutory income tax rate is approximately 34%. The Company is also subject to applicable state income taxes. As a result of losses at March 31, 2012 and losses incurred since inception, and due to uncertainties surrounding the ability of the Company to realize the tax benefits associated with these losses, there is no provision or benefit for income taxes in the accompanying financial statements. As of March 31, 2012, the Company had a net operating loss carryforward of approximately \$29 million that began to expire in 2010. The Company has established a full valuation allowance against its net deferred tax assets as the Company's ability, to realize such assets, is predicated upon the Company achieving profitability. In addition, the use of net operating loss carryforwards may be limited as a result of ownership changes resulting from stock issuances.

## 7. STOCK-BASED COMPENSATION

### Stock-Based Compensation Expense

The fair values of stock options granted were estimated at the date of grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model was originally developed for use in estimating the fair value of traded options, which have different characteristics from the Company's employee stock options. The model is also sensitive to changes in assumptions, which can materially affect the fair value estimate. The Company used the following assumptions for determining the fair value of options granted under the Black-Scholes option-pricing model for the nine months ended March 31, 2012:

Risk-free interest rate	0.72% to 4.88%
Expected volatility	110% to 126%
Expected life (in years)	5
Expected dividend yield	0.00%

Total compensation cost charged related to employee stock options amounted to \$113,109 and \$90,762 for the three months ended March 31, 2012 and 2011, respectively. No compensation cost related to share-based payment arrangements was capitalized as part of the cost of any asset at March 31, 2012 and 2011.

The weighted average grant-date fair values of the options granted during the three months ended March 31, 2012 and 2011 were \$0.49 and \$0.58, respectively. The weighted average inception to date exercise price of these options was \$0.55.

### Stock Options Granted to Non-Employees

The Company accounts for its stock-based awards issued to non-employees in return for services using the fair value method. The fair value of the award is measured using the Black-Scholes option valuation model on the date that the services have been completed or on the performance commitment date, whichever is earlier (the "measurement date"). The fair value of the

award is estimated on the date of grant and the measurement date and is recognized as an expense in the accompanying statements of operations over the vesting period.

### Stock Options

The Company has two stock option plans (the “Plans”). The 1998 Stock Option Plan (the “Participant Plan”) provides for the granting of stock options to key employees, consultants or other persons (“Participants”). The objective of the Plans includes attracting and retaining the best personnel, providing for additional performance incentives and promoting the success of the Company by providing Participants the opportunity to acquire common stock. The Plans provides for the granting of both options that will qualify as “incentive stock options” and options that are non-qualified stock options. The objectives of the second plan, the Director Option Plan (“the Director Plan”) is to attract and retain the best available personnel for service as outside directors of the Company, as well as to provide additional incentive to the outside directors of the Company to serve as directors and to encourage their continued service on the Board. On June 18, 1999, the Board of Directors approved an increase in shares reserved for grant under the Participant Plan and Director Plan up to 850,000 and 450,000 shares, respectively. On September 11, 2000, the Board of Directors approved an increase in the number of shares reserved for grant under the Participant Plan to 2,500,000 and on December 5, 2001 the Board of Directors approved an increase in the number of shares reserved for grant under the Participant Plan to 5,000,000. The stockholders at the June 7, 2002 stockholders’ meeting approved the increase in the Plan. Options expire on such date as the Board of Directors or the Committee may determine. The term of director stock options issued after January 1, 1998 and scheduled to expire before June 30, 2014 have been extended to expire on June 30, 2014. In addition, 200,000 options scheduled to expire on June 30, 2009 have been extended to expire on June 30, 2014. These expiration dates extensions are reflected in the calculations below.

The following table summarizes stock option activity for the Company for the three months ended March 31, 2012 and the fiscal year ended December 30, 2011:

	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding at January 1, 2011	6,984,498	\$0.549
Granted	560,000	0.659
Exercised	0	0.000
Cancelled	<u>(250,000)</u>	0.550
Outstanding at December 31, 2011	7,294,498	0.559
Granted	20,000	0.490
Exercised	0	0.000
Cancelled	<u>(140,000)</u>	1.140
Outstanding at March 31, 2012	<u>7,174,498</u>	\$0.548

The following table summarizes information about stock options outstanding at March 31, 2012:

Exercise Price Range	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Life (Years)	Weighted-Average Exercise Price	Number Outstanding	Weighted-Average Remaining Life (Years)	Weighted-Average Exercise Price
\$0.187	321,180	0.33	\$0.1870	321,180	0.33	\$0.1870
0.2-0.3	875,000	1.54	0.2094	875,000	1.54	0.2094
0.312-0.625	2,793,318	4.72	0.4283	2,697,654	4.57	0.4272
0.64-1.0	2,945,000	6.12	0.7470	1,285,000	3.29	0.8768
\$1.015-2.1	<u>240,000</u>	2.52	1.2042	<u>240,000</u>	2.52	1.2042
	<u>7,174,498</u>	4.64	\$0.5476	<u>5,418,834</u>	3.43	\$0.5188

As of March 31, 2012, warrants to purchase 3,688,750 shares of the Company's stock were outstanding at prices ranging from \$.20 to \$1.00 per share. The weighted average warrant price as of March 31, 2012 was \$.31.

As of March 31, 2012, there was unrecognized compensation expense of \$1,520,879 remaining to be amortized through 2020.

## 8. CONCENTRATION OF CREDIT RISK

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and trade receivables. The deposits at a financial institution are guaranteed by the Federal Deposit Insurance Company (FDIC) up to \$250,000. At various times during the year, the Company had deposits in excess of the FDIC limit. The Company had accounts receivable balances of \$3,101 and \$11,189 as of March 31, 2012 and 2011, respectively.

## 9. NOTES PAYABLE

Notes payable at March 31, 2012 consist of the following:

In August 2004, the Company entered into a \$500,000 term loan and a \$500,000 revolving credit facility. The term loan bears interest at a variable rate of prime plus one-half percent (.5%) per annum and matured on February 28, 2012. Beginning March 1, 2012, the Company will make monthly principal payments, in addition to the interest payments, on the term loan. The payments will continue for a period of 36 months, at which time the balance of the loan will be paid in full. The revolving credit line matured on February 28, 2012 and was not renewed. The term loan continues to be guaranteed by one shareholder and one shareholder/director of the Company.

Total balance outstanding as of March 31, 2012	\$486,110
Less amounts due on demand or within one year	<u>(125,000)</u>
Total long-term debt	<u>\$361,110</u>

Throughout 2006, Mr. Abbott extended bridge loans to the Company totaling \$500,000. Demand notes were issued for these funds at an interest rate of 10%.

Interest expense on the above notes payable and all other obligations of the Company was \$16,656 and \$16,542 for the years ended March 31, 2012 and 2011, respectively.

#### 10. COMMITMENTS AND CONTINGENCIES

From time to time, the Company is involved in legal proceedings arising in the ordinary course of business. We believe there is no litigation pending against the Company that could have a material adverse effect on the Company's financial position, results of operations or cash flows.

#### 11. SUBSEQUENT EVENTS

The Company has evaluated subsequent events for potential recognition and/or disclosure through May 15, 2012, the date the financial statements were available to be issued.