

22nd Century Group, Inc.  
Form 10-Q  
November 13, 2012

UNITED STATES

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended September 30, 2012**

**“ 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: 000-54111

**22nd Century Group, Inc.**

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

|   |                                      |
|---|--------------------------------------|
| Nevada  | 98-0468420                           |
| (State or other jurisdiction<br>of incorporation) | (IRS Employer<br>Identification No.) |

**9530 Main Street, Clarence, New York 14031**

(Address of principal executive offices)

**(716) 270-1523**

*(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 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  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.

Large Accelerated Filer  Accelerated Filer

Non-accelerated Filer  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

As of October 31, 2012, there were 31,598,979 shares of common stock issued and outstanding.



**22nd CENTURY GROUP, INC.**

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**Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****22nd CENTURY GROUP INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****September 30, 2012 with Comparative Figures at December 31, 2011**

|  | September 30,<br>2012<br>(unaudited) | December 31,<br>2011 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>                                  |                                      |                      |
| Current assets:                                |                                      |                      |
| Cash   | \$ 5,941                             | \$ 252,249           |
| Due from related party                         | 23,969                               | 15,491               |
| Due from officers                              | -                                    | 7,714                |
| Inventory                                      | 1,154,190                            | 678,123              |
| Prepaid expenses                               | 26,342                               | 17,675               |
| Total current assets                           | 1,210,442                            | 971,252              |
| Other assets:                                  |                                      |                      |
| Patent and trademark costs, net                | 1,366,184                            | 1,387,104            |
| Office furniture and fixtures, net             | 6,488                                | 7,862                |
| Deferred private placement costs               | 46,875                               | -                    |
| Deferred debt issuance costs, net              | 8,464                                | 22,405               |
| Total other assets                             | 1,428,011                            | 1,417,371            |
| Total assets                                   | \$ 2,638,453                         | \$ 2,388,623         |
| <b>LIABILITIES AND SHAREHOLDERS' DEFICIT</b>   |                                      |                      |
| Current liabilities:                           |                                      |                      |
| Demand bank loans                              | \$ 174,925                           | \$ 174,925           |
| Accounts payable                               | 1,308,138                            | 1,064,892            |
| Accrued interest payable to related parties    | 3,719                                | 21,502               |
| Accrued expenses                               | 554,412                              | 545,578              |
| Due to officers                                | 50,206                               | -                    |
| Notes payable                                  | 623,000                              | 425,000              |
| Convertible notes, net of unamortized discount | 1,551,054                            | 641,886              |
| Total current liabilities                      | 4,265,454                            | 2,873,783            |

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|  |              |              |
|--|--------------|--------------|
| Long term portion of notes payable                         | -            | 177,000      |
| Convertible notes, net of unamortized discount             | 77,720       | -            |
| Warrant liability  | 653,933      | 550,000      |
| Total liabilities  | 4,997,107    | 3,600,783    |
| Commitments and contingencies (Note 10)                    | -            | -            |
| Shareholders' deficit                                      |              |              |
| Capital stock authorized:                                  |              |              |
| 10,000,000 preferred shares, \$.00001 par value            |              |              |
| 300,000,000 common shares, \$.00001 par value              |              |              |
| Capital stock issued and outstanding:                      |              |              |
| 0 preferred shares   | -            | -            |
| 31,048,979 common shares (27,209,646 at December 31, 2011) | 312          | 273          |
| Capital in excess of par value                             | 7,112,246    | 5,822,882    |
| Accumulated deficit  | (9,471,212 ) | (7,041,297 ) |
| Non-controlling interest - consolidated subsidiary         | -            | 5,982        |
| Total shareholders' deficit                                | (2,358,654 ) | (1,212,160 ) |
| Total liabilities and shareholders' deficit                | \$ 2,638,453 | \$ 2,388,623 |

See accompany notes to consolidated financial statements.

**22nd CENTURY GROUP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****Three Months Ended September 30, 2012 and 2011****(unaudited)**

|   | September 30, 2012 |   | September 30, 2011 |   |
|---|--------------------|---|--------------------|---|
| Revenue   | \$ 15,683          |   | \$ 529,370         |   |
| Other income - therapeutic grant                                | -                  |   | 80,000             |   |
| Total revenue   | 15,683             |   | 609,370            |   |
| Operating expenses:   |                    |   |                    |   |
| Costs of goods sold   | 60,852             |   | 130,495            |   |
| Research and development  | 155,318            |   | 711,996            |   |
| General and administrative                                      | 370,240            |   | 451,087            |   |
| Sales and marketing costs                                       | 11,363             |   | 37,106             |   |
| Amortization and depreciation                                   | 50,458             |   | 44,630             |   |
|   | 648,231            |   | 1,375,314          |   |
| Operating loss  | (632,548           | ) | (765,944           | ) |
| Other income (expense)  |                    |   |                    |   |
| Warrant liability change - net                                  | 535,017            |   | 337,500            |   |
| Interest expense and amortization of debt discount and expense: |                    |   |                    |   |
| Related parties   | (55,793            | ) | (9,401             | ) |
| Other   | (295,601           | ) | (12,526            | ) |
|   | 183,623            |   | 315,573            |   |
| Net loss  | (448,925           | ) | (450,371           | ) |
| Net income attributable to non-controlling interest             | -                  |   | (14,711            | ) |
| Net loss attributed to common shareholders                      | \$ (448,925        | ) | \$ (465,082        | ) |
| Loss per common share - basic and diluted                       | \$ (0.01           | ) | \$ (0.02           | ) |
| Common shares used in basic earnings per share calculation      | 31,048,979         |   | 27,209,646         |   |

See accompany notes to consolidated financial statements.



**22nd CENTURY GROUP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****Nine Months Ended September 30, 2012 and 2011****(unaudited)**

|   | September 30, 2012 |   | September 30, 2011 |   |
|---|--------------------|---|--------------------|---|
| Revenue   | \$ 15,683          |   | \$ 801,636         |   |
| Other income - therapeutic grant                                | -                  |   | 223,540            |   |
| Total revenue   | 15,683             |   | 1,025,176          |   |
| Operating expenses:   |                    |   |                    |   |
| Costs of goods sold   | 60,852             |   | 224,146            |   |
| Research and development  | 484,316            |   | 1,509,050          |   |
| General and administrative                                      | 1,732,162          |   | 1,381,480          |   |
| Sales and marketing costs                                       | 46,045             |   | 267,810            |   |
| Amortization and depreciation                                   | 146,374            |   | 132,432            |   |
|   | 2,469,749          |   | 3,514,918          |   |
| Operating loss  | (2,454,066         | ) | (2,489,742         | ) |
| Other income (expense)  |                    |   |                    |   |
| Warrant liability change - net                                  | 1,167,416          |   | 337,500            |   |
| Interest expense and amortization of debt discount and expense: |                    |   |                    |   |
| Related parties   | (194,074           | ) | (28,177            | ) |
| Other   | (950,647           | ) | (24,939            | ) |
|   | 22,695             |   | 284,384            |   |
| Net loss  | (2,431,371         | ) | (2,205,358         | ) |
| Net loss (income) attributable to non-controlling interest      | 1,456              |   | (13,004            | ) |
| Net loss attributed to common shareholders                      | \$ (2,429,915      | ) | \$ (2,218,362      | ) |
| Loss per common share - basic and diluted                       | \$ (0.08           | ) | \$ (0.08           | ) |
| Common shares used in basic earnings per share calculation      | 29,477,387         |   | 26,263,743         |   |

See accompany notes to consolidated financial statements.



**22nd CENTURY GROUP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****Nine Months Ended September 30, 2012 and 2011****(unaudited)**

|   | September 30, 2012 | September 30, 2011 |
|---|--------------------|--------------------|
| Cash flows from operating activities:                                   |                    |                    |
| Net loss  | \$ (2,431,371      | ) \$ (2,205,358    |
| Adjustments to reconcile net loss to cash used by operating activities: |                    |                    |
| Amortization and depreciation   | 146,374            | 132,432            |
| Amortization of debt issuance costs                                     | 18,954             | -                  |
| Amortization of debt discount   | 1,053,987          | 3,999              |
| Interest due to debt conversion   | 31,350             | -                  |
| Gain warrant liability - derivative                                     | (1,167,416         | ) (337,500         |
| Equity based employee compensation expense                              | 776,441            | 327,458            |
| Equity based payments for outside services                              | 116,940            | -                  |
| (Increase) decrease in assets:  |                    |                    |
| Accounts receivable   | -                  | (86,682            |
| Grant receivable  | -                  | 223,540            |
| Inventory   | (476,067           | ) (524,734         |
| Prepaid expenses  | 162,579            | 129,294            |
| Deposits  | -                  | 1,535              |
| Increase (decrease) in liabilities:                                     |                    |                    |
| Accounts payable  | 473,920            | (65,811            |
| Accrued interest payable to related parties                             | (17,783            | ) (163,101         |
| Accrued expenses  | 8,842              | 314,722            |
| Deferred revenue  | -                  | (223,540           |
| Net cash used by operating activities                                   | (1,303,248         | ) (2,473,746       |
| Cash flows from investing activities:                                   |                    |                    |
| Acquisition of patents and trademarks                                   | -                  | (570,641           |
| Acquisition of office furniture and fixtures                            | -                  | (9,106             |
| Net cash used by investing activities                                   | -                  | (579,747           |
| Cash flows from financing activities:                                   |                    |                    |
| Proceeds from issuance of notes   | 56,000             | 215,000            |
| Payments on borrowings - notes payable                                  | (35,000            | ) (458,275         |
| Net proceeds from January 25, 2011 private placement                    | -                  | 3,293,888          |
| Net proceeds from May 2012 private placement                            | 786,500            | -                  |
| Proceeds from issuance of convertible notes                             | 210,000            | -                  |
| Deferred private placement costs  | (10,000            | ) -                |
| Net payments to related party   | (8,478             | ) (21,272          |

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|  |            |              |
|--|------------|--------------|
| Net advances from officers   | 57,920     | 28,217       |
| Net cash provided by financing activities  | 1,056,942  | 3,057,558    |
| Net (decrease) increase in cash  | (246,308   | ) 4,065      |
| Cash - beginning of period   | 252,249    | 310          |
| Cash - end of period   | \$ 5,941   | \$ 4,375     |
| Cash paid during the period for interest   | \$ 13,529  | \$ 191,524   |
| Cash paid during the period for income taxes   | \$ -       | \$ -         |
| Supplemental disclosure of noncash investing and financing activities:   |            |              |
| Reduction of accounts payable not related to operating activities:   |            |              |
| Common stock issued as payment of accounts payable   | \$ 359,754 | \$ -         |
| Common stock issued as payment of deferred private placement costs   | 36,875     | -            |
| Payment of accounts payable for patent costs   | -          | 500,000      |
| Payment of accounts payable for deferred private placement costs   | -          | 526,127      |
| Accounts payable converted to promissory notes   | -          | 587,000      |
|  | \$ 396,629 | \$ 1,613,127 |
| Common stock issued for prepaid services   | \$ 171,246 | \$ -         |
| Non controlling interest acquired for common stock   | \$ 4,526   | \$ -         |
| Deferred private placement costs charged to contributed capital  | \$ -       | \$ 587,133   |
| Notes payable converted to common shares   | \$ 120,750 | \$ -         |
| Conversion of shareholder note and accrued interest to common shares and warrants  | \$ -       | \$ 614,070   |
| Original issue discount on convertible debt  | \$ 12,600  | \$ -         |
| Beneficial conversion value upon issuance of convertible debt recoded as debt discount and an increase in capital in excess of par value | \$ 63,600  | \$ -         |
| Issuance of warrants as derivative liability instruments upon conversion of note payable   | \$ 152,100 | \$ -         |
| Issuance of warrants as derivative liability instruments   | \$ 92,750  | \$ 3,061,750 |
| Patent and trademark additions included in accounts payable  | \$ 124,080 | \$ -         |
| Deferred debt issuance costs included in accounts payable  | \$ 5,000   | \$ -         |

See accompanying notes to consolidated financial statements.

**22nd CENTURY GROUP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF SHAREHOLDERS' DEFICIT****Nine Months Ended September 30, 2012****(unaudited)**

|  | Common<br>Shares<br>Outstanding | Par value<br>of Common<br>Shares | Contributed<br>Capital | Accumulated<br>Deficit | Non-<br>controlling<br>Interest | Shareholders'<br>Deficit |
|--|---------------------------------|----------------------------------|------------------------|------------------------|---------------------------------|--------------------------|
| Balance at December 31, 2011                                       | 27,209,646                      | \$ 273                           | \$5,822,882            | \$(7,041,297 )         | \$ 5,982                        | \$(1,212,160 )           |
| Stock based compensation under<br>Equity Incentive Plan            | 700,000                         | 7                                | 690,968                | -                      | -                               | 690,975                  |
| Common stock issued as payment<br>of services and accounts payable | 1,267,500                       | 13                               | 534,815                | -                      | -                               | 534,828                  |
| Common stock issued upon<br>exercise of Convertible Notes          | 161,000                         | 2                                | (2 )                   | -                      | -                               | -                        |
| Common stock issued in May 2012<br>private placement               | 1,710,833                       | 17                               | (17 )                  | -                      | (4,526 )                        | (4,526 )                 |
| Beneficial conversion feature of<br>convertible debt               | -                               | -                                | 63,600                 | -                      | -                               | 63,600                   |
| Net loss   | -                               | -                                | -                      | (2,429,915 )           | (1,456 )                        | (2,431,371 )             |
| Balance at September 30, 2012                                      | 31,048,979                      | \$ 312                           | \$7,112,246            | \$(9,471,212 )         | \$ -                            | \$(2,358,654 )           |

See accompanying notes to consolidated financial statements.

**22nd CENTURY GROUP, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012**

**NOTE 1. - NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Introduction** - These unaudited consolidated financial statements of 22nd Century Group, Inc. (“22nd Century Group”) and its direct and indirect subsidiaries (collectively with 22nd Century Group, the “Company”) incorporate and reflect the reverse acquisition of 22nd Century Limited, LLC by 22nd Century Group as described below.

On January 25, 2011, 22nd Century Limited, LLC (“22nd Century Ltd”) completed a reverse merger transaction (the “Merger”) with 22nd Century Group (formerly Touchstone Mining Limited). As a result, 22nd Century Ltd became a wholly owned subsidiary of 22nd Century Group which continues to operate the business of 22nd Century Ltd. In connection with the Merger, 22nd Century Group issued 21,434,446 shares of its common stock to the holders of limited liability company membership interests of 22nd Century Ltd, whose share amount represented 80.1% of the outstanding shares immediately following the Merger. All references contained herein to shareholders or common shares include the historical members and limited liability company membership interests of 22nd Century Ltd because, in the Merger, limited liability company membership interests were exchanged for common shares on a one-for-one basis and from an accounting standpoint they are equivalent.

The Merger is being accounted for as a reverse acquisition and a recapitalization; 22nd Century Ltd is the acquirer for accounting purposes. Consequently, the assets and liabilities and the historical operations that are reflected in the financial statements set forth herein for periods prior to the Merger are those of 22nd Century Ltd and are recorded at the historical cost basis of 22nd Century Ltd, and the consolidated financial statements set forth herein for periods beginning on and following completion of the Merger include the assets and liabilities of 22nd Century Ltd, historical operations of 22nd Century Ltd, and operations of 22nd Century Group from the closing date of the Merger.

Upon the closing of the Merger, 22nd Century Group transferred all of its operating assets and liabilities to Touchstone Split Corp. and split-off Touchstone Split Corp. through the sale of all of the outstanding capital stock of Touchstone Split Corp. (the “Split-Off”). After the completion of the Merger and Split Off, 22nd Century Group’s consolidated financial statements include only the assets and liabilities of 22nd Century Ltd.

Immediately prior to the Merger on January 25, 2011, 22nd Century Ltd completed a private placement offering (the “Private Placement”) of 5,434,446 securities (the “PPO Securities”) at the purchase price of \$1.00 per Unit, each such Unit consisting of one (1) limited liability company membership interest of 22nd Century Ltd and a five-year warrant to purchase one-half of one (1/2) limited liability company membership interest of 22nd Century Ltd at an exercise price

of \$1.50 per whole common share. In connection with the Private Placement, 22nd Century Ltd approved a prorata distribution of 5,016,722 five-year warrants to purchase one limited liability company membership interest at an exercise price of \$3.00. These warrants were valued at \$1,550,000 and classified as liabilities resulting in a decrease to contributed capital. Private Placement proceeds included \$614,070 from the conversion of 22nd Century Ltd indebtedness into PPO Securities and \$395,376 from the conversion of placement agent fees into PPO Securities, resulting in gross cash proceeds of \$4,425,000. Private Placement expenses incurred included cash expenses of approximately \$1,025,000 and non-cash expenses consisting of the placement agent fees of \$395,376 which were converted into PPO Securities and \$390,000 for the estimated fair value of 934,755 placement agent and advisor warrants issued to the placement agent. An additional \$167,820 of cost was incurred in the second and third quarters of 2011 in connection with the registration process for the common stock issued in the Private Placement. 22nd Century Ltd/Group received net cash proceeds of approximately \$3.2 million from the Private Placement and a reduction of debt and accrued interest obligations to shareholders that were on the balance sheet at December 31, 2010 of approximately \$614,000, which was exchanged for equity interests in the offering. A portion of the proceeds, amounting to \$1,511,750, was allocated to the warrants issued and classified as derivative liabilities.

***Basis of Presentation*** - The accompanying unaudited statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair and non-misleading presentation of the financial statements have been included.

The results of operations for any interim period are not necessarily indicative of results for the full year. Operating results for the nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

**Nature of Business** - 22nd Century Ltd, 22nd Century Group’s wholly-owned subsidiary, is a plant biotechnology company specializing in technology that allows for the level of nicotine and other nicotinic alkaloids (e.g., nornicotine, anatabine and anabasine) in tobacco plants to be decreased or increased through genetic engineering and plant breeding. The Company owns or exclusively controls 105 issued patents in 78 countries plus an additional 38 pending patent applications. Hercules Pharmaceuticals, LLC (“Hercules Pharmaceuticals”) and Goodrich Tobacco Company, LLC (“Goodrich Tobacco”) are subsidiaries of 22nd Century Ltd and are business units for the Company’s (i) smoking cessation product and (ii) premium cigarettes and potential modified risk tobacco products, respectively.

**Principles of Consolidation** - The accompanying consolidated financial statements include the accounts of 22nd Century Group, its wholly owned subsidiary, 22nd Century Ltd, and 22nd Century Ltd’s wholly owned subsidiaries, Hercules Pharmaceuticals and Goodrich Tobacco. In May 2012, 22nd Century Ltd acquired from an employee the non-controlling membership units of Goodrich Tobacco that it did not own so that Goodrich Tobacco became a wholly owned subsidiary. All intercompany accounts and transactions have been eliminated.

**Reclassifications** - Certain items in the 2011 financial statements have been reclassified to conform to the 2012 classification.

**Preferred stock authorized** - the authorization is for “blank check” preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to our common stock.

**Inventory** - Inventories are valued at the lower of cost or market. Cost is determined on the first-in, first-out (FIFO) method. Inventories are evaluated to determine whether any amounts are not recoverable based on slow moving or obsolete condition and are written off or reserved as appropriate. The Company’s inventory consisted of the following categories:

|                           | September 30,<br>2012 | December 31,<br>2011 |
|---------------------------|-----------------------|----------------------|
| Materials, mainly tobacco | \$ 1,154,190          | \$ 678,123           |
| Finished goods            | -                     | -                    |
| Total                     | \$ 1,154,190          | \$ 678,123           |

**Intangible Assets** - Intangible assets are recorded at cost and consist primarily of expenditures incurred with third parties related to the processing of patent claims and trademarks with government authorities. The Company also capitalized costs as a result of one of its exclusively licensed patent applications being subject to an interference proceeding invoked by the U.S. Patent and Trademark Office, which favorably resulted in the Company obtaining

rights to a third party's issued patent. The amounts capitalized relate to patents the Company owns or to which it has exclusive rights and its trademarks, and exclude approximately \$1.8 million recovered from a former licensee as direct reimbursements of costs incurred. These capitalized costs are amortized using the straight-line method over the remaining statutory life of the Company's primary patent family, which expires in 2019 (the assets' estimated lives). Periodic maintenance or renewal fees, which are generally due on an annual basis, are expensed as incurred. Annual minimum license fees are charged to expense in the year the licenses are effective. Total patent and trademark costs capitalized and accumulated amortization amounted to \$2,187,892 and \$821,708, respectively, as of September 30, 2012 (\$2,063,812 and \$676,708, respectively, as of December 31, 2011). The estimated annual amortization expense for the next five years is approximately \$203,000.

***Impairment of Long-Lived Assets*** - The Company reviews the carrying value of its amortizing long-lived assets whenever events or changes in circumstances indicate that the historical cost-carrying value of an asset may no longer be recoverable.

The Company assesses recoverability of the asset by estimating the future undiscounted net cash flows expected to result from the asset, including eventual disposition. If the estimated future undiscounted net cash flows are less than the carrying value of the asset, an impairment loss is recorded equal to the difference between the asset's carrying value and its fair value. There was no impairment loss recorded during the nine months ended September 30, 2012 or 2011.

***Deferred Debt Issuance Costs*** - The Company incurred costs related to a private placement of convertible notes that closed on December 16, 2011 ("Convertible Notes"). These costs were recorded in the balance sheet as a deferred charge and are being amortized over the one-year term of the Convertible Notes. The unamortized balance at September 30, 2012 is \$8,464 (\$22,405 as of December 31, 2011), which is expected to be fully amortized in the fourth quarter of 2012. Amortization expense for the three and nine months ended September 30, 2012 amounted to \$5,859 and \$18,954, respectively.

**Income Taxes** - Prior to the Merger, the Company was treated as a partnership for federal and state income tax purposes. As a result, there was no entity level income tax for periods prior to the Merger because all taxable income tax deductions and tax credits were passed through to the members of the Company. Following the Merger on January 25, 2011, the Company is treated as a corporation, subject to federal and state income taxes. Accordingly, as of the Merger date the Company is required to recognize deferred tax assets and liabilities for any basis differences in its assets and liabilities between tax and GAAP reporting, and for operating loss and credit carryforwards.

In light of the Company's history of cumulative losses management has determined that it is more likely than not that its net deferred tax asset will not be realized. Accordingly the Company established a valuation allowance to fully offset its net deferred tax asset as of September 30, 2012 and December 31, 2011.

The Company's federal and state tax returns for the years ended December 31, 2010 to December 31, 2011, including the pre-Merger short period from January 1, 2011 through January 25, 2011, are currently open to audit under the statutes of limitations. There are no pending audits as of September 30, 2012.

**Stock Based Compensation** - The Company uses a fair-value based method to determine compensation for all arrangements under which Company employees and others receive shares, options or warrants to purchase common shares of 22nd Century Group. Stock based compensation expense is recorded over the requisite service period based on estimates of probability and time of achieving milestones and vesting. For accounting purposes, the shares will be considered issued and outstanding upon vesting.

**Debt Discounts** - Original issue discount ("OID") is recorded equal to the difference between the cash proceeds, after allocation to warrants issued or issuable upon payment of the debt, and the face value of the debt when issued and amortized as interest expense during the term of the debt.

When the convertible feature of the conventional convertible debt is issued, the embedded conversion feature is evaluated to determine if bifurcation and derivative treatment is required and whether there is a beneficial conversion feature. When the convertible debt provides for an effective rate of conversion that is below market value, this feature is characterized as a beneficial conversion feature ("BCF"). Prior to the determination of the BCF, the proceeds from the debt instrument were first allocated between the convertible debt and any embedded or detachable free standing instruments that are included, such as common stock warrants. The proceeds allocated to any warrants are recorded as a debt discount.

For the Convertible Notes, bifurcation of the embedded conversion feature was not required and the Company recorded the OID and the BCF related to these Convertible Notes as a debt discount and recorded the Convertible Notes net of the discount related to both the OID and the BCF. Debt discount is amortized to interest expense over the

life of the debt. In the case of any conversion prior to the maturity date there will be an unamortized amount of debt discount that relates to such conversion. The prorata amount of unamortized discount at the time of such conversion is charged to interest expense as accelerated amortization of the discount. The fair value of warrants issued at the time of conversion is recorded as a reduction of the amount applied to the common stock issued in the conversion and to the extent that the fair value of warrants exceeds the carrying value of the debt a charge to interest expense results for such excess amount.

**Other income - therapeutic grant** - In 2010, 22nd Century Ltd received approval of a government grant as partial support for its clinical trial for the U.S. Food and Drug Administration (“FDA”). All costs associated with this grant were charged to research and development expense and the grant income was fully recognized in 2011. During the three and nine month periods ending September 30, 2011 \$80,000 and \$223,540, respectively, was recognized into income and included in other income on the statement of operations.

**Revenue Recognition** - The Company recognizes revenue at the point the product is shipped to a customer and title has transferred. Revenue from the sale of the Company’s products is recognized net of cash discounts, sales returns and allowances. Cigarette federal excise taxes are included in net sales and accounts receivable billed to customers, except on sales of *SPECTRUM* research cigarettes and exported cigarettes in which such taxes do not apply.

The Company was chosen to be a subcontractor for a 5-year government contract between RTI International (“RTI”) and the National Institute on Drug Abuse (“NIDA”) to supply NIDA research cigarettes which includes four development stages. These government research cigarettes are distributed under the Company’s mark *SPECTRUM*. The Company completed the four developmental stages and delivered approximately 9 million *SPECTRUM* research cigarettes during the year ended December 31, 2011 and recognized the related revenue (\$529,370 and \$801,636 in the three and nine month periods ending September 30, 2011, respectively). The Company has delivered an additional 2.7 million *SPECTRUM* research cigarettes in July 2012 and recognized the related revenue (\$15,683 in the three and nine month periods ending September 30, 2012). Future revenue under this sub-contract arrangement is expected to be related to the delivery of *SPECTRUM* and will be recognized at the point the product is shipped and title has transferred.

***Derivatives*** - We do not use derivative instruments to hedge exposures to cash flow, market or foreign currency risks. We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair market value and then is revalued at each reporting date, with changes in fair value reported in the consolidated statement of operations. The methodology for valuing our outstanding warrants classified as derivative instruments utilizes a lattice model approach which includes probability weighted estimates of future events including volatility of our common stock. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within twelve months of the balance sheet date.

***Research and Development*** - Research and development costs are expensed as incurred.

***Loss Per Common Share*** - Basic loss per common share is computed using the weighted-average number of common shares outstanding. Diluted loss per share is computed assuming conversion of all potentially dilutive securities. Potential common shares outstanding are excluded from the computation if their effect is anti-dilutive.

***Commitment and Contingency Accounting*** - The Company evaluates each commitment and/or contingency in accordance with the accounting standards, which state that if the item is more likely than not to become a direct liability, then the Company will record the liability in the financial statements. If not, the Company will disclose any material commitments or contingencies that may arise.

***Use of Estimates*** - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ

from those estimates.

***Fair Value of Financial Instruments***- Financial instruments include cash, receivables, accounts payable, accrued expenses, notes payable, convertible notes payable and warrant liability. Fair value for everything except for the warrant liability is assumed to approximate carrying values for these financial instruments, since they are short term in nature or they are receivable or payable on demand. The determination of the fair value of the warrant liability is disclosed in Note 9.

***Recent Accounting Pronouncements*** - In May 2011, the FASB issued Accounting Standards Update No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRS. ASU 2011-04 is required to be applied prospectively in interim and annual periods beginning after December 15, 2011. Early application was not permitted. The adoption of ASU 2011 did not have a material impact on the consolidated financial statements.

## **NOTE 2. - LIQUIDITY AND MANAGEMENT'S PLANS**

Since 2006, 22nd Century Ltd has incurred substantial operating losses as it transitioned from being solely a licensor of its proprietary technology and tobaccos to commercializing its own tobacco products. At September 30, 2012, the Company had current assets of \$1,210,442 and current liabilities of \$4,265,454. Cash on hand at September 30, 2012 of \$5,941 is insufficient to sustain operations and pay outstanding current liabilities as they become due. The Company has suspended clinical trials for X-22 in order to reduce expenditures and is seeking licensing agreements for its products with both domestic and international businesses. The Company's Board of Directors authorized management to seek additional financing involving equity securities which will be dilutive to 22nd Century Group's existing shareholders' respective ownership percentages.

The Company continues to explore an alternative manufacturer while exploring distribution channels for its proprietary cigarettes, *RED SUN* and *MAGIC*, through its subsidiary, Goodrich Tobacco. Until certain benchmarks are achieved, the Company is currently not taking orders for these products for the U.S. market.

The Company's ability to fund operations and meet its obligations during 2012 will be dependent upon obtaining additional equity financing and signing one or more significant licensing arrangements for its products. There can be no assurance that the Company will be able to raise sufficient equity financing or obtain a significant licensing contract.

### **NOTE 3. - MAY 2012 PRIVATE PLACEMENT**

On May 15, 2012 the Company issued 1,710,833 shares of its common stock and warrants to purchase up to 1,710,833 shares of its common stock for total consideration of \$1,026,500 consisting of: \$786,500 in cash, cancellation by a vendor of \$150,000 in accounts payable and the exchange by an employee of his 4% minority interest in Goodrich Tobacco for stock and warrants valued at \$90,000 in the offering. The warrants issued have an exercise price of \$1.00 per share, a five year term and a "down round provision" so they will be classified as derivatives for accounting purposes, which (similarly to the January 25, 2011 Warrants) means they are reported as a liability and marked to market at each balance sheet date. At the date of issuance of these warrants the value was estimated to be \$1,841,000 which exceeded the total consideration received in the offering by \$814,500 resulting in an immediate charge to other income and expense - warrant liability - net for this amount. This private placement constituted a "down round" for purposes of all previously issued warrants and the December 16, 2011 convertible notes and resulted in adjustments to the exercise price, conversion price and the number of shares issuable upon exercise or conversion of these previously issued securities.

### **NOTE 4. - AMOUNTS OWED NORTH CAROLINA STATE UNIVERSITY ("NCSU")**

Pursuant to the terms of an exclusive license agreement with NCSU, the Company owes NCSU approximately \$865,000 as of September 30, 2012 for patent costs and license fees (as compared to \$753,000 owed as of December 31, 2011). These amounts are included in accounts payable and accrued liabilities in the consolidated balance sheets. The Company was required to pay these amounts within thirty days of being invoiced and they are past due. NCSU has the right to claim interest on the balance. Management periodically communicates its plans for commercialization of products using the technology licensed from NCSU and believes its relations with NCSU are sound. In order to facilitate the Company's plans to raise capital and commercialize its products NCSU agreed, in a letter dated November 22, 2011, not to invoke its rights to terminate for non-payment or non-performance that it may have under the agreement until October 15, 2012. Currently, NCSU may have the right to terminate the exclusive license agreement, but can only do so with a 60-day prior written notice, including the opportunity to cure within this timeframe. As of September 30, 2012, patent costs associated with the exclusive license agreements that could potentially be terminated had a carrying value of approximately \$700,000. Additionally, NCSU has not imposed

interest charges on past due amounts invoiced to the Company and as such the Company has not recorded accrued interest or interest expense.

#### NOTE 5. - DEMAND BANK LOAN

The demand loan that is among the Company's short term liabilities is payable to a commercial bank under a revolving credit agreement and is guaranteed by a shareholder of the Company. This loan had a balance of \$174,925 at September 30, 2012 and December 31, 2011. The Company is required to pay interest monthly at an annual rate of 0.75% above the prime rate, or 4.00% at September 30, 2012 and December 31, 2011. The Company is current in meeting this interest payment obligation. The terms of the demand loan includes an annual "clean-up" provision, which requires the Company to repay all principal amounts outstanding for a period of 30 consecutive days every year. The Company has not complied with this requirement; however, the bank has not demanded payment. The bank has a lien on all the Company's assets.

#### NOTE 6. - NOTES PAYABLE

Notes payable consisted of the following as of the dates set forth below:

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| Notes date September 15 and October 15, 2009 | \$ -                  | \$ 25,000            |
| Convertible Note dated March 31, 2011        | 77,000                | 87,000               |
| Note dated January 25, 2011                  | 140,000               | 140,000              |
| Note dated March 30, 2011                    | 350,000               | 350,000              |
| Note dated March 22, 2012 and April 13, 2012 | 50,000                | -                    |
| Note dated June 20, 2012                     | 6,000                 | -                    |
|  | 623,000               | 602,000              |
| Less long term portion of notes payable      | -                     | (177,000 )           |
| Notes Payable (shown in current liabilities) | \$ 623,000            | \$ 425,000           |

**Notes Dated September 15 and October 15, 2009 (unsecured)** - On September 15, 2009 and October 15, 2009, the Company issued two notes payable to the same third party in the amounts of \$15,000 and \$10,000, respectively. The notes were fully paid in June 2012 together with accrued interest at 10% since issuance.

**Note Dated January 25, 2011(unsecured)** - On January 25, 2011, the Company issued a note for \$140,000 to a shareholder as satisfaction of the balance due for principal and interest on matured notes that were not paid in cash or converted to common stock of 22nd Century Group and warrants to purchase shares of common stock of 22nd Century Group. The note bears interest at 12% and is due on July 1, 2013 together with accrued interest. As of September 30, 2012 and December 31, 2011, the outstanding principal amount of this note is \$140,000.

**Convertible Note Dated March 31, 2011(unsecured)** - On March 31, 2011, the Company issued a note to a vendor in the original amount of \$237,000 as satisfaction of past due invoices previously recorded by the Company in accounts payable. The note bears interest at an annual rate of 9%. In December 2011 the note was amended and the principal was reduced by a cash payment of \$50,000 and \$100,000 of the note was exchanged for \$115,000 of a portion of the Convertible Notes issued December 16, 2011 so that the remaining principal balance under the note is \$87,000 as of December 31, 2011. The note amendment also provided for principal payments together with accrued interest to be due as follows: \$50,000 on May 1, 2012 and \$37,000 on January 1, 2013, the maturity date. The Company made only \$10,000 of the May 1, 2012 principal installment, leaving a remaining balance of \$77,000 as of September 30, 2012, and the note is callable by the holder because of this payment default. The note is convertible into common stock of the Company at the option of the holder. The conversion rate will be determined at the time of conversion based on the average of the closing price of the Company's common stock on the day of and day after the conversion date.

**Note Dated March 30, 2011(unsecured)** - On March 30, 2011, the Company issued a note to a vendor in the amount of \$350,000 as satisfaction of past due invoices previously recorded by the Company in accounts payable. The note bears interest at an annual rate of 4%. Principal and accrued interest, which were due on July 1, 2012 have not been paid. As of September 30, 2012 and December 31, 2011, the outstanding principal on this note is \$350,000.

**Notes Dated March 22, 2012 and April 13, 2012(secured)** - On March 22, 2012 and April 13, 2012, the Company issued two notes in the amount of \$25,000 each. The notes bear interest at an annual rate of 15%. Principal and accrued interest were due on October 1, 2012 and have not been paid. As of September 30, 2012, the outstanding principal on these notes is \$50,000. The notes are secured by all assets of the Company and its subsidiaries. An officer of the Company is the managing member of the lender.

**Note Dated June 20, 2012 (unsecured)** - On June 20, 2012, the Company issued a note in the amount of \$6,000 to an officer of the Company. The note bears interest at an annual rate of 15%. Principal and accrued interest were due on October 1, 2012 and have not been paid. As of September 30, 2012, the outstanding principal on this note is \$6,000.

**NOTE 7. - CONVERTIBLE NOTES**

*ISSUED DECEMBER 16, 2011*

The Company issued Convertible Notes on December 16, 2011 in a negotiated sale with 24 investors in the total face amount of \$1,926,250. The Convertible Notes were sold for \$1,675,000 - an original issue discount (OID) of \$251,250. The Convertible Notes do not bear interest and the total face amount is due December 16, 2012. The Convertible Notes can be converted, at the option of each holder, in whole or in part, into shares of the Company's common stock at \$0.75 per share at which time the holder shall also receive warrants equal to 120% of the number of shares of Company common stock into which such Convertible Notes have been then converted. The Company can also force the investors to decide whether to convert by sending a 15-day written notice in which each investor is forced to decide whether to convert or get repaid. Such warrants will have a term of five years and an exercise price of \$1.50 per share of common stock. The Company will have the right to mandatorily require the conversion of the Convertible Notes in the event the Company engages in a subsequent financing transaction of at least \$5,000,000 in shares of Company's common stock with a sale price equal to or greater than \$0.80 per share or debt securities which are convertible into shares of Company common stock with a conversion price equal to or greater than \$0.80 per share of common stock. Also, in the event of a subsequent financing transaction of at least \$5,000,000, the note holders have "piggyback" registration rights of the common shares and warrants underlying the conversion of the Convertible Notes. The Convertible Notes contain "down round" provisions which provide for adjustments to the conversion price if the Company issues shares of common stock of 22nd Century Group at a price that is less than the exercise price. As a result of the May private placement the conversion price was reduced to \$0.7417 and another minor adjustment will result from the August 2012 convertible notes issued. The conversion feature was not considered to be a derivative because it does not have a net cash settlement provision as a result of the limited market and trading activity for the underlying stock. To the extent the Convertible Notes are converted, the warrants issued at conversion have a "down round provision" and will be classified as derivatives for accounting purposes, which (similarly to the January 25, 2011 Warrants) means they are reported as a liability and marked to market at each balance sheet date.

The Company's common stock closed at \$0.90 per share on December 16, 2011, which is greater than the portion of the conversion price under the Convertible Notes allocated to the underlying common shares. This difference is a beneficial conversion feature (BCF) which was valued at \$1,062,759 at the issue date and recorded as debt discount and additional paid in capital. This BCF is being amortized over the one year life of the Convertible Notes. During the three and nine month period ended September 30, 2012, \$308,011 and \$1,029,917, respectively, of the debt discount was amortized and recorded as interest expense related to the OID and BCF discounts, leaving \$254,446 of unamortized debt discount as of September 30, 2012 (\$1,284,363 as of December 31, 2011).

Three of the Company's officers at the time of issuance acquired a portion of the Convertible Notes - with a face value of \$368,000 for cash of \$105,000 and conversion of \$215,000 short term unsecured 12% notes issued by the Company earlier in 2011.

During the nine month period ended September 30, 2012 notes with a face amount of \$120,750 (carrying value at time of conversion of approximately \$68,000, net of unamortized discount) were converted into 161,000 shares of common stock and warrants to purchase 193,200 shares of common stock. As a result of the conversion, the unamortized portion of the debt discount amounting to approximately \$66,000 was immediately charged to interest and a derivative warrant liability valued at approximately \$152,000 was recorded. The difference in the warrant value and debt relieved amounting to approximately \$31,000 was also charged to interest expense. Included in note conversions during the nine months ended September 30, 2012 were a note converted by an officer with a face amount of \$86,250 converted into 115,000 shares of common stock and warrants to purchase 138,000 shares of common stock.

#### *ISSUED AUGUST 9, 2012*

The Company issued Convertible Notes on August 9, 2012 in a negotiated sale with 4 investors in the total face amount of \$222,600. The Convertible Notes were sold for \$210,000 - an original issue discount (OID) of \$12,600. The Convertible Notes do not bear interest and the total face amount is due August 9, 2013 together with warrants equal to 50% of the number of shares of Company common stock into which such Convertible Notes could have been converted. These warrants were valued at \$92,750 and represent additional debt discount and warrant liability. The Convertible Notes can be converted, at the option of each holder, in whole or in part, into shares of the Company's common stock at \$0.60 per share at which time the holder shall also receive warrants equal to 100% of the number of shares of Company common stock into which such Convertible Notes have been then converted. Additional warrants required as a result of conversion will be valued and recorded as a warrant liability at that time and will reduce the equity recorded as a result of the conversion. In the event the warrant value exceeds the amount of equity, an immediate charge to other expense will be recorded. The Company can also force the investors to decide whether to convert by sending a 15-day written notice in which each investor is forced to decide whether to convert or get paid off. The warrants issued upon conversion or maturity will have a term of five years and an exercise price of \$1.00 per share of common stock. The conversion feature was not considered to be a derivative because it does not have a net cash settlement provision as a result of the limited market and trading activity for the underlying stock. The warrants to be issued at conversion or maturity have a "down round provision" and will be classified as derivatives for accounting purposes, which (similarly to previously issued Warrants) means they are reported as a liability and marked to market

at each balance sheet date. (See Note 9)

The Company's common stock closed at \$0.45 per share on August 9, 2012, which is greater than the portion of the conversion price under the Convertible Notes allocated to the underlying common shares. This difference is a beneficial conversion feature (BCF) which was valued at \$63,600 at the issue date and recorded as debt discount and additional paid in capital. This BCF is being amortized over the one year life of the Convertible Notes.

During the three and nine month period ended September 30, 2012, \$24,070 of debt discount was amortized and recorded as interest expense related to the OID, warrant and BCF discounts, leaving \$144,880 of unamortized debt discount as of September 30, 2012.

The following table summarizes convertible notes and related discount.

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| Face value of Convertible Notes payable through maturity | \$ 2,028,100          | \$ 1,926,250         |
| Less unamortized original issue discount                 | (138,993 )            | (245,582 )           |
| Less unamortized discount related to BCF                 | (260,333 )            | (1,038,782 )         |
| Convertible Notes, net of unamortized debt discount      | \$ 1,628,774          | \$ 641,886           |
| Carrying value of December 16, 2011 notes                | \$ 1,551,054          | \$ 641,886           |
| Carrying value of August 9, 2012 notes                   | \$ 77,720             | \$ -                 |

#### **NOTE 8. - DUE FROM OR TO RELATED PARTY**

The Company has conducted transactions with a related party, Alternative Cigarettes, Inc. (“AC”). AC is entirely owned by certain shareholders of the Company, including the CEO. AC shares office space and employee services with the Company. During the year ended December 31, 2011 the Company acquired its *MAGIC* trademark from AC for a purchase price of \$22,500; other activity during the nine months ended September 30, 2012 and the year ended December 31, 2011 consisted mainly of repayments and advances. The net amount due from AC amounted to \$23,969 as of September 30, 2012 (\$15,491 as of December 31, 2011). No interest has been accrued or paid on the amount due from or to AC and there are no repayment terms.

As of September 30, 2012, the Company has a liability to certain officers in the amount of \$50,206 related to amounts they have paid on the Company’s behalf. These amounts do not bear interest and have no stated repayment terms.

#### **NOTE 9. - WARRANTS FOR COMMON STOCK**

In connection with the January 25, 2011 Private Placement and Merger, the Company issued five year warrants (“January 25, 2011 Warrants”) to purchase shares of common stock of 22nd Century Group. These warrants contain “down round” provisions which provide for adjustments to the exercise price if the Company issues common shares of stock of 22nd Century Group at a price that is less than the respective warrant exercise prices. This provision is a guarantee of value which requires that these warrants be classified as derivatives for accounting purposes which means they are reported as a liability and marked to market at each balance sheet date. As a result of partial conversion of the Convertible Notes and the May 2012 private placement, the “down round provision” of the January 25, 2011 Warrants was triggered and the adjusted warrants now outstanding are: 5,319,150 with an exercise price of \$2.82 per share and 3,777,905 with an exercise price of \$1.45 per share. The original amount of the warrant liability related to the 5,016,722 warrants was \$1,550,000 and was recorded as a reduction of equity on January 25, 2011; the original amount of the warrant liability related to the 3,651,978 warrants is \$1,511,750, and, because it was recorded

as a liability, the portion of proceeds from the Private Placement that was recorded as contributed capital was reduced accordingly. As of September 30, 2012 there are 3,777,905 with an exercise price of \$1.45 per share and 5,319,150 with an exercise price of \$2.82 per share outstanding.

As a result of the May 2012 Private Placement, 193,200 warrants issued upon partial conversion of the Convertible Notes now amount to 199,862 five year warrants with an exercise price of \$1.45 per share as a result of the “down round provisions”. All 199,862 of these warrants are outstanding as of September 30, 2012. As a result of the August 2012 convertible notes, another minor adjustment to those warrants will be required.

All 1,710,833 warrants to purchase common stock issued in the May 2012 private placement (\$1.00 per share five year term) are outstanding as of September 30, 2012. As a result of the August 2012 convertible notes issued, the exercise price of those warrants was reduced accordingly.

The convertible notes issued in August 2012 require the Company to issue at least 185,500 warrants (\$1.00 per share five year term) and resulted in a derivative liability upon issuance of the notes of approximately \$92,750.

The Company estimates the value of warrant liability at upon issuance of the warrants and at each balance sheet date using the binomial lattice model to allocate total enterprise value to the warrants and other securities in the Company’s capital structure. Volatility was estimated based on historical observed equity volatilities and implied (forward) or expected volatilities for a sample group of guideline companies and consideration of recent market trends. The following table is a roll-forward of the warrant liability:

|  |             |
|--|-------------|
| Fair value of warrant liability upon issuance - January 25, 2011   | \$3,061,750 |
| Gain as a result of change in fair value   | (2,511,750) |
| Fair value at December 31, 2011  | 550,000     |
| Fair value of warrant liability upon partial conversion of December 16, 2011 Notes                                     | 152,100     |
| Fair value of warrant liability upon issuance – May 15, 2012   | 1,841,000   |
| Fair value of warrant liability related to minimum warrants issuable upon maturity of August 9, 2012 convertible notes | 92,750      |
| Gain as a result of change in fair value   | (1,981,917) |
| Fair value at September 30, 2012   | \$653,933   |

The aggregate net gain on warrant liabilities for the three and nine month periods ended September 30, 2012 amounted to \$535,017 and \$1,981,917 and are included in other income and expense as “warrant liability-net” in the accompanying consolidated statement of operations. The amount for the nine month period ended September 30, 2012 has been offset by a charge to other expense as a result of warrant liabilities issued in connection with the May private placement (See Note 3) in excess of the proceeds raised in the amount of \$814,500.

ASC 820 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows.

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

Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument.

Level 3 inputs are unobservable inputs based on the Company’s own assumptions used to measure assets and liabilities at fair value.

A financial asset or liability’s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The warrant liability is measured at fair value using certain estimated factors such as volatility and probability which are classified within Level 3 of the valuation hierarchy. Significant unobservable inputs are used in the fair value measurement of the Company’s derivative warrant liabilities include volatility. Significant increases (decreases) in the volatility input would result in a significantly higher (lower) fair value measurement.

The following table summarizes the warrant activity since December 31, 2010:

|  | Number of Warrants |
|--|--------------------|
| Warrants outstanding at December 31, 2010                  | -                  |
| January 25, 2011 Warrants issued                           | 8,668,701          |
| Warrants exercised during 2011                             | -                  |
| Warrants outstanding at December 31, 2011                  | 8,668,701          |
| Warrants issued  | 1,904,033          |
| Additional warrants due to anti-dilution provisions        | 435,020            |
| Warrants exercised during 2012                             | -                  |
| Warrants outstanding and exercisable at September 30, 2012 | 11,007,754         |

**NOTE 10. - COMMITMENTS**

**License Agreements** - Under its exclusive license agreement with NCSU, the Company is required to pay minimum annual royalty payments, which are credited against running royalties on sales of licensed products. The annual minimum royalty for each of the calendar years 2012 and 2013 is \$75,000, and in 2014 the annual minimum royalty increases to \$200,000. The license agreement continues through the life of the last-to-expire patent, which is expected to be 2022. These minimum royalty payments are due each February following the end of the applicable calendar year and are reduced by any running royalties paid or payable for that year. The agreement also requires a milestone payment of \$150,000 upon FDA approval of a product that uses the NCSU licensed technology. The Company is also responsible for reimbursing NCSU for actual third-party patent costs incurred. These costs vary from year to year and the Company has certain rights to direct the activities that result in these costs. During the nine month period ended September 30, 2012, the costs incurred related to patent costs and patent maintenance amounted to \$55,853 (\$93,343 during the year ended December 31, 2011).

The Company has two other exclusive license agreements which require aggregate annual license fees of approximately \$65,000, which are credited against running royalties on sales of licensed products. Each license agreement continues through the life of the last-to-expire patent.

The Company entered into a three year lease for approximately 3,800 square feet of office space in Clarence, NY, which commenced September 1, 2011. Scheduled rent remaining as of September 30, 2012 is as follows:

|      |          |
|------|----------|
| 2012 | \$8,750  |
| 2013 | \$37,833 |
| 2014 | \$28,000 |

**NOTE 11. - EARNINGS PER COMMON SHARE**

The following table sets forth the computation of basic and diluted earnings per common share for the three month periods ended September 30, 2012 and 2011:

|  | September 30,<br>2012 | September 30,<br>2011 |
|--|-----------------------|-----------------------|
| Net loss attributed to common shareholders   | \$ (448,925 )         | \$ (465,082 )         |
| Denominator for basic earnings per share-weighted average shares outstanding                                 | 31,048,979            | 27,209,646            |
| Effect of dilutive securities:<br>Warrants, restricted stock and options outstanding                         | -                     | -                     |
| Denominator for diluted earnings per common share - weighted average shares adjusted for dilutive securities | 31,048,979            | 27,209,646            |
| Income (loss) per common share - basic   | \$ (0.01 )            | \$ (0.02 )            |
| Income (loss) per common share- diluted  | \$ (0.01 )            | \$ (0.02 )            |

The following table sets forth the computation of basic and diluted earnings per common share for the nine month periods ended September 30, 2012 and 2011:

|  | September 30,<br>2012 | September 30,<br>2011 |
|--|-----------------------|-----------------------|
| Net loss attributed to common shareholders   | \$ (2,429,915 )       | \$ (2,218,362 )       |
| Denominator for basic earnings per share-weighted average shares outstanding                                 | 29,477,387            | 26,263,743            |
| Effect of dilutive securities:<br>Warrants, restricted stock and options outstanding                         | -                     | -                     |
| Denominator for diluted earnings per common share - weighted average shares adjusted for dilutive securities | 29,477,387            | 26,263,743            |
| Loss per common share - basic  | \$ (0.08 )            | \$ (0.08 )            |
| Loss per common share- diluted   | \$ (0.08 )            | \$ (0.08 )            |

Securities outstanding that were excluded from the computation of earnings per share for the nine month periods because they would have been anti-dilutive are as follows:

|  | September 30,<br>2012 | September 30,<br>2011 |
|--|-----------------------|-----------------------|
| Warrants   | 11,007,754            | 8,651,978             |
| Convertible Debt Issued December 16, 2011 (number of shares including related warrants upon conversion of 2,888,800) | 5,296,133             | -                     |
| Convertible Debt Issued August 9, 2012 (number of shares including related warrants upon conversion of 371,000)      | 742,000               | -                     |
| Restricted Stock   | 550,000               | 700,000               |
| Convertible Note   | 290,566               | -                     |
| Options  | 450,000               | 35,000                |
|  | 18,336,453            | 9,386,978             |

**NOTE 12. - STOCK BASED COMPENSATION**

On October 21, 2010, the Company established the 2010 Equity Incentive Plan (“EIP”) for officers, employees, directors, consultants and advisors to the Company and its affiliates, consisting of 4,250,000 shares of common stock. The EIP has a term of ten years and is administered by our Board of Directors (“Board”) or a committee to be established by our Board (the “Administrator”), to determine the various types of incentive awards that may be granted to recipients under this plan and the number of shares of common stock to underlie each such award under the EIP. On June 30, 2011, the Company filed a Form S-8 registration statement with the SEC to register all of the shares of common stock of 22nd Century Group that it may issue under the EIP

For the three and nine months ended September 30, 2012, the Company recorded compensation expense related to awards under the EIP of \$31,241 and \$690,975, respectively (\$48,979 and \$327,458 for the three and nine months ended September 30, 2011, respectively), which included the award of 550,000 restricted shares that vested immediately and were valued at the closing price on the award date.

As of September 30, 2012, unrecognized compensation expense related to non-vested restricted shares and stock options amounted to \$131,563, which is expected to be substantially recognized during 2013. No expense was recorded for restricted stock grants with milestone vesting not considered probable, which had a fair value at grant date of \$51,000.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. No options were issued during the three months ended September 30, 2012.

A summary of all stock option activity since December 31, 2011 is as follows:

|                                  | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|----------------------|--|---|---------------------------------|
| Outstanding at December 31, 2011 | 35,000               | \$ 1.20                                  |   |                                 |
| Granted in 2012                  | 415,000              | \$ 0.69                                  |   |                                 |

|                                   |         |         |            |      |
|-----------------------------------|---------|---------|------------|------|
| Outstanding at September 30, 2012 | 450,000 | \$ 0.73 | 9.54 years | \$ - |
| Exercisable at September 30, 2012 | 380,000 | \$ 0.74 | 9.72 years | \$ - |

**NOTE 13. – SUBSEQUENT EVENT**

Subsequent to September 30, 2012, the Company raised approximately \$750,000 in a private placement offering. Each unit in the offering was sold for \$0.25 and consisted of one share of common stock and one-half of a warrant to purchase common stock. Each full warrant issued has an exercise price of \$1.00 per share, a five year term and a “down round provision” so the warrants will be classified as derivatives for accounting purposes, which means they are reported as a liability and marked to market at each balance sheet date. This private placement will constitute a “down round” for purposes of certain previously issued warrants and convertible notes and will result in adjustments to the exercise price, conversion price and the number of shares issuable upon exercise or conversion of these previously issued securities.

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

### Forward-Looking Statements

*This Quarterly Report on Form 10-Q contains "forward-looking statements" that reflect, when made, the Company's expectations or beliefs concerning future events that involve risks and uncertainties. Forward-looking statements frequently are identified by the words "believe," "anticipate," "expect," "estimate," "intend," "project," "will be," "will continue," "likely result," or other similar words and phrases. Similarly, statements herein that describe the Company's objectives, plans or goals also are forward-looking statements. Actual results could differ materially from those projected, implied or anticipated by the Company's forward-looking statements. Some of the factors that could cause actual results to differ include: our ability to raise capital or enter into a licensing transaction in order to continue as a going concern; our ability to achieve profitability; our ability to manage our growth effectively; our ability to obtain FDA and foreign regulatory approval for our X-22 smoking cessation product and our potential modified risk cigarettes; our ability to gain market acceptance for our products and our ability to maintain our rights to our intellectual property licenses. For a discussion of these and all other known risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see "Risk Factors" in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011, which is available on the SEC's website at [www.sec.gov](http://www.sec.gov). All forward-looking statements are qualified in their entirety by this cautionary statement, and the Company undertakes no obligation to revise or update this Quarterly Report on Form 10-Q to reflect events or circumstances after the date hereof.*

*For purposes of this Management's Discussion and Analysis of Financial Condition and Results of Operations, references to the "Company," "we," "us" or "our" refer to the operations of 22nd Century Group, Inc. and its direct and indirect subsidiaries for the periods described herein.*

### Overview

22nd Century Ltd, our wholly-owned subsidiary, is a plant biotechnology company and we believe the global leader in technology that allows for the level of nicotine and other nicotinic alkaloids (e.g., nornicotine, anatabine and anabasine) in tobacco plants to be decreased or increased through genetic engineering and plant breeding. We own or exclusively control 105 issued patents in 78 countries plus an additional 38 pending patent applications. Hercules Pharmaceuticals, LLC and Goodrich Tobacco Company, LLC are subsidiaries of 22nd Century Ltd and are business units for our (i) smoking cessation product and (ii) premium cigarettes and potential modified risk tobacco products, respectively. We believe that our proprietary technology will enable us to capture a significant share of the global market for approved smoking cessation aids and the emerging market for modified risk tobacco products. The Company is primarily involved in the following activities:

The development of its botanical smoking cessation aid, *X-22*;

The development of its modified risk tobacco products;

The pursuit of necessary regulatory approvals and clearances at the U.S. Food and Drug Administration (the "FDA") to market *X-22* as a prescription smoking cessation aid and *BRAND A* and *BRAND B* as modified risk tobacco products in the U.S.;

The manufacture, marketing and distribution of *RED SUN* and *MAGIC* proprietary cigarettes in traditional tobacco market channels in the U.S. and for export through Goodrich Tobacco;

The international licensing of 22nd Century Ltd's trademarks, brands, proprietary tobaccos, and technology; and

The production of *SPECTRUM* research cigarettes for the National Institute on Drug Abuse ("NIDA").

We have operated at a loss since 2006 when we increased our research and development expenditures. We realized revenue from our research cigarette program of \$15,683 in the first nine months of 2012, \$788,601 in the year ended December 31, 2011 and \$49,784 in 2010. We are in the process of transitioning from solely developing proprietary technology and tobacco to developing and commercializing our own products.

Our prospects depend on our ability to generate and sustain revenues from sales and/or licensing of our *RED SUN* and *MAGIC* cigarettes, our *X-22* smoking cessation aid, our potential modified risk tobacco products such as *BRAND A* and *BRAND B* and our proprietary tobacco and technology. Our ability to generate meaningful revenue in the United States from *X-22* depends on FDA approval and our ability to generate meaningful revenue from our potential modified risk tobacco products in the United States depends on obtaining FDA authorization to market these products as modified risk. If these products are approved and authorized by the FDA, we must still meet the challenges of successful marketing and distribution and consumer acceptance.

The Company expects to file applications in 2013 with the FDA for two types of modified risk cigarettes in accordance with the FDA's issued *Modified Risk Tobacco Product Applications Draft Guidance* released on March 30, 2012. This provides the framework for applicants to submit data for modified risk product candidates. Goodrich Tobacco Company, 22nd Century's subsidiary, has developed two types of potential modified risk tobacco cigarettes. The first proprietary cigarette, referred to as *BRAND A*, is a very low nicotine (VLN) cigarette containing approximately 95 percent less nicotine than the leading U.S. cigarette brands. 22nd Century's recent Phase II-B clinical trial and studies by independent researchers have demonstrated that smoke exposure (and cigarettes per day) is significantly reduced with VLN cigarettes. The second proprietary cigarette, referred to as *BRAND B*, is a low-tar cigarette with a relatively high nicotine content, effectively the world's lowest tar-to-nicotine ratio cigarette. Unlike low-tar/low-nicotine brands currently on the market (previously labeled "light" or "ultra-light" before these descriptors were banned in the U.S. by the Tobacco Control Act in 2010), the nicotine yield of *BRAND B* is not reduced. Studies have demonstrated that compensatory smoking (e.g., more and/or larger puffs per cigarette) of low-tar research cigarettes, similar to *BRAND B*, is greatly curtailed.

Our Investigational New Drug Application for *X-22*, a kit of very low nicotine (VLN) cigarettes, was cleared by the FDA in July 2011. Our *X-22* Phase II-B clinical trial was completed in the first quarter of 2012 and did not demonstrate a statistically significant difference in quitting between *X-22* and the active control, a cigarette containing conventional nicotine levels. In evaluating the results of this trial, we believe we may have gone too far in reducing the nicotine content of *X-22*, which was less than half the nicotine content of VLN cigarettes used in various independent clinical trials that were successful. We continue to believe that VLN cigarettes are effective as a smoking cessation aid. However, we have suspended sponsoring further *X-22* clinical trials pending the results of two independent smoking-cessation Phase II trials utilizing a different version of our VLN cigarette with a nicotine content similar to those used in previous successful smoking-cessation trials, and higher than the those used in our own sponsored Phase II-B trial. Both of these trials have concluded and will be compared to our Phase II-B trial to determine which variables optimize cessation. At that time we may resume our own sponsored *X-22* clinical trials.

The National Institute on Drug Abuse ("NIDA"), a component of the National Institutes of Health ("NIH"), provides the scientific community with controlled and uncontrolled research chemicals and drug compounds in its Drug Supply Program. In 2009, NIDA included an option to develop and produce research cigarettes with various levels of nicotine (from very low to high), or Research Cigarette Option, in its request for proposals for a five-year contract for Preparation and Distribution of Research and Drug Products. We have agreed, as a subcontractor to RTI International ("RTI") in RTI's contract with NIDA for the Research Cigarette Option, to supply modified nicotine cigarettes to NIDA. In August 2010, we met with officials from NIDA, FDA, RTI, the National Cancer Institute and the Centers for Disease Control and Prevention to finalize certain aspects of the design of these research cigarettes. These government research cigarettes are distributed under the Company's mark *SPECTRUM*. The Company has delivered approximately 9 million *SPECTRUM* research cigarettes during the year ended December 31, 2011 and has delivered an additional 2.7 million *SPECTRUM* research cigarettes in July 2012.

In March 2011, our subsidiary, Goodrich Tobacco introduced two of our products, *RED SUN* and *MAGIC* cigarettes, into the U.S. market. Goodrich Tobacco intends to focus marketing efforts on tobacconists, smoke shops and tobacco outlets. We are currently in discussions with participating manufacturers of the "Master Settlement Agreement," a settlement between the states and the tobacco industry, to have the production *RED SUN* and *MAGIC* transferred to

such a manufacturer, however we have not entered into any definitive arrangement and do not expect any such arrangement to materialize, if at all, until the first quarter 2013.

Our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 provides additional information about our business, operations and financial condition.

### **Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011**

*Revenue.* We realized revenue of \$15,683 in the three months ended September 30, 2012 as compared to revenue of \$529,370 in the three months ended September 30, 2011. The 2011 period reflected the completion of the initial phases and stocking order for research cigarettes under our subcontract agreement with RTI and the 2012 period reflected a modest subsequent order.

*Other income.* In the three months ended September 30, 2011, we recognized other income of \$80,000 from a therapeutic grant award we received in the fourth quarter of 2010. The revenue from this grant was completely recognized in 2011.

*Costs of goods sold.* In the three months ended September 30, 2012, costs of goods sold was \$60,852 which exceeded revenue by 288% because we provided RTI with cigarettes without charge. In the three months ended September 30, 2011, costs of goods sold was \$130,495 or 25% of revenue.

*Research and development expense.* Research and development (R&D) expense was \$155,318 in the three months ended September 30, 2012, a decrease of \$556,678, or 78%, from \$711,996 in the three months ended September 30, 2011. This decrease was a result of suspending, early in the first quarter of 2012, FDA activities related to X-22. In the third quarter of 2011 we initiated our Phase II-B clinical trial for X-22.

*General and administrative expense.* General and administrative expense was \$370,240 in the three months ended September 30, 2012, a decrease of \$80,847, or 18%, from \$451,087 in three months ended September 30, 2011. The decrease was mainly due to reduced compensation costs and professional fees

*Sales and marketing costs.* Sales and marketing costs were \$11,363 in the three months ended September 30, 2012, a decrease of \$25,743, or 69%, from \$37,106 in three months ended September 30, 2011. The costs in 2011 related to the domestic market introduction of *RED SUN* and *MAGIC* and included expenses related to product testing, product and packaging design, product branding, trade samples, trade shows and marketing. Early in 2012 we suspended our marketing activity of these brands in the U.S. in order to focus on reaching agreement to have these products produced by a participating manufacturer of the “Master Settlement Agreement. As a result sales and marketing costs in 2012 are reduced.

*Amortization and depreciation expense.* Amortization and depreciation expense relates almost entirely to capitalized patent and trademark costs. Amortization and depreciation expense increased 13% in the three months ended September 30, 2012 to \$50,458, up from \$44,630 in the three months ended September 30, 2011. This increase of \$5,828 is mainly due to additional investment in patents and trademarks.

*Warrant liability change – net.* The gain in the third quarter of 2012 of \$535,017 compares to a gain of \$337,500 in the third quarter of 2011, an increase of \$197,517. The gain in both periods resulted from the decrease in the estimated fair value of warrants outstanding during the respective period.

*Interest expense and amortization of debt discount and expense.* Interest expense and amortization of debt discount and debt issuance costs increased in the three months ended September 30, 2012 to \$351,394 from \$21,927 in the three months ended September 30, 2011. This increase of \$329,467 or 1,503% was a result of the amortization of debt discount and debt issuance costs related to Convertible Notes.

*Net loss.* We had a net loss of \$448,925 in the three months ended September 30, 2012 as compared to a net loss of \$450,371 in the three months ended September 30, 2011. This decrease of \$1,446 was a result of the net decrease in operating expenses of \$727,083 (mostly research and development) and the \$197,517 increase in the gain related to the warrant liability offset by decreased revenue and other income of \$593,687 and the increase in amortization of debt discount and expense of \$329,467.

### **Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011**

*Revenue.* We realized revenue of \$15,683 in the nine months ended September 30, 2012 as compared to revenue of \$801,636 in the nine months ended September 30, 2011. The 2011 period reflected the initial phases and stocking order for research cigarette under our subcontract agreement with RTI and the 2012 period reflected a modest subsequent order.

*Other income.* In the nine months ended September 30, 2011, we recognized other income of \$223,540 from a therapeutic grant award we received in fourth quarter of 2010. The revenue from this grant was completely recognized in 2011.

*Costs of goods sold.* In the nine months ended September 30, 2012, costs of goods sold was \$60,852 which exceeded revenue by 288% since we provided RTI with *SPECTRUM* research cigarettes without charge. In the nine months ended September 30, 2011, costs of goods sold was \$224,146 or 28% of revenue.

*Research and development expense.* Research and development (R&D) expense was \$484,316 in the nine months ended September 30, 2012, a decrease of \$1,024,734, or 68%, from \$1,509,050 in the nine months ended September 30, 2011. This decrease was a result of suspending, early in the first quarter of 2012, FDA activities related to X-22. In the first nine months of 2011 we executed the planning and initial stages of our Phase II-B clinical trial and filed our IND with the FDA for X-22.

*General and administrative expense.* General and administrative expense was \$1,732,162 in the nine months ended September 30, 2012, an increase of \$350,682, or 25%, from \$1,381,480 in nine months ended September 30, 2011. The increase was mainly due to the \$354,908 increase in equity based compensation costs which were \$631,366 in the first nine months of 2012 as compared to \$276,458 in the first nine months of 2011. This increase was partially offset by a reduction in professional fees.

*Sales and marketing costs.* Sales and marketing costs were \$46,045 in the nine months ended September 30, 2012, a decrease of \$221,765, or 83%, from \$267,810 in nine months ended September 30, 2011. The costs in 2011 related to the domestic market introduction of *RED SUN* and *MAGIC* and included expenses related to product testing, product and packaging design, product branding, trade samples, trade shows and advertising. Early in 2012, we suspended our domestic sales and marketing activity of these brands in order to focus on reaching an agreement to have these products produced by a participating manufacturer of the “Master Settlement Agreement,” a settlement between the states and the tobacco industry. As a result, sales and marketing costs in 2012 are reduced.

*Amortization and depreciation expense.* Amortization and depreciation expense relates almost entirely to capitalized patent and trademark costs. Amortization and depreciation expense increased 10.5% in the nine months ended September 30, 2012 to \$146,374, up from \$132,432 in the nine months ended September 30, 2011. This increase of \$13,942 is mainly due to additional investment in patents and trademarks.

*Warrant liability change – net.* In connection with the May 2012 private placement, we issued warrants which were accounted for as derivatives and upon issuance a liability at the estimated fair value was recorded. At the date of issuance of these warrants the value was estimated to be \$1,841,000, which exceeded the total consideration received in the offering by \$814,500 resulting in an immediate charge to expense for this amount. This charge offset the gain of \$1,981,916 resulting from the decrease in the estimated fair value of these warrants and other previously issued warrants during the nine month period ending September 30, 2012 so that the net gain for this period was \$1,167,416. The market adjustment recorded in the nine month period ended September 30, 2011 was \$337,500.

*Interest expense and amortization of debt discount and expense.* Interest expense and amortization of debt discount and debt issuance costs increased in the nine months ended September 30, 2012 to \$1,144,721 from \$53,116 in the nine months ended September 30, 2011. This increase of \$1,091,605 or 2,055% was a result of the amortization of debt discount and debt issuance costs related to Convertible Notes issued on December 16, 2011 and August 9, 2012, which also includes charges to write off unamortized debt discounts and the value of warrants in excess of the note payable converted, totaling approximately \$97,000 related to the partial conversions of the December 16, 2011 Convertible Notes.

*Net loss.* We had a net loss of \$2,431,371 in the nine months ended September 30, 2012 as compared to a net loss of \$2,205,358 in the nine months ended September 30, 2011. This increase of \$226,013 was a result of the substantial reduction in revenue and other income and the \$1,091,605 increase in amortization of debt discount and expense,

partially offset by the \$1,167,416 warrant liability gain and the net decrease in operating expenses mainly due to the sharp reduction in research and development expense.

## **Liquidity and Capital Resources**

### *Summary of Balances and Recent Sources and Uses*

As of September 30, 2012, we had negative working capital of approximately \$3.1 million compared to negative working capital of approximately \$1.9 million at December 31, 2011. The \$1.2 million increase in our negative working capital position was mainly a result of the disbursement of nearly all our cash during the period including the proceeds of the May 2012 private placement and the August 9, 2012 convertible notes mainly to fund operations and acquire inventory.

### *Cash demands on operations*

Since January 1, 2010 we operated at a loss and operating activities consumed more than \$5.7 million in cash. Cash on hand at September 30, 2012 of \$5,941 is insufficient to fund operations and meet our obligations as they come due.

We will need to raise funds through the issuance of debt or equity securities during the next twelve months in order to continue operations. Failure to raise sufficient funds would significantly increase the risk that we would be unable to continue operations. Financing may not be available on acceptable terms, or at all, and our failure to raise capital when needed could materially adversely impact our plans to commercialize our products, our ability to continue as a going concern and our financial condition and results of operations. Additional equity financing will be dilutive to shareholders of our common stock. To the extent that we raise additional funds through collaboration and licensing arrangements, it may be necessary in certain countries to relinquish some rights to our technologies or our potential products or grant licenses on terms that are not favorable to us.

*Net Cash used in Operating Activities.*

In the first nine months of 2012, \$1,303,248 of cash was used in operating activities compared to \$2,473,746 of cash used in operating activities in the first nine months of 2011. This reduction in use of cash in operations of \$1,170,498 was partially due to the reduction in the cash portion of the net loss in the first nine months 2012 as compared to the first nine months of 2011 of approximately \$624,000. The balance of the decrease in use of cash in operations was a result of approximately \$546,000 million less cash used for working capital components related to operations.

*Net Cash used in Investing Activities.*

In the first nine months of 2012, we did not use any cash related to third party costs incurred for patents and trademarks as compared to \$570,641 used in the first nine months of 2011. This decrease was mainly attributable to our payment in the first quarter of 2011 of approximately \$500,000 towards outstanding patent costs charges that were deferred in prior periods.

*Net Cash From Financing Activities.*

During the first nine months of 2012, we generated approximately \$1,057,000 from our financing activities mainly as a result of the \$786,500 proceeds from the May 2012 private placement, the \$210,000 proceeds from the August 9, 2012 convertible notes, \$58,000 in advances from officers and \$56,000 in proceeds from the issuance of short term secured notes partially offset by payments on borrowings of \$35,000, deferred private placement costs of \$10,000 and net advances to a related party of approximately \$8,000. During the first nine months of 2011, we generated net cash of approximately \$3,058,000 from our financing activities; we received approximately \$3,294,000 in net cash proceeds from the Private Placement that closed on January 25, 2011 partially offset by the payment of approximately \$458,000 in shareholder notes and approximately \$21,000 in net advances to officers and a related party.

The Company will need to raise additional capital to continue operations and make payments on obligations that are and become due in 2012 and 2013. The Company's Board of Directors authorized management to seek additional equity financing on a negotiated basis. The ability to complete additional equity financings on acceptable terms will depend on a number of factors, including the general performance of the capital markets, the Company's progress in the manufacture, distribution and sale of its products, and results on independent smoking cessation clinical trials. Failure to raise sufficient funds would significantly increase the risk that we would be unable to continue operations. Financing may not be available on acceptable terms, or at all, and our failure to raise capital when needed could materially adversely impact our plans to commercialize our products, our ability to continue as a going concern and our financial condition and results of operations. These equity financings will be dilutive to our existing shareholders' respective ownership.

## Critical Accounting Policies and Estimates

Accounting principles generally accepted in the United States of America, or U.S. GAAP, require estimates and assumptions to be made that affect the reported amounts in our consolidated financial statements and accompanying notes. Some of these estimates require difficult, subjective and/or complex judgments about matters that are inherently uncertain and, as a result, actual results could differ from those estimates. Due to the estimation processes involved, the following summarized accounting policies and their application are considered to be critical to understanding our business operations, financial condition and results of operations.

### *Revenue Recognition*

We recognize revenue at the point the product is shipped to a customer and title has transferred. Revenue from the sale of our products is recognized net of cash discounts, sales returns and allowances. Cigarette federal excise taxes are included in net sales and accounts receivable billed to customers, except on sales of *SPECTRUM* and exported cigarettes in which such taxes do not apply.

We were chosen to be a subcontractor for a 5-year government contract between RTI International (“RTI”) and the National Institute on Drug Abuse (“NIDA”) to supply NIDA research cigarettes which includes four development stages. The company has completed the four developmental stages and delivered approximately 9 million cigarettes during the year ended December 31, 2011 and recognized the related revenue. These government research cigarettes are distributed under the mark *SPECTRUM*. The Company has delivered an additional 2.7 million *SPECTRUM* research cigarettes in July 2012. Future revenue under this sub-contract arrangement is expected to be related to the delivery of *SPECTRUM* and will be recognized at the point the product is shipped and title has transferred.

### *Impairment of Long-Lived Assets*

We review the carrying value of amortizing long-lived assets whenever events or changes in circumstances indicate that the historical cost-carrying value of an asset may no longer be appropriate. We also assess recoverability of the asset by estimating the future undiscounted net cash flows expected to result from the asset, including eventual disposition. If the estimated future undiscounted net cash flows are less than the carrying value of the asset, an impairment loss is recorded equal to the difference between the asset's carrying value and its fair value. Non-amortizing intangibles (trademarks) are reviewed annually for impairment. We have not recognized any impairment losses during the two years ended December 31, 2011 and 2010.

### *Amortization Estimates of Intangible Assets*

We generally determine amortization based on the estimated useful lives of the assets and record amortization expense on a straight-line method over such lives. The remaining life of the patent is generally used to determine the estimated useful life of the related patent costs.

### *Valuation of our Equity Securities*

We have issued shares of our common stock to satisfy obligations to vendors or employees that were due in cash. These shares have been valued based on the cash value of the obligation satisfied by their issuance. We have also issued warrants to purchase shares of our stock in connection with the issuance of debt obligations. These warrants have been valued based on the value ascribed to the underlying shares issued in cash transactions, in settlement of cash obligations or, since the Merger on January 25, 2011, the closing price of our common stock.

### *Convertible Debt*

When the convertible feature of the conventional convertible debt is issued, the embedded conversion feature is evaluated to determine if bifurcation and derivative treatment is required whether there is a beneficial conversion feature. When the convertible debt provides for an effective rate of conversion that is below market value, this feature is characterized as a beneficial conversion feature (BCF"). Prior to the determination of the BCF, the proceeds from the debt instrument were first allocated between the convertible debt and any embedded or detachable free standing instruments that are included, such as common stock warrants. We record a BCF as a debt discount pursuant to FASB ASC Topic 470-20. In those circumstances, the convertible debt will be recorded net of the discount related to the BCF. We amortize the discount to interest expense over the life of the debt.

For the Convertible Notes issued December 16, 2011, we recorded the OID and the BCF related to these Convertible Notes as a debt discount and recorded the Convertible Notes net of the discount related to both the OID and the BCF. For the Convertible Notes issued August 9, 2012, we recorded the OID and the warrant liability related to these Convertible Notes as a debt discount and recorded the Convertible Notes net of the discount related to both the OID and the warrant liability debt discount is amortized to interest expense over the life of the debt. In the case of any conversion prior to the maturity date there will be an unamortized amount of debt discount that relates to such conversion. The prorata amount of unamortized discount at the time of conversion will be charged to interest expense as accelerated amortization of the discount. The fair value of warrants issued at the time of conversion is recorded as a reduction of the amount applied to the common stock issued in the conversion and to the extent that the fair value of warrants exceeds the carrying value of the debt a charge to interest expense results for such excess amount.

#### *Income taxes*

Prior to the closing of the Merger, 22nd Century Ltd was organized as a limited liability company and treated as a partnership for income tax purposes; accordingly, prior to the Merger, 22nd Century Ltd was not directly responsible for income taxes (income and losses passed through to its LLC members) and did not have to account for them. Following the Merger on January 25, 2011, we are subject to federal and state income taxes. Accordingly, since the Merger date we are required to recognize deferred tax assets and liabilities for any differences in basis in assets and liabilities between tax and GAAP reporting. The corresponding asset that resulted has been fully offset by a valuation allowance. The Company incurred a net operating loss from the closing of the Merger to December 31, 2011 and, accordingly, has made no provision for current income taxes. The income tax asset arising from this net operating loss has been fully reserved because it is not probable that it will be realized before its expiration.

### *Derivative Financial Instruments*

The warrants to purchase shares of our stock that were issued in connection with the Merger are treated as derivative instruments for accounting purposes. Accordingly, upon issuance, these instruments are reported as liabilities rather than equity. We do not use derivative instruments to hedge exposures to cash flow, market or foreign currency risks. We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair market value and then is revalued at each reporting date, with changes in fair value reported in the consolidated statement of operations. We use a lattice model approach which for valuing our outstanding warrants classified as derivative instruments which includes probability weighted estimates of future events including volatility of our common stock. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within twelve months of the balance sheet date.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements as defined by Item 303(a)(4) of Regulation S-K.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

As a smaller reporting company, we are not required to present this information.

### **Item 4. Controls and Procedures**

#### **(a) Evaluation of Disclosure Controls and Procedures:**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its 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 the Company's management, including the Company's chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter

how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Our chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15(e) or 15d-15(e)) as of the end of the period covered by this annual report, have concluded that our disclosure controls and procedures were not effective and that material weaknesses described in our Form 10-K for the fiscal year ended December 31, 2011 exist in our internal control over financial reporting based on his evaluation of these controls and procedures as required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

**(b) Changes in Internal Control over Financial Reporting:**

There were no changes in the Company's internal control over financial reporting during the third quarter of 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

Neither 22nd Century Group nor any of its subsidiaries are involved in any material legal proceeding.

**Item 1A. Risk Factors**

Our risk factors have not changed materially from those disclosed in our annual report on Form 10-K for the year ended December 31, 2011 filed on April 16, 2012.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On August 9, 2012, the Company completed a private placement of \$222,600 of convertible notes, which were sold at a 6% discount. The Company received proceeds of \$210,000. The face amount of the notes may be converted into common stock at the rate of \$0.60 per share at the option of the note holder. In the event a holder of the convertible notes elects to convert the note into shares of common stock, then the holder shall receive warrants equal to one-hundred percent of the number of shares of common stock into which the notes were convertible into. However, in the event the Company prepays the convertible notes or pays the convertible notes at maturity, then the holder shall receive warrants equal to fifty percent of the number of shares of common stock into which the notes were convertible into. The warrants have a five-year term and a \$1.00 per share exercise price.

Each of the sales were offered and sold in reliance on the exemption from registration afforded by Section 4(2) and Regulation D (Rule 506) under the Securities Act of 1933, as amended.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

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Exhibit  
31.1 Section 302 Certification – Chief Executive Officer

Exhibit  
31.2 Section 302 Certification – Chief Financial Officer

Exhibit  
32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive data files formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Cash Flows, and (iv) the Notes to the Consolidated Financial Statements.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

**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:

22nd CENTURY GROUP, INC

Date: November 13, 2012 By: /s/ Joseph Pandolfino  
Joseph Pandolfino  
Chief Executive Officer

Date: November 13, 2012 By: /s/ Henry Sicignano III  
Henry Sicignano III  
President and Chief Financial Officer