

IGI INC  
Form 10-Q  
August 15, 2005

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

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Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2005 or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-08568

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IGI, Inc.

(Exact name of registrant as specified in its charter)

Delaware  
(State or other Jurisdiction of  
incorporation or organization)

01-0355758  
(I.R.S. Employer Identification No.)

105 Lincoln Avenue  
Buena, New Jersey  
(Address of Principal Executive Offices)

08310  
(Zip Code)

(856) 697-1441  
(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

The number of shares outstanding of the issuer's class of common stock, as of the latest practicable date:

Common Shares Outstanding at August 9, 2005 is 12,108,780.

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## ITEM 1. Financial Statements

## PART I FINANCIAL INFORMATION

IGI, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except share and per share information)  
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Revenues:				
Product sales, net	\$ 593	\$ 785	\$1,098	\$1,640
Licensing and royalty income	232	413	502	545
Total revenues	825	1,198	1,600	2,185
Cost and expenses:				
Cost of sales	354	336	767	685
Selling, general and administrative expenses	362	657	673	1,086
Product development and research expenses	265	1,051	500	1,263
Operating (loss)	(156)	(846)	(340)	(849)
Loss on impairment of investment securities	(77)	-	(77)	-
Interest income	2	6	5	15
Other income	32	-	32	-
Loss from continuing operations before benefit				
(provision) for income taxes	(199)	(840)	(380)	(834)
Benefit (provision) for income taxes	8	(2)	6	(4)
Net loss attributable to common stock	\$(191)	\$ (842)	\$ (374)	\$ (838)
Basic and Diluted Loss Per Common Share				
Net loss per share	\$ (.02)	\$ (.07)	\$ (.03)	\$ (.07)
Weighted Average of Common Stock and Common Stock Equivalents Outstanding				

Basic and diluted	11,859,984	11,579,582	11,771,247	11,513,417
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The accompanying notes are an integral part of the consolidated financial statements.

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IGI, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands, except share and per share information)

	June 30, 2005	December 31, 2004
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 214	\$ 380
Restricted cash	50	50
Marketable securities	327	377
Accounts receivable, less allowance for doubtful accounts of \$10 in 2005 and 2004	395	306
Licensing and royalty income receivable	151	155
Inventories	428	247
Prepaid expenses and other current assets	136	8
	<hr/>	<hr/>
Total current assets	1,701	1,523
Property, plant and equipment, net	3,208	3,168
Other assets	32	39
	<hr/>	<hr/>
Total assets	\$ 4,941	\$ 4,730
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	492	157
Accrued payroll	13	16
Other accrued expenses	179	243
Income taxes payable	-	5
Deferred income	218	180
	<hr/>	<hr/>
Total current liabilities	902	601
Deferred income	49	121
	<hr/>	<hr/>
Total liabilities	951	722
	<hr/>	<hr/>
Stockholders' equity:		
Common stock \$.01 par value, 50,000,000 shares authorized; 14,070,700 and 13,547,520 shares issued in 2005 and 2004, respectively	141	135

Additional paid-in capital	24,788	24,467
Accumulated deficit	(19,541)	(19,167)
Accumulated other comprehensive loss	(3)	(32)
Less treasury stock, 1,965,740 shares at cost in 2005 and 2004	(1,395)	(1,395)
	<hr/>	<hr/>
Total stockholders' equity	3,990	4,008
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 4,941	\$ 4,730
	<hr/>	<hr/>

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

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IGI, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(Unaudited)

	Six months ended June 30,	
	2005	2004
	<hr/>	<hr/>
Cash flows from operating activities:		
Net loss	\$(374)	\$(838)
Reconciliation of net loss to net cash used in operating activities:		
Depreciation and amortization	149	140
Loss on impairment of investment securities	77	-
Recognition of deferred income	(84)	(79)
Stock option compensation expense	2	548
Changes in operating assets and liabilities:		
Accounts receivable	(89)	(10)
Inventories	(181)	(5)
Licensing and royalty income receivable	4	17
Prepaid expenses and other assets	(128)	3
Accounts payable and accrued expenses	156	57
Deferred income	50	-
Income taxes payable	(5)	-
	<hr/>	<hr/>
Net cash used in operating activities	(423)	(167)
	<hr/>	<hr/>
Cash flows from investing activities:		
Capital expenditures	(68)	(189)
Purchase of available for sale securities	-	(88)
	<hr/>	<hr/>

Net cash used in investing activities	(68)	(277)
	<u>                    </u>	<u>                    </u>
Cash flows from financing activities:		
Proceeds from exercise of common stock options	325	223
	<u>                    </u>	<u>                    </u>
Net cash provided by financing activities	325	223
	<u>                    </u>	<u>                    </u>
Net decrease in cash and cash equivalents	(166)	(221)
Cash and equivalents at beginning of period	380	821
	<u>                    </u>	<u>                    </u>
Cash and equivalents at end of period	\$ 214	\$ 600
	<u>                    </u>	<u>                    </u>

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

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IGI, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

IGI, Inc. ("IGI" or the "Company"), a Delaware corporation, operating in the State of New Jersey, is primarily engaged in the production and marketing of cosmetics and skin care products. IGI's Consumer Products business is primarily focused on the continued commercial use of the Novasome<sup>(R)</sup> microencapsulation technologies for skin care applications. These efforts have been directed toward the development of high quality skin care products marketed by the Company or through collaborative arrangements with cosmetic and consumer products companies.

In the start of the second quarter of 2005, the Company began production in our metal finishing division, utilizing the patented UltraCem technology. This division is still in the beginning stages of development; however, marketing and sales efforts are underway and we look forward to benefiting from this venture in the future.

The accompanying consolidated financial statements have been prepared by IGI, Inc. without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"), and reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. All such adjustments are of a normal recurring nature.

Certain information in footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the SEC, although the Company believes the disclosures are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the "2004 10-K Annual Report"). The results of operations for the six month period ended June 30, 2005 are not necessarily indicative of the results for the entire year ending December 31, 2005.

Estee Lauder, a significant customer, accounted for \$214,000 or 36% of product sales and \$113,000 or 52% of royalty revenues for the three months ended June 30, 2005 and \$386,000 or 35% of product sales and \$279,000 or 56% of royalty revenues for the six months ended June 30, 2004. The Company has successfully renegotiated its contract with Estee Lauder. Estee Lauder is manufacturing Novasome<sup>(R)</sup> products in house and is paying the

Company a \$5.00 royalty per kilogram up to \$2 million, and then \$2.00 per kilogram on all Novasome<sup>(R)</sup> products manufactured by Estee Lauder, including all new products developed. The Company's contract manufacturing of Estee Lauder non-Novasome<sup>(R)</sup> products terminated contractually on June 30, 2004, however, the Company continues to manufacture non- Novasome<sup>(R)</sup> products for Estee Lauder on occasion.

## 2. Marketable Securities

Marketable securities at June 30, 2005 consist of an investment in a short term bond mutual fund and an investment in securities. The Company currently classifies all marketable securities as available-for-sale, in accordance with Statement of Financial Accounting Standards (SFAS) 115. Securities classified as available-for-sale are required to be reported at fair value with unrealized gains and losses, net of taxes, excluded from earnings and shown separately as a component of accumulated other comprehensive loss within stockholders' equity. Realized gains and losses on the sale of securities available-for-sale are determined using the specific-identification method.

The activity of the available-for-sale marketable securities is as follows (amounts in thousands):

As of Dec 31, 2004:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Carrying Amount
Mutual funds	\$ 297	\$ -	\$ (4)	\$ 295	\$ 295
Securities	110	-	(28)	82	82
	\$ 407	\$ -	\$ (32)	\$ 377	\$ 377

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IGI, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
Continued

As of June 30,2005:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Carrying Amount
Mutual Funds	\$ 297	\$ -	\$(3)	\$ 294	\$ 294
Securities	33	-	-	33	33
	\$ 330	\$ -	\$(3)	\$ 327	\$ 327

The decrease in net unrealized holding losses on available-for-sale securities in the amount of \$1,000 was charged to stockholders' equity for the six months ended June 30, 2005.

In accordance with SFAS 115 and EITF 03-1, for individual securities classified as available-for-sale, a company shall determine whether a decline in fair value below the amortized cost basis is other than temporary. If the decline

is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (or accounted for as a realized loss). For the six months ended June 30, 2005, a loss (or write-down) of \$77,000 was included in our net loss for the decline in value of our investment in securities. The new cost basis of these securities is \$33,000.

### 3. Inventories

Inventories are valued at the lower of cost, using the first-in, first-out ("FIFO") method, or market. Inventories at June 30, 2005 and December 31, 2004 consist of:

	June 30, 2005	December 31, 2004
	(amounts in thousands)	
Finished goods	\$ 43	\$ 42
Raw materials	385	205
Total	\$428	\$247

### 4. Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board issued Statement No. 123 (revised) *Share-Based Payment* ("SFAS No. 123R"), which is a revision of Statement No. 123, *Accounting for Stock-Based Compensation* ("SFAS No. 123"). SFAS No. 123R supersedes APB No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25"), and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123R is similar to the approach described in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123R must be adopted in the first annual financial reporting period beginning after December 15, 2005. The Company anticipates adopting SFAS No. 123R on January 1, 2006.

SFAS No. 123R permits public companies to adopt its requirements using one of two methods:

A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date.

Or a "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either for (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS No. 123R using the modified prospective method.

The Company currently accounts for share-based payments to employees using the intrinsic value method permitted by APB No. 25 and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS No. 123R's fair value method will have a significant impact on the Company's results of operations, although it will have no impact on the Company's overall financial position. The impact of adoption of

SFAS No. 123R cannot be predicted at this time because it will depend on levels of share-based  
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IGI, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
Continued

payments granted in the future. However, had the Company adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share below. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature.

This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. The Company cannot estimate what those amounts will be in the future because they depend on, among other things, when employees exercise stock options. If the Company applied the fair value principles of SFAS No. 123, for its options, its net loss (income) for the six months ending June 30, 2005 and 2004 would have increased as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share information)			
Net income (loss) - as reported				
Deduct: Total stock-based employee compensation expense determined under the fair-value based method (net of tax \$0)	\$ (191)	\$ (842)	\$ (374)	\$ (838)
Net (loss) - pro forma	(36)	(71)	(78)	(91)
	\$ (227)	\$ (913)	\$ (452)	\$ (929)
Income (loss) per share - as reported				
Basic and diluted	\$ (.02)	\$ (.07)	\$ (.03)	\$ (.07)
Income (loss) per share - pro forma				
Basic and diluted	\$ (.02)	\$ (.08)	\$ (.04)	\$ (.08)

## 5. Legal and U.S. Regulatory Proceedings

### Gallo Matter

As previously reported by the Company in its historical filings with the SEC, including without limitation its Form 10-K for the year ending December 31, 1999, for most of 1997 and 1998 the Company was subject to intensive government regulatory scrutiny by the U.S. Departments of Justice, Treasury and Agriculture. In June 1997, the Company was advised by the Animal and Plant Health Inspection Service ("APHIS") of the United States Department of Agriculture ("USDA") that the Company had shipped quantities of some of its poultry vaccine



products without complying with certain regulatory and record keeping requirements. The USDA subsequently issued an order that the Company stop shipment of certain of its products. Shortly thereafter, in July 1997, the Company was advised that the USDA's Office of Inspector General had commenced an investigation into possible violations of the Virus Serum Toxin Act of 1914 and alleged false statements made to APHIS. In April 1998, the SEC advised the Company that it was conducting an informal inquiry and requested information and documents from the Company, which the Company voluntarily provided to the SEC.

Based upon these events, the Board of Directors caused an immediate and thorough investigation of the facts and circumstances of the alleged violations to be undertaken by independent counsel. The Company continued to refine and strengthen its regulatory programs with the adoption of a series of compliance and enforcement policies, the addition of new managers of Production and Quality Control and a new Senior Vice President and General Counsel. At the instruction of the Board of Directors, the Company's General Counsel established and oversaw a comprehensive employee training program, designated in writing a Regulatory Compliance Officer, and established a fraud detection program, as well as an employee "hotline." The Company continued to cooperate with the USDA and SEC in all aspects of their investigation and regulatory activities. On March 13, 2002, the Company reached a settlement with the staff of the SEC to resolve matters arising with respect to the investigation of the Company. Under the settlement, the Company neither admitted nor denied that the Company violated the financial reporting and record-keeping requirements of Section 13 of the Securities and Exchange Act of 1934, as amended, for the three years ended December 31, 1997. Further, the Company agreed to the entry of an order to cease and desist from any such violation in the future. No monetary penalty was assessed.

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IGI, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
Continued

As a result of its internal investigation, in November 1997, the Company terminated the employment of John P. Gallo as President and Chief Operating Officer for willful misconduct. On April 21, 1998, the Company instituted a lawsuit against Mr. Gallo in the New Jersey Superior Court. The lawsuit alleged willful misconduct and malfeasance in office, as well as embezzlement and related claims (referred to as "the IGI Action"). On April 28, 1998, Mr. Gallo instituted a separate action against the Company and two of its Directors, Edward Hager, M.D. and Constantine Hampers, M.D., alleging that he had been wrongfully terminated from employment and further alleging wrongdoings by the two Directors (referred to as the "Gallo Action"). The Court subsequently ordered the consolidation of the IGI Action and the Gallo Action (collectively referred to as the "Consolidated Action").

In response to these allegations, the Company instituted an investigation of the two Directors by an independent committee ("Independent Committee") of the Board assisted by the Company's General Counsel. The investigation included a series of interviews of the Directors, both of whom cooperated with the Company, and a review of certain records and documents. The Company also requested an interview with Mr. Gallo who, through his counsel, declined to cooperate. In September 1998, the Independent Committee reported to the Board that it had found no credible evidence to support Mr. Gallo's claims and allegations and recommended no further action. The Board adopted the recommendation.

The Company denied all allegations plead in the Gallo Action and asserted all claims in the Gallo Action to be without merit. The Company did not reserve any amount relating to such claims. The Company tendered the claim to its insurance carriers, but was denied insurance coverage for both defense and indemnity of the Gallo Action.

In July 1998, the Company sought to depose Mr. Gallo in connection with the Consolidated Action. Through his counsel, Mr. Gallo asserted his Fifth Amendment privilege against self-incrimination and advised that he would not participate in the discovery process until such time as a federal grand jury investigation, in which he was a target, was concluded. In January 1999, at the suggestion of the Court, the Company and Mr. Gallo agreed to a voluntary

dismissal without prejudice of the Consolidated Action, with the understanding that the statute of limitations was tolled for all parties and all claims, and that the Company and Mr. Gallo were free to reinstate their suits against each other at a later date, with each party reserving all of their rights and remedies against the other.

As of the date hereof, neither the Company nor Mr. Gallo have filed suit against each other in the Superior Court of New Jersey or any other court of competent jurisdiction to reinstitute the claims, in whole or part, previously at issue in the Consolidated Action, and pursuant to the previous order of dismissal entered in the Consolidated Action, the statute of limitation on all claims and defenses continues to be tolled as to both parties. However, the Company did receive a letter dated November 21, 2003 from Mr. Gallo's attorneys seeking to reach a settlement of the claims asserted against IGI in the Gallo Action without further resort to the courts. The letter provides a general description of Mr. Gallo's claims and a calculation of damages allegedly sustained by Mr. Gallo relative thereto. The letter states that Mr. Gallo's damages are calculated to be in the range of \$3,400,000 to \$5,100,000. The Company denies liability for the claims and damages alleged in the letter from Mr. Gallo's counsel dated November 21, 2003, and as such, the Company did not make any formal response thereto. Mr. Gallo has contacted the Company's Chief Executive Officer and Chairman, Frank Gerardi, in a continued effort to initiate settlement discussions. As of June 30, 2005, the Company continues to deny any merit and/or liability for the claims alleged by Mr. Gallo and has not engaged in any formal settlement discussions with either Mr. Gallo or his attorneys.

On December 8, 2003, Mr. Gallo filed suit against Novavax, Inc. in the Superior Court of New Jersey, Law Division, Atlantic County, docket no. ATL-L-3388-03, asserting claims under seven counts for damages allegedly sustained as a result of the cancellation of certain Novavax stock options held by Mr. Gallo due to his termination from IGI in November 1997 for willful misconduct (referred to as the "Novavax Action").

On March 5, 2004, Novavax filed an Answer denying the allegations asserted by Mr. Gallo in his First Amended Complaint. In addition, while denying any liability under the First Amended Complaint, Novavax also filed a Third Party Complaint in the Novavax Action against the Company for contribution and indemnification, alleging that if liability for Mr. Gallo's claims is found, the Company has primary liability for any and all such damages sustained.

IGI has been notified by its insurance carriers that coverage is not afforded under their respective policies of insurance for defense and/or indemnification of the claims alleged by the Third Party Complaint. After IGI was notified of the foregoing, but prior to IGI's filing of any responsive pleading, the Third Party Complaint against IGI

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IGI, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
Continued

was voluntarily dismissed without prejudice by Novavax on June 30, 2004. Novavax may at any time pursuant to the rules of court re-file its Third Party Complaint against IGI.

On July 8, 2004, Novavax filed a motion for summary judgment on all claims asserted under Gallo's First Amended Complaint (referred to as "the SJ Motion"). As of the filing date hereof, the SJ Motion is pending subject to filing of Gallo's opposition and any reply thereto by Novavax. The court has not yet scheduled a hearing date for the SJ Motion. In the event the court denies the SJ Motion, the Company believes that there is a substantial likelihood that Novavax will re-file its Third Party Complaint against IGI for which coverage was previously denied by its insurance carriers.

As of August 15, 2005, the Third Party Complaint against IGI has not been re-filed.

6. License Agreements

In February 2004, the Company signed a license agreement with Universal Chemical Technologies, Inc. ("UCT") to utilize its patented technology for an electroless nickel boride metal finishing process. This is a new venture for the Company and the Company has had initial capital expenditures of approximately \$913,000 through June 30, 2005, in order to set up the operations. The Company has also hired two new employees to oversee the facility operations, in which these costs were expensed in costs of goods sold. The Company has an exclusive license within a 150 mile radius of its facility for commercial and military applications. The Company believes there is the possibility of revenue and profit growth using this application, but there is no guarantee that it will materialize.

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## IGI, INC. AND SUBSIDIARIES

### ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis may contain forward-looking statements. Such statements are subject to certain risks and uncertainties, including those discussed below or in the Company's 2004 10-K Annual Report that could cause actual results to differ materially from the Company's expectations. See "Factors Which May Affect Future Results" below and in the 2004 10-K Annual Report. Readers are cautioned not to place undue reliance on any forward-looking statements, as they reflect management's analysis as of the date hereof. The Company undertakes no obligation to release the results of any revision to these forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of anticipated events.

#### Recent Events

On August 10, 2005, The Company entered into a Severance Agreement (the "Agreement") with Frank Gerardi, the Company's Chairman and Chief Executive Officer. Upon the occurrence of a Termination Event (as defined in the Agreement), the Company will pay to Mr. Gerardi: (i) \$150,000, payable in a lump sum, or in regular payroll payments until paid in full; (ii) a lump sum payment for any unused accrued vacation days for that calendar year; and (iii) continued coverage under the Company's existing health and benefit plans for a one (1) year period from the date that written notice of termination is given.

#### Results of Operations

##### Three months ended June 30, 2005 compared to June 30, 2004

##### Revenues (in thousands):

	2005	2004	\$ Change	% Change
Product Sales	\$ 593	\$ 785	\$ (192)	-24%
Royalty Revenue	232	413	(181)	-44%
<b>Total Revenues</b>	<b>\$ 825</b>	<b>\$1,198</b>	<b>\$ (373)</b>	<b>-31%</b>

Total revenues for the quarter ended June 30, 2005 consisted of product sales of \$593,000, compared to \$785,000 in 2004; royalty revenues of \$232,000 in 2005, compared to \$413,000 in 2004. Due to the change in the way we do business with Estee Lauder, there was a significant shift of revenue from product revenue to royalty revenue in 2005 that accounts for the majority of the decrease in product sales. The decrease in royalty revenue was related to a \$300,000 royalty that we received in May of 2004 from Tarpan Therapeutics, offset by an increase in royalty from Estee Lauder in 2005.

Costs and expenses (in thousands):

	2005	2004	\$ Change	% Change
Cost of goods sold	\$ 354	\$ 336	\$ 18	5%
Selling, general and administrative	362	657	(295)	-45%
Product development and research	265	1,051	(786)	-75%
Totals costs and expenditures	\$ 981	\$2,044	\$(1,063)	-52%

As a percentage of product sales, cost of sales was 60% for the quarter ended June 30, 2005 and 43% for the quarter ended June 30, 2004. The increase in cost of sales was a result of the loss of product sales to Estee Lauder for the quarter ended June 30, 2005. Estee Lauder products were sold at a higher gross margin percentage than other products resulting in the higher cost of sales for this quarter. In addition, sample batches have been completed for the new metal finishings division, however, no sales have been generated to offset the costs related to that division, therefore, they are included with costs of goods sold. The costs related to the metal plating division amounted to \$34,000 for the quarter ended June 30, 2005.

Selling, general and administrative expenses decreased \$295,000, or 45%, from \$657,000 in the quarter ended June 30, 2004. As a percentage of revenues, these expenses were 44% of revenues in the second quarter of 2005 compared to 55% for the second quarter of 2004. Overall, expenses decreased primarily due to a

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### IGI, INC. AND SUBSIDIARIES

#### ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

severance accrual of \$203,000 recorded in the second quarter of 2004 and approximately \$68,000 of lower executive salaries, travel and entertainment costs in 2005.

Product development and research expenses decreased \$786,000, or 75%, compared to the quarter ended June 30, 2004. The decrease was a result of the Company recording a \$548,000 non cash expense related to the SFAS 123 value of 325,000 stock options granted to Dr. Holick and a \$232,000 cash expense paid to Dr. Holick in accordance with his agreement in the second quarter of 2004.

Net income (loss) (in thousands):

	2005	2004	\$ Change	% Change
Net income (loss)	\$ (191)	\$(842)	\$ 651	77%
Net loss per share	(.02)	(.07)	.05	71%

Net loss for quarter ended June 30, 2005 was \$191,000 or \$.02 per share, compared to \$842,000 or \$.07 per share for 2004, a decreased loss of \$651,000 or \$.05 per share. The decreased loss relates to lower expenses in 2005,

particularly the expenses related to the SFAS 123 value of stock options granted to Dr. Holick in 2004.

Six months ended June 30, 2005 compared to June 30, 2004

Revenues (in thousands):

	2005	2004	\$ Change	% Change
Product Sales	\$1,098	\$1,640	\$(542)	-33%
Royalty Revenue	502	545	(43)	-8%
<b>Total Revenues</b>	<b>\$1,600</b>	<b>\$2,185</b>	<b>\$(585)</b>	<b>-27%</b>

Total revenues for the six months ended June 30, 2005 consisted of product sales of \$1,098,000, compared to \$1,640,000 in 2004; royalty revenues of \$502,000 in 2005, compared to \$545,000 in 2004. Due to the change in the way we do business with Estee Lauder, there was a significant shift of revenue from product revenue to royalty revenue in 2005 that accounts for the majority of the decrease in product sales. The decrease in royalty revenue was related to a \$300,000 royalty that we received in May of 2004 from Tarpan Therapeutics, offset by an increase in royalty from Estee Lauder in 2005.

Costs and expenses (in thousands):

	2005	2004	\$ Change	% Change
Cost of sales	\$ 767	\$ 685	\$ 82	12%
Selling, general and administrative	673	1,086	(413)	-38%
Product development and research	500	1,263	(763)	-60%
<b>Totals costs and expenses</b>	<b>\$1,940</b>	<b>\$3,034</b>	<b>\$(1,094)</b>	<b>-36%</b>

As a percentage of product sales, cost of sales was 70% for the six months ended June 30, 2005 and 42% for the quarter ended June 30, 2004. The increase in cost of sales was a result of the loss of product sales to Estee Lauder for the six months ended June 30, 2005. Estee Lauder products were sold at a higher gross margin percentage than other products resulting in the higher cost of sales for this quarter. In addition, sample batches have been completed for the new metal finishings division, however, no sales have been generated to offset the costs related to that division, therefore, they are included with costs of goods sold. The costs related to the metal plating division amounted to \$126,000 for the six month period ended June 30, 2005.

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IGI, INC. AND SUBSIDIARIES

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

Selling, general and administrative expenses decreased \$413,000, or 38%, from \$1,086,000 in the six months ended

June 30, 2004. As a percentage of revenues, these expenses were 42% of revenues for the six months ended June 30, 2005 compared to 50% for the six months ended June 30, 2004. Overall, expenses decreased primarily due to a severance accrual of \$203,000 recorded in the second quarter 2004 and approximately \$135,000 of lower executive salaries, travel and entertainment costs in 2005.

Product development and research expenses decreased \$763,000, or 60%, compared to the six months ended June 30, 2004. The decrease was a result of the Company recording a \$548,000 non cash expense related to the SFAS 123 value of 325,000 stock options granted to Dr. Holick and a \$232,000 cash expense paid to Dr. Holick in accordance with his agreement in the second quarter of 2004.

Net income (loss) (in thousands):

	2005	2004	\$ Change	% Change
Net income (loss)	\$ (374)	\$(838)	\$ 464	55%
Net loss per share	(.03)	(.07)	.04	57%

Net loss for 2005 was \$374,000 or \$.03 per share, compared to \$838,000 or \$.07 per share for 2004, a decreased loss of \$450,000 or \$.04 per share. The decrease in loss relates to lower expenses in 2005, particularly the expenses related to the SFAS 123 value of stock options granted to Dr. Holick in 2004.

**Liquidity and Capital Resources**

The Company's operating activities used \$423,000 of cash during the six months ended June 30, 2005 compared to \$167,000 used in the comparable period of 2004. The money used represents purchases of inventory for the manufacturing of one of our new product lines along with increases in prepaid vendor advances and the renewal of our business insurance policies.

The Company used \$68,000 of cash in the six months ended June 30, 2005 for investing activities compared to \$277,000 used in investing activities in the first six months of 2004. The money used represents capital expenditures to purchase machinery and equipment related to the electroless nickel boride finishing operations.

The Company's financing activities provided \$325,000 of cash in the six months ended June 30, 2005 compared to \$223,000 provided by financing activities in the six months ended June 30, 2004. The cash provided in 2005 and 2004 represents proceeds from the exercise of stock options.

The Company's principal sources of liquidity are cash from operations, cash and cash equivalents and marketable securities. Management believes that existing cash and cash equivalents, marketable securities and cash flows from operations will be sufficient to meet the Company's foreseeable cash needs for at least the next year. In addition, two shareholders of the Company have agreed to loan the Company up to \$500,000 each, if necessary, to fund the Company's deficit through December 31, 2005. There may be acquisition and other growth opportunities; however that require additional external financing. Management may, from time to time, seek to obtain additional funds from the public or private issuances of equity or debt securities. There can be no assurance that such financings will be available or available on terms acceptable to the Company.

The Company has an option, which is exercisable by December 13, 2005, to extend its exclusive license for the use of the technologies in the IGI Field for an additional ten-year term in exchange for a \$1,000,000 cash payment. Management fully intends to exercise this option and is currently evaluating several opportunities that will generate

sufficient funds to enable the Company to exercise this option.

There have been no material changes to the Company's contractual commitments as reflected in the 2004 10-K Annual Report other than those disclosed in this Form 10-Q.

#### Off Balance Sheet Arrangements

The Company does not have any off balance sheet arrangements as of the date of this report.

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## IGI, INC. AND SUBSIDIARIES

### ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

#### Factors Which May Affect Future Results

The industry segments in which the Company competes are subject to intense competitive pressures. The following sets forth some of the risks which the Company faces.

#### Intense Competition in Consumer Products Business

The Company's Consumer Products business competes with large, well-financed cosmetics and consumer products companies with development and marketing groups that are experienced in the industry and possess far greater resources than those available to the Company. There is no assurance that the Company's consumer products can compete successfully against its competitors or that it can develop and market new products that will be favorably received in the marketplace. In addition, certain of the Company's customers that use the Company's Novasome<sup>(R)</sup> lipid vesicles in their products may decide to reduce their purchases from the Company or shift their business to other suppliers.

#### Effect of Rapidly Changing Technologies

The Company expects to sublicense its technologies to third parties, which would manufacture and market products incorporating the technologies. However, if its competitors develop new and improved technologies that are superior to the Company's technologies, its technologies could be less acceptable in the marketplace and therefore the Company's planned technology sublicensing could be materially adversely affected.

#### Revision of Current Contract with Estee Lauder

As noted above, in 2004, the Company renegotiated its agreement with Estee Lauder. The Company will no longer manufacture products for Estee Lauder. Estee will manufacture all products in house and pay the Company \$5.00 per kilogram produced, up to \$2 million, and then \$2.00 per kilogram. In addition, the exclusivity clause was removed from the Estee Lauder agreement and, consequently, the Company may now sell its products in department and specialty stores. Although it is the Company's belief that this will increase business and revenue in the future, there is no guarantee that it will occur.

#### Licensing Agreement with Universal Chemical Technologies, Inc.

In February 2004, the Company signed a license agreement with UCT to utilize their patented technology for an electroless nickel boride metal finishing process. This will be a new venture for the Company and will require significant capital expenditures in the Company's existing manufacturing facility to set up the operations. The Company has an exclusive license within a 150 mile radius of its facility for commercial and military applications.

Frank Gerardi, the Company's Chairman and Chief Executive Officer, as well as a major IGI shareholder, has personally invested \$350,000 in UCT, which represents less than a 1% ownership interest by Mr. Gerardi in UCT. The Company believes there is the possibility of major revenue and profit growth using this application, but there is no guarantee that it will materialize.

#### American Stock Exchange (AMEX) Continuing Listing Standards

On March 28, 2002, the Company was notified by AMEX that it was below certain of the Exchange's continuing listing standards. Specifically, the Company was required to reflect income from continuing operations and net income for 2002 and a minimum of \$4,000,000 in stockholders' equity by December 31, 2002 in order to remain listed.

On April 25, 2002, the Company submitted a plan of compliance to AMEX. On June 12, 2002, AMEX notified the Company that it had accepted the Company's plan of compliance and had granted the Company an extension of time to regain compliance with the continued listing standards by December 31, 2002. The Company was subject to periodic review by the AMEX staff during the extension period. Based on the Company's reported results for 2002, the Company was not in compliance with the AMEX listing standards for income from continuing operations. On April 14, 2003, the Company received formal notification from AMEX that the Company was deemed to be in compliance with all AMEX requirements for continued listing on AMEX. This determination is subject to the Company's favorable progress in satisfying the AMEX guidelines for continued listing and to AMEX's routine periodic reviews of the Company's SEC filings. Based on the Company's 2003 year-end results and since, the

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### IGI, INC. AND SUBSIDIARIES

#### ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

Company was not in compliance with the AMEX requirement for reporting income from continuing operations and net income for the year ended December 31, 2003 and since

As of the date of the filing of the Form 10-Q for the quarter ended June 30, 2005, the Company has not been contacted by AMEX concerning the Company's non-compliance with the AMEX requirements. While as of this date, the Company has not received any notification of non-compliance from AMEX, the Company has no knowledge of nor can it predict whether AMEX shall at any time hereafter issue formal notification to the Company of its non-compliance with the requirements for continued listing on AMEX, which could result in the Company's delisting from AMEX or otherwise adversely affect the Company.

#### Critical Accounting Policies

There have been no material changes to the Company's critical accounting policies as reflected in the 2004 10-K Annual Report.

#### ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may impact the financial position, results of operations, or cash flow of the Company due to adverse changes in market prices and interest rates. The Company is exposed to market risk because of changes in interest rates and changes in the fair market value of its marketable securities portfolio.



The Company does not use derivatives for any hedging or speculative strategies. Accordingly, at June 30, 2005, the Company is not a party to any derivative transactions. The Company classifies its investments in its marketable securities portfolio as available-for-sale and records them at fair value. The securities unrealized holding gains and losses are excluded from income and are recorded directly to stockholders' equity in accumulated other comprehensive income. Changes in interest rates are not expected to have an adverse effect on the Company's financial condition or results of operations.

#### ITEM 4. Controls and Procedures

Under the supervision and with the participation of certain members of the Company's management, including the Chief Executive Officer and Vice President of Finance, the Company completed an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) to the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based on this evaluation, the Company's Chief Executive Officer and Vice President of Finance believe that the disclosure controls and procedures were not effective as of the end of the period covered by this report with respect to timely communicating to them and other members of management responsible for preparing periodic reports all material information required to be disclosed in this report as it relates to the Company and its consolidated subsidiaries for the reasons more fully described below which were identified during our fiscal 2004 evaluation of internal control over financial reporting.

In a report to the Audit Committee of our Board of Directors and management of the Company, delivered by our independent audit firm, Amper, Politziner & Mattia P.C. on March 24, 2005 in connection with their review of our financial results for the year end December 31, 2004, two items were identified as material weaknesses in our internal controls. Those material weaknesses were identified as insufficient resources and administrative support in the accounting department and an unreliable accounting software package. Management of the Company took steps as soon as possible to remedy these weaknesses. On January 1, 2005, a new accounting/manufacturing software package was installed and implemented throughout the Company. Also, the Company hired an outside consulting firm who is familiar with our software package to assist in the implementation of the software package. In addition, on July 5, 2005, an additional support person was hired for the accounting department. We believe that these actions have corrected our material weaknesses with respect to our internal controls over financial reporting that we identified during our fiscal 2004 evaluation.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future certain events. Given these and

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#### IGI, INC. AND SUBSIDIARIES

#### ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their stated goals under all potential future conditions.

Other than the aforementioned, there was no change in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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#### IGI, INC. AND SUBSIDIARIES

#### PART II

#### OTHER INFORMATION

## ITEM 1. Legal Proceedings

### Gallo Matter

As previously reported by the Company in its historical filings with the Securities and Exchange Commission ("SEC"), including without limitation its Form 10-K for the year ending December 31, 1999, for most of 1997 and 1998 the Company was subject to intensive government regulatory scrutiny by the U.S. Departments of Justice, Treasury and Agriculture. In June 1997, the Company was advised by the Animal and Plant Health Inspection Service ("APHIS") of the United States Department of Agriculture ("USDA") that the Company had shipped quantities of some of its poultry vaccine products without complying with certain regulatory and record keeping requirements. The USDA subsequently issued an order that the Company stop shipment of certain of its products. Shortly thereafter, in July 1997, the Company was advised that the USDA's Office of Inspector General had commenced an investigation into possible violations of the Virus Serum Toxin Act of 1914 and alleged false statements made to APHIS. In April 1998, the SEC advised the Company that it was conducting an informal inquiry and requested information and documents from the Company, which the Company voluntarily provided to the SEC.

Based upon these events, the Board of Directors caused an immediate and thorough investigation of the facts and circumstances of the alleged violations to be undertaken by independent counsel. The Company continued to refine and strengthen its regulatory programs with the adoption of a series of compliance and enforcement policies, the addition of new managers of Production and Quality Control and a new Senior Vice President and General Counsel. At the instruction of the Board of Directors, the Company's General Counsel established and oversaw a comprehensive employee training program, designated in writing a Regulatory Compliance Officer, and established a fraud detection program, as well as an employee "hotline." The Company continued to cooperate with the USDA and SEC in all aspects of their investigation and regulatory activities. On March 13, 2002, the Company reached a settlement with the staff of the SEC to resolve matters arising with respect to the investigation of the Company. Under the settlement, the Company neither admitted nor denied that the Company violated the financial reporting and record-keeping requirements of Section 13 of the Securities and Exchange Act of 1934, as amended, for the three years ended December 31, 1997. Further, the Company agreed to the entry of an order to cease and desist from any such violation in the future. No monetary penalty was assessed.

As a result of its internal investigation, in November 1997, the Company terminated the employment of John P. Gallo as President and Chief Operating Officer for willful misconduct. On April 21, 1998, the Company instituted a lawsuit against Mr. Gallo in the New Jersey Superior Court. The lawsuit alleged willful misconduct and malfeasance in office, as well as embezzlement and related claims (referred to as "the IGI Action"). On April 28, 1998, Mr. Gallo instituted a separate action against the Company and two of its Directors, Edward Hager, M.D. and Constantine Hampers, M.D., alleging that he had been wrongfully terminated from employment and further alleging wrongdoings by the two Directors (referred to as the "Gallo Action"). The Court subsequently ordered the consolidation of the IGI Action and the Gallo Action (collectively referred to as the "Consolidated Action").

In response to these allegations, the Company instituted an investigation of the two Directors by an independent committee ("Independent Committee") of the Board assisted by the Company's General Counsel. The investigation included a series of interviews of the Directors, both of whom cooperated with the Company, and a review of certain records and documents. The Company also requested an interview with Mr. Gallo who, through his counsel, declined to cooperate. In September 1998, the Independent Committee reported to the Board that it had found no credible evidence to support Mr. Gallo's claims and allegations and recommended no further action. The Board adopted the recommendation.

The Company denied all allegations plead in the Gallo Action and asserted all claims in the Gallo Action to be without merit. The Company did not reserve any amount relating to such claims. The Company tendered the claim to its insurance carriers, but was denied insurance coverage for both defense and indemnity of the Gallo Action.

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IGI, INC. AND SUBSIDIARIES  
PART II  
OTHER INFORMATION, Continued

In July 1998, the Company sought to depose Mr. Gallo in connection with the Consolidated Action. Through his counsel, Mr. Gallo asserted his Fifth Amendment privilege against self-incrimination and advised that he would not participate in the discovery process until such time as a federal grand jury investigation, in which he was a target, was concluded. In January 1999, at the suggestion of the Court, the Company and Mr. Gallo agreed to a voluntary dismissal without prejudice of the Consolidated Action, with the understanding that the statute of limitations was tolled for all parties and all claims, and that the Company and Mr. Gallo were free to reinstate their suits against each other at a later date, with each party reserving all of their rights and remedies against the other.

As of the date hereof, neither the Company nor Mr. Gallo have filed suit against each other in the Superior Court of New Jersey or any other court of competent jurisdiction to reinstitute the claims, in whole or part, previously at issue in the Consolidated Action, and pursuant to the previous order of dismissal entered in the Consolidated Action, the statute of limitation on all claims and defenses continues to be tolled as to both parties. However, the Company did receive a letter dated November 21, 2003 from Mr. Gallo's attorneys seeking to reach a settlement of the claims asserted against IGI in the Gallo Action without further resort to the courts. The letter provides a general description of Mr. Gallo's claims and a calculation of damages allegedly sustained by Mr. Gallo relative thereto. The letter states that Mr. Gallo's damages are calculated to be in the range of \$3,400,000 to \$5,100,000. The Company denies liability for the claims and damages alleged in the letter from Mr. Gallo's counsel dated November 21, 2003, and as such, the Company did not make any formal response thereto. Mr. Gallo has contacted the Company's Chief Executive Officer and Chairman, Frank Gerardi, in a continued effort to initiate settlement discussions. As of the present date, the Company continues to deny any merit and/or liability for the claims alleged by Mr. Gallo and has not engaged in any formal settlement discussions with either Mr. Gallo or his attorneys.

On December 8, 2003, Mr. Gallo filed suit against Novavax, Inc. in the Superior Court of New Jersey, Law Division, Atlantic County, docket no. ATL-L-3388-03, asserting claims under seven counts for damages allegedly sustained as a result of the cancellation of certain Novavax stock options held by Mr. Gallo due to his termination from IGI in November 1997 for willful misconduct (referred to as the "Novavax Action").

On March 5, 2004, Novavax filed an Answer denying the allegations asserted by Mr. Gallo in his First Amended Complaint. In addition, while denying any liability under the First Amended Complaint, Novavax also filed a Third Party Complaint in the Novavax Action against the Company for contribution and indemnification, alleging that if liability for Mr. Gallo's claims is found, the Company has primary liability for any and all such damages sustained.

IGI has been notified by its insurance carriers that coverage is not afforded under their respective policies of insurance for defense and/or indemnification of the claims alleged by the Third Party Complaint. After IGI was notified of the foregoing, but prior to IGI's filing of any responsive pleading, the Third Party Complaint against IGI was voluntarily dismissed without prejudice by Novavax on June 30, 2004. Novavax may at any time pursuant to the rules of court re-file its Third Party Complaint against IGI.

On July 8, 2004, Novavax filed a motion for summary judgment on all claims asserted under Gallo's First Amended Complaint (referred to as "the SJ Motion"). As of the filing date hereof, the SJ Motion is pending subject to filing of Gallo's opposition and any reply thereto by Novavax. The court has not yet scheduled a hearing date for the SJ Motion. In the event the court denies the SJ Motion, the Company believes that there is a substantial likelihood that Novavax will re-file its Third Party Complaint against IGI for which coverage was previously denied by its insurance carriers.

As of August 15, 2005, the Third Party Complaint against IGI has not been filed.

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.

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IGI, INC. AND SUBSIDIARIES  
PART II  
OTHER INFORMATION, Continued

ITEM 5. Other Information

On August 10, 2005, The Company entered into a Severance Agreement (the "Agreement") with Frank Gerardi, the Company's Chairman and Chief Executive Officer. Upon the occurrence of a Termination Event (as defined in the Agreement), the Company will pay to Mr. Gerardi: (i) \$150,000, payable in a lump sum, or in regular payroll payments until paid in full; (ii) a lump sum payment for any unused accrued vacation days for that calendar year; and (iii) continued coverage under the Company's existing health and benefit plans for a one (1) year period from the date that written notice of termination is given.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 10.113 Severance Agreement between IGI, Inc. and Frank Gerardi dated August 10, 2005
- 31.1 Certification of the Chairman and Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Vice President of Finance Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chairman and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as enacted under Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Vice President of Finance pursuant to 18 U.S.C. Section 1350, as enacted under Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

None.

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IGI, INC. AND SUBSIDIARIES

SIGNATURES

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.

IGI, Inc.  
(Registrant)

Date: August 15, 2005

By:

/s/ Frank Gerardi

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Frank Gerardi  
Chairman and Chief Executive Officer

Date: August 15, 2005

By:

/s/ Carlene Lloyd

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Carlene Lloyd  
Vice President, Finance

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