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INTERPHARM HOLDINGS INC  
Form 10-K  
September 28, 2004

SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

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FORM 10-K  
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ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended June 30, 2004

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

Commission File Number 0-22710

INTERPHARM HOLDINGS, INC.  
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(Exact name of registrant as specified in its charter)

Delaware

13-3673965

-----  
(State or other jurisdiction of  
corporation or organization)

(IRS. Employer  
Identification Number)

69 Mall Drive, Commack, New York

11725

-----  
(Address of principal executive offices)

(Zip Code)

Issuer's telephone number, including area code (631) 543-2800  
-----

Securities registered pursuant to Section 12(b) of the Act: Common Stock \$.01  
par value

Securities registered pursuant to Section 12(g) of the Act: Series A Preferred  
Stock \$.01 par value

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 requirement for the past 90 days.

YES  NO

Indicate by check mark if disclosure of delinquent filer pursuant to Item  
405 of Regulation S-K is not contained herein, and will not be contained, to the  
best of Registrant's knowledge, in definitive proxy or information statements  
incorporated by reference in Part III of this Form 10-K or any amendment to this  
Form 10-K.

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YES [ ] NO [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

On December 31, 2003, the aggregate market value of the voting common equity of Interpharm Holdings, Inc., held by non-affiliates of the Registrant was \$50,567,655, based on the closing price of \$4.69 for such common stock on said date as reported by the American Stock Exchange

YES [ ] NO [X]

On September 22, 2004, the aggregate market value of the voting common equity of Interpharm Holdings, Inc., held by non-affiliates of the Registrant was \$37,211,755 based on the closing price of \$3.45 for such common stock on said date as reported by the American Stock Exchange. On such date, we had 24,967,166 shares of common stock outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE:

Certain information required by Part III (Items 10, 11, 12, and 14) is incorporated by reference to the Registrant's definitive proxy statement (the "2004 Proxy Statement") in connection with its 2004 annual meeting of stockholders, which is to be filed with the Securities and Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934.

ii

## INTERPHARM HOLDINGS, INC. Form 10-K Fiscal Year Ended June 30, 2004

| Table of Contents |  | Page |
|-------------------|--|------|
| PART I            | -----  | ---- |
| Item 1.           | Business.....  | 2    |
| Item 2.           | Properties.....  | 16   |
| Item 3.           | Legal Proceedings.....   | 17   |
| Item 4.           | Submission of Matters to a Vote of<br>Security Holders.....                                      | 17   |
| PART II           |  |      |
| -----             |  |      |
| Item 5.           | Market for Common Stock<br>and Related Stockholder Matters.....                                  | 18   |
| Item 6.           | Selected Financial Data.....   | 22   |
| Item 7.           | Management's Discussion and Analysis of<br>Financial Condition and Results of Operations.....    | 23   |
| Item 7A.          | Quantitative and Qualitative Disclosure<br>About Market Risk.....                                | 40   |
| Item 8.           | Financial Statements and Supplementary Data.....   | 40   |
| Item 9.           | Changes in and Disagreements with<br>Accountants on Accounting and<br>Financial Disclosures..... | 40   |
| Item 9A.          | Controls and Procedures.....   | 41   |
| PART III          |  |      |
| -----             |  |      |

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Item 10. Directors and Executive Officers  
of the Registrant.....43

Item 11. Executive Compensation.....43

Item 12. Security Ownership of Certain Beneficial  
Owners and Management and Related  
Stockholder Matters.....43

Item 13. Certain Relationships and Related  
Transactions.....43

Item 14. Principal Accounting Fees and Services.....44

Item 15. Exhibits, Financial Statement Schedules  
and Reports on Form 8-K.....44

Signatures.....47

Financial Statements.....F-1

FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISK

Certain statements in this Report, and the documents incorporated by reference herein, constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause deviations in actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied. Such factors include, but are not limited to: the difficulty in predicting the timing and outcome of legal proceedings, the difficulty of predicting the timing of U.S. Food and Drug Administration ("FDA") approvals; court and FDA decisions on exclusivity periods; competitor's ability to extend exclusivity periods past initial patent terms; market and customer acceptance and demand for our pharmaceutical products; our ability to market our products; the successful integration of acquired businesses and products into our operations; the use of estimates in the preparation of our financial statements; the impact of competitive products and pricing; the ability to develop and launch new products on a timely basis; the regulatory environment; fluctuations in operating results, including spending for research and development and sales and marketing activities; and, other risks detailed from time-to-time in our filings with the Securities and Exchange Commission.

The words "believe, expect, anticipate, intend and plan" and similar expressions identify forward-looking statements. These statements are subject to risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date the statement was made.

PART I

ITEM 1. BUSINESS

GENERAL

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Interpharm Holdings, Inc. (formerly ATEC Group, Inc.), is a Delaware holding company which, through its operating wholly-owned subsidiary, Interpharm, Inc., (collectively, "we" or "us") is engaged in the business of developing, manufacturing and marketing generic prescription strength and over-the-counter pharmaceutical products in solid oral dosage form, consisting of tablets, caplets and capsules. The U.S. Food and Drug Administration ("FDA") has defined generic drugs as "identical, or bioequivalent to a brand-name drug in dosage form, safety, strength, route of administration, quality, performance characteristics and intended use." The FDA has also stated: "Although generic drugs are chemically identical to their branded counterparts, they are typically sold at substantial discounts from the branded price. According to the Congressional Budget Office, generic drugs save consumers an estimated \$8 to \$10 billion a year at retail pharmacies."

Brand-name drugs are typically patented in order to protect the developing company's investment in the drug and the lengthy approval process. Generic drugs, on the other hand, may be manufactured and marketed only if relevant patents on their brand-name equivalents (and any additional government-mandated market exclusivity periods) have expired, been challenged and invalidated, or otherwise validly circumvented. Generic drugs, however, need not go through the same lengthy approval process as brand-name drugs involving testing and clinical research - they need only go through an Abbreviated New Drug Application ("ANDA") to show that the generic version of the drug has the same ingredients, strength, dosage, administration and batch requirements as the brand-name drug as well as that it is bioequivalent and manufactured under the same standards as the brand-name drug.

We currently manufacture and market various dosage strengths for 21 generic drug products. Fourteen of our products are produced pursuant to ANDAs. The remaining products are manufactured under an over-the-counter monogram or are drugs which do not otherwise require ANDAs. In addition, we manufacture eight dosage strengths of three distinct products for United Research Laboratories, Inc. and Mutual Pharmaceutical Company, Inc. ("URL/Mutual"), which holds the applicable ANDAs, pursuant to a Manufacturing and Supply Agreement, dated January 24, 2002.

We market our products primarily to our distributors/wholesalers who sell to retail stores; the U.S. Department of Veteran Affairs through a government appointed prime vendor; and to resellers who repackage our products and sell them directly to retail stores. Approximately 60% of our sales are made under our own label. The rest of our sales are to wholesalers and distributors which sell our products under their own labels.

During the fiscal year ended June 30, 2004, two of our customers collectively accounted for approximately 55% of our total sales. For the six-month period ended June 30, 2003, two of our customers collectively accounted for approximately 50% of our total sales. The loss of any of our largest customers could have a material adverse effect on our business. Although we have a contractual relationship with one of our two largest customers, most of our sales are still not made pursuant to contracts, but rather through individual purchase orders. Therefore, although we have very strong relationships with our customers, most of whom have requested us to provide larger quantities of our products than we have historically sold to them, there is nothing requiring many of them to continue to purchase our products, and there can be no guarantee that they will continue to do so. We expect that as we continue to grow, a larger percentage of our revenue will be to customers with whom we will have contractual relationships.

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### BUSINESS AND CORPORATE HISTORY AND DEVELOPMENT

Interpharm, Inc. was incorporated under the laws of the State of New York in 1984 and operated as a family owned private company until May 30, 2003. On May 30, 2003, Interpharm, Inc. was acquired by ATEC Group, Inc. ("ATEC") which then changed its name to Interpharm Holdings, Inc. In that transaction, ATEC acquired all of the issued and outstanding shares of Interpharm, Inc. in exchange for both ATEC common and preferred stock. Concurrently with the acquisition of Interpharm, Inc., ATEC sold its then existing computer/systems integration business to certain members of ATEC management who simultaneously resigned from ATEC. These transactions were approved by our shareholders on May 29, 2003 and are fully described in ATEC's definitive proxy statement, filed with the Securities and Exchange Commission on May 2, 2003.

From the early 1990s until 2002, our sales were primarily composed of Ibuprofen in various dosage strengths. While our revenues increased steadily during that time, in 2002, we began an expansion plan in order to expand our product line and increase production by investment in new equipment and facilities. As a result of our expansion plans, we have invested in excess of \$3.0 million in new equipment since January 1, 2003. In addition, on June 29, 2004, we acquired a new facility in Brookhaven, New York for approximately \$9.4 million. We paid approximately \$2.0 million of the purchase price and closing costs and financed the remaining \$7.4 million with a mortgage loan.

Our net sales have grown from approximately \$27.5 million for the twelve months ended June 30, 2003 to approximately \$41.1 million for the year ended June 30, 2004. While overall net sales of Ibuprofen have increased by approximately \$300,000, Ibuprofen, as a percentage of net sales, decreased from approximately 86% during the twelve months ended June 30, 2003, to approximately 60% during the twelve month period ended June 30, 2004.

We have adopted a Code of Ethics that applies to all of our directors, officers, employees and representatives. This code is annexed to this Form 10-K as Exhibit 99.3. Amendments to the code of ethics and any grant of a waiver from a provision of the code requiring disclosure under applicable SEC rules will be available on our website and future public filings. The charter of the Nominating Committee of our Board of Directors is also annexed to this Form 10-K as Exhibit 99.4. Any of these materials may also be requested in print by writing to us, Attention: George Aronson, Chief Financial Officer, at 75 Adams Avenue, Hauppauge, New York 11788.

3

### INDUSTRY

#### THE GENERIC DRUG MARKET AND NECESSARY APPROVALS

Much of the growth of the generic pharmaceutical industry has been attributed to The Drug Price Competition and Patent Term Restoration Act of 1984 (the "Waxman-Hatch Act"), which encourages generic competition. Before the Waxman-Hatch Act, generic drug manufacturers had to put their products through an approval process similar to that for the original approval for brand-name drugs. Now, there is an accelerated approval process in which the generic manufacturer needs only to demonstrate to the FDA that the generic product is bioequivalent to the brand-name product through the filing of an ANDA. The ANDA may rely on information from the brand-name drug's application with the FDA.

**Branded Drugs:** Pharmaceutical products in the United States are generally marketed as either "brand-name" or "generic" drugs. Brand-name products are drugs generally sold by the holder of the drug's patent or through an exclusive

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marketing arrangement. A company that receives approval for a new drug application ("NDA") from the FDA, usually the patent holder, has the exclusive right to produce and sell the drug for about twenty years from the date of filing of the patent application. This market exclusivity generally provides brand-name products the opportunity to build up physician and customer loyalties.

Generic Drugs: Once a patent on a drug expires, a manufacturer can obtain FDA approval to market a "generic" version. A generic drug is therefore usually marketed after the patent on a brand drug expires and is comparable to a brand-name drug. In fact, the FDA requires a generic drug to be identical or bio-equivalent to a brand name drug in dose, form, safety, strength, route of administration, quality, performance characteristic and intended use. Although generic drugs are chemically identical to their branded counterparts, they are typically sold at substantial discounts from the branded prices. According to the Congressional Budget Office, generic drugs provide savings to the consumers at an estimated amount of \$8 billion to \$10 billion a year at retail pharmacies, not including the saving from the use of generic drugs in hospitals and other health care facilities (see [www.fda.gov/cder/ogd/](http://www.fda.gov/cder/ogd/)). These cost savings have resulted in sustained growth of the generic pharmaceutical industry in the United States. According to a Congressional Budget Office study, "How Increased Competition from Generic Drugs has Affected Prices and Returns in the Pharmaceutical Industry," (available at [HTTP://WWW.CBO.GOV/SHOWDOC.CFM?INDEX=655&SEQUENCE=0](http://www.cbo.gov/showdoc.cfm?index=655&sequence=0)) in 1984, 19% of prescription drugs sold in the United States were generic. -As of March, 2004, more than 50% of all prescriptions are filled with generic drugs according to the FDA (see "Update from the Office of Generic Drugs," March 2, 2004 available at [http://www.fda.gov/cder/ogd/2004-03-02\\_GPHA\\_Boca-gjb\\_files/frame.htm](http://www.fda.gov/cder/ogd/2004-03-02_GPHA_Boca-gjb_files/frame.htm)).

4

Over the past two years, the FDA has improved its procedures and received more funding in order to expedite the processing of ANDAs and encourage the growth of the generic drug market.

On December 8, 2003, the Medicare Prescription Drug, Modernization and Improvement Act of 2003 (the "MMA") was enacted. The MMA seeks to bring generic drugs to market sooner in an effort to save consumers up to \$35 billion over 10 years. The MMA streamlines the generic drug approval process by limiting a brand-name drug company to only one 30-month stay of a generic drug's entry into the market for resolution of a patent challenge. The MMA also establishes a 180 day exclusivity period for a generic company that successfully challenges a patent, provided that the generic drug at issue is marketed within the first 75 days of that period.

### BUSINESS STRATEGY AND FISCAL YEAR ENDED JUNE 30, 2004 HIGHLIGHTS

We have experienced substantial growth over the past few years. We believe that our continued growth is dependent upon our ability to (i) continue increasing our market share in our existing product lines by utilizing our manufacturing efficiency, cost competitiveness, and customer loyalty, (ii) obtain FDA approval for the drugs currently under development, (iii) successfully implement our research and development strategy with a view towards expanding and diversifying our product line with a focus on higher margin products, (iv) leverage our competitive strength in manufacturing to capture market share on our new product lines, (v) increase production capacity in our current plant, (vi) obtain FDA approval for our new facility in a timely manner, (vii) utilize our manufacturing efficiencies to enter into additional manufacturing and supply arrangements, (viii) enter into joint ventures and strategic alliances with companies whose strengths compliment ours, and (ix)

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create marketing and distribution channels for our existing and future products.

### MANUFACTURING CAPACITY:

We currently conduct our manufacturing operations out of a leased facility of approximately 100,000 square feet with recently purchased and up to date equipment. Over the past five years, we have upgraded our facilities, including building additional tablet compression and packaging rooms, adding new air handling units and installing new manufacturing and laboratory equipment. We are currently taking steps to increase the size of this facility for products requiring segregated rooms.

We believe that the most important component to our growth during the fiscal year ended June 30, 2004 has been our commitment to capital investment to increase production capacity. During the year ended June 30, 2004, we invested approximately \$2.4 million in new machinery and equipment, and infrastructure improvements in our current plant. During the period from January 1, 2002 through June 30, 2003, we invested approximately \$2.2 million in equipment and improvements. Our commitment to increase capacity has allowed us to both continue to meet increasing demand for our existing products such as Ibuprofen, while, at the same time, allowing us to meet our requirements generated through various strategic alliances.

5

We realize that in order to effectuate our plans to increase and diversify our product line, we will need to continue to demonstrate our commitment to increasing our production capacity. To that end, on June 29, 2004, we completed the acquisition of a 92,000 square foot building with an additional 30,000 square feet of mezzanine space, located on over thirty-seven acres of land. The acquisition cost for the building and land, which are located in Brookhaven, New York, was approximately \$9.4 million. Because the new facility is located in New York's Brookhaven Empire Zone, we will be eligible for a number of economic benefits, including, grants based on the number of employees hired, discounted utility bills and real property and other tax reductions and credits.

In addition to using the new building as an additional manufacturing facility, we intend to construct a new research and development laboratory and move our corporate offices to the location. In order to be used for manufacturing, the new facility will require site approval from the FDA. Pending such approval, the facility can be used for warehousing and related activities, thereby creating additional capacity in our current manufacturing plant. Once FDA site approval is obtained, we will have two facilities with a combined size of approximately 200,000 square feet. In addition, the thirty-seven acres of land could, if needed, allow us to expand the new facility to over 500,000 square feet.

Our ability to purchase our new facility and land, to renovate the new building so as to meet our production requirements and FDA requirements, to continue to increase our purchases of new machinery and equipment, and to renovate our existing plant, have been assisted through a \$21 million advised line of credit obtained from HSBC Bank. Depending upon market conditions, we may continue to rely on this advised credit line, or seek other means of financing in the future.

### STRATEGIC ALLIANCES:

URL/Mutual. In January 2002, we entered into an agreement with URL/Mutual to manufacture four drugs in various dosage strengths. The agreement is for a five-year term, which may be renewed for an additional two years. The agreement

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also contains a non-compete provision stating that we may not distribute any of the drugs covered by the agreement for five years after its termination. Since we do not have ANDAs for any of these products, we produce them pursuant to URL/Mutual's ANDAs, and were required to obtain Site Transfer Approvals ("STA") from the FDA.

Whereas an ANDA approves the formula for a given product produced at a specified location, an STA granted by the FDA allows for the production of an approved drug at a site other than the one approved in the ANDA. In order for the FDA to approve an STA, the new production location must be shown to comply with all of the terms and conditions set forth in the approved ANDA.

6

In July 2003, we began manufacturing Atenolol Tablets for URL/Mutual. This was the first of the four products that we were scheduled to manufacture for URL/Mutual. Atenolol is a synthetic, beta-selective (cardioselective) adrenoreceptor blocking agent and a generic version of the branded drug Tenormin(R). Atenolol is indicated in the management of hypertension, for the long-term management of patients with angina pectoris, and in the management of patients with definite or suspected acute myocardial infarction to reduce cardiovascular mortality.

In August 2003, we began manufacturing Allopurinol Tablets for URL/Mutual in both 100mg and 300mg strengths. Allopurinol is a xanthine oxidase inhibitor which is a generic version of the branded drug Zyloprim (R). Allopurinol is used to lower blood uric acid levels. Uric acid is produced when the body breaks down purines that are found in foods. Uric acid forms crystals in the tissues of the body to cause the inflammation of gout. Elevated blood uric acid levels can also cause kidney disease and stones. Allopurinol can be used to prevent uric acid kidney stones and to prevent recurrent gouty arthritis attacks.

Allopurinol also can be used to treat patients with multiple recurrent gout attacks, erosive destructive gouty joint disease, hard lumps or uric acid deposits in tissues (called tophi), gouty kidney disease, or uric acid stones. It is also used to prevent elevation of blood uric acid in patients undergoing chemotherapy for the treatment of certain cancers.

The other two products to be manufactured under our agreement with URL/Mutual are Prednisone and Amitriptyline. We began manufacturing Prednisone for URL/Mutual in 2004. Total sales for this product during the fiscal year ended June 30, 2004 were approximately \$225,000. We anticipate that we will begin manufacturing Amitriptyline during the second fiscal quarter of the fiscal year ending June 30, 2005.

Watson Pharmaceuticals. On May 18, 2004, the FDA approved our ANDA for Hydrocodone Bitartrate and Ibuprofen Tablets, 5 mg/200 mg. This product is a new lower strength version of Hydrocodone Bitartrate and Ibuprofen Tablets, 7.5 mg/200 mg, which is the generic equivalent to the branded drug Vicoprofen(R). We received a six-month exclusivity for marketing of this product from the FDA. Since we are the first company to receive approval to manufacture and market this product in this strength, we were provided the opportunity to market the product as a branded generic drug.

We began marketing the product under the name Reprexain(R) in June 2004, pursuant to a contract with Watson Pharmaceuticals, Inc. Pursuant to the terms of the contract, we will manufacture and supply the product to Watson, who will market, sell and distribute the product in the United States. We will receive payment from Watson based on the amount of Reprexian ordered by it for sale as well as a percentage of sales that Watson generates through its marketing



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efforts.

Reprexain(R) is indicated for the short-term (generally less than 10 days) management of acute pain. Reprexain(R) addresses a market opportunity by combining 5 mg hydrocodone, the most commonly prescribed dose of hydrocodone in a combination with 200 mg of ibuprofen, the leading prescribed non-steroidal anti-inflammatory drug; a combination not available prior to introduction of the product. Combining both central and peripheral analgesic action, Reprexain(R) offers patients a balanced approach to the management of acute pain.

7

### STRATEGIC AND PRODUCT DEVELOPMENT:

In furtherance of our expansion plans, during the fiscal year ended June 30, 2004, we began to focus on increasing our product pipeline with an emphasis on higher margin products. Historically, the majority of our revenues were derived from sales of Ibuprophen tablets in both prescription and over-the-counter strengths. During our fiscal year ended June 30, 2004, Ibuprophen accounted for approximately 60% of our total revenue. This is a significant decrease from the same period ended 2003 when Ibuprophen accounted for approximately 86% of our total revenue.

We believe that one source of higher margin products is a number of successful brand-name products for which patent protection is due to expire over the next several years. Other sources are successful generic products where we can enter with a competitive advantage in manufacturing or sourcing of raw materials.

We have expanded our pipeline of drugs under development since 2002 and are formulating a plan to increase the pipeline. We currently have ten drugs that are in various stages of development. In order to assist in strategic and product development, we have added Cameron Reid to our Board of Directors. Mr. Reid has over twenty-five years of experience in the pharmaceutical business, most recently as the President of Dr. Reddy's Laboratories, Inc. Mr. Reid is working with Bhupatlal Sutaria, our President, to formulate our plan to increase our pipeline and strategically plan its marketing and sale. There can be no assurances, however, that the FDA will ultimately approve the drugs that are under development. During the fiscal year ended June 30, 2004, we spent approximately \$538,000 on research and development activities.

As we develop our product line, we (i) identify and conduct patent and market research on brand name drugs for which patent protection has expired or will expire in the near future, (ii) determine which products would supplement our existing product line, and which products could potentially represent new opportunities, (iii) research and develop new product formulations based upon such drugs so as to ensure that FDA approval is received, and (iv) introduce technology to improve production efficiency and enhance product quality.

### GOVERNMENTAL REGULATION:

FDA approval is required before any generic drug can be marketed through an ANDA. While the FDA has significantly streamlined the process of obtaining ANDA approval for generic drugs, it is difficult to predict how long the process will take for any specific drug. In fact, the length of time necessary to bring a product to market can vary significantly and can depend on, among other things, availability of funding, problems relating to formulation, safety or efficacy, patent issues associated with the product or barriers to market entry from brand-name product manufacturers. Therefore, there is always the risk that the introduction of new products can be delayed.

The ANDA process requires that a company's manufacturing procedures and operations conform to FDA requirements and guidelines, generally referred to as current Good Manufacturing Practices ("cGMP"). The requirements for FDA approval encompass all aspects of the production process, including validation and record keeping, and involve changing and evolving standards. Compliance with cGMP regulations requires substantial expenditures of time, money and effort in such areas as production and quality control to ensure full technical compliance. The evolving and complex nature of these regulatory requirements, the broad authority and discretion of the FDA and the generally high level of regulatory oversight result in a continuing possibility that we may be adversely affected by regulatory actions despite our efforts to comply with regulatory requirements.

The ANDA process also requires bioequivalency studies to show that the generic drug is bioequivalent to the approved drug. Bioequivalence compares the bioavailability of one drug product with that of another formulation containing the same active ingredient. When established, bioequivalency confirms that the rate of absorption and levels of concentration in the bloodstream of a formulation of the approved drug and the generic drug are equivalent. Bioavailability indicates the rate and extent of absorption and levels of concentration of a drug product in the bloodstream needed to produce the same therapeutic effect.

We contract with outside laboratories to conduct biostudies. Historically, the vast majority of our research and development expenditures have been on biostudies. While we believe that the companies contracted to perform the biostudies are reliable, there can be no assurance that they will use the proper due diligence or that their work will otherwise be accurate.

Supplemental ANDAs are required for approval of various types of changes to an approved application, and these supplements may be under review for six months or more. In addition, certain types of changes may only be approved once new bioequivalency studies are conducted or other requirements are satisfied.

The scientific process of developing new products and obtaining FDA approval is complex, costly and time consuming and there can be no assurance that any products will be developed and approved despite the amount spent on research and development. The development of products may be curtailed in the early or later stages of development due to the introduction of competing generic products or for other strategic reasons.

Even if an ANDA is approved, brand-name companies can impose substantial barriers to market entry which may include: filing new patents on drugs whose original patent protection is about to expire, developing patented controlled-release products or other product improvements, developing and marketing, as over-the-counter products, brand-name products that will soon face generic competition, and commencement of marketing initiatives, regulatory activities and litigation. While none of these actions have been taken against us to date, there can be no assurance that they will not be taken in the future, particularly as we significantly expand our product development efforts.

In addition to the Federal government, individual states have laws regulating the manufacture and distribution of pharmaceuticals, as well as

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regulations pertaining to the substitution of generic drugs for brand-name drugs. Our operations are subject to regulation, licensing requirements and inspection by the states in which we are located or conduct business.

We must also comply with federal, state and local laws of general applicability, such as laws regulating working conditions and equal opportunity employment. Additionally, we are subject, as are all manufacturers, to various federal, state and local environmental protection laws and regulations, including those governing the discharge of materials into the environment. Historically, the costs of complying with such environmental provisions have not had a material adverse effect on our earnings, cash requirements or competitive position, and we do not expect such costs to have any such material adverse effect in the foreseeable future. However, if changes to such environmental provisions are made that require significant changes in our operations or the expenditure of significant funds, such changes could have a material adverse effect on our earnings, cash requirements or competitive position.

As a public company, we are subject to the Sarbanes-Oxley Act of 2002 (the "SOX Act"). The SOX Act contains a variety of provisions affecting public companies, including the relationship with its auditors, prohibiting loans to executive officers and requiring an evaluation of its disclosure controls and procedures and internal controls.

The federal government made significant changes to Medicaid drug reimbursement as part of the Omnibus Budget Reconciliation Act of 1990 ("OBRA"). Generally, OBRA provides that a generic drug manufacturer must offer the states an 11% rebate on drugs dispensed under the Medicaid program and must enter into a formal drug rebate agreement with the Federal Health Care Financing Administration. Although not required under OBRA, we have also entered into similar agreements with various states.

Continuing studies of the proper utilization, safety and efficacy of pharmaceutical products are being conducted by the pharmaceutical industry, government agencies and others. Such studies, which increasingly employ sophisticated methods and techniques, can call into question the utilization, safety and efficacy of previously marketed products. There can be no assurances that these studies will not, in the future, result in the discontinuance of product marketing.

### MARKETING STRATEGY:

We market our products primarily through wholesalers, drug distributors, other manufacturers and by our internal sales staff, as well as independent sales representatives. In addition, we have also begun to market products through strategic alliances with companies, such as Watson Pharmaceuticals, Inc., whose marketing expertise exceeds our own. Some of our wholesalers and distributors purchase products that are warehoused for drug chains, independent pharmacies, state and federal governmental agencies and managed healthcare organizations. Consistent with industry practice, we have a returned goods policy. Pursuant to our policy, any unopened item in its original packaging may be returned if accompanied by (i) an authorization form obtained from Interpharm, and a "Returned Goods Authorization Number" with a proof of purchase. Transportation charges for returns are paid by the customer. If the foregoing procedures are followed, we will return the customer's original purchase price or the current market price, whichever is lower.

Pursuant to our return policy, we will not accept any of the following for return, unless we have an agreement with a party which dictates otherwise: (i)

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short-dated products (14 months or less remaining on the expiration date), (ii) expired products, products which have been opened, tampered with or which have a broken seal, (iii) products which have stickers or other price markings, (iv) products which have been damaged by improper handling, fire, flood or other catastrophes, (v) products stored under conditions other than as specified on the label, (vi) products returned by someone other than the direct purchaser, or (vii) products without proof of purchase.

We have not experienced returns of material quantities of any of the products we sell and therefore, do not believe that we are subject to material risk of inventory buildup attributable to returns.

### RAW MATERIALS:

The raw materials that we use in the manufacturing of our products consist of pharmaceutical chemicals in various forms, which are available from various sources. FDA approval is required in connection with the process of selecting active ingredient suppliers. The raw materials purchased from these suppliers are available from a number of vendors. In selecting a vendor, we consider not only their status as an FDA approved supplier, but consistency of their products, timeliness of delivery, and price. To date, we have experienced no significant difficulty in obtaining raw materials and expect that raw materials will generally continue to be available in the future. However, should we be required to replace one or more of our suppliers, we may experience a delay of six months or more in the manufacture and marketing of the drug involved while the new supplier becomes qualified by the FDA and its manufacturing process is found to meet FDA standards. Depending on the particular product, it may cause a material adverse effect on our results of operations and financial condition. We generally attempt, where economically and otherwise feasible, to minimize these risks by having more than one approved supplier for the drugs that we manufacture.

### PRODUCTS

Below is a list of the drugs that we manufacture and sell, including the drugs that we are currently manufacturing pursuant to our agreement with URL/Mutual. The names of all of the drugs under the caption "Brand-Name Drug" are registered trademarks. The holders of the registered trademarks are non-affiliated pharmaceutical manufacturers.

11

| PRODUCT NAME<br>-----  | BRAND-NAME DRUG<br>----- |
|--|--------------------------|
| 1. Acetaminophen 500 mg White Tablets                        | Tylenol (R)              |
| 2. Acetaminophen 500 mg White Caplets                        | Tylenol (R)              |
| 3. Acetaminophen 325 mg White Tablets                        | Tylenol (R)              |
| 4. Acetaminophen & Diphenhydramine HCl<br>Caplets 500mg/25mg | Tylenol PM (R)           |
| 5. Allopurinol 100 mg White Tablets*                         | Zyloprim (R)             |
| 6. Allopurinol 300 mg White Tablets*                         | Zyloprim (R)             |
| 7. Atenolol 25 mg White Tablets*                             | Tenormin (R)             |

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|   |                   |
|---|-------------------|
| 8. Atenolol 50 mg White Tablets*  | Tenormin (R)      |
| 9. Atenolol 100 mg White Tablets*   | Tenormin (R)      |
| 10. Clorpheniramine Maleate 4mg Yellow Tablets  | Chlortrimetron(R) |
| 11. Hydrocodone Bitartrate & Ibuprofen Tablets<br>5mg/200mg                                       | Reprexain(R)**    |
| 12. Ibuprofen 200mg White Tablets   | Advil(R)          |
| 13. Ibuprofen 200mg Brown Tablets   | Advil(R)          |
| 14. Ibuprofen 200mg Orange Tablets  | Motrin(R)         |
| 15. Ibuprofen 200mg White Caplets   | Advil(R)          |
| 16. Ibuprofen 200mg Brown Caplets   | Advil(R)          |
| 17. Ibuprofen 200mg Orange Caplets  | Motrin(R)         |
| 18. Ibuprofen 400mg White Tablets   | Motrin(R)         |
| 19. Ibuprofen 600mg White Tablets   | Motrin(R)         |
| 20. Ibuprofen 800mg White Tablets   | Motrin(R)         |
| 21. Isometheptene Mucate, Dichloralphenazone,<br>Acetaminophen, Red/Red Capsule, 65mg/100mg/325mg | Midrane (R)       |

12

|  |               |
|--|---------------|
| 22. Naproxen 250mg White Tablets                                       | Naprosyn (R)  |
| 23. Naproxen 375mg White Tablets                                       | Naprosyn (R)  |
| 24. Naproxen 500mg White Tablets                                       | Naprosyn (R)  |
| 25. Prednisone 5mg*  | Deltasone (R) |
| 26. Prednisone 10mg*   | Deltasone (R) |
| 27. Prednisone 20 mg*  | Deltasone (R) |
| 28. Pseudoephedrine HCl 60mg White Tablets                             | Sudafed(R)    |
| 29. Pseudoephedrine HCl, Triprolidine HCl White<br>Tablets, 60mg/2.5mg | Actifed(R)    |

\* Manufactured for URL/Mutual, which holds the ANDA for the product.

\*\* Reprexian(R) is our brand-name drug which is marketed by Watson Pharmaceuticals, Inc.

### COMPETITION

The generic pharmaceutical industry is intensely competitive. Most of our significant competitors have longer operating histories and greater financial, research and development, marketing and other resources. Consequently, many of our competitors may develop products and/or processes competitive with, or

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superior to, ours.

The primary means of competition in the generic pharmaceutical industry involve manufacturing capabilities and efficiencies, innovation and development, timely FDA approval, product quality, marketing, reputation, level of service, including the maintenance of sufficient inventory levels to assure timely delivery of products, product appearance and price. Often, price is the key factor in the generic pharmaceutical business. Therefore, to compete effectively and remain profitable, a generic drug manufacturer must manufacture its products in a cost effective manner.

We believe that we maintain adequate levels of inventories to meet customer demand and have them readily available. Also, the modernization of our facility, hiring of experienced staff, and implementation of quality control programs have improved our competitive position in recent years. In addition, once our new facility obtains FDA site approval, we believe that our competitive position should be further improved.

13

During the past several years the number of chain drug stores and wholesaler customers has declined due to industry consolidation. In addition, the remaining chain drug stores and wholesaler customers have instituted buying programs that have caused them to buy more products from fewer suppliers. At the same time, mail-order prescription services and managed care organizations have grown in importance and they also limit the number of vendors. The reduction in the number of our customers and limitation on the number of vendors by the remaining customers has increased competition among generic drug marketers. However, these pressures have not had a material adverse impact on our business and we believe that we have good relationships with our key customers.

In addition to generic manufacturers, we have also experienced competition from brand-name companies that have purchased generic companies or license their products to generic companies prior to, or as relevant patents expire. No further regulatory approvals are required for a brand-name manufacturer to sell its pharmaceutical products directly or through a third party to the generic market, nor do such manufacturers face any other significant barriers for entry into such market.

As is the case with many generic pharmaceutical manufacturers, many of our competitors have longer operating histories and greater financial resources than us. Consequently, some of these competitors may have larger production capabilities, may be able to develop products at a significantly faster pace at a reduced cost, and may be able to devote far greater resources to marketing their product lines.

Certain manufacturers of brand-name drugs and/or their affiliates have been introducing generic pharmaceutical products equivalent to such brand-name drugs at relatively low prices. Such pricing, with its attendant diminished profit margins, could have the effect of inhibiting us and other manufacturers of generic pharmaceutical products from developing and introducing generic pharmaceutical products comparable to certain brand-name drugs. Also, consolidation among wholesalers, distributors, and repackagers, and technological advances in the industry and pricing pressures from large buying groups, may create pricing pressure, which could reduce our profit margins on our product lines.

In addition, increased price competition among manufacturers of generic pharmaceutical products, resulting from new generic pharmaceutical products being introduced into the market and other generic pharmaceutical products being

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reintroduced into the market, has led to an increase in demands by customers for downward price adjustments by the manufacturers of generic pharmaceutical products. No assurance can be given that such price adjustments, which reduce gross profit margins, will not continue, or even increase, with a consequent adverse effect on our earnings.

Brand-name companies also pursue other strategies to prevent or delay generic competition. These strategies may include: seeking to establish regulatory and legal obstacles that would make it more difficult to demonstrate bioequivalence, initiating legislative efforts in various states to limit the substitution of generic versions of certain types of brand-name pharmaceuticals, instituting legal action that automatically delays approval of generic products, the approval of which requires certifications that the brand-name drug's patents are invalid or unenforceable, or introducing "second generation" products prior to the expiration of market exclusivity for the reference product, obtaining extensions of market exclusivity by conducting trials of brand-name drugs, persuading the FDA to withdraw the approval of brand-name drugs, for which the patents are about to expire, thus allowing the brand-name company to obtain new patented products serving as substitutes for the products withdrawn, or seeking to obtain new patents on drugs for which patent protection is about to expire.

14

The ability of brand-name companies to successfully delay generic competition in any of our targeted new product lines may adversely affect our ability to enter into the desired product line or may impact our ability to attain our desired market share for that product.

The Food and Drug Modernization Act of 1997 includes a pediatric exclusivity provision that may provide an additional six months of market exclusivity for indications of new or currently marketed drugs if certain agreed upon pediatric studies are completed by the applicant. Brand-name companies are utilizing this provision to extend periods of market exclusivity.

### BACKLOG

We do not have a significant backlog, as we normally deliver products purchased by our customers within a short time of the date of order.

### GOVERNMENT CONTRACTS

On December 5, 2002, our bid was accepted by the Department of Veterans Affairs to supply Ibuprofen tablets for the period January 2, 2003 through January 1, 2004. This bid provides for four one-year renewals at the option of the Department of Veterans Affairs. The Department of Veterans Affairs exercised that option for the period January 2, 2004 through January 1, 2005. The bid covers sales to a number of government entities including: all Department of Veterans Affairs facilities, all Indian Health Service facilities, Department of Health and Human Service Supply Center at Perry Point and all Option 2 State Veterans Homes.

### PATENTS AND TRADEMARKS

We do not own any Patents or Trademarks that are currently used in our business. We have, however, entered into several agreements giving us the rights to use the trademarks and tradenames of other parties for labeling and marketing of certain drugs.

### EMPLOYEES

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As of June 30, 2004, we had 322 full time employees, of which 247 were employed in manufacturing, 56 were employed in quality assurance and regulatory affairs, 15 were employed in selling, general and administrative activities, and 4 were employed in research and development. We believe we have a strong relationship with our employees. None of our employees are represented by a union.

15

### SEASONALITY

While we believe that our business is generally not seasonal, we typically experience a decrease in orders in the fiscal quarter ending September 30 as compared to other quarters. We believe that this decrease in orders is primarily the result of decreased demand for certain over the counter cold remedies and other products in the summer months and because many purchasing agents tend to take vacations during this time and order more products prior to, or after the quarter.

### ITEM 2. PROPERTIES

#### DESCRIPTION OF PROPERTY

We lease an entire building in Hauppauge, New York, pursuant to a non-cancellable lease expiring in October, 2019, which houses our manufacturing, warehousing and some of our executive offices. The leased building is approximately 100,000 square feet and is located in an industrial/office park. The current annual lease payments to the landlord, Sutaria Family Realty, LLC, are \$480,000. Sutaria Family Realty, LLC is owned by Mona Rametra, Perry Sutaria and Raj Sutaria, who collectively own 9,663,983 shares of our common stock, 456,562 shares of our Series A-1 Preferred Stock and 1,757,480 shares of our Series K Preferred Stock and are the children of Dr. Maganlal K. Sutaria, the Chairman of our Board of Directors and our Chief Executive Officer, and the niece and nephews of Bhupatlal K. Sutaria, our President. Mona Rametra is also the wife of our General Counsel and Secretary, Munish K. Rametra. In addition, Raj Sutaria is an officer of Interpharm, Inc. Upon a change in ownership of the Company, and every three years thereafter, the annual base rent will be adjusted to fair market value, as determined by an independent appraisal. There are no tenants in the building other than us.

We also lease approximately 23,175 square feet of office space at 69 Mall Drive in Commack, New York for some our executive offices. The lease for this office space expires in May, 2005. The annual lease payments are approximately \$187,000. During the remaining eleven months of this lease, we have sublet approximately 18,500 square feet for \$139,000.

On June 29, 2004, pursuant to a contract entered into on November 14, 2003, and through our wholly owned subsidiary, Interpharm Realty, LLC, we purchased a 92,000 square foot facility on thirty seven acres of land, located at 50 Horseblock Road in Brookhaven, New York. The purchase price for the building and land was approximately \$9.4 million. The new facility is located in Suffolk County, New York's Brookhaven Empire Zone. We will construct an expanded research and development laboratory at the new location which will also house our executive offices.

16

### ITEM 3. LEGAL PROCEEDINGS



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Because Interpharm, Inc. utilizes certain controlled substances, it is subject to routine inspection by the U.S. Drug Enforcement Agency. In June, 2004, Interpharm, Inc. received a notice from the United States Attorney's Office for the Eastern District of New York relating to a routine inspection conducted in November, 2003. The notice references certain alleged record keeping violations. As of the date of this report, no complaint has been filed by the United States Attorney's Office, and Interpharm, Inc. is in the process of setting up a meeting with the United States Attorney's Office to resolve the matter. The Company is unable to predict the outcome of this claim and, accordingly, no adjustments have been made in the consolidated financial statements.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our securityholders during the fiscal quarter ended June 30, 2004.

17

## PART II

### ITEM 5. MARKET PRICE OF AND DIVIDENDS ON THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS PRICE RANGE OF COMMON STOCK

Our common stock is currently traded on the American Stock Exchange under the symbol "IPA." The following table sets forth the high and low sale prices for our common stock for the periods indicated as reported by the American Stock Exchange. Such prices reflect inter-dealer prices, without retail mark-up, markdown or commissions and may not necessarily represent actual transactions. It should be noted that prior to May 30, 2003, the Company was in the computer/systems integration business. On May 30, 2003, that business was sold and Interpharm, Inc. was acquired. Accordingly, historical stock prices prior to May 30, 2003 are not representative of our current business. On June 2, 2003, our stock symbol changed from "TEC" to "IPA."

|                          | HIGH    | LOW     |
|--------------------------|---------|---------|
|                          | ----    | ---     |
| 2002                     |         |         |
| Quarter ended 3/31.....  | \$ 0.79 | \$ 0.43 |
| Quarter ended 6/30.....  | 0.50    | 0.40    |
| Quarter ended 9/30.....  | 0.44    | 0.26    |
| Quarter ended 12/31..... | 0.85    | 0.26    |
| 2003                     |         |         |
| Quarter ended 3/31.....  | 0.72    | 0.54    |
| Quarter ended 6/30.....  | 2.93    | 0.62    |
| Quarter ended 9/30.....  | 8.90    | 3.30    |
| Quarter ended 12/31..... | 5.47    | 4.00    |
| 2004                     |         |         |
| Quarter ended 3/31.....  | 5.87    | 4.30    |
| Quarter ended 6/30.....  | 4.80    | 2.45    |

As of September 21, 2004, there were approximately 8,856 holders of our common stock, 17 holders of record of Series A preferred shares, 294 holders of record of Series C preferred shares, 4 holders of record of Series K Preferred Stock and 3 holders of record of Series A-1 Preferred Stock.

18

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We do not currently pay dividends on our common stock. It is our current intention not to declare or pay dividends on our common stock, but to retain earnings for the operation and expansion of our business.

The holders of our Series A and Series A-1 preferred shares are entitled to certain dividend payments upon declaration by the Board of Directors. The Series A preferred shares are entitled to a cumulative dividend of 10% of par value (\$0.10 per share), when and as declared by our Board of Directors. The Series B preferred shares are entitled to a non-cumulative dividend of \$1.00 per share. The Series A-1 preferred shares are entitled to a cumulative annual dividend of \$0.0341 per share when and as declared by our Board of Directors (See "Series K and Series A-1 Preferred Stock" below).

### SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

The following table gives information about our common stock that may be issued upon the exercise of options, warrants and rights under all of our equity compensation plans as of June 30, 2004. The table includes the following plans: 1997 Stock Option Plan and 2000 Flexible Stock Plan.

| Plan Category   | Number of<br>Securities to be<br>issued upon<br>exercise of<br>outstanding<br>options, warrants<br>and rights | Weighted-average<br>exercise price of<br>Outstanding<br>options, warrants<br>and rights |
|---|---|---|
| Equity compensation plans approved by security holders: |   |   |
| 1997 Stock Option Plan                                  | 1,436,370   | \$ 2.30   |
| 2000 Flexible Stock Plan(1)                             | 9,023,630   | \$ 1.51   |
|   | =====   | =====   |
| Total   | 10,460,000  | \$ 1.62   |
|   | =====   | =====   |

(1) Securities available for future issue increase each year by 10% of our outstanding common stock at the beginning of each year. The total amount of common stock available under the plan cannot exceed 20 million shares.

### RECENT SALES OF UNREGISTERED SECURITIES

During the fiscal quarter ended June 30, 2004, we have made the following sales of restricted securities:

On June 18, 2004, we sold 10,000 shares of our common stock to David Reback pursuant to the exercise of a stock option. The shares were issued in reliance upon Section 4(2) of the Securities Act.

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### SERIES K AND A-1 PREFERRED STOCK

The following is a summary of the designations, preferences and rights of our Series K and Series A-1 preferred stocks, which is qualified, in its entirety, by the certificate of designations, preferences and rights for the Series K and A-1 preferred stocks (the "Certificates").

#### Series K

- Title. \$.01 par value per share Series K Convertible Preferred Stock.
- Voting. The Series K Stock is entitled to one vote per share, voting together as a class with the holders of our Common Stock.
- Liquidation Preference. None.
- Dividend Rights. Same as Common Stock.
- Redemption Provisions. None.
- Amount Authorized. 3 million shares.
- Amount Outstanding. 1,757,480
  
- Conversion. The Series K Stock began converting into shares of our Common Stock on June 4, 2004. On that date, 292,913 shares of Series K Stock converted into 6,274,775 shares of Common Stock. Assuming that the accelerated vesting provisions of the Series K Stock Certificate described below will not apply, the Series K shares will automatically convert into a like amount on each June 4, 2005 through 2010, for an aggregate of an additional 37,648,650 shares of common stock.

20

Under the terms of the accelerated vesting provisions of the Series K Stock Certificate, and a separate agreement with the Series K holders in which they agreed to forego certain rights they possess pursuant to the terms of the Series K Stock Certificate, in the event that (i) (a) any person or group other than the holders of the Series K acquires 50% or more of Interpharm's common stock or (b) if following a tender offer or proxy contest, the persons who were previously Interpharm's directors do not constitute a majority of the Board of Directors, and (ii) the Series K holders own less than 51% of Interpharm's Common Stock, additional shares of Series K may convert at the request of the Series K holders such that they own, in the aggregate, at least 51% of Interpharm's Common Stock.

While the holders of the Series K have demand registration rights with respect to the Common Stock to be issued upon conversion of the Series K, they have not exercised that right as of the date of this Report. Therefore, all common stock issued pursuant to the June 4, 2004 conversion is restricted.

#### Series A-1

- Title. \$.01 par value per share Series A-1 Convertible Cumulative Preferred Stock.
- Voting. No voting rights.

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- Liquidation Preference. \$0.682 per share.
- Dividend Rights. \$0.0341 per share, per year, when and as declared by our Board of Directors.
- Redemption Provisions. None.
- Amount Authorized. 5 million shares.
- Amount Issued. 4,855,309
- Conversion. Converts on a 1:1 basis into common stock upon:
  - i. the Company reaching \$150 million in revenues;
  - ii. a merger, consolidation, sale of assets or similar transaction; or
  - iii. a "Change in Control" which occurs if (a) any person, or any two or more persons acting as a group, and all affiliates of such person or persons, shall, acquire and own, beneficially, 50% or more of the common stock outstanding, or (b) if following (i) a tender or exchange offer for voting securities of the Company, or (ii) a proxy contest for the election of directors of the Company, the persons who were directors of the Company immediately before the initiation of such event cease to constitute a majority of the Board of Directors of the Company upon the completion of such tender or exchange offer or proxy contest or within one year after such completion.

21

### ITEM 6. SELECTED FINANCIAL DATA

The following table presents summary financial data for the year ended June 30, 2004, the six-months ended June 30, 2003 and June 30, 2002 and the four previous years ended December 31, 2002. The summary financial data set forth below with respect to our statements of operations for the years ended December 31, 2000 and 1999 and the balance sheet data as at December 31, 2000 and 1999 was derived from our consolidated financial statements which are not included in this Report. The following summary financial data should be read in conjunction with the consolidated financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere in this Report.

|                             | YEAR ENDED<br>JUNE 30, 2004 | SIX MONTHS<br>ENDED<br>JUNE 30, 2003 | SIX MONTHS<br>ENDED<br>JUNE 30,<br>2002 (1) | YEAR ENDED<br>DECEMBER 31,<br>2002 | YEAR ENDED<br>DECEMBER 31,<br>2001 | YEAR ENDED<br>DECEMBER 31,<br>2000 |
|-----------------------------|-----------------------------|--------------------------------------|---|------------------------------------|------------------------------------|------------------------------------|
| Net Sales                   | \$41,099,728                | \$14,953,438                         | \$11,743,440                                | \$24,312,245                       | \$18,435,446                       | \$18,435,446                       |
| Net income                  | 3,122,821                   | 723,645                              | 610,802                                     | 1,050,419                          | 514,565                            | 514,565                            |
| Income per<br>common share: |                             |                                      |   |                                    |                                    |                                    |
| Basic                       | 0.16                        | 0.08                                 | 0.07  | 0.13                               | 0.06                               | 0.06                               |
| Diluted                     | 0.04                        | 0.02                                 | 0.02  | 0.03                               | 0.01                               | 0.01                               |
| Balance Sheet Data          |                             |                                      |   |                                    |                                    |                                    |

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|                                |            |            |            |            |           |
|--------------------------------|------------|------------|------------|------------|-----------|
| Total Assets                   | 35,167,945 | 20,338,795 | 10,904,362 | 11,198,347 | 9,645,807 |
| Long-term obligations          | 7,075,801  | 267,056    | 3,460,959  | 3,335,754  | 3,591,480 |
| Cash dividend per common share | 0          | 0          | 0          | 0          | 0         |

(1) Unaudited.

22

### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### RESULTS OF OPERATIONS

##### OVERVIEW

Interpharm Holdings, Inc. ("Interpharm," "we," or "us"), through its wholly-owned subsidiary, Interpharm, Inc., is engaged in the business of developing, manufacturing and marketing generic over-the-counter and prescription strength pharmaceutical products. We make sales both under our own label and to wholesalers and distributors which sell our products under their labels.

We market our products primarily to wholesalers, drug distributors, repackagers, and other manufacturers through our internal sales staff as well as independent sales representatives. Some of our wholesalers and distributors purchase products that are warehoused for drug chains, independent pharmacies, state and federal governmental agencies and managed healthcare organizations. Sales are recognized when the product is shipped and appropriate provisions are made for returns, rebates and chargebacks.

Our operating results for the fiscal year ended June 30, 2004 reflect our continuing expansion plan, including continuing investments in increasing our production capacity and our pursuit of strategic alliances. Presented below are some of our financial highlights for the year ended June 30, 2004 and the unaudited twelve-months ended June 30, 2003.

|                  |           |      | Fiscal Year Ended<br>June 30, 2004<br>(Audited) | Twelve Months<br>Ended<br>June 30, 2003<br>(Unaudited) |
|------------------|-----------|------|---|--|
|                  |           |      |   |  |
| Revenue          | Increased | 49%  | \$41,099,728                                    | \$27,522,243   |
| Gross Profit     | Increased | 95%  | \$9,794,835                                     | \$5,021,829  |
| Operating Income | Increased | 152% | \$5,060,375                                     | \$2,011,597  |
| Net Income       | Increased | 168% | \$3,122,821                                     | \$1,163,262  |

We believe that a key component of our growth has been, and, will continue to be, our commitment to capital investment to increase production capacity. During the past year, we invested approximately \$2.4 million in new machinery, equipment and leasehold improvements.

Further, on June 29, 2004, we closed on the purchase of a 92,000 square foot facility in Brookhaven, New York. Once FDA approval is obtained, this facility will double our current available space of approximately 100,000 square feet and provide us with sufficient additional acreage for potential further expansion of our production facilities in the future. Until we obtain FDA

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approval for manufacturing at the Brookhaven facility, we may use the new facility for warehousing and other activities, which would enable us to free up space for additional manufacturing in our current plant.

23

On May 18, 2004, the FDA approved our ANDA for Hydrocodone Bitartrate and Ibuprofen Tablets, 5 mg/200 mg. This product is a new lower strength version of Hydrocodone Bitartrate and Ibuprofen Tablets, 7.5 mg/200 mg, which is the generic equivalent to the branded drug Vicoprofen(R). We received a six-month exclusivity period for marketing of this product from the FDA. Since we are the first company to receive approval to manufacture and market this product in this strength, we were provided the opportunity to market the product as a branded generic drug.

We began marketing the product under the name Reprexain(R) in June 2004, pursuant to a contract with Watson Pharmaceuticals, Inc. Pursuant to the terms of the contract, we will manufacture and supply the product to Watson, which will market, sell and distribute the product in the United States. We will receive payment from Watson based on the amount of Reprexian ordered by it for sale as well as a percentage of sales that Watson generates through its marketing efforts.

In furtherance of our expansion plans, during the fiscal year ended June 30, 2004, we began to focus on increasing our product pipeline with an emphasis on higher margin products. Historically, the majority of our revenues were derived from sales of Ibuprofen tablets in both prescription and over-the-counter strengths. During our fiscal year ended June 30, 2004, Ibuprofen accounted for approximately 60% of our total revenue. This is a significant decrease from the same period ended 2003 when Ibuprofen accounted for approximately 86% of our total revenue.

As we continue to implement our expansion plan, we are focusing our efforts to (i) continue increasing our market share in our existing product lines by utilizing our manufacturing efficiency, cost competitiveness, and customer loyalty, (ii) obtain FDA approval for the drugs currently under development, (iii) successfully implement our research and development strategy with a view towards expanding and diversifying immensely increasingly our product line with a focus on higher margin products to a more diversified portfolio of products resulting in higher margins, (iv) leverage off of our competitive strengths in manufacturing to capture market share on our new product lines, (v) increase production capacity in our current plant, (vi) obtain FDA approval for our new facility in a timely manner, (vii) utilize our manufacturing efficiencies to enter into additional manufacturing and supply arrangements, (viii) enter into joint ventures and strategic alliances with companies whose strengths compliment ours, and (ix) create marketing and distribution channels for our existing and future products.

24

FISCAL YEAR ENDED JUNE 30, 2004 COMPARED TO TWELVE-MONTHS ENDED JUNE 30, 2003  
(All financial information for the twelve months ended June 30, 2003 is Unaudited)

| FOR THE TWELVE<br>MONTHS ENDED<br>JUNE 30, 2004<br>AUDITED<br>----- | FOR THE TWELVE<br>MONTHS ENDED<br>JUNE 30, 2003<br>UNAUDITED<br>----- |
|---|---|
|---|---|

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|  |               |               |
|--|---------------|---------------|
| SALES, Net                                   | \$ 41,099,728 | \$ 27,522,243 |
| COST OF SALES                                | 31,304,893    | 22,500,414    |
| GROSS PROFIT                                 | 9,794,835     | 5,021,829     |
|  | -----         | -----         |
| Gross profit percentage                      | 23.83%        | 18.25%        |
|  | -----         | -----         |
| OPERATING EXPENSES                           |               |               |
| Selling, general and administrative expenses | 4,124,261     | 2,485,863     |
| Related party rent expense                   | 72,000        | 72,000        |
| Research and development                     | 538,199       | 452,369       |
|  | -----         | -----         |
| TOTAL OPERATING EXPENSES                     | 4,734,460     | 3,010,232     |
|  | -----         | -----         |
| OPERATING INCOME                             | 5,060,374     | 2,011,597     |
|  | -----         | -----         |
| OTHER INCOME (EXPENSES)                      |               |               |
| Related party interest expense               | --            | (163,187)     |
| Interest expense                             | (21,368)      | (112,860)     |
| Interest and other income                    | 69,451        | 8,229         |
|  | -----         | -----         |
| TOTAL OTHER INCOME (EXPENSE)                 | 48,084        | (267,818)     |
|  | -----         | -----         |
| INCOME BEFORE INCOME TAXES                   |               |               |
| INCOME TAX EXPENSE                           | 5,108,457     | 1,743,779     |
|  | 1,985,638     | 580,517       |
|  | -----         | -----         |
| NET INCOME                                   | \$ 3,122,820  | \$ 1,163,262  |
|  | =====         | =====         |

### Net Sales and Gross Profit

Net sales for the fiscal year ended June 30, 2004 were \$41.1 million compared to \$27.5 million for the twelve-months ended June 30, 2003, an increase of 49.3% or \$13.6 million. Our increase in sales was attributable to increased sales of Allopurinol, Atenolol and Naproxen which totaled approximately \$13.8 million compared to approximately \$1.8 million for the twelve-months ended June 30, 2003.

We launched production of Naproxen in December 2001 and have experienced an increase in sales primarily as the result of customer awareness of our entry into this market and their willingness to increase orders. We did not sell Allopurinol during the twelve-months ended June 30, 2003.

25

The increase in net sales was not attributable to any change in prices which, for our entire product line, remained stable.

Gross profit for the fiscal year ended June 30, 2004 increased approximately \$4.8 million, or 95%, to \$9.8 million, compared to \$5.0 million for the twelve-months ended June 30, 2003.

In addition, our gross profit percentage increased 5.6 percentage points from 18.3% for the twelve-months ended June 30, 2003 to 23.8% for the fiscal year ended June 30, 2004. Our increased margins are primarily the result of the diversification of our product line to higher margin drugs as well as increased manufacturing efficiency.

During the fiscal year ended June 30, 2004, two customers accounted for approximately 29% and 26% of total sales, respectively.

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### Cost of Sales

Cost of sales increased \$8.8 million to \$31.3 million for the fiscal year ended June 30, 2004, or 39.1% from \$22.5 million for the twelve-months ended June 30, 2003, primarily due to increased production and sales. Significant factors contributing to the increase are: (i) approximately \$4.6 million, or 51.7% is attributable to the cost of raw materials, increased quantities of which were necessary due to increased production. Raw material prices were relatively constant during the period; (ii) approximately \$2.0 million, or 23.0%, was for increased labor costs, including payroll taxes and benefits, and (iii) approximately \$750,000 or 8.5% is attributable to increased costs of packaging, lab and factory supplies.

We continued to increase our production capabilities to satisfy increasing demand from existing customers. The increase in production is attributable to our continued efforts to grow our new product lines, as well as increased production of Ibuprofen.

### Research and Development

Research and development expenses for the fiscal year ended June 30, 2004 were approximately \$538,000 compared to approximately \$452,000 for the twelve-months ended June 30, 2003, an increase of approximately \$86,000. Research and development expenses were primarily for materials, wages and biostudies for new drugs currently in development. We believe that research and development expenses will represent a substantially larger percentage of our net sales in the future as we seek to expand our product line.

### Selling, General and Administrative

Selling, general and administrative expenses were \$4.1 million, in the fiscal year ended June 30, 2004, or 10.0% of net sales, compared to \$2.5 million, or 9.0% of net sales, for the twelve-months ended June 30, 2003.

Selling, general and administrative expenses for the fiscal year ended June 30, 2004 were primarily made up of salaries, including payroll taxes and benefits (\$1,461,000), selling commissions (\$577,000), freight expenses (\$419,000), legal, accounting and other professional services (\$587,000), insurance expense (\$170,000) and utilities (\$108,000). Salaries, including payroll taxes and benefits increased \$863,000, or 144.1% from the twelve-months ended June 30, 2003 due to increases in staff to accommodate increased production. Selling commissions, utilities, insurance and freight similarly increased by 226.3%, 61.2%, 48.7% and 28.7% respectively, from the fiscal year ended June 30, 2003 due to increased production and sales.

26

### Operating Income

Operating income for the fiscal year ended June 30, 2004 increased approximately \$3.1 million, or 151.6%, to approximately \$5.1 million from approximately \$2.0 million in the twelve-months ended June 30, 2003. The increase in operating income is primarily the result of our increasing net sales \$13.6 million, diversification of our product line to higher margin drugs and increased manufacturing efficiencies.

### Income Taxes

Our provision for income taxes for the year ended June 30, 2004 increased approximately \$1,405,000 to \$1,986,000 when compared to \$581,000 for the



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twelve-months ended June 30, 2003. This is primarily due to the 193.0% increase in income before income taxes of \$3,365,000 when comparing \$5,109,000 to \$1,744,000 for the years ended June 30, 2004 and 2003, respectively.

### LIQUIDITY AND CAPITAL RESOURCES

We currently finance our operations and capital expenditures through cash flows from operations, bank loans, lines of credit, cash acquired in our reverse merger in May, 2003 and cash received from the exercises of stock options. Net income for the fiscal year ended June 30, 2004 was \$3.1 million, an increase of \$2.0 million from \$1.1 million for the twelve-months ended June 30, 2003. Net cash provided by operating activities for the fiscal year ended June 30, 2004 was \$1.9 million, as compared to \$1.2 million for the same period last year. Net cash from operating activities during this period increased \$2.0 million as a result of realizing \$2.0 million in cash savings from the tax benefits associated with the exercise of stock options, as well as depreciation and amortization expenses of \$886,000. Net cash was substantially offset by increases in accounts receivable (\$2.0 million) and inventories (\$947,000). The increase in inventories occurred gradually throughout the fiscal year in order to accommodate increasing demand for our products. Net cash was also offset by a decrease of \$784,000 in accounts payable, accrued expenses and other liabilities. Other items affecting our net cash provided from operating activities aggregated \$370,000.

During the fiscal year ended June 30, 2004, we were able to pay down bank loans aggregating \$462,000 and bank lines of credit by \$1.64 million, in total approximately \$2.1 million. As discussed in Note 8, during the fiscal year ended June 30, 2004, we recently obtained a \$21,000,000 credit facility consisting of:

- o A \$7,400,000 mortgage loan which is to be repaid with 119 monthly installments, based upon an amortization schedule of twenty years, and a balloon payment due in ten years for the balance.

27

- o Two advised credit lines aggregating \$6,600,000 primarily to acquire new equipment and for renovations of the Company's new Brookhaven, NY plant. The balance of the funds accessed through these credit lines will convert to fully amortizing five year term loans.
- o A \$2 million advised non-revolving secured facility for equipment purchases. Each advance cannot exceed 90% of the invoice amount of the new equipment and is convertible into separate notes that fully amortize over 60 months.
- o A \$5,000,000 advised line of credit primarily for working capital and general corporate purposes.

This new credit facility is collateralized by substantially all of our assets. At our option, interest will generally be calculated at (i) LIBOR plus 1.5% for 3 to 36 months periods, or (ii) at the Bank's then fixed prime rate. In addition, we will be required to comply with certain financial covenants. The Bank will review the new credit facility annually; the next review is scheduled to occur no later than November 30, 2004. The credit lines are terminable by the Bank at any time as to undrawn amounts.

Net cash used in investing activities was \$2.9 million for the fiscal year ended June 30, 2004, which is as a result of increases in fixed assets of \$2.4 million and the downpayment for a new facility of \$2.0 million in Brookhaven, New York, offset by the collection of \$1.5 million of notes receivable from our reverse merger with Atec Group, Inc., and the sale of property and equipment of

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\$19,000. Net cash provided by financing activities was \$1.5 million for the fiscal year ended June 30, 2004, which resulted from the receipt of \$3.5 million from option exercises and \$64,000 of additional cash received after the reverse merger transaction, less repayment of various bank lines and notes of approximately \$2.1 million. Subsequent to June 30, 2004, the Company paid down the complete balance owing on the general lines of credit of \$424,847.

As a result of our cash flows from operations and financing activities during the fiscal year ended June 30, 2004, working capital increased \$6.2 million to \$11.7 million from \$5.5 million at June 30, 2003.

We believe our advised bank lines of credit, increased working capital, funds generated from operations and cash provided by option exercises will allow us to continue our expansion plans and will be sufficient to continue meet our operating requirements. We may nevertheless, choose to raise additional funds or seek other financing arrangements to facilitate more rapid expansion and additional research and development activities. There can be no assurance, however, that such additional funds will be available, or, if available, on commercially acceptable terms.

At June 30, 2004, we had approximately \$12.2 million in Federal net operating loss carryforwards ("NOLs") available to reduce future taxable income. These NOLs could result in savings of approximately \$4.5 million in future income tax payments (although there will be no corresponding benefit on income tax expenses).

28

### Accounts Receivable

Our accounts receivable at June 30, 2004 was \$6.8 million as compared to \$4.9 million at June 30, 2003. This increase is primarily attributable to the increase in sales for the fiscal year ended June 30, 2004. The average number of days outstanding of our accounts receivable for the fiscal year ended June 30, 2004 was 51.6 days and for the twelve-months ended June 30, 2003 was 60.5 days.

### Inventory

At June 30, 2004, our inventory was \$5.5 million as compared to \$4.6 million at June 30, 2003. We believe the increase in inventory is necessary in order to maintain our growth and overall customer demands. Our turnover of inventory was 6.19 turns at June 30, 2004 and 6.23 at June 30, 2003.

### Accounts Payable

Accounts payable, accrued expenses and other liabilities, in the aggregate, decreased approximately \$769,000. We believed it was important to improve our relationships with key vendors. As such, during the fiscal year ended June 30, 2004, we reduced our overall accounts payable when compared to June 30, 2003.

### Cash and Cash Equivalents

During the year ended June 30, 2004, cash and cash equivalents increased \$548,000 from \$2,336,000 at June 30, 2003 to \$2,885,000 at June 30, 2004, primarily among other factor the result of: (i) collection of \$1,524,000 of notes receivable associated with the reverse merger and (ii) through the collection of approximately \$3,520,000 from the exercise of stock options. These inflows were offset by: (i) net cash used in operating activities of \$1,947,000, consisting of net income of \$3,123,000, offset by net funds used in operating activities of \$1,176,000; (ii) the cash used for the acquisition of our new

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facility as well as new packaging equipment and other fixed assets aggregating \$4,424,000; and (iii) repayment of various bank lines of credit and bank notes payable totaling approximately \$2,102,000.

We believe that one of the most important factors in our ability to continue to grow our business will be our ability to launch new products. To that end, we plan to devote substantially greater resources to our research and development efforts than we have in previous years. In addition, we plan to continue to devote substantial resources to increasing our production capacity through the purchase of new equipment and otherwise improving our production facility. While we anticipate that our cash flow and current credit arrangements will be sufficient for at least the next 12 to 18 months, we may choose to raise additional funds or seek other financing arrangements to facilitate more rapid expansion, to develop new products at a faster pace, or to acquire or invest in complimentary businesses, technologies, services or products.

29

### OUR OBLIGATIONS

As of June 30, 2004, our obligations and the periods in which they are scheduled to become due are set forth in the following table:

| OBLIGATION             | TOTAL         | DUE IN LESS<br>THAN 1<br>YEAR | DUE<br>IN 1-3<br>YEARS | DUE<br>IN 4-5<br>YEARS |
|------------------------|---------------|-------------------------------|------------------------|------------------------|
| Lines of credit(1)     | \$ 424,847    | \$ 424,847                    | \$ --                  | \$ --                  |
| Bank notes payable(1)  | \$ 7,400,000  | \$ 339,197                    | \$ 740,000             | \$ 740,000             |
| Operating leases       | \$ 7,500,839  | \$ 620,839                    | \$ 960,000             | \$ 960,000             |
|                        | -----         | -----                         | -----                  | -----                  |
| Total cash obligations | \$ 15,325,686 | \$ 1,384,883                  | \$ 1,700,000           | \$ 1,700,000           |
|                        | =====         | =====                         | =====                  | =====                  |

(1) See "Bank Loans and Lines of Credit," below.

The following are financial covenants related to the lines of credit and bank loans:

- o Minimum debt service ratio of at least 1.25 : 1.0, on a semi-annual basis;
- o Maximum debt to net worth ratio of not more than 1.2 : 1.0, on an annual basis;
- o Current Ratio not less than 1.5 : 1.0

All Ratios shall be tested quarterly, and Debt Service Coverage Ratio and Interest Coverage Ratio shall be on a rolling four-quarter basis.

We are in compliance with all of the above covenants.

Bank Loans and Lines of Credit

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Our advised credit lines and loans are fully described in Note 8 of the accompanying financial statements.

### Leases

We lease an entire building in Hauppauge, New York, pursuant to a non-cancellable lease expiring in October, 2019, which houses our manufacturing, warehousing and some executive offices. The leased building is approximately 100,000 square feet and is located in an industrial/office park. The current annual lease payments to the landlord, Sutaria Family Realty, LLC, are \$480,000. Sutaria Family Realty, LLC is owned by Mona Rametra, Perry Sutaria and Raj Sutaria. Upon a change in ownership of the Company, and every three years thereafter, the annual base rent will be adjusted to fair market value, as determined by an independent appraisal. There are no tenants in the building other than us.

30

We also lease approximately 23,175 square feet of office space at 69 Mall Drive in Commack, New York for some of our executive offices. The lease for this office space expires in May 2005. The annual lease payments are approximately \$187,000 and we have sublet 18,500 square feet for \$164,000 per year. During the remaining eleven months of this lease, we have sublet approximately 18,500 square feet for \$139,000.

FOR SIX MONTHS ENDED JUNE 30, 2003 COMPARED TO JUNE 30, 2002  
(All June 30, 2002 financial information is unaudited.)

### Financial Highlights

- o Net sales increased 27.3% or \$3.2 million to \$14.9 million from \$11.7 million.
- o Gross profit increased 27.0% or \$580,000 to \$2.7 million from \$2.1 million.
- o Operating income increased 15.6% or \$168,000 to \$1.2 million from \$1.0 million.
- o Net income increased 18.5% or \$113,000 to \$724,000 from \$611,000.

### Net Sales and Gross Profit

Net sales for the six-month period ended June 30, 2003 were \$15.0 million compared to \$11.7 million for the six-month period ended June 30, 2002, an increase of 27.3% or \$3.2 million. The increase in sales is primarily attributable to increased orders from our existing customers resulting from our increased production capacity. We launched production of Naproxen in December 2001. We have experienced an increase in our sales of Naproxen which is primarily the result of customer awareness of our entry into this market and their willingness to increase orders for Naproxen as they do for Ibuprofen. The increase in net sales was not attributable to any change in prices which, for our entire product line, remained stable. Gross profit for the six months ended June 30, 2003 was \$2.7 million.

During the six months ended June 30, 2003, two customers accounted for approximately 50% of total sales.

### Cost of Sales

Cost of sales increased \$2.6 million to \$12.2 million for the six-month period ended June 30, 2003, or 27.4% from \$9.6 million for the six-month period ended June 30, 2002, primarily due to increased production and sales. Approximately \$1.9 million, or 72.2% of this increase is attributable to the

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cost of raw materials, increased quantities of which were necessary due to increased production. Raw material prices were constant during the period. Approximately \$386,000, or 14.7%, was for increased labor costs, including payroll taxes and benefits. Approximately \$242,000 or 9.2% is attributable to increased costs of packaging, lab and factory supplies.

31

We continued to increase our production capabilities to satisfy increasing demand from existing customers. The increase in production is attributable to our continued efforts to grow Naproxen, as well as increased production of Ibuprofen.

### Research and Development

Research and development expenses for the six-month period ended June 30, 2003 were \$186,000 or 1% of net sales, compared to \$149,000, or 1% of net sales for the same period in 2002, an increase of \$37,000. Research and development expenses were used primarily for materials and biostudies for new drugs currently in development. We believe that research and development expenses will represent a substantially larger percentage of our net sales in the future as we seek to expand our product line.

### Selling, General and Administrative

Selling, general and administrative expenses were \$1.3 million, in the six-month period ended June 30, 2003, or 8.5% of net sales, compared to \$900,000, or 7.6% of net sales, for the same period in 2002.

Selling, general and administrative expenses for the six-month period ended June 30, 2003 were primarily made up of salaries, including payroll taxes and benefits (\$320,000), selling commissions (\$91,000), freight expenses (\$197,000), legal, accounting and other professional services (\$252,000), insurance expense (\$71,000), bad debts (\$40,000), and utilities (\$40,000). Salaries increased \$40,000, or 14.3% from the six month period ended June 30, 2002 due to increases in staff to accommodate increased production. Legal, accounting and other professional services increased \$204,000, or 429.7% from the six month period ended June 30, 2002. This increase is attributable to costs associated with the acquisition of Interpharm, Inc. by ATEC and the increased legal and accounting expenses resulting from being a public company. No sales were made to any customer whose balance was written off during the six month period ended June 30, 2003.

### Operating Income

Operating income for the six-month period ended June 30, 2003 increased \$168,000 to \$1.2 million as compared to \$1.1 million, or 15.6% as compared to the same period ended June 30, 2002. The six-month period ended June 30, 2003 included an increase of approximately \$204,000 of legal, professional and accounting costs, as compared to the same period in 2002. These increased expenses are the result of the acquisition of Interpharm, Inc., by ATEC which was consummated on May 30, 2003, and the legal and accounting fees associated with being a public company. For the six-month period ended June 30, 2002, there were no such fees.

32

### Income Taxes

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The effective tax rate for the six-month period ended June 30, 2003 was 35% compared to 34% for 2002. Our deferred tax asset was primarily attributable to New York State investment tax and employment incentive tax credits. The tax credits utilized are limited to the state taxes computed on the minimum taxable income base. These tax credits also expire in 15 years if not utilized. We estimated a reserve for the deferred tax asset based upon prior years' actual credits utilized and projected credits to be utilized on future taxable income. The valuation allowance reserve has decreased due to our increased taxable income which has utilized more credits and our estimate of future growth which has reduced the estimated credits that will not be utilized.

### LIQUIDITY AND CAPITAL RESOURCES

Cash flows from operations were \$200,000 during the six-month period ended June 30, 2003. As a result of Interpharm, Inc.'s cash flows from operations during the six-month period ended June 30, 2003 and the sale of Atec Group, Inc.'s computer operations on May 30, 2003, working capital increased \$2.9 million to \$5.2 million from \$2.3 million at December 31, 2002. We believe that Interpharm, Inc.'s working capital and cash provided by operating activities are sufficient to meet its operating needs for the next 12 months.

Net cash used in investing activities for the six-month period ended June 30, 2003 was approximately \$1.0 million related to the purchase of production equipment.

During the six-month period ended June 30, 2003, we generated approximately \$3.1 million including approximately \$2.1 million (net of \$190,000 of costs) from the reverse merger with ATEC and \$1.1 million of proceeds from our bank credit line. The exercise of 2,187,863 options from July 1, 2003 to September 12, 2003 resulted in cash proceeds to us of \$2.7 million. These options were outstanding prior to the closing of the transaction with ATEC. In addition, promissory notes in the amount of \$1.5 million from the purchaser of Atec Group, Inc.'s computer business were collected subsequent to June 30, 2003.

In August 2003, we increased our credit lines from \$3.5 million (at December 31, 2002) to \$7 million. In addition, we retired approximately \$3.3 million in related party loans to Interpharm in exchange for our Series A-1 Preferred Stock. We believe that our increased liquidity will afford us the opportunity to increase our Research and Development expenditures on a more aggressive pace than in previous years.

At June 30, 2003, we have approximately \$7.7 million in Federal net operating loss carryforwards ("NOLs") available to reduce future taxable income. These NOLs could result in savings of up to \$3.0 million in future income tax payments (although there will be no effect on income tax expenses).

33

In addition, the exercise of 2,251,382 employee stock options and warrants from July 1, 2003 to September 24, 2003 resulted in additional future tax deductions approximating \$9.0 million which could result in cash savings of up to \$3.0 million.

### Accounts Receivable

Our accounts receivable at June 30, 2003 was \$4.9 million as compared to \$4.2 million at December 31, 2002. This increase is primarily attributable to the increase in sales for the six-month period ended June 30, 2003. The average number of days outstanding of our accounts receivable for the six-month period ended June 30, 2003 consistently ranged from 54 to 59 days. Inventory

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In late 2000 and early 2001, Interpharm, Inc. commenced a program to increase inventory production levels to meet demand created by increasing sales. At June 30, 2003, our inventory increased to \$4.6 million from \$3.4 million at December 31, 2002, which is a level we believe to be sufficient to meet current demand.

### Accounts Payable

The accounts payable, accrued expenses and other liabilities increased approximately \$1.2 million and amounts due on our working capital credit line increased \$1.1 million from December 31, 2002. This increase is primarily attributable to increased inventory production to meet demand.

### Cash and Cash Equivalents

Cash and cash equivalents at June 30, 2003 were \$2.3 million as compared to \$106,000 at December 31, 2002, an increase of \$2.2 million. This increase is primarily attributable to the proceeds from the sale of ATEC computer operations, Interpharm, Inc.'s cash flow from operating activities and net bank borrowings of approximately \$1.0 million. Offsetting these events were equipment purchases of \$1,031,000 during the six month period ending June 30, 2003.

We believe that one of the most important factors in our ability to continue to grow our business will be our ability to launch new products. To that end, we plan to devote substantially greater resources to our research and development efforts than we have in previous years. In addition, we plan to continue to devote substantial resources to increasing our production capacity through the purchase of new equipment and otherwise improving our production facility. While we anticipate that our cash flow and current credit arrangements will be sufficient for at least the next 12 to 18 months, we may choose to raise additional funds or seek other financing arrangements to facilitate more rapid expansion, to develop new products at a faster pace, or to acquire or invest in complimentary businesses, technologies, services or products.

34

From time to time in the past, Interpharm, Inc.'s shareholders, directors, and officers had made loans to it for working capital. As of December 31, 2002, each of these loans was paid by Interpharm, Inc. with the exception of a loan with a \$3.0 million principal balance from Dr. Maganlal K. Sutaria to Interpharm, Inc. and a \$311,375 loan from a shareholder. Both loans were converted into Series A-1 preferred stock on May 30, 2003.

FISCAL YEAR ENDED DECEMBER 31, 2002 COMPARED TO DECEMBER 31, 2001

### Financial Highlights

- o Net sales increased 32% or \$5.9 million to \$24.3 million from \$18.4 million.
- o Gross profit increased 27% or \$0.9 million to \$4.4 million from \$3.5 million.
- o Operating income increased 80% or \$0.8 million to \$1.8 million from \$1.0 million.
- o Net income increased 104% or \$535,854 to \$1,050,419 from \$514,565.

### Net Sales and Gross Profit

Net sales for the fiscal year ended December 31, 2002 were \$24.3 million compared to \$18.4 million for the fiscal year ended December 31, 2001, an increase of \$5.9 million. Of this 32% increase in net sales approximately \$5.1 million is attributable to increased orders from existing customers spread

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evenly across Interpharm, Inc.'s product lines and resulting from Interpharm, Inc.'s increased production capacity and \$800,000 is attributable to the introduction of Naproxen to Interpharm, Inc.'s product line. The increase in net sales was not attributable to any change in prices which, for all products in Interpharm, Inc.'s product line, remained stable from the fiscal year ended December 31, 2001 to the year ended December 31, 2002. Gross profit for the year ended December 31, 2002 was \$4.4 million, an increase of 22% or \$900,000 from the \$3.5 million for the prior year.

During the year ended December 31, 2002, two Interpharm, Inc. customers accounted for approximately 48% of Interpharm, Inc.'s total sales.

### Cost of Sales

Cost of sales increased to \$19.9 million in the fiscal year ended December 31, 2002, or 34% from \$14.9 million in the prior year due to increased production. Approximately \$3.7 million, or 73% of this increase is primarily raw material purchases and approximately \$1.0 million, or 12%, was for increased labor costs. Raw material prices were constant during the period.

Interpharm, Inc. increased its production to satisfy existing demand from existing customers which have additional purchasing capacity. The increase in production is attributable to the introduction of Naproxen as well as increased production of Ibuprofen and Iso Cap, the production of which increased 25% and 30% respectively.

35

### Research and Development

Research and development expenses for the fiscal year ended December 31, 2002 were \$415,618, or 2% of net sales, compared to \$110,000, or 1% of net sales in 2001, an increase of \$305,618. Research and development expenses were used primarily for materials and biostudies for new drugs currently in development.

### Selling, General and Administrative

Selling, general and administrative expenses were \$2.1 million, in the year ended December 31, 2002, or 9% of net sales, compared to \$2.0 million, or 11% of net sales, for 2001.

Selling, general and administrative expenses for the fiscal year ended December 31, 2002 were primarily made up of salaries (\$492,000), selling commissions (\$164,000), freight expenses (\$370,000), legal, accounting and other professional services (\$328,000), repairs and maintenance costs (\$74,000) and insurance expense (\$23,000). Salaries increased \$37,000 due to increases in staff to accommodate increased production. In addition, bad debt expense decreased by \$214,000 due to the write-off of one customer balance in the preceding year and write-offs occurring during the year ended December 31, 2002 were \$47,000. No sales were made to the customer whose balance was written off in the fiscal year ended December 31, 2002.

### Income Taxes

The effective tax rate for the fiscal year ended December 31, 2002 was 32% compared to 29% for 2001. The increase in the effective tax rate for 2002 was primarily due to a decrease in the net deferred tax asset valuation allowance in the 2001 fiscal period. The deferred tax asset was primarily attributable to New York State investment tax and employment incentive tax credits. The tax credits utilized are limited to the state taxes computed on the minimum taxable income base. These tax credits also expire in 15 years if not utilized. Management has



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estimated a reserve for the deferred tax asset based upon prior years' actual credits utilized and projected credits to be utilized on future taxable income. The valuation allowance reserve has decreased due to Interpharm, Inc.'s increased taxable income which has utilized more credits and management's estimate of future growth which has reduced the estimated credits that will not be utilized.

### LIQUIDITY AND CAPITAL RESOURCES - DECEMBER 31, 2002

Cash flows from operations were \$1,747,585 during the fiscal year ended December 31, 2002, \$906,343 during year ended December 31, 2001 and \$353,293 during 2000. As a result of Interpharm, Inc.'s cash flows from operations during fiscal 2002, working capital increased \$0.2 million to \$2.3 million from \$2.1 million in 2001.

Net cash used in investing activities for the fiscal year ended December 31, 2002, 2001 and 2000 were \$1,203,221, \$964,259 and \$175,583, respectively. These were all for the purchase of production equipment except for \$19,011 in 2002 for the purchase of marketable securities. In the year ended 2002, Interpharm, Inc. used \$1,044,176 to repay bank notes of \$236,455 and loans to related parties of \$807,721. In the year ended 2001, Interpharm, Inc. removed \$313,166 of net equipment from service.

36

### Accounts Receivable

The accounts receivable increase from December 31, 2001 to December 31, 2002 is primarily attributable to the increase in sales throughout 2002. This increase resulted in an increased accounts receivable balance at December 31, 2002.

The accounts receivable days outstanding for the periods December 31, 2001 through December 31, 2002 consistently ranged from 54-59 days.

### Inventory

During the later part of 2000 and early 2001 Interpharm, Inc. commenced a program to increase inventory production levels to meet the demand for increasing sales. Due to the increase in sales at the end of 2001 Interpharm, Inc.'s inventory had decreased. During 2002 Interpharm, Inc. had increased production capacity to produce more inventory to meet future demand resulting in a more optimal level of inventory at December 31, 2002.

The inventory turnover for the periods ended December 31, 2001 through December 31, 2002 has consistently improved with a decrease in number days sales in inventory from 58 days to 50 days.

### Accounts Payable

The accounts payable, accrued expenses and other liabilities increase from December 31, 2001 to December 31, 2002 is primarily attributable to increased inventory production to meet future sales demands.

### Cash and Cash Equivalents

The decrease in cash and cash equivalents from December 31, 2001 to December 31, 2002 of \$478,069 is primarily attributable to \$1,184,210 in equipment purchases and \$1,044,176 to repay bank notes of \$236,455 and loans to related parties of \$807,721. These amounts were partially offset by \$1,747,535 in net cash provided by operating activities.

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From time to time in the past, Interpharm, Inc.'s shareholders, directors and officers had made loans to it for working capital. As of December 31, 2002, each of these loans was paid by Interpharm, Inc. with the exception of a loan with a balance of \$304,750 from Mona Sutaria and a loan with a \$3 million principal balance from Dr. Maganlal K. Sutaria to Interpharm, Inc. The \$3,000,000 loan reflected in Interpharm, Inc.'s December 31, 2002 financial statements has a maturity date of January 1, 2012. Repayment of this loan was subordinated to Interpharm, Inc.'s bank debt.

37

### CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of financial condition and results of operations discusses our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires that Interpharm make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, Interpharm evaluates judgments and estimates made, including those related to revenue recognition, inventories, income taxes and contingencies including litigation. Interpharm bases its judgments and estimates on historical experience and on various other factors that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We consider the following accounting policies to be most critical in understanding the more complex judgments that are involved in preparing its financial statements and the uncertainties that could impact results of operations, financial condition and cash flows.

Revenue from the sale of Interpharm products are recognized upon shipment of the product. Upon a review of specific accounts and historical experience we record, when necessary, a provision for allowances, chargebacks, returns and other sales credits based. These provisions have been recorded as a reduction of sales in the consolidated statements of income.

We purchase raw materials from two suppliers, which are manufactured into finished goods and sold back to such suppliers as well as to other customers. We can, and do, purchase raw materials from other suppliers. We also (i) have the general inventory risk of loss associated with the raw materials purchased; (ii) negotiate the selling price for the finished product; (iii) significantly change the raw material into a finished product based upon our specifications, and (iv) have the option to obtain the raw materials from alternate sources. These factors among others, qualify us as the principal under the indicators set forth in EITF 99-19, "Reporting Revenue Gross as a Principal vs. Net as an Agent." If the terms and substance of the arrangement change, such that we no longer qualify to report these transactions on a gross reporting basis, our net income and cash flows would not be affected. However, our sales and cost of sales would both be reduced by a similar amount.

#### Allowance for Doubtful Accounts

We record allowances for doubtful accounts based upon customer specific analysis and assessment of past-due balances. Additional allowances for doubtful accounts may be required if there is an increase in past-due balances or for customer specific circumstances. The allowance for doubtful accounts was \$74,166

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at June 30, 2004 and \$47,776 at June 30, 2003.

38

### Inventory

Our inventories are valued at the lower of cost or market, determined on a first-in, first-out basis, and include the cost of raw materials and manufacturing. We continually evaluate the carrying value of our inventories and when factors such as expiration dates and spoilage indicate that impairment has occurred, either a reserve is established against the inventories' carrying value or the inventories are disposed of and completely written off in the period incurred.

### Income Taxes

We account for income taxes using the liability method which requires the determination of deferred tax assets and liabilities based on the differences between the financial and tax bases of assets and liabilities using enacted tax rates in effect for the year in which differences are expected to reverse. The net deferred tax asset is adjusted by a valuation allowance, if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized. Our net deferred tax asset at June 30, 2004 was \$4,182,000 and \$2,561,400 at June 30, 2003.

### RECENT ACCOUNTING PRONOUNCEMENTS

In January 2003, and revised in December 2003, the Financial Accounting Standards Board issued Interpretation No. 46R ("FIN 46"), "Consolidation of Variable Interest Entities." Prior to the issuance of this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN 46 requires a variable interest entity, as defined, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns. For these purposes, variable interests held by related parties should be combined with the reporting entity. FIN 46 is effective for our Company. The adoption of FIN 46 had no impact on our financial position, results of operation or cash flows.

39

### ISSUE AND UNCERTAINTIES

#### RISK OF PRODUCT LIABILITY CLAIMS

The testing, manufacturing and marketing of pharmaceutical products subject us to the risk of product liability claims. We believe that we maintain an adequate amount of product liability insurance, but no assurance can be given that such insurance will cover all existing and future claims or that we will be able to maintain existing coverage or obtain additional coverage at reasonable rates.

#### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Our principal financial instrument currently is a \$22.0 million credit facility. At June 30, 2004, \$7.4 million mortgage note payable and borrowings of \$425,000 under the line of credit was outstanding. The \$425,000 borrowings were repaid subsequent to June 30, 2004. Any obligations created under this credit facility incur interest calculated at our option at (i) LIBOR plus 1.5% for

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periods ranging in length from 3 to 36 months, or (ii) at the Bank's then fixed prime rate. As of June 30, 2004, the interest rates on the borrowings and mortgage note payable were 4.5% and 2.86%, respectively. We are required to comply with certain financial covenants. The Bank will review the new credit facility annually; the next review is scheduled to occur no later than November 30, 2004. The credit lines are terminable by the Bank at any time as to undrawn amounts.

We do not use any derivative financial instruments to hedge our exposure to adverse fluctuations in interest rates, fluctuations in commodity prices or other market risks, nor do we invest in speculative financial instruments.

Due to the nature of our borrowings as described above and our relatively small amount of short-term investments, we have concluded that there is no material risk exposure which could occur as a result of possible changes in market interest rates.

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements, including the notes thereto, together with the report from our independent registered public accounting firm are presented beginning at page F-1.

### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

During the previous two fiscal years, and the subsequent interim period, our accountant has not resigned, declined to stand for re-election and was not dismissed. During the previous two fiscal years, and the subsequent interim period, there were no material disagreements with Interpharm, Inc.'s accountant with respect to any matter.

Following the acquisition of Interpharm, Inc. by Atec Group, Inc., on June 9, 2003, we dismissed Weinick Sanders Leventhal & Co., LLP ("WSLCO") as our independent accountant. WSLCO had been previously engaged as the principal accountant to audit Atec Group, Inc.'s financial statements. The reason for the termination was the acquisition of Interpharm, Inc., which is now our primary business unit and which has been audited by the firm of Marcum & Kliegman LLP. We believe that it is in our best interests to have Marcum & Kliegman LLP continue to work with us.

40

WSLCO's report on Atec Group, Inc.'s financial statements for the previous two years did not contain an adverse opinion or a disclaimer of opinion, and was not qualified or modified as to uncertainty, audit scope, or accounting principles.

The decision to change accountants was recommended by our Board of Directors and approved by the Audit Committee of our Board of Directors.

During our two most recent fiscal years, and the subsequent interim periods, there were no disagreements with our accountants on any matter of accounting principles or practices, financial statement disclosure, auditing scope, or procedure, which disagreements, if not resolved to the satisfaction of our accountants, would have caused it to make reference to the subject matter of the disagreement in connection with its reports.

On June 11, 2003, we retained Marcum & Kliegman LLP as our independent accountant. Marcum & Kliegman LLP is located at 130 Crossways Park Drive, Woodbury, New York 11797.

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### ITEM 9A. CONTROLS AND PROCEDURES

#### EVALUATION OF 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 to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives.

At the conclusion of the period ended June 30, 2004, we carried out an evaluation, under the supervision and with the participation of our management, including our Chairman and Chief Executive Officer, Chief Financial Officer and General Counsel, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, the Chairman and Chief Executive Officer, Chief Financial Officer and General Counsel concluded that our disclosure controls and procedures were effective in alerting them in a timely manner to information relating to the Company required to be disclosed in this report but adopted additional disclosure controls and procedures to improve the quality and timeliness of disclosure during our transition from a private to a public company.

41

On September 20, 2004, our independent registered accounting firm Marcum & Kliegman, LLP ("MK"), informed us and our Audit Committee of the Board of Directors that in connection with their review of our financial results for the fiscal year ended June 30, 2004, MK had discovered a condition which they deemed to be a material weakness in our internal controls (as defined by standards established by the Public Company Accounting Oversight Board). MK noted the lack of adequate internal control / review procedures required to properly and timely record customer chargebacks. Management has informed MK and the Audit Committee that it is modifying its internal control / review procedures in such a manner that it believes will prevent reoccurrences of this deficiency. The impact of the above condition was isolated to the fiscal quarter ended June 30, 2004, and did not affect the results of any prior periods.

### ITEM 9B OTHER INFORMATION

None

42

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item is incorporated herein by reference to the section entitled "Directors and Executive Officers of the Registrant " of the 2004 Proxy Statement.

### ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the section entitled "Executive Compensation " of the 2004 Proxy Statement.

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### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to the section entitled "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" of the 2004 Proxy Statement.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

#### Lease

Our 100,000 square foot facility at 75 Adams Avenue in Hauppauge, New York is owned by Sutaria Family Realty, LLC which is owned by Perry Sutaria, Raj Sutaria and Mona Rametra.

43

No third party assessment or appraisal of the lease was made at the time it was entered into or at any subsequent time. Interpharm, Inc. is obligated to pay minimum annual rent of \$480,000, plus property taxes, insurance, maintenance and other expenses related to the leased facility. Upon a change in ownership of the Company, and every three years thereafter, the annual rent will be adjusted to fair market value, as determined by an independent third party.

### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

The information required by this Item is incorporated herein by reference to the section entitled "Principal Accounting Fees and Services" of the 2004 Proxy Statement.

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

#### (a) (1) FINANCIAL STATEMENTS

The following financial statements of Interpharm Holdings, Inc., are included herein:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of June 30, 2004 and June 30, 2003

Consolidated Statements of Income for the year ended June 30, 2004, for the six-months ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001

Consolidated Statement of Stockholders' Equity for the year ended June 30, 2004, for the six-months ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001

Consolidated Statements of Comprehensive Income for the year ended June 30, 2004, for the six-months ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001

Consolidated Statements of Cash Flows for the year ended June 30, 2004, for the six-months ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001

#### (2) OTHER SCHEDULES

All other schedules are omitted since the required information is not

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present or is not present in an amount sufficient to require submission of schedules, or because the information required is included in the financial statements and notes thereto.

(3) EXHIBITS

See (c) below.

44

(b) REPORTS ON FORM 8-K

We filed the following reports on Form 8-K in the quarter ended June 30, 2004:

| REPORT DATE<br>----- | ITEM REPORTED<br>-----  |
|----------------------|---|
| June 30, 2004        | The June 29, 2004 closing of the acquisition of a 92,000 square foot facility on thirty seven acres of land, located in Brookhaven, New York.               |
| June 11, 2004        | The conversion of a portion of our Series K convertible preferred stock.  |
| May 17, 2004         | Announcing our financial results for the three and nine-months ended March 31, 2004.  |
| April 21, 2004       | Announcing the resignation of Bhupatlal K. Sutaria and Praveen Bhutani as directors and the appointment as Directors of Dr. Mark Goodman and James Charles. |

(c) EXHIBITS

| NUMBER | DESCRIPTION   |
|--------|---|
| 3.1    | Certificate of Incorporation of the Company; (1)  |
| 3.2    | Certificate of Amendment of Certificate of Incorporation, filed October 21, 1992; (1)   |
| 3.3    | By-laws of the Company; (1)   |
| 3.4    | Certificate of Amendment of Certificate of Incorporation, filed December 22, 1992; (1)  |
| 3.5    | Form of Certificate of Powers, Designations, Preferences and Rights of the Series A 10% Cumulative Convertible Preferred Stock; (1) |
| 3.6    | Certificate of Powers, Designations, Preferences and Rights of the Series K Convertible Preferred Stock; (1)                        |
| 3.7    | Certificate of Powers, Designations, Preferences and Rights of the Series A-1 Convertible Preferred Stock; (1)                      |
| 4.7    | Form of Common Stock Certificate; (1)   |
| 4.9    | Form of Preferred Stock Certificate; (1)  |
| 10.1   | November 25, 2002 Capital Stock Exchange Agreement; (2)   |
| 10.2   | January 24, 2002 agreement between Interpharm, Inc. and URL/Mutual (3);   |
| 10.3   | Form of Employment Agreements for Interpharm Holdings, Inc. employees (3);  |

45

10.4 December 5, 2002 Department of Veterans Affairs acceptance of

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- 10.5 Interpharm, Inc.'s bid to supply Ibuprofen Tablets (3);  
Contract of Sale for Land and Building at 50 Horseblock Road, Yaphank, N.Y.
- 21.1 List of Subsidiaries;
- 23.1 Consent of Marcum & Kliegman, LLP;
- 31.1 Certification of Dr. Maganlal K. Sutaria pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002;
- 31.2 Certification of George Aronson pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002;
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002;
- 99.1 Form of Incentive Stock Option Agreement (3);
- 99.2 Form of Non-Qualified Stock Option Agreement (3);
- 99.3 Interpharm Holdings, Inc. Code of Ethics;
- 99.4 Interpharm Holdings, Inc. Nominating Committee Charter.

Footnotes:

- 1. Incorporated by reference from Registration Statement on Form SB-2 registration no. 33-54356 filed by the Company with the Securities and Exchange Commission on November 9, 1992.
- 2. Annexed to our Current Report on Form 8-K filed on November 26, 2002 and incorporated herein by reference;
- 3. Annexed to our Transition Report on Form 10-K filed on September 29, 2003 and incorporated herein by reference.

46

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

INTERPHARM HOLDINGS, INC.

By: /s/ Dr. Maganlal K. Sutaria

-----  
Dr. Maganlal K. Sutaria, Chief Executive  
Officer and Chairman of the Board of Directors

Dated: September 28, 2004

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ George Aronson September 28, 2004

-----  
George Aronson, Chief Financial Executive Officer

/s/ Bhupatlal K. Sutaria September 28, 2004

-----  
Bhupatlal K. Sutaria, President and Treasurer



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|  |                    |
|--|--------------------|
| /s/ Surinder Rametra<br>-----<br>Surinder Rametra, Director of Corporate Development<br>and Director | September 28, 2004 |
| /s/ Dr. Mark Goodman<br>-----<br>Dr. Mark Goodman, Director  | September 28, 2004 |
| /s/ Stewart Benjamin<br>-----<br>Stewart Benjamin, Director  | September 28, 2004 |
| /s/ David Reback<br>-----<br>David Reback, Director  | September 28, 2004 |
| /s/ James Charles<br>-----<br>James Charles, Director  | September 28, 2004 |
| /s/ Cameron Reid<br>-----<br>Cameron Reid, Director  | September 28, 2004 |

47

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

For the Year Ended June 30, 2004, for the Six Months Ended June 30, 2003 and  
2002 (Unaudited) and for the Years Ended December 31, 2002, and 2001

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

CONTENTS

|   | Page |
|---|------|
| REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM | F-1  |
| CONSOLIDATED FINANCIAL STATEMENTS                       |      |
| Consolidated Balance Sheets                             | F-2  |
| Consolidated Statements of Income                       | F-4  |
| Consolidated Statement of Stockholders' Equity          | F-5  |
| Consolidated Statements of Comprehensive Income         | F-6  |
| Consolidated Statements of Cash Flows                   | F-7  |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

F-10

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee of  
Interpharm Holdings, Inc.

We have audited the accompanying consolidated balance sheets of Interpharm Holdings, Inc. and Subsidiaries (the "Company") as of June 30, 2004 and 2003, and the related consolidated statements of income, stockholders' equity, comprehensive income and cash flows for the year ended June 30, 2004, the six month period ended June 30, 2003 and for the years ended December 31, 2002 and 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Interpharm Holdings, Inc. and Subsidiaries at June 30, 2004 and 2003, and the consolidated results of its operations and its cash flows for the year ended June 30, 2004, the six month period ended June 30, 2003 and the years ended December 31, 2002 and 2001, in conformity with accounting principles generally accepted in the United States of America.

/s/ Marcum & Kliegman LLP

Woodbury, New York  
September 15, 2004

F-1

### INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

#### CONSOLIDATED BALANCE SHEETS

|   | June 30,     |              |
|---|--------------|--------------|
|   | 2004         | 2003         |
| ASSETS                                      |              |              |
| CURRENT ASSETS                              |              |              |
| Cash and cash equivalents                   | \$ 2,884,639 | \$ 2,336,203 |
| Marketable securities, at fair market value | 36,791       | 48,462       |
| Accounts receivable, net                    | 6,849,778    | 4,930,109    |
| Notes receivable, current                   | --           | 1,000,000    |
| Inventories, net                            | 5,530,161    | 4,583,205    |

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|   |              |              |
|---|--------------|--------------|
| Prepaid expenses and other current assets | 453,157      | 224,149      |
| Deferred tax assets                       | 1,280,000    | 23,500       |
|   | -----        | -----        |
| Total Current Assets                      | 17,034,526   | 13,145,628   |
| Land, building and equipment, net         | 15,007,132   | 4,085,302    |
| Notes receivable, long-term               | --           | 524,092      |
| Deferred tax assets                       | 2,902,000    | 2,537,900    |
| Deposits                                  | 224,287      | 45,873       |
|   | -----        | -----        |
| TOTAL ASSETS                              | \$35,167,945 | \$20,338,795 |
|   | =====        | =====        |

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

F-2

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

-----

LIABILITIES AND STOCKHOLDERS' EQUITY

|   | June 30,   |         |
|---|------------|---------|
|   | -----      |         |
|   | 2004       |         |
|   | -----      |         |
| CURRENT LIABILITIES   |            |         |
| Current maturities of bank debt   | \$ 764,014 | \$ 2    |
| Accounts payable, accrued expenses and other liabilities  | 4,545,345  | 5       |
|   | -----      | -----   |
| Total Current Liabilities   | 5,309,359  | 7       |
|   | -----      | -----   |
| OTHER LIABILITIES   |            |         |
| Bank debt, less current maturities  | 7,060,833  |         |
| Other liabilities   | 14,968     |         |
|   | -----      | -----   |
| Total Other Liabilities   | 7,075,801  |         |
|   | -----      | -----   |
| TOTAL LIABILITIES   | 12,385,160 | 7       |
|   | -----      | -----   |
| COMMITMENTS AND CONTINGENCIES   |            |         |
| STOCKHOLDERS' EQUITY  |            |         |
| Preferred stocks, 10,000,000 shares authorized; issued and outstanding -<br>6,902,963 and 7,300,876, respectively; aggregate<br>liquidation preference of \$5,494,080 |            | 348,042 |
| Common stock, \$.01 par value, 70,000,000 shares authorized;<br>shares issued - 25,591,311 and 15,671,649 respectively  |            | 255,913 |



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|   |              |            |            |
|---|--------------|------------|------------|
| Interest expense  | (21,367)     | (63,299)   | (52,542)   |
| Interest and other income   | 69,451       | 8,166      | --         |
|   | -----        | -----      | -----      |
| TOTAL OTHER INCOME (EXPENSES)                                     | 48,084       | (124,258)  | (146,605)  |
|   | -----        | -----      | -----      |
| INCOME BEFORE INCOME TAXES  | 5,108,459    | 1,118,312  | 928,365    |
| PROVISION FOR INCOME TAXES  | 1,985,638    | 394,667    | 317,563    |
|   | -----        | -----      | -----      |
| NET INCOME  | \$ 3,122,821 | \$ 723,645 | \$ 610,802 |
|   | =====        | =====      | =====      |
| EARNINGS PER SHARE  |              |            |            |
| Basic earnings per share  | \$ 0.16      | \$ 0.08    | \$ 0.07    |
|   | =====        | =====      | =====      |
| Diluted earnings per share  | \$ 0.04      | \$ 0.02    | \$ 0.02    |
|   | =====        | =====      | =====      |
| Basic weighted average shares outstanding                         | 17,594,979   | 7,721,524  | 6,151,178  |
|   | =====        | =====      | =====      |
| Diluted weighted average shares and equivalent shares outstanding | 68,637,185   | 41,664,357 | 35,935,062 |
|   | =====        | =====      | =====      |

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

F-4

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

|   | Preferred Stock<br>Shares | Amount    | Common<br>Shares |
|---|---------------------------|-----------|------------------|
|   | -----                     | -----     | -----            |
| BALANCE - January 1, 2001                     | 2,050,393                 | \$ 20,504 | 6,151,178        |
| Unrealized gain on marketable securities, net | --                        | --        | --               |
| Net income                                    | --                        | --        | --               |
|   | -----                     | -----     | -----            |
| BALANCE - December 31, 2001                   | 2,050,393                 | 20,504    | 6,151,178        |
| Unrealized loss on marketable securities, net | --                        | --        | --               |
| Net income                                    | --                        | --        | --               |
|   | -----                     | -----     | -----            |
| BALANCE - December 31, 2002                   | 2,050,393                 | 20,504    | 6,151,178        |

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|  |           |            |            |
|--|-----------|------------|------------|
| Outstanding equity securities of<br>ATEC Group, Inc.                       | 395,094   | 282,963    | 9,495,471  |
| Conversion of related party notes payable to<br>Series A-1 preferred stock | 4,855,389 | 48,554     | --         |
| Shares issued for option exercised   | --        | --         | 25,000     |
| Unrealized gain on marketable securities, net                              | --        | --         | --         |
| Net income   | --        | --         | --         |
|  | -----     | -----      | -----      |
| BALANCE - June 30, 2003  | 7,300,876 | 352,021    | 15,671,649 |
| Shares issued for options and warrants exercised                           | --        | --         | 3,535,887  |
| Tax benefit in connection<br>with exercise of stock options                | --        | --         | --         |
| Adjustments related to reverse merger                                      | --        | --         | 4,000      |
| Conversion of Series J preferred stock                                     | (105,000) | (1,050)    | 105,000    |
| Conversion of Series K preferred stock                                     | (292,913) | (2,929)    | 6,274,775  |
| Unrealized loss on marketable securities, net                              | --        | --         | --         |
| Net income   | --        | --         | --         |
|  | -----     | -----      | -----      |
| BALANCE - June 30, 2004  | 6,902,963 | \$ 348,042 | 25,591,311 |
|  | =====     | =====      | =====      |

|   | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Retained<br>Earnings/<br>(Deficit) | Treasury<br>Shares |
|---|--|------------------------------------|--------------------|
|   | -----  | -----                              | -----              |
| BALANCE - January 1, 2001                     | \$ (14,529)  | \$ (1,618,951)                     | --                 |
| Unrealized gain on marketable securities, net | 16,972   | --                                 | --                 |
| Net income                                    | --   | 514,565                            | --                 |
|   | -----  | -----                              | -----              |
| BALANCE - December 31, 2001                   | 2,443  | (1,104,386)                        | --                 |
| Unrealized loss on marketable securities, net | (3,334)  | --                                 | --                 |
| Net income                                    | --   | 1,050,419                          | --                 |
|   | -----  | -----                              | -----              |
| BALANCE - December 31, 2002                   | (891)  | (53,967)                           | --                 |

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|  |          |              |         |
|--|----------|--------------|---------|
| Outstanding equity securities of<br>ATEC Group, Inc.                       | --       | --           | 624,145 |
| Conversion of related party notes payable to<br>Series A-1 preferred stock | --       | --           | --      |
| Shares issued for option exercised   | --       | --           | --      |
| Unrealized gain on marketable securities, net                              | 12,470   | --           | --      |
| Net income   | --       | 723,645      | --      |
|  | -----    | -----        | -----   |
| BALANCE - June 30, 2003  | 11,579   | 669,678      | 624,145 |
| Shares issued for options and warrants exercised                           | --       | --           | --      |
| Tax benefit in connection<br>with exercise of stock options                | --       | --           | --      |
| Adjustments related to reverse merger                                      | --       | --           | --      |
| Conversion of Series J preferred stock                                     | --       | --           | --      |
| Conversion of Series K preferred stock                                     | --       | --           | --      |
| Unrealized loss on marketable securities, net                              | (11,671) | --           | --      |
| Net income   | --       | 3,122,821    | --      |
|  | -----    | -----        | -----   |
| BALANCE - June 30, 2004  | \$ (92)  | \$ 3,792,499 | 624,145 |
|  | =====    | =====        | =====   |

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

F-5

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

|   | Year Ended<br>June 30,<br>2004 | Six Months Ended June 30, |            | Year Ended De |
|---|--------------------------------|---------------------------|------------|---------------|
|   |                                | 2003                      | 2002       | 2002          |
|   |                                | (Unaudited)               |            |               |
| NET INCOME  | \$ 3,122,821                   | \$ 723,645                | \$ 610,802 | \$ 1,050,419  |
| OTHER COMPREHENSIVE INCOME                              |                                |                           |            |               |
| Unrealized (loss) gain<br>on marketable securities, net | (11,671)                       | 12,470                    | (3,677)    | (3,334)       |
|   | -----                          | -----                     | -----      | -----         |





INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS, Continued

|  | Year Ended<br>June 30,<br>2004 | Six Months Ended June 30,<br>-----<br>2003                      2002<br>----- |             | Year Ended<br>2002 |
|--|--------------------------------|---|-------------|--------------------|
|  |                                | (Unaudited)   |             |                    |
| CASH FLOWS FROM FINANCING ACTIVITIES                       |                                |   |             |                    |
| (Repayment of) proceeds from bank debt                     | \$(2,101,708)                  | \$ 962,625  | \$ (98,454) | \$ (214,662)       |
| Due to related parties                                     | --                             | --  | (24,000)    | (807,721)          |
| Cash received in   |                                |   |             |                    |
| reverse merger transaction                                 | 64,029                         | 2,067,510   | --          | --                 |
| Proceeds from options                                      |                                |   |             |                    |
| and warrants exercised                                     | 3,520,142                      | 31,250  | --          | --                 |
|  | -----                          | -----   | -----       | -----              |
| NET CASH PROVIDED BY<br>(USED IN) FINANCING<br>ACTIVITIES  | 1,482,463                      | 3,061,385   | (122,454)   | (1,022,383)        |
|  | -----                          | -----   | -----       | -----              |
| NET INCREASE (DECREASE)<br>IN CASH AND<br>CASH EQUIVALENTS | 548,436                        | 2,230,414   | (140,246)   | (478,069)          |
|  | -----                          | -----   | -----       | -----              |
| CASH AND CASH<br>EQUIVALENTS - Beginning                   | 2,336,203                      | 105,789   | 583,858     | 583,858            |
|  | -----                          | -----   | -----       | -----              |
| CASH AND CASH<br>EQUIVALENTS - Ending                      | \$ 2,884,639                   | \$ 2,336,203  | \$ 443,612  | \$ 105,789         |
|  | =====                          | =====   | =====       | =====              |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION          |                                |   |             |                    |
| Cash paid during the periods for:                          |                                |   |             |                    |
| Interest   | \$ 21,367                      | \$ 125,799  | \$ 52,542   | \$ 412,230         |
| Income Taxes   | \$ 110,013                     | \$ 348,302  | \$ 227,728  | \$ 405,047         |

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

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS, Continued

|  | Year Ended<br>June 30,<br>2004 | Six Months Ended June 30,<br>-----<br>2003                      2002<br>----- |  | Year Ended Decem<br>2002 |
|--|--------------------------------|---|--|--------------------------|
|--|--------------------------------|---|--|--------------------------|

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(Unaudited)

Non-cash investing  
and financing activities:

|   |              |              |       |       |       |
|---|--------------|--------------|-------|-------|-------|
| Mortgage loan utilized to acquire<br>new facility (Note 6)                    | \$ 7,400,000 | \$ --        | \$ -- | \$ -- | \$ -- |
|   | =====        | =====        | ===== | ===== | ===== |
| Conversion of related<br>party notes payable to<br>Series A-1 preferred stock | \$ --        | \$ 3,311,375 | \$ -- | \$ -- | \$ -- |
|   | =====        | =====        | ===== | ===== | ===== |
| Reverse merger (Note 1)   |              |              |       |       |       |
| Cash received, net of \$190,051<br>of transaction costs paid<br>in 2003       | \$ 64,029    | \$ 2,067,510 | \$ -- | \$ -- | \$ -- |
| Equipment   | --           | 11,965       | --    | --    | --    |
| Notes receivable  | --           | 1,524,092    | --    | --    | --    |
| Deposits  | --           | 34,494       | --    | --    | --    |
| Deferred tax assets   | (60,000)     | 2,610,000    | --    | --    | --    |
| Accounts payable  | --           | (144,044)    | --    | --    | --    |
| Other liabilities   | --           | (29,535)     | --    | --    | --    |
|   | -----        | -----        | ----- | ----- | ----- |
| Net assets obtained in reverse<br>merger transaction                          | \$ 4,029     | \$ 6,074,482 | \$ -- | \$ -- | \$ -- |
|   | =====        | =====        | ===== | ===== | ===== |

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

F-9

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - Summary of Significant Accounting Policies

Nature of Business

Interpharm Holdings, Inc. and Subsidiaries (the "Company") through its wholly-owned subsidiary, Interpharm, Inc. ("Interpharm, Inc.") is in the business of developing, manufacturing and marketing generic prescription strength and over-the-counter pharmaceutical products for wholesale distribution throughout the United States. The majority of the Company's sales have been derived from sales of Ibuprofen tablets in both over-the-counter and prescription strength.

All references below to the six-months ended June 30, 2002 are unaudited.

Reverse Merger

On May 30, 2003, Interpharm, Inc. was acquired by ATEC Group, Inc. ("ATEC"), which simultaneously changed its name to Interpharm Holdings, Inc. In this transaction, ATEC acquired all of the issued and outstanding

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shares of Interpharm, Inc. in exchange for both ATEC common stock and Series K Convertible Preferred Stock ("Series K"), which totaled approximately 48% of ATEC's voting securities after the transaction was consummated.

ATEC issued to the stockholders of Interpharm, Inc. a total of 6,151,178 shares of common stock and 2,050,393 shares of Series K in exchange for all outstanding shares of Interpharm, Inc. In addition, Interpharm, Inc. assumed the equity structure of ATEC, which comprised of 9,495,471 shares of common stock, less 624,145 shares of treasury stock and four classes of preferred stock totaling 395,094 shares. For additional information concerning these equity securities, please see Note 12.

Since this transaction is in substance, a recapitalization of Interpharm, Inc. and not a business combination, the reverse merger with ATEC has been recorded based on the fair value of ATEC's net tangible assets, which consist primarily of cash, equipment, notes receivable, deposits and a deferred tax asset with an aggregate value of \$6,078,511 (net of transaction costs of \$190,051). Accordingly, pro forma information is not presented. The recapitalization has been given retroactive effect in the accompanying financial statements. The accompanying consolidated financial statements represent those of Interpharm, Inc. for all periods prior to the consummation of the reverse merger.

### Principles of Consolidation

The consolidated financial statements include the accounts of Interpharm Holdings, Inc. and its wholly-owned subsidiaries. The results of ATEC are included in the consolidated financial statements commencing May 30, 2003.

On June 6, 2003, the minority owner of Interpharm, Inc.'s 50% owned subsidiary transferred its interest to Interpharm, Inc. in exchange for the forgiveness of a \$40,000 advance due from the minority owner. As a result, the subsidiary became wholly-owned by the Company. This subsidiary has been consolidated for all periods presented.

F-10

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 1 - Summary of Significant Accounting Policies, continued

#### Change of Fiscal Year

The Company has changed its fiscal year end from December 31 to June 30. A Transition Report on Form 10-K was filed for the six month transition period ended June 30, 2003.

#### Revenue Recognition

The Company recognizes revenue upon the shipment of product. The Company records a provision for allowances, returns and other sales credits based upon a review of specific accounts and historical experience. Such provision for allowances, returns and credits has been recorded as a reduction of sales in the consolidated statements of income.

The Company purchases raw materials from two suppliers, which are

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manufactured into finished goods and sold back to such suppliers as well as to other customers. The Company can, and does, purchase raw materials from other suppliers. Pursuant to Emerging Issues Task Force No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent," the Company recorded sales to, and purchases from, these suppliers on a gross basis. Sales and purchases were recorded on a gross basis since the Company (i) has a risk of loss associated with the raw materials purchased, (ii) converts the raw material into a finished product based upon Company developed specifications, (iii) has other sources of supply of the raw material, and (iv) has credit risk related to the sale of such product to the suppliers. For the year ended June 30, 2004, the six month periods ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001, the Company purchased raw materials from the two suppliers totaling approximately \$12,367,000, \$3,573,000, \$3,693,000, \$6,805,000 and \$2,189,000, respectively and sold finished goods to such suppliers totaling approximately \$22,625,000, \$5,795,000, \$5,290,000, \$10,745,000 and \$3,601,000, respectively.

### Earnings Per Share

Basic earnings per share ("EPS") of common stock is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted EPS reflects the amount of earnings for the period available to each share of common stock outstanding during the reporting period, giving effect to all potentially dilutive shares of common stock from the potential exercise of stock options and warrants and conversions of convertible preferred stocks.

The effect of the recapitalization of Interpharm, Inc. has been given retroactive application in the earnings per share calculation. The common stock issued and outstanding with respect to the pre-merger ATEC Group, Inc. has been included since the effective date of the reverse merger. In accordance with EITF Issue No. 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128, Earnings Per Share," the Company uses the two-class method to calculate the effect of the participating Series K on the calculation of basic EPS and the if-converted method is used to calculate the effect of the participating Series K on diluted EPS. The adoption of EITF Issue No. 03-6 did not require any changes to the Company's calculation of EPS.

F-11

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 1 - Summary of Significant Accounting Policies, continued

The computation of diluted EPS does not assume conversion, exercise or contingent issuance of securities that would have an antidilutive effect on EPS (i.e. improving earnings per share). The dilutive effect of outstanding options and warrants and their equivalents are reflected in dilutive EPS by the application of the treasury stock method. Options and warrants will have a dilutive effect only when the average market price of the common stock during the period exceeds the exercise price of the options or warrants.

### Allowance for Doubtful Accounts

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The allowance for doubtful accounts reflects management's best estimate of probable losses inherent in the account receivable balance. Management determines the allowance based on known troubled accounts, historical experience and other currently available evidence.

### Inventories

Inventories are valued at the lower of cost (first-in, first-out basis) or market value. Losses from the write-down of damaged, nonusable, or otherwise nonsalable inventories are recorded in the period in which they occur.

### Land, Building and Equipment

Land, building and equipment is stated at cost. Maintenance and repairs are charged to expense as incurred, costs of major additions and betterments are capitalized. When equipment is sold or otherwise disposed of, the cost and related accumulated depreciation is eliminated from the accounts and any resulting gain or loss is reflected in income.

### Depreciation and Amortization

Depreciation is provided for on the straight-line method over the estimated useful lives of the related assets. The cost of leasehold improvements is amortized over the lesser of the length of the related leases or the estimated useful lives of the improvements.

### Cash and Cash Equivalents

For purposes of the statement of cash flows, the Company considers all short-term investments with an original maturity of three months or less to be cash equivalents.

### Comprehensive Income

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income," the Company reports comprehensive income in addition to net income. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the calculation of net income.

F-12

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 1 - Summary of Significant Accounting Policies, continued

#### Use of Estimates in the Financial Statements

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

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results could differ from those estimates. Significant estimates include deferred tax asset valuations and inventory overhead costing estimates.

### Impairment of Long-Lived Assets

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine if impairment exists, the Company compares the estimated future undiscounted cash flows from the related long-lived assets to the net carrying amount of such assets. Once it has been determined that an impairment exists, the carrying value of the asset is adjusted to fair value. Factors considered in the determination of fair value include current operating results, trends and the present value of estimated expected future cash flows.

### Income Taxes

The Company accounts for income taxes using the liability method which requires the determination of deferred tax assets and liabilities based on the differences between the financial and tax bases of assets and liabilities using enacted tax rates in effect for the year in which differences are expected to reverse. The net deferred tax asset is adjusted by a valuation allowance, if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized. The Company and its subsidiaries file a consolidated Income tax return.

### Marketable Securities

Marketable securities, which are classified as "available for sale," are valued at fair market value. Unrealized gains or losses are recorded net of income taxes as accumulated other comprehensive income or loss in stockholders' equity, whereas realized gains and losses are recognized in the Company's consolidated statements of income using the first-in, first-out method. Other than temporary declines in the value of marketable securities are also recognized as a loss in the consolidated statements of income.

### Shipping Costs

The Company's shipping and handling costs are included in selling, general and administrative expenses. For the year ended June 30, 2004, the six months ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001, shipping and handling costs approximated \$419,000, \$198,000, \$181,000, \$370,000 and \$248,000, respectively.

F-13

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 1 - Summary of Significant Accounting Policies, continued

#### Research and Development

Research and development is expensed as incurred.

#### Concentrations and Fair Value of Financial Instruments

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Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and accounts receivable. At June 30, 2004, the Company has cash investments totaling approximately \$4,192,000 at two financial institutions. Concentrations of credit risk with respect to accounts receivable are disclosed in Note 14. The Company performs ongoing credit evaluations of its customers' financial conditions and, generally, requires no collateral from its customers. Unless otherwise disclosed, the fair values of financial instruments approximates their recorded value.

### Reclassification

Certain accounts in the prior period's financial statements have been reclassified for comparative purposes to conform with the presentation in the current period's financial statements. These reclassifications have no effect on previously reported income.

### Stock Based Compensation

At June 30, 2004, the Company had two stock-based employee plans. As permitted under Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," which amended SFAS No. 123, "Accounting for Stock-Based Compensation," the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangements as defined by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and related interpretations including Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 44, "Accounting for Certain Transactions Involving Stock Compensation," an interpretation of APB No. 25. No stock-based employee compensation cost is reflected in operations, as all options granted under those plans have an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

F-14

### INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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#### NOTE 1 - Summary of Significant Accounting Policies, continued

#### Stock Based Compensation, continued

|  | Year Ended<br>June 30,<br>2004 | Six Months<br>Ended June 30,<br>2003 | Year Ended<br>December 31,<br>2002 | Year Ended<br>December 31,<br>2001 |
|--|--------------------------------|--------------------------------------|------------------------------------|------------------------------------|
|  | -----                          |                                      |                                    |                                    |
| Net income as Reported                             | \$ 3,122,821                   | \$ 723,645                           | \$ 1,050,419                       | \$ 514,565                         |
| Less: Stock-based employee<br>compensation expense |                                |                                      |                                    |                                    |

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|  |              |            |              |            |
|--|--------------|------------|--------------|------------|
| determined under fair value-based method for all awards, net of income tax | 803,544      | 60,000     | --           | --         |
|  | -----        | -----      | -----        | -----      |
| Pro forma  | \$ 2,319,277 | \$ 663,645 | \$ 1,050,419 | \$ 514,565 |
|  | =====        | =====      | =====        | =====      |
| Basic net income per share   |              |            |              |            |
| As reported  | \$ .16       | \$ .08     | \$ .13       | \$ .06     |
|  | =====        | =====      | =====        | =====      |
| Pro forma  | \$ .11       | \$ .07     | \$ .13       | \$ .06     |
|  | =====        | =====      | =====        | =====      |
| Diluted net income per share   |              |            |              |            |
| As reported  | \$ .04       | \$ .02     | \$ .03       | \$ .01     |
|  | =====        | =====      | =====        | =====      |
| Pro forma  | \$ .03       | \$ .02     | \$ .03       | \$ .01     |
|  | =====        | =====      | =====        | =====      |

The fair values of Company common stock options granted to employees were estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions: (1) expected volatility ranging from 126% to 135%, (2) risk-free interest rates ranging from 4.25% to 4.50% and (3) expected average lives of 10 years.

New Accounting Pronouncement

In January 2003, and revised in December 2003, the Financial Accounting Standards Board issued Interpretation No. 46R ("FIN 46"), "Consolidation of Variable Interest Entities." Prior to the issuance of this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN 46 requires a variable interest entity, as defined, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns. For these purposes, variable interests held by related parties should be combined with the reporting entity. FIN 46 is effective for the Company. The adoption of FIN 46 had no impact on the Company's financial position, results of operation or cash flows.

F-15

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - Marketable Securities

Management has classified its equity securities as available-for-sale securities, which are reported at fair market value. The costs and fair market value of marketable securities are as follows:

|      |           |           |
|------|-----------|-----------|
|      | June 30,  |           |
|      | -----     | -----     |
|      | 2004      | 2003      |
|      | -----     | -----     |
| Cost | \$ 36,883 | \$ 36,883 |



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|                        |           |           |
|------------------------|-----------|-----------|
| Unrealized (loss) gain | (92)      | 11,579    |
|                        | -----     | -----     |
| Fair market value      | \$ 36,791 | \$ 48,462 |
|                        | =====     | =====     |

NOTE 3 - Accounts Receivable

Accounts receivable is shown net of allowance for doubtful accounts of \$74,166 and \$47,776 at June 30, 2004 and 2003, respectively. The changes in the allowance for doubtful accounts are summarized as follows:

|                                 | Year Ended<br>June 30, | Six Months<br>Ended<br>June 30, | Year Ended<br>December 31, |           |
|---------------------------------|------------------------|---------------------------------|----------------------------|-----------|
|                                 | 2004                   | 2003                            | 2002                       | 2001      |
| Beginning balance               | \$ 47,776              | \$ 47,776                       | \$ 47,776                  | \$ 26,950 |
| Provision for doubtful accounts | 40,000                 | 40,200                          | 47,165                     | 261,641   |
| Charge-offs                     | (13,610)               | (40,200)                        | (47,165)                   | (240,815) |
|                                 | -----                  | -----                           | -----                      | -----     |
| Ending balance                  | \$ 74,166              | \$ 47,776                       | \$ 47,776                  | \$ 47,776 |
|                                 | =====                  | =====                           | =====                      | =====     |

NOTE 4 - Inventories

Inventories consist of the following:

|                     | June 30,    |             |
|---------------------|-------------|-------------|
|                     | 2004        | 2003        |
| Finished goods      | \$ 534,175  | \$ 347,189  |
| Work in process     | 2,710,270   | 2,227,139   |
| Raw materials       | 1,932,971   | 1,733,109   |
| Packaging materials | 352,745     | 275,768     |
|                     | -----       | -----       |
| Total               | \$5,530,161 | \$4,583,205 |
|                     | =====       | =====       |

F-16

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Inventories, continued

During the quarter ended December 31, 2002, the Company incurred a \$202,000 loss from the write-down of damaged and unusable raw materials inventory.

NOTE 5 - Notes Receivable

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Two notes receivable acquired as part of the reverse merger (Note 1) with an aggregate amount of \$1,524,092 were repaid in full during the three months ended September 30, 2003.

### NOTE 6 - Land, Building and Equipment

Land, building and equipment consists of the following:

|  | June 30,     |              | Estimated       |
|--|--------------|--------------|-----------------|
|  | 2004         | 2003         | Useful<br>Lives |
| Land   | \$ 4,924,000 | \$ --        |                 |
| Building   | 4,475,482    | --           | 20 Years        |
| Machinery and equipment                            | 5,457,395    | 3,454,147    | 5-7 Years       |
| Furniture and fixtures                             | 319,762      | 107,565      | 5 Years         |
| Leasehold improvements                             | 2,623,203    | 2,095,845    | 5-15 Years      |
| Construction in progress (a)                       | --           | 346,648      |                 |
|  | 17,799,842   | 6,004,205    |                 |
| Less: accumulated<br>depreciation and amortization | 2,792,710    | 1,918,903    |                 |
| Land, Building & Equipment, net                    | \$15,007,132 | \$ 4,085,302 |                 |

(a) Construction in progress represents costs of constructing a manufacturing equipment line in the Company's current facility. The equipment was placed in service in fiscal 2004.

On June 29, 2004, the Company completed a transaction in which it acquired a second facility located in Brookhaven, New York. The 92,000 square foot facility, situated on 37 acres, was purchased for \$9,399,482 which included closing costs of \$149,482. \$4,924,000 has been allocated to land with the balance, \$4,475,482, attributable to the building. The Company secured a \$7,400,000 mortgage loan for part of the purchase price.

Depreciation and amortization expense for the year ended June 30, 2004, the six month period ended June 30, 2003 and for the years ended December 31, 2002 and 2001 was \$886,141, \$317,034, \$494,986 and \$378,208, respectively.

F-17

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 7 - Accounts Payable, Accrued Expenses and Other Liabilities

Accounts payable, accrued expenses and other liabilities consist of the following:

| June 30, |      |
|----------|------|
| 2004     | 2003 |
|          |      |

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|  |                 |                 |
|--|-----------------|-----------------|
| Trade accounts payable                         | \$3,455,444     | \$4,927,448     |
| Accrued expenses and other current liabilities | 1,089,901       | 386,893         |
|  | -----           | -----           |
| <br>Total                                      | <br>\$4,545,345 | <br>\$5,314,341 |
|  | =====           | =====           |

### NOTE 8 - Bank Debt

The Company had a credit facility agreement with a Bank, which consisted of an advised secured line of credit totaling \$5,000,000 and a \$2,000,000 non-revolving secured facility for equipment purchases. Borrowings under this credit facility were collateralized by substantially all assets of the Company and personally guaranteed by four of the Company's stockholders. In addition, the Company was required to comply with certain financial covenants. As of June 30, 2004, the Company had outstanding borrowings of \$424,847 under the line of credit. Subsequent to June 30, 2004, the Company paid down this entire balance.

On March 29, 2004, the Company obtained a \$21 million credit facility from the same Bank. The new credit facility consists of (i) a \$7.4 million mortgage loan for the purchase of the Company's second manufacturing plant in Brookhaven, NY (Note 6); (ii) \$8.6 million of credit lines primarily to acquire new equipment and for renovations, and (iii) a \$5 million general line of credit. This credit facility replaces the \$7 million credit facility discussed above. Details of the new facility are as follows:

- o The \$7,400,000 mortgage loan is to be repaid with 119 monthly principal installments of \$30,833 commencing on August 1, 2004 with the balance due June 1, 2014.
- o Two advised secured credit lines aggregating \$6,600,000 primarily for acquisitions of equipment and for renovations of the Company's new Brookhaven, NY plant. The balance of the funds accessed through these credit lines will convert to fully amortizing five year term loans.
- o A \$2,000,000 advised non-revolving secured facility for equipment purchases (the "Term Loan Line"). Each advance cannot exceed 90% of the invoice amount of the new equipment and is convertible into separate notes that fully amortize over 60 months.
- o The \$5,000,000 advised secured line of credit is primarily for working capital and general corporate purposes.

F-18

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 8 - Bank Debt, continued

This new credit facility is collateralized by substantially all assets of the Company and no longer requires personal guarantees of four of the Company's stockholders. At the option of the Company, interest will generally be calculated at (i) LIBOR plus 1.5% for 3 to 36 month periods, or at (ii) the Bank's then fixed prime rate. As of June 30, 2004, the

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interest rates on the working capital line and mortgage note payable were 4.5% and 2.86%, respectively. In addition, the Company is required to comply with certain financial covenants. The Bank will review the new credit facility annually; the next review is scheduled to occur no later than November 30, 2004. The credit lines are terminable by the Bank at any time as to undrawn amounts.

A summary of the outstanding balances is as follows:

|   | June 30,    |             |
|---|-------------|-------------|
|   | 2004        | 2003        |
| Working capital lines                   | \$ 424,847  | \$2,064,793 |
| Mortgage note payable                   | 7,400,000   | --          |
| Equipment notes payable                 | --          | 461,762     |
|   | 7,824,847   | 2,526,555   |
| Total Long-Term Debt                    | 7,824,847   | 2,526,555   |
| Less: current maturities                | 764,014     | 2,289,034   |
|   | \$7,060,833 | \$ 237,521  |
| Long-Term Debt, Less Current Maturities | \$7,060,833 | \$ 237,521  |

Scheduled annual maturities of the bank debt are as follows:

| For the Year<br>Ending June 30, | Amount      |
|---------------------------------|-------------|
| 2005                            | \$ 764,014  |
| 2006                            | 370,000     |
| 2007                            | 370,000     |
| 2008                            | 370,000     |
| 2009                            | 370,000     |
| Thereafter                      | 5,580,833   |
|                                 | \$7,824,847 |
| Total                           | \$7,824,847 |

F-19

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 9 - Related Party Lease

The Company leases its business premises ("Premises") from an entity controlled by three stockholders of the Company under a noncancelable lease expiring in October 2019. The Company is obligated to pay minimum annual rent of \$480,000, plus property taxes, insurance, maintenance and other expenses related to the Premises.

Upon a change in ownership of the Company, and every three years thereafter, the annual rent will be adjusted to fair market value, as

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determined by an independent third party.

Future annual minimum rental payments under this operating lease are as follows:

| For the Year<br>Ending June 30, | Amount      |
|---------------------------------|-------------|
| 2005                            | \$ 480,000  |
| 2006                            | 480,000     |
| 2007                            | 480,000     |
| 2008                            | 480,000     |
| 2009                            | 480,000     |
| Thereafter                      | 4,960,000   |
| -----                           |             |
| Total                           | \$7,360,000 |
| =====                           |             |

The lease does not grant the Company the option to purchase the Premises at any time during the lease term or at its termination, nor will the Company share in any proceeds that may result from sale or disposition of the Premises. Three of the stockholders of the Company purchased the Premises by making cash payments in the amount of \$1,255,000 and by issuing \$3,720,000 in mortgage notes. Repayment of the mortgage notes had been guaranteed for the term of the mortgage primarily by the three stockholders. Repayment of the mortgage notes was secondarily guaranteed by the Company; however, on September 26, 2003, the bank agreed to terminate the Company's guarantee.

F-20

### INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 10 - Income Taxes

The income tax (benefit) expense is comprised of the following:

|                | Year Ended<br>June 30,<br>2004 | Six Months<br>Ended June 30,<br>2003 | Year Ended<br>December 31,<br>-----<br>2002                      2001 |            |
|----------------|--------------------------------|--------------------------------------|---|------------|
| -----          |                                |                                      |   |            |
| Current        |                                |                                      |   |            |
| Federal        | \$ (30,967)                    | \$ 243,255                           | \$ 404,663  | \$ 240,635 |
| State          | 18,105                         | 35,312                               | 19,250  | 5,649      |
|                | -----                          | -----                                | -----   | -----      |
| Total Current  | (12,862)                       | 278,567                              | 423,913   | 246,284    |
|                | -----                          | -----                                | -----   | -----      |
| Deferred       |                                |                                      |   |            |
| Federal        | 1,785,200                      | 119,500                              | 67,100  | 4,000      |
| State          | 213,300                        | (3,400)                              | 12,400  | (36,000)   |
|                | -----                          | -----                                | -----   | -----      |
| Total Deferred | 1,998,500                      | 116,100                              | 79,500  | (32,000)   |

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|               | -----        | -----      | -----      | -----      |
|---------------|--------------|------------|------------|------------|
| Provision for |              |            |            |            |
| Income Taxes  | \$ 1,985,638 | \$ 394,667 | \$ 503,413 | \$ 214,284 |
|               | =====        | =====      | =====      | =====      |

The Company's effective income tax rate differs from the statutory U.S. Federal income tax rate as a result of the following:

|                                 | Year Ended<br>June 30,<br>2004 | Six<br>Months<br>Ended<br>June 30,<br>2003 | Year Ended<br>December 31,<br>-----<br>2002 | Year Ended<br>December 31,<br>-----<br>2001 |
|---------------------------------|--------------------------------|--|---|---|
| Statutory U.S. federal tax rate | 34.0%                          | 34.0%                                      | 34.0%                                       | 34.0%                                       |
| State taxes                     | 3.0                            | 2.0  | 1.2   | 1.2   |
| Permanent differences           | 0.2                            | (0.7)                                      | (0.9)                                       | (0.6)                                       |
| Change in valuation allowance   | 0.7                            | (0.4)                                      | (1.5)                                       | (4.4)                                       |
| Other                           | 1.0                            | 0.4  | (0.4)                                       | (0.8)                                       |
|                                 | ----                           | ----                                       | ----  | ----  |
| Effective income tax rate       | 38.9%                          | 35.3%                                      | 32.4%                                       | 29.4%                                       |
|                                 | =====                          | =====                                      | =====                                       | =====                                       |

F-21

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 - Income Taxes, continued

The components of deferred tax assets and liabilities consist of the following:

|  | June 30,      |               |
|--|---------------|---------------|
|  | -----<br>2004 | -----<br>2003 |
| Deferred Tax Assets, Current Portion     |               |               |
| Capitalized inventory                    | \$ 17,000     | \$ 7,000      |
| Receivable allowance and reserves        | 27,000        | 16,500        |
| Other                                    | 45,000        | --            |
| Net operating loss carryforwards         | 1,191,000     | --            |
|  | -----         | -----         |
| Deferred Tax Assets, current             | \$ 1,280,000  | \$ 23,500     |
|  | =====         | =====         |
| Deferred Tax Assets, Non-Current Portion |               |               |
| Investment tax credits                   | \$ 518,000    | \$ 302,000    |
| Other                                    | --            | 26,600        |
| Net operating loss carryforwards         | 3,295,000     | 3,067,300     |
|  | -----         | -----         |
|  | 3,813,000     | 3,395,900     |

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|   |              |              |
|---|--------------|--------------|
| Valuation allowance                           | (620,000)    | (650,000)    |
|   | -----        | -----        |
| Deferred Tax Assets, Non-Current              | 3,193,000    | 2,745,900    |
|   | -----        | -----        |
| Deferred Tax Liabilities, Non-Current Portion |              |              |
| Depreciation and amortization                 | (291,000)    | (208,000)    |
|   | -----        | -----        |
| Deferred Tax Assets, Non-Current, net         | 2,902,000    | 2,537,900    |
|   | -----        | -----        |
| Total Deferred Tax Assets, Net                | \$ 4,182,000 | \$ 2,561,400 |
|   | =====        | =====        |

As part of the reverse merger transaction (Note 1), approximately \$7,370,000 of ATEC's net operating loss carryforwards ("NOLs") are available to the Company. During the year ended June 30, 2004, stock options were exercised which generated approximately \$9,900,000 of income tax deductions, resulting in a tax benefit of \$3,679,100 which was credited to additional paid-in capital.

At June 30, 2004 the Company has remaining Federal NOLs of approximately \$12,170,000 and State NOLs of approximately \$11,600,000 expiring through 2024. Pursuant to Section 382 of the Internal Revenue Code regarding substantial changes in Company ownership, utilization of approximately \$11,640,000 of these NOLs is limited to approximately \$2,690,000 per year, plus any prior years' amount not utilized, if any. As of June 30, 2004, the Company has determined that it is more likely than not, that the Company will utilize all of the Federal NOLs in the future. The Company reserved approximately 30% of the State NOLs which the Company does not anticipate utilizing due to State limitations.

F-22

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 - Income Taxes, continued

In addition, at June 30, 2004, the Company has approximately \$518,000 of New York State investment tax credit carryforwards, expiring in various years through 2019. These carryforwards are available to reduce future New York State income tax liabilities. However, the Company has reserved 100% of the investment tax credit carryforward, which the Company does not anticipate utilizing.

NOTE 11 - Earning Per Share

The calculations of basic and diluted EPS are as follows:

|                        | Six Months Ended<br>June 30, | Year Ended<br>December |
|------------------------|------------------------------|------------------------|
| Year Ended<br>June 30, | -----                        | -----                  |

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|  | 2004         | 2003       | 2002       | 2002         |
|--|--------------|------------|------------|--------------|
| -----  |              |            |            |              |
| Numerator:   |              |            |            |              |
| Net income   | \$ 3,122,821 | \$ 723,645 | \$ 610,802 | \$ 1,050,419 |
| Less: Preferred stock dividend                                   | 165,569      | 13,150     | --         | --           |
| Less: Net income attributable to Series K preferred stockholders | 194,476      | 86,765     | 152,701    | 262,605      |
|  | -----        | -----      | -----      | -----        |
| Numerator for basic EPS  | 2,762,776    | 623,730    | 458,101    | 787,814      |
| Effect of dilutive securities:                                   |              |            |            |              |
| Net income attributable to Series K preferred stockholders       | 194,476      | 86,765     | 152,701    | 262,605      |
|  | -----        | -----      | -----      | -----        |
| Numerator for diluted EPS  | \$ 2,957,252 | \$ 710,495 | \$ 610,802 | \$ 1,050,419 |
|  | =====        | =====      | =====      | =====        |
| Denominator:   |              |            |            |              |
| Denominator for basic EPS  |              |            |            |              |
| Weighted average shares outstanding                              | 17,594,979   | 7,721,524  | 6,151,178  | 6,151,178    |
| Effect of dilutive securities:                                   |              |            |            |              |
| Convertible Series K preferred stock                             | 43,460,533   | 32,609,356 | 29,783,884 | 29,783,884   |
| Convertible Series A, B, C and J preferred stocks                | 11,454       | 19,879     | --         | --           |
| Stock options  | 7,570,219    | 1,313,598  | --         | --           |
|  | -----        | -----      | -----      | -----        |
| Denominator for diluted EPS                                      | 68,637,185   | 41,664,357 | 35,935,062 | 35,935,062   |
|  | =====        | =====      | =====      | =====        |
| Basic EPS  | \$ .16       | \$ .08     | \$ .07     | \$ .13       |
|  | =====        | =====      | =====      | =====        |
| Diluted EPS  | \$ .04       | \$ .02     | \$ .02     | \$ .03       |
|  | =====        | =====      | =====      | =====        |

F-23

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 - Earning Per Share, continued

As of June 30, 2004, the total number of common shares outstanding and the number of common shares potentially issuable upon exercise of all outstanding stock options and conversion of preferred stocks (including contingent conversions) is as follows:

|  |            |
|--|------------|
| Common stock outstanding                                   | 24,967,166 |
| Stock options outstanding (see Note 12)                    | 10,460,000 |
| Common stock issuable upon conversion of preferred stocks: |            |



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|  |            |
|--|------------|
| Series A                                       | 1,526      |
| Series A-1 (maximum contingent conversion) (a) | 4,855,389  |
| Series B                                       | 292        |
| Series C                                       | 5,620      |
| Series K (b)                                   | 37,648,650 |
|  | -----      |
| Total (c)                                      | 77,938,643 |
|  | =====      |

- (a) As described in Note 12, the Series A-1 shares are convertible only if the Company reaches \$150 million in annual sales or upon a merger, consolidation, sale of assets or similar transaction.
- (b) On June 4, 2004 one seventh of the 2,050,393 Series K shares, or 292,913 shares, converted into 6,274,775 of the Company's common stock. On June 4, 2005 and on each anniversary date thereof, through June 4, 2010, 292,913 Series K shares will automatically convert into 6,274,775 shares of the Company's common stock (see Note 12).
- (c) Assuming no further issuance of equity instruments, or changes to the equity structure of the Company, this total represents the maximum number of shares of common stock that could be outstanding through December 31, 2011 (the end of the current vesting and conversion periods).

F-24

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 - Equity Securities

Preferred Stocks

The Company's preferred stocks consist of the following:

|                                      | Shares<br>Authorized | Shares Issued<br>and<br>Outstanding | Par Value  | Liquidation<br>Preference |
|--------------------------------------|----------------------|-------------------------------------|------------|---------------------------|
|                                      | -----                | -----                               | -----      | -----                     |
| June 30, 2004:                       |                      |                                     |            |                           |
| Preferred Stocks:                    |                      |                                     |            |                           |
| *Series A Cumulative<br>Convertible  | 29,233               | 7,631                               | \$ 763     | \$ 763,100                |
| Series A-1 Cumulative<br>Convertible | 5,000,000            | 4,855,389                           | 48,554     | 3,311,375                 |
| *Series B Convertible                | 12,704               | 1,458                               | 145        | 14,580                    |
| *Series C Convertible                | 350,000              | 281,005                             | 281,005    | 1,405,025                 |
| *Series J Convertible                | 105,000              | --                                  | --         | --                        |
| Series K Convertible                 | 3,000,000            | 1,757,480                           | 17,575     | --                        |
|                                      | -----                | -----                               | -----      | -----                     |
| Total preferred                      | 8,496,937            | 6,902,963                           | \$ 348,042 | \$5,494,080               |
|                                      | =====                | =====                               | =====      | =====                     |

\* Classes of preferred stock assumed in the ATEC reverse merger.

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At June 30, 2004, the Company had six authorized series of preferred stock; Series A Cumulative Convertible (par value \$.10), Series A-1 Cumulative convertible (par value \$.01), Series B Convertible (par value \$.10), Series C Convertible (par value \$1), Series J Convertible (par value \$.01) and Series K Convertible (par value \$.01) (hereafter referred to as the "A", "A-1", "B", "C", "J" and "K" shares, respectively).

The A shares have an annual dividend rate of 10% of the par value, which is cumulative. They are senior to all other series or classes of capital stock. The B shares have a non-cumulative stated annual dividend rate of \$1 each and are senior to all but the rights of the A stockholders. The C and J shares have no dividend rights, except as may be authorized at the sole discretion of the Company's Board of Directors. The K shares are entitled to receive dividends to the same extent and in the same amounts as the common stock. The A-1 shares have a cumulative annual dividend of \$.0341 per share when and as declared by the Board of Directors.

Each of the A, B, C and K shares has the right to one vote on all matters in which stockholders are entitled to vote. The holders of Series A-1 and J shares shall not be entitled to any voting rights. Each of the A, B, C and A-1 shares carry dissolution rights upon liquidation amounting to \$100, \$10, \$5 and \$.682 per share, respectively. The A shares grant the

F-25

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 12 - Equity Securities, continued

#### Preferred Stocks, continued

Company the right to redeem such shares at a price of \$100 per share. The A, B and C shares may be converted into shares of common stock at an exchange rate of five, five and fifty shares, respectively, for each share of common stock or approximately 7,438 shares. The conversion rights of the J, K and A-1 shares are described below.

The J shares had a mandatory conversion provision, if any time on or after the applicable issuance date, the closing price of the common stock of the Company for three consecutive trading days is equal to or greater than five dollars. In the first quarter of fiscal 2004, the mandatory conversion price was attained and all of the outstanding J shares converted into 105,000 shares of common stock. The J shares cannot be re-issued.

On June 4, 2004, the Company was deemed by AMEX to be in compliance with applicable listing standards, and as a result, a "Triggering Event" occurred. Upon the occurrence of the Triggering Event, the holders of the K shares, in accordance with a defined formula, which assumes among other things, the conversion of the A, B, C and J shares into common stock, converted one seventh or 292,913 of the K shares into 6,274,775 restricted shares of the Company's common stock. The K shares automatically convert into a like amount on each June 4, 2005 through 2010, for an aggregate of an additional 37,648,650 shares of common stock. Upon a change in control, as defined, the conversion of the K shares may accelerate. The holders of the K shares have demand registration rights with respect to the common stock to be issued upon conversion. The net effect of the conversion

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feature, together with the shares of common stock issued in the reverse merger, would be to issue to Interpharm, Inc. stockholders, common stock totaling approximately 80% of the total number of shares of common stock and voting convertible preferred stock, outstanding as of the date of the Triggering Event, after giving effect to the conversion, less shares of common stock issued between the date of the closing of the reverse merger and the date of the Triggering Event arising out of obligations which arose after the date of closing.

On May 30, 2003 the Company authorized the satisfaction of loans due to the Company's Chief Executive Officer and one of its stockholders, by issuing 4,855,389 A-1 shares. The A-1 shares convert on a 1:1 basis into Company common stock subject to the definitive terms in the list of designations upon (i) the Company reaching \$150 million in sales or (ii) a merger, consolidation, sale of assets or similar transaction.

### Stock Options

On May 30, 2003, Interpharm, Inc., as a part of the ATEC reverse merger transaction, assumed options to acquire ATEC's common stock which were granted previously by ATEC pursuant to two Stock Option Plans. The two option plans are the 1997 Stock Option Plan ("1997 Plan") and the 2000 Flexible Stock Option Plan ("2000 Plan"). Both plans provide for the issuance of qualified and non-qualified options as those terms are defined by the Internal Revenue Code.

F-26

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 12 - Equity Securities, continued

#### Stock Options, continued

The 1997 Plan provides for the issuance of 6,000,000 shares of common stock. All options issued, pursuant to the 1997 Plan, can not have a term greater than ten years. Options granted under this plan vest over periods established in option agreements. As of June 30, 2004, 1,436,370 options are outstanding under this plan. No additional shares can be granted under this plan.

The 2000 Plan provides for the issuance of 10,000,000 shares of common stock plus an annual increase, effective on the first day of each calendar year, equal to 10% of the number of outstanding shares of common stock as of the first day of such calendar year, but in no event, more than 20,000,000 shares in the aggregate. All options issued, pursuant to the 2000 Plan, can not have a term greater than ten years. Options granted under the 2000 Plan vest over periods established in option agreements. As of June 30, 2004, the 2000 Plan provides for the issuance of 13,932,721 shares of common stock. As of that date, 9,023,630 options are outstanding under this plan.

The following table summarizes the options assumed by Interpharm, Inc. in the ATEC reverse merger and activity for the period May 30, 2003 to June 30, 2004. There were no options issued by Interpharm, Inc. prior to the reverse merger.

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|   | Number<br>of Options | Weighted Average<br>Exercise Price |
|---|----------------------|------------------------------------|
| Options assumed from ATEC in reverse merger<br>transaction - May 30, 2003 | 7,495,691            | \$ 1.51                            |
| Granted   | 5,075,000            | \$ .68                             |
| Exercised   | (25,000)             | \$ 1.25                            |
|   | -----                |                                    |
| Outstanding at June 30, 2003  | 12,545,691           | \$ 1.17                            |
| Granted   | 1,415,000            | \$ 4.10                            |
| Exercised   | (3,477,441)          | \$ 1.04                            |
| Forfeited   | (23,250)             | \$ .94                             |
|   | -----                |                                    |
| Outstanding at June 30, 2004  | 10,460,000           | \$ 1.62                            |
|   | =====                |                                    |

F-27

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 - Equity Securities, continued

Stock Options, continued

The following table summarizes information concerning outstanding and exercisable stock options as of June 30, 2004:

| Range of<br>Exercise Prices | Options Outstanding                          |   |  | Options Exercisable                          |  |
|-----------------------------|--|---|--|--|--|
|                             | Number<br>Outstanding<br>At<br>June 30, 2004 | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Weighted<br>Average<br>Exercise<br>Price | Number<br>Exercisable<br>at<br>June 30, 2004 | Weighted<br>Average<br>Exercise<br>Price |
| \$0.450 - \$0.680           | 7,608,630                                    | 8.39  | \$0.63                                   | 2,555,391                                    | \$0.                                     |
| \$1.625 - \$3.970           | 1,416,370                                    | 3.38  | \$3.50                                   | 416,370                                      | \$2.                                     |
| \$4.260 - \$6.800           | 1,435,000                                    | 4.94  | \$5.00                                   | 1,020,000                                    | \$5.                                     |
|                             | -----  |   |  | -----  |  |
|                             | 10,460,000                                   |   |  | 3,991,761                                    |  |
|                             | =====  |   |  | =====  |  |

During the year ended June 30, 2004, 3,477,441 options and 58,446 warrants were exercised generating cash proceeds to the Company of approximately \$3,520,000, and resulting in tax deductions approximating \$9,900,000 (Note 10).

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### NOTE 13 - Commitments and Contingencies

#### Employment Agreements

On June 1, 2003 the Company entered into employment agreements with 6 executive officers and 7 employees. Additionally, in January, 2004, the Company entered into an employment agreement with its Chief Financial Officer. Each of the agreements is substantially identical and provides for the following significant terms:

- employment terms extend through December 31, 2008, termination with or without cause, and upon termination, the employee is entitled to receive only any accrued salary and vacation pay,

- confidentiality and non-competition clauses which remain effective following termination of employment,

- annual salary ranging from \$80,000 through \$150,000 (\$910,000 in total) for the 7 executive officers and salary ranging from \$55,000 through \$95,000 (\$477,000 in total) for the 7 employees, with increases and bonus payments at the sole discretion of the Board of Directors. The agreements also provide the executive officers and three employees with an automobile allowance. These officers and employees also received an aggregate of 5,245,000 stock options.

F-28

INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 13 - Commitments and Contingencies, continued

#### Operating Leases

The Company's corporate headquarters is located in Commack, New York, where the Company leases 23,175 square feet of space for executive offices from an unrelated party. The lease expires in May, 2005. Rent expense under this operating lease was \$186,684 for the year ended June 30, 2004 and \$15,557 for the one-month period ended June 30, 2003. The Company is subletting a portion of the facility to three unrelated parties. Rental income of \$167,719 and \$13,676 was recognized under these agreements for the year ended June 30, 2004 and the one-month period ended June 30, 2003.

#### Legal Proceedings

Because Interpharm, Inc. utilizes certain controlled substances, it is subject to routine inspection by the U.S. Drug Enforcement Agency. On May 27, 2004, Interpharm, Inc. received a notice from the United States Attorney's Office for the Eastern District of New York relating to a routine inspection conducted in November, 2003. The notice references certain alleged record keeping violations. As of the date of this report, no complaint has been filed by the United States Attorney's Office, and Interpharm, Inc. is in the process of setting up a meeting with the United States Attorney's Office to resolve the matter. The Company is unable to predict the outcome of this claim and, accordingly, no adjustments have been made in the consolidated financial statements.

From time to time, the Company is a party to litigation arising in the

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normal course of its business operations. In the opinion of management, it is not anticipated that the settlement or resolution of any such matters will have a material adverse impact on the Company's financial condition, liquidity or results of operations.

### NOTE 14 - Economic Dependency

#### Major Customers

The Company had the following customer concentrations for the year ended June 30, 2004, the six month periods ended June 30, 2003 and 2002 and for each of the years ended December 31, 2002 and 2001:

|               | Sales - Percent of Revenue |                  |                  |               |
|---------------|----------------------------|------------------|------------------|---------------|
|               | Year Ended                 | Six Months Ended |                  | Year          |
|               | June 30,<br>2004           | 2003             | June 30,<br>2002 | Decem<br>2002 |
| Customer A ** | --                         | --               | --               | --            |
| Customer B    | 29%                        | 37%              | 45%              | 44%           |
| Customer C    | *                          | 13%              | 16%              | *             |
| Customer D    | *                          | *                | *                | *             |
| Customer E    | 26%                        | *                | *                | *             |

F-29

### INTERPHARM HOLDINGS, INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 14 - Economic Dependency, continued

|               | Accounts Receivable |           |
|---------------|---------------------|-----------|
|               | June 30,            |           |
|               | 2004                | 2003      |
| Customer A ** | \$ --               | \$ --     |
| Customer B    | 2,760,500           | 2,202,354 |
| Customer C    | 172,851             | 736,022   |
| Customer D    | 34,280              | 229,288   |
| Customer E    | 849,055             | 461,721   |

\* Sales to customers were less than 10%

\*\* This customer was the minority owner of Interpharm, Inc.'s subsidiary prior to the transfer of interest on June 6, 2003.

#### Major Suppliers

The Company purchased materials from three suppliers, during the year ended June 30, 2004, totaling approximately 82%, and two suppliers totaling approximately 60%, 72%, 68% and 65% of the Company's total purchases, during the six month periods ended June 30, 2003 and 2002 and for the years ended December 31, 2002 and 2001, respectively. At June 30,

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2004 and 2003 amounts due to these suppliers included in accounts payable, were approximately \$2,590,000 and \$2,737,000, respectively.

### NOTE 15 - Quarterly Financial Data (Unaudited)

Summarized quarterly financial information consists of the following:

|              | Sept. 30, 2003 | Dec. 31, 2003 | March 31, 2004 | June 30, 2004 |
|--------------|----------------|---------------|----------------|---------------|
| Sales, net   | \$ 6,875,348   | \$11,706,231  | \$11,307,974   | \$11,210,175  |
| Gross profit | 1,431,830      | 2,618,275     | 2,815,151      | 2,929,579     |
| Net income   | 227,439        | 1,024,097     | 983,530        | 887,755       |
| Basic EPS    | \$ .01         | \$ .05        | \$ .05         | \$ .04        |
| Diluted EPS  | \$ .00         | \$ .01        | \$ .01         | \$ .01        |
| -----        |                |               |                |               |
|              | Sept. 30, 2002 | Dec. 31, 2002 | March 31, 2003 | June 30, 2003 |
| Sales, net   | \$5,932,585    | \$6,636,220   | \$7,191,002    | \$7,762,436   |
| Gross profit | 1,074,386      | 1,208,827     | 1,366,290      | 1,372,326     |
| Net income   | 191,693        | 247,924       | 480,575        | 243,070       |
| Basic EPS    | \$ .02         | \$ .04        | \$ .08         | \$ .02        |
| Diluted EPS  | \$ .01         | \$ .01        | \$ .01         | \$ --         |

### NOTE 15 - Quarterly Financial Data (Unaudited), continued

The unaudited interim financial information reflects all adjustments, which in the opinion of management, are necessary to fairly present the results of the interim periods presented. All adjustments are of a normal recurring nature. The sum of the quarterly EPS amounts may not equal the full year amounts due to rounding.