

Converted Organics Inc.  
Form 10-Q  
November 19, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended: September 30, 2008**

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the transition period from: \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 333-120908**

**Converted Organics Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**20-4075963**

(I.R.S. Employer Identification No.)

**7A Commercial Wharf W, Boston, MA 02110**

(Address of principal executive offices) (Zip Code)

**(617) 624-0111**

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of November 14, 2008, there were 6,416,658 shares of our common stock outstanding.

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**CONVERTED ORGANICS INC.  
CONSOLIDATED BALANCE SHEETS**

	September 30, 2008 (Unaudited)	December 31, 2007 (Audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 2,844,396	\$ 287,867
Restricted cash	229,926	2,590,053
Accounts receivable, net	232,013	
Inventories	354,378	
Prepaid rent	341,027	190,600
Other prepaid expenses	140,135	40,282
Other receivables	20,974	55,450
Total current assets	4,162,849	3,164,252
Deposits	1,032,495	554,978
Restricted cash	4,607,721	12,006,359
Property and equipment, net	9,822,586	
Construction-in-progress	9,416,118	4,947,067
Capitalized bond costs, net	873,927	909,679
Intangible assets, net	1,073,375	585,750
Deferred financing and issuance costs, net	108,292	8,642
Total assets	\$ 31,097,363	\$ 22,176,727
<b>LIABILITIES AND OWNERS EQUITY (DEFICIT)</b>		
<b>CURRENT LIABILITIES</b>		
Term notes payable current	\$ 464,170	\$ 375,000
Accounts payable	3,758,051	898,270
Accrued compensation, officers, directors and consultants	351,516	397,781
Accrued legal and other expenses	195,784	199,261
Accrued interest	325,481	630,890
Note payable, net of unamortized discount	3,337,525	
Convertible note payable, current, net of unamortized discount	327,390	
Mortgage payable, current	18,164	
Total current liabilities	8,778,081	2,501,202
Term note payable, net of current portion		89,170
Mortgage payable, net of current portion	230,214	
Convertible note payable, net of current portion	436,996	

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Bonds payable	17,500,000	17,500,000
Total liabilities	26,945,291	20,090,372

COMMITMENTS AND CONTINGENCIES

OWNERS' EQUITY (DEFICIT)

Preferred stock, \$.0001 par value, authorized 10,000,000 shares; no shares issued and outstanding

Common stock, \$.0001 par value, authorized 40,000,000 shares; 5,557,968 and 4,229,898 shares issued and outstanding at September 30, 2008 and December 31, 2007

	555	423
Additional paid-in capital	25,553,116	12,460,357
Members' equity	591,980	
Accumulated deficit	(21,993,579)	(10,374,425)
Total owners' equity	4,152,072	2,086,355
Total liabilities and owners' equity	\$ 31,097,363	\$ 22,176,727

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

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**CONVERTED ORGANICS INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	Three months ended		Nine months ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Revenues	\$ 428,516	\$	\$ 1,181,423	\$
Cost of good sold	647,817		1,272,365	
Gross loss	(219,301)		(90,942)	
Operating expenses				
General and administrative expenses	1,469,988	702,481	6,816,407	2,217,397
Research and development	102,528	178,592	300,915	493,243
Amortization of license	4,125	4,125	12,375	12,375
Loss from operations	(1,795,942)	(885,198)	(7,220,639)	(2,723,015)
Other income/(expenses)				
Interest income	59,692	229,778	266,319	650,480
Depreciation expense	(61,542)		(68,431)	
Amortization of capitalized costs	(99,834)	(20,041)	(285,917)	(42,815)
Interest expense	(1,156,739)	(237,665)	(4,284,071)	(910,409)
	(1,258,423)	(27,928)	(4,372,100)	(302,744)
Loss before provision for income taxes	(3,054,365)	(913,126)	(11,592,739)	(3,025,759)
Provision for income taxes				
Net loss	\$ (3,054,365)	\$ (913,126)	\$ (11,592,739)	\$ (3,025,759)
Net loss per share, basic and diluted (Note 8)	\$ (0.48)	\$ (0.21)	\$ (1.92)	\$ (0.80)
Weighted average common shares outstanding (Note 8)	6,390,947	4,414,567	6,050,593	3,786,324

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



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**CONVERTED ORGANICS INC.**  
**CONSOLIDATED STATEMENT OF CHANGES IN OWNERS' EQUITY (DEFICIT) (UNAUDITED)**  
**Nine months ended September 30, 2008**

	Common Stock Shares		Additional	Members	Accumulated	Total Owners Equity
	Issued and	Outstanding	Paid-in	Equity	Deficit	(Deficit)
	Amount	Amount	Capital			
Balance January 1, 2008	4,229,898	\$ 423	\$ 12,460,357	\$	\$ (10,374,425)	\$ 2,086,355
Consolidation of variable interest entity				23,965		23,965
Common stock issued upon exercise of warrants	921,833	92	6,169,462			6,169,554
Common stock issued upon exercise of options	143,000	14	536,236			536,250
Warrants issued in connection with financings, net of cancellations			1,113,750			1,113,750
Beneficial conversion features on convertible notes			2,943,386			2,943,386
Stock dividend	263,237	26	(26)			
Issuance of stock options			2,329,951			2,329,951
Members' contributions				541,600		541,600
Net income (loss)				26,415	(11,619,154)	(11,592,739)
 Balance, September 30, 2008	 5,557,968	 \$ 555	 \$ 25,553,116	 \$ 591,980	 \$ (21,993,579)	 \$ 4,152,072

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



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**CONVERTED ORGANICS INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

	Nine months ended	
	September 30, 2008	September 30, 2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (11,592,739)	\$ (3,025,759)
Adjustments to reconcile net loss to net cash used in operating activities:		
Consolidation of variable interest entity	6,164	
Amortization of intangible asset license	12,375	12,375
Amortization of capitalized bond costs	35,752	31,779
Amortization of deferred financing fees	245,350	
Depreciation of property and equipment	213,323	11,036
Amortization of beneficial conversion features	1,780,026	
Amortization of discounts on private financing	1,563,750	
Stock option compensation expense	2,329,951	
Stock issued for extension of bridge financing		178,048
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(203,311)	
Inventories	(343,264)	
Prepaid expenses and other current assets	(260,280)	(194,335)
Other assets	34,476	
Deposits	(486,517)	(350,000)
Increase (decrease) in:		
Accounts payable and other accrued expenses	2,631,391	(588,843)
Accrued compensation officers, directors and consultants	(46,265)	
Accrued interest	(305,409)	123,408
Other	25,000	
Net cash used in operating activities	(4,360,227)	(3,802,291)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Release of restricted cash	9,758,765	4,948,013
Cash paid for acquisitions	(1,500,000)	
Purchase of property and equipment	(7,025,121)	
Capitalized interest	(638,368)	(299,507)
Construction costs	(3,830,683)	(3,345,709)
Restrictions of cash		(20,646,611)
Deposit on license		(139,978)
Net cash used in investing activities	(3,235,407)	(19,483,792)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		

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Net proceeds from exercise of warrants	6,169,554	
Proceeds from private financing, net of original issue discount	3,715,000	
Net proceeds from exercise of options	536,250	
Member s contributions	541,600	
Payments made for deferred issuance costs		(42,916)
Payments made on mortgage payable	(5,912)	
Repayment of term notes issued for acquisition	(734,729)	
Net proceeds from bond financing (Note 3)		16,546,625
Net proceeds from initial public offering of stock (Note 6)		8,859,784
Proceeds from term notes		89,170
Repayment of term notes		(275,000)
Repayment of demand notes	(69,600)	(100,000)
Repayment of bridge loan		(1,515,000)
Net cash provided by financing activities	10,152,163	23,562,663
NET INCREASE IN CASH	2,556,529	276,580
CASH AND CASH EQUIVALENTS, beginning of period	287,867	66,853
CASH AND CASH EQUIVALENTS, end of period	\$ 2,844,396	\$ 343,433
Supplemental cash flow information:		
Cash paid during the period in:		
Interest	\$ 1,722,863	\$ 908,456
Non-cash financing activities:		
Financing costs paid from proceeds of private financing	\$ 335,000	\$
Issuance costs paid from proceeds of initial public offering		990,000
Issuance costs paid from proceeds of bond financing		953,375
Deferred financing and issuance costs		207,158
Beneficial conversion discount on convertible note	2,943,386	
Warrants issued in connection with financing	1,113,750	

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

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**CONVERTED ORGANICS INC.  
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS  
(UNAUDITED)**

**NOTE 1 BASIS OF PRESENTATION**

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. Certain information and footnote disclosures normally included in the annual financial statements of Converted Organics Inc. (the Company) have been condensed or omitted. In the Company's opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments that are necessary for a fair presentation of its financial position and operating results as of and for the three-month and nine-month interim periods ended September 30, 2008 and 2007.

The results of operations for the interim periods are not necessarily indicative of the results to be expected for the entire year. This Form 10-Q should be read in conjunction with the audited financial statements and notes thereto included in the Company's Form 10-KSB/A as of and for the year ended December 31, 2007 and for the period commencing from inception (May 3, 2003) to December 31, 2007.

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES**

***NATURE OF OPERATIONS***

Converted Organics Inc. uses food and other waste as a raw material to manufacture, sell and distribute all-natural soil amendment products combining disease suppression and nutrition characteristics. The Company transitioned from a development stage company to an operating company in the second quarter of 2008 as operations have commenced and the Company has approximately \$1.2 million in revenues for the nine-month period ended September 30, 2008. When the Company becomes fully operational, its revenues will come from two sources: product sales and tip fees. Product sales revenue comes from the sale of the Company's fertilizer products. The Company's products possess a combination of nutritional, disease suppression and soil amendment characteristics. Waste haulers will pay the Company tip fees for accepting food waste generated by food distributors such as grocery stores, produce docks and fish markets, food processors, and hospitality venues such as hotels, restaurants, convention centers and airports.

Converted Organics of California, LLC (California), a California limited liability company and wholly-owned subsidiary of the Company, was formed when the Company acquired the assets of United Organics Products, LLC. California operates a plant in Gonzales, California, in the Salinas Valley. California produces approximately 25 tons of organic fertilizer per day, and sells primarily to the California agricultural market. The California facility employs a proprietary method called High Temperature Liquid Composting (HTLC), which is the intellectual property acquired in the purchase of the assets of Waste Recovery Industries. The facility is currently being upgraded to expand its capacity and to enable it to accept larger amounts of food waste from waste haulers, earning a tip fee.

Converted Organics of Woodbridge, LLC (Woodbridge), a New Jersey limited liability company and wholly-owned subsidiary of the Company, was formed for the purpose of owning, constructing and operating the Woodbridge, New Jersey facility. The Woodbridge facility is designed to service the New York-Northern New Jersey metropolitan area. The facility remains under construction with only a portion of it being operational during the third quarter of 2008. The facility is expected to be fully completed during the fourth quarter of 2008. Limited operations will continue during the remaining construction period.

Converted Organics of Rhode Island, LLC (Rhode Island), a Rhode Island limited liability company and subsidiary of the Company, was formed for the purpose of developing a facility at the Rhode Island central landfill.

***CONSOLIDATION***

The accompanying unaudited interim consolidated financial statements include the transactions and balances of Converted Organics Inc. and its subsidiaries, Converted Organics of California, LLC, Converted Organics of Woodbridge, LLC and Converted Organics of Rhode Island, LLC. The transactions and balances of Valley Land Holdings, LLC, a variable interest entity of Converted Organics of California, LLC, have also been consolidated therein. All intercompany transactions and balances have been eliminated in consolidation.



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**CONVERTED ORGANICS INC.**  
**NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS** *CONTINUED*  
**(UNAUDITED)**

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES** *CONTINUED*  
**VARIABLE INTEREST ENTITY**

The consolidated interim financial statements include Valley Land Holdings, LLC ( VLH ), as VLH has been deemed to be a variable interest entity of the Company as it is the primary beneficiary of that variable interest entity following the acquisition of the net assets of United Organic Products, LLC. VLH s assets and liabilities consist primarily of land and a mortgage note payable on the land on which the California facility is located. Its operations consist of rental income on the land from the Company and related operating expenses. VLH s activities support the operations of the California facility and do not have sufficient equity at risk to remain viable without the support of the Company.

**USE OF ESTIMATES**

The preparation of consolidated 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 and disclosures in the consolidated financial statements. Actual results could differ from those estimates.

**CASH AND CASH EQUIVALENTS**

The Company considers financial instruments with a maturity date of three months or less from the date of purchase to be cash equivalents. The Company had cash equivalents of \$425,250 at September 30, 2008 consisting of certificates of deposit. There were no cash equivalents at December 31, 2007.

**RESTRICTED CASH**

As of September 30, 2008, the Company had remaining approximately \$4,800,000 of restricted cash as required by its bond agreement with the New Jersey Economic Development Authority. This cash was raised by the Company in its initial public offering and bond financing on February 16, 2007 and is set aside in three separate accounts consisting of approximately \$2,600,000 for the construction of the Woodbridge operating facility, approximately \$10,000 for the working capital requirements of the Woodbridge subsidiary while the facility is under construction and approximately \$2,190,000 in reserve for bond principal and interest payments along with a reserve for lease payments. The Company has classified this restricted cash as non-current to the extent that such funds are to be used to acquire non-current assets or are to be used to service non-current liabilities. Third party trustee approval is required for disbursement of all restricted funds.

**ACCOUNTS RECEIVABLE**

Accounts receivable represents balances due from customers, net of applicable reserves for doubtful accounts. There were no reserves deemed necessary at September 30, 2008 and December 31, 2007. In determining the need for an allowance, objective evidence that a single receivable is uncollectible, as well as historical collection patterns for accounts receivable are considered at each balance sheet date.

**INVENTORIES**

Inventories are valued at the lower of cost or market, with cost determined by the first in, first out basis. Inventory consists primarily of raw materials and finished goods, which consist of soil amendment products. Inventory balances are presented net of applicable reserves. There were no inventory reserves deemed necessary by management at September 30, 2008 and December 31, 2007.

**DEFERRED FINANCING AND ISSUANCE COSTS**

In connection with the private financing arrangement of January 24, 2008, the Company incurred legal and placement fees of \$345,000, \$10,000 of which was paid in the year ended December 31, 2007, and \$335,000 of which was paid from the proceeds of the loan. These fees are being amortized over one year. Amortization expense of \$236,708 was recorded during the nine months ended September 30, 2008, related to these costs.

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**CONVERTED ORGANICS INC.  
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS *CONTINUED*  
(UNAUDITED)**

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES *CONTINUED*  
*INTANGIBLE ASSETS***

Pursuant to a license agreement with an effective date of July 15, 2003 and amended effective date of February 9, 2006, the Company entered into an exclusive license to use its enhanced Autogenous Thermophylic Aerobic Digestion process (EATAD) technology for the design, construction and operation of facilities for the conversion of food waste into solid and liquid organic material. The license is stated at amortized cost. Amortization is provided for using the straight-line method over the life of the license, which is 40 years.

In June 2007, the Company placed a deposit of approximately \$140,000 on a second plant license with the licensor. When received, the second license will be capitalized and amortized over its future life.

On January 24, 2008, the Company acquired the assets, including the intellectual property, of Waste Recovery Industries, LLC ( WRI ). This acquisition included the proprietary technology and process known as the High Temperature Liquid Composting (HTLC) system, which processes various biodegradable waste products into liquid and solid organic-based fertilizer and feed products. The intellectual property is carried at cost, which represents the fair value as determined in the allocation of the purchase price of WRI. The estimated useful life of the intellectual property is indefinite. As a result, the intellectual property will be reviewed for impairment in accordance with SFAS No. 142, Goodwill and Other Intangible Assets.

***ACCOUNTING PRONOUNCEMENTS NOT YET ADOPTED***

There are no accounting pronouncements not yet adopted that are expected to have a significant impact on the Company.

***EARNINGS (LOSS) PER SHARE***

Basic earnings (loss) per share ( EPS ) is computed by dividing the net income (loss) attributable to the common stockholders (the numerator) by the weighted average number of shares of common stock outstanding (the denominator) during the reporting periods. Diluted income (loss) per share is computed by increasing the denominator by the weighted average number of additional shares that could have been outstanding from securities convertible into common stock, such as stock options and warrants (using the treasury stock method), and convertible preferred stock and debt (using the if-converted method), unless their effect on net income (loss) per share is antidilutive. Under the if-converted method, convertible instruments are assumed to have been converted as of the beginning of the period or when issued, if later. The effect of computing the diluted income (loss) per share is antidilutive and, as such, basic and diluted earnings (loss) per share are the same for the three-month and nine-month periods ended September 30, 2008 and 2007.

***RECLASSIFICATIONS***

Certain prior period amounts have been reclassified to conform to the current year presentation.

***SEGMENT REPORTING***

The Company has no reportable segments as defined by SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information.

**NOTE 3 ACQUISITIONS**

On January 24, 2008, the Company acquired the assets, including the intellectual property, of Waste Recovery Industries, LLC of Paso Robles, CA. This acquisition allows the Company to be the exclusive owner of the proprietary technology and process known as the High Temperature Liquid Composting (HTLC) system, which processes various biodegradable waste products into liquid and solid organic-based fertilizer and feed products. The purchase price of \$500,000 was paid with a 7% short-term note that matured on May 1, 2008 and was repaid on that date. Interest on that note was payable monthly. In addition, the purchase price provides for future contingent payments of \$5,500 per ton of capacity, when and if, additional tons of waste-processing capacity are added to the Company's existing current or planned capacity, using the acquired technology.

In addition, Waste Recovery Industries, LLC had begun discussion with a third party (prior to the Company acquiring it) to explore the possibility of building a facility to convert fish waste into organic fertilizer using the

HTLC technology. The Company has completed those negotiations and has entered into an agreement with Pacific Choice Seafoods whereby the Company will be required to pay 50% of the Company's profits (as defined) to the former owner, (who is now an officer and

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**CONVERTED ORGANICS INC.**  
**NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS** *CONTINUED*  
**(UNAUDITED)**

**NOTE 3 ACQUISITIONS** *CONTINUED*

director of the Company) that are earned from the facility. The contingent profit-sharing payments under this agreement will be accounted for as expenses of the appropriate period, in accordance with EITF 95-8, Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination. The Company estimates that no such payments will be payable in the twelve months following the acquisition. Payments, if any, after that will be expensed as incurred. The maximum payment due under these arrangements is \$7,000,000, with no minimum.

On January 24, 2008, the Company also formed Converted Organics of California, LLC, a wholly-owned subsidiary of Converted Organics Inc., who acquired the net assets of United Organic Products, LLC of Gonzales, CA ( UOP ). With this acquisition, the Company acquired a liquid fertilizer product line, as well as a production facility that services a West Coast agribusiness customer base through established distribution channels. This facility is operational and began to generate revenues for the Company immediately upon acquisition. The purchase price of \$2,500,000 was paid in cash of \$1,500,000 and a note payable of \$1,000,000. This note matures on February 1, 2011, has an interest rate of 7%, payable monthly in arrears and is convertible into common stock six months after the acquisition date for a price equal to the five-day average closing price of the stock on Nasdaq for the five days preceding conversion.

The acquisitions have been accounted for in the first quarter of 2008 using the purchase method of accounting in accordance with SFAS No. 141, Business Combinations . Accordingly, the net assets have been recorded at their estimated fair values as of the acquisition date, and operating results have been included in the Company s consolidated financial statements from the date of acquisition. The purchase price has been allocated on a preliminary basis using information currently available. The allocation of the purchase price to the assets and liabilities acquired will be finalized in 2008, as the Company obtains more information regarding asset valuations, liabilities assumed and revisions of preliminary estimates of fair values made at the date of purchase.

The preliminary allocation of the purchase price is as follows:

Inventories	United Organic Products, LLC	\$ 11,114
Accounts receivable	United Organic Products, LLC	28,702
Intellectual property	Waste Recovery Industries, LLC	500,000
Building	United Organic Products, LLC	668,325
Equipment and machinery	United Organic Products, LLC	2,016,772
Assumption of liabilities	United Organic Products, LLC	(224,913)
Total allocation of purchase price		\$ 3,000,000

The unaudited supplemental pro forma information discloses the results of operations for the current fiscal year up to the date of the most recent interim period presented (and for the corresponding periods in the preceding year) as though the business combination had been completed as of the beginning of the period reported on.

The pro forma condensed consolidated financial information is based upon available information and certain assumptions that the Company believes are reasonable. The unaudited supplemental pro forma information does not purport to represent what the Company s financial condition or results of operations would actually have been had these transactions in fact occurred as of the dates indicated above or to project the Company s results of operations for the period indicated or for any other period.

Nine months ending September  
30,



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	2008	2007
Revenues (in thousands)	\$ 1,181	\$ 1,067
Net loss (in thousands)	(11,621)	(3,647)
Net loss per share basic and diluted	(2.21)	(1.11)

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**CONVERTED ORGANICS INC.  
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS *CONTINUED*  
(UNAUDITED)**

**NOTE 4 PROPERTY AND EQUIPMENT**

The Company's property and equipment at September 30, 2008 consisted of the following:

Land and improvements	\$ 325,691
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