

PURE BIOSCIENCE
Form 10-Q
December 10, 2008

**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 OCTOBER 31, 2008**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file No. 0-21019

PURE BIOSCIENCE

(Exact name of registrant as specified in charter)

California
(State or other jurisdiction of incorporation or organization)

33-0530289
(I.R.S. Employer Identification No.)

**1725 Gillespie Way
El Cajon, California**
(Address of principal executive offices)

92020
(Zip Code)

Registrant's telephone number, including area code: **(619) 596-8600**

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 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 December 8, 2008, there were 29,795,816 shares of the registrant's common stock, no par value, outstanding.

PURE Bioscience
FORM 10-Q
For the Quarterly Period Ended October 31, 2008

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SIGNATURES

PURE Bioscience

CONSOLIDATED BALANCE SHEETS

| | (Unaudited) October 31, 2008 | July 31, 2008 |
|---|------------------------------------|------------------|
| | <hr/> | <hr/> |
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 1,047,804 | \$ 2,024,400 |
| Short-term investments | 4,081,099 | 4,607,888 |
| Accounts receivable, net of allowance for doubtful accounts of \$0 at July 31, 2008 and \$0 at October 31, 2008 | 842,793 | 834,721 |
| Inventories, net | 432,022 | 370,043 |
| Prepaid expenses | 22,183 | 52,560 |
| | <hr/> | <hr/> |
| Total current assets | 6,425,901 | 7,889,612 |
| Total property, plant and equipment, net | 1,009,987 | 1,034,835 |
| Other Assets | | |
| Patents | 1,993,440 | 2,016,391 |
| | <hr/> | <hr/> |
| Total assets | \$ 9,429,328 | \$ 10,940,838 |
| | <hr/> | <hr/> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 296,705 | \$ 596,132 |
| Accrued liabilities | 283,914 | 126,141 |
| Deferred revenue | 252,800 | 256,793 |
| Taxes payable | 2,400 | 2,400 |
| | <hr/> | <hr/> |
| Total current liabilities | 835,819 | 981,466 |
| Deferred rent | 17,664 | 15,798 |
| | <hr/> | <hr/> |
| Total liabilities | 853,483 | 997,264 |
| Stockholders' Equity | | |
| Preferred Stock, no par value: 5,000,000 shares authorized, no shares issued | | |
| Class A common stock, no par value: 50,000,000 shares authorized 29,573,936 issued and outstanding at July 31, 2008, and 29,795,816 issued and outstanding at October 31, 2008 | 35,625,756 | 35,436,077 |
| Additional Paid-In Capital | 4,217,998 | 4,155,608 |
| Warrants: 880,351 issued and outstanding at July 31, 2008, and 880,351 issued and outstanding at October 31, 2008 | 1,766,159 | 1,766,159 |
| Accumulated other comprehensive income | 4,106 | 18,588 |
| Accumulated deficit | (33,038,174) | (31,432,858) |
| | <hr/> | <hr/> |
| Total stockholders' equity | 8,575,845 | 9,943,574 |
| | <hr/> | <hr/> |
| Total liabilities and stockholders' equity | \$ 9,429,328 | \$ 10,940,838 |
| | <hr/> | <hr/> |

The accompanying notes are an integral part of the consolidated financial statements

PURE Bioscience

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

| | For the Three Months Ended October 31, | |
|--|---|-------------|
| | 2008 | 2007 |
| Net revenues | \$ 110,621 | \$ 95,290 |
| Cost of sales | 59,812 | 31,693 |
| Gross profit | 50,809 | 63,597 |
| Selling expenses | 151,192 | 88,202 |
| General and administrative expenses | 1,262,435 | 707,609 |
| Research and development | 286,962 | 288,205 |
| Total operating expenses | 1,700,589 | 1,084,016 |
| Loss from operations | (1,649,780) | (1,020,419) |
| Other income and (expense): | | |
| Interest income | 8,763 | 11,657 |
| Other | 35,701 | 58 |
| Total other income (expense) | 44,464 | 11,715 |
| Net loss before income taxes | (1,605,316) | (1,008,704) |
| Income tax provision | | |
| Net loss | (1,605,316) | (1,008,704) |
| Net loss per common share, basic and diluted | (0.05) | (0.04) |
| Weighted average common shares used in computing basic and diluted net loss per common share | 29,668,089 | 25,333,567 |

The accompanying notes are an integral part of the consolidated financial statements

PURE Bioscience
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | For the Three Months Ended October 31, | |
|---|---|---------------------|
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net loss | \$ (1,605,316) | \$ (1,008,704) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Amortization and depreciation | 108,397 | 97,373 |
| Stock-based compensation | 86,991 | 78,331 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (8,072) | (26,017) |
| Prepaid expense | 30,377 | (20,564) |
| Inventories | (61,979) | 9,546 |
| Deferred rent | 1,866 | 9,817 |
| Deferred revenue | (3,993) | |
| Accounts payable and accrued liabilities | (141,653) | (226,755) |
| Net cash (used) in operating activities | (1,593,382) | (1,086,973) |
| Cash flows from investing activities | | |
| Investment in patents | (19,663) | (32,873) |
| Purchase of property, plant and equipment | (40,936) | (26,026) |
| Purchases of short-term investments | (4,076,992) | (4,749,973) |
| Sales of short-term investments | 4,589,298 | 700,869 |
| Net cash provided by (used) in investing activities | 451,707 | (4,108,003) |
| Cash flows from financing activities | | |
| Net proceeds from the sale of common stock | | 7,740,967 |
| Proceeds from exercise of stock options and warrants | 165,079 | 389,310 |
| Net cash provided by (used in) financing activities | 165,079 | 8,130,277 |
| Net increase (decrease) in cash and cash equivalents | (976,596) | 2,935,301 |
| Cash and cash equivalents at beginning of period | 2,024,400 | 735,654 |
| Cash and cash equivalents at end of period | \$ 1,047,804 | \$ 3,670,955 |

The accompanying notes are an integral part of the consolidated financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Basis of Presentation

PURE Bioscience (sometimes referred to herein as the Company or we) was incorporated in the state of California on August 24, 1992. The accompanying unaudited financial statements include the consolidated accounts of PURE Bioscience and its subsidiaries. All inter-company balances and transactions have been eliminated.

The financial statements included herein have been prepared by PURE Bioscience without audit, in accordance with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in the financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted as allowed by such rules and regulations, however we believe that the accompanying unaudited financial statements contain all adjustments (including normal recurring adjustments) necessary to present fairly the financial condition, results of operations and cash flows for the periods presented. These unaudited consolidated financial statements presented herein should be read in conjunction with our audited financial statements for the period ended July 31, 2008, and their accompanying notes, as filed with the Securities and Exchange Commission in our 10-K on October 14, 2008.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in the statements and accompanying notes, and actual results could differ materially from those estimates. The results of operations for the three months ended October 31, 2008 are not necessarily indicative of the results of operations for the full year, or any future periods.

Note 2. Summary of Significant Accounting Policies

Revenue Recognition

During the periods presented herein our revenue was derived from the sale of silver dihydrogen citrate (SDC) concentrate and the sale of finished packaged products containing SDC. We recognize revenue from sales of these products under the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition*, which is generally when we ship the products free on board from either our facility or from third party packagers, we have transferred title to the goods, and we have eliminated our risk of loss.

Intangible Assets / Long-Lived Assets

Our intangible assets primarily consist of the worldwide patent portfolio of our silver ion technologies, and to a lesser extent our Triglycylboride technology. Outside legal costs and filing fees related to obtaining patents are capitalized as incurred. The total amounts capitalized for pending patents were \$19,663 and \$32,873 in the three month periods ended October 31, 2008 and 2007, respectively. Patents are stated net of accumulated amortization of \$1,122,880 and \$1,080,265 at October 31, 2008 and July 31, 2008, respectively. The cumulative cost of acquiring patents is amortized on a straight-line basis over the estimated remaining useful lives of the patents, generally between 17 and 20 years from the date of issuance. At October 31, 2008, the weighted average remaining amortization period for all patents was approximately 11.5 years. Amortization expense for the three month periods ended October 31, 2008 and 2007 was \$42,614 and \$43,396, respectively.

Accounting for Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) revised SFAS 123(R), *Share-Based Payment*, which establishes accounting for share-based awards exchanged for employee and Director services and requires us to expense the estimated fair value of these awards over the applicable service period. Under SFAS No. 123(R), share-based compensation cost is measured at the grant date based on the estimated fair value of the award, and is recognized as expense over the applicable service period. We do not have, and have not had during the three month periods ended October 31, 2008 or 2007, any stock option awards with market or performance conditions.

We adopted the accounting provisions of SFAS No. 123(R) in the three month period ended October 31, 2006, using the modified prospective application. Under the modified prospective application, prior fiscal periods are not revised for comparative purposes. Prior to August 1, 2006, we followed Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, as amended, in our accounting for share-based compensation. The valuation provisions of SFAS No. 123(R) apply to new awards and to awards that were outstanding on the adoption date and were or are subsequently modified or cancelled.

Stock Options to Non-Employees

Charges for stock options granted to non-employees have been determined in accordance with SFAS No. 123(R) and EITF No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, whereby we use the estimated fair value of the stock options issued, based on the Black-Scholes Option Pricing Model. During the three month

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periods ended October 31, 2008 and 2007, we recorded \$4,979 and \$9,758 in research and development expense.

Cash, Cash Equivalents and Short-term Investments

We consider all liquid investments with maturities of ninety days or less when purchased to be cash equivalents. Our short-term investments have maturities of greater than ninety days from the date of purchase. We classify securities as available-for-sale in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, and carry these investments at fair value with any unrealized gains and losses reported as a component of shareholders' equity on the consolidated balance sheets and in the statements of shareholders' equity. All of our short-term investments as of July 31 and October 31, 2008 are carried at fair value, based upon market prices quoted on the last day of the fiscal period, and are considered available for sale. We use the specific identification method to determine the cost of debt securities sold, and include gross realized gains and losses in investment income. Realized gains recorded for the three month periods ended October 31, 2008 and 2007 were \$35,701 and \$5,902, respectively. All interest and dividends received from short-term investments are included in interest income.

As of October 31, 2008 and July 31, 2008, all cash deposits and short-term investments were invested in either U.S. FDIC insured bank accounts; institutional money market mutual funds investing in A-1 (S&P) or Prime-1 (Moody's); U.S. Treasury Securities, or United States Government obligations issued by or backed by a federal agency of the United States Government.

Comprehensive Income

SFAS 130, *Reporting Comprehensive Income*, requires us to display comprehensive income or loss and its components as part of our consolidated financial statements. Our comprehensive loss includes our net loss and certain changes in equity that are excluded from our net loss, including unrealized holding gains and losses on available-for-sale securities. SFAS 130 requires such changes in shareholders' equity to be included in accumulated other comprehensive income or loss. For the three month periods ended October 31, 2008 and 2007, our comprehensive loss was \$1,619,798 and \$1,006,346, respectively. During the three month periods ended October 31, 2008 and 2007, we recorded unrealized gains on available for sale securities of \$4,106 and \$2,358. Realized gains on the sale of available for sale securities, which are included in our net loss for the three month periods ended October 31, 2008 and 2007, were \$35,701 and \$5,902, respectively.

Net Loss Per Common Share

In accordance with FASB Statement No. 128, *Earnings Per Share* (SFAS 128), we compute basic loss per share by dividing the applicable net loss by the weighted average number of common shares outstanding during the respective period. Diluted per share amounts assume the conversion, exercise or issuance of all potential common stock equivalents, including stock options and warrants, unless the effect is to reduce a loss or increase the income per common share from continuing operations. As we incurred losses in three month periods ended October 31, 2008 and 2007, we did not include common stock equivalent shares in the computation of net loss per share as the effect would have been anti-dilutive. Therefore, both the basic and diluted loss per common share for the three month periods ended October 31, 2008 and 2007 are based on the weighted average number of shares of our common stock outstanding during the periods.

Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except Statement No. 123R and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-2, *Effective Date of FASB Statement No. 157*, which provides a one year deferral of the effective date of FAS 157 for non-financial assets and non-financial liabilities to years beginning after November 15, 2008 (our fiscal year ending July 31, 2010). As a result, we are only partially adopting SFAS No. 157 as it relates to our financial assets and liabilities until we are required to apply this pronouncement to our non-financial assets and liabilities beginning with fiscal year 2010.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS No. 159 are elective, however the amendment to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. The fair value option established by SFAS No. 159 permits all entities to choose to measure eligible items at fair value at specified election dates. Under SFAS No. 159, we would report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. This statement became effective for us August 1, 2008, however, we did not elect the fair value option for any of our financial assets or financial liabilities.

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In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141R). SFAS 141R replaces SFAS No. 141, *Business Combinations* and requires an acquirer in a business combination to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in SFAS 141R. SFAS 141R also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the non-controlling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141R). In addition, SFAS 141R's requirement to measure the non-controlling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the non-controlling interest in addition to that attributable to the acquirer. SFAS 141R amends SFAS No. 109, *Accounting for Income Taxes*, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination, or directly in contributed capital, depending on the circumstances. It also amends SFAS 142, *Goodwill and Other Intangible Assets*, to provide guidance on the impairment testing of acquired research and development intangible assets and assets that the acquirer intends not to use. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the adoption of the provisions of SFAS 141R to have a material effect on our financial condition, results of operations or cash flows.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 amends Accounting Research Bulletin 51, *Consolidated Financial Statements*, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the non-controlling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the adoption of the provisions of SFAS No. 160 to have a material effect on our financial condition, results of operations or cash flows.

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of the position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, and other U.S. generally accepted accounting principles. The provisions of FSP No. FAS 142-3 are effective for fiscal years beginning after December 15, 2008 (our fiscal year ending July 31, 2010). We are currently evaluating the impact, if any, that the adoption of FSP No. FAS 142-3 could have on our consolidated financial statements or results of operations.

Note 3. Fair Value

Effective August 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). In February 2008, the FASB issued FASB Staff Position (FSP) No. SFAS 157-2, *Effective Date of FASB Statement No. 157*, which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. As a result, we only partially adopted SFAS 157 as it relates to our financial assets and liabilities until we are required to apply this pronouncement to our non-financial assets and liabilities beginning with fiscal year 2010. The adoption of SFAS 157 did not have a material impact on our consolidated results of operations or financial condition.

In October 2008, the FASB issued FSP No. SFAS 157-3 *Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active* (FSP SFAS 157-3). FSP SFAS 157-3 clarifies the application of SFAS No. 157, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP SFAS 157-3 is effective upon issuance, including prior periods for which financial statements have not been issued. The adoption of FSP SFAS 157-3 had no impact on our consolidated results of operations, financial position or cash flows.

SFAS 157 defines fair value, establishes a framework for measuring fair value under U.S. GAAP and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. SFAS 157 describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

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

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- Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or 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.

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The following table represents our fair value hierarchy for our financial assets (cash equivalents and short-term investment) measured at fair value on a recurring basis as of October 31, 2008:

| | Level 1 | Level 2 | Level 3 | Total |
|-------------------------------|---------------------|-----------|-----------|---------------------|
| Money market funds | \$ 551,853 | \$ | \$ | \$ 551,853 |
| US Government debt securities | 4,081,099 | | | 4,081,099 |
| | \$ 4,632,952 | \$ | \$ | \$ 4,632,952 |
| Total | \$ 4,632,952 | \$ | \$ | \$ 4,632,952 |

Note 4. Other Equity and Common Stock Transactions

We paid no cash dividends during any of the periods presented, and have never paid cash dividends.

In August 2008, we received an aggregate of \$150,000 from the exercise of non-employee options to purchase 50,000 shares of our common stock at an exercise price of \$3.00, and received \$15,079 from the exercise of options to purchase 28,450 shares of our common stock by two officers, at an average exercise price of \$0.53.

In September 2008, we entered into a one year consulting agreement with an independent third party for intellectual property legal services, the compensation being a fee of \$11,000 per month and a two-year bi-annual vesting option to purchase 25,000 shares of our common stock. The options, which have an exercise price of \$4.41, were valued at \$59,745 using the Black-Scholes Option Pricing Model, assuming no dividend yield, volatility of 103.18% and a risk free interest rate of 2.00%. During the three month period ended October 31, 2008 we expensed \$4,979 of the options fair value to research and development. The options will be revalued quarterly until fully vested with any change to fair value expensed.

In October 2008, we issued 10,000 shares in exchange for consulting services, valued at \$24,600 based on the market price of \$2.46 per share. In addition, there was a net exercise from one of our directors on 165,000 options that resulted in the issuance of 133,430 shares of our common stock. As these shares were net exercised, as permitted under the respective option agreements, we did not receive any cash. Furthermore, during the three months ended October 31, 2008 we recorded \$57,412 of employee stock option expense.

At October 31, 2008, we had outstanding warrants to purchase 880,351 shares of our common stock with exercise prices ranging from \$0.50 to \$8.60. These warrants expire at various times between March 2009 and October 2012.

Note 5. Stock-Based Compensation

We have, or have had during the fiscal years presented herein, the following equity incentive plans (the Plans) pursuant to which we have granted options to acquire our common stock: the 1998 Directors and Officers Stock Option Plan; the 2001 Directors and Officers Stock Option Plan; the 2001 ETIH2O Stock Option Plan; the 2001 Consultants and Advisors Stock Option Plan; the 2002 Non-Qualified Stock Option Plan; the 2002 Employee Incentive Stock Option Plan; the 2004 Consultants and Advisors Stock Option Plan; and the 2007 Equity Incentive Plan. The Plans are administered by the Compensation Committee of the Board of Directors (the Compensation Committee). The exercise price for stock options, or the value of other incentive grants granted under the Plans, are set by the Compensation Committee but may not be for less than the fair market value of the shares on the date the award is granted. The period in which options can be exercised is set by the Compensation Committee but is not to exceed five years from the date of grant.

On August 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS123(R)), requiring us to recognize expense related to the fair value of share-based compensation awards to employees and directors. We elected to use the modified-prospective-transition method as permitted by SFAS 123R and therefore have not restated our financial results for prior fiscal years. We recognize compensation expense for stock option awards on a straight-line basis over the applicable service period of the award. The service period is generally the vesting period, with the exception of options granted subject to a consulting agreement, whereby the option vesting period and the service period defined pursuant to the terms of the consulting agreement may be different. Share-based compensation expense for awards granted subsequent to July 31, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R, using the Black-Scholes Option Pricing Model. The following methodology and assumptions were used to calculate share based compensation for the three month periods ended October 31, 2008 and 2007:

For the three month periods ended October 31,

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For the three month periods ended October 31,

| | 2008 | 2007 |
|--------------------------------|------------------|-----------------|
| Expected price volatility | 97.70% - 103.18% | 88.27% - 91.36% |
| Risk-free interest rate | 2.00% | 5.25% |
| Expected rate of forfeiture | 0.0% | 0.0% |
| Expected dividend yield | 0.0% | 0.0% |
| Weighted average expected term | 1.89 years | 1.63 years |

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Expected price volatility is the measure by which our stock price is expected to fluctuate during the expected term of an option. Expected volatility is derived from the historical daily change in the market price of our common stock, as we believe that historical volatility is the best indicator of future volatility. For stock options granted subsequent to July 31, 2006, we have excluded the period prior to November 1, 2005 from our historical price volatility, as during this period our market price reflected significant uncertainty associated with both our arbitration proceedings against Falken Industries and our ability to close the sale of the assets of the Water Treatment Division. We believe that the volatility of the market price of our common stock during periods prior to November 1, 2005 is not reflective of future expected volatility.

Following the guidance of Staff Accounting Bulletin No. 107 (SAB 107), we have been following the Simplified Method to determine the expected term of Plain Vanilla options issued to employees and directors. All of our outstanding options granted to employees and directors are Plain Vanilla options. Under the Simplified Method, the expected term is presumed to be the mid-point between the vesting date and the end of the contractual term. In SAB 107, the Staff stated that it would not expect a company to use the Simplified Method for share option grants after December 31, 2007, however on December 21, 2007, the SEC published Staff Accounting Bulletin No. 110 (SAB 110), which expressed the views of the Staff regarding the continued use of a Simplified Method in certain circumstances where a company is unable to rely on historical data. We are unable to rely on our historical exercise data as there have been only a limited number of option exercises in recent periods; there have been a limited number of plan participants which is expected to grow; our common stock was traded until April 2008 on the illiquid Bulletin Board but our common stock is now listed on the NASDAQ Capital Market; we have had over recent years significant trading blackout periods for employees and directors; there has been minimal employee and director turnover; we have recently changed the terms of employee stock option grants to reduce the term of such grants; there are no comparable companies in terms of size, location and industry (particularly as we are developing a platform technology and operate in multiple industries); and we have had significant structural changes in our business including the sale of the Water Treatment Division and abandonment of our Triglycylboride technology, and expect to continue to change in the foreseeable future. We are therefore, under the guidance of SAB 110, continuing to use the Simplified Method to determine the expected term of options issued to employees and directors, but will continually evaluate our historical data as a basis for determining the expected terms of such options.

Our estimation of the expected term for stock options granted to parties other than employees or directors is the contractual term of the option award.

For the purposes of estimating the fair value of stock option awards, the risk-free interest rate used in the Black-Scholes calculation is based on the prevailing U.S. Treasury yield as determined by the U.S. Federal Reserve. We have never paid any cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future.

Stock-based compensation expense recognized in the consolidated statements of operations is based on awards ultimately expected to vest, reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant, and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Historically, we have not had significant forfeitures of unvested stock options granted to employees and directors. A significant number of our stock option grants are fully vested at issuance or have short vesting provisions. Therefore, we have estimated the forfeiture rate of our outstanding stock options as zero, but will continually evaluate our historical data as a basis for determining expected forfeitures.

The following table sets forth the share-based compensation expense recorded in our consolidated statements of operations for the three month periods ended October 31, 2008 and 2007 resulting from share-based compensation awarded to our employees, directors and third party service providers:

| | Three Months Ended October 31, 2008 | Three Months Ended October 31, 2007 |
|--|--|--|
| Share-based compensation for employees and directors: | | |
| Selling expense | \$ | \$ |
| General and administrative expenses | 57,412 | 24,822 |
| Research and development | | |
| | 57,412 | 24,822 |
| Share-based compensation for third party service providers: | | |
| Selling expense | \$ | \$ |
| General and administrative expenses | 24,600 | 43,750 |
| Research and development | 4,979 | |
| | 29,579 | 43,750 |
| Total share-based compensation for third party service providers | 29,579 | 43,750 |
| Total share-based compensation expense | \$ 86,991 | \$ 68,572 |

| Three Months Ended October 31, 2008 | Three Months Ended October 31, 2007 |
|--|--|
| <hr/> <hr/> | <hr/> <hr/> |

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A summary of stock option activity is as follows:

| | Number of Shares | Weighted-Average Exercise Price (\$) | Aggregate Intrinsic Value (\$000's) |
|-----------------------------|---------------------|---|---|
| Balance at July 31, 2008 | 7,442,447 | \$1.62 | |
| Granted | 35,000 | \$4.41 | |
| Exercised | (211,880) | \$1.11 | |
| Forfeited / Cancelled | (131,570) | \$0.74 | |
| Balance at October 31, 2008 | 7,133,997 | \$1.67 | \$ 14,152 |

| Range of Exercise Prices | Outstanding | | | Exercisable | | |
|--------------------------|---------------------------------|---|--|---------------------------------|---|--|
| | Number of Shares Outstanding | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Number of Shares Exercisable | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price |
| \$0.50 to \$0.75 | 2,364,531 | 1.27 | \$0.53 | 2,364,531 | 1.27 | \$0.53 |
| \$0.80 to \$1.20 | 729,166 | 2.07 | \$0.81 | 729,166 | 2.07 | \$0.81 |
| \$1.50 to \$7.50 | 4,040,300 | 2.12 | \$2.49 | 3,696,300 | 2.23 | \$2.39 |
| | 7,133,997 | 1.83 | \$1.67 | 6,789,997 | 1.88 | \$1.57 |

Cash received from options exercised for the three month periods ended October 31, 2008 and 2007 was \$165,079 and \$363,750, respectively. The intrinsic value of all options exercised during the three month periods ended October 31, 2008 and 2007 was \$505,784 and \$3,337,650, respectively, and the weighted-average grant date fair value of equity options granted during the three month periods ended October 31, 2008 and 2007 was \$2.30 and \$3.69, respectively.

As of October 31, 2008, there was \$265,375 of unrecognized non-cash compensation cost related to unvested options, which will be recognized over a weighted average period of 1.3 years.

Note 6. Inventory

Inventories are stated at the lower of cost or net realizable value using the average cost method. Inventories at October 31, 2008 and July 31, 2008 consisted of:

| | October 31, 2008 | July 31, 2008 |
|------------------|------------------|---------------|
| Raw Materials | \$ 243,256 | \$ 252,491 |
| Work in Progress | | |
| Finished Goods | 188,766 | 117,552 |
| | \$ 432,022 | \$ 370,043 |

Note 7. Business Segment and Sales Concentrations

In accordance with the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, certain information may be disclosed based on the way we organize financial information for making operating decisions and assessing performance. SFAS 131 requires that we apply standards based on a management approach, and requires segmentation based upon our internal organization and

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disclosure of revenue and operating income based upon internal accounting methods. In determining operating segments, we have reviewed the current management structure reporting to the chief operating decision-maker (CODM) and analyzed the reporting the CODM receives to allocate resources and measure performance.

We have determined that based upon the end use of our products, the value added contributions made by us, the regulatory requirements, the customers and partners, and the strategy required to successfully market finished products, we are operating in a single segment.

Our customers are strategic partners who are developing markets for products that include our SDC technology, and distributors who sell products containing SDC under multiple regulatory approvals. During the three month period ended October 31, 2008, 83% of sales were made to three strategic partners that are also developing markets for our products. 100% of sales for the period were made to U.S. domestic customers.

All of our tangible assets are located in the United States.

Note 8. Subsequent Events

There have been no subsequent events.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report on Form 10-Q to conform such statements to actual results or to changes in our expectations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part II of this Quarterly Report under the Caption Risk Factors and in our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended July 31, 2008, previously filed with the Securities and Exchange Commission (SEC).

Risk factors that could cause actual results to differ from those contained in the forward-looking statements include but are not limited to: our limited operating history; our history of losses; our future capital needs; the rapidly changing technologies and market demands; the failure of our products to achieve broad acceptance; our failure to successfully compete; our dependence on a single product; our failure to comply with government regulation; the loss of a key member of our management team; our failure to protect our intellectual property; our exposure to intellectual property and product liability claims; changes in government policies and other risks identified in Item 1A of this Quarterly Report on Form 10-Q.

OVERVIEW

PURE Bioscience (sometimes referred to herein as the Company or we) was incorporated in the state of California on August 24, 1992. We began as a provider of pharmaceutical water purification products. We now focus on markets that we believe have broader potential by developing new, proprietary bioscience products based upon our patented silver ion antimicrobial technologies. We are developing technology-based bioscience products, including our silver dihydrogen citrate-based antimicrobials, which we believe have the potential to provide best in class, non-toxic solutions to numerous global health challenges and represent innovative advances in diverse markets. We believe that our technologies are in a position to contribute significantly to today s global trend toward industrial and consumer use of green products, while providing competitive advantages in efficacy and safety.

Bioscience Technologies

Our flagship bioscience technology is an aqueous disinfectant, silver dihydrogen citrate (SDC). A patented new molecular entity, SDC is an electrolytically generated source of stabilized ionic silver that can serve as the basis for a broad range of products in diverse markets. SDC liquid is colorless, odorless, tasteless, non-caustic and formulates well with other compounds. As a platform technology, our SDC-based antimicrobial is distinguished from competitors in the marketplace because of its superior efficacy combined with reduced toxicity. We are producing and plan to expand the production of pre-formulated, ready-to-use products for private label distribution, as well as varying strengths of SDC concentrate as an additive or raw material for inclusion in other companies products, including as an active pharmaceutical ingredient. In addition to SDC, we have obtained patent protection for ionic silver-based molecular entities utilizing 14 organic acids other than citric acid.

We also own certain rights to a patent-pending pesticide technology, Triglycylboride which, like SDC, provides effective results without human toxicity and is an alternative to traditional poisons. Triglycylboride has been formulated into our Environmental Protection Agency (EPA) registered RoachX® and AntX products, though these products are not currently being actively marketed or developed.

Sources of Revenue

Our principal sources of revenue are comprised of sales of SDC concentrate as well as both bulk and individually bottled SDC-based hard surface disinfectant. SDC concentrate is sold to distributors that either resell the concentrate as an active ingredient or preservative in other companies products, or blend the product into hard surface disinfectant products for sale to retail, commercial and institutional customers.

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SDC-based hard surface disinfectant is sold in bulk and as individually bottled products to distributors that in turn sell the product to retail, commercial and institutional customers. In addition to sales of SDC concentrate and finished goods, we anticipate generating additional revenues from licensing and royalty arrangements in future periods.

Cost of Revenues and Operating Expenses

Costs of Revenue. Costs of revenue includes materials consumed, manufacturing overheads, shipping costs, salaries, benefits and related expenses of operations. Gross profit represents net revenue less the costs of revenue. Gross profit percentage is highly dependent on contract agreements, royalty receipts and overhead allocations. We do not believe that historical gross profit margins are a reliable indicator of future gross profit margins.

Selling and Marketing. Selling and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses also include share-based compensation allocable to personnel performing services related to sales and marketing.

General and Administrative. General and administrative expenses include salaries and related expenses for personnel engaged in finance, human resources, insurance, information technology, administrative activities and legal and accounting fees. General and administrative expenses also include share-based compensation allocable to personnel performing general and administrative services.

Research and Development. Research and development costs include in-house costs, patent amortization, outside legal costs for maintaining issued patents, and product registration expenditures, We do not currently expect our research and development expense to grow significantly in future periods, however if opportunities arise, particularly in the development and testing of new formulations, we will evaluate the need for additional research expenditures based on potential market sizes and our estimation of the likelihood of our technology achieving successful results.

CRITICAL ACCOUNTING POLICIES

Accounting for Long-Lived Assets / Intangible Assets

We assess the impairment of long-lived assets, consisting of property, plant, equipment and finite-lived intangible assets, whenever events or circumstances indicate that the carrying value may not be recoverable. Examples of such events or circumstances include:

An asset's ability to continue to generate income from operations and positive cash flow in future periods;

Loss of legal ownership or title to an asset;

Significant changes in our strategic business objectives and utilization of the asset(s); and

The impact of significant negative industry or economic trends.

Recoverability of assets to be held and used in operations is measured by a comparison of the carrying amount of an asset to the future net cash flows expected to be generated by the assets. The factors used to evaluate the future net cash flows, while reasonable, requires a high degree of judgment and the results could vary if the actual results are materially different than the forecasts. In addition, we base useful lives and amortization or depreciation expense on our subjective estimate of the period that the assets will generate revenue or otherwise be used by us. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.

We also periodically review the lives assigned to our intangible assets to ensure that our initial estimates do not exceed any revised estimated periods from which we expect to realize cash flows from the technologies. If a change were to occur in any of the above-mentioned factors or estimates, the likelihood of a material change in our reported results would increase.

Accounting for Stock-Based Compensation

We adopted the fair value provisions of SFAS 123(R) on August 1, 2006. Stock-based compensation expense for all stock-based compensation awards granted after August 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Specifically, we estimate the weighted-average fair value of options granted using the Black-Scholes Option Pricing Model based on evaluation assumptions regarding expected volatility, dividend yield, risk-free interest rates, the expected term of the option and the expected forfeiture rate. Each of these assumptions, while reasonable, requires a certain degree of judgment and the fair value estimates could vary if the actual results are materially different than those initially applied. Prior to the adoption of SFAS 123(R), we were not required to record compensation cost in the consolidated financial statements for stock options issued to employees or directors.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED OCTOBER 31, 2008 VS. THREE MONTHS ENDED OCTOBER 31, 2007

Revenue and Gross Margin

For the three months ended October 31, 2008 (the First Quarter), revenues of \$110,600 increased by \$15,300, or 16%, compared with the three months ended October 31, 2007. The increase is primarily due to new customers with whom we have entered into development and distribution agreements over the last year. 83% of sales for the First Quarter were made to three strategic partners that are pursuing regulatory approvals and developing markets for our products. 100% of sales for the First Quarter were to U.S. domestic customers.

Gross profit for the First Quarter was \$50,800, compared with \$63,600 in the same period of the prior fiscal year. The gross margin percentage decreased from 67% in the prior fiscal year to 46% in the current period, due primarily to product mix. During the First Quarter, sales were primarily from finished packaged products, while during the three months ended October 31, 2007 a higher proportion of sales were from bulk SDC concentrate, which we sell at higher margins.

Operating Costs

Operating costs increased by \$616,600, from \$1,084,000 in the three months ended October 31, 2007, to \$1,700,600 in the First Quarter. Within these aggregate operating costs, selling expenses increased by \$63,000 to \$151,200 in the First Quarter compared with the same period in the prior fiscal year. The increase in selling expenses is primarily due to approximately \$75,500 of additional salary expense, which was partially

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offset by \$12,500 of consulting fees in the three month period ended October 31, 2007.

General and administrative expenses increased by \$554,800, to \$1,262,400 in the First Quarter, compared with the three months ended October 31, 2007. Accounting fees increased by \$97,300 compared with the same period in the prior fiscal year. The increase was mainly due to costs associated with Sarbanes-Oxley compliance. Legal fees charged to general and administrative expense, primarily related to the development of contracts and protection of our intellectual property, increased by \$127,000 compared to the same period in the prior fiscal year. Additionally, payroll related expenses increased quarter-over-quarter by \$207,400 due to new hires, salary increases and bonuses. Other general and administrative expenditures such as depreciation, insurance and board of director fees also increased during the First Quarter.

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Research and development costs decreased by \$1,200 from \$288,200 in the three months ended October 31, 2007 to \$287,000 in the First Quarter. Decreases in patent maintenance fees and third party consulting were partially offset by increases in payroll, stock option expense and third-party testing. We do not currently expect our research and development expense to grow significantly in future periods; however, if opportunities arise, particularly in the development and testing of new formulations, we will evaluate the need for additional research expenditures based on potential market sizes and our estimation of the likelihood of our technology achieving successful results.

Our loss from operations before taxes increased by \$629,400 from a loss of \$1,020,400 for the three months ended October 31, 2007 to a loss of \$1,649,800 for the First Quarter.

Other Income

Other income increased by \$32,700 in the First Quarter compared to the same period of the prior fiscal year. Gains on the sale of U.S. Treasury Bills were partially offset by decreased interest income from lower average cash balances and lower interest rates.

Net Income (Loss)

Our net loss after taxes increased by \$596,600 from a net loss of \$1,008,700 for the three months ended October 31, 2007 to a net loss of \$1,605,300 for the First Quarter.

LIQUIDITY AND CAPITAL RESOURCES

From inception through the present, we have financed our operations primarily through sales of our equity securities, through lines of credit and the issuance of debentures and in May 2005 by the sale of our Water Treatment Division. At October 31, 2008, we had cash, cash equivalents and short-term investments of \$5,128,900, a decrease of \$1,503,400 from July 31, 2008, and no long-term debt.

Total current assets at October 31, 2008 were \$6,425,900, a decrease of \$1,463,700 from July 31, 2008.

Total cash inflows from financing activities for the First Quarter were \$165,100. In August 2008, we received an aggregate of \$150,000 from the exercise of non-employee options to purchase 50,000 shares of our common stock at an exercise price of \$3.00, and received \$15,100 from the exercise of options to purchase 28,450 shares of our common stock by two officers, at an average exercise price of \$0.53. Cash and cash equivalents at October 31, 2008 were \$1,047,800, a decrease for the three month period from July 31, 2008 of \$976,600, while short-term investments decreased over the same period by \$526,800, to \$4,081,100.

During the First Quarter, cash provided by investing activities was \$451,700. Of this amount, a net amount (cash purchases less cash sales) of \$512,300 was invested in short-term investments. In addition, during the First Quarter we invested \$19,700 in patents; however, the capitalized value of our patents at October 31, 2008, primarily related to our silver ion technology, declined by \$23,000 due to an excess of patent amortization over capitalization. Total property, plant and equipment at October 31, 2008 of \$1,010,000 declined by \$24,800 from July 31, 2008 due to an excess of depreciation over new asset acquisitions of \$40,900.

Cash used in operating activities for the First Quarter was \$1,593,400, compared with \$1,087,000 for the same three month period of the prior fiscal year. The increase in operating cash expenditures is primarily a result of increased general and administrative expenses including payroll, insurance, patent related research and development and amounts paid for professional services. Accounts receivable grew by \$8,100 from July 31, 2008 to October 31, 2008, while the value of our raw materials and finished goods inventory grew by \$62,000 over the same period, primarily due to the purchase of raw materials for our concentrate manufacturing and our bottling processes. In addition, prepaid expenses decreased by \$30,400 from July 31, 2008 to October 31, 2008, due to the amortization of prepaid insurance policies of the succeeding year.

At October 31, 2008, we had current liabilities of \$835,800, a decrease of \$145,700 from July 31, 2008, primarily due to a decline in accounts payable.

At October 31, 2008, we had receivables of \$781,600 due from two strategic partners. Although these receivables are out of term, we have not established a reserve because management currently considers the receivables to be fully collectible.

We expect to continue to invest in our manufacturing processes, to improve efficiency and to ensure that we are able to meet anticipated demand. Additionally, during the next twelve months, we anticipate making significant investments in regulatory applications for new products or additional claims, in our corporate and business development infrastructure and in programs required for us to maintain our compliance with securities laws as well as the listing standards of the NASDAQ Capital Market, among other investments. We believe, however, that our existing cash resources are sufficient to meet our anticipated needs during the next twelve months.

OFF BALANCE SHEET ARRANGEMENTS

We do not have any off balance sheet arrangements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk at October 31, 2008 is related to our investment portfolio which consists largely of debt instruments and other securities of high quality corporate issuers and the U.S. government and its agencies. From time to time our investments may be exposed to market risk related to changes in interest rates. Our current investment policy is to maintain an investment portfolio consisting only of diversified institutional money market mutual funds investing in A-1 (S&P) or Prime-1 (Moody's); U.S. Treasury Securities, or United States Government obligations issued by or backed by a federal agency of the United States Government. We do not enter into investments for trading or speculative purposes, and our cash is deposited in, and invested through, highly rated financial institutions in the United States. While our available for sale securities are subject to interest rate risk and would fall in value if market interest rates increased, we estimate that the fair value of our investment portfolio would not decline by a material amount in the event of an increase in market interest rates. We therefore would not expect our operating results or cash flows to be affected to any significant degree by the effect of a change in market interest rates on our investments. We have operated mainly in the United States, and the majority of our sales since inception have been made in U.S. dollars. Further, all of our sales to international markets have been to independent parties in transactions conducted in U.S. dollars. Accordingly, we have not had any material exposure to foreign currency rate fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, who also acts as our Principal Accounting Officer, as appropriate, to allow timely decisions regarding required disclosure based closely on the definition of disclosure controls and procedures in Rule 13a-14(c). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Changes in Internal Control Over Financial Reporting

We made no changes in our internal control over financial reporting during the first quarter of fiscal year 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Evaluation of Disclosure Controls and Procedures

We have carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer/Principal Accounting Officer, of the effectiveness of the design and operation of all of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer/Principal Accounting Officer concluded that our disclosure controls and procedures were effective as of October 31, 2008.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

Except for the historical information contained herein or incorporated by reference, this quarterly report on Form 10-Q and the information incorporated by reference contains forward-looking statements that involve risks and uncertainties. These statements include projections about our accounting and finances, plans and objectives for the future, future operating and economic performance and other statements regarding future performance. These statements are not guarantees of future performance or events. Our actual results may differ materially from those discussed here. Factors that could cause or contribute to differences in our actual results include those discussed in the following section, as well as those discussed in Part I, Item 2 entitled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere throughout this quarterly report on Form 10-Q and in any other documents incorporated by reference into this report. You should consider carefully the following risk factors, together with all of the other information included or incorporated in this quarterly report on Form 10-Q. Each of these risk factors, either alone or taken together, could adversely affect our business, operating results and financial condition, as well as adversely affect the value of an investment in our common stock. There may be additional risks that we do not presently know of or that we currently believe are immaterial which could also impair our business and financial position. If any of the events described below were to occur, our financial condition, results of operations and future growth prospects could be materially and adversely affected and the market price of our common stock could decline. As a result you could lose some or all of any investment you may have made or may make in our common stock.

We have a history of losses, and we may not achieve or maintain profitability

We had a loss of \$1,605,316 after taxes for the three month period ended October 31, 2008, a loss of \$6,540,300 after taxes for the fiscal year ended July 31, 2008, and a loss of \$4,654,900 after taxes for the fiscal year ended July 31, 2007. As of October 31, 2008, we had an accumulated deficit of approximately \$33.0 million. We may continue to have losses in the future. If the penetration into the marketplace of SDC is later than anticipated, revenue growth is slower than anticipated or operating expenses exceed expectations, it may take an unforeseen period of time to achieve or sustain profitability and we may never achieve or sustain profitability. Slower than anticipated revenue growth could force us to reduce research, testing, development and marketing of our technology and/or force us to reduce the size and scope of our operations, or cease operations altogether. If we do become profitable in future periods, we have an employment contract with our Chief Executive Officer and President which includes a provision for him to be paid an amount equal to 3% of our net income before taxes, if any. Such payments would reduce our profitability.

We do not yet have significant cash inflows from product sales to offset our ongoing and planned investments in corporate infrastructure, research and development projects, regulatory submissions, business development activities, and sales and marketing, among other investments. These investments may not be successful. In addition, some of these investments cannot be postponed and we may be contractually or legally obligated to make them. In future periods we may need to seek additional capital through the issuance of debt, equity, convertible securities or through other means, any one of which could reduce the value to us, perhaps substantially, of our technology and its commercial potential. We currently have no long-term debt, however the issuance of debt, equity or convertible securities in future periods, if any, could lead to the dilution of our existing shareholders. There is no guarantee that we would be able to obtain capital on terms acceptable to us, or at all. Insufficient funds could cause us to fail to execute our business plan, fail to take advantage of future opportunities, or fail to respond to competitive pressures or unanticipated customer requirements, and further may require us to delay, reduce or eliminate some or all of our research and product development programs, license to third parties the right to commercialize products or technologies that we would otherwise commercialize ourselves, or to reduce or cease operations.

In addition, the risks associated with our business may more acute during periods of economic slowdown or recession. In addition to other consequences, these periods may be accompanied by decreased consumer spending generally, as well as decreased demand for, or additional downward pricing pressure on, our products. Accordingly, any prolonged economic slowdown or a lengthy or severe recession with respect to either the U.S. or the global economy is likely to have a material adverse effect on our results of operations, financial condition and business prospects. As a result, given the deteriorating position of the U.S. and global economy, as well as the decreasing purchasing power of consumers, we expect that our business will continue to suffer for so long as, and to the extent that, such adverse economic conditions exist.

If our efforts to achieve and maintain market acceptance of our core SDC technology are not successful, or we fail to obtain necessary governmental approval, we are unlikely to attain profitability

We have invested a significant portion of our time and financial resources in the development and commercialization of our core SDC technology. Although we believe SDC has applications in multiple industries, we expect that sales of SDC will constitute a substantial portion, or all, of our revenues in future periods. Any material decrease in the overall level of sales or expected sales of, or the prices for SDC, whether as a result of competition, change in consumer demand, or any other factor, would have a materially adverse effect on our business, financial condition and results of operations.

We are marketing our new antimicrobial silver ion technology to industrial and consumer markets. These products have not yet been accepted into the marketplace, and may never be accepted. In addition, even if our products achieve market acceptance, we may not be able to maintain that market acceptance over time if new products or technologies are introduced that are more favorably received than our products, are more cost-effective or otherwise render our products less attractive or obsolete. Other risks involved in introducing these new products include liability for product effectiveness and safety, and competition from existing or emerging sources. Additionally, government regulation in the U.S. and in other countries is a significant factor in the development, manufacturing and marketing of many of our products and in our ongoing research and development activities. Complying with applicable government regulations and obtaining necessary clearances or approvals can be time consuming and expensive, and there can be no assurance that regulatory review will not involve delays or other actions adversely affecting the marketing and sale of our products. We also cannot predict the extent or impact of future legislation or regulation. Some of our new bioscience applications for the healthcare markets and food preparation markets will require approval by government agencies prior to marketing or sale in the U.S. We have not yet applied for FDA or Department of Agriculture approval to market any such products. If any future product applications are not approved by the appropriate regulatory authority, we will not be able to market or sell such products, which would limit our revenues. Even after approval, if any, we will remain subject to changing governmental policies regulating antimicrobial products.

If we are not able to manage our anticipated growth effectively, we may not become profitable

We anticipate that expansion will continue to be required to address potential market opportunities for our SDC technology. There can be no assurance that our infrastructure will be sufficiently scalable to manage any future growth. There also can be no assurance that if we continue to expand our operations, management will be effective in expanding our physical facilities or that our systems, procedures or controls will be adequate to support such expansion. In addition, we will need to provide additional sales and support services if we achieve our anticipated growth with respect to the sale of our SDC technology for various applications. Failure to properly manage an increase in customer demands could result in a material adverse effect on customer satisfaction, our ability to perform on new contracts and on our operating results.

The industries in which we operate are heavily regulated and we may be unable to compete effectively

We are a bioscience company focused on the marketing and continued development of our electrolytically generated stabilized ionic silver technology, including our flagship SDC antimicrobial. While the rewards in these fields are potentially great, the risks, regulatory hurdles and costs of doing business in our target markets are high. Our SDC is a platform technology rather than a single use applied technology. As such, products developed from the platform fall under the jurisdiction of multiple U.S. and international regulatory agencies. We currently have EPA registration for our 2400-parts per million (ppm) technical grade SDC concentrate (trade name Axenohl), as well as for our Axen and Axen30 hard surface disinfectant products for commercial, industrial and consumer applications including restaurants, homes and medical facilities. We intend to fund and manage additional EPA-regulated product development internally, in conjunction with our regulatory consultants and potentially by partnering with other third parties. We are also partnering, or intend to partner, with third parties who are seeking, or intend to seek, approvals to market SDC-based products in markets outside the U.S. However, the introduction of additional regulated antimicrobial products in the U.S. or in markets outside the U.S. could take several years, or may never be achieved. In addition, doing business internationally carries a great deal of risk with regard to foreign government regulation, banking and other factors.

We are subject to intense competition

Our silver ion and other products compete in highly competitive markets dominated by extremely large, well financed domestically and internationally recognized chemical and pharmaceutical companies. Many of our competitors have greater financial resources than we do in the areas of sales, marketing, branding and product development and we expect to face additional competition from these competitors in the future. Many of our competitors already have well established brands and distribution. Focused competition by chemical and pharmaceutical giants could substantially limit or eliminate our potential market share and ability to profit from our products and technologies. Our ability to compete will depend upon our ability, and the ability of our distributors and other partners, to develop brand recognition and novel distribution methods, and to displace existing, established and future products in our relevant target markets. We or our partners or distributors may not be successful in doing so.

We rely on a small number of key supply ingredients in order to manufacture our products

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All of the supply ingredients used to manufacture our products are readily available from multiple suppliers. However, commodity prices for these ingredients can vary significantly and the margins that we are able to generate could decline if prices rise. For example, both silver and citric acid prices have risen recently. A decision is expected imminently by the European Commission on an antidumping action against Chinese citric acid producers, a dominant force in the global citric acid market, which has caused global citric acid price increases in anticipation of antidumping duties that the European Commission could impose on Chinese producers. Any measures could be followed by similar action from the authorities in the U.S. In many of our distribution and development agreements, we are unable to raise our product prices to our customers quickly to maintain our margins, and significant price increases for key inputs would therefore have an adverse effect on our results of operations.

If we are unable to successfully develop or commercialize new applications of our SDC technology, our operating results will suffer

In addition to its use on inanimate surfaces, we believe that our SDC technology also shows promise as a broad-spectrum antimicrobial for use in human and veterinary healthcare products. We plan to pursue additional EPA and FDA regulatory approvals for other applications. We have entered into agreements with Therapeutics and with FTA for the development and commercialization of certain FDA regulated SDC-based products. However, we do not exercise any control over these development partners. Both Therapeutics and FTA's resources are limited and progress to date on all indications has been slow. The FDA and comparable agencies in many foreign countries impose substantial limitations on the introduction of new products through costly and time-consuming laboratory and clinical testing and other procedures. The process of obtaining FDA and other required regulatory approvals is lengthy, expensive and uncertain. There is no guarantee that either our existing or any other potential partner, or we, will be able to obtain the resources necessary to further develop our technology or obtain regulatory approvals, or that the products will be successful in meeting the strict criteria imposed by the FDA. It may be several years before we, or any third party to whom we grant rights to use our silver ion technologies, are able to introduce any FDA regulated antimicrobial pharmaceutical products containing our technology. Such products may never achieve regulatory approval and may never be commercialized. If they are commercialized, we may not receive a share of future revenues that provides an adequate return on our historical or future investment.

Our ability to generate increased revenue depends in part upon the ability and willingness of our current and potential strategic partners in both FDA and non-FDA environments to increase awareness of our solution to their customers and provide implementation services. If our strategic partners fail to increase awareness of our solution or to assist us in getting access to decision-makers, then we may need to increase our marketing expenses, change our marketing strategy or enter into marketing relationships with different parties, any of which could impair our ability to generate increased revenue.

Because we are an early stage company, it is difficult to evaluate our prospects, our financial results may fluctuate and these fluctuations may cause our stock price to fall

Since acquiring the rights to our SDC technology, we have encountered and likely will continue to encounter risks and difficulties associated with new and rapidly evolving markets. These risks include the following, among others:

we may not increase our sales to our existing customers and expand our customer base;

we may not succeed in maintaining and expanding our current sales and in penetrating other markets and applications of our SDC technology;

we may not establish and maintain effective marketing programs and continue to build our brand identity;

we may not attract and retain key business development, technical and management personnel;

we may not succeed in locating strategic partners and licensees of our technology; and

we may not effectively manage our anticipated growth.

In addition, because of our limited operating history and the early stage of the market for our SDC technology, we have limited insight into trends that may emerge and affect our business. Forecasting future revenues is difficult, especially since our technology is novel and we are at the early stages of the adoption of such technology. Market acceptance of our products may change rapidly. In addition, our customer base is highly concentrated. Fluctuations in the buying patterns of our current or potential customers for any reason, could significantly affect the level of our net sales on a period to period basis. As a result, our financial results could fluctuate to an extent that may not meet market expectations and that also may adversely affect our stock price. There are a number of other factors that could cause our financial results to fluctuate unexpectedly, including product sales, cost of product sales, the achievement and timing of research and development and regulatory milestones, changes in expenses, including non-cash expenses such as the fair value of stock options granted, and manufacturing or supply issues.

We have no product distribution experience and we expect to rely on third parties who may not successfully sell our products

We have no product distribution experience and currently rely and plan to rely primarily on product distribution arrangements with third parties, including our collaborators. We also plan to license our technology to certain third parties for commercialization of certain applications. We expect to enter into additional distribution agreements and licensing agreements in the future, and we may not be able to enter into these additional agreements on terms that are favorable to us, if at all. In addition, we may have limited or no control over the distribution activities of these third parties. These third parties could sell competing products and may devote insufficient sales efforts to our products. As a result, our future revenues from sales of our products, if any, will depend on the success of the efforts of these third parties.

If we are unable to obtain, maintain or defend patent and other intellectual property ownership rights relating to our technology, we may not be able to develop and market products based on our technology, which would have a material adverse impact on our results of operations and the price of our common stock

We rely and expect in the future to rely on a combination of patent, trademark, trade secret and copyright law and contractual restrictions to protect the proprietary aspects of our technology and business. These legal protections afford only limited protection for our intellectual property and trade secrets. Despite efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our proprietary technology or otherwise obtain and use information that we regard as proprietary. As a result, we cannot assure you that our means of protecting our proprietary rights will be adequate.

We have filed for U.S. and foreign patent applications and trademark registrations for our patents and trademarks. We may not be successful in obtaining these patents and trademarks, and we may be unable to obtain additional patent and trademark protection in the future. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. It is possible that, despite our efforts, competitors or others will create and use products in violation of our patents and/or adopt service names similar to our service names or otherwise misappropriate our intellectual property. Such patent infringement or misappropriation could have a material adverse effect on our business. Any unauthorized production of our SDC-based products, whether in the U.S. or overseas, would or could reduce our own sales of SDC-based products, thereby reducing, perhaps significantly, our actual or potential profits. Adopting similar names and trademarks by competitors could lead to customer confusion. Any claims or customer confusion related to our trademarks could negatively affect our business.

Litigation may be necessary to enforce our intellectual property rights and protect our trade secrets. If third parties prepare and file applications in the U.S. or other countries that claim trademarks used or registered by us, we may oppose those applications and may be required to participate in proceedings before the regulatory agencies who determine priority of rights to such trademarks. Any litigation or adverse priority proceeding could result in substantial costs and diversion of resources, and could seriously harm our business and operating results. If we are found to have violated the trademark, trade secret, copyright, patent or other intellectual property rights of others, such a finding could result in the need to cease use of a trademark, trade secret, copyrighted work or patented invention in our business and the obligation to pay a substantial amount for past infringement. It could also be necessary for us to pay a substantial amount in the future if the rights holders are willing to permit us to continue to use the intellectual property rights. Either having to cease use or pay such amounts could make us much less competitive and could have a material adverse impact on our business, operating results and financial condition.

To the extent that we operate internationally, the laws of foreign countries may not protect our proprietary rights to the extent as do the laws of the U.S. Many countries have a first-to-file trademark registration system. As a result, we may be prevented from registering or using our trademarks in certain countries if third parties have previously filed applications to register or have registered the same or similar trademarks. Our means of protecting our proprietary rights may not be adequate, and our competitors could independently develop similar technology.

We may become subject to product liability claims

As a business which manufactures and markets products for use by consumers, we may become liable for any damage caused by our products when used in the manner intended. Any such claim of liability, whether meritorious or not, could be time-consuming and/or result in costly litigation. Although we maintain general liability insurance, our insurance may not cover potential claims of the types described above and may not be adequate to indemnify for all liabilities that may be imposed. Any imposition of liability that is not covered by insurance or is in excess of insurance coverage could harm our business and operating results, and you may lose some or all of any investment you have made, or may make, in our common stock.

Litigation may harm our business or otherwise distract our management

Substantial, complete or extended litigation could cause us to incur large expenditures and distract our management. For example, lawsuits by employees, shareholders or customers could be very costly and substantially disrupt our business. Disputes from time to time with such companies or individuals are not uncommon, and we cannot assure you that we will always be able to resolve such disputes on terms favorable to us.

Maintaining compliance with our obligations as a public company may strain our resources and distract management, and if we do not remain compliant our stock price may be adversely affected

Our common stock is registered under the Securities Exchange Act of 1934, as amended (the Exchange Act). It is therefore subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act. The SEC continues to issue new and proposed rules, and complying with existing and new rules results in significant costs to us of being a public company, including substantial costs during the fiscal year ending July 31, 2009 and in future years. This additional cost will reduce our future profits or increase our future losses, and a greater proportion of management time and effort will be needed to meet our regulatory obligations than before.

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We are required to evaluate our internal controls systems in order to allow management to report on our internal controls as required by Section 404 of the Sarbanes-Oxley Act. Based on the market capitalization of our common stock at January 31, 2008, we met the defined requirements for becoming an accelerated filer, which require us to attest to, and have our Independent Registered Public Accounting Firm attest to, our internal controls under Section 404 of the Sarbanes-Oxley Act. We are also required to file our annual and quarterly reports with the Commission on an accelerated basis. Recent SEC pronouncements suggest that in the next several years we may be required to report our financial results using new International Financial Reporting Standards, replacing U.S. GAAP, which would require us to make significant investments in training, hiring, consulting and information technology. All of these and other reporting requirements and heightened corporate governance obligations that we will face or are already facing will further increase the cost to us, perhaps substantially, of remaining compliant with our obligations under the Exchange Act and the Sarbanes-Oxley Act. In order to meet these incremental obligations, we will need to invest in our corporate and accounting infrastructure and systems, and acquire additional services from third party advisors. As a result of these requirements and investments, we will incur significant additional expenses and will suffer a significant diversion of management's time. There is no guarantee that we will be able to continue to meet these obligations in a timely manner, and we could therefore be subject to sanctions or investigation by regulatory authorities such as the Commission, the Public Company Accounting Oversight Board, or the NASDAQ Capital Market. Any such actions could adversely affect our financial results and the market price of our common stock, perhaps significantly.

Our publicly-filed reports are reviewed from time to time by the SEC, and any significant changes or amendments required as a result of any such review may result in material liability to us and may have a material adverse impact on the trading price of our common stock

The reports of publicly-traded companies are subject to review by the SEC from time to time for the purpose of assisting companies in complying with applicable disclosure requirements, and the SEC is required to undertake a comprehensive review of a company's reports at least once every three years under the Sarbanes-Oxley Act of 2002. SEC reviews may be initiated at any time. While we believe that our previously filed SEC reports comply, and we intend that all future reports will comply, in all material respects with the published rules and regulations of the SEC, we could be required to modify, amend or reformulate information contained in prior filings as a result of an SEC review. Any modification, amendment or reformulation of information contained in such reports could be significant and result in material liability to us and have a material adverse impact on the trading price of our common stock.

We are dependent on our management team, and the loss of any key member of this team may prevent us from achieving our business plan in a timely manner

Our success depends largely upon the continued services of our executive officers and other key personnel. In particular, we rely on Michael L. Krall, our President and Chief Executive Officer. Our executive officers and key personnel could terminate their employment with us at any time without penalty. We do not maintain key person life insurance policies on our employees, other than Mr. Krall, and the policy we have on Mr. Krall would likely not provide a benefit sufficient to offset the financial losses resulting from the loss of Mr. Krall's future services. The loss of one or more of our key employees could seriously harm our business, results of operations and financial condition. We cannot assure you that in such an event we would be able to recruit personnel to replace these individuals in a timely manner, or at all, on acceptable terms.

Because competition for highly qualified business development and bioengineering personnel is intense, we may not be able to attract and retain the employees we need to support our planned growth

To successfully meet our objectives, we must continue to attract and retain highly qualified business development and bioengineering personnel with specialized skill sets focused on our industry. Competition for qualified business development and bioengineering personnel can be intense. Our ability to meet our business development objectives will depend in part on our ability to recruit, train and retain top quality people with advanced skills who understand our industry. In addition, it takes time for our new business development personnel to become productive, particularly with respect to obtaining major customer accounts. In many cases, newly hired business development personnel are unable to develop their skills rapidly enough, which results in a relatively high turnover rate and a corresponding increased need to make continual new hires. If we are unable to hire or retain qualified business development and bioengineering personnel, or if newly hired personnel fail to develop the necessary skills or reach productivity slower than anticipated, it would be more difficult for us to sell our products or to license our technology, and we may experience a shortfall in revenue and not achieve our planned growth.

Anti-takeover provisions under our charter documents and California law could delay or prevent a change of control and could also limit the market price of our stock

Certain provisions of our charter and by-laws may delay or frustrate the removal of incumbent directors and may prevent or delay a merger, tender offer or proxy contest involving us that is not approved by our Board of Directors (the "Board"), even if such events may be beneficial to the interests of shareholders. For example, our Board, without shareholder approval, has the authority and power to issue all authorized and unissued shares of common stock and preferred stock which have not otherwise been reserved for issuance on such terms as the Board determines. The Board could also issue 5,000,000 shares of preferred stock and such preferred stock could have voting or conversion rights which could adversely affect the voting power of the holders of our common stock. In addition, California law contains provisions that have the effect of making it more difficult for others to gain control of us.

Our management and our Board of Directors has significant influence over our direction and policies, and may be able to delay or prevent a change of control of our Company, which could adversely affect our stock price

As of December 8, 2008, Michael L. Krall, our President and Chief Executive Officer, beneficially owned, including exercisable options, approximately 7% of our common stock. As of the same date, our directors and officers as a group beneficially owned, including exercisable options and warrants, approximately 21% of our common stock. As a result, our management, and Mr. Krall in particular, are in a position to significantly influence our direction and policies, the election of our Board and the outcome of any other matters requiring shareholder approval. This concentration of ownership may harm the market price of our common stock by, among other things:

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delaying, deferring, or preventing a change in control of our Company;

impeding a merger, consolidation, takeover, or other business combination involving our Company; or

discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of our Company.

The price of our common stock may be volatile, which may limit our ability to raise capital in the future or cause investment losses for our shareholders

Since our initial public offering in August 1996, the price and trading volume of our common stock have been highly volatile. The price has ranged from below \$1 per share to over \$8 per share, and the monthly trading volume has varied from under 200,000 shares to over 7.8 million shares. During the twelve months prior to December 8, 2008, the closing price of our common stock on any given day has ranged from \$2.46 to \$8.50 per share, and the monthly trading volume has varied from approximately 1.2 million shares to approximately 7.9 million shares. In the future, the market price of our common stock may be volatile and could fluctuate substantially due to many factors, including:

actual or anticipated fluctuations in our results of operations;

the introduction of new products or services, or product or service enhancements by us or our competitors;

developments with respect to our or our competitors' intellectual property rights;

announcements of significant acquisitions or other agreements by us or our competitors;

our sale of common stock or other securities in the future;

sales of our common stock by our insiders (management and directors);

the trading volume of our common stock;

conditions and trends in our industry;

changes in our pricing policies or the pricing policies of our competitors;

changes in the estimation of the future size and growth of our markets; and

general economic conditions.

In addition, the stock market in general, the NASDAQ Capital Market, and the market for shares of novel technology and biotechnology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Further, the market prices of securities and biotechnology companies have been unusually volatile in recent months, and many economists expect such unusual volatility to continue for the foreseeable future. These broad market and industry factors may materially harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, shareholder derivative lawsuits and securities class action litigation have often been instituted against that company. Such litigation, if instituted against us, could result in substantial costs and a diversion of management's attention and resources. In addition, this volatility could adversely affect an investor's ability to sell shares of our common stock and/or the available price for such shares, and could result in lower prices being available to an investor if the investor wishes to sell their shares at any given time.

We may not be able to maintain our NASDAQ listing

In April 2008, we obtained a listing for our common stock on the NASDAQ Capital Market. In order to maintain our listing, we will need to continue to meet certain minimum listing standards that include, or may include, our shareholders' equity, the market value of our listed or publicly held securities, the number of publicly held shares, our net income, a minimum bid price for our common stock, the number of shareholders, the number of market makers, and certain of our corporate governance policies. If we fail to maintain the standards required now or in future by the NASDAQ Capital Market, our common stock could be delisted from the NASDAQ Capital Market. Such delisting could cause our stock to be classified as penny stock, which could significantly impact your ability to sell your shares.

If outstanding options and warrants to purchase shares of our common stock are exercised, or if other remaining authorized shares of our common stock are issued, the interests of our shareholders could be diluted

We have approximately 8,014,400 shares of common stock reserved for issuance, which includes shares under equity compensation plans, vested and unvested options, and warrants. These shares have a weighted-average exercise price of approximately \$2.11. In addition, approximately 12,189,800 authorized shares of our common stock remain available for future issuance under equity compensation plans or otherwise. The exercise of options and warrants, and the sale of shares underlying such options or warrants, could have an adverse effect on the market for our common stock, including the price that an investor could obtain for their shares. Investors may experience dilution in the net tangible book value of their investment upon the exercise of outstanding options and warrants granted under our stock option plans, and options and warrants yet to be granted or issued.

We may not be able to utilize all of, or any of, our tax net operating loss carry-forwards and our future after-tax earnings, if any, could be reduced

At October 31, 2008, we had federal and California tax net operating loss carry-forwards of approximately \$40,350,300 and \$30,753,800 respectively. The difference between federal and California tax loss carry-forwards is primarily due to limitations on California loss carry-forwards.

Utilization of the net operating loss carry-forwards may be subject to a substantial annual limitation due to ownership change limitations that may have occurred or that could occur in the future, as required by Section 382 of the Internal Revenue Code as well as similar state provisions. These ownership changes may limit the amount of net operating loss carry-forwards that can be utilized annually to offset future taxable income and tax, respectively. In general, an ownership change, as defined by Section 382 of the Internal Revenue Code results from a transaction or series of transactions over a three-year period resulting in an ownership change of more than 50 percentage points of the outstanding stock of a company by certain stockholders or public groups. Since the Company's formation, we have raised capital through the issuance of capital stock on several occasions (both before and after our initial public offering in 1996) which, combined with the purchasing stockholders' subsequent disposition of those shares, may have resulted in such an ownership change, or could result in an ownership change in the future upon subsequent disposition. While the company does not believe it has experienced an ownership change, the pertinent tax rules related thereto are complex and subject to varying interpretations, and thus complete assurance cannot be provided that the taxing authorities would not take an alternative position.

In addition, our federal tax loss carry-forwards will begin expiring in the year ending July 31, 2017 unless previously utilized, and will completely expire in the year ending July 31, 2028. The California tax loss carry-forwards will begin to expire in the year ended July 31, 2013 and will completely expire in the year ending July 31, 2018. If we are unable to earn sufficient profits to utilize the carry-forwards by these dates, they will no longer be available to offset profits.

We may never pay dividends

We have never paid any cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The future payment of dividends on our common stock will depend on our earnings, financial condition and other business and economic factors, which our Board may consider relevant.

ITEM 5. OTHER INFORMATION

On December 9, 2008, our Board of Directors appointed the Company's Controller, Mark Elliott, to serve as the Company's Acting Principal Financial Officer as a result of our Chief Financial Officer's inability to perform such function due to health-related issues.

ITEM 6. EXHIBITS

A. Exhibits

The following Exhibits are filed as part of this report pursuant to Item 601 of Regulation S-K:

- 3.1 (1) Articles of Incorporation
 - 3.1.1 (2) Articles of Amendment to Articles of Incorporation, dated March 11, 2002
 - 4.3 (3) Amended and Restated Bylaws
 - 4.3 (1) Form of Common Stock Certificate
 - 4.4 (4) Form of Investor Warrant
 - 4.5 (5) Form of Placement Agent Warrant
 - 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
 - 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
 - 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
 - 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
- (1) Incorporated by reference from Exhibit 3.1 to the Form SB-2 registration statement, SEC File #333-00434 effective August 8, 1996
 - (2) Incorporated by reference from Exhibit 3.1.2 to the Annual Report on Form 10KSB for the fiscal year ended July 31, 2002, filed with the SEC on October 29, 2003
 - (3) Incorporated by reference from Exhibit 3.2 to the Current Report on Form 8-K, filed with the SEC on February 25, 2008
 - (4) Incorporated by reference from Exhibit 4.4 to the Current Report on Form 8-K, filed with the SEC on October 25, 2007
 - (5) Incorporated by reference from Exhibit 4.5 to the Current Report on Form 8-K, filed with the SEC on October 25, 2007

* Filed herewith.

SIGNATURES

Pursuant to the requirement 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.

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By: /s/ Michael L. Krall

Michael L. Krall, President/CEO
December 10, 2008

By: /s/ Mark S. Elliott

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Mark S. Elliott, Acting Principal Financial Officer
December 10, 2008
