STEMCELLS INC
Form 10-Q
November 03, 2011
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

## QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF

## THE SECURITIES EXCHANGE ACT OF 1934

**For the quarter ended: September 30, 2011**

**Commission File Number: 0-19871**

# STEMCELLS, INC.

**(Exact name of registrant as specified in its charter)**

| **DELAWARE** | **94-3078125** |
|---|---|
| **(State or other jurisdiction of** | **(I.R.S. Employer** |

**incorporation or organization)** **identification No)**

**7707 Gateway Blvd**

**Newark, CA 94560**

**(Address of principal executive offices including zip code)**

**(510) 456-4000**

**(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 twelve months (or for such shorter periods that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 x 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 x |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | 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 x

At November 1, 2011, there were 14,326,889 shares of Common Stock, $.01 par value, issued and outstanding.

**Table of Contents**

STEMCELLS, INC.

INDEX


| | Page Number |
|---|---|
| PART I. FINANCIAL INFORMATION | 3 |
| Item 1. Financial Statements (Unaudited) | 3 |
| Condensed Consolidated Balance Sheets at September 30, 2011 and December 31, 2010 | 3 |
| Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2011 and 2010 | 4 |
| Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010 | 5 |
| Notes to Condensed Consolidated Financial Statements | 6 |
| Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations | 18 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 31 |
| Item 4. Controls and Procedures | 31 |
| PART II. OTHER INFORMATION | 31 |
| Item 1. Legal Proceedings | 31 |
| Item 1A. Risk Factors | 32 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 32 |
| Item 3. Defaults Upon Senior Securities | 32 |
| Item 4. Submission of Matters to a Vote of Security-Holders | 32 |
| Item 5. Other Information | 32 |
| Item 6. Exhibits | 32 |
| SIGNATURES | 33 |


**NOTE REGARDING REFERENCES TO US AND OUR COMMON STOCK**

Throughout this Form 10-Q, the words we, us, our, and StemCells refer to StemCells, Inc., including our directly and indirectly wholly-owned subsidiaries. Common stock refers to the common stock, $.01 par value, of StemCells, Inc.

Table of Contents

**PART I-FINANCIAL INFORMATION**

ITEM 1. FINANCIAL STATEMENTS

STEMCELLS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 7,294,074 | $ 19,707,821 |
| Marketable securities, current | 5,240,400 | 190,804 |
| Trade receivables | 76,718 | 118,890 |
| Other receivables | 527,466 | 151,144 |
| Prepaid assets | 485,238 | 610,980 |
| Other assets, current | | 389,039 |
| Total current assets | 13,623,896 | 21,168,678 |
| Property, plant and equipment, net | 2,247,801 | 2,626,821 |
| Other assets, non-current | 1,913,637 | 1,931,871 |
| Goodwill | 1,905,611 | 1,877,315 |
| Other intangible assets, net | 2,768,962 | 2,996,888 |
| Total assets | $ 22,459,907 | $ 30,601,573 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,424,436 | $ 1,098,962 |
| Accrued expenses and other current liabilities | 2,322,833 | 2,828,168 |
| Accrued wind-down expenses, current | 1,429,469 | 1,310,571 |
| Deferred revenue, current | 54,065 | 45,885 |
| Capital lease obligation, current | 35,581 | 67,847 |
| Deferred rent, current | 3,579 | |
| Bonds payable, current | 197,333 | 176,250 |
| Total current liabilities | 5,467,296 | 5,527,683 |
| Capital lease obligation, non-current | | 17,979 |
| Bonds payable, non-current | 371,417 | 522,500 |
| Fair value of warrant liability | 171,551 | 6,671,929 |
| Deposits and other long-term liabilities | 291,807 | 276,439 |
| Accrued wind-down expenses, non-current | 1,050,194 | 1,989,800 |
| Deferred rent, non-current | 1,031,737 | 1,227 |
| Deferred revenue, non-current | 100,768 | 113,387 |
| Total liabilities | 8,484,770 | 15,120,944 |
| Commitments and contingencies (Note 7) Stockholders equity: | | |
| Common stock, $0.01 par value; 75,000,000 shares authorized; issued and outstanding 14,283,853 at September 30, 2011 and 12,731,287 at December 31, 2010* | 1,391,335 | 1,273,128 |
| Additional paid-in capital | 337,909,810 | 325,359,265 |
| Accumulated deficit | (325,388,266) | (311,271,486) |

| | | |
|---|---|---|
| Accumulated other comprehensive income | 62,258 | 119,722 |
| Total stockholders equity | 13,975,137 | 15,480,629 |
| Total liabilities and stockholders equity | $ 22,459,907 | $ 30,601,573 |

See Notes to Condensed Consolidated Financial Statements.

* Adjusted for the 1-for-10 reverse stock split as discussed in Note 1

**Table of Contents**

STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Revenue: | | | | |
| Revenue from licensing agreements and grants | $ 41,265 | $ 123,693 | $ 162,614 | $ 409,092 |
| Revenue from product sales | 182,321 | 129,826 | 516,536 | 318,831 |
| Total revenue | 223,586 | 253,519 | 679,150 | 727,923 |
| Cost of product sales | 60,501 | 35,914 | 167,390 | 104,538 |
| Gross profit | 163,085 | 217,605 | 511,760 | 623,385 |
| Operating expenses: | | | | |
| Research and development | 4,524,334 | 5,200,612 | 15,103,845 | 15,096,354 |
| Selling, general and administrative | 1,733,229 | 2,017,872 | 5,912,220 | 6,889,292 |
| Wind-down expenses | 68,694 | | 258,749 | 291,168 |
| Total operating expenses | 6,326,257 | 7,218,484 | 21,274,814 | 22,276,814 |
| Loss from operations | (6,163,172) | (7,000,879) | (20,763,054) | (21,653,429) |
| Other income (expense): | | | | |
| Realized gain on sale of marketable securities | | | 83,750 | |
| Change in fair value of warrant liability | 1,697,194 | 1,227,585 | 6,500,377 | 5,184,304 |
| Interest income | 3,514 | 10,911 | 11,332 | 24,814 |
| Interest expense | (16,585) | (22,221) | (56,585) | (72,775) |
| Other income (expense) | 144,697 | 232,348 | 107,400 | 230,408 |
| Total other income (expense), net | 1,828,820 | 1,448,623 | 6,646,274 | 5,366,751 |
| Net loss | $ (4,334,352) | $ (5,552,256) | $ (14,116,780) | $ (16,286,678) |
| Basic and diluted net loss per share* | $ (0.31) | $ (0.44) | $ (1.02) | $ (1.33) |
| Shares used to compute basic and diluted loss per share* | 14,009,341 | 12,709,172 | 13,831,749 | 12,201,532 |

See Notes to Condensed Consolidated Financial Statements.

* Adjusted for the 1-for-10 reverse stock split as discussed in Note 1

**Table of Contents**

STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

| | Nine months ended September 30, | |
|---|---|---|
| | **2011** | **2010** |
| Cash flows from operating activities: | | |
| Net loss | $ (14,116,780) | $ (16,286,678) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 917,147 | 1,169,054 |
| Stock-based compensation | 2,636,445 | 2,987,883 |
| Gain on sale of marketable securities | (83,750) | |
| Gain from settlement agreement, net | | (226,580) |
| Loss on disposal of fixed assets | 32,145 | 1,854 |
| Write-down of fixed assets | | 62,807 |
| Write-down of intangible assets | | 35,684 |
| Change in fair value of warrant liability | (6,500,377) | (5,184,304) |
| Changes in operating assets and liabilities: | | |
| Other receivables | 252 | 558,709 |
| Trade receivables | (281,709) | 54,309 |
| Prepaid and other current assets | 465,514 | (209,259) |
| Other assets, non-current | 18,830 | 42,482 |
| Accounts payable and accrued expenses | (142,120) | (1,706,687) |
| Accrued wind-down expenses | (820,708) | (762,474) |
| Deferred revenue | (4,541) | (61,289) |
| Deferred rent | 1,034,088 | (130,768) |
| Net cash used in operating activities | (16,845,564) | (19,655,257) |
| Cash flows from investing activities: | | |
| Purchase of marketable securities | (10,223,957) | |
| Proceeds from the sale and maturity of marketable securities | 5,134,206 | |
| Purchases of property, plant and equipment | (330,740) | (766,907) |
| Proceeds from sale of property, plant and equipment | 42,427 | |
| Net cash used in investing activities | (5,378,064) | (766,907) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock, net of issuance costs | 10,426,121 | 7,015,322 |
| Proceeds from the exercise of stock options | 2,386 | 18,936 |
| Payments related to net share issuance of stock based awards | (396,201) | (483,406) |
| Repayment of capital lease obligations | (50,246) | (52,069) |
| Repayment of bonds payable | (130,000) | (118,750) |
| Net cash provided by financing activities | 9,852,060 | 6,380,033 |
| Decrease in cash and cash equivalents | (12,371,565) | (14,042,131) |
| Effects of foreign exchange rate changes on cash | (42,182) | (21,272) |
| Cash and cash equivalents, beginning of period | 19,707,821 | 38,617,977 |
| Cash and cash equivalents, end of period | $ 7,294,074 | $ 24,554,574 |
| Supplemental disclosure of cash flow information: | | |

| | | |
|---|---|---|
| Interest paid | $ 56,585 | $ 72,775 |
| Supplemental schedule of non-cash investing and financing activities: | | |
| Stock retired from settlement agreement[1] | | $ 241,150 |

See Notes to Condensed Consolidated Financial Statements.

[1] On April 1, 2009, we acquired the operations of Stem Cell Sciences Plc (SCS), which changed its name to Asset Realisation Company Limited. Pursuant to the acquisition agreement, 53,000 shares were placed into an escrow for a twelve month period to satisfy any indemnification obligations owed to us by SCS. On August 19, 2010, we entered into a settlement agreement with SCS in which the parties agreed to the release of half the escrowed shares to SCS and half to us in full satisfaction of our claims for indemnification, and both parties waived all other claims, known and unknown, against the other. The 26,500 shares returned to us are being treated as retired and no longer outstanding. We have recorded approximately $227,000 as other income, which was the value of these shares based on the closing price of $9.10 per share on August 19, 2010, and net of amounts already accrued for potential claims against the escrowed shares.

Table of Contents

**Notes to Condensed Consolidated Financial Statements (Unaudited)**

**September 30, 2011 and 2010**

**Note 1. Summary of Significant Accounting Policies**

**Nature of Business**

StemCells, Inc., a Delaware corporation, is a biopharmaceutical company that operates in one segment, the research, development, and commercialization of stem cell therapeutics and related technologies.

The accompanying financial data as of and for the three and nine months ended September 30, 2011 and 2010 have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to these rules and regulations. The December 31, 2010 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. However, we believe that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

We have incurred significant operating losses since inception. We expect to incur additional operating losses over the foreseeable future. We have very limited liquidity and capital resources and must obtain significant additional capital and other resources in order to provide funding for our product development efforts, the acquisition of technologies, businesses and intellectual property rights, preclinical and clinical testing of our products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, selling, general and administrative expenses and other working capital requirements. We rely on our cash reserves, proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, government grants and funding from collaborative arrangements, to fund our operations. If we exhaust our cash reserves and are unable to obtain adequate financing, we may be unable to meet our operating obligations and we may be required to initiate bankruptcy proceedings. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

**Reverse Stock Split**

We effected a 1-for-10 reverse stock split on July 6, 2011. As a result of the reverse stock split, the outstanding shares of common stock issued and outstanding were reduced from approximately 139 million to 13.9 million. Concurrent with the reverse stock split, we reduced the authorized number of common shares from 250 million to 75 million. The reverse stock split proportionately reduced all issued and outstanding shares of our common stock, as well as common stock underlying stock options, warrants and other common stock based equity grants outstanding immediately prior to the effectiveness of the reverse stock split. The exercise price on outstanding equity-based grants was proportionately increased, and the number of shares available under our equity-based plans was proportionately reduced. Share and per share data (except par value) for the periods presented reflect the effects of this reverse stock split. References to numbers of shares of common stock and per share data in the accompanying financial statements and notes thereto have been adjusted to reflect the reverse stock split on a retroactive basis.

**Principles of Consolidation**

The condensed consolidated financial statements include the accounts of StemCells, Inc., and our wholly-owned subsidiaries, including StemCells California, Inc., Stem Cell Sciences Holdings Ltd, and Stem Cell Sciences (UK) Ltd. All significant intercompany accounts and transactions have been eliminated.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported in our condensed consolidated financial statements and accompanying notes. Actual results could differ materially from these estimates.

Table of Contents

Significant estimates include the following:

- the grant date fair value of stock-based awards recognized as compensation expense (see Note 5, Stock-Based Compensation );
- accrued wind-down expenses (see Note 6, Wind-Down Expenses );
- the fair value of warrants recorded as a liability (see Note 8, Warrant Liability ); and
- the fair value of goodwill and other intangible assets (see Note 4, Goodwill and Other Intangible Assets ).

**Financial Instruments**

*Cash and Cash Equivalents*

Cash equivalents are money market accounts, money market funds and investments with maturities of 90 days or less from the date of purchase.

*Marketable Securities*

Our existing marketable securities are designated as available-for-sale securities. These securities are carried at fair value (see Note2, Financial Instruments ), with the unrealized gains and losses reported as a component of stockholders equity. Management determines the appropriate designation of its investments (current or non-current) in marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. The cost of securities sold is based upon the specific identification method.

If the estimated fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery to the cost of the investment, and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. Other-than-temporary declines in estimated fair value of all marketable securities are charged to Other income (expense), net in the accompanying condensed consolidated statements of operations. No such impairment was recognized during the nine months ended September 30, 2011 or 2010.

*Trade and Other Receivables*

Our receivables generally consist of interest income on our financial instruments, revenue from licensing agreements and grants, revenue from product sales, and rent from our sub-lease tenants.

*Warrant Liability*

Authoritative accounting guidance prescribes that warrants issued under contracts that could require net-cash settlement should be classified as liabilities and contracts that only provide for settlement in shares should be classified as equity. In order for a contract to be classified as equity, specific conditions must be met. These conditions are intended to identify situations in which net cash settlement could be forced upon the issuer. We issued warrants as part of both our November 2008 and November 2009 financings (see Note 8, Warrant Liability ). As the contracts include the possibility of net-cash settlement, we are required to classify the fair value of the warrants issued as a liability, with subsequent changes in fair value to be recorded as income (loss) on change in fair value of warrant liability. We use the Black-Scholes-Merton (Black-Scholes) option pricing model to estimate fair value of warrants issued. In using this model, we make certain assumptions about risk-free interest rates, dividend yields, volatility and expected term of the warrants. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is derived from the historical volatility of our common stock as traded on NASDAQ. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement.

Table of Contents

**Goodwill and Other Intangible Assets**

Goodwill and intangible assets are primarily from a business acquisition accounted for under the purchase method. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Intangible assets with finite useful lives are amortized generally on a straight-line basis over the periods benefited. Intangible assets with finite useful lives are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Prior to fiscal year 2001, we capitalized certain patent costs, which are being amortized over the estimated lives of the patents and would be expensed at the time such patents are deemed to have no continuing value. Since 2001, all patent costs are expensed as incurred. License costs are capitalized and amortized over the estimated life of the license agreement.

**Revenue Recognition**

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property, from government grants, and from product sales. Licensing agreements may contain multiple elements, such as upfront fees, payments related to the achievement of particular milestones and royalties. Revenue from upfront fees for licensing agreements that contain multiple elements are generally deferred and recognized on a straight-line basis over the term of the agreement. Fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned. Revenue from licensing agreements are recognized net of a fixed percentage due to licensors as royalties. Grant revenue from government agencies are funds received to cover specific expenses and are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the relevant collaborative agreement or grant. Revenue from product sales are recognized when the product is shipped and the order fulfilled.

**Stock-Based Compensation**

Compensation expense for stock-based payment awards to employees is based on their grant date fair value as calculated and amortized over their vesting period. See Note 5, Stock-Based Compensation for further information.

We use the Black-Scholes model to calculate the fair value of stock-based awards.

**Net Loss per Share**

Basic net loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is computed based on the weighted average number of shares of common stock and other dilutive securities. To the extent these securities are anti-dilutive, they are excluded from the calculation of diluted earnings per share. Share and per share amounts have been adjusted to reflect the one-for-ten reverse stock split effected in July 2011.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net loss | $ (4,334,352) | $ (5,552,256) | $ (14,116,780) | $ (16,286,678) |
| Weighted average shares outstanding used to compute basic and diluted net loss per share | 14,009,341 | 12,709,172 | 13,831,749 | 12,201,532 |
| Basic and diluted net loss per share | $ (0.31) | $ (0.44) | $ (1.02) | $ (1.33) |

The following outstanding potentially dilutive common stock equivalents were excluded from the computation of diluted net loss per share because the effect would have been anti-dilutive as of September 30:

| | 2011 | 2010 |
|---|---|---|
| Options | 895,962 | 1,142,710 |

| | | |
|---|---|---|
| Restricted stock units | 338,041 | 466,006 |
| Warrants | 1,434,483 | 1,434,483 |
| Total | 2,668,486 | 3,043,199 |

Table of Contents

**Comprehensive Loss**

Comprehensive loss is comprised of net losses and other comprehensive loss or income (OCL). OCL includes certain changes in stockholders equity that are excluded from net losses. Specifically, we include in OCL changes in unrealized gains and losses on our marketable securities and unrealized gains and losses on foreign currency translations. Accumulated other comprehensive income was $62,258 as of September 30, 2011 and $119,722 as of December 31, 2010.

The activity in OCL was as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net loss | $ (4,334,352) | $ (5,552,256) | $ (14,116,780) | $ (16,286,678) |
| Net change in unrealized gains and losses on marketable securities | (5,413) | 20,462 | (123,905) | (51,572) |
| Net change in unrealized gains and losses on foreign currency translations | (133,593) | 267,769 | 66,441 | (138,911) |
| Comprehensive loss | $ (4,473,358) | $ (5,264,025) | $ (14,174,244) | $ (16,477,161) |

**Recent Accounting Pronouncements**

In May 2011, the FASB issued additional authoritative guidance relating to fair value measurement and disclosure requirements. For fair value measurements categorized in Level 3 of the fair value hierarchy, the new guidance requires (1) disclosure of quantitative information about unobservable inputs; (2) a description of the valuation processes used by the entity; and (3) a qualitative discussion about the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, if any. Entities must report the level in the fair value hierarchy of assets and liabilities that are not recorded at fair value in the statement of financial position but for which fair value is disclosed. The new requirements clarify that the concepts of highest and best use and valuation premise only apply to measuring the fair value of nonfinancial assets. The new requirements also specify that in the absence of a Level 1 input, a reporting entity should incorporate a premium or a discount in a fair value measurement if a market participant would take into account such an input in pricing and asset or liability. Additionally, the new guidance introduces an option to measure certain financial assets and financial liabilities with offsetting positions on a net basis if certain criteria are met. For public entities, these new requirements become effective for interim and annual periods beginning after December 15, 2011. It is applicable to our fiscal year beginning January 1, 2012. We do not expect this new guidance to have a material effect on our consolidated financial statements.

In June 2011, the FASB issued new accounting guidance which eliminates the current option to present other comprehensive income and its components in the statement of changes in equity. However, under the new guidance, comprehensive income and its components must still be presented under one of two new alternatives. Under the first alternative, the components of other comprehensive income and the components of net income may be presented in one continuous statement referred to as the statement of comprehensive income. Under the second alternative, a statement of other comprehensive income would immediately follow the statement of net income and must be shown with equal prominence as the other primary financial statements. Under either alternative, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. For public entities, these new requirements will become effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively to all prior periods presented. It is applicable to our fiscal year beginning January 1, 2012. We do not expect this new guidance to have a material effect on our consolidated financial statements.

In September 2011, the FASB issued an update to previous guidance on testing goodwill for impairment. The amendments in this update simplifies how entities, both public and nonpublic companies test goodwill for impairment. .Under the amendments, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the

qualitative assessment in any subsequent period. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. We do not expect this new guidance to have a material effect on our consolidated financial statements.

Table of Contents

**Note 2. Financial Instruments**

The following table summarizes the fair value of our cash, cash equivalents and available-for-sale marketable securities held in our current investment portfolio:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---|---|---|---|---|
| **September 30, 2011** | | | | |
| Cash | $ 826,186 | $ | $ | $ 826,186 |
| Cash equivalents | 6,467,888 | | | 6,467,888 |
| Marketable debt securities, current | 5,247,956 | | (7,556) | 5,240,400 |
| Total cash, cash equivalents, and marketable securities | $ 12,542,030 | | $ (7,556) | $ 12,534,474 |
| **December 31, 2010** | | | | |
| Cash | $ 1,001,868 | $ | $ | $ 1,001,868 |
| Cash equivalents | 18,705,953 | | | 18,705,953 |
| Marketable equity securities, current | 74,456 | 116,348 | | 190,804 |
| Total cash, cash equivalents, and marketable securities | $ 19,782,277 | $ 116,348 | $ | $ 19,898,625 |

Gross unrealized gains and losses on cash equivalents were not significant at September 30, 2011 and December 31, 2010. At September 30, 2011, our cash equivalents were primarily money market funds consisting mainly of U.S. Treasury debt securities.

Our investment in marketable debt securities are short term investments that consist primarily of commercial paper and corporate debt securities.

Our investment in marketable equity securities consists of ordinary shares of ReNeuron Group Plc (ReNeuron), a publicly listed U.K. corporation. In July 2005, we entered into an agreement with ReNeuron under which we granted ReNeuron a license that allows ReNeuron to exploit its c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. We received shares of ReNeuron common stock, as well as a cross-license to the exclusive use of ReNeuron s technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy, and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either we or ReNeuron might have had against the other in connection with any putative infringement of certain of each party s patent rights prior to the effective date of the agreement. In July and August 2005, we received approximately 8,836,000 ordinary shares of ReNeuron common stock, net of approximately 104,000 shares that were transferred to NeuroSpheres, Ltd., an Alberta corporation (NeuroSpheres), and subsequently, as a result of certain anti-dilution provisions in the agreement, we received approximately 1,261,000 more shares, net of approximately 18,000 shares that were transferred to NeuroSpheres. In February 2007, we sold 5,275,000 shares for net proceeds of approximately $3,075,000. We recognized approximately $716,000 as realized gain from this transaction. In the first quarter of 2009, we sold 2,900,000 shares of ReNeuron and received net proceeds of approximately $510,000 for a realized gain of approximately $398,000. In the second quarter of 2011, we sold our remaining 1,921,924 shares of ReNeuron and received net proceeds of approximately $158,000 for a realized gain of approximately $84,000. As of June 30, 2011, we no longer hold any shares of ReNeuron.

**Note 3. Fair Value Measurement**

The following tables present our assets and liabilities that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy. The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value.

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Directly or indirectly observable inputs other than in Level 1, that include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 Unobservable inputs which are supported by little or no market activity that reflects the reporting entity s own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Table of Contents

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Our cash equivalents, marketable securities, bonds payable and warrant liability are classified within Level 1 or Level 2. This is because our cash equivalents and marketable securities are valued primarily using quoted market prices, our bonds payable are valued using alternative pricing sources and models utilizing market observable inputs and our warrant liability is valued using an option pricing model that uses assumptions with observable inputs such as risk-free interest rates that are derived from the yield on U.S. Treasury debt securities, volatility and price based on our common stock as traded on NASDAQ.

We currently do not have any Level 3 financial assets or liabilities.

The following table presents financial assets and liabilities measured at fair value:

| | Fair Value Measurement at Reporting Date Using | | |
|---|---|---|---|
| | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | As of September 30, 2011 |
| Financial assets Cash equivalents: | | | |
| Money market funds | $ 6,467,888 | $ | $ 6,467,888 |
| Marketable securities: Debt securities | 5,240,400 | | 5,240,400 |
| Total financial assets | $ 11,708,288 | $ | $ 11,708,288 |
| Financial liabilities Bond payable | $ | $ 568,750 | $ 568,750 |
| Warrant liability | | 171,551 | 171,551 |
| Total financial liabilities | $ | $ 740,301 | $ 740,301 |

**Note 4. Goodwill and Other Intangible Assets**

On April 1, 2009, we acquired the operations of Stem Cell Sciences Plc (SCS) for an aggregate purchase price of approximately $5,135,000. The acquired operations includes proprietary cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion.

The purchase price was allocated as follows:

| | Allocated purchase Price | Estimated life of intangible assets in years |
|---|---|---|
| Net tangible assets | $ 36,000 | |
| Intangible assets: | | |

| | | |
|---|---|---|
| Customer relationships and developed technology | 1,310,000 | 6 to 9 |
| In-process research and development | 1,340,000 | 13 to 19 |
| Trade name | 310,000 | 15 |
| Goodwill | 2,139,000 | N/A |
| Total | $ 5,135,000 | |

In-process research and development assets relate to: 1) the acquisition of certain intellectual property rights not expected to expire until 2027 related to our program focused on developing genetically engineered rat models of human disease (our Transgenic Rat Program ); and 2) the acquisition of certain technology related to the commercialization of our SC Proven cell culture products and the development and commercialization of cell-based assay platforms for use in drug discovery and development (our Assay Development Program ).

At the time of valuation (April 2009), the technology related to our Transgenic Rat Program was in its nascent stage, and therefore we concluded that the remaining 19 years of legal life of the intellectual property was appropriate as the remaining useful life for this technology.

As for our Assay Development Program, at the time of valuation (April 2009), we expected to achieve proof of concept by 2012. Due to the foundational nature of our Assay Development Program patents and technologies, we expect the technologies to remain useful

Table of Contents

and relevant within the industry for at least 10 years following commercial launch of a product or service under our Assay Development Program. Because these technologies are not expected to begin generating revenue until 2011-2012, we estimated the remaining useful life for these technologies to be approximately 13 years from the valuation date.

Trade name relates to the SC Proven trademark of our cell culture products which we expect to market for 15 years from the date of acquisition, based on which, we estimated a remaining useful life of 15 years from the valuation date.

The following table presents changes in goodwill:

| | |
|---|---|
| Balance as of December 31, 2010 | $ 1,877,315 |
| Foreign currency translation | 28,296 |
| Balance as of September 30, 2011 | $ 1,905,611 |

The components of our other intangible assets at September 30, 2011 are summarized below:

| Other Intangible Asset Class | Net Carrying Amount |
|---|---|
| Customer relationships and developed technology | $ 966,119 |
| In-process research and development | 1,211,697 |
| Trade name | 280,253 |
| Patents | 310,893 |
| Total other intangible assets | $ 2,768,962 |

Amortization expense was approximately $92,000 in the third quarter of 2011.

The expected future annual amortization expense for each of the next five years based on current balances of our intangible assets is as follows:

| For the year ending December 31: | |
|---|---|
| 2012 | $ 357,040 |
| 2013 | $ 357,040 |
| 2014 | $ 357,040 |
| 2015 | $ 357,040 |
| 2016 | $ 357,040 |

**Note 5. Stock-Based Compensation**

We currently grant stock-based awards under two equity incentive plans. As of September 30, 2011, we had 1,104,167 shares authorized to be granted under the two plans. Under these plans we may grant various types of equity awards to our employees, directors and consultants, at prices determined by our Board of Directors, including incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, and performance-based shares. Incentive stock options may only be granted to employees under these plans with a grant price not less than the fair market value of the stock on the date of grant. We also use these plans to grant shares to employees for the employer match of employee 401(k) plan contributions. Share numbers and exercise prices have been adjusted for the 1-for-10 reverse stock split effected in July 2011.

Our stock-based compensation expense for the three and nine months ended September 30 was as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Research and development expense | $ 343,845 | $ 371,694 | $ 1,304,846 | $ 1,531,632 |
| Selling, general and administrative expense | 320,539 | 493,675 | 1,308,265 | 1,456,251 |
| Total employee stock-based compensation expense and effect on net loss | $ 664,384 | $ 865,369 | $ 2,613,111 | $ 2,987,883 |
| Effect on basic and diluted net loss per share | $ (0.05) | $ (0.07) | $ (0.19) | $ (0.24) |

As of September 30, 2011, we had approximately $3,736,000 of total unrecognized compensation expense related to unvested awards of stock options and restricted stock units granted under our various equity incentive plans that we expect to recognize over a weighted-average vesting period of 2.1 years.

Table of Contents

*Stock Options*

Generally, stock options granted to employees have a maximum term of ten years, and vest over a four year period from the date of grant; 25% vest at the end of one year, and 75% vest monthly over the remaining three-year service period. We may grant options with different vesting terms from time to time. Upon employee termination of service, any unexercised vested option will be forfeited three months following termination or the expiration of the option, whichever is earlier. Unvested options are forfeited on termination.

A summary of our stock option activity for the three months ended September 30, 2011 is as follows:

| | Number of options | Weighted-average exercise price ($) |
|---|---|---|
| Balance at June 30, 2011 | 996,463 | 20.10 |
| Granted | | |
| Exercised | | |
| Cancelled | (100,498) | 19.10 |
| Outstanding options at September 30, 2011 | 895,965 | 20.20 |

A summary of changes in unvested options for the three months ended September 30, 2011 is as follows:

| | Number of options | Weighted-average exercise price ($) | Weighted-average grant date fair value ($) |
|---|---|---|---|
| Unvested options at June 30, 2011 | 196,542 | 12.10 | 9.70 |
| Granted | | | |
| Vested | (23,157) | 14.40 | 11.50 |
| Cancelled | (2,913) | 11.60 | 8.40 |
| Unvested options at September 30, 2011 | 170,472 | 11.80 | 9.50 |

The estimated fair value of options vested was approximately $266,000 in the three months ended September 30, 2011.

*Restricted Stock Units*

We have granted restricted stock units (RSUs) to certain employees which entitle the holders to receive shares of our common stock upon vesting of the RSUs. The fair value of restricted stock units granted are based upon the market price of the underlying common stock as if it were vested and issued on the date of grant.

A summary of changes in unvested restricted stock units for the three months ended September 30, 2011 is as follows:

| | Number of RSUs | Weighted-average grant date fair value ($) |
|---|---|---|
| Unvested restricted stock units at June 30, 2011 | 294,507 | 11.40 |
| Granted(1) | 1,000 | 2.08 |

| | | |
|---|---|---|
| Vested | (5,832) | 13.00 |
| Cancelled | | |
| Balance unvested at September 30, 2011 | 289,675 | 11.40 |

(1) These restricted stock units vest and convert into shares of our common stock after one year from the date of grant.

*Stock Appreciation Rights*

In July 2006, we granted cash-settled Stock Appreciation Rights (SARs) to certain employees that give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SARs.

The SARs have a maximum term of ten years with an exercise price of $20.00, which is equal to the market price of our common stock at the date of grant. The SARs vest 25% on the first anniversary of the grant date and 75% vest monthly over the remaining three-year service period. All of the outstanding SARs as of September 30, 2011 are fully vested. Compensation expense is based on the fair value of SARs which is calculated using the Black-Scholes option pricing model. The stock-based compensation expense and liability are re-measured at each reporting date through the earlier date of settlement or forfeiture of the SARs.

Table of Contents

A summary of the changes in SARs for the three months ended September 30, 2011 is as follows:

| | Number of SARs |
|---|---|
| Outstanding at June 30, 2011 | 135,409 |
| Granted | |
| Exercised | |
| Forfeited and expired | (20,222) |
| Outstanding SARs at September 30, 2011 | 115,187 |
| SARs exercisable at September 30, 2011 | 115,187 |

For the three months ended September 30, 2011, we re-measured the liability related to the SARs and reduced compensation expense by approximately $4,000. For the same period in 2010, we reduced compensation expense by approximately $97,000.

The compensation expense recognized for the three months ended September 30, 2011 may not be representative of compensation expense for future periods and its resulting effect on net loss and net loss per share attributable to common stockholders, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting. We will continue to recognize compensation cost each period, which will be the change in fair value from the previous period through the earlier date of settlement or forfeiture of the SARs.

**Note 6. Wind-Down Expenses**

*Rhode Island*

In October 1999, we relocated to California from Rhode Island and established a wind down reserve for the estimated lease payments and operating costs of our scientific and administrative facility in Rhode Island. Even though we intend to dispose of the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, we periodically re-evaluate and adjust the reserve. We consider various factors such as our lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy.

The summary of the changes to our wind-down reserve related to this facility for 2011 and 2010 were as follows:

| | January 1 to March 31, 2011 | April 1 to June 30, 2011 | July to September 30, 2011 | January 1 to September 30, 2011 | January 1 to December 31, 2010 |
|---|---|---|---|---|---|
| Accrued wind-down reserve at beginning of period | $ 2,644,000 | $ 2,402,000 | $ 2,216,000 | $ 2,644,000 | $ 3,572,000 |
| Less actual expenses recorded against estimated reserve during the period | (317,000) | (301,000) | (308,000) | (926,000) | (1,219,000) |
| Additional expense recorded to revise estimated reserve at period-end | 75,000 | 115,000 | 69,000 | 259,000 | 291,000 |
| Revised reserve at period-end | 2,402,000 | 2,216,000 | 1,977,000 | 1,977,000 | 2,644,000 |
| Add deferred rent at period-end | 605,000 | 554,000 | 503,000 | 503,000 | 656,000 |
| Total accrued wind-down expenses at period-end (current and non-current) | $ 3,007,000 | $ 2,770,000 | $ 2,480,000 | $ 2,480,000 | $ 3,300,000 |
| Accrued wind-down expenses, current | $ 1,356,000 | $ 1,406,000 | $ 1,430,000 | $ 1,430,000 | $ 1,311,000 |
| Accrued wind-down expenses, non-current | 1,651,000 | 1,364,000 | 1,050,000 | 1,050,000 | 1,989,000 |

| | | | | | |
|---|---|---|---|---|---|
| Total accrued wind-down expenses | $ 3,007,000 | $ 2,770,000 | $ 2,480,000 | $ 2,480,000 | $ 3,300,000 |

***Australia***

On April 1, 2009, as part of our acquisition of the SCS operations, we acquired certain operations near Melbourne, Australia. In order to reduce operating complexity and expenses, we made the decision to close our site in Australia and consolidate personnel and programs to our Cambridge, U.K. and Palo Alto, California sites. At June 30, 2009, we established a reserve of approximately $310,000 for the estimated costs to close down and exit our Australia operations. The reserve reflects the estimated cost to terminate our facility lease in Australia (which provided for an original termination date of December 31, 2010), employee termination benefits and other liabilities associated with the wind-down and relocation of our operations in Australia. As of December 31, 2010, the facility lease agreement had been terminated and our operations in Australia had been relocated to Cambridge, U.K. and Palo Alto, California. We recorded actual expenses, net of foreign currency translation changes of approximately $241,000 against this reserve. At December 31, 2010, we concluded that all costs related to the close down and exit of our Australia operations have been recorded against the reserve and we closed the reserve by crediting the remaining reserve balance of $69,000 to wind-down expense.

Table of Contents

**Note 7. Commitments and Contingencies**

***Leases***

*Capital Leases*

We entered into direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling $5,000,000 to finance the construction of our pilot manufacturing facility in Rhode Island. The related lease agreements are structured such that lease payments fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. The interest rate for the remaining bond series is 9.5%. The bond contains certain restrictive covenants which limit, among other things, the payment of cash dividends and the sale of the related assets. The outstanding principal was approximately $569,000 at September 30, 2011 and $699,000 at December 31, 2010.

*Operating Leases*

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

*Operating Leases California*

In September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California. We will pay approximately $695,000 in aggregate as rent over the term of the lease. The lease contains escalating rent payments, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately $4,000 as of September 30, 2011, and approximately $1,000 as of December 31, 2010.

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC ( BMR ), as landlord, for approximately 43,000 square feet of office and research space at BMR s Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years, and we relocated our corporate headquarters and core research activities from a facility located at the Stanford Research Park in Palo Alto, California, to this facility in July 2011. The lease for the Palo Alto facility expired on August 31, 2011, and a letter of credit for approximately $389,000, which served as a security deposit was transferred from our restricted cash account to our cash and cash equivalents account. Initial base rent for the facility in Newark is expected to be approximately $2.20 per square foot, with yearly increases throughout the term, and subject to certain adjustments for draws upon the tenant allowances among other things. We will pay approximately $14,906,000 in aggregate as rent over the term of the lease, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately $1,032,000 as of September 30, 2011. We constructed laboratories, offices and related infrastructure within the leased space during the first several months of the lease. As part of the lease, BMR has agreed to provide various financial allowances so that we can build initial and future laboratories, offices and other improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. As part of the lease, we have, until January 2013, an option to lease up to an additional 30,000 square feet in the building.

*Operating Leases Rhode Island*

We entered into a fifteen-year lease agreement for a scientific and administrative facility (SAF) in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013 and includes escalating rent payments which we recognize on a straight-line basis. Deferred rent expense for this facility was approximately $503,000 at September 30, 2011 and $656,000 at December 31, 2010, and is included as part of the wind-down accrual on the accompanying condensed consolidated balance sheets. For the year 2011, we expect to pay approximately $1,172,000 in operating lease payments and estimated operating expenses of approximately $635,000, before receipt of sub-tenant income and we expect to receive, in aggregate, approximately $422,000 in sub-tenant rent and operating expenses. As a result of the above transactions, our estimated cash outlay net of sub-tenant rent for the SAF will be approximately $1,385,000 for 2011.

Table of Contents

*Operating Leases United Kingdom*

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. We expect to pay approximately 55,000 GBP as rental payments for 2011. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd s obligations under the existing lease.

With the exception of the operating leases discussed above, we have not entered into any off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

***Contingencies***

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem s activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem s activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in 2012.

In addition to the actions described above, in April 2008, we filed an opposition to Neuralstem s European Patent No. 0 915 968 (methods of isolating, propagating and differentiating CNS stem cells), because the claimed invention is believed by us to be unpatentable over prior art, including the patents exclusively licensed by us from NeuroSpheres. In December 2010, the European Patent Office ruled that all composition claims in Neuralstem s 968 European patent were invalid and unpatentable over prior art including several of the NeuroSpheres patents licensed to us. Neuralstem has appealed this decision.

Effective 2008, as part of an indemnification agreement with NeuroSpheres, we are entitled to offset all litigation costs incurred in this patent infringement suit, against amounts that would otherwise be owed to NeuroSpheres under our exclusive license agreements with NeuroSpheres, such as annual maintenance fees, milestones and royalty payments. Under the terms of our license agreements, we are required to make annual payments of $50,000 to NeuroSpheres, and we expect to make these annual payments through the remaining life of the patent which, at December 31, 2010, was approximately 14 years. We have therefore capitalized $700,000 (14 years at $50,000 per year) to offset litigation costs. The amount capitalized is not dependent on the achievement of any milestones or related to any other contingent payments which may become due under the arrangement. We will reduce this asset by $50,000 per year in lieu of the cash payments due to NeuroSpheres. As the $50,000 annual payments are fully creditable against royalties due to Neurospheres, we have classified the capitalized amount as prepaid royalties under Other assets, non-current on our accompanying Consolidated Balance Sheets. We have concluded that the estimated balance of $700,000, as of September 30, 2011, is a fair estimate and realizable against future milestone and royalty payments to NeuroSpheres, and that litigation costs incurred above this amount will be expensed as incurred. Management will reevaluate this estimate on a quarterly basis based on actual costs and other relevant factors.

Table of Contents

**Note 8. Warrant Liability**

We use the Black-Scholes option pricing model to estimate fair value of warrants issued. In using this model, we make certain assumptions about risk-free interest rates, dividend yields, volatility and expected term of the warrants. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is derived from the historical volatility of our common stock as traded on NASDAQ. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement. Share numbers and exercise prices have been adjusted for the 1-for-10 reverse stock split.

In November 2008, we sold 1,379,310 units to institutional investors at a price of $14.50 per unit, for gross proceeds of $20,000,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of $23.00 per share, were offered as a registered direct offering under a shelf registration statement previously filed with, and declared effective by, the SEC. We received total proceeds, net of offering expenses and placement agency fees, of approximately $18,637,000. We recorded the fair value of the warrants to purchase 1,034,483 shares of our common stock as a liability. The fair value of the warrant liability will be revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

The assumptions used for the Black-Scholes option pricing model are as follows:

| | To Calculate Fair Value of Warrant Liability at | |
|---|---|---|
| | September 30, 2011 | December 31, 2010 |
| Expected life (years) | 2.6 | 3.4 |
| Risk-free interest rate | 0.3% | 1.2% |
| Expected volatility | 67.3% | 83.6% |
| Expected dividend yield | 0% | 0% |

| | At September 30, 2011 | At December 31, 2010 | Change in Fair Value of Warrant Liability |
|---|---|---|---|
| Fair value of warrant liability | $ 30,724 | $ 4,408,449 | $ (4,377,725) |

In November 2009, we sold 1,000,000 units to institutional investors at a price of $12.50 per unit, for gross proceeds of $12,500,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.40 shares of common stock at an exercise price of $15.00 per share, were offered as a registered direct offering under a shelf registration statement previously filed with, and declared effective by, the SEC. We received total proceeds, net of offering expenses and placement agency fees, of approximately $11,985,000. We recorded the fair value of the warrants to purchase 400,000 shares of our common stock as a liability. The fair value of the warrant liability will be revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

The assumptions used for the Black-Scholes option pricing model are as follows:

| | To Calculate Fair Value of Warrant Liability at | |
|---|---|---|
| | September 30, 2011 | December 31, 2010 |
| Expected life (years) | 3.6 | 4.3 |
| Risk-free interest rate | 0.5% | 1.6% |
| Expected volatility | 83.8% | 77.5% |

| | | |
|---|---|---|
| Expected dividend yield | 0% | 0% |

| | At September 30, 2011 | At December 31, 2010 | Change in Fair Value of Warrant Liability |
|---|---|---|---|
| Fair value of warrant liability | $ 140,828 | $ 2,263,480 | $ (2,122,652) |

Table of Contents

**Note 9. Common Stock**

We effected a 1-for-10 reverse stock split on July 6, 2011. As a result of the reverse stock split, the outstanding shares of common stock issued and outstanding were reduced from approximately 139 million to 13.9 million. Concurrent with the reverse stock split, we reduced the authorized number of common shares from 250 million to 75 million. The reverse stock split proportionately reduced all issued and outstanding shares of our common stock, as well as common stock underlying stock options, warrants and other common stock based equity grants outstanding immediately prior to the effectiveness of the reverse stock split. The exercise price on outstanding equity based-grants was proportionately increased, while the number of shares available under our equity-based plans was proportionately reduced. Share and per share data (except par value) for the periods presented reflect the effects of this reverse stock split. References to numbers of shares of common stock and per share data in the accompanying financial statements and notes thereto have been adjusted to reflect the reverse stock split on a retroactive basis.

In January 2011, we sold 1,000,000 shares of our common stock to selected institutional investors at a price of $10.00 per share. We received net proceeds, after deducting offering expenses and fees, of approximately $9,400,000. The investors were also granted an option to purchase an additional 600,000 shares at $10.00 per share. The option was not exercised and expired on February 18, 2011. The shares were offered under a shelf registration previously filed with, and declared effective by, the SEC.

In the second and third quarter of 2011, we sold a total of 423,216 shares of our common stock under a sales agreement entered into in June 2009 at an average price per share of $2.58 for gross proceeds of approximately $1,093,000. The sales agent is paid compensation equal to 3% of gross proceeds pursuant to the terms of the agreement. The shares were offered under a shelf registration previously filed with, and declared effective by, the SEC.

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

This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of operations; the progress of our research, product development and clinical programs; the need for, and timing of, additional capital and capital expenditures; partnering prospects; costs of manufacture of products; the protection of, and the need for, additional intellectual property rights; effects of regulations; the need for additional facilities; and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, including the fact that additional trials will be required to confirm the safety and demonstrate the efficacy of our HuCNS-SC cells for the treatment of spinal cord injury, Pelizeaus-Merzbacher disease (PMD), age-related macular degeneration or any other disease; uncertainty as to whether the U.S. Food and Drug Administration (FDA), Swissmedic, or other regulatory authorities will permit us to proceed with clinical testing of proposed products despite the novel and unproven nature of our technologies; the risk that our clinical trials or studies could be substantially delayed beyond their expected dates or cause us to incur substantial unanticipated costs; uncertainties in our ability to obtain the capital resources needed to continue our current research and development operations and to conduct the research, preclinical development and clinical trials necessary for regulatory approvals; the uncertainty regarding our ability to obtain a corporate partner or partners, if needed, to support the development and commercialization of our potential cell-based therapeutics products; the uncertainty regarding the outcome of our clinical trials or studies we may conduct in the future; the uncertainty regarding the validity and enforceability of our issued patents; the risk that we may not be able to manufacture additional master and working cell banks when needed; the uncertainty whether any products that may be generated in our cell-based therapeutics programs will prove clinically safe and effective; the uncertainty whether we will achieve significant revenue from product sales or become profitable; uncertainties regarding our obligations with respect to our former facilities in Rhode Island; obsolescence of our technologies; competition from third parties; intellectual property rights of third parties; litigation risks; and other risks to which we are subject. All forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors set forth in Risk Factors in Part I, Item 1A of our Form 10-K for the year ended December 31, 2010.

Table of Contents

**Overview**

***The Company***

We are engaged in researching, developing, and commercializing stem cell therapeutics and enabling tools and technologies for stem cell-based research and drug discovery and development. Our research and development (R&D) programs are primarily focused on identifying and developing potential cell-based therapeutics which can either restore or support organ function. In particular, since we relocated our corporate headquarters to California in 1999, our R&D efforts have been directed at refining our methods for identifying, isolating, culturing, and purifying the human neural stem cell and human liver engrafting cells (hLEC) and developing these as potential cell-based therapeutics for the central nervous system (CNS) and the liver, respectively. In our CNS Program, our HuCNS-SC® product candidate (purified human neural stem cells) is currently in clinical development for spinal cord injury and Pelizeaus-Merzbacher Disease (PMD), a myelination disorder in the brain. We are currently conducting a Phase I/II clinical trial in Switzerland of our HuCNS-SC cells for the treatment of chronic spinal cord injury, and successfully transplanted the first patient in this trial in September 2011. In February 2011, we completed patient accrual in our Phase I clinical trial in PMD, a fatal disorder in which patients do not produce normal myelin in the brain; and in November 2011, we announced interim data from this study, including MRI analysis of a patient which shows changes consistent with the early development of new myelin in the regions in which the clinical investigators transplanted our HuCNS-SC cells. The trial will be completed in February 2012 and we expect to report results of the trial in early 2012. In addition, we plan to submit in 2011 an IND to conduct a Phase I/II clinical trial in the dry form of age-related macular degeneration. We previously completed a Phase I clinical trial in infantile and late infantile neuronal ceroid lipofuscinosis (NCL, also known as Batten disease), and the data from that trial showed that our HuCNS-SC cells were well tolerated and non-tumorigenic, and that there was evidence of engraftment and long-term survival of the transplanted HuCNS-SC cells. In our Liver Program, we are focused on identifying and developing liver cells as potential therapeutics for a range of liver diseases. For a brief description of our significant therapeutic research and development programs see Overview Research and Development Programs in the Business Section of Part I, Item 1 of our Form 10-K for the year ended December 31, 2010.

We are also engaged in developing and commercializing applications of our technologies to enable research, which we believe represent current and nearer-term commercial opportunities. Our portfolio of technologies includes cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products and antibody reagents business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion. Much of these enabling technologies were acquired in April 2009 as part of our acquisition of the operations of Stem Cell Sciences Plc (SCS).

We have not derived any revenue or cash flows from the sale or commercialization of any products except for license revenue for certain of our patented cells and sales of cell culture products for use in research. As a result, we have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. Therefore, we are dependent upon external financing from equity and debt offerings, government grants and revenue from collaborative research arrangements with corporate sponsors to finance our operations. We have no such collaborative research arrangements at this time and there can be no assurance that such financing or partnering revenue will be available when needed or on terms acceptable to us.

Before we can derive revenue or cash inflows from the commercialization of any of our therapeutic product candidates, we will need to: (i) conduct substantial *in vitro* testing and characterization of our proprietary cell types, (ii) undertake preclinical and clinical testing for specific disease indications; (iii) develop, validate and scale-up manufacturing processes to produce these cell-based therapeutics, and (iv) obtain required regulatory approvals. These steps are risky, expensive and time consuming.

Overall, we expect our R&D expenses to be substantial and to increase for the foreseeable future as we continue the development and clinical investigation of our current and future product candidates. However, expenditures on R&D programs are subject to many uncertainties, including whether we develop our product candidates with a partner or independently. We cannot forecast with any degree of certainty which of our current product candidates will be subject to future collaboration, when such collaboration agreements will be secured, if at all, and to what degree such arrangements would affect our development plans and capital requirements. In addition, there are numerous factors associated with the successful commercialization of any of our cell-based therapeutics, including future trial design and regulatory requirements, many of which cannot be determined with accuracy at this time given the stage of our development and the novel nature of stem cell technologies. The regulatory pathways, both in the United States and internationally, are complex and fluid given the novel and, in general, clinically unproven nature of stem cell technologies. At this time, due to such uncertainties and inherent risks, we cannot estimate in a meaningful way the duration of, or the costs to complete, our R&D programs or whether, when or to what extent we will generate revenues or cash inflows from the commercialization and sale of any of our therapeutic product candidates. While we are currently focused on advancing each of our product development programs, our future R&D expenses will depend on the determinations we make as to the scientific and clinical prospects of each product candidate, as well as our ongoing assessment of the regulatory requirements and each product candidate s commercial potential.

19

Table of Contents

Given the early stage of development of our therapeutic product candidates, any estimates of when we may be able to commercialize one or more of these products would not be meaningful. Moreover, any estimate of the time and investment required to develop potential products based upon our proprietary HuCNS-SC and hLEC technologies will change depending on the ultimate approach or approaches we take to pursue them, the results of preclinical and clinical studies, and the content and timing of decisions made by the FDA, Swissmedic and other regulatory authorities. There can be no assurance that we will be able to develop any product successfully, or that we will be able to recover our development costs, whether upon commercialization of a developed product or otherwise. We cannot provide assurance that any of these programs will result in products that can be marketed or marketed profitably. If certain of our development-stage programs do not result in commercially viable products, our results of operations could be materially adversely affected.

The research markets served by our tools and technologies products are highly competitive, complex and dynamic. Technological advances and scientific discoveries have accelerated the pace of change in biological research, and stem cell technologies have been evolving particularly fast. We compete mainly by focusing on specialty media and antibody reagent products and cell-based assays, which are custom designed for use in stem cell-based research, where we believe our expertise, intellectual property and reputation give us competitive advantage. We believe that, in this particular market niche, our products and technologies offer customers specific advantages over those offered by our competitors. We compete by offering innovative, quality-controlled products, consistently made and designed to produce reproducible results. We continue to make investments in research and development, quality management, quality improvement, and product innovation. We cannot assure you that we will have sufficient resources to continue to make such investments. For the three-month period ended September 30, 2011, we generated revenues from the sale of specialty cell culture products of approximately $182,000. There can be no assurance that we will be able to continue to generate such revenues in the future.

***Significant Events***

In July 2011 a collaborative study, in which commercially available SC Proven serum-free cell culture media was used for the reproducible and robust production of large numbers of genetically stable, self-renewing cells that retain true multi-potent biological function over extended culture periods, was published. This work overcame a key hurdle to the use of non-immortalized cells for regenerative medicine, and demonstrated the utility of human tissue-derived neural stem cells as a scalable platform for cell-based drug discovery and drug screening applications. The paper was published in a special edition of *Neurochemistry International* dedicated to The Potential of Stem Cells for 21st Century Neuroscience.

In July 2011, we relocated our corporate headquarters and U.S.-based research and development operations to Newark, California. Our new facilities comprise newly constructed, custom designed laboratory and office space, and house the majority of our U.S. workforce.

In July 2011, following the affirmative vote of our stockholders at our Annual Meeting, we effected a one-for-ten reverse stock split which reduced the number of shares outstanding from approximately 139 million to approximately 13.9 million.

In July 2011, we received notification from The NASDAQ Stock Market that we had regained compliance with the minimum bid price requirement needed to continue listing on the NASDAQ Global Market. The NASDAQ Listing Rules require the Company s stock to evidence a closing bid price of $1.00 per share or more for ten consecutive days.

In September 2011, the first patient in our breakthrough Phase I/II clinical trial in chronic spinal cord injury was enrolled and successfully transplanted with our HuCNS-SC cells. The clinical trial is being conducted at Balgrist University Hospital, University of Zurich, a world leading medical center for spinal cord injury and rehabilitation.

In September 2011, the California Institute of Regenerative Medicine (CIRM) approved our application for a Disease Team Therapy Development Planning Award and awarded a grant totaling approximately $100,000. We were one of only four companies to be awarded a disease team planning grant, which will help fund our plans to develop our proprietary HuCNS-SC cells in Alzheimer s disease by enabling us and our collaborators to prepare and submit an application for a Disease Team Therapy Development Research Award. Each Research Award may be up to $20 million, payable over four years, to fund preclinical and IND-enabling activities with the aim of starting human clinical trials within a four-year window. The CIRM has indicated it plans to approve and fund Research Awards in the summer of 2012.

In November 2011, we announced interim data from our Phase I PMD trial, including MRI evidence consistent with new myelin production following HuCNS-SC transplantation, as well as safety data that suggests the procedure and cells have been well tolerated.

Table of Contents

**Critical Accounting Policies and the Use of Estimates**

The accompanying discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements and the related disclosures, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates, assumptions, and judgments that affect the reported amounts in our condensed consolidated financial statements and accompanying notes. These estimates form the basis for making judgments about the carrying values of assets and liabilities. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, and we have established internal controls related to the preparation of these estimates. Actual results and the timing of the results could differ materially from these estimates.

***Stock-Based Compensation***

U.S. GAAP requires us to recognize expense related to the fair value of our stock-based payment awards, including employee stock options and restricted stock units. Under the provisions of U.S. GAAP, employee stock-based payment is estimated at the date of grant based on the award s fair value using the Black-Scholes-Merton (Black-Scholes) option-pricing model and is recognized as expense ratably over the requisite service period. The Black-Scholes option-pricing model requires the use of certain assumptions, the most significant of which are our estimates of the expected volatility of the market price of our stock and the expected term of the award. Our estimate of the expected volatility is based on historical volatility. The expected term represents our estimated period during which our stock-based awards remain outstanding. We estimate the expected term based on historical experience of similar awards, giving consideration to the contractual terms of the awards, vesting requirements, and expectation of future employee behavior, including post-vesting terminations.

We review our valuation assumptions at each grant date and, as a result, our assumptions in future periods may change. As of September 30, 2011, we expect to recognize approximately $3,736,000 of compensation expense related to unvested stock-based awards over a weighted-average period of 2.1 years. See also Note 5, Stock-Based Compensation, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

***Wind-down expenses Rhode Island***

In connection with exiting our research and manufacturing operations in Lincoln, Rhode Island, and the relocation of our corporate headquarters and remaining research laboratories to California in October 1999, we provided a reserve for our estimate of the exit cost obligation. The reserve reflects estimates of the ongoing costs of our former scientific and administrative facility in Lincoln, which we hold on a lease that terminates on June 30, 2013. We are seeking to sublease, assign, sell, or otherwise divest ourselves of our interest in the facility at the earliest possible time, but we cannot determine with certainty a fixed date by which such events will occur, if at all.

In determining the facility exit cost reserve amount, we are required to consider our lease payments through to the end of the lease term and estimate other relevant factors such as facility operating expenses, real estate market conditions in Rhode Island for similar facilities, occupancy rates, and sublease rental rates projected over the course of the leasehold. We re-evaluate the estimate each quarter, taking account of changes, if any, in each underlying factor. The process is inherently subjective because it involves projections over time from the date of the estimate through the end of the lease and it is not possible to determine any of the factors, except the lease payments, with certainty over that period.

Management forms its best estimate on a quarterly basis, after considering actual sublease activity, reports from our broker/realtor about current and predicted real estate market conditions in Rhode Island, the likelihood of new subleases in the foreseeable future for the specific facility and significant changes in the actual or projected operating expenses of the property. We discount the projected net outflow over the term of the leasehold to arrive at the present value, and adjust the reserve to that figure. The estimated vacancy rate for the facility is an important assumption in determining the reserve because changes in this assumption have the greatest effect on estimated sublease income. In addition, the vacancy rate estimate is the variable most subject to change, while at the same time it involves the greatest judgment and uncertainty due to the absence of highly predictive information concerning the future of the local economy and future demand for specialized laboratory and office space in that area. The average vacancy rate of the facility over the last eight years (2003 through 2010) was approximately 74%, varying from 62% to 89%. As of September 30, 2011, based on current information available to management, the vacancy rate is projected to be approximately 69% for 2011, and approximately 70% from

Table of Contents

2012 through the end of the lease. These estimates are based on actual occupancy as of September 30, 2011, predicted lead time for acquiring new subtenants, historical vacancy rates for the area, and assessments by our broker/realtor of future real estate market conditions. If the assumed vacancy rate for the remainder of the lease had been 5% higher or lower at September 30, 2011, then the reserve would have increased or decreased by approximately $60,000. Similarly, a 5% increase or decrease in the operating expenses for the facility would have increased or decreased the reserve by approximately $50,000, and a 5% increase or decrease in the assumed average rental charge per square foot would have decreased or increased the reserve by approximately $18,000. Management does not wait for specific events to change its estimate, but instead uses its best efforts to anticipate them on a quarterly basis. See Note 6 Wind-Down Expenses, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

***Wind-down expenses Australia***

On April 1, 2009, as part of our acquisition of the SCS operations, we acquired certain operations near Melbourne, Australia. In order to reduce operating complexity and expenses, we made the decision to close our site in Australia and consolidate personnel and programs to our Cambridge, U.K. and Palo Alto, California sites. At June 30, 2009, we established a reserve of approximately $310,000 for the estimated costs to close down and exit our Australia operations. The reserve reflects the estimated cost to terminate our facility lease in Australia (which provided for an original termination date of December 31, 2010), employee termination benefits and other liabilities associated with the wind-down and relocation of our operations in Australia. As of December 31, 2010, the facility lease agreement has been terminated and our operations in Australia have been relocated to Cambridge, U.K. and Palo Alto, California. We recorded actual expenses, net of foreign currency translation changes of approximately $241,000 against this reserve. At December 31, 2010, we concluded that all costs related to the close down and exit of our Australia operations have been recorded against the reserve and we closed the reserve by crediting the remaining reserve balance of $69,000 to wind-down expense.

***Business Combinations***

The operating results of acquired companies or operations are included in our consolidated financial statements starting on the date of acquisition. Goodwill is recorded at the time of an acquisition and is calculated as the difference between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. Accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. If the assumptions and estimates used to allocate the purchase price are not correct, or if business conditions change, purchase price adjustments or future asset impairment charges could be required. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Impairment evaluations involve management estimates of asset useful lives and future cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the evaluations. It is possible, however, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analysis, are lower than the original estimates used to assess the recoverability of these assets, we could incur impairment charges in a future period.

***Warrant Liability***

We use the Black-Scholes option pricing model to estimate fair value of warrants issued. In using this model, we make certain assumptions about risk-free interest rates, dividend yields, volatility and expected term of the warrants. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is derived from the historical volatility of our common stock as traded on NASDAQ. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement. The fair value of the warrant liability will be revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

**Results of Operations**

Our results of operations have varied significantly from year to year and quarter to quarter and may vary significantly in the future due to the occurrence of material recurring and nonrecurring events, including without limitation the receipt and payment of recurring and nonrecurring licensing payments, the initiation or termination of clinical studies, research collaborations and development programs for both cell-based therapeutic products and research tools, unpredictable or unanticipated manufacturing and supply costs,

Table of Contents

unanticipated capital expenditures necessary to support our business, expenses arising out of the integration of the acquired SCS operations, developments in on-going patent prosecution ] and litigation, the on-going expenses to lease and maintain our Rhode Island facilities, and the costs associated with operating our California and Cambridge, U.K. facilities.

We acquired the operations of SCS on April 1, 2009, and have consolidated such operations since that date.

In May 2011, we eliminated 20 full-time positions in our US-based workforce, primarily in the research and general and administrative areas. We estimate this reduction in force will generate annual expense reductions of approximately $2.3 million, primarily from savings in salaries and benefits and reductions in laboratory supply costs. We recorded a one-time charge for severance and related expenses of approximately $260,000 in the second quarter ended June 30, 2011.

We effected a 1-for-10 reverse stock split on July 6, 2011. References to numbers of shares of common stock and per share data have been adjusted to reflect the reverse stock split on a retroactive basis. See Note 1 Summary of Significant Accounting Policies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

***Revenue and Cost of Product Sales***

Revenue for the three and nine-month periods ended September 30, 2011, as compared with the same periods in 2010, is summarized in the table below:

| | Three months ended, September 30 | | Change in 2011 versus 2010 | | Nine months ended, September 30 | | Change in 2011 versus 2010 | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2010 | $ | % | 2011 | 2010 | $ | % |
| Revenue: | | | | | | | | |
| Licensing agreements and grants | $ 41,265 | $ 123,693 | $ (82,428) | (67)% | $ 162,614 | $ 409,092 | $ (246,478) | (60)% |
| Product sales | 182,321 | 129,826 | 52,495 | 40% | 516,536 | 318,831 | 197,705 | 62% |
| Total revenue | 223,586 | 253,519 | (29,933) | (12)% | 679,150 | 727,923 | (48,773) | (7)% |
| Cost of product sales | 60,501 | 35,914 | 24,587 | 68% | 167,390 | 104,538 | 62,852 | 60% |
| Gross Profit | $ 163,085 | $ 217,605 | $ (54,520) | (25)% | $ 511,760 | $ 623,385 | $ (111,625) | (18)% |

*Third quarter ended September 30, 2011 versus third quarter ended September 30, 2010.* Total revenue in the third quarter of 2011 was approximately $224,000, which was 12% lower than total revenue of approximately $254,000 in the third quarter of 2010. In the third quarter of 2011, revenue from product sales was approximately $52,000, or 40%, higher as compared to the same period in 2010. This increase was primarily attributable to both increased unit volumes and new product launches in our SC Proven line of media and reagents. Licensing and grant revenue decreased by approximately $82,000, or 67%, in 2011 compared to 2010, which was primarily attributable to the completion and termination of several projects funded by grants in 2010.

*Nine-month period ended September 30, 2011 versus nine-month period ended September 30, 2010.* Total revenue in the nine-month period ended September 30, 2011 was approximately $679,000, which was 7% lower than total revenue of approximately $728,000 in the similar period of 2010. In the nine-month period ended September 30, 2011, revenue from product sales was approximately $198,000, or 62%, higher as compared to the same period in 2010. This increase was primarily attributable to both increased unit volumes and new product launches in our SC Proven line of media and reagents. Licensing and grant revenue decreased by approximately $246,000, or 60%, in 2011 compared to 2010, which was primarily attributable to the completion and termination of several projects funded by grants in 2010.

***Operating Expenses***

Operating expenses for the three and nine-month periods ended September 30, 2011, as compared with the same periods in 2010, is summarized in the table below:

| | Three months ended, September 30 | | Change in 2011 versus 2010 | | Nine months ended, September 30 | | Change in 2011 versus 2010 | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2010 | $ | % | 2011 | 2010 | $ | % |
| Operating expenses: | | | | | | | | |
| Research & development | $ 4,524,334 | $ 5,200,612 | $ (676,278) | (13)% | $ 15,103,845 | $ 15,096,354 | $ 7,491 | * |
| Selling, general & administrative | $ 1,733,229 | $ 2,017,872 | $ (284,643) | (14)% | $ 5,912,220 | $ 6,889,292 | $ (977,072) | (14)% |
| Wind-down expenses | 68,694 | | 68,694 | ** | 258,749 | 291,168 | (32,419) | (11)% |
| Total operating expenses | $ 6,326,257 | $ 7,218,484 | $ (892,227) | (12)% | $ 21,274,814 | $ 22,276,814 | $ (1,002,000) | (5)% |

* Less than 1%
** Calculation not meaningful

Table of Contents

*Research and Development Expenses*

Our R&D expenses consist primarily of salaries and related personnel expenses, costs associated with clinical trials and regulatory submissions, costs associated with preclinical activities such as toxicology studies, costs associated with cell processing and process development, certain patent-related costs such as licensing, facilities related costs such as depreciation, lab equipment and supplies. Clinical trial expenses include payments to vendors such as clinical research organizations, contract manufacturers, clinical trial sites, laboratories for testing clinical samples and consultants. Cumulative R&D costs incurred since we refocused our activities on developing cell-based therapeutics (fiscal years 2000 through the three months ended September 30, 2011) were approximately $147 million. Over this period, the majority of these cumulative costs were related to: (i) characterization of our proprietary HuCNS-SC cells, (ii) expenditures for toxicology and other preclinical studies, preparation and submission of applications to regulatory agencies to conduct clinical trials and obtaining regulatory clearance to initiate such trials, all with respect to our HuCNS-SC cells, (iii)preclinical studies and development of our human liver engrafting cells, (iv) costs associated with cell processing and process development, and (v) costs associated with our clinical studies.

We use and manage our R&D resources, including our employees and facilities, across various projects rather than on a project-by-project basis for the following reasons. The allocations of time and resources change as the needs and priorities of individual projects and programs change, and many of our researchers are assigned to more than one project at any given time. Furthermore, we are exploring multiple possible uses for each of our proprietary cell types, so much of our R&D effort is complementary to and supportive of each of these projects. Lastly, much of our R&D effort is focused on manufacturing processes, which can result in process improvements useful across cell types. We also use external service providers to assist in the conduct of our clinical trials, to manufacture certain of our product candidates and to provide various other R&D related products and services. Many of these costs and expenses are complementary to and supportive of each of our programs. Because we do not have a development collaborator for any of our product programs, we are currently responsible for all costs incurred with respect to our product candidates.

*Third quarter ended September 30, 2011 versus third quarter ended September 30, 2010.* R&D expenses totaled approximately $4,524,000 in the third quarter of 2011 compared with $5,201,000 in the third quarter of 2010. The decrease of approximately $676,000, or 13%, in 2011 compared to 2010, was primarily attributable to (i) a decrease of approximately $489,000 in personnel expenses due to the reduction in force effected in May 2011, (ii) a decrease of approximately $241,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, (iii) a decrease of approximately $173,000 in external services primarily related to cell manufacturing, and, (iv) a decrease of approximately $204,000 in other operating expenses. These decreased expenses were partially offset by (i) an increase in of approximately $279,000 in clinical trial expenses; including, in September 2011, the enrollment and dosing of the first patient in our Phase I/II clinical trial in chronic spinal cord injury and (ii) an increase in facilities expense of approximately $152,000 primarily due to recognizing operating lease expense on a straight-line basis (See Note 7 Commitment and Contingencies, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information).

*Nine-month period ended September 30, 2011 versus nine-month period ended September 30, 2010.* R&D expenses totaled approximately $15,104,000 in the nine-month period ended September 30, 2011, which was relatively flat as compared with $15,096,000 for the same period in 2010. In 2011, we had decreases in the following expenses: (i) approximately $878,000 in personnel expenses due to the reduction in force effected in May 2011, (ii) approximately $601,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, (iii) approximately $773,000 in expenses related to manufacturing and other external services and, (iv) a decrease of approximately $167,000 in other operating expenses. These decreases in expenses were offset by the following increases: (i) approximately $222,000 in severance payments related to the reduction in force effected in May 2011, (ii) approximately $592,000 in clinical study expenses; including, in September 2011, the enrollment and dosing of the first patient in

Table of Contents

our Phase I/II clinical trial in chronic spinal cord injury, iii) approximately $899,000 in external service expenses primarily related to continuing preclinical studies and IND-enabling activities related to retinal disorders and other potential indications, and (iv) approximately $713,000 in facilities expense primarily due to recognizing operating lease expense on a straight-line basis (See Note 7 Commitment and Contingencies, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information).

*Selling, General and Administrative Expenses*

Selling, general and administrative (SG&A) expenses are primarily comprised of salaries, benefits and other staff related costs associated with sales and marketing, finance, legal, human resources, information technology, and other administrative personnel, facilities and overhead costs, external legal and other external general and administrative services.

*Third quarter ended September 30, 2011 versus third quarter ended September 30, 2010.* SG&A expenses totaled approximately $1,733,000 in the third quarter of 2011 compared with approximately $2,018,000 in the third quarter of 2010. The decrease of approximately $285,000, or 14%, in 2011 compared to 2010, was primarily attributable to (i) a decrease of approximately $185,000 in personnel expenses primarily due to the reduction in force effected in May 2011, and (ii) a decrease of approximately $97,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, and (iii) a decrease of $3,000 in other operating expenses.

*Nine-month period ended September 30, 2011 versus nine-month period ended September 30, 2010.* SG&A expenses totaled approximately $5,912,000 in the nine-month period ended September 30, 2011, as compared with $6,889,000 for the same period in 2010. The decrease of approximately $977,000, or 14%, in 2011 compared to 2010, was primarily attributable to (i) a decrease of approximately $305,000 in personnel expenses primarily due to the reduction in force effected in May 2011, (ii) a decrease of approximately $459,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, (iii) a decrease in external services of approximately $153,000, and (vi) a decrease of $60,000 in other operating expenses. This decrease in the nine months of 2011 compared to 2010 was net of approximately $38,000 in severance payments related to the reduction in force effected in May 2011.

*Wind-down Expenses*

| | Three months ended, September 30 | | Change in 2011 versus 2010 | | Nine months ended, September 30 | | Change in 2011 versus 2010 | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2010 | $ | % | 2011 | 2010 | $ | % |
| Wind-down expenses | $ 68,694 | | $ 68,694 | ** | $ 258,749 | $ 291,168 | (32,419) | (11)% |

*Rhode Island*

In 1999, in connection with exiting our former research facility in Rhode Island, we created a reserve for the estimated lease payments and operating expenses related to it. The reserve has been re-evaluated and adjusted based on assumptions relevant to real estate market conditions and the estimated time until we could either fully sublease, assign or sell our remaining interests in the property. The reserve was approximately $2,644,000 at December 31, 2010. Payments net of subtenant income of approximately $308,000 for the third quarter of 2011 and approximately $926,000 for the nine-month period ended September 30, 2011 were recorded against this reserve. We re-evaluated the estimate at the end of each quarter in 2011 and adjusted the reserve to approximately $1,977,000 by recording in aggregate for the nine-month period ended September 30, 2011, additional wind-down expenses of approximately $259,000. In 2010, payments recorded against the reserve were approximately $303,000 for the third quarter and approximately $898,000 for the nine-month period ended September 30, 2010. To adjust the reserve, we recorded in aggregate additional wind-down expenses of approximately $291,000 for the nine month period ended September 30, 2010. Expenses for this facility will fluctuate based on changes in tenant occupancy rates and other operating expenses related to the lease. Even though it is our intent to sublease, assign, sell, or otherwise divest ourselves of our interests in the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, based on estimates, we will periodically re-evaluate and adjust the reserve, as necessary. See Note 6 Wind-down expenses, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

** Calculation not meaningful

25

Table of Contents

*Australia*

On April 1, 2009, as part of our acquisition of the SCS operations, we acquired certain operations near Melbourne, Australia. In order to reduce operating complexity and expenses, we made the decision to close our site in Australia and consolidate personnel and programs to our Cambridge, U.K. and Palo Alto, California sites. At June 30, 2009, we established a reserve of approximately $310,000 for the estimated costs to close down and exit our Australia operations. The reserve reflects the estimated cost to terminate our facility lease in Australia (which provided for an original termination date of December 31, 2010), employee termination benefits and other liabilities associated with the wind-down and relocation of our operations in Australia. As of December 31, 2010, the facility lease agreement has been terminated and our operations in Australia have been relocated to Cambridge, U.K. and Palo Alto, California. We recorded actual expenses, net of foreign currency translation changes of approximately $241,000 against this reserve. At December 31, 2010, we concluded that all costs related to the close down and exit of our Australia operations have been recorded against the reserve and we closed the reserve by crediting the remaining reserve balance of $69,000 to wind-down expense.

**Other Income (Expense)**

Other income totaled approximately $1,829,000 in the third quarter of 2011 compared with other income of $1,449,000 in the same period of 2010, and other income of $6,646,000 for the nine-month period ended September 30, 2011 compared with other income of approximately $5,367,000 for the nine-month period ended September 30, 2010.

| | Three months ended, September 30 | | Change in 2011 versus 2010 | | Nine months ended, September 30 | | Change in 2011 versus 2010 | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | 2010 | $ | % | 2011 | 2010 | $ | % |
| Other income (expense): | | | | | | | | |
| Change in fair value of warrant liability | $ 1,697,194 | $ 1,227,585 | $ 469,609 | 38% | $ 6,500,377 | $ 5,184,304 | $ 1,316,073 | 25% |
| Realized gain on sale of marketable securities | | | | | 83,750 | | 83,750 | ** |
| Interest income | 3,514 | 10,911 | (7,397) | (68)% | 11,332 | 24,814 | (13,482) | (54)% |
| Interest expense | (16,585) | (22,221) | 5,636 | (25)% | (56,585) | (72,775) | 16,190 | (22)% |
| Other income , net | 144,697 | 232,348 | (87,651) | (38)% | 107,400 | 230,408 | (123,008) | (53)% |
| Total other income | $ 1,828,820 | $ 1,448,623 | $ 380,197 | 26% | $ 6,646,274 | $ 5,366,751 | $ 1,279,523 | 24% |

*Change in Fair Value of Warrant Liability*

As part of both our November 2008 and November 2009 financings, we issued warrants with five year terms to purchase 1,034,483 and 400,000 shares of our common stock at $23.00 and $15.00 per share, respectively. As the contracts include the possibility of net-cash settlement, we are required to classify the fair value of the warrants issued as a liability, with subsequent changes in fair value to be recorded as income (loss) on change in fair value of warrant liability. The fair value of the warrants is determined using the Black-Scholes option pricing model and is affected by changes in inputs to that model including our stock price, expected stock price volatility, the contractual term, and the risk-free interest rate. Our estimate of the expected volatility is based on historical volatility. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability. See Note 8 Warrant Liability in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

*Realized Gain on Sale of Marketable Securities*

In the second quarter of 2011, we sold our remaining 1,921,924 shares of ReNeuron for net proceeds of approximately $158,000 and a realized gain of approximately $84,000. As of June 30, 2011, we hold no shares of ReNeuron. See Note 2 Financial Instruments in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

*Interest Income*

Interest income in the three month period ended September 30, 2011 and 2010 were not significant due to low average yields.

Table of Contents

*Interest Expense*

Interest expense decreased by approximately $6,000 or 25% in the third quarter of 2011, and $16,000 or 22% for the nine-month period ended September 30, 2011, when compared to the same periods in 2010. Interest expense is primarily for outstanding debt and capital lease balances. See Note 7 Commitment and Contingencies, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

*Other income (expense), net*

Other income for the three and nine month periods in 2011 include the receipt of approximately $150,000 as a break-up fee paid to us upon the expiration of an exclusivity period granted to a potential licensee. Other income was partially offset by other expenses primarily state franchise taxes. Other income for the three and nine month periods in 2010 includes approximately $227,000 from final settlement of various claims related to the SCS acquisition.

**Liquidity and Capital Resources**

Since our inception, we have financed our operations through the sale of common and preferred stock, the issuance of long-term debt and capitalized lease obligations, revenue from collaborative agreements, research grants, license fees, and interest income.

| | September 30, 2011 | December 31, 2010 | Change $ | Change % |
|---|---|---|---|---|
| Cash and cash equivalents | $ 7,294,074 | $ 19,707,821 | $ (12,413,747) | (63)% |

In summary, our cash flows were:

| | Nine months ended September 30, 2011 | 2010 | Change in 2011 versus 2010 $ | % |
|---|---|---|---|---|
| Net cash used in operating activities | $ (16,845,564) | $ (19,655,257) | $ 2,809,693 | (14)% |
| Net cash used in investing activities | $ (5,378,064) | $ (766,907) | $ (4,611,157) | ** |
| Net cash provided by financing activities | $ 9,852,060 | $ 6,380,033 | $ 3,472,027 | 54% |

***Net Cash Used in Operating Activities***

Net cash used in operating activities in the nine-month period ended September 30, 2011 decreased by approximately $2,810,000, or 14%, when compared to the same period of 2010. Cash used in operating activities is primarily driven by our net loss as adjusted for non-cash charges and differences in the timing of operating cash flows.

***Net Cash Used in Investing Activities***

The increase of approximately $4,611,000, from 2010 to 2011 for net cash used in investing activities, was primarily attributable to the net purchase of short-term marketable debt securities of approximately $5,090,000 in the nine-month period ended September 30, 2011 as compared to none in the similar period of 2010. This increase was partially offset by a decrease in net capital expenditures of approximately $479,000 in the nine-month period ended September 30, 2011 as compared to the similar period of 2010.

***Net Cash Provided by Financing Activities***

Net cash provided by financing activities in the nine-month period ended September 30, 2011 increased by approximately $3,472,000 compared to the same period in 2010. In January 2011, we raised gross proceeds of $10,000,000 through the sale of 1,000,000 shares of our common stock to selected institutional investors at a price of $10.00 per share. We received net proceeds, after deducting offering expenses and fees, of approximately $9,400,000. The investors were also granted an option to purchase an additional 600,000 shares at $10.00 per share. The option was not exercised and expired on February 18, 2011. The shares were offered under a shelf registration filed with and declared effective by, the SEC. In the second and third quarter of 2011, we sold a total of 423,216 shares of our common stock under a sales agreement entered into in

June 2009 at an average price per share of $2.58 for gross proceeds of approximately $1,093,000. The sales agent is paid compensation equal to 3% of gross proceeds pursuant to the terms of the agreement. The shares were offered under a shelf registration previously filed with, and declared effective by, the SEC.

** Calculation is not meaningful

Table of Contents

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenue to achieve or sustain profitability in the future. We do not expect to be profitable in the next several years, but rather expect to incur additional operating losses. We have limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our therapeutic products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for selling, general and administrative expenses and other working capital requirements. We rely on cash balances and proceeds from equity and debt offerings, proceeds from the transfer or sale of our intellectual property rights, equipment, facilities or investments, government grants, and funding from collaborative arrangements, if obtainable, to fund our operations.

We intend to pursue opportunities to obtain additional financing in the future through equity and debt financings, grants and collaborative research arrangements. In November 2010, we filed with the SEC, and the SEC declared effective, a universal shelf registration statement which permits us to issue up to $100 million worth of registered debt and equity securities. As of October 25, 2011, we had approximately $89 million under this universal shelf registration statement available for issuing debt or equity securities. Under this effective shelf registration, we have the flexibility to issue registered securities, from time to time, in one or more separate offerings or other transactions with the size, price and terms to be determined at the time of issuance. Registered securities issued using this shelf may be used to raise additional capital to fund our working capital and other corporate needs, for future acquisitions of assets, programs or businesses, and for other corporate purposes.

The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, on our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed at all, or on terms acceptable to us. Lack of necessary funds may require us, among other things, to delay, scale back or eliminate some or all of our research and product development programs, planned clinical trials, and/or our capital expenditures or to license our potential products or technologies to third parties. In addition, the decline in economic activity, together with the deterioration of the credit and capital markets, could have an adverse impact on potential sources of future financing.

On March 3, 2011, we were notified by NASDAQ that the closing bid price of our common stock had been below $1.00 per share for 30 consecutive business days, and therefore we did not meet the requirements for continued listing on the NASDAQ Global Market. In accordance with NASDAQ rules, we had 180 calendar days, or until August 30, 2011, to regain compliance with this minimum bid price requirement. We would regain compliance if the closing bid price of our common stock is $1.00 per share or higher for a minimum of ten consecutive business days during the initial 180-day compliance period. In July 2011, following the affirmative vote of our stockholders at our Annual Meeting, we effected a one-for-ten reverse stock split. Later in July 2011, we received notification from NASDAQ that we had regained compliance with the minimum bid price requirement for continued listing on the NASDAQ Global Market.

***Commitments***

See Note 7, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

***Off-Balance Sheet Arrangements***

We have certain contractual arrangements that create potential risk for us and are not recognized in our Consolidated Balance Sheets. Discussed below are those off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

*Operating Leases*

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

*Operating Leases California*

In September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California. We will pay approximately $695,000 in aggregate as rent over the term of the lease. The lease contains escalating rent payments, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately $4,000 as of September 30, 2011, and approximately $1,000 as of December 31, 2010.

28

Table of Contents

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC ( BMR ), as landlord, for approximately 43,000 square feet of office and research space at BMR s Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years, and we relocated our corporate headquarters and core research activities from a facility located at the Stanford Research Park in Palo Alto, California, to this facility in July 2011. The lease for the Palo Alto facility expired on August 31, 2011, and a letter of credit for approximately $389,000, which served as a security deposit was transferred from our restricted cash account to our cash and cash equivalents account. Initial base rent for the facility in Newark is expected to be approximately $2.20 per square foot, with yearly increases throughout the term, and subject to certain adjustments for draws upon the tenant allowances among other things. We will pay approximately $14,906,000 in aggregate as rent over the term of the lease, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately $1,032,000 as of September 30, 2011. We constructed laboratories, offices and related infrastructure within the leased space during the first several months of the lease. As part of the lease, BMR has agreed to provide various financial allowances so that we can build initial and future laboratories, offices and other improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. As part of the lease, we have, until January 2013, an option to lease up to an additional 30,000 square feet in the building.

*Operating Leases Rhode Island*

We entered into a fifteen-year lease agreement for a scientific and administrative facility (SAF) in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013 and includes escalating rent payments which we recognize on a straight-line basis. Deferred rent expense for this facility was approximately $503,000 at September 30, 2011 and $656,000 at December 31, 2010, and is included as part of the wind-down accrual on the accompanying condensed consolidated balance sheets. For the year 2011, we expect to pay approximately $1,172,000 in operating lease payments and estimated operating expenses of approximately $635,000, before receipt of sub-tenant income and we expect to receive, in aggregate, approximately $422,000 in sub-tenant rent and operating expenses. As a result of the above transactions, our estimated cash outlay net of sub-tenant rent for the SAF will be approximately $1,385,000 for 2011.

*Operating Leases United Kingdom*

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. We expect to pay approximately 55,000 GBP as rental payments for 2011. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd s obligations under the existing lease.

With the exception of the leases discussed above, we have not entered into any off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

***Contractual Obligations***

In the table below, we set forth our legally binding and enforceable contractual cash obligations at September 30, 2011:

| | Total Obligations at September 30, 2011 | Payable in (October to December) 2011 | Payable in 2012 | Payable in 2013 | Payable in 2014 | Payable in 2015 | Payable in 2016 and Beyond |
|---|---|---|---|---|---|---|---|
| Operating lease payments(1) | $ 17,448,998 | $ 724,486 | $ 2,558,793 | $ 1,933,202 | $ 1,252,242 | $ 1,303,704 | $ 9,676,571 |
| Capital lease (equipment) | 36,677 | 18,348 | 18,329 | | | | |
| Bonds Payable (principal & interest)(2) | 675,536 | 60,425 | 240,666 | 237,593 | 136,852 | | |
| Total contractual cash obligations | $ 18,161,211 | $ 803,259 | $ 2,817,788 | $ 2,170,795 | $ 1,389,094 | $ 1,303,704 | $ 9,676,571 |

(1)

Operating lease payments exclude space-sharing and sub-lease income (see Off-Balance Sheet Arrangements Operating Leases above for further information), but include rent payments for our Rhode Island facility that are included as part of our Accrued wind-down expenses in our condensed consolidated financial statements. See Note 6, Wind-down expenses and Note 7, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Table of Contents

(2) See Note 7, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Under license agreements with NeuroSpheres, Ltd., we obtained an exclusive patent license covering all uses of certain neural stem cell technology. We made up-front payments to NeuroSpheres of 6,500 shares of our common stock and $50,000, and will make additional cash payments as stated milestones are achieved. Effective in 2004, we were obligated to pay annual payments of $50,000, creditable against certain royalties. Effective in 2008, as part of the indemnification agreement with NeuroSpheres described above, we offset the annual $50,000 obligation against litigation costs incurred under that agreement.

We periodically enter into licensing agreements with third parties to obtain exclusive or non-exclusive licenses for certain technologies. The terms of certain of these agreements require us to pay future milestone payments based upon achievement of certain developmental, regulatory or commercial milestones. We do not anticipate making any milestone payments under any of our licensing agreements for 2011. Milestone payments beyond fiscal year 2011 cannot be predicted or estimated, due to the uncertainty of achieving the required developmental, regulatory or commercial milestones.

We do not have any material unconditional purchase obligations or commercial commitments related to capital expenditures, clinical development, clinical manufacturing, or other external services contracts at September 30, 2011.

**Recent Accounting Pronouncements**

In May 2011, the FASB issued additional authoritative guidance relating to fair value measurement and disclosure requirements. For fair value measurements categorized in Level 3 of the fair value hierarchy, the new guidance requires (1) disclosure of quantitative information about unobservable inputs; (2) a description of the valuation processes used by the entity; and (3) a qualitative discussion about the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, if any. Entities must report the level in the fair value hierarchy of assets and liabilities that are not recorded at fair value in the statement of financial position but for which fair value is disclosed. The new requirements clarify that the concepts of highest and best use and valuation premise only apply to measuring the fair value of nonfinancial assets. The new requirements also specify that in the absence of a Level 1 input, a reporting entity should incorporate a premium or a discount in a fair value measurement if a market participant would take into account such an input in pricing and asset or liability. Additionally, the new guidance introduces an option to measure certain financial assets and financial liabilities with offsetting positions on a net basis if certain criteria are met. For public entities, these new requirements become effective for interim and annual periods beginning after December 15, 2011. It is applicable to our fiscal year beginning January 1, 2012. We do not expect this new guidance to have a material effect on our consolidated financial statements.

In June 2011, the FASB issued new accounting guidance which eliminates the current option to present other comprehensive income and its components in the statement of changes in equity. However, under the new guidance, comprehensive income and its components must still be presented under one of two new alternatives. Under the first alternative, the components of other comprehensive income and the components of net income may be presented in one continuous statement referred to as the statement of comprehensive income. Under the second alternative, a statement of other comprehensive income would immediately follow the statement of net income and must be shown with equal prominence as the other primary financial statements. Under either alternative, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. For public entities, these new requirements will become effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively to all prior periods presented. It is applicable to our fiscal year beginning January 1, 2012. We do not expect this new guidance to have a material effect on our consolidated financial statements.

In September 2011, the FASB issued an update to previous guidance on testing goodwill for impairment. The amendments in this update simplifies how entities, both public and nonpublic companies test goodwill for impairment. Under the amendments, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is

Table of Contents

required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. We do not expect this new guidance to have a material effect on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risks at September 30, 2011 have not changed materially from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2010 on file with the U.S. Securities and Exchange Commission.

See also Note 2, Financial Assets, in the notes to condensed consolidated financial statements in Part I, Item 1 of this Form 10-Q.

ITEM 4. CONTROLS AND PROCEDURES

In response to the requirement of the Sarbanes-Oxley Act of 2002, as of the end of the period covered by this report, our chief executive officer and chief financial officer, along with other members of management, reviewed the effectiveness of the design and operation of our disclosure controls and procedures. Such controls and procedures are designed to ensure that information required to be disclosed in the Company s 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 management, including the chief executive officer and the chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, the chief executive officer and chief financial officer have concluded that the Company s disclosure controls and procedures are effective.

During the most recent quarter, there were no changes in internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, these controls of the Company.

**PART II-OTHER INFORMATION**

ITEM 1. LEGAL PROCEEDINGS

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem s activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem s activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in 2012.

In addition to the actions described above, in April 2008, we filed an opposition to Neuralstem s European Patent No. 0 915 968 (methods of isolating, propagating and differentiating CNS stem cells), because the claimed invention is believed by us to be unpatentable over prior art, including the patents exclusively licensed by us from NeuroSpheres. In December 2010, the European Patent Office ruled that all composition claims in Neuralstem s 968 European patent were invalid and unpatentable over prior art including several of the NeuroSpheres patents licensed to us. Neuralstem has appealed this decision.

**Table of Contents**

ITEM 1A. RISK FACTORS

There have been no material change from the risk factors disclosed in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

| | |
|---|---|
| **Exhibit 31.1** | Certification of Martin McGlynn under Section 302 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 31.2** | Certification of Rodney K. B. Young under Section 302 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 32.1** | Certification of Martin McGlynn Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 32.2** | Certification of Rodney K. B. Young Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 101.1** | The following materials from the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2011 are formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.(****) |

**** Pursuant to Rule 406T of Regulation S-T, the XBRL files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

Table of Contents

SIGNATURE

Pursuant to the requirements 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.

STEMCELLS, INC.
(name of Registrant)

November 2, 2011

/s/ Rodney K. B. Young
Rodney K. B. Young
Chief Financial Officer

Table of Contents

Exhibit Index

| | |
|---|---|
| **Exhibit 31.1** | Certification of Martin McGlynn under Section 302 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 31.2** | Certification of Rodney K. B. Young under Section 302 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 32.1** | Certification of Martin McGlynn Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 32.2** | Certification of Rodney K. B. Young Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| **Exhibit 101.1** | The following materials from the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2011 are formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements.(****) |

**** Pursuant to Rule 406T of Regulation S-T, the XBRL files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.