

22nd Century Group, Inc.
Form 10-Q
August 15, 2011

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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2011

☐ 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: 333-173420

22nd Century Group, Inc.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

98-0468420
(I.R.S. Employer Identification No.)

8201 Main Street, Suite 6
Williamsville, New York 14221
(Address of principal executive offices)

(716) 270-1523
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-accelerated Filer ☐ Smaller Reporting Company ☒

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

As of August 15, 2011, there were 27,909,646 shares of common stock issued and outstanding.

22nd CENTURY GROUP, INC.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

22nd CENTURY GROUP INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | June 30, 2011 (unaudited) | December 31, 2010 |
|--|---------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash | \$86,575 | \$ 310 |
| Accounts receivable | 150,000 | - |
| Grant receivable | - | 223,540 |
| Due from related party | 14,330 | - |
| Inventory | 916,159 | 308,662 |
| Prepaid expenses | 150,194 | 211,717 |
| Total current assets | 1,317,258 | 744,229 |
| Other assets: | | |
| Patent and trademark costs, net | 1,432,308 | 1,467,623 |
| Office furniture and fixtures, net | 4,428 | - |
| Deferred private placement costs | - | 587,133 |
| Deposits | 1,535 | 1,535 |
| Total other assets | 1,438,271 | 2,056,291 |
| Total assets | \$2,755,529 | \$ 2,800,520 |
| LIABILITIES AND SHAREHOLDERS' DEFICIT | | |
| Current liabilities: | | |
| Demand bank loans | \$174,925 | \$ 174,925 |
| Accounts payable | 1,209,149 | 2,900,684 |
| Accrued interest payable to shareholders | 11,722 | 190,977 |
| Accrued expenses | 190,388 | 227,724 |
| Deferred grant revenue | 80,000 | 223,540 |
| Notes payable to shareholders, net of unamortized discount | - | 1,095,643 |
| Current portion of long-term debt | 123,223 | - |
| Due to related party | - | 6,942 |
| Due to officer | 4,509 | 3,200 |
| Total current liabilities | 1,793,916 | 4,823,635 |
| Long-term notes, less current portion | 627,000 | 65,557 |
| Warrant liability | 3,061,750 | - |
| Total liabilities | 5,482,666 | 4,889,192 |
| Commitments and contingencies (Note 10) | - | - |
| Shareholders' deficit | | |
| Capital stock authorized: | | |
| 10,000,000 preferred shares, \$.00001 par value | | |

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300,000,000 common shares, \$.00001 par value

Capital stock issued and outstanding:

| | | |
|--|-----------------|------------------|
| 0 preferred shares | - | - |
| 27,209,646 common shares (16,000,000 at December 31, 2010) | 273 | |
| Capital in excess of par value | 4,715,105 | 3,598,856 |
| Accumulated deficit | (7,440,674) | (5,687,394) |
| Non-controlling interest - consolidated subsidiary | (1,841) | (134) |
| Total shareholders' deficit | (2,727,137) | (2,088,672) |
| Total liabilities and shareholders' deficit | \$2,755,529 | \$ 2,800,520 |

See accompanying notes to consolidated financial statements.

22nd CENTURY GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Three Months Ended June 30, 2011 and 2010
(unaudited)

| | 2011 | 2010 |
|--|----------------|--------------|
| Revenue | \$ 154,810 | \$ 1,800 |
| Other Income - Therapeutic Grant Credit | 94,324 | - |
| Total revenue | 249,134 | 1,800 |
| Operating expenses: | | |
| Costs of goods sold | 46,648 | 1,000 |
| Research and development | 580,764 | 120,023 |
| General and administrative | 604,298 | 148,557 |
| Sales and marketing costs | 59,336 | - |
| Amortization and depreciation | 44,225 | 41,072 |
| | 1,335,271 | 310,652 |
| Operating loss | (1,086,137) | (308,852) |
| Interest expense and debt expense: | | |
| Shareholders | (6,631) | (63,381) |
| Other | (10,553) | (12,867) |
| Net loss | (1,103,321) | (385,100) |
| Net loss attributable to non-controlling interest | 3,457 | - |
| Net loss attributed to common shareholders | \$(1,099,864) | \$(385,100) |
| Loss per common share - basic and diluted | \$(0.04) | \$(0.03) |
| Common shares used in basic earnings per share calculation | 27,204,701 | 11,193,668 |

See accompanying notes to consolidated financial statements.

22nd CENTURY GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Six Months Ended June 30, 2011 and 2010

(unaudited)

| | 2011 | 2010 |
|--|----------------|--------------|
| Revenue | \$272,266 | \$1,800 |
| Other Income - Therapeutic Grant Credit | 143,540 | - |
| Total revenue | 415,806 | 1,800 |
| Operating expenses: | | |
| Costs of goods sold | 93,650 | 1,000 |
| Research and development | 797,055 | 215,443 |
| General and administrative | 930,393 | 244,665 |
| Sales and marketing costs | 230,704 | - |
| Amortization and depreciation | 87,802 | 80,932 |
| | 2,139,604 | 542,040 |
| Operating loss | (1,723,798) | (540,240) |
| Interest expense and debt expense: | | |
| Shareholders | (18,776) | (121,400) |
| Other | (12,413) | (28,477) |
| Net loss | (1,754,987) | (690,117) |
| Net loss attributable to non-controlling interest | 1,707 | 4 |
| Net loss attributed to common shareholders | \$(1,753,280) | \$(690,113) |
| Loss per common share - basic and diluted | \$(0.07) | \$(0.08) |
| Common shares used in basic earnings per share calculation | 25,556,710 | 9,153,410 |

See accompanying notes to consolidated financial statements.

22nd CENTURY GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Six Months Ended June 30, 2011 and 2010

(unaudited)

| | 2011 | 2010 |
|---|---------------|--------------|
| Cash flows from operating activities: | | |
| Net loss | \$(1,754,987) | \$(690,117) |
| Adjustments to reconcile net loss to cash used by operating activities: | | |
| Amortization and depreciation | 87,802 | 80,932 |
| Amortization of debt issuance costs | - | 21,554 |
| Amortization of debt discount | 2,666 | 80,792 |
| Equity based employee compensation expense | 278,479 | 122,808 |
| (Increase) decrease in assets: | | |
| Accounts receivable | (150,000) | - |
| Grant receivable | 223,540 | - |
| Inventory | (607,497) | (267,364) |
| Prepaid expenses | 61,523 | (36,792) |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (78,408) | (29,927) |
| Accrued interest payable to shareholders | (172,554) | 39,692 |
| Accrued expenses | (37,336) | 92,936 |
| Deferred grant revenue | (143,540) | - |
| Net cash used by operating activities | (2,290,312) | (585,486) |
| Cash flows from investing activities: | | |
| Acquisition of patents and trademarks | (552,123) | (84,882) |
| Acquisition of office furniture and fixtures | (4,791) | - |
| Net cash used by investing activities | (556,914) | (84,882) |
| Cash flows from financing activities: | | |
| Payment of deferred private placement costs | - | (53,452) |
| Payment on demand loan | - | (7,383) |
| Proceeds from issuance of notes and warrants | - | 450,000 |
| Payments on notes payable to shareholders | (393,275) | (4,389) |
| Proceeds from issuance of common stock | - | 410,000 |
| Net proceeds from January 25, 2011 private placement | 3,346,729 | - |
| Net payments to related party | (21,272) | (90,400) |
| Net advances from (payments to) officers | 1,309 | (930) |
| Net cash provided by financing activities | 2,933,491 | 703,446 |
| Net increase in cash | 86,265 | 33,078 |
| Cash - beginning of period | 310 | 158 |
| Cash - end of period | \$86,575 | \$33,236 |
| Cash paid during the period for interest | \$189,736 | \$7,598 |
| Supplemental disclosure of noncash investing and financing activities: | | |
| Reduction of accounts payable not related to operating activities: | | |
| Payment of accounts payable for patent costs | \$500,000 | \$- |
| Payment of accounts payable for deferred private placement costs | 526,127 | - |
| Accounts payable converted to promissory notes | 587,000 | - |
| | \$1,613,127 | \$- |
| Deferred private placement costs charged to contributed capital | \$587,133 | \$- |
| Conversion of member note to common shares and warrants | \$614,070 | \$31,311 |

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| | | |
|--|-------------|-----------|
| Issuance of warrants as derivative liability instruments and reduction of capital in excess of par value | \$3,061,750 | \$- |
| Patent and trademark additions included in accounts payable | \$- | \$16,367 |
| Deferred private placement cost additions included in accounts payable | \$- | \$209,177 |

See accompanying notes to consolidated financial statements.

22nd CENTURY GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' DEFICIT
For the six months ended June 30, 2011
(unaudited)

| | Common Shares Outstanding | Par value of Common Shares | Contributed Capital | Accumulated Deficit | Non-controlling Interest | Shareholders' Deficit |
|---|---------------------------------|----------------------------------|------------------------|------------------------|-----------------------------|--------------------------|
| Balance at December 31, 2010 | 16,000,000 | \$- | \$3,598,856 | \$ (5,687,394) | \$ (134) | \$ (2,088,672) |
| Distribution of 5,000,000 warrants for common stock, exercise price of \$3.00 per share | | | (1,550,000) | | | (1,550,000) |
| Common Shares issued in January 25, 2011 private placement | 5,434,446 | | 2,388,043 | | | 2,388,043 |
| Merger of 22nd Century Limited and 22nd Century Group | 5,325,200 | 268 | (268) | | | - |
| Stock based compensation | 450,000 | 5 | 278,474 | | | 278,479 |
| Net loss | | | | (1,753,280) | (1,707) | (1,754,987) |
| Balance at June 30, 2011 | 27,209,646 | \$273 | \$4,715,105 | \$ (7,440,674) | \$ (1,841) | \$ (2,727,137) |

See accompanying notes to consolidated financial statements.

22nd CENTURY GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2011

NOTE 1. - NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Introduction - These unaudited consolidated financial statements of 22nd Century Group Inc. (“22nd Century Group”) and its direct and indirect subsidiaries (collectively with 22nd Century Group, the “Company”) incorporate and reflect the reverse acquisition of 22nd Century Limited, LLC by 22nd Century Group, Inc. as described below.

On January 25, 2011, 22nd Century Limited, LLC (“22nd Century Ltd”) completed a reverse merger transaction (the “Merger”) with 22nd Century Group, Inc. (formerly Touchstone Mining Limited). As a result, 22nd Century Ltd became a wholly owned subsidiary of 22nd Century Group which continues to operate the business of 22nd Century Ltd. In connection with the Merger, 22nd Century Group issued 21,434,446 shares of its common stock to the holders of limited liability company membership interests of 22nd Century Ltd, which share amount represented 80.1% of the outstanding shares immediately following the Merger. All references contained herein to shareholders or common shares include the historical members and limited liability company membership interests of 22nd Century Ltd because, in the Merger, limited liability company membership interests were exchanged for common shares on a one-for-one basis and from an accounting standpoint they are equivalent.

The Merger is being accounted for as a reverse acquisition and a recapitalization; 22nd Century Ltd is the acquirer for accounting purposes. Consequently, the assets and liabilities and the historical operations that are reflected in the financial statements set forth herein for periods prior to the Merger are those of 22nd Century Ltd and are recorded at the historical cost basis of 22nd Century Ltd, and the consolidated financial statements set forth herein for periods beginning on and following completion of the Merger include the assets and liabilities of 22nd Century Ltd, historical operations of 22nd Century Ltd, and operations of 22nd Century Group from the closing date of the Merger.

Upon the closing of the Merger, 22nd Century Group transferred all of its operating assets and liabilities to Touchstone Split Corp. and split-off Touchstone Split Corp. through the sale of all of the outstanding capital stock of Touchstone Split Corp. (the “Split-Off”). After the completion of the Merger and Split Off, 22nd Century Group’s consolidated financial statements include only the assets and liabilities of 22nd Century Ltd. Refer to the Current Report on Form 8-K that the Company filed with the Securities and Exchange Commission on February 1, 2011 for further information on the Merger.

Immediately prior to the Merger on January 25, 2011, 22nd Century Ltd completed a private placement offering (the “Private Placement”) of 5,434,446 securities (the “PPO Securities”) at the purchase price of \$1.00 per Unit, each such Unit consisting of one (1) limited liability company membership interest of 22nd Century Ltd and a five-year warrant to purchase one-half of one (1/2) limited liability company membership interest of 22nd Century Ltd at an exercise price of \$1.50 per whole common share. In connection with the Private Placement, 22nd Century Ltd approved a prorata distribution of 5,000,000 five-year warrants to purchase one limited liability company membership interest at an exercise price of \$3.00. Private Placement proceeds included \$614,070 from the conversion of 22nd Century Ltd indebtedness into PPO Securities and \$395,376 from the conversion of placement agent fees into PPO Securities, resulting in gross cash proceeds of \$4,425,000. Private Placement expenses incurred included cash expenses of approximately \$1,025,000 and non-cash expenses consisting of the placement agent fees of \$395,376 which were converted into PPO Securities and \$390,000 for the estimated fair value of 934,755 placement agent and advisor warrants issued to the placement agent. An additional \$114,979 of cost was incurred in the second quarter of 2011 in connection with registration process for the common stock issued in the Private Placement. 22nd Century Ltd/Group received net cash proceeds of approximately \$3.3 million from the Private Placement and a reduction of debt and accrued interest obligations to shareholders that were on the balance sheet at December 31, 2010 of approximately \$614,000, which was exchanged for equity interests in the offering. A portion of the proceeds were allocated to the

warrants issued, which are classified as liabilities (see Note 9).

Basis of Presentation - The accompanying unaudited statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair and non-misleading presentation of the financial statements have been included.

The results of operations for any interim period are not necessarily indicative of results for the full year. Operating results for the six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The balance sheet at December 31, 2010 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

Nature of Business - 22nd Century Group is a holding company and is the sole member of 22nd Century Ltd, which is a plant biotechnology company. 22nd Century Ltd owns or exclusively licenses 98 issued patents in 79 countries predominantly related to modifying the content of nicotinic alkaloids in plants, specifically tobacco plants, through genetic engineering and plant breeding.

The overall objectives of 22nd Century Ltd are to reduce smoking-related disease by increasing smoking cessation with X-22, its botanical prescription smoking cessation aid in development, and reducing the harm to smokers with 22nd Century's potential modified risk tobacco products (as defined in the Overview of Management Discussion), for smokers unwilling to quit. 22nd Century Ltd, including its subsidiary, Goodrich Tobacco Company Ltd. ("Goodrich Tobacco"), is primarily involved in the following activities:

- The development of its botanical smoking cessation aid, X-22;
- The development of its modified risk tobacco products;
- The pursuit of necessary regulatory approvals at the U.S. Food and Drug Administration (the "FDA") to market X-22 as a prescription smoking cessation aid and its proprietary cigarettes as modified risk tobacco products in the U.S.;
- The manufacture, marketing and distribution of RED SUN and MAGIC proprietary cigarettes in traditional tobacco market channels in the U.S. through its subsidiary Goodrich Tobacco;
- The international licensing of 22nd Century's trademarks, brands, proprietary tobaccos, and technology; and
- The production of SPECTRUM research cigarettes for the National Institute on Drug Abuse ("NIDA").

Principles of Consolidation - The accompanying consolidated financial statements include the accounts of 22nd Century Group, 22nd Century Ltd, and Goodrich Tobacco, a subsidiary of 22nd Century Ltd. 22nd Century Ltd owns 96% of the outstanding membership units of Goodrich Tobacco. All intercompany accounts and transactions have been eliminated.

Inventory - Inventories are valued at the lower of cost or market. Cost is determined on the first-in, first-out (FIFO) method. The Company's inventory consisted of the following categories:

| | June 30, 2011 | December 31, 2010 |
|---------------------------|------------------|----------------------|
| Materials, mainly tobacco | \$ 796,059 | \$ 292,480 |
| Finished goods | 120,100 | 16,182 |
| Total | \$ 916,159 | |