

Neonode, Inc  
Form 10-Q  
May 15, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

- Quarterly report pursuant to section 13 or 15(d)  
of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2009

- Transition report pursuant to section 13 or 15(d) of the  
Securities and Exchange Act of 1934

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

Commission file number 0-8419

NEONODE INC.

---

(Exact name of registrant as specified in its charter)

Delaware

94-1517641

(State or other jurisdiction of  
incorporation or organization)

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

Sweden Linnegatan 89, SE-115 23 Stockholm, Sweden  
USA 651 Byrdee Way, Lafayette, CA. 94549

---

(Address of principal executive offices and zip code)

Sweden + 46 8 667 17 17  
USA + 1 925 768 0620

---

(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 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

Edgar Filing: Neonode, Inc - Form 10-Q

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 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 an large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "non-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

The number of shares of registrant's common stock with par value \$0.001 per share outstanding as of May 12, 2009 was 226,067,153.

---

Due to our current lack of cash resources, we were unable to obtain a review of the interim financial statements for the three months ended March 31, 2009 by our registered independent accountants in accordance with Rule 10-01(d) of the Securities and Exchange Commission Regulation S-X. We plan to obtain such a review as soon as we are able to pay our registered independent accountants for their review.

PART I Financial Information

NEONODE INC.

INDEX TO MARCH 31, 2009 FORM 10-Q

|            |  |    |
|------------|--|----|
| Item 1     | Financial Statements   |    |
|            | Condensed Consolidated Balance Sheets as of March 31, 2009 and December 31, 2008                   | 3  |
|            | Condensed Consolidated Statements of Operations for the three months ended March 31, 2009 and 2008 | 4  |
|            | Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2009 and 2008 | 5  |
|            | Notes to Condensed Consolidated Financial Statements   | 6  |
| Item 2     | Management's Discussion and Analysis of Financial Condition and Results of Operations              | 20 |
| Item 4     | Controls and Procedures  | 32 |
| PART II    | Other Information  |    |
| Item 6     | Exhibits   | 33 |
| SIGNATURES |  | 36 |
| EXHIBITS   |  |    |

PART I. Financial Information  
Item 1. Financial Statements

NEONODE INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands)  
(Unaudited)

|  | March<br>31, 2009 | December<br>31, 2008 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Current assets:  |                   |                      |
| Cash and cash equivalents  | \$ 153            | \$ 17                |
| Prepaid expense  | 60                | 46                   |
| Other receivables  | 78                | —                    |
| Total current assets   | 291               | 63                   |
| Property plant and equipment, net 16   | 116               |                      |
| Total assets   | \$ 307            | \$ 179               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                      |
| Current liabilities:   |                   |                      |
| Current portion of debt  | \$ —              | \$ 17                |
| Accounts payable   | 581               | 688                  |
| Accrued expenses   | 202               | 320                  |
| Embedded derivatives of warrants   | 2,875             | —                    |
| Total current liabilities  | 3,658             | 1,025                |
| Long term convertible debt and leases  | 139               | 207                  |
| Total liabilities  | 3,797             | 1,232                |
| Commitments and contingencies (note 8)   |                   |                      |
| Stockholders' deficit:   |                   |                      |
| Series A Preferred Stock, 899,081 shares authorized with par value \$0.001 at March 31, 2009 and December 31, 2008, respectively. 855,522 share issued and outstanding at March 31, 2009 and December 31, 2008, respectively. (In the event of dissolution, each share of Series A Preferred Stock has a liquidation preference equal to par value of \$0.001 over the shares of Common Stock) | 3,531             | 3,531                |
| Series B Preferred Stock, 108,850 shares authorized with par value \$0.001 at March 31, 2009 and December 31, 2008, respectively. 92,796 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively. (In the event of dissolution, each share of Series B Preferred Stock has a liquidation preference equal to par value of \$0.001 over the shares of Common Stock) | 2                 | 2                    |
| Common stock, 75,000,000 shares authorized with par value \$0.001 at March 31, 2009 and December 31, 2008, respectively; 37,009,589 and 35,058,011 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively   | 37                | 35                   |
| Additional paid in capital   | 65,390            | 60,090               |
| Stock subscription receivable  | —                 | (1,035)              |

Edgar Filing: Neonode, Inc - Form 10-Q

|   |          |          |
|---|----------|----------|
| Accumulated deficit                         | (72,450) | (64,602) |
| Total stockholders' deficit                 | (3,490)  | (1,053)  |
| Total liabilities and stockholders' deficit | \$ 307   | \$ 179   |

See notes to condensed consolidated financial statements.

3

---

NEONODE INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands, except per share amounts)  
(Unaudited)

|  | Three months ended |                     |
|--|--------------------|---------------------|
|  | March 31,          |                     |
|  | 2009               | 2008                |
| Total net sales  | \$                 | —\$ 391             |
| Cost of sales  |                    | — 641               |
| Gross margin   |                    | — (250)             |
| <b>Operating expenses:</b>   |                    |                     |
| Product research and development   |                    | 221 1,492           |
| Sales and marketing  |                    | 58 1,830            |
| General and administrative   |                    | 2,030 2,513         |
| Total operating expenses   |                    | 2,309 5,835         |
| Operating loss   |                    | (2,309) (6,085)     |
| <b>Other income (expense, net):</b>  |                    |                     |
| Interest and other income, net   |                    | (30) 165            |
| Interest expense   |                    | (3) (9)             |
| Foreign currency loss  |                    | (12) —              |
| Gain on conversion and forgiveness of accounts payable   |                    | 55 —                |
| Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants |                    | (2,808) (5,510)     |
| Total other income (expense), net  |                    | (2,798) (5,354)     |
| Net loss   |                    | (5,107) (11,439)    |
| Deemed dividend to Preferred Stockholders  |                    | (2,741) —           |
| Net loss attributable to common stockholders   | \$                 | (7,848) \$ (11,439) |
| <b>Loss per common share:</b>  |                    |                     |
| Basic and diluted loss per share   | \$                 | (0.21) \$ (0.47)    |
| Basic and diluted – weighted average shares used in per share computations   |                    | 36,515 24,426       |

See notes to condensed consolidated financial statements.

NEONODE INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

|  | Three months ended<br>March 31, |             |
|--|---------------------------------|-------------|
|  | 2009                            | 2008        |
| <b>Cash flows from operating activities:</b>   |                                 |             |
| Net loss attributable to common stockholders   | \$ (7,848)                      | \$ (11,439) |
| <b>Adjustments to reconcile net loss to net cash used by operating activities:</b>               |                                 |             |
| Stock based compensation expense   | 1,625                           | 890         |
| Loss on retirement of assets   | 30                              | 16          |
| Depreciation and amortization  | 3                               | 129         |
| Debt and warrant conversion expense  | 2,741                           | —           |
| Gain on conversion and forgiveness of accounts payable   | (55)                            | —           |
| Debt discounts and deferred financing fees and the valuation of conversion features and warrants | 2,808                           | 5,510       |
| <b>Changes in operating assets and liabilities:</b>  |                                 |             |
| Accounts receivable and other current assets   | (78)                            | 575         |
| Inventories  | —                               | (4,039)     |
| Other assets   | —                               | 37          |
| Prepaid expenses   | (14)                            | (186)       |
| Accounts payable and other accrued expense   | (48)                            | (689)       |
| Deferred revenue   | —                               | (384)       |
| Other liabilities  | —                               | (152)       |
| Net cash used in operating activities  | (836)                           | (9,732)     |
| <b>Cash flows from investing activities:</b>   |                                 |             |
| Proceeds from sale of property and equipment   | —                               | 31          |
| Purchase of property, plant and equipment  | (17)                            | (115)       |
| Net cash used in investing activities  | (17)                            | (84)        |
| <b>Cash flows from financing activities:</b>   |                                 |             |
| Proceeds from issuance of convertible debt   | —                               | 35          |
| Debt discounts & deferred financing fees related to conversion                                   | —                               | (19)        |
| Increase in capital lease liability  | —                               | 24          |
| Amortization of debt   | —                               | (24)        |
| Proceeds from issuance of preferred stock  | 1,035                           | —           |
| Proceeds from issuance of common stock   | —                               | 4,500       |
| Equity issuance costs  | (46)                            | (488)       |
| Restricted cash  | —                               | 5,706       |
| Net cash provided by financing activities  | 989                             | 9,734       |
| Effect of exchange rate changes on cash  | —                               | (409)       |
| Net increase (decrease) in cash and cash equivalents   | 136                             | (82)        |
| Cash and cash equivalents at beginning of period   | 17                              | 1,147       |
| Cash and cash equivalents at end of period   | \$ 153                          | \$ 656      |

Supplemental disclosure of cash flow information:

|               |    |   |    |    |
|---------------|----|---|----|----|
| Interest paid | \$ | 8 | \$ | 59 |
|---------------|----|---|----|----|

Supplemental disclosure of non-cash transactions:

|   |    |       |    |   |
|---|----|-------|----|---|
| Fair value of conversion to common stock of Series A and B Preferred stock issued to note and warrant holders related to corporate restructuring in excess of amounts recorded in equity at December 31, 2008 | \$ | 2,741 | \$ | — |
|---|----|-------|----|---|

|                        |    |       |    |   |
|------------------------|----|-------|----|---|
| Fair value of warrants | \$ | 2,875 | \$ | — |
|------------------------|----|-------|----|---|

|   |    |    |    |   |
|---|----|----|----|---|
| Fair value of 762,912 shares of common stock issued to convert accounts payable to equity | \$ | 23 | \$ | — |
|---|----|----|----|---|

|  |    |       |    |   |
|--|----|-------|----|---|
| Fair value of conversion to common stock of 495,000 shares of Series A Preferred stock issued to related parties for 100% of AB Cypressen recorded as compensation expense | \$ | 1,584 | \$ | — |
|--|----|-------|----|---|

See notes to condensed consolidated financial statements



NEONODE INC  
Notes to the Condensed Consolidated Financial Statements  
(Unaudited)

Due to our current lack of cash resources, we were unable to obtain a review of the interim financial statements for the three months ended March 31, 2009 by our registered independent accountants in accordance with Rule 10-01(d) of the Securities and Exchange Commission Regulation S-X. We plan to obtain such a review as soon as we are able to pay our registered independent accountants for their review.

#### 1. Interim Period Reporting

The condensed consolidated balance sheet of Neonode Inc (the Company) as of December 31, 2008 is derived from audited consolidated financial statements. The unaudited interim condensed consolidated financial statements, include all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations and cash flows for the interim periods. The results of operations for the three months ended March 31, 2009 are not necessarily indicative of expected results for the full 2009 fiscal year.

The accompanying financial data as of March 31, 2009 and for the three months ended March 31, 2009, and 2008 has been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally contained in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes contained in our audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2008.

#### Liquidity

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the ordinary course of business. The report of our independent registered public accounting firm in respect of the 2008 fiscal year includes an explanatory going concern paragraph which raises substantial doubt to continue as a going concern, which indicates an absence of obvious or reasonably assured sources of future funding that will be required by us to maintain ongoing operations. We have incurred net operating losses and negative operating cash flows since inception. As of March 31, 2009, we had an accumulated deficit of \$72.5 million and working capital deficit (current assets less current liabilities, not including non-cash warrant liability) of \$492,000. Our operations are subject to certain risks and uncertainties frequently encountered by companies in the early stages of operations. Such risks and uncertainties include, but are not limited to, technical and quality problems in new products, ability to raise additional funds, credit risks and costs for developing new products. Our ability to generate revenues in the future will depend substantially on our ability to enter customer contracts with customers and raise additional funds through debt or equity. In December 2008, we completed a private placement offering of \$1.1 million of our preferred stock.

There is no assurance that we will be successful in obtaining sufficient funding on acceptable terms, if at all. If we are unable to secure additional funding and/or our stockholders, if required, do not approve such financing, we would have to curtail certain expenditures which we consider necessary for optimizing the probability of success of developing new products and executing our business plan. If we are unable to obtain additional funding for operations, we may not be able to continue operations as proposed, requiring us to modify our business plan, curtail various aspects of our operations or cease operations. The financial statements do not include any adjustments related to the recovery of assets and classification of liabilities that might be necessary should we be unable to continue as a going concern.



Refinancing and Capital Raising Transactions

Series A Preferred Stock:

On December 31, 2008, we issued 112,190.40 shares of Series A Preferred stock that at the date of issuance had a conversion rate of one share of common stock for each share of Series A Preferred stock to investors in a private placement transaction that raised \$1,121,904. On March 31, 2009, our shareholders approved a resolution to increase the conversion ratio to 480.63 shares of common stock for each share of Series A Preferred Stock. Upon conversion, the shares of Series A Preferred stock will convert into 53,922,072 shares of our common stock.

On December 31, 2008, we issued 244,265.56 shares of Series A Preferred Stock that at the date of issuance had a conversion rate of one share of common stock for each share of Series A Preferred Stock to holders of \$6.2 million of convertible and promissory notes in exchange for the surrender of the Convertible Notes by the note holders. Upon conversion, the shares of Series A Preferred Stock will convert into 117,401,326 shares of our common stock.

On December 31, 2008, we acquired AB Cypressen nr 9683 (Cypressen) by issuing 495,000 shares of Series A Preferred stock that at the date of issuance had a conversion rate of one share of common stock for each share of Series A Preferred stock to the related party stockholders of AB Cypressen: Iwo Jima SARL, Wirelesstoys AB, and Athemis Ltd. (the Cypressen Stockholders). Pursuant to the terms of the Share Exchange Agreement, upon the closing of the transaction, Cypressen became a wholly-owned subsidiary of the Company. Upon conversion, the shares of Series A Preferred Stock will convert into 237,911,185 shares of our common stock.

In addition, on December 31, 2008, we issued 4,067.02 shares of Series A Preferred Stock to Ellis International LP as full consideration for certain services supplied by Ellis International LP to the Company. Upon conversion, the shares of Series A Preferred Stock will convert into 1,954,732 shares of our common stock.

Series B Preferred Stock:

On December 31, 2008, we exchanged outstanding warrants to purchase 12,255,560 shares of our common stock by waving the warrant exercise price and issuing 92,795.94 shares of Series B Preferred Stock to warrant holders. At the date of issuance, these warrants had a conversion rate of one share of common stock for each share of Series B Preferred Stock. On March 31, 2009, our shareholders approved a resolution to increase the conversion ratio to 132.07 shares of common stock for each share of Series B Preferred stock. Upon conversion, the shares of Series B Preferred Stock will convert into 12,255,560 shares of our common stock.

Conversion of Preferred Stock to Common Stock

|                          | Shares of<br>Preferred<br>Stock<br>Issued | Conversion<br>Ratio | Shares of<br>Common Stock<br>after Conversion<br>of all<br>Outstanding<br>Shares of<br>Preferred Stock<br>to Common<br>Stock |
|--------------------------|---|---------------------|--|
| Series A Preferred stock | 855,522.98                                | 480.63              | 411,190,010  |
| Series B Preferred stock | 92,795.94                                 | 132.07              | 12,255,560   |

Edgar Filing: Neonode, Inc - Form 10-Q

|       |            |   |             |
|-------|------------|---|-------------|
| Total | 948,319.90 | - | 423,445,570 |
|-------|------------|---|-------------|

On April 24, 2009, we initiated the process of allowing the shareholders of our preferred stock to convert the Series A and B Preferred stock to shares of our common stock. In order to convert the preferred stock to common stock each preferred stock shareholder is required to submit the preferred stock certificate to our transfer agent and request conversion to common stock. The conversion to common stock is not mandatory and shareholders who own preferred stock may chose to not to convert their preferred stock to shares of our common stock.

## Neonode AB Bankruptcy

On December 9, 2008, Neonode AB, our wholly owned subsidiary located in Sweden, filed for liquidation under the bankruptcy laws in Sweden. Under Swedish bankruptcy law, effective with the bankruptcy filing we no longer have an ownership interest in Neonode AB, and as such, we are no longer responsible for the liabilities of Neonode AB and we no longer have title or an ownership interest in the assets of Neonode AB. The Swedish bankruptcy court appointed a Swedish legal firm as receiver with the expressed duty to liquidate all the assets of Neonode AB and enter into final settlements with the creditors of Neonode AB.

We account for our investment in Neonode AB in accordance with the AICPA Statement of Position, SOP 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code, and Accounting Research Bulletin, ARB 51, Consolidate Financial Statements. ARB 51 precludes consolidation of a majority-owned subsidiary where control does not rest with the majority owners, for instance, where the subsidiary is in bankruptcy. Accordingly, we deconsolidated Neonode AB from our consolidated financial statements on the date it filed for bankruptcy, December 9, 2008. Our Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2008 include the accounts of Neonode AB. Our Condensed Consolidated Balance Sheets do not include the accounts of Neonode AB at December 31, 2008 or March 31, 2009.

## 2. Summary of significant accounting policies

### Fiscal Year

Our fiscal year is the calendar year.

### Principles of Consolidation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2008 include the accounts of Neonode Inc and Neonode AB. The Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2009 include the accounts of Neonode Inc and Cypressen. The Condensed Consolidated Balance Sheet as of March 31, 2009 and December 31, 2008 include the accounts of Neonode Inc and Cypressen. All inter-company accounts and transactions have been eliminated in consolidation.

### Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires making estimates and assumptions that affect, at the date of the financial statements, the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Actual results could differ from these estimates. Significant estimates include but are not limited to collectibility of accounts receivable, estimated useful lives of long-lived assets and the fair value of securities such as options and warrants issued for stock-based compensation and in certain financing transactions.

### Segment information

We have one reportable segment. The segment is evaluated based on consolidated operating results. We currently operate in one industry segment; the development of touchscreen technology. In 2008 we also operated in the development and selling of multimedia mobile phones. To date, we have carried out substantially all of our operations through our subsidiary in Sweden.

New Accounting Pronouncements

The following are the expected effects of recent accounting pronouncements. We are required to analyze these pronouncements and determine the effect, if any; that the adoption of these pronouncements would have on our results of operations or financial position.

8

---

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement on Financial Accounting Standards (SFAS) No. 141 (revised 2007), Business Combinations (SFAS No. 141R). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity's fiscal year that begins after 15 December 2008, and will be adopted in the first quarter of 2009. The adoption of SFAS 141R will affect the way we account for any acquisitions made after January 1, 2009.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), Fair Value Measurements which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements, but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for financial assets and financial liabilities within its scope for fiscal years beginning after November 15, 2007 and for interim periods within those fiscal years. We adopted SFAS 157 for financial assets and financial liabilities within its scope during the first quarter of 2008, and the adoption did not have an impact on our financial statements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2 (FSP FAS 157-2), Effective Date of FASB Statement No. 157, which defers the effective date of SFAS 157 for all non-financial assets and non-financial liabilities for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for items within the scope of FSP FAS 157-2. The adoption of FSP FAS 157-2 effective January 1, 2009 for the Company's non-financial assets and non-financial liabilities is not expected to have an impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements. SFAS 160 establishes new standards that will govern the accounting for and reporting of noncontrolling interests in partially owned subsidiaries. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008 and requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements shall be applied prospectively. The adoption of this standard will have no impact on the financial results of the Company on the date of adoption.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133, as amended and interpreted, which requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. Disclosing the fair values of derivative instruments and their gains and losses in a tabular format provides a more complete picture of the location in an entity's financial statements of both the derivative positions existing at period end and the effect of using derivatives during the reporting period. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended and its related interpretations (together SFAS 133), and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS 161 to have a material impact on our financial position, and we will make all necessary disclosures upon adoption, if applicable.

In April 2008, the FASB issued EITF 07-05, Determining whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock, (EITF 07-05). EITF 07-05 provides guidance on determining what types of instruments or embedded features in an instrument held by a reporting entity can be considered indexed to its own stock for the purpose of evaluating the first criteria of the scope exception in paragraph 11(a) of FAS 133. EITF 07-05 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and early application is not

permitted. . We do not believe that the adoption of EITF 07-05 will have a significant impact on our consolidated financial statements, as the fair value of any financial instruments and related conversion features are not significant.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 is effective on November 15, 2008. The adoption of SFAS 162 did not have any financial impact on our consolidated financial statements.



In May 2008, the FASB issued Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and requires retrospective application for all periods presented. We do not believe that adoption of FSP APB 14-1 will have a significant impact on our financial position and operating results, as the embedded conversion features of our convertible debt instruments had been accounted for as a derivative.

#### 4. Convertible Debt and Notes Payable

Our convertible notes payable consists of the following (in thousands):

|  | March 31,<br>2009 | December 31,<br>2008 |
|--|-------------------|----------------------|
| Senior Convertible Secured Notes           | \$ 139            | \$ 139               |
| Capital leases                             | —                 | 85                   |
| Total                                      | 139               | 224                  |
| Less: short-term portion of long-term debt | —                 | 17                   |
| Long-term debt                             | \$ 139            | \$ 207               |

Future maturities of notes payable (in thousands):

| Year ended December 31,  | Future<br>Maturity of<br>Notes Payable |
|--------------------------|--|
| 2009                     | \$ —                                   |
| 2010                     | 139                                    |
| Total principal payments | \$ 139                                 |

#### Senior Convertible Secured Notes

At March 31, 2009 and December 31, 2008, we had \$139,000 of three-year promissory notes maturing on August 31, 2010, bearing the greater of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share.

All liabilities related to the convertible notes, except for the remaining \$139,000, and warrants were extinguished on December 31, 2008 when the convertible notes were converted to equity.

#### Senior Convertible Secured August Bridge Notes

On August 8, 2007, we made an offering of convertible notes pursuant to a Note Purchase Agreement (August Bridge Notes or Bridge Notes), dated as of July 31, 2007, amended most recently on March 24, 2008. The August Bridge

Notes were originally convertible into the units described below. We received \$3,250,000 from the Bridge Note offering. The August Bridge Notes originally matured on December 31, 2007; however, the maturity date of these notes was extended to December 31, 2008.

The August Bridge Notes were due December 31, 2008, and bore 8% per annum interest and were convertible into purchase units that are made up of a combination of shares of our common stock, convertible debt and warrants. The note holders had a right to convert their notes plus accrued interest anytime before December 31, 2008 into purchase units. Each purchase unit of \$3,000 is comprised of one \$1,500 three-year promissory note bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share, 600 shares of our common stock and 5 year warrants to purchase 696.5 shares of our common stock at a price of \$1.27 per share. . Prior to the conversion of the Bridge Notes into shares of our Series A Preferred stock on December 31, 2008, for accounting purposes, the embedded conversion feature was determined to meet the definition of a derivative and was recorded as liability. This was because the holder of the notes could convert debt and accrued interest, where interest is at the greater of 8% or LIBOR plus 3%, and therefore, the total number of shares the instrument could be convertible into was not fixed. Accordingly, the embedded conversion feature was bifurcated from the debt host instrument and treated as a liability, with the offset to debt discount. The related warrants were also recorded as a liability for the same reason.

The fair value of the embedded conversion feature related to the Bridge Notes was calculated at March 31, 2008 using the Black-Scholes option pricing model and amounted to \$791,000. The liability of the embedded conversion feature at March 31, 2008 is a decrease of \$713,000 from the \$1.2 million for the embedded conversion feature at December 31, 2007. The value of the embedded conversion feature was revalued at each period-end and the liability is adjusted with the change recorded as “Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2008. The assumptions used for the Black-Scholes option pricing model at March 3, 2008 were a term of 0.49 years, volatility of 111.1% and a risk-free interest rate of 1.51%.

On December 31, 2008, all of the Bridge Notes plus accrued interest were converted into 123,641 shares of our Series A Preferred stock. The liability related to the embedded conversion feature was extinguished on December 31, 2008 when the Bridge Notes were converted to equity.

#### August Bridge Notes Extension Warrants

On September 26, 2007, the August Bridge Note holders were given three year warrants to purchase up to 219,074 shares (Extension Warrants) of our common stock at a price of \$3.92 per share in exchange for an agreement to extend the term of their notes from the original date of December 31, 2007 until June 30, 2008. The Extension Warrants were classified as a liability pursuant to the guidance provided in paragraph 17 of EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock. Prior to the conversion of the Extension Warrants into shares of our Series B Preferred stock on December 31, 2008, the fair value of the Extension Warrants was recorded as a debt issuance cost and was allocated to interest expense based on the effective interest rate method over the nine month term of the notes with the offsetting entry to a liability. The liability for the Extension Warrants issued to the August Bridge Note holders was revalued at the end of each reporting period and the change in the liability is recorded as “Non-cash items related to debt discounts and deferred financing fee and the valuation of conversion features and warrants s.”

The fair value of the Extension Warrants was calculated at March 31, 2008 using the Black-Scholes option pricing model and amounted to \$472,000. The liability of the Extension Warrants at March 31, 2008 is a decrease of \$136,000 from the \$608,000 for the liability of the Extension Warrants at December 31, 2007. The value of the Extension Warrants was revalued at each period-end and the liability was adjusted with the change recorded as “Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2008. The assumptions used for the Black-Scholes option pricing model when calculating the value of the Extension Warrants at March 31, 2008 were a term of 2.49 years, volatility of 128% and a risk-free interest rate of 1.71%.

On December 31, 2008, all of the Extension Warrants related to the Bridge Notes were exchanged into 1,659 shares of our Series B Preferred stock. The liability related to the Extension Warrants was extinguished on December 31, 2008 when the Extension Warrants were converted to equity.

### Option to Invest in Bridge Notes

In conjunction with the issuance of the August Bridge Notes, we issued an investor an option to invest up to \$750,000 under the same terms and conditions as the August Bridge Notes. The initial fair value of the option to purchase \$750,000 of the August Bridge Notes amounted to \$716,000 based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the original option to invest were a term of 0.39 years, volatility of 99% and interest rate of 4.16%. The initial fair value of the option to invest was recorded as a deferred financing fee was allocated to interest expense using the effective interest rate method over the term of the Bridge Notes with the offset recorded as other current liability. The liability for the option to purchase additional August Bridge Notes is revalued at the end of each reporting period and the change in the liability is recorded as “Non-cash items relating to debt discounts and deferred financing fees and the valuation of conversion features and warrants.”

- At December 31, 2007, the liability related to the fair value of the option warrants amounted to \$474,000. The assumptions used when calculating the fair value of the warrants at December 31, 2007 were a term of 0.39 years, volatility of 33% and a risk-free interest rate of 4.16%.
- The fair value of the option to purchase \$750,000 of the August Bridge Notes originally issued on August 8, 2007 and due to expire on December 31, 2007 was extended until March 15, 2008 on December 31, 2007 and revalued based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the extended option to invest were a term of 0.21 years, volatility of 99% and interest rate of 3.36%. The fair value of the extension totaled \$475,000 and was recorded as a deferred financing fee to be allocated to interest expense using the effective interest rate method over the 12 month remaining term of the August Bridge Notes with the offset recorded as other current liability. When this financing package was abandoned in February 2008, the value of the option recorded as deferred financing fees was charged to “Financing fees and other non-cash financing items”.
- On March 31, 2008, the expiration of the option was extended again to June 30, 2008. The value of the extension of this option was calculated using the Black-Scholes option pricing model and amounted to \$43,000. The assumptions used for the Black-Scholes option pricing model were a term of 0.27 years, volatility of 72% and interest rate of 1.24%. The \$43,000 value of the warrants was recorded as a liability with the corresponding amount recorded as a non-cash finance expense.

On May 21, 2008, the option holder exercised 50% of the option and invested \$375,000 in a warrant re-pricing transaction and received 295,275 shares common stock and 590,550 five-warrants at an exercise price of \$1.45 per share.

On December 31, 2008, all of the 590,550 5-year warrants were exchanged for 4,471 shares of our Series B Preferred stock. The option to invest the remaining unexercised \$375,000 of the original \$750,000 option to invest terminated on December 31, 2008 without the option holder exercising the option. The liability related to the five-year warrants was extinguished on December 31, 2008 when the five-year warrants were converted to equity.

### Senior Convertible Secured Notes September 26, 2007 Financing

#### Convertible Notes

On September 26, 2007, we sold \$5.7 million of securities in a private placement, comprised of \$2.9 million of three-year promissory notes bearing the greater of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share, 952,499 shares of our common stock, and 5 year warrants to purchase 1,326,837 shares of our common stock at a price of \$3.92 per share.

In addition, on September 26, 2007, certain holders of the August Bridge Notes converted an aggregate of \$454,900 of debt and accrued interest into units offered in the September 26, 2007 financing. The debt holders of the August Bridge Notes that were converted received (i) \$227,450 three-year promissory notes bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share, (ii) 75,817 shares of our common stock, and (iii) 5-year warrants to purchase 105,612 shares of our common stock at a price of \$3.92 per share. The fair value of the 5-year warrants totaled \$340,000 and was calculated using the Black-Scholes option pricing model.

The total issuance of securities and debt on September 26, 2007 to investors and Bridge Note holders who converted was (i) \$3.1 million of three-year promissory notes bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share, (ii) 1,028,316 shares of our common stock, and (iii) 5-year warrants to purchase 1,432,449 shares of our common stock at a price of \$3.92 per share.

The embedded conversion feature of the convertible debt issued on September 26, 2007 met the definition of a derivative financial instrument and is classified as a liability in accordance with SFAS 133 and EITF 00-19. The note holder has the right to convert the debt and accrued interest and the interest rate is calculated at the greater of 8% or LIBOR plus 3%, and therefore, the total number of shares of our common stock that the convertible note can be convertible into is not fixed. Prior to the conversion of the Convertible Notes into shares of our Series A Preferred stock on December 31, 2008, the embedded conversion features were revalued on each balance sheet date and marked to market with the adjusting entry to Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations .“

- The liability of the embedded conversion feature was \$791,000 at March 31, 2008 compared to \$1.5 million at December 31, 2007 with the decrease of \$713,000 recorded in “ Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2008.”

On December 31, 2008, \$3.1 million of the Senior Secured Convertible Notes plus accrued interest were converted into 120,624 shares of our Series A Preferred stock. After conversion, \$139,000 of the Senior Secured convertible Notes due August 31, 2010 remain outstanding. The liability related to the Senior Secured Convertible Notes was extinguished on December 31, 2008 when the Senior Secured Convertible Notes were converted to equity.

#### Warrants

The 5-year warrants to purchase 1,432,449 shares of our common stock at a price of \$3.92 per share. issued in conjunction with the September 26, 2007 financing met the definition of a liability pursuant to the provisions of EITF No. 00-19. The fair value of the warrants was calculated using the Black-Scholes option pricing model. Prior to the conversion of the Warrants into shares of our Series B Preferred stock on December 31, 2008, the fair value of the Warrants was recorded as a liability. The liability for the Warrants issued to Senior Convertible Secured Notes from September 2007 was revalued at the end of each reporting period and the change in the liability is recorded as “Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants.”

- The value of these warrants at March 31, 2008 decreased to \$3.2 million compared to \$3.7 million at December 31, 2007 and the offsetting amount of \$511,000 was recorded in Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2008.

All of the warrants, except for warrants to purchase 5,804 shares of our common stock, related to the Senior Convertible Secured Notes from September 2007 were exchanged for 8,994 shares of our Series B Preferred stock at December 31, 2008. The liability related to the Senior Secured Convertible Notes Warrants was extinguished on December 31, 2008 when the Senior Secured Convertible Notes Warrants were converted to equity.

At December 31, 2008, The remaining outstanding 5,804 warrants no longer met the classification of liabilities in accordance with EITF 00-19 since the anti-dilution feature related to September 26, 2007 financing expired when the value of outstanding notes payable dropped below \$2,000,000. The fair value of the warrants was measured at year end and the change in the fair value is included in the Consolidated Statements of Operations in the Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants The fair value of \$174.00 is included in equity as of December 31, 2008.





## Placement Agent Warrants

As part of the September 26, 2007 Private Placement, we issued 142.875 unit purchase warrants to Empire Asset Management Company (Empire) for financial advisory services provided in connection with the placement. Each unit purchase warrant has a strike price of \$3,250 and is comprised of a \$1,500 three-year promissory note, bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share, 500 shares of our common stock and a five-year warrant to purchase 696.5 shares of our common stock at a purchase price of \$3.92 per share. At the date of issuance the unit purchase warrants met the definition of a liability pursuant to the provisions of EITF No. 00-19. The fair value of the warrants was calculated using the Black-Scholes option pricing model. Prior to the conversion of certain of the Warrants into shares of our Series B Preferred stock on December 31, 2008, the fair value of the Warrants was recorded as a liability. The liability for the Warrants issued to the Empire were revalued at the end of each reporting period and the change in the liability is recorded as "Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants."

At March 31, 2008, the fair value of the unit purchase warrants issued to Empire decreased to \$402,000 from \$509,000 at December 31, 2007 with the adjusting offset of \$107,000 recorded in "Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants" on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2008. The assumptions used for the Black-Scholes option pricing model at March 31, 2008 were a term of 4.5 years, volatility of 92% and a risk-free interest rate of 4.5%.

On December 31, 2008, all of the unit purchase warrants related to the Senior Convertible Secured Notes were exchanged for 5,990 shares at no exercise price of our Series B Preferred stock. The liability related to the unit purchase warrants was extinguished on December 31, 2008 when the unit purchase warrants were converted to equity.

## Anti-Dilution Feature and Price Protection

The September 26, 2007 financing agreement contained anti-dilution features for each of the common stock, convertible debt and the warrants whereby these instruments were protected separately for 18 months or until the outstanding debt is less than \$2.0 million against future private placements made at lower share prices. September 2007 common stock investors would receive additional shares if there are future issuances of common stock with a lower price. September 2007 convertible debt and warrant holder investors would receive an adjustment to the conversion price or exercise price, respectively. Accordingly, there are no longer anti-dilution features in such common stock, convertible debt and warrants since December 31, 2008, when the outstanding debt was reduced to \$139,000. The 2,124,403 remaining outstanding warrants contain price protection whereby these instruments are protected separately for the life of the warrants. Under the price protection clause, if we issued warrants at a lower exercise price than the remaining outstanding warrants, the exercise price of such warrants would be reduced to the lower price. The warrant holders would not be entitled to additional shares of common stock, only the reduction in the exercise price. At December 31, 2008, the fair value of the warrants totaled \$67,000 and is included in equity.

In May 2008, the FASB issued Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning

after December 15, 2008, and interim periods within those fiscal years, and requires retrospective application for all periods presented.

FASB also issued EITF 07-05, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock, which addresses the first part of paragraph 11A of APB 14-1 as to whether or not a derivative is indexed to an entity's own stock. This EITF is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and requires retrospective application for all periods presented. EITF 07-05 requires that warrants with downside ratchet to be accounted for as liabilities that previously had been accounted for as equity under SFAS 133. Prior to EITF 07-05, these ratchet provisions were only evaluated under EITF 00-19, and because these ratchet provisions are generally within the company's control, they did not trigger liability or derivative accounting. Now under EITF 07-05 they do.

On January 1, 2009, we adopted FSP APB 14-1 and EITF 07-05. We determined that the 2,124,403 outstanding warrants that include anti-dilution features fall under the guidance of EITF 07-05 and the fair value of the warrants must be recorded as a liability and marked-to-market each reporting period with the changes in the fair value recorded as income/expense in the statement of operations.

- At March 31, 2009, the fair value of the outstanding warrants is 2.9 million and had been recorded as a liability recorded in “Embedded derivatives of warrants” with the corresponding expense, net of \$67,000 that was previously recorded in equity, recorded in “Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants” on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2009. The assumptions used for the Black-Scholes option pricing model at March 31, 2009 were a term of 4.1 years, volatility of 178% and a risk-free interest rate of 1.5%.

## 5. Stockholders' Equity

On September 4, 2008, we received a summons to appear in the United States District Court for the Southern District of New York because one of our investors in previous private placements transactions, Alpha Capital Anstalt (Alpha) alleged that we failed to issue certain stock certificates pursuant to the terms and conditions of the September 2007 investment subscription agreements. Alpha was asking the court to award them \$734,650 in damages plus attorneys fees. Although we believed the claim had no merit, we signed a definitive settlement agreement on January 21, 2009 and issued Alpha 1,096,997 shares of our common stock as settlement in full. On February 13, 2009 a notice was sent to the Court by Alpha's legal counsel requesting dismissal of the action. The fair value of the common stock issued to Alpha totaled \$54,000 and was accrued as a legal settlement expense and a liability at December 31, 2008. On January 21, 2009, we issued the common stock to Alpha and the \$54,000 accrued liability was reclassified to common stock additional paid in capital .

We converted approximately \$53,000 of our accounts payable to 792,912 shares of our common stock on January 26, 2009. The fair value of the shares of common stock issued to settle the accounts payable was \$23,000 based on our stock price on January 26, 2009. We recorded \$23,000 as common stock additional paid in capital and the difference of \$30,000 is included in Gain on Conversion and Forgiveness of Accounts Payable on our Condensed Consolidated Statements of Operations.

### Series A Preferred Stock

On December 31, 2009 we issued the following Series A Preferred stock:

- 112,290.40 shares to investors in a private placement who invested \$1,121,904.
- 244,265.56 shares to convertible debt holders who converted \$6,195,805 of principal and accrued interest.
  - 495,000 shares to acquire Cypressen.
- 4,067.02 shares for brokerage services in regards to the refinancing and capital raising transactions.

On March 31, 2009, our shareholders approved a resolution increasing the conversion ratio from one-to-one to 480.63 shares of common stock for each share of Series A Preferred Stock. Upon conversion, the shares of Series A Preferred Stock will convert into 411,190,010 shares of our common stock.

The fair value of the conversion of the 244,265.56 shares of Series A Preferred shares issued to the convertible debt holders that will be converted to 117,401,356 shares of our common stock at a later date was \$4.7 million based on our stock price on March 31, 2009. On March 31, 2009 and December 31, 2008, the \$2.4 million fair value of the Series A preferred issued prior to the shareholder approval is included in Series A Preferred stock in the Shareholders' Equity on the Condensed Consolidated Balance Sheets . On March 31, 2009, we recorded the \$2.3 million increase in the fair value as an increase in Common Stock Additional Paid In Capital on the Condensed Consolidated Balance Sheets and as a Deemed Dividend to Preferred Stockholders on our Condensed Consolidated Statements of Operations for the three months ended March 31, 2009..

The fair value of the conversion of the 495,000 shares of Series A Preferred shares issued to the related parties to acquire Cypressen that will be converted to 237,911,185 shares of our common stock at a later date was \$9.5 million based on our stock price on March 31, 2009. On March 31, 2009 and December 31, 2008, the \$12,000 fair value of the Series A preferred issued to the related parties prior to the shareholder approval is included in Series A Preferred stock in the Shareholders' Equity on the Condensed Consolidated Balance Sheets. The ownership of the stock vests on a straight line basis over 18 months. The \$9.5 million fair value of the common stock that will be issued upon conversion is amortized to compensation expense at the rate of \$1.6 million per quarter for six quarters beginning January 1, 2009. The \$1.6 million is recorded as an increase to Common Stock Additional Paid In Capital on the Condensed Consolidated Balance Sheets and as compensation expense included in our General and Administrative expense on our Condensed Consolidated Statements of Operations.

Series B Preferred Stock:

On December 31, 2008, we issued 92,795.94 shares of Series B Preferred Stock to warrant holders to convert their warrants to equity. On March 31, 2009, our shareholders approved a resolution increasing the conversion ratio from one-to-one to 132.07 shares of common stock for each share of Series B Preferred Stock. Upon conversion, the shares of Series B Preferred Stock will convert into 12,255,560 shares of our common stock.

The fair value of the conversion of the 92,795.94, shares of Series B Preferred shares issued to the warrant holders that will be converted to 12,255,560 shares of our common stock at a later date was \$490,000 based on our stock price on March 31, 2009. On March 31, 2009 and December 31, 2008, the \$2,000 fair value of the Series B preferred issued prior to the shareholder approval is included in Series B Preferred stock in the Shareholders' Equity on the Condensed Consolidated Balance Sheets. On March 31, 2009, we recorded the \$488,000 million increase in the fair value as an increase in Common Stock Additional Paid In Capital on the Condensed Consolidated Balance Sheets and as a Deemed Dividend to Preferred Stockholders on our Condensed Consolidated Statements of Operations for the three months ended March 31, 2009.

6. Fair Value Measurement of Assets and Liabilities

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which became effective for us on January 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS 157 does not mandate any new fair-value measurements and is applicable to assets and liabilities that are required to be recorded at fair value under other accounting pronouncements. Implementation of this standard did not have a material effect on our results of operations or consolidated financial position.

In February 2008, the FASB issued FASB Staff Position (FSP) FAS No. 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Its Related Interpretive Accounting Pronouncements That Address Leasing Transactions (FSP 157-1), which became effective for the company on January 1, 2008. This FSP excludes FSAS No. 13, Accounting for Leases, and its related interpretive accounting pronouncements from the provisions of FAS 157.

Also in February 2008, the FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which delayed our application of SFAS 157 for certain nonfinancial assets and liabilities until January 1, 2009. In this regard, the major categories of assets and liabilities for which we will not apply the provisions of FAS 157 until January 1, 2009, are long-lived assets that are measured at fair value upon impairment and liabilities for asset retirement obligations.

Our implementation of SFAS 157 for financial assets and liabilities on January 1, 2008, had no effect on our existing fair-value measurement practices but requires disclosure of a fair-value hierarchy of inputs we use to value an asset or a liability. The three levels of the fair-value hierarchy are described as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities. We had no level 1 assets or liabilities.

Level 2: Inputs other than Level 1 that are observable, either directly or indirectly. We had no level 1 assets or liabilities.

Level 3: Unobservable inputs. We valued our the fair value of warrants and the Series A and Series B Preferred stock that all were without observable market values and the valuation required a high level of judgment to determine fair

value (level 3 inputs).

16

---

The following table shows the classification of our liabilities and equity at March 31, 2009 that are subject to fair value measurements and the roll-forward of these liabilities and equity from December 31, 2008:

|                                     | March 31,<br>2009 | Decrease | Increase | December 31,<br>2008 |
|-------------------------------------|-------------------|----------|----------|----------------------|
| Series A Preferred stock            | \$ 3,531          | \$ -     | \$ -     | \$ 3,531             |
| Series B Preferred stock            | 2                 | -        | -        | 2                    |
| Fair value of Warrants              | 2,875             | -        | -        | -                    |
| Total Preferred stock at Fair Value | \$ 6,408          | \$ -     | \$ -     | \$ 3,533             |

## 7. Stock-Based Compensation

We have several approved stock option plans for which stock options and restricted stock awards are available to grant to employees, consultants and directors. All employee and director stock options granted under our stock option plans have an exercise price equal to the market value of the underlying common stock on the grant date. There are no vesting provisions tied to performance conditions for any options, as vesting for all outstanding option grants was based only on continued service as an employee, consultant or director. All of our outstanding stock options and restricted stock awards are classified as equity instruments.

### Stock Options

As of March 31, 2009, we had four equity incentive plans:

- The 1996 Stock Option Plan (the 1996 Plan), which terminated in January 2006;
- The 1998 Non-Officer Stock Option Plan (the 1998 Plan), which terminated in June 2008 ;
- The 2007 Neonode Stock Option Plan (the Neonode Plan), we will not grant any additional equity awards out of the Neonode Plan; and
- The 2006 Equity Incentive Plan (the 2006 Plan).

We also had one non-employee director stock option plan as of March 31, 2009:

- The 2001 Non-Employee Director Stock Option Plan (the Director Plan).

The following table details the outstanding options to purchase shares of our common stock pursuant to each plan at March 31, 2009:

| Plan          | Shares<br>Reserved | Options<br>Outstanding | Available<br>for Issue | Outstanding<br>Options<br>Vested |
|---------------|--------------------|------------------------|------------------------|----------------------------------|
| 1996 Plan     | 45,000             | 45,000                 | —                      | 45,000                           |
| 1998 Plan     | 51,495             | 51,495                 | —                      | 51,495                           |
| Neonode Plan  | 353,190            | 353,190                | —                      | 353,190                          |
| 2006 Plan     | 1,300,000          | 281,505                | 101,049                | 132,754                          |
| Director Plan | 68,000             | 42,500                 | —                      | 42,500                           |
| <b>Total</b>  | <b>1,817,685</b>   | <b>773,690</b>         | <b>101,049</b>         | <b>624,939</b>                   |

A summary of the combined activity under all of the stock option plans is set forth below:

|                                  | Weighted<br>Average<br>Number of<br>Shares | Exercise Price<br>Per Share | Weighted<br>Average Exercise<br>Price |
|----------------------------------|--|-----------------------------|---------------------------------------|
| Outstanding at December 31, 2008 | 1,322,978                                  | \$ 0.60 - \$27.50           | \$ 2.85                               |
| Granted                          | —  | —                           | —                                     |
| Cancelled or expired             | (549,288)                                  | \$ 2.12 - \$12.95           | 2.19                                  |
| Exercised                        | —  | —                           | —                                     |
| Outstanding at March 31, 2009    | 773,690                                    | \$ 0.60 - \$ 27.50          | \$ 3.31                               |

The 1996 Plan terminated effective January 17, 2006 and the 1998 Plan terminated effective June 15, 2008 and although we can no longer issue stock options out of the plans, the outstanding options at the date of termination will remain outstanding and vest in accordance with their terms. Options granted under the Director Plan vest over a one to four-year period, expire five to seven years after the date of grant and have exercise prices reflecting market value of the shares of our common stock on the date of grant. Stock options granted under the 1996, 1998 and 2006 Plans are exercisable over a maximum term of ten years from the date of grant, vest in various installments over a one to four-year period and have exercise prices reflecting the market value of the shares of common stock on the date of grant

The Neonode Plan has been designed for participants (i) who are subject to Swedish income taxation (each, a “Swedish Participant”) and (ii) who are not subject to Swedish income taxation (each, a “Non-Swedish Participant”). We will not grant any additional equity awards out of the Neonode Plan. The options issued under the plan to the Non-Swedish Participant are five year options with 25% vesting immediately and the remaining vesting over a three year period. The options issued to Swedish participants are vested immediately upon issuance.

We did not grant any stock options to employees or members of our Board of Directors (Board) during the three months ending March 31, 2009 compared to grants of 410,000 stock options for shares of our common stock to employees or members of our Board during the three months ending March 31, 2008. The fair value of stock-based compensation related to the employee and director stock options is calculated using the Black-Scholes option pricing model as of the grant date of the underlying stock options.

Salary expense for the three months ending March 31, 2009 and 2008 includes a stock compensation charges relating to the above issuance of employee and director stock options. The fair value of the options at the date of issuance of the Swedish options was calculated using the Black-Scholes option pricing model. The amount allocated to the unvested portion is amortized on a straight line basis over the remaining vesting period.

The stock compensation expense reflects the fair value of the vested portion of options for the Swedish and Non-Swedish participants at the date of issuance, the amortization of the unvested portion of the stock options, less the option premiums received from the Swedish participants. Employee and director stock-based compensation expense related to stock options in the accompanying condensed statements of operations is as follows (in thousands):

|                          | Three months<br>ended<br>March<br>31, 2008 | Three months<br>ended March<br>31, 2009 | Remaining<br>unamortized<br>expense at March<br>31, 2009 |
|--------------------------|--|---|--|
| Stock based compensation | \$ 890                                     | \$ 41                                   | \$ 339   |



Edgar Filing: Neonode, Inc - Form 10-Q

The remaining unamortized expense related to stock options will be recognized on a straight line basis monthly as compensation expense over the remaining vesting period which approximates 2.5 years.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

| Options granted in three months ended March 31 | 2009 | 2008    |
|--|------|---------|
| Expected life (in years)                       | N/A  | 2.11    |
| Risk-free interest rate                        | N/A  | 3.32%   |
| Volatility                                     | N/A  | 163.66% |
| Dividend yield                                 | N/A  | 0.00%   |

There were no stock options issued during the three months ended March 31, 2009. The weighted average grant-date fair value of options granted during the three months ended March 31, 2008 was \$2.67. There were no stock options exercised during the three months ending March 31, 2009 and 2008, respectively.

The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from our stock options. The Black-Scholes model also requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term and forfeiture rate of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior, as well as expected behavior on outstanding options. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of our stock price. These factors could change in the future, which would affect fair values of stock options granted in such future periods, and could cause volatility in the total amount of the stock-based compensation expense reported in future periods.

#### 8. Warranty Obligations and Other Guarantees:

The following is a summary of our agreements that we have determined are within the scope of FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others.

We have agreed to indemnify each of our executive officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. However, we have directors' and officers' liability insurance policy that should enable us to recover a portion of future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal and have no liabilities recorded for these agreements as of March 31, 2009 and December 31, 2008, respectively.

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with business partners, contractors, customers and landlords. Under these provisions we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by us with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments we could be required to make under these indemnification provisions is unlimited. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of March 31, 2009 and December 31, 2008, respectively.

On December 9, 2008, Empire Asset Management (Empire), a broker dealer that acted as the Company's financial advisor and exclusive placement agent in previous private placement transactions, initiated a law suit against the Company in the Supreme Court of the State of New York alleging that the Corporation misrepresented the success of its business to induce Empire's customers to invest in the Company. Empire is seeking compensatory damages in an unspecified amount for the harm allegedly suffered. The Company believes that the action has no merit and intends to defend vigorously against the action. The Company's Directors and Officer (D&O) insurance provider has extended coverage and will provide us with legal representation. Our D&O insurance policy has a \$150,000 retention provision and we have recorded a liability related to the potential payment of the retention under our D&O insurance policy

totaling \$150,000 at March 31, 2009 and December 31, 2008, respectively.

On March 24, 2009, the Company was informed that a complaint had been filed against the Company by an investor, Mr. David Berman, who invested \$600,000.00 in the Company on March 4, 2008 and May 16, 2008. The Company was informed that Mr. Berman invested in the Company through Empire. To date, the Company has not received a copy of the complaint, but the Company believes that the action has no merit and intends to defend vigorously against the action.

We are the secondary guarantor on the sublease of our previous headquarters until March 2010. We believe we will have no liabilities on this guarantee and have not recorded a liability at March 31, 2009 and December 31, 2008, respectively.

## 9. Net Loss Per Share

Basic net loss per common share for the three months ended March 31, 2009 and 2008 was computed by dividing the net loss for the relevant period by the weighted average number of shares of common stock outstanding. Diluted earnings per common share is computed by dividing net loss by the weighted average number of shares of common stock and common stock equivalents outstanding.

However, common stock equivalents of approximately 0 and 723,128 stock options and 2.1 million and 7.7 million warrants to purchase common stock are excluded from the diluted earnings per share calculation for the three months ended March 31, 2008 and 2007, respectively, due to their anti-dilutive effect.

| (in thousands, except per share amounts)                 | Three Months ended<br>March 31, |             |
|--|---------------------------------|-------------|
|  | 2009                            | 2008        |
| <b>BASIC AND DILUTED</b>                                 |                                 |             |
| Weighted average number of common shares outstanding (a) | 36,515                          | 24,426      |
| Number of shares for computation of net loss per share   | 36,515                          | 24,426      |
| Net loss available to comm. stockholders                 | \$ (7,848)                      | \$ (11,439) |
| Net loss per share basic and diluted                     | \$ (0.21)                       | \$ (0.47)   |

(a) In loss periods, common share equivalents would have an anti-dilutive effect on net loss per share and therefore have been excluded.

## 11. Segment Information

We have one reportable segment, as defined in SFAS 131, Disclosures about Segments of an Enterprise and Related Information. Prior to December 9, 2008, the date Neonode AB filed for bankruptcy, we operated in one industry segment: the development of intellectual property related to optical infrared touchscreen and the sale of associated products and licenses that encompass this technology. In December 2008, prior to our subsidiary, Neonode AB, filing for bankruptcy we transferred the patents, copyrights and all technology intellectual property to Neonode Inc pursuant to an intercompany debt pledge agreement and continue to develop and license our touchscreen technology. We have carried out substantially all of our operations through our subsidiary Neonode AB located in Sweden, although we did carry out some development activities together with our manufacturing partner in Malaysia. The majority of the sales of our mobile phones were concentrated in Europe.

Sales to individual countries in excess of 15% of net sales for the three months ended March 31, 2008 included sales to Belgium of \$207,000, or 30% of net sales and sales to Czech & Hungary of \$186,000, or 27% of net sales. All sales were executed in Euros or U.S. dollars.

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

### Forward Looking Statements

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties. Words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Readers are cautioned that the forward-looking statements reflect our analysis only as of the date hereof, and we assume no obligation to update these statements. Actual events or results may differ materially from the results discussed in or implied by the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those risks and uncertainties set forth under the caption "Risk Factors" below.

The following discussion should be read in conjunction with the condensed consolidated financial statements and the notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and financial statements for the year ended December 31, 2008.

## Overview

We specialize in user-friendly touchscreen solutions for hand-held devices, based on our innovative optical technology, which we refer to as zForce™. Our mission is to make the easiest (to use and integrate), best (functionality and design) and cheapest touch screen solution for handheld devices.

Through our wholly owned subsidiary, Neonode AB, we developed our touchscreen technology and an optical touchscreen mobile phone product, the Neonode N2 that provided a unique user experience that did not require any keypads, buttons or other moving parts. On December 1, 2008, we transferred the Neonode AB intellectual property including patents, copyrights and trademarks from Neonode AB to Neonode inc. pursuant to an intercompany debt pledge agreement. On December 9, 2008, Neonode AB filed for liquidation under the Swedish bankruptcy laws. Neonode AB had a total of approximately 10,000 N2 mobile phones in inventory at the time of its bankruptcy filing. Effective with Neonode AB's bankruptcy filing on December 9, 2008, Neonode Inc. is no longer in the mobile phone business and there are no known financial obligations related to the accounts payable or other debts of Neonode AB that Neonode Inc has responsibility. The Swedish bankruptcy court continues to pursue sales opportunities for Neonode AB's remaining inventory of N2 mobile phones. Although we may be the beneficiary of a portion of any sales proceeds from such sales. The majority of any future sales proceeds from the sale of the N2s in Neonode AB's inventory will be distributed to the creditors of Neonode AB by the Swedish bankruptcy court.

We believe our current product, the Neonode N2, is the world's smallest touchscreen mobile phone handset. The N2 fits in the palm of your hand and is designed to allow the user to navigate the menus and functions with simple finger based taps and sweeps. The N2 incorporates our patent pending touchscreen and other proprietary technologies to deliver a mobile phone with a completely unique user experience that doesn't require any keypads, buttons or other moving parts.

We have not generated sufficient cash from the sale of our products or licensing of our technology to support our operations and have incurred significant losses. The report of our independent registered public accounting firm in respect of the 2008 fiscal year includes an explanatory going concern paragraph which raises substantial doubt to continue as a going concern, which indicates an absence of obvious or reasonably assured sources of future funding that will be required by us to maintain ongoing operations. We have incurred net operating losses and negative operating cash flows since inception. During the twelve months ended December 31, 2008, we raised approximately \$9.6 million net cash through the sale of our securities, most recently \$1.1 million on December 31, 2008. Unless we are able to increase our revenues and decrease expenses substantially in addition to securing additional sources of financing, we will not have sufficient cash to support our operations through the end of 2009.

Our success is dependent on our obtaining sufficient capital or operating cash flows to fund our operations and to development of our technology and products, and on our bringing such technology and products to the worldwide market. To achieve these objectives, we may be required to raise additional capital through public or private financings or other arrangements. It cannot be assured that such financings will be available on terms attractive to us, if at all. Such financings may be dilutive to stockholders and may contain restrictive covenants.

In addition to the immediate risks relating to our ability to continue as a going concern and to obtain funding under the current market conditions, we are subject to certain risks common to technology-based companies in similar stages of development. See "Risk Factors" in our Form 10K for the year ended December 31, 2008. Principal risks include risks relating to the uncertainty of growth in market acceptance for our technology, a history of losses since inception, our ability to remain competitive in response to new technologies, the costs to defend, as well as risks of losing, patents

and intellectual property rights, a reliance on our future customers' ability to develop and sell products that incorporate our technology, the concentration of our operations in a limited number of facilities, the uncertainty of demand for our technology in certain markets, our ability to manage growth effectively, our dependence on key members of our management and development team, our limited experience in conducting operations internationally, and our ability to obtain adequate capital to fund future operations.

## Background

We account for our investment in Neonode AB in accordance with the AICPA Statement of Position, SOP 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code, and Accounting Research Bulletin, ARB 51, Consolidate Financial Statements. ARB 51 precludes consolidation of a majority-owned subsidiary where control does not rest with the majority owners, for instance, where the subsidiary is in bankruptcy. Accordingly, we deconsolidated Neonode AB from our consolidated financial statements on the date it filed for bankruptcy, December 9, 2008. Our Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2008 include the accounts of Neonode AB. Our Condensed Consolidated Balance Sheets do not include the accounts of Neonode AB at December 31, 2008 or March 31, 2009.

## Critical Accounting Policies and Estimates

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2008 include the accounts of Neonode Inc and Neonode AB. The Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2009 include the accounts of Neonode Inc and Cypressen. The Condensed Consolidated Balance Sheet as of March 31, 2009 and December 31, 2008 include the accounts of Neonode Inc and Cypressen. All inter-company accounts and transactions have been eliminated in consolidation.

## Revenue Recognition

### Neonode AB Mobile Phone Business and Licensing of Our Intellectual Property:

We recognize revenue from product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of products to our customers. We estimate expected sales returns and record the amount as a reduction of revenues and cost of sales at the time of shipment. Our policy complies with the guidance provided by the Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements, issued by the Securities and Exchange Commission. We recognize revenue from the sale of our mobile phones when all of the following conditions have been met: (1) evidence exists of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our products have been delivered and risk of loss has passed to the customer; (3) we have completed all of the necessary terms of the contract; (4) the amount of revenue to which we are entitled is fixed or determinable; and (5) we believe it is probable that we will be able to collect the amount due from the customer. To the extent that one or more of these conditions has not been satisfied, we defer recognition of revenue. Judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectibility is reasonably assured.

For the three months ended March 31, 2008, our revenues generated by the sale of Neonode AB's mobile phones have consisted primarily by sales to distributors. From time to time, we allowed certain distributors price protection subsequent to the initial product shipment. Price protection may allow the distributor a credit (either in cash or as a discount on future purchases) if there is a price decrease during a specified period of time or until the distributor resells the goods. Future price adjustments are difficult to estimate since we do not have a sufficient history of making price adjustments. Therefore, we deferred recognition of revenue (in the balance sheet line item "deferred revenue") derived from sales to these customers until they resold our products to their customers. Although revenue recognition and related cost of sales were deferred, we recorded an accounts receivable at the time of initial product shipment. As standard terms were generally FOB shipping point, payment terms were enforced from the shipment date, and legal title and risk of inventory loss passed to the distributor upon shipment.





For products sold to distributors with agreements allowing for price protection and product returns, we recognized revenue based on our best estimate of when the distributor sold the product to its end customer. Our estimate of such distributor sell-through was based on information received from our distributors. Revenue was not recognized upon shipment since, due to various forms of price concessions; the sales price was not substantially fixed or determinable at that time.

Revenue from products sold directly to end-users through our web sales channels were generally recognized when title and risk of loss has passed to the buyer, which typically occurs upon shipment. Reserves for sales returns are estimated based primarily on historical experience and were provided at the time of shipment.

Generally, our customers were responsible for the payment of all shipping and handling charges directly with the freight carriers.

#### Hardware Product:

We may from time-to-time develop custom hardware products for our customers that incorporate our touchscreen technology. Our policy is to recognize revenue from hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We defer and recognize service revenue over the contractual period or as services are rendered. We estimate expected sales returns and record the amount as a reduction of revenue and cost of hardware and other revenue at the time of shipment. Our policy complies with the guidance provided by the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements. Judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectibility is reasonably assured. Our sales transactions are denominated in U.S. dollars or Euros. The software component of our hardware products is considered incidental. Therefore, we do not recognize software revenue related to our hardware products separately from the hardware product sale. To date, we have not sold any hardware products.

When selling hardware, we expect our agreements with OEMs to incorporate clauses reflecting the following understandings:

- all prices are fixed and determinable at the time of sale;
- title and risk of loss pass at the time of shipment (FOB shipping point);
- collectibility of the sales price is probable (the OEM is creditworthy, the OEM is obligated to pay and such obligation is not contingent on the ultimate sale of the OEM's integrated solution);
- the OEM's obligation to us will not be changed in the event of theft or physical destruction or damage of the product;
- we do not have significant obligations for future performance to directly assist in the resale of the product by the OEMs; and
- there is no contractual right of return other than for defective products.

#### Software Products:

We may derive revenues from the following sources: (1) software, which includes our Neno™ software licenses and (2) engineering services, which include consulting. We account for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition. SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. These documents include post delivery support, upgrades, and similar services. To date, we have not sold any software products.

For software license arrangements that do not require significant modification or customization of the underlying software, we recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured. We initially defer all revenue related to the software license and maintenance fees until such time that we are able to establish VSOE for these elements of our software products. Revenue deferred under these arrangements is recognized to revenue over the expected contract term. We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted.

#### Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue as the engineering services stipulated under the contract are completed and accepted by our customers. To date, we have not sold any engineering services.

#### Allowance for Doubtful Accounts

Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of our customers when determining or modifying their credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer's account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation, such as in the case of a bankruptcy filing, deterioration in the customer's operating results or financial position, or other material events impacting its business, we record a specific allowance to reduce the related receivable to the amount we expect to recover. Should all efforts fail to recover the related receivable, we will write-off the account. We also record an allowance for all customers based on certain other factors including the length of time the receivables are past due and our historical collection experience with customers.

#### Research and Development

Research and Development (R&D) costs are expensed as incurred. R&D costs are accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 2, Accounting for Research and Development Costs. Research and development costs consist mainly of personnel related costs in addition to some external consultancy costs such as testing, certifying, and measurements.

#### Long-lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. If the estimated undiscounted cash flow related to these assets decreases in the future or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset.

#### Stock Based Compensation Expense

We account for stock-based employee compensation arrangements in accordance with SFAS 123 (revised 2004), Share-Based Payment (SFAS 123R). We account for equity instruments issued to non-employees in accordance with SFAS 123R and Emerging Issues Task Force (EITF) 96-18, Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, which require that such equity instruments be recorded at their fair value and the unvested portion is re-measured each reporting period. When determining stock based compensation expense involving options and warrants, we determine the estimated fair value of options and warrants using the Black-Scholes option pricing model.

#### Accounting for Debt Issued with Stock Purchase Warrants

We accounted for debt issued with stock purchase warrants in accordance with Accounting Principles Board (APB) Opinion 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, if they met equity classification. We allocate the proceeds of the debt between the debt and the detachable warrants based on the relative

fair values of the debt security without the warrants and the warrants themselves. The warrants were classified as a liability pursuant to the guidance provided in paragraph 17 of EITF 00-19. The warrants were recorded among “Liability for warrants to purchase common stock” and are valued at fair value at the end of each reporting period using the Black-Scholes option pricing model. As of December 31, 2008, all of the outstanding warrants are classified as equity.

## Liability for Warrants and Embedded Derivatives

We do not enter into derivative contracts for purposes of risk management or speculation. However, from time to time, we enter into contracts that are not considered derivative financial instruments in their entirety but that include embedded derivative features. Such embedded derivatives are assessed at inception of the contract and every reporting period, depending on their characteristics, are accounted for as separate derivative financial instruments pursuant to SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended (together, SFAS 133), if such embedded conversion features, if freestanding, would meet the classification of a liability. SFAS 133 requires that we analyze all material contracts and determine whether or not they contain embedded derivatives. Any such embedded conversion features that meet the above criteria are then bifurcated from their host contract and recorded on the consolidated balance sheet at fair value and the changes in the fair value of these derivatives are recorded each period in the consolidated statements of operations as an increase or decrease to Non-cash charges for conversion features and warrants.

Similarly, if warrants meet the classification of liabilities in accordance with EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, then the fair value of the warrants are recorded on the consolidated balance sheet at their fair values, and any changes in such fair values are recorded each period in the consolidated statements of operations as an increase or decrease to Non-cash charges for conversion features and warrants.

In May 2008, the FASB issued Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and requires retrospective application for all periods presented.

FASB also issued EITF 07-05, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock, which addresses the first part of paragraph 11A of APB 14-1 as to whether or not a derivative is indexed to an entity's own stock. EITF 07-05 requires Warrants with downside ratchet to be accounted for as liabilities that previously had been accounted for as equity under SFAS 133. Prior to EITF 07-05, these ratchet provisions were only evaluated under EITF 00-19, and because these ratchet provisions are generally within the company's control, they did not trigger liability or derivative accounting. Now under EITF 07-05 they do.

On January 1, 2009, we adopted FSP APB 14-1 and EITF 07-05. We determined that the 2,124,403 outstanding warrants that include anti-dilution features fall under the guidance of EITF 07-05 and the fair value of the warrants must be recorded as a liability and marked-to-market each reporting period with the changes in the fair value recorded as income/expense in the statement of operations.

## Income taxes

We account for income taxes in accordance with SFAS 109, Accounting for Income Taxes. SFAS 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of items that have been included in the financial statements or tax returns. We estimate income taxes based on rates in effect in each of the jurisdictions in which we operate. Deferred income tax assets and liabilities are determined based upon differences between the financial statement and income tax bases of assets and liabilities using enacted tax rates in effect for the

year in which the differences are expected to reverse. The realization of deferred tax assets is based on historical tax positions and expectations about future taxable income. Valuation allowances are recorded against net deferred tax assets where, in our opinion, realization is uncertain based on the “not more likely than not” criteria of SFAS 109.

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of March 31, 2009 and December 31, 2008. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such a determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

Effective January 1, 2007, we adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, which provisions included a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions accounted for in accordance with SFAS 109. As a result of the implementation of FIN 48, we recognized no increase in the liability for unrecognized tax benefits and a decrease in the related reserve of the same amount. Therefore upon implementation of FIN 48, we recognized no material adjustment to the January 1, 2007 balance of retained earnings. As of March 31, 2009 and December 31, 2008, we had no unrecognized tax benefits.

#### New Accounting Pronouncements

The following are expected effects of recent accounting pronouncements. We are required to analyze these pronouncements and determined the effect, if any; the adoption of these pronouncements would have on our results of operations or financial position.

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement on Financial Accounting Standards (SFAS) No. 141 (revised 2007), Business Combinations (SFAS No. 141R). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity's fiscal year that begins after 15 December 2008, and will be adopted by us in the first quarter of 2009. The adoption of SFAS 141R will affect the way we account for any acquisitions made after January 1, 2009.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), Fair Value Measurements which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements, but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for financial assets and financial liabilities within its scope for fiscal years beginning after November 15, 2007 and for interim periods within those fiscal years. We adopted SFAS 157 for financial assets and financial liabilities within its scope during the first quarter of 2008, and the adoption did not have an impact on our financial statements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2 (FSP FAS 157-2), Effective Date of FASB Statement No. 157, which defers the effective date of SFAS 157 for all non-financial assets and non-financial liabilities for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for items within the scope of FSP FAS 157-2. The adoption of FSP FAS 157-2 effective January 1, 2009 for the Company's non-financial assets and non-financial liabilities is not expected to have an impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements. SFAS 160 establishes new standards that will govern the accounting for and reporting of noncontrolling interests in partially owned subsidiaries. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008 and requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements shall be applied prospectively. The adoption of this standard will have no impact on the financial results of the Company on the date of adoption.



In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133, as amended and interpreted, which requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. Disclosing the fair values of derivative instruments and their gains and losses in a tabular format provides a more complete picture of the location in an entity's financial statements of both the derivative positions existing at period end and the effect of using derivatives during the reporting period. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended and its related interpretations (together SFAS 133), and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS 161 to have a material impact on our financial position, and we will make all necessary disclosures upon adoption, if applicable.

In April 2008, the FASB issued EITF 07-05, Determining whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock, (EITF 07-05). EITF 07-05 provides guidance on determining what types of instruments or embedded features in an instrument held by a reporting entity can be considered indexed to its own stock for the purpose of evaluating the first criteria of the scope exception in paragraph 11(a) of FAS 133. EITF 07-05 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and early application is not permitted. . We do not believe that the adoption of EITF 07-05 will have a significant impact on our consolidated financial statements, as the fair value of any financial instruments and related conversion features are not significant.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 is effective as of November 15, 2008. The adoption of SFAS 162 did not have any financial impact on our consolidated financial statements.

### Results of Operations

On December 9, 2008, our wholly owned Swedish subsidiary, Neonode AB filed for liquidation under the bankruptcy laws of Sweden. Pursuant to the Swedish bankruptcy laws, we are no longer responsible for the debt and liabilities nor do we have any ownership interest in the assets of Neonode AB as of the effective date of the bankruptcy filing, December 9, 2008. The Condensed Consolidated Statements of Operations and Cash Flows appearing elsewhere in this Periodic Report on Form 10-Q and the discussion of our financial condition and results of operations for the three months ended March 31, 2008 appearing below include the results of operations of our former wholly owned subsidiary, Neonode AB, only from January 1, 2008 through March 31, 2008. Pursuant to AICPA Statement of Position, SOP 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code, and Accounting Research Bulletin, ARB 51, Consolidate Financial Statements. ARB 51 precludes consolidation of a majority-owned subsidiary where control does not rest with the majority owners, for instance, where the subsidiary is in bankruptcy. Accordingly, we deconsolidated Neonode AB from our consolidated financial statements on the date it filed for bankruptcy, December 9, 2008.

On December 29, 2008, we entered into a Share Exchange Agreement with AB Cypresen nr 9683 (Cypresen), a Swedish engineering company, and the stockholders of Cypresen: Iwo Jima SARL, Wirelesstoys AB, and Athemis Ltd. (the Cypresen Stockholders), pursuant to which we agreed to acquire all of the issued and outstanding shares of Cypresen in exchange for the issuance of 495,000 shares of Neonode Inc. Series A Preferred Stock to the Cypresen Stockholders. Pursuant to the terms of the Share Exchange Agreement, upon the closing of the transaction, Cypresen became a wholly-owned subsidiary of the Company. Neonode's Condensed Consolidated Balance Sheets as of March 31, 2009 and December 31, 2008 include the accounts of Neonode Inc. and its new wholly owned subsidiary, Cypresen. The Condensed Consolidated Statements of Operations and Cash Flows appearing elsewhere in this Periodic Report on Form 10-Q and the discussion of our financial condition and results of operations for the three months ended March 31, 2009 appearing below include the results of operations of our new wholly owned subsidiary, AB Cypresen, only from January 1, 2009 through March 31, 2009.

### Net Sales

We did not have any net sales for the three months ended March 31, 2009. Net sales for the three months ended March 31, 2008 were \$391,000. Our revenue for the three month period ending March 31, 2008 were related to the sell-through of the N2 phones that were shipped to our customer in prior periods. We did not ship any new N2 phones in the three months ended March 31, 2008.

In January 2008 we discovered a technical issue that affected the quality of the voice reception of our N2 phone in the sub 900 Megahertz bandwidth. As a result, we undertook a program to recall and modify the phones that our customers held in inventory in order to bring the quality of the voice reception up to our standards. Due to the recall, we stopped all shipments of our N2 phones during the first quarter of 2008 and as a result our customers withheld payment of amounts due to until such time as we are able to return the modified phones to them. When the modifications are completed we may choose to redistribute the recall phones among our existing customers or to new customers.

License revenue for the three months ended March 31, 2008 amounted to \$9,000. The license revenue reported in the three month period ending March 31, 2008 relates to residual license revenues from the sale of the SBE software business in August 2007.

We sold our mobile phone products through a direct sales force that supports our distributors.

#### Gross Margin (Loss)

Gross margin (loss) was (\$250,000) for the three months ended March 31, 2008 . Our cost of goods include the direct cost of production of the phone plus indirect costs such as the cost of our internal production department and accrued estimated warranty costs. Gross loss for the three month period ending March 31, 2008 is a result of low sales volumes that were unable to efficiently absorb the cost of our internal production department.

#### Product Research and Development

Product research and development (R&D) expenses for the three month period ending March 31, 2009 were \$221,000 compared to \$1.5 million for the same period in 2008. Factors that contributed to the increase in R&D costs include a quarter-over-quarter increase in the headcount of our engineering department from 14 in three month period ending March 31, 2008 compared to five in the three months ended March 31, 2009. In addition, we incurred approximately \$400,000 in external consultancy costs related to the further development of the N2 as well as early stage development of successor products in the three months ended March 31, 2008 compared to no external development costs on 2009. Concurrently with the bankruptcy of Neonode AB on December 9, 2008 we terminated all the employees. We reorganized the Company on December 29, 2008 under Cypressen and hired R&D staff beginning January 22, 2009.

#### Sales and Marketing

Sales and marketing expenses for the three month period ended March 31, 2009 were \$58,000 compared to \$1.8 million for the same period in 2008. This decrease in 2009 as compared to 2008 is primarily related to decreases in product marketing activities such as advertising agency fees and marketing co-op expenses as well as an decrease in sales and marketing headcount . Concurrently with the bankruptcy of Neonode AB on December 9, 2008 we terminated all the employees. We reorganized the Company on December 29, 2008 under Cypressen and hired one sales consultant. The expense for sales and marketing for the three months ended March 31, 2009 are comprised of the costs to attend one trade show and the costs related to the sales consultant.

#### General and Administrative

General and administrative expenses for the three months ended March 31, 2009 were \$2.0 million compare to \$2.5 million for the same period in 2008.

General and administrative expense for 2009 includes \$1.6 million of non-cash amortization of compensation expense related to the \$9.5 million fair value of the common stock issued to related parties to acquire Cypressen. The \$9.5 million will be amortized to compensation expense over six quarters beginning January 1, 2009.

#### Interest Expense

Interest expense for the three month period ended March 31, 2009 was \$3,000 as compared to \$9,000 for the same period ended March 31, 2008. The decrease is primarily due to the conversion of substantially all the outstanding debt to equity on December 31, 2008. \$139,000 debt remains outstanding with a future quarterly interest expense of

\$3,000 until the note due date on August 31, 2010.

28

---

Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants

Charges related to debt extinguishments and debt discounts

Charges related to debt discounts and deferred financing fees for the three months ended March 31, 2008 amounted to \$2.2 million. All debt, except \$139,000, was converted to equity on December 31, 2009. As a result there are no charges related to debt discounts and deferred financing fees for the three months ended March 31, 2009.

Non-Cash valuation for Conversion Features and Warrants

Due to various previous financing arrangement as described in the notes to the financial statements, prior to conversion of warrants to equity we carried certain warrant as liabilities on our balance sheet. In addition, we recorded the value of the conversion features of the previous outstanding debt as a liability in our financial statements. These warrants and the value of the conversion features were valued at the end of each reporting period and marked to market. During the three months ended March 31, 2008, we recorded changes in the value of the warrants and conversion features amounting to a charge of \$5.5 million. Factors that affect the valuation of the warrants and conversion features in the three month period ending March 31, 2008 were changes in our stock price, volatility of our stock price over time, interest rates and the time period remaining for the warrants and conversion features being valued. All liabilities related to warrants and conversion features were converted to equity or terminated on December 31, 2009.

In May 2008, the FASB issued Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement). This FSP clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt issued with Stock Purchase Warrants. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and requires retrospective application for all periods presented.

FASB also issued EITF 07-05, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock, which addresses the first part of paragraph 11A of APB 14-1 as to whether or not a derivative is indexed to an entity's own stock. EITF 07-05 requires Warrants with downside ratchet to be accounted for as liabilities that previously had been accounted for as equity under SFAS 133. Prior to EITF 07-05, these ratchet provisions were only evaluated under EITF 00-19, and because these ratchet provisions are generally within the company's control, they did not trigger liability or derivative accounting. Now under EITF 07-05 they do.

On January 1, 2009, we adopted FSP APB 14-1 and EITF 07-05. We determined that the 2,124,403 outstanding warrants that include anti-dilution features fall under the guidance of EITF 07-05 and the fair value of the warrants must be recorded as a liability and marked-to-market each reporting period with the changes in the fair value recorded as income/expense in the statement of operations. We calculate the fair value each reporting period using the Black-Scholes option pricing model.

- At March 31, 2009, the fair value of the outstanding warrants is 2.9 million and had been record as a liability recorded in "Embedded derivatives of warrants" with the corresponding expense recorded in "Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants" on the Condensed Consolidated Statements of Operations for the three months ended March 31, 2009. The assumptions

used for the Black-Scholes option pricing model at March 31, 2009 were a term of 4.1 years, volatility of 178% and a risk-free interest rate of 1.5%.

Gain on conversion and forgiveness of accounts payable

We converted approximately \$53,000 of our accounts payable to 792,912 shares of our common stock on January 26, 2009. The fair value of the shares of common stock issued to settle the accounts payable was \$23,000 based on our stock price on January 26, 2009. We recorded \$23,000 as common stock additional paid in capital and the difference of \$30,000 is include in Gain on Conversion and Forgiveness of Accounts Payable on our Condensed Consolidated Statements of Operations.

#### Deemed Divided to Preferred Stockholders

On March 31, 2009, our shareholders approved a resolution increasing the conversion ratio from one-to-one to 480.63 shares of common stock for each share of Series A Preferred Stock. Upon conversion, the shares of Series A Preferred Stock will convert into 411,190,010 shares of our common stock.

The fair value of the conversion of the 244,265.56 shares of Series A Preferred shares issued to the convertible debt holders that will be converted to 117,401,356 shares of our common stock at a later date was \$4.7 million based on our stock price on March 31, 2009. On March 31, 2009 and December 31, 2008, the \$2.4 million fair value of the Series A preferred issued prior to the shareholder approval is included in Series A Preferred stock in the Shareholders' Equity on the Condensed Consolidated Balance Sheets. On March 31, 2009, we recorded the \$2.3 million increase in the fair value as an increase in Common Stock Additional Paid In Capital on the Condensed Consolidated Balance Sheets and as a Deemed Divided to Preferred Stockholders on our Condensed Consolidated Statements of Operations for the three months ended March 31, 2009.

On December 31, 2008, we issued 92,795.94 shares of Series B Preferred Stock to warrant holders to convert their warrants to equity. On March 31, 2009, our shareholders approved a resolution increasing the conversion ratio from one-to-one to 132.07 shares of common stock for each share of Series B Preferred Stock. Upon conversion, the shares of Series B Preferred Stock will convert into 12,255,560 shares of our common stock.

The fair value of the conversion of the 92,795.94, shares of Series B Preferred shares issued to the warrant holders that will be converted to 12,255,560 shares of our common stock at a later date was \$490,000 based on our stock price on March 31, 2009. On March 31, 2009 and December 31, 2008, the \$2,000 fair value of the Series B preferred issued prior to the shareholder approval is included in Series B Preferred stock in the Shareholders' Equity on the Condensed Consolidated Balance Sheets. On March 31, 2009, we recorded the \$488,000 million increase in the fair value as an increase in Common Stock Additional Paid In Capital on the Condensed Consolidated Balance Sheets and as a Deemed Divided to Preferred Stockholders on our Condensed Consolidated Statements of Operations for the three months ended March 31, 2009.

#### Income Taxes

Our effective tax rate was 0% in the three months ended March 31, 2009 and 2008, respectively. We recorded valuation allowances for the three month periods ending March 31, 2009 and 2008 for deferred tax assets related to net operating losses due to the uncertainty of realization. In the event of future taxable income, our effective income tax rate in future periods could be lower than the statutory rate as such tax assets are realized.

#### Net Loss

As a result of the factors discussed above, we recorded a net loss of \$7.8 million for the three month period ending March 31, 2009 compared to a net loss of \$11.4 million in the comparable period in 2008.

#### Off-Balance Sheet Arrangements

We do not have any transactions, arrangements, or other relationships with unconsolidated entities that are reasonably likely to affect our liquidity or capital resources other than the operating leases noted above. We have no special purpose or limited purpose entities that provide off-balance sheet financing, liquidity, or market or credit risk support; or engage in leasing, hedging, research and development services, or other relationships that expose us to liability that is not reflected on the face of the financial statements



## Liquidity and Capital Resources

Our liquidity is dependent on many factors, including sales volume, operating profit and the efficiency of asset use and turnover. Our future liquidity will be affected by, among other things:

- actual versus anticipated licensing of our technology;
- our actual versus anticipated operating expenses;

- the timing of our OEM customer product shipments;
- the timing of payment for our technology licensing agreements;
  - our actual versus anticipated gross profit margin;
  - our ability to raise additional capital, if necessary; and
  - our ability to secure credit facilities, if necessary.

The consolidated financial statements included herein have been prepared on a going concern basis, which contemplates continuity of operations and the realization of assets and repayment of liabilities in the ordinary course of business. The report of our independent registered public accounting firm in respect of the 2008 fiscal year includes an explanatory going concern paragraph which raises substantial doubt to continue as a going concern, which indicates an absence of obvious or reasonably assured sources of future funding that will be required by us to maintain ongoing operations. Although we have been able to fund our operations to date, there is no assurance that cash flow from our operations or our capital raising efforts will be able to attract the additional capital or other funds needed to sustain our operations. The going concern qualification from our auditors may make it more difficult for us to raise funds. If we are unable to obtain additional funding for operations, we may not be able to continue operations as proposed, requiring us to modify our business plan, curtail various aspects of our operations or cease operations. In such event, investors may lose a portion or all of their investment.

On December 31, 2008, we completed certain refinancing and capital raising transactions, acquired Cypressen, and began operations with a primary focus on licensing our touchscreen technology to third party OEM customers. We do not have any current active customer for our touchscreen technology. In most circumstances our target customers will have to successfully integrate our technology into their products and then sell those products to their customers before we will receive any cash from those technology license agreements.

Our cash is subject to interest rate risk. We invest primarily on a short-term basis. Our financial instrument holdings at March 31, 2009 were analyzed to determine their sensitivity to interest rate changes. The fair values of these instruments were determined by net present values. In our sensitivity analysis, the same change in interest rate was used for all maturities and all other factors were held constant. If interest rates increased by 10%, the expected effect on net loss related to our financial instruments would be immaterial. The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona, and is subject to foreign currency exchange rate risk. Any increase or decrease in the exchange rate of the U.S. Dollar compared to the Swedish Krona will impact Neonode's future operating results.

At March 31, 2009, we had cash and cash equivalents of \$153,000 as compared to \$17,000 at December 31, 2008. In the three month period ended March 31, 2009, \$836,000 of cash was used in operating activities, primarily as a result of our net loss increased by the following non-cash items (in thousands):

|  |    |       |
|--|----|-------|
| Depreciation and amortization  | \$ | 3     |
| Stock-based compensation expense   |    | 1,625 |
| Debt and warrant conversion expense  |    | 2,741 |
| Debt discounts and deferred financing fees and the valuation of conversion features and warrants |    | 2,808 |
| Loss of retirement of assets   |    | 30    |
| Gain on conversion and forgiveness of accounts payable   |    | (55)  |
| Total net non-cash items included in cash used in our operations                                 | \$ | 7,152 |

Working capital deficit was \$492,000 (current assets less current liabilities, not including non-cash warrant liability) at March 31, 2009, compared to working capital deficit of \$962,000 at December 31, 2008.

Edgar Filing: Neonode, Inc - Form 10-Q

In the three month period ended March 31, 2008, we purchased \$17,000 of fixed assets, consisting primarily of computers and engineering equipment.

In January and February 2009 we collected cash of \$989,000, net of \$133,000 in legal costs and amounts collected in December 2008, from a private placement financing transaction entered into on December 30, 2008 where we issued 112,190.40 shares of our Series A Preferred Stock to the investors for a total investment of \$1,121,904.

The majority of our cash has been provided by borrowings from senior secured notes and bridge notes that have been or are convertible into shares of our common stock or from the sale of our common stock and common stock purchase warrants to private investors. We have been able to convert approximately \$6.1 million of the \$6.3 million outstanding convertible debt to equity. The \$139,000 convertible note that was not converted into equity is due in August 2010. We will require sources of capital in addition to cash on hand to continue operations and to implement our strategy. Our operations are not cash flow positive and we may be forced to seek credit line facilities from financial institutions, additional private equity investment or debt arrangements. No assurances can be given that we will be successful in obtaining such additional financing on reasonable terms, or at all. If adequate funds are not available on acceptable terms, or at all, we may be unable to adequately fund our business plans and it could have a negative effect on our business, results of operations and financial condition. In addition, if funds are available, the issuance of equity securities or securities convertible into equity could dilute the value of shares of our common stock and cause the market price to fall, and the issuance of debt securities could impose restrictive covenants that could impair our ability to engage in certain business transactions.

#### Item 4. Controls and Procedures

##### Disclosure Controls and Procedures

Under the supervision of and with the participation of our management, including the Company's Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the March 31, 2009. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective for the reasons described below.

During the audit of our consolidated financial statements for the year ended December 31, 2008, management determined that we had certain material weaknesses relating to our accounting for certain financing transactions, including convertible debt and derivative financial instruments. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a Company's annual or interim financial statements will not be prevented or detected on a timely basis. In addition, we entered into several complex financing transactions (including conversion of convertible debt, derivatives, conversion of warrants, bankruptcy of Neonode AB and complex valuation and measurement activities) that resulted in accounting adjustments during our year-end audit. Because these material weaknesses as to internal control over financial reporting also bear upon our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer were unable to conclude our disclosure controls and procedures were effective.

Despite the conclusion that disclosure controls and procedures were not effective as of the end of period covered by this report, the Chief Executive Officer and Chief Financial Officer believe that the financial statements and other information contained in this annual report present fairly, in all material respects, our business, financial condition and results of operations.

##### Internal Control over Financial Reporting

###### Report of Management on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system has been designed to provide reasonable, not absolute, assurance to our management and Board of Directors that the objectives of our control system with respect to the integrity, reliability and fair presentation of published financial statements are met. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that

the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we assessed the effectiveness of our internal control over financial reporting as of March 31, 2009. In making this assessment, we used the criteria established in the framework on Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission. Based on our assessment, which was conducted according to the COSO criteria, we have concluded that our internal control over financial reporting was not effective in achieving its objectives as of March 31, 2009 due to a material weakness that existed in our internal controls relating to our accounting for certain financing transactions, including convertible debt and derivative financial instruments.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. Based on management's assessment of our internal control over financial reporting as of March 31, 2009, the following material weakness existed as of that date:

The Company's controls over accounting for certain financing transactions did not operate effectively as of March 31, 2009. In addition, we entered into several complex financing transactions (including conversion of convertible debt, derivatives, conversion of warrants, bankruptcy of Neonode AB and complex valuation and measurement activities) that resulted in accounting adjustments during our year-end audit.

This annual report is not required to include a report of the Company's independent registered public accounting firm due to temporary rules of the Commission that would permit us to provide only management's assessment in this annual report.

This annual report is not required to include a report of the Company's independent registered public accounting firm due to temporary rules of the Commission that would permit us to provide only management's assessment in this annual report.

As discussed elsewhere in this report, the bankruptcy on December 9, 2008 of our previous operating subsidiary Neonode AB and the recent acquisition of Cypressen on December 30, 2008 represented a significant change in our business and financial operations. Having occurred in the final quarter of the fiscal year, the bankruptcy and acquisition left management with insufficient time to finalize integration and consolidate operations to fully assess the effectiveness of internal control over financial reporting.

As we move towards complete integration and consolidation of business and financial operations of Cypressen and Neonode, we expect to take steps to both remedy the material weaknesses described above and facilitate our management's assessment of internal control over financial reporting in accordance with the Sarbanes-Oxley Act and Commission rules. Our planned steps include:

- adding personnel to our financial department, consultants, or other resources (including those with public company reporting experience) to enhance our policies and procedures, including those related to revenue recognition;
- exploring the suitability of further upgrades to our accounting system to complement the new management reporting system software described above; and
- engaging a qualified consultant in 2009 to perform an assessment of the effectiveness of our internal control over financial reporting and assist us in implementing appropriate internal controls on weaknesses determined, if any, documenting, and then testing the effectiveness of those controls.

## PART II. Other Information

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

None

### ITEM 6. Exhibits and Reports on Form 8-K

Edgar Filing: Neonode, Inc - Form 10-Q

Exhibits

| Exhibit # | Description  |
|-----------|--|
| 2.1       | Agreement and Plan of Merger and Reorganization between SBE, Inc. and Neonode Inc., dated January 19, 2007 (incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on January 22, 2007 ) ( In accordance with Commission rules, we supplementally will furnish a copy of any omitted schedule to the Commission upon request ) |
| 2.2       | Amendment No. 1 to the Agreement and Plan of Merger and Reorganization between SBE, Inc. and Neonode Inc., dated May 18, 2007, effective May 25, 2007 ( incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on May 29, 2007 )   |
| 3.1       | Amended and Restated Certificate of Incorporation, dated December 20, 2007, effective December 21, 2007  |
| 3.2       | Bylaws, as amended through December 5, 2007  |
| 4.1       | Certificate of Designations, Preferences and Rights of the Series A and Series B Preferred Stock dated 29 December 2008 ( incorporated by reference as Exhibit 4.1 of our Current Report on Form 8-K filed on December 31, 2008 )  |
| 4.2       |  |
| 4.3       | Certificate of Increase of Designation of Series B Preferred Stock dated 2 January 2009<br>Certificate of Increase of Designation of Series B Preferred Stock dated 28 January 2009  |
| 10.1      | Senior Secured Note, dated August 8, 2007 ( incorporated by reference to Exhibit 10.22(a) of our Current Report on Form 8-K filed on October 2, 2007 )   |
| 10.2      | Amendment to Senior Secured Note, dated September 10, 2007 ( incorporated by reference to Exhibit 10.22(b) of our Current Report on Form 8-K filed on October 2, 2007 )  |
| 10.3      | Form of Common Stock Purchase Warrant issued pursuant to Amendment to Senior Secured Notes, dated September 10, 2007 ( incorporated by reference to Exhibit 10.22(c) of our Current Report on Form 8-K filed on October 2, 2007 )  |
| 10.4      | Subscription Agreement, dated September 10, 2007 ( incorporated by reference to Exhibit 10.23 of our Current Report on Form 8-K filed on October 2, 2007 )   |
| 10.5      | Convertible Promissory Note ( incorporated by reference to Exhibit 10.24 of our Current Report on Form 8-K filed on October 2, 2007 )  |
| 10.6      | Form of Common Stock Purchase Warrant ( incorporated by reference to Exhibit 10.25 of our Current Report on Form 8-K filed on October 2, 2007 )  |
| 10.7      | Form of Unit Purchase Warrant ( incorporated by reference to Exhibit 10.26 of our Current Report on Form 8-K filed on October 2, 2007 )  |
| 10.8      | Subscription Agreement, dated March 4, 2008 ( incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on March 3, 2008 )   |
| 10.8      | Asset Purchase Agreement with One Stop Systems, Inc., dated January 11, 2007 ( incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on January 12, 2007 )  |
| 10.9      | Asset Purchase Agreement with Rising Tide Software, dated August 15, 2007 ( incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on August 24, 2007 )  |
| 10.10     | Lease for 4000 Executive Parkway, Suite 200 dated July 27, 2005 with Alexander Properties Company  |
| 10.11     | 1998 Non-Officer Stock Option Plan, as amended ( incorporated by reference to Exhibit 99.2 of our Registration Statement on Form S-8 (333-63228) filed on June 18, 2001 )+   |
| 10.12     | 2001 Non-Employee Directors' Stock Option Plan, as amended ( incorporated by reference to Exhibit 10.2 of our Annual Report on Form 10-K for the fiscal year ended October 31, 2002, as filed on January 27, 2003 )+   |
| 10.13     | Director and Officer Bonus Plan, dated September 21, 2006 ( incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on September 26, 2006 )+   |
| 10.14     | Executive Severance Benefits Agreement with David W. Brunton, dated April 12, 2004 ( incorporated by reference to Exhibit 10.13 of our Quarterly Report on Form 10-Q for the period ended January 31, 2005,  |

Edgar Filing: Neonode, Inc - Form 10-Q

- as filed on March 2, 2005 )+
- 10.15 Note Conversion Agreement, dated December 31, 2008 ( incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on December 31, 2008)
  - 10.16 Share Exchange Agreement, dated December 30, 2008 ( incorporated by reference to Exhibit 10.4 of our Current Report on Form 8-K filed on December 31, 2008)
  - 10.17 Series A Stock Subscription Agreement, dated December 31, 2008 ( incorporated by reference to Exhibit 10.3 of our Current Report on Form 8-K filed on December 31, 2008)
  - 10.18 Warrant Conversion Agreement, dated December 31, 2008 ( incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K filed on December 31, 2008 )
  - 10.19 Employment Agreement with Per Bystedt
  - 10.20 Employment Agreement with Thomas Eriksson
  - 10.21 Employment Agreement with Magnus Goertz



- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002
  - 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002
  - 32 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- + Management contract or compensatory plan or arrangement

35

---

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly this report to be signed on its behalf by the undersigned thereunto duly authorized, on May 15, 2009.

Neonode Inc.  
Registrant

Date: May 15, 2009

By: /s/ David W. Brunton  
David W. Brunton  
Chief Financial Officer,  
Vice President, Finance  
and Secretary  
(Principal Financial and  
Accounting Officer)