Bacterin International Holdings, Inc.
Form 10-Q
May 10, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2013

OR

.. **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: 001-34951

BACTERIN INTERNATIONAL HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware	20-5313323
(State or other jurisdiction	(I.R.S. Employer

of incorporation or organization) Identification No.)

600 CRUISER LANE

BELGRADE, MONTANA 59714

(Address of principal executive offices) (Zip code)

(406) 388-0480

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ 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	¨	(Do not check if a smaller reporting company)	Smaller reporting company	þ

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

Yes ¨ No þ

Number of shares of common stock, $0.000001 par value, of registrant outstanding at April 25, 2013: 42,762,624

BACTERIN INTERNATIONAL HOLDINGS, INC.

FORM 10-Q

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-Q that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Our forward-looking statements include, but are not limited to, statements regarding our “expectations,” “hopes,” “beliefs,” “intentions,” “plans,” or “strategies” regarding the future. In addition, any statements that refer to projections, forecasts, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. The words “anticipate,” “believe,” “continue,” “could,” “estimat “expect,” “intend,” “may,” “might,” “plan,” “possible,” “potential,” “predict,” “project,” “should” and “would,” as well as simi may identify forward-looking statements, but the absence of these words does not mean that a statement is not forward looking. Forward-looking statements in this Form 10-Q may include, for example, statements about:

- the future performance and market acceptance of our products;
- our ability to maintain our competitive position;
- negative media publicity;
- our ability to obtain donor cadavers for our products;
- our ability to expand our production capacity;
- our efforts to innovate and develop new products;
- our ability to engage and retain qualified technical personnel and members of our management team;
- our reliance on our current facilities;
- our ability to generate funds or raise capital to finance our growth;
- our efforts to expand our sales force;
- the ability of our sales force to achieve expected results;

¨government regulations and additional taxes;

¨fluctuations in our operating results;

¨government and third-party coverage and reimbursement for our products;

¨our ability to manage our growth;

¨ our ability to manage our ongoing management transition;

¨ our ability to attract and retain a well qualified Chief Executive Officer;

¨ our ability to meet the obligations of our secured lending facility;

¨ our ability to manage our cash flow and achieve profitability;

¨ our ability to successfully conclude government investigations;

¨our ability to successfully integrate future business combinations or acquisitions;

¨ our ability to obtain regulatory approvals;

¨product liability claims and other litigation to which we may be subjected;

¨product recalls and defects;

¨timing and results of clinical trials;

¨our ability to obtain and protect our intellectual property and proprietary rights;

¨ infringement and ownership of intellectual property;

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- our ability to attract broker coverage;

- the trading market, market prices, dilution, and dividends of our common stock;

- our ability to remain listed on the NYSE MKT exchange;

- influence by our management; and

- our ability to issue preferred stock.

The forward-looking statements contained in this Form 10-Q are based on our current expectations and beliefs concerning future developments and their potential effects on us. There can be no assurance that future developments affecting us will be those that we have anticipated. These forward-looking statements involve a number of risks, uncertainties, or assumptions, many of which are beyond our control, which may cause actual results or performance to be materially different from those expressed or implied by these forward-looking statements. These risks and uncertainties include, but are not limited to, those factors described in the "Risk Factors" section of this Quarterly Report on Form 10-Q. Should one or more of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, actual results may vary in material respects from those projected in these forward-looking statements. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as may be required under applicable securities laws.

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

BACTERIN INTERNATIONAL HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	As of March 31, 2013	As of December 31, 2012
ASSETS		
Current Assets:		
Cash and cash equivalents	$2,119,079	$4,926,066
Trade accounts receivable, net of allowance for doubtful accounts of $1,673,631 and $1,576,955, respectively	7,164,269	7,154,065
Inventories, net	13,608,482	13,141,421
Prepaid and other current assets	742,780	353,271
Total current assets	23,634,610	25,574,823
Non-current inventories	1,238,225	1,238,225
Property and equipment, net	5,526,887	5,234,867
Intangible assets, net	577,817	592,378
Goodwill	728,618	728,618
Other assets	1,039,942	1,126,643
Total Assets	$32,746,099	$34,495,554
LIABILITIES & STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$3,981,696	$3,997,789
Accounts payable - related party	290,001	418,922
Accrued liabilities	2,831,236	2,400,090
Warrant derivative liability	349,001	984,356
Current portion of capital lease obligations	154,898	149,729
Current portion of royalty liability	788,000	698,408
Current portion of long-term debt	45,632	45,135
Total current liabilities	8,440,464	8,694,429
Long-term Liabilities:		
Capital lease obligation, less current portion	205,014	245,703

Long term royalty liability, less current portion	6,723,584	6,839,935
Long-term debt, less current portion	14,719,782	14,483,102
Total Liabilities	30,088,844	30,263,169
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock, $.000001 par value; 5,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $.000001 par value; 95,000,000 shares authorized; 42,957,770 shares issued and outstanding as of March 31, 2013 and 42,877,770 shares issued and outstanding as of December 31, 2012	43	43
Additional paid-in capital	51,992,018	51,897,890
Accumulated deficit	(49,334,806)	(47,665,548)
Total Stockholders' Equity	2,657,255	4,232,385
Total Liabilities & Stockholders' Equity	$32,746,099	$34,495,554

See notes to unaudited condensed consolidated financial statements.

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BACTERIN INTERNATIONAL HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31, 2013	2012
Revenue		
Tissue sales	$ 8,523,348	$ 7,670,949
Royalties and other	95,459	99,052
Total Revenue	8,618,807	7,770,001
Cost of tissue and medical devices sales	3,120,686	1,858,722
Gross Profit	5,498,121	5,911,279
Operating Expenses		
General and administrative	2,857,082	2,590,772
Sales and marketing	3,798,377	4,146,343
Depreciation and amortization	106,378	119,074
Non-cash consulting expense	(30,297)	328,253
Total Operating Expenses	6,731,540	7,184,442
Loss from Operations	(1,233,419)	(1,273,163)
Other Income (Expense)		
Interest expense	(1,063,988)	(170,781)
Change in warrant derivative liability	635,355	217,551
Other income (expense)	(7,206)	179,598
Total Other Income (Expense)	(435,839)	226,368
Net Loss Before (Provision) Benefit for Income Taxes	(1,669,258)	(1,046,795)
(Provision) Benefit for Income Taxes		
Current	-	-
Deferred	-	-
Net Loss	$ (1,669,258)	$ (1,046,795)
Net loss per share:		
Basic	$ (0.04)	$ (0.03)
Dilutive	$ (0.04)	$ (0.03)
Shares used in the computation:		

Basic	42,926,564	41,548,087
Dilutive	42,926,564	41,548,087

See notes to unaudited condensed consolidated financial statements.

BACTERIN INTERNATIONAL HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2013	2012
Operating activities:		
Net loss	$ (1,669,258)	$ (1,046,795)
Noncash adjustments:		
Depreciation and amortization	200,378	213,542
Amortization of debt discount	249,209	26,854
Non-cash consulting expense/stock option expense	29,310	518,536
Non-cash interest	(26,759)	-
Provision for losses on accounts receivable and inventory	85,388	5,592
Change in derivative warrant liability	(635,355)	(217,551)
Increase/(reduction) of contingent liability	7,206	(212,026)
Changes in operating assets and liabilities:		
Accounts receivable	(106,880)	(525,675)
Inventories	(455,773)	(1,978,796)
Prepaid and other current assets	(302,808)	(126,930)
Accounts payable	(145,014)	1,313,599
Accrued liabilities	488,758	(909,349)
Net cash used in operating activities	(2,281,598)	(2,938,999)
Investing activities:		
Purchases of property and equipment and intangible assets	(477,837)	(347,659)
Net cash used in investing activities	(477,837)	(347,659)
Financing activities:		
Payments on long-term debt	(12,032)	(10,682)
Payments on capital leases	(35,520)	(10,237)
Proceeds from issuance of stock	-	3,899,996
Proceeds from exercise of options	-	20,099
Net cash (used in) provided by financing activities	(47,552)	3,899,176
Net change in cash and cash equivalents	(2,806,987)	612,518
Cash and cash equivalents at beginning of period	4,926,066	751,111
Cash and cash equivalents at end of period	$ 2,119,079	$ 1,363,629

See notes to unaudited condensed consolidated financial statements.

Notes to Consolidated Financial Statements

(1) Business Description and Summary of Significant Accounting Policies

Business Description

The accompanying consolidated financial statements include the accounts of Bacterin International Holdings, Inc., a Delaware corporation, and its wholly owned subsidiary, Bacterin International, Inc., a Nevada corporation, (collectively, the "Company" or "Bacterin"). All intercompany balances and transactions have been eliminated in consolidation. Bacterin's biologics division develops, manufactures and markets biologics products to domestic and international markets. Bacterin's proprietary methods are used in human allografts to create stem cell scaffolds and promote bone and other tissue growth. These products are used in a variety of applications including enhancing fusion in spine surgery, relief of back pain with a facet joint stabilization, promotion of bone growth in foot and ankle surgery, promotion of skull healing following neurosurgery and regeneration in knee and other joint surgeries.

Bacterin's device division develops and licenses coatings for various medical device applications.

An operating segment is a component of an enterprise whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. The primary performance measure used by management is net income or loss. The Company operates in two distinct lines of business consisting of the biologics and devices divisions. However, due to the immaterial revenue from devices to date, the Company reports as one segment.

The Company's revenue is derived principally from the sale or license of its medical products, coatings and device implants. The markets in which the Company competes are highly competitive and rapidly changing. Significant technological advances, changes in customer requirements, or the emergence of competitive products with new capabilities or technologies could adversely affect the Company's operating results. The Company's business could be harmed by a decline in demand for, or in the prices of, its products or as a result of, among other factors, any change in pricing or distribution model, increased price competition, changes in government regulations or a failure by the Company to keep up with technological change. Further, a decline in available tissue donors could have an adverse impact on our business.

The accompanying interim condensed consolidated financial statements of Bacterin for the three months ended March 31, 2013 and 2012 are unaudited and are prepared in accordance with accounting principles generally accepted in the

United States of America. They do not include all disclosures required by generally accepted accounting principles for annual financial statements, but in the opinion of management, include all adjustments, consisting only of normal recurring items, necessary for a fair presentation. Interim results are not necessarily indicative of results which may be achieved in the future for the full year ending December 31, 2013.

These financial statements should be read in conjunction with the financial statements and notes thereto which are included in Bacterin's Annual Report on Form 10-K for the year ended December 31, 2012. The accounting policies set forth in those annual financial statements are the same as the accounting policies utilized in the preparation of these financial statements, except as modified for appropriate interim financial statement presentation.

Presentation

Certain amounts in the 2012 condensed consolidated financial statements have been reclassified to conform to the 2013 presentation.

Concentrations and Credit Risk

The Company's accounts receivable are due from a variety of health care organizations and distributors throughout the world. Approximately 98% and 99% of sales were in the United States for the three months ended March 31, 2013 and 2012, respectively. One customer accounted for approximately 15% and 7% of the Company's revenue for the three months ended March 31, 2013 and 2012, respectively. One customer represented 21% and 19% of accounts receivable at March 31, 2013 and 2012, respectively. The Company provides for uncollectible amounts when specific credit issues arise. Management's estimates for uncollectible amounts have been adequate during prior periods, and management believes that all significant credit risks have been identified at March 31, 2013.

Revenue by geographical region is as follows:

	Three months ended March 31,	
	2013	2012
United States	$8,433,834	$7,654,923
Rest of World	184,973	115,078
	$8,618,807	$7,770,001

Use of Estimates

The preparation of the financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period; the carrying amount of property and equipment and intangible assets; valuation allowances for trade receivables and deferred income tax assets; valuation of the warrant derivative liability; inventory reserve; contingent consideration from acquisitions; royalty liability; and estimates for the fair value of stock options grants and other equity awards upon which the Company determines stock-based compensation expense. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity date of three months or less to be cash equivalents. Cash equivalents are recorded at cost, which approximates market value. At times the Company maintains deposits in financial institutions in excess of federally insured limits.

Accounts Receivable

Accounts receivable represents amounts due from customers for which revenue has been recognized. Normal terms on trade accounts receivable are net 30 days and some customers are offered discounts for early pay. The Company performs credit evaluations when considered necessary, but generally does not require collateral to extend credit.

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing receivables. The Company determines the allowance based on factors such as historical collection experience, customer's current creditworthiness, customer concentration, age of accounts receivable balance, general economic conditions that may affect a customer's ability to pay and management judgment. Actual customer collections could differ from estimates. Account balances are charged to the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Provisions to the allowance for doubtful accounts are charged to expense. The Company does not have any off-balance sheet credit exposure related to its customers.

Accounts Payable - Related Party

Accounts payable to a related party includes amounts due to American Donor Services, a supplier of donors to the Company. See Note 14, “Related Party Transactions” below.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the specific identification method and includes materials, labor and overhead. The Company calculates an inventory reserve for estimated obsolescence or excess inventory based on historical usage and sales, as well as assumptions about future demand for its products. These estimates for excess and obsolete inventory are reviewed and updated on a quarterly basis. Increases in the inventory reserves result in a corresponding expense, which is generally recorded to cost of tissue and medical devices sales. Inventories where the sales cycle is estimated to be beyond twelve months are classified as Non-current inventories.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three to seven years for computers and equipment, and 30 years for buildings. Leasehold improvements are depreciated over the shorter of their estimated useful life or the remaining term of the lease. Repairs and maintenance are expensed as incurred.

Goodwill

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have indefinite useful lives are not amortized, instead are tested for impairment at least annually and whenever events or circumstances indicate the carrying amount of the asset may not be recoverable. In its evaluation of goodwill, the Company performs an assessment of qualitative factors to determine if it is more-likely-than-not that goodwill might be impaired and whether it is necessary to perform the two-step goodwill impairment. The Company conducts its annual impairment test on December 31 of each year. See Note 3, “Goodwill” below.

Derivative Instruments

The Company accounts for its derivative instruments in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 815 “Accounting for Derivative Instruments and Hedging Activities”. The only derivative instruments presented in the accompanying consolidated financial statements relates to warrants issued in connection with certain debt financings. The Company has not designated its warrant derivative liability as a hedging instrument as described in ASC 815 and any changes in the fair market value of the warrant derivative liability is recognized in the consolidated statement of operations during the period of change. See Note 10, “Warrants” below.

Intangible Assets

Intangible assets with estimable useful lives must be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or circumstances indicate their carrying amount may not be recoverable. Intangible assets include trademarks, customer lists and patents and include costs to acquire and protect Company patents. Intangible assets are carried at cost less accumulated amortization. The

Company amortizes these assets on a straight-line basis over their estimated useful lives of five years for customer lists and 15 years for all other intangible assets.

Revenue Recognition

Revenue is recognized when all of the following criteria are met: a) the Company has entered into a legally binding agreement with the customer; b) the products or services have been delivered; c) the Company's fee for providing the products and services is fixed or determinable; and d) collection of the Company's fee is probable.

The Company's policy is to record revenue net of any applicable sales, use, or excise taxes. If an arrangement includes a right of acceptance or a right to cancel, revenue is recognized when acceptance is received or the right to cancel has expired.

The Company ships to certain customers under consignment arrangements whereby the Company's product is stored by the customer. The customer is required to report the use to the Company and upon such notice, the Company invoices the customer and revenue is recognized when above criteria has been met.

The Company also receives royalty revenue from third parties related to licensing agreements. The Company has royalty agreements with Nufix, RyMed and Bard Access Systems. Revenue under these agreements represented less than 1% of total revenue for the three months ended March 31, 2013 and 2012.

Non-Cash Consulting Expense

From time to time, the Company issues restricted stock awards to consultants and advisors to the Company. These awards are measured at fair value at each reporting date, recognized ratably over the vesting period and are recorded in non-cash consulting expense.

Advertising Costs

The Company expenses advertising costs as incurred. The Company had no Advertising expense in the three months ended March 31, 2013 and $18,000 for the quarter ended March 31, 2012.

Research and Development

Research and development costs, which are principally related to internal costs for the development of new technologies and processes for tissue and coatings, are expensed as incurred.

Income Taxes

The Company accounts for income taxes under the asset and liability method of accounting for deferred taxes as prescribed under FASB ASC 740, Accounting for Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. When applicable, a valuation allowance is established to reduce any deferred tax asset when it is determined that it is more likely than not that some portion of the deferred tax asset will not be realized. ASC 740 also requires reporting of taxes based on tax positions that meet a more-likely-than-not standard and that are measured at the amount that is more-likely-than-not to be realized. Differences between financial and tax reporting which do not meet this threshold are required to be recorded as unrecognized tax benefits. ASC 740 also provides guidance on the presentation of tax matters and the recognition of potential IRS interest and penalties. The Company classifies penalty and interest expense related to income tax liabilities as an income tax expense. There are no significant interest and penalties recognized in the statement of operations or accrued on the balance sheet. See Note 12, “Income Taxes” below.

Long-Lived Assets

Long-lived assets, including intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. No impairment was recorded during the quarters ended March 31, 2013 or 2012.

Net Loss Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding. Shares issued during the period and shares reacquired during the period are weighted for the portion of the period that they were outstanding. Diluted net income (loss) per share is computed in a manner consistent with that of basic earnings per share while giving effect to all potentially dilutive common shares outstanding during the period, which include the assumed exercise of stock options and warrants using the treasury stock method. Diluted net loss per share was the same as basic net loss per share for the quarters ended March 31, 2013 and 2012 as shares issuable upon the exercise of stock options and warrants were anti-dilutive as a result of the net losses incurred for those periods.

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Stock-Based Compensation

The Company records stock-compensation expense according to the provisions of ASC 718. Under ASC 718, stock-based compensation costs are recognized based on the estimated fair value at the grant date for all stock-based awards. The Company estimates grant date fair values using the Black-Scholes-Merton option pricing model, which requires assumptions of the life of the award and the stock price volatility over the term of the award. The Company records compensation cost of stock-based awards using the straight line method, which is recorded into earnings over the vesting period of the award. Pursuant to the income tax provisions included in ASC 718-740, the Company has elected the "short cut method" of computing its hypothetical pool of additional paid-in capital that is available to absorb future tax benefit shortfalls.

Fair Value of Financial Instruments

The carrying values of financial instruments, including trade accounts receivable, accounts payable, other accrued expenses and long-term debt, approximate their fair values based on terms and related interest rates.

We follow a framework for measuring fair value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. During the three months ended March 31, 2013 and 2012, there was no reclassification in financial assets or liabilities between Level 1, 2 or 3 categories.

The following tables set forth by level, within the fair value hierarchy, our assets and liabilities as of March 31, 2013 and December 31, 2012 that are measured at fair value on a recurring basis:

Accrued stock compensation

	As of March 31, 2013	As of December 31, 2012
Level 1	$ 105,807	$ 218,850
Level 2	-	-
Level 3	-	-

The valuation technique used to measure fair value of the accrued stock compensation is based on quoted stock market prices.

Warrant derivative liability

	As of March 31, 2013	As of December 31, 2012
Level 1	-	-
Level 2	-	-
Level 3	$ 349,001	$ 984,356

Acquisition contingent consideration liability

	As of March 31, 2013	As of December 31, 2012
Level 1	-	-
Level 2	-	-
Level 3	$ 98,946	$ 91,740

The valuation technique used to measure fair value of the warrant liability and contingent consideration is based on a lattice model and significant assumptions and inputs determined by us.

Level 3 Changes

The following is a reconciliation of the beginning and ending balances for liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ending March 31, 2013:

Warrant derivative liability

Balance at January 1, 2013	$984,356
Gain recognized in earnings	(635,355)
Balance at March 31, 2013	$349,001

Acquisition contingent consideration liability

Balance at January 1, 2013	$91,740
Change recognized in earnings	7,206
Balance at March 31, 2013	$98,946

During the quarter ended March 31, 2013, the Company did not change any of the valuation techniques used to measure its liabilities at fair value.

Items measured at fair value on a non-recurring basis:

The Company’s royalty liability is carried at its estimated fair value based upon the discounted present value of the payments using an estimated discount rate. The Company did not have access to a readily traded market for similar credit risks and the estimated interest rate was based upon the Company’s estimate of a market interest rate to obtain similar financing. The Company originally discounted the $16.8 million of estimated payments at an interest rate of 16.7%. This was adjusted to an estimated royalty total of $13.8 million as of December 31, 2012 and was not adjusted in the first quarter of 2013. Accordingly, these inputs are classified as Level 3 inputs.

Recent Accounting Pronouncements

There are no recently issued accounting standards for which the Company expects a material impact to its consolidated financial statements.

(2) Equity

During the first quarter of 2012, we issued 1,475,037 shares of our common stock to Lincoln Park Capital for aggregate proceeds of $3,899,996. We used the proceeds for working capital and general corporate purposes.

(3) Acquisition

In 2011, the company acquired the assets of a medical devices company. As part of the purchase agreement, we agreed to pay an additional $500,000 in common stock if gross revenue from the sale of products resulting from the purchased assets (“Products”) equals or exceeds $1 million, and an additional $500,000 in common stock when gross revenue from the sale of Products equals or exceeds $2 million, provided that such gross revenue thresholds are achieved within 2 years. As of March 31, 2013, these revenue thresholds have not been achieved.

The initial valuation of the contingent consideration was based upon management's estimates of the probability of reaching the milestones that would trigger the requirement to pay the contingent amounts. During 2013, management reviewed and adjusted the assumptions associated with the contingent liability which resulted in a reduction of the contingent liability to $98,946 as of March 31, 2013.

(4) Inventories

Inventories consist of the following:

	March 31, 2013	December 31, 2012
Current inventories		
Raw materials	$2,024,667	$1,919,250
Work in process	4,698,274	4,991,032
Finished goods	7,993,446	7,350,332
	14,716,387	14,260,614
Reserve	(1,107,905)	(1,119,193)
Current inventories, total	$13,608,482	$13,141,421
Non-current inventories		
Finished goods	$1,238,225	$1,238,225
Non-current inventories, total	$1,238,225	$1,238,225
Total inventories	$14,846,707	$14,379,646

(5) Property and Equipment, Net

Property and equipment, net are as follows:

	March 31, 2013	December 31, 2012
Buildings	$1,653,263	$1,653,263
Equipment	5,643,358	5,172,523
Computer equipment	312,650	312,650
Computer software	395,146	392,206
Furniture and fixtures	170,118	170,118
Leasehold improvements	1,793,462	1,793,756
Vehicles	78,306	78,306
Total cost	10,046,303	9,572,822

Less: accumulated depreciation	(4,519,416)	(4,337,955)
	$5,526,887	$5,234,867

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The Company leases certain equipment under capital leases. For financial reporting purposes, minimum lease payments relating to the assets have been capitalized. As of March 31, 2013, the Company has recorded $549,604 gross assets in Equipment, and $107,477 of accumulated depreciation relating to assets under capital leases.

Maintenance and repairs expense for the first quarter of 2013 and 2012 was $82,837 and $47,654, respectively. Depreciation expense related to property and equipment, including property under capital lease for the first quarter of 2013 and 2012 was $181,461 and $194,752, respectively.

(6) Intangible Assets

Bacterin has applied for various patents with regards to processes for its products.

The following table sets forth information regarding intangible assets:

	March 31, 2013	December 31, 2012
Intellectual Property		
Gross carrying value	$825,134	$ 820,778
Accumulated amortization	$(247,317)	$ (228,400)
Net carrying value	$577,817	$ 592,378
Aggregate amortization expense:	$18,917	$ 74,918
Estimated amortization expense:		
Remainder of 2013		$ 56,189
2014		$ 74,918
2015		$ 74,918
2016		$ 74,918
2017		$ 74,918
Thereafter		$ 221,956
Total		$ 577,817

(7) Accrued Liabilities

Accrued liabilities consist of the following:

	March 31, 2013	December 31, 2012
Acquisition contingent liability	$98,946	$ 91,740
Accrued stock compensation	105,807	218,850
Wages/commissions payable	1,619,921	1,013,909
Other accrued expenses	1,006,562	1,075,591
	$2,831,236	$ 2,400,090

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(8) Long-term Debt

On April 23, 2012, the Company secured an accounts receivable credit facility with Midcap Financial LLC and Silicon Valley Bank. The revolving loan credit facility allowed Bacterin to borrow up to $5 million through January 1, 2015. The facility allowed borrowings based upon a predetermined formula of up to 80% of Bacterin's eligible accounts receivable, as defined in the credit and security agreement. The Company also amended its existing Loan and Security Agreement with MidCap to allow the Company to borrow up to an additional $3 million for the next nine months in connection with a permitted acquisition. The credit facility carried an interest rate of LIBOR plus 4%, subject to a LIBOR floor rate of 2.5%. The Company also agreed to pay a 0.5% collateral management fee on the average outstanding balance of the facility and 1% of the average unused portion of the facility, as well as a 1% origination fee. We repaid the outstanding balance owed on this credit facility in full with the proceeds from our credit facility with ROS Acquisition Offshore LP (“ROS”) on August 24, 2012.

On August 24, 2012, the Company entered into a Credit Agreement with ROS, whereby ROS agreed to provide an initial $20 million term loan and Bacterin may also borrow an additional $5 million upon achievement of certain revenue objectives prior to December 31, 2013. The loan carries an interest rate of LIBOR plus 12.13%, subject to a LIBOR floor rate of 1.0%. Bacterin also agreed to pay a royalty of 1.75% on the first $45,000,000 of net sales, plus 1.0% of net sales in excess of $45,000,000 for each of the next ten years. Bacterin has the right to repay the loan and royalty interest at amounts to be determined based on the date of repayment and the amount of prior principal, interest and royalty payments. The loan is secured by substantially all of our assets. The estimate of the royalty component of the facility over the life of the agreement resulted in a debt discount and a royalty liability of $7,341,520. The debt discount will be amortized to interest expense over the seven year term of the loan using the effective interest method. The royalty liability will be accreted to $13.8 million through interest expense over the ten year term of the royalty agreement using the effective interest method. Payments made under the royalty agreement, per the table below, will directly reduce the royalty liability.

The Company received net proceeds of approximately $10 million following repayment of the existing term loan and accounts receivable credit facility with MidCap Financial, including prepayment penalties. The Company plans to use the net proceeds for working capital and general corporate purposes.

Long-term debt consists of the following:

	March 31, 2013	December 31, 2012
Loan payable to ROS Acquisition Offshore, LIBOR plus 12.13% maturing August 2019	$ 20,000,000	$ 20,000,000
6.00% loan payable to Valley Bank of Belgrade, $10,746 monthly payments including interest, maturing December 24, 2030; secured by building	1,409,388	1,421,420

	21,409,388	21,421,420
Less: Current portion	(45,632)	(45,135)
Debt discount	(6,643,974)	(6,893,183)
Long-term debt	$14,719,782	$14,483,102

The following is a summary of maturities due on the debt as of March 31, 2013:

Remainder of 2013	33,500
2014	47,727
2015	50,670
2016	1,720,679
2017	6,724,041
Thereafter	12,832,771
Total	$21,409,388

The following is a summary of estimated future royalty payments as of March 31, 2013:

Remainder of 2013	591,000
2014	853,000
2015	1,050,000
2016	1,289,000
2017	1,384,000
Thereafter	8,477,000
Total	$13,644,000

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(9) Stock-Based Compensation

Our Equity Incentive Plan ("The Plan") provides for stock awards, including options and performance stock awards, to be granted to employees, consultants, independent contractors, officers and directors. The purpose of the incentive compensation plan is to enable us to attract, retain and motivate key employees, directors and, on occasion, independent consultants, by providing them with stock options and restricted stock grants. Stock options granted under the incentive compensation plan may be either incentive stock options to employees, as defined in Section 422A of the Internal Revenue Code of 1986, or non-qualified stock options. The plan is currently administered by the compensation committee of our Board of Directors. The administrator of the plan has the power to determine the terms of any stock options granted under the incentive plan, including the exercise price, the number of shares subject to the stock option and conditions of exercise. Stock options granted under the incentive plan are generally not transferable, vest in installments over the requisite service period and are exercisable during the stated contractual term of the option only by such optionee. The exercise price of all incentive stock options granted under the incentive plan must be at least equal to the fair market value of the shares of common stock on the date of the grant. 9 million shares are authorized under the Plan and at March 31, 2013, we had approximately 1,629,898 shares available for issuance. Shares issued under the Plan may be authorized, but unissued, or reacquired shares.

Stock compensation expense recognized in the statement of operations for the quarters ended March 31, 2013 and 2012 is based on awards ultimately expected to vest and reflects an estimate of awards that will be forfeited. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The estimated fair value of stock options granted is done using the Black-Sholes-Merton method applied to individual grants. The Company utilizes historical employee termination behavior to determine the estimated forfeiture rates. If the actual forfeitures differ from those estimated by management, adjustments to compensation expense will be made in future periods. A assumed forfeiture rate of 24.32% was used for the first quarter of 2013,

Activity under our stock option plans was as follows:

	2013			2012		
		Weighted Average	Weighted Average Fair Value at Grant Date		Weighted Average	Weighted Average Fair Value at Grant Date

	Shares	Exercise Price		Shares	Exercise Price	
Outstanding at January 1	5,266,535	$ 2.02	$ 1.03	4,828,910	$ 2.14	$ 1.01
Granted	-	-	-	622,500	2.36	1.38
Exercised	-	-	-	(15,000)	1.34	0.45
Cancelled or expired	(70,000)	2.89	1.45	(610,000)	1.65	0.78
Outstanding at March 31	5,196,535	$ 2.01	$ 1.03	4,826,410	$ 2.23	$ 1.04
Exercisable at March 31	2,672,301	$ 1.83	$ 0.83	1,986,093	$ 1.67	$ 0.68

The aggregate intrinsic value of options outstanding as of March 31, 2013 is $300,516. The aggregate intrinsic value of exercisable options as of March 31, 2013 is $300,516. As of March 31, 2013, there were 2,524,234 unvested options with a weighted average fair value at the grant date of $1.18 per option. As of March 31, 2013, there is no compensation related to nonvested awards not yet recognized.

From time to time we may grant stock options and restricted stock grants to consultants. We account for consultant stock options in accordance with ASC 505-50. Consulting expense for the grant of stock options to consultants is determined based on the estimated fair value of the stock options at the measurement date as defined in ASC 505-50 and is recognized over the vesting period.

The following table summarizes restricted stock award activity during the quarter ended March 31, 2013:

	Shares
Outstanding at Jan. 1, 2013	733,900
Awarded	-
Cancelled	(112,500)
Vested	(80,000)
Outstanding at March 31, 2013	541,400

The restricted stock awards generally vest over three to five year periods. The Company recognized reduction of non-cash consulting expense of $30,297 for the first quarter of 2013 and expense of $328,253 for the quarter ended March 31, 2012. As of March 31, 2013, the total expense related to nonvested restricted stock awards not yet recognized is $265,995 and is expected to be recognized over four years.

(10) Warrants

In the fourth quarter of 2012, the Company issued 297,991 warrants with an exercise price of $2.30 to a broker in conjunction with the August 24, 2012 financing arrangement with ROS. These were recorded in “Other Assets” and will be amortized over the life of the financing term. In addition, on July 23, 2012 the Company issued 300,895 warrants with an exercise price of $1.03 to a private party resulting in $342,485 recorded in “Other Expense”.

The following table summarizes our warrant activities for the period ended March 31, 2013:

	Shares	Weighted Average Exercise Price
Outstanding at January 1, 2013	7,321,667	$ 2.20
Issued	-	-
Exercised	-	-
Expired	(533,173)	2.00
Outstanding at March 31, 2013	6,788,494	$ 2.22

The exercise of 244,748 warrants in 2012 resulted in the issuance of 129,972 shares of common stock as the warrants were exercised using the cashless feature of the warrants.

We utilize a lattice model to determine the fair market value of the warrants accounted for as liabilities. The 1,570,565 warrants issued in connection with a 2010 bridge financing and 375,000 warrants issued in connection with a 2010 debt financing were accounted for as derivative liabilities in connection with the price protection provisions of the warrants in compliance with ASC 815. There were an additional 143,700 warrants in the first quarter of 2012 as a result of the LPC share issuance triggering the anti-dilution clause in the original warrant agreement. The lattice model accommodates the probability of exercise price adjustment features as outlined in the warrant agreements. We recorded an unrealized gain of $635,355 resulting from the change in the fair value of the warrant derivative liability for the first quarter of 2013. Under the terms of the warrant agreement, at any time while the warrant is outstanding, the exercise price per share can be reduced to the price per share of future subsequent equity sales of our common stock or common stock equivalents that is lower than the exercise price per share as stated in the warrant agreement.

The estimated fair value was derived using the lattice model with the following weighted-average assumptions:

	Three months ended March 31, 2013		Three months ended March 31, 2012	
Value of underlying common stock (per share)	$0.83		$1.29	
Risk free interest rate	0.24	%	0.38	%
Expected term	3.58 years		4.60 years	
Dividend yield	0	%	0	%
Volatility	72	%	65	%

The following table summarizes our activities related to number of warrants used in the derivative liability for the period ended March 31, 2013 and 2012:

	2013	2012
Balance at January 1	1,649,707	1,506,007
Derivative warrants issued	-	143,700
Derivative warrants exercised	-	-
Balance at March 31	1,649,707	1,649,707

(11) Commitments and Contingencies

Operating Leases

We lease two office facilities under non-cancelable operating lease agreements with expiration dates in 2013 and 2019. We have the option to extend both the leases for another ten year term and for one facility, we have the right of first refusal on any sale. We lease an additional office facility under a month-to-month arrangement. Future minimum payments for the next five years and thereafter as of March 31, 2013, under these leases, are as follows:

Remainder of 2013	$205,702
2014	$270,993
2015	$263,136
2016	$263,136
2017	$263,136
Thereafter	$936,057
Total	$2,202,160

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