NEOMEDIA TECHNOLOGIES INC
Form 10-Q
August 05, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10 - Q**

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

**For the quarterly period ended June 30, 2013**

**or**

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

**For the transition period from __________ to ____________**

**Commission File Number 0-21743**

**NeoMedia Technologies, Inc.**

(Exact Name of Issuer as Specified In Its Charter)

| **Delaware** | **36-3680347** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**100 W Arapahoe Avenue, Suite 9, Boulder, Colorado 80302**

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

**303-546-7946**

(Registrants' 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 Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller Reporting Company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The number of outstanding shares of the registrant's Common Stock on August 2, 2013 was 4,984,827,279.

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**NeoMedia Technologies, Inc.**

**Form 10-Q**

**For the Quarterly Period Ended June 30, 2013**

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PART I — FINANCIAL INFORMATION

**ITEM 1. Financial Statements**

**NeoMedia Technologies, Inc. and Subsidiaries**

**Condensed Consolidated Balance Sheets**

**(in thousands, except share and per share data)**

| | June 30, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 70 | $ 611 |
| Trade accounts receivable | 885 | 217 |
| Prepaid expenses and other assets | 39 | 120 |
| Total current assets | 994 | 948 |
| | | |
| Property, plant and equipment, net | 27 | 44 |
| Goodwill | 3,418 | 3,418 |
| Proprietary software, net | - | 99 |
| Patents and other intangible assets | 1,353 | 1,490 |
| Other long term assets | - | 40 |
| Total assets | $ 5,792 | $ 6,039 |
| | | |
| LIABILITIES AND SHAREHOLDERS' DEFICIT | | |
| Current Liabilities: | | |
| Accounts payable | $ 562 | $ 506 |
| Accrued expenses | 497 | 399 |
| Deferred revenue and customer prepayments | 2,852 | 3,735 |
| Notes payable | - | 50 |
| Deferred tax liability | 706 | 706 |
| Derivative financial instruments - warrants | 276 | 3,687 |
| Derivative financial instruments - Series C and D preferred stock and debentures payable | 4,286 | 2,147 |
| Debentures payable - carried at amortized cost | 53 | 53 |
| Debentures payable - carried at fair value | 82,906 | 64,292 |
| Total current liabilities | 92,138 | 75,575 |
| | | |
| Commitments and contingencies | - | - |
| | | |
| Series C convertible preferred stock, $0.01 par value, 27,000 shares authorized, 4,816 and 4,840 shares issued and outstanding, respectively, and a liquidation value of $4,816 and $4,480 at June 30, 2013 and December 31, 2012, respectively. | 4,816 | 4,840 |

| | | |
|---|---|---|
| Series D convertible preferred stock, $0.01 par value, 25,000 shares authorized, 3,481 shares issued and outstanding, respectively, and a liquidation value of $348 at June 30, 2013 and December 31, 2012, respectively. | 348 | 348 |
| | | |
| Shareholders' deficit: | | |
| Common stock, $0.001 par value, 5,000,000,000 shares authorized, 4,909,827,279 and 2,106,035,882 shares issued and outstanding as of June 30, 2013 and December 31, 2012, respectively | 4,910 | 2,106 |
| Additional paid in capital | 190,923 | 188,814 |
| Accumulated deficit | (286,663) | (264,630) |
| Accumulated other comprehensive loss | 99 | (235) |
| Treasury stock, at cost, 2,012 shares of common stock | (779) | (779) |
| Total shareholders' deficit | $ (91,510) | $ (74,724) |
| Total liabilities and shareholders' deficit | $ 5,792 | $ 6,039 |

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

**NeoMedia Technologies, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) (Unaudited)**

**(in thousands, except share and per share data)**

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Revenue | $1,667 | $461 | $2,269 | $1,187 |
| Cost of revenues | 269 | 6 | 300 | 28 |
| Gross profit | 1,398 | 455 | 1,969 | 1,159 |
| Sales and marketing expenses | 47 | 215 | 108 | 420 |
| General and administrative expenses | 665 | 913 | 1,471 | 1,913 |
| Research and development costs | 172 | 259 | 384 | 593 |
| Operating income (loss) | 514 | (932) | 6 | (1,767) |
| Loss on extinguishment of debt | - | (27,479) | - | (27,479) |
| Gain/(loss) from change in fair value of hybrid financial instruments | (29,569) | 36,773 | (22,795) | 5,603 |
| Gain/(loss) from change in fair value of derivative liability - warrants | 289 | 42,409 | 3,411 | 921 |
| Gain/(loss) from change in fair value of derivative liability - Series C and D preferred stock and debentures | (1,849) | 75,351 | (2,149) | (14,298) |
| Other Income | 227 | - | 227 | - |
| Interest (expense) / income | 16 | (2,003) | 16 | (4,395) |
| Net income (loss) available to common shareholders | $(30,372) | $124,119 | $(21,284) | $(41,415) |
| Comprehensive income (loss): | | | | |
| Net income (loss) | (30,372) | 124,119 | (21,284) | (41,415) |
| Other comprehensive gain/(loss) - investment in GmbH and foreign currency adjustment | (223) | (8) | (334) | (15) |
| Comprehensive income (loss): | $(30,595) | $124,111 | $(21,618) | $(41,430) |
| Net income (loss) per share, basic and diluted: | | | | |
| Basic | $(0.007) | $0.11 | $(0.007) | $(0.13) |
| Fully diluted | $(0.007) | $- | $(0.007) | $(0.13) |

| | | | | |
|---|---|---|---|---|
| Weighted average number of common shares: | | | | |
| Basic | 4,057,691,643 | 1,148,526,738 | 3,230,324,614 | 326,414,797 |
| Fully diluted | 4,057,691,643 | 8,113,106,249 | 3,230,324,614 | 326,414,797 |

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

**NeoMedia Technologies, Inc. and Subsidiaries**

**Condensed Consolidated Statements of Cash Flows (Unaudited)**

(in thousands)

| | For the six months ended June 30, 2013 | 2012 |
|---|---|---|
| Cash Flows from Operating Activities: | | |
| Net income / (loss) | $(21,284) | $(41,415) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 253 | 487 |
| Loss on extinguishment of debt | - | 27,479 |
| (Gain)/loss from change in fair value of hybrid financial instruments | 2,149 | (5,603) |
| (Gain)/loss from change in fair value of derivative liability - warrants | (3,411) | (921) |
| (Gain)/loss from change in fair value of derivative liability - Series C and D preferred stock and debentures | 22,795 | 14,298 |
| Interest expense related to convertible debt | - | 4,395 |
| Stock based compensation expense | 1 | 14 |
| Increase in value of life insurance policies | - | (34) |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in accounts receivable | (441) | (242) |
| (Increase) decrease in prepaid expenses and other assets | 80 | (44) |
| Increase (decrease) in accounts payable & accrued expenses | 91 | (53) |
| Increase (decrease) in deferred revenue and customer prepayments | (1,108) | (342) |
| Net cash used in operating activities | (875) | (1,981) |
| Cash Flows from Investing Activities | | |
| Acquisition of property and equipment | - | (3) |
| Net cash used in investing activities | - | (3) |
| Cash Flows from Financing Activities | | |
| Borrowing under convertible debt instruments, net | - | 2,075 |
| Net cash provided by financing activities | - | 2,075 |
| Effect of exchange rate changes on cash | 334 | 15 |
| Net change in cash and cash equivalents | (541) | 106 |
| Cash and cash equivalents, beginning of period | 611 | 30 |
| Cash and cash equivalents, end of period | $70 | $136 |

| | | |
|---|---|---|
| Supplemental cash flow information: | | |
| Series C preferred stock converted to common stock | 24 | 878 |
| Series D preferred stock converted to common stock | - | 2,342 |
| Convertible debentures converted to common stock | 2,561 | 10,104 |

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

**NeoMedia Technologies, Inc. and Subsidiaries**

**Notes to Condensed Consolidated Financial Statements**

**June 30, 2013 and December 31, 2012**

**(Unaudited)**

**Note 1 - General**

***Business –*** NeoMedia Technologies, Inc., a Delaware corporation ("NeoMedia", and also referred to herein as "us", "we" and "our"), was founded in 1989 and is headquartered in Boulder, Colorado. We have pioneered 2D mobile barcode technology and infrastructure solutions that enable the mobile barcode ecosystem world-wide. NeoMedia strives to harness the power of the mobile phone in innovative ways with state-of-the-art mobile barcode technology. With this technology, mobile phones with cameras become barcode scanners and this enables a range of practical applications including mobile marketing, mobile commerce and advertising. In addition, we offer barcode management reader solutions as well as intellectual property licensing.

***Going Concern*** – We have historically incurred net losses from operations and we expect that we will continue to have negative cash flows as we implement our business plan. There can be no assurance that our continuing efforts to execute our business plan will be successful and that we will be able to continue as a going concern. The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("US GAAP"), which contemplates our continuation as a going concern. Net (loss) for the six months ended June 30, 2013 and 2012, respectively, was $(21.3) million and $(41.4) million, of which $(21.5) million and $(35.3) million, respectively, were net losses related to our financing instruments. Our operating income was $5,800 for the six months ended June 30, 2013, and our operating loss was $(1.8) million for the six months ended June 30, 2012.

Net cash used by operations during the six months ended June 30, 2013 and 2012 was $(875,000) and $(2.0) million, respectively. At June 30, 2013, we have an accumulated deficit of $(287) million. We also have a working capital deficit of $(91.1) million, of which $(87.5) million is related to our financing instruments related to the fair value of warrants and those debentures that are recorded as hybrid financial instruments and the amortized cost carrying value of certain of our debentures and the fair value of the associated derivative liabilities.

The items discussed above raise substantial doubt about our ability to continue as a going concern.

We currently do not have sufficient cash or commitments for financing to sustain our operations for the next twelve months. Our plan is to develop new client and customer relationships and substantially increase our revenue derived from improved products and IP licensing. If our revenues do not reach the level set anticipated in our plan and our operating expenses cannot be reduced to sustain our operations, we may require additional financing in order to execute our operating plan; however, we believe that our revenues will reach such level and such additional financing will not be necessary. If additional financing is required, we cannot predict whether this additional financing will be in the form of equity, debt, or another form and we may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In the event that these financing sources do not materialize, or that we are unsuccessful in increasing our revenues and profits, we may be unable to implement our current plans for expansion, repay our debt obligations or respond to competitive pressures, any of which circumstances would have a material adverse effect on our business, prospects, financial condition and results of operations.

The Convertible debentures and preferred stock used to finance the Company, which may be converted into Common Stock at the sole option of the holders, have a highly dilutive impact when they are converted, greatly increasing the number of common shares outstanding. During the three and six months ended June 30, 2013, there were 1,564,810,047 and 2,803,791,397 shares of common stock issued for these conversions, respectively. The Company cannot predict if nor when each holder may or may not elect to convert into common shares.

Our financial statements do not include any adjustments relating to the recoverability and reclassification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should we be unable to continue as a going concern.

**Note 2 - Summary of Significant Accounting Policies**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with US GAAP for interim financial information and Rule 8.03 of Regulation S-X. They do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation have been included. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. For further information, refer to our financial statements as of December 31, 2012 and 2011, and for the years then ended, including notes thereto, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

***Basis of Presentation*** – The consolidated financial statements include the accounts of NeoMedia Technologies, Inc. and our wholly-owned subsidiaries. We operate as one reportable segment. All significant intercompany accounts and transactions have been eliminated.

***Use of Estimates*** – The preparation of consolidated financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Changes in facts and circumstances may result in revised estimates, which are recorded in the period in which they become known.

***Stock-Based Compensation -*** FASB ASC 718, *Stock Compensation*, requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the grant date fair value of the award. We account for modifications of the terms of existing option grants as exchanges of the existing equity instruments for new instruments. The fair value of the modified option at the grant date is compared with the value at that date of the original option immediately before its terms are modified. Any excess fair value of the modified option over the original option is recognized as additional compensation expense.

***Revenue Recognition –*** We derive revenues from the following sources: (1) license fees relating to intellectual property, and (2) software and service revenues related to mobile marketing barcode infrastructure management and development, barcode readers and internally developed software.

In accordance with Financial Accounting Standard Board (“FASB”) and Securities and Exchange Commission (“SEC”) Staff Accounting guidance on revenue recognition the Company considers revenue earned and realizable when: (a) persuasive evidence of the sales arrangement exists, (b) the arrangement fee is fixed or determinable, (c) service delivery or performance has occurred, (d) customer acceptance has been received, if contractually required, and (e) collectability of the arrangement fee is probable. Revenue associated with licensing agreements primarily consists of non-refundable upfront license fees. Non-refundable upfront license fees received under license agreements, whereby continued performance or future obligations are considered inconsequential to the relevant license technology, are recognized as revenue upon delivery of the technology. The Company typically uses signed contractual agreements as persuasive evidence of a sales arrangement.

If at the inception of an arrangement the fee is not fixed or determinable, we defer revenue until the arrangement fee becomes due and payable. If we determine collectability is not probable, we defer revenue until we receive payment or collection becomes probable, whichever is earlier. The determination of whether fees are collectible requires judgment of our management, and the amount and timing of revenue recognition may change if different assessments are made.

***Basic and Diluted Net Income (Loss) Per Share*** – Basic net income (loss) per share is computed by dividing net income (loss) attributable to common shareholders by the weighted average number of shares of our Common Stock, par value $0.001 per share ("Common Stock"), outstanding during the period. During the three and six months ended June 30, 2013 and the six months ended June 30, 2012, we reported a net loss per share, and as such, basic and diluted losses per share were equivalent. During the three months ended June 30, 2012, we reported net income per share and included dilutive instruments in the fully diluted net income per share calculation. For the three and six months ended June 30, 2013 and 2012, approximately 513,342,555 and 513,342,555 and zero and 6,964,579,511, respectively, of potentially dilutive shares were excluded from the calculation as they were anti-dilutive.

| | Three Months Ended June 30, | | **Six Months Ended June 30,** | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands, except share and per share data) | | | |
| Numerator: | | | | |
| Net income (loss) available to common shareholders | $(30,372) | $124,119 | $(21,284) | $(41,415) |
| Numerator for diluted earnings per share-income (loss) available to common stockholders after assumed conversions of debentures and exercise of warrants | $(30,372) | $124,119 | $(21,284) | $(41,415) |
| Denominator: | | | | |
| Weighted average shares used to compute basic EPS | 4,057,691,643 | 1,148,526,738 | 3,230,324,614 | 326,414,797 |
| Denominator for diluted earnings per share-adjusted weighted average shares and assumed conversions and exercise of options | 4,057,691,643 | 8,113,106,249 | 3,230,324,614 | 326,414,797 |
| Basic earnings per share | $(0.007) | $0.11 | $(0.007) | $(0.13) |
| Diluted earnings per share | $(0.007) | $0.00 | $(0.007) | $(0.13) |

***Goodwill*** –Goodwill represents the excess of the purchase price paid for NeoMedia Europe over the fair value of the identifiable net assets and liabilities acquired, based on an independent appraisal of the assets and liabilities acquired. In accordance with FASB ASC 350, *Intangibles - Goodwill and Other* goodwill is not amortized, but is tested for impairment, at least annually, by applying the recognition and measurement provisions of FASB ASC 350, which require that we compare the carrying amount of the asset to its fair value. If impairment of the carrying value based on the estimated fair value exists, we measure the impairment through the use of discounted cash flows. If the carrying amount exceeds fair value, an impairment loss is recognized. Our last test for impairment was completed as of December 31, 2012, and no adjustment was deemed needed.

***Recent Accounting Pronouncements***

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income, which is included in ASC 220, Comprehensive Income. This update improves the reporting of reclassification out of accumulated other comprehensive income. The guidance is effective for the Company's interim and annual reporting periods beginning January 1, 2013, and applied prospectively. Management does not anticipate that the accounting pronouncement will have any material future effect on our consolidated financial statements.

In March 2013, the FASB issued ASU No. 2013-05, *Liabilities (Topic 830): Parent's Accounting for Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity.* This ASU is effective for interim and annual periods beginning after December 15, 2013 and requires the release of any cumulative translation adjustment into net income upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in foreign entity. Management does not anticipate that the accounting pronouncement will have any material future effect on our consolidated financial statements.

In July 2013, FASB issued ASU No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.* This ASU is effective for interim and annual periods beginning after December 15, 2013. This update standardizes the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Management does not anticipate that the accounting pronouncement will have any material future effect on our consolidated financial statements.

**Note 3 – Accrued Liabilities**

Accrued liabilities consist of the following as of June 30, 2013 and December 31, 2012:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Accrued operating expenses | $313 | $ 374 |
| Accrued payroll related expenses | - | 6 |
| Accrued interest | - | 19 |
| Accrued legal fees | 184 | - |
| Total | $497 | $ 399 |

**Note 4 – Financing**

At June 30, 2013, financial instruments arising from our financing transactions with YA Global Investments, L.P., an accredited investor, included shares of our Series C Preferred Stock issued in February 2006, Series D Preferred Stock issued in January 2010, a series of thirty-two secured convertible debentures issued between August 2006 and July 2012 and various warrants to purchase shares of our Common Stock. All of our assets are pledged to secure our obligations under the debt securities. At various times, YA Global has assigned or distributed portions of its holdings of these securities to other holders, including persons who are officers of YA Global and its related entities, as well as to other holders who are investors in YA Global's funds.

***Secured Debentures -*** The underlying agreements for each of the current thirty-two debentures that we have issued are very similar in form, except in regard to the interest rate, conversion prices, and the number of warrants that were issued in conjunction with each of the debentures. The debentures are convertible into our Common Stock, at the option of the holder, at the lower of a fixed conversion price per share or a percentage of the lowest volume-weighted average price ("VWAP") for a specified number of days prior to the conversion (the "look-back period"). Typically, the conversion is limited such that the holder cannot exceed 9.99% ownership of the outstanding Common Stock, unless the holder waives their right to such limitation. All of the debentures are secured according to the terms of a Security Pledge Agreement dated August 23, 2006, which was entered into in connection with the first convertible debenture issued to YA Global and which provides YA Global with a security interest in substantially all of our assets. The debentures are also secured by a Patent Security Agreement dated July 29, 2008. On August 13, 2010, our wholly owned subsidiary, NeoMedia Europe GmbH, became a guarantor of all outstanding financing transactions between us and YA Global, through pledges of their intellectual property and other movable assets. As security for our obligations to YA Global, all of our Pledged Property, Patent Collateral and other collateral is affirmed through the several successive Ratification Agreements which have been executed in connection with each of the 2010, 2011 and 2012 financings.

All debentures with YA Global contain provisions for acceleration of principal and interest upon default. Certain debentures also contain default interest rates and conversion prices, as reflected in the table below.

We evaluated the financing transactions in accordance with FASB ASC 815, *Derivatives and Hedging*, and determined that the conversion features of the Series C and Series D Preferred Stock and the Debentures were not afforded the exemption for conventional convertible instruments due to their variable conversion rates. The contracts have no explicit limit on the number of shares issuable so they did not meet the conditions set forth in current accounting standards for equity classification. Accordingly, either the embedded derivative instruments, including the conversion option, must be bifurcated and accounted for as derivative instrument liabilities or, as permitted by FASB ASC 815-15-25-4, *Recognition of Embedded Derivatives*, the instruments may be carried in their entirety at fair value.

At inception, we elected to bifurcate the embedded derivatives related to the Series C and Series D Preferred Stock and certain debentures, while electing the fair value option for the March 2007, August 2007, April 2008, May 2008 and April 2012 Debentures. FASB ASC 825, *Financial Instruments*, allows us to elect the fair value option for recording financial instruments when they are initially recognized or if there is an event that requires re-measurement of the instruments at fair value, such as a significant modification of the debt.

On May 25, 2012, the terms of the debentures held by YA Global were modified to extend the stated maturity dates to August 1, 2013 and reduce the interest rates to 9.5% per year, with interest being payable on the maturity date in cash or, provided certain equity conditions are satisfied, in shares of our Common Stock at the applicable conversion price. Because the effect of the modifications exceeded a significance threshold relative to cash flows prescribed by ASC 470-50, *Debt Modifications and Extinguishments*, the modifications of the amounts due under these arrangements were accounted for as extinguishments, whereby the existing debentures are considered to be retired and new debentures issued. The existing instruments were first adjusted to fair value as of May 25, 2012 using the interest rate and maturity date prior to the amendment. The fair value of the new instruments was then calculated using the modified interest rate and maturity date to determine the fair value of the instrument subsequent to the amendment. The differences in the fair values before and after the amendment were recorded as an extinguishment loss of approximately $27.5 million in the accompanying statements of operations.

As of the date of the modification, we have elected to carry all modified debentures at the fair value of the hybrid instrument with changes in the fair value of the debentures charged or credited to income each period.

On February 4, 2013, we entered into a Debenture Extension Agreement with YA Global to extend the maturity dates of the secured convertible debentures to August 1, 2014. Because the effect of the extension did not exceed a significance threshold relative to cash flows prescribed by ASC 470-50, *Debt Modifications and Extinguishments*, extinguishment accounting was not applicable.

The following table summarizes the significant terms of each of the convertible debentures for which the entire hybrid instrument is recorded at fair value as of June 30, 2013:

| | | | | **Conversion Price – Lower of Fixed Price or Percentage of VWAP for Look-back period** | | | | |
|---|---|---|---|---|---|---|---|---|
| **Debenture Issuance Year** | **Face Amount (in thousands)** | **Interest Rate** | **Default Interest Rate** | **Fixed Price** | **Anti-Dilution Adjusted Price** | **%** | **Default %** | **Look-Back Period** |
| 2006 | $6,493 | 9.50% | n/a | $2.00 | $0.00 | 90% | n/a | 125 Days |
| 2007 | 7,373 | 9.50% | n/a | $2.00 | | 80%-90% | n/a | 125 Days |
| 2008 | 6,308 | 9.50% | 20%-24% | $1.00-$2.00 | $0.00032-$0.00038 | 80%-95% | 50%-75% | 125 Days |
| 2009 | 1,062 | 9.50% | 20% | $2.00 | $0.00 | 95% | 50% | 125 Days |
| 2010 | 3,806 | 9.50% | 20% | $0.10- $0.30 | $0.00 | 95% | 50% | 60 Days |
| 2011 | 1,551 | 9.50% | 20% | $0.10 | $0.00 | 95% | 50% | 60 Days |
| 2012 | 1,543 | 9.50% | 20% | $0.10 | $0.00 | 95% | 50% | 60 Days |
| Total | $28,136 | | | | | | | |

For the portion of the debentures held by investors other than YA Global (which debentures were not modified on May 25, 2012) and for the Series C and Series D Preferred Stock, the election to carry the instruments at fair value in their entirety is not available. Accordingly, we continue to bifurcate the compound embedded derivatives related to the Series C and Series D Preferred Stock and these debentures and carry these financial instruments as liabilities in the accompanying balance sheet. Significant components of the compound embedded derivative include (i) the embedded conversion feature, (ii) down-round anti-dilution protection features and (iii) default, non-delivery and buy-in puts, all of which were combined into one compound instrument that is carried at fair value as a derivative liability. Changes in the fair value of the compound derivative liability are charged or credited to income each period.

The table below summarizes the significant terms of the debentures that are carried at their amortized cost and for which the compound embedded derivative is bifurcated and accounted for as a derivative liability as of June 30, 2013:

| | | | | Conversion Price – Lower of Fixed Price or Percentage of VWAP for Look-back Period | | | |
|---|---|---|---|---|---|---|---|
| Debenture Issuance Year | Face Amount (in thousands) | Interest Rate | Default Interest Rate | Fixed Price | Anti-Dilution Adjusted Price | % | Look-back Period |
| 2006 | $ 53 | 10 % | n/a | $2.00 | $ 0.000360 | 90% | 125 days |

***Conversions and Repayments*–**Our preferred stock and convertible debentures are convertible into shares of our Common Stock. Upon conversion of any of the convertible financial instruments in which the compound embedded derivative is bifurcated, the carrying amount of the debt, including any unamortized premium or discount, and the related derivative instrument liability are credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized. For instruments that are recorded in their entirety at the fair value of the hybrid instrument, the fair value of the hybrid instrument converted is credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized. Beginning in April 2013, the trading market price of our Common Stock (and the conversion price) was less than its par value. We are limited to issuing shares of Common Stock at no less than the par value, and all shares of our Common Stock issued in those conversions were issued at par value. However, the methodology used to estimate the number of shares of convertible debentures and preferred stock converted during this time are based upon the value received for the shares issued, with the difference between that value and the par value recorded as a deemed dividend.

The following table provides a summary of the preferred stock conversions that have occurred since inception and the number of common shares issued upon conversion.

| | Preferred shares issued | Preferred shares converted | Preferred shares remaining | Common shares issued |
|---|---|---|---|---|
| | (in thousands) | | | |
| Series C Preferred Stock | 22 | 17 | 5 | 314,619 |

| | | | | |
|---|---|---|---|---|
| Series D Preferred Stock | 25 | 22 | 3 | 245,162 |

The outstanding principal and accrued interest for the debentures as of June 30, 2013 is reflected in the following table in addition to the principal and interest converted since inception and the number of common shares issued upon conversion.

| | Outstanding principal and accrued interest at June 30, 2013 | Principal and accrued interest converted since inception | Common shares issued |
|---|---|---|---|
| | (in thousands) | | |
| Debentures | $42,599 | $ 11,720 | 4,328,415 |

***Warrants -*** YA Global holds warrants to purchase shares of our Common Stock that were issued in connection with the convertible debentures and the Series C and Series D Preferred Stock. The warrants are exercisable at a fixed exercise price which, from time to time, has been reduced due to anti-dilution provisions when the Company has entered into subsequent financing arrangements with a lower price. The exercise prices may be reset again in the future if we subsequently issue stock or enter into a financing arrangement with a lower price. In addition, upon each adjustment in the exercise price, the number of warrant shares issuable is adjusted to the number of shares determined by multiplying the warrant exercise price in effect prior to the adjustment by the number of warrant shares issuable prior to the adjustment divided by the warrant exercise price resulting from the adjustment.

The warrants issued to YA Global do not meet all of the established criteria for equity classification in FASB ASC 815-40, *Derivatives and Hedging – Contracts in Entity's Own Equity,* and accordingly, are recorded as derivative liabilities at fair value. Changes in the fair value of the warrants are charged or credited to income each period.

Effective February 1, 2013, 1.4 billion of the 1.9 billion warrants held by YA Global were cancelled and the remaining 500 million had their exercise price reduced to $0.0001 per share. These changes resulted in a decrease in fair value of the warrants of approximately $1.64 million during the first quarter of 2013 as reflected in the gain (loss) from change in fair value of derivative liabilities-warrants.

***Fair value disclosures***

Bifurcated Embedded Derivative Instruments – Series C and Series D Preferred Stock and convertible debentures held by investors other than YA Global - For financings in which the embedded derivative instruments are bifurcated and recorded separately, the compound embedded derivative instruments are valued using a Monte Carlo Simulation methodology because that model embodies certain relevant assumptions (including, but not limited to, interest rate risk, credit risk, and conversion/redemption privileges) that are necessary to value these complex derivatives.

The conversion price in each of the convertible debentures is subject to adjustment for down-round, anti-dilution protection. Accordingly, if we sell Common Stock or common share indexed financial instruments below the stated or variable conversion price of the debenture, the conversion price adjusts to that lower amount.

The assumptions included in the calculations are highly subjective and subject to interpretation. Assumptions used as of June 30, 2013 included exercise estimates/behaviors and the following other significant estimates: (i) Preferred Stock: remaining term of 1.09 years, equivalent volatility of 136%, equivalent interest rate of 8%, equivalent credit-risk adjusted rate of 6.5% and conversion price of $0.00038, (ii) convertible debentures: Anti-dilution adjusted conversion price of $0.00032-$0.00038. Equivalent amounts reflect the net results of multiple modeling simulations that the Monte Carlo Simulation methodology applies to underlying assumptions.

Due to the variability of the conversion prices, fluctuations in the trading market price of our Common Stock may result in significant variations to the calculated conversion price. For each debenture, we analyze the ratio of the conversion price (as calculated based on the percentage of VWAP for the appropriate look-back period) to the trading market price for a period of time equal to the term of the debenture to determine the average ratio for the term of the note. Each quarter, the ratio in effect on the date of the valuation is compared with the average ratio over the term of the debenture to determine if the calculated conversion price is representative of past trends or if it is considered unrepresentative due to a large fluctuation in the Common Stock price over a short period of time. If the calculated conversion price results in a ratio that deviates significantly from the average ratio over the term of the agreement, the average ratio of the conversion price to the trading market price is then multiplied by the current trading market price to determine the variable conversion price for use in the fair value calculations. This variable conversion price is then compared with the fixed conversion price and, as required by the terms of the debentures, the lower of the two amounts is used as the conversion price in the Monte Carlo Simulation model used for valuation purposes. On June 30, 2013, the fixed conversion price for each of the debentures was equal to or higher than the calculated variable conversion price. Accordingly, the variable conversion price was used in the Monte Carlo Simulation model. This analysis is performed each quarter to determine if the calculated conversion price is reasonable for purposes of determining the fair value of the embedded conversion features (for instruments recorded under FASB ASC 815-15-25-1) or the fair value of the hybrid instrument (for instruments recorded under FASB ASC 815-15-25-4).

The following table reflects the face value of the instruments, their amortized carrying value and the fair value of the separately-recognized compound embedded derivative, as well the number of common shares into which the instruments are convertible as of June 30, 2013 and December 31, 2012.

| June 30, 2013 | Face Value (in thousands) | Carrying Value | Accrued Interest | Embedded Conversion Feature | Common Stock Shares |
|---|---|---|---|---|---|
| Series C Preferred Stock | $4,816 | $ 4,816 | $ - | $ 3,967 | 12,411,508 |
| Series D Preferred Stock | $348 | $ 348 | $ - | 287 | 897,165 |
| Debentures: | | | | | |
| 2006 | $53 | $ 53 | $ 9 | 32 | 171,153 |
| Total | $53 | $ 53 | $ 9 | $ 4,286 | 13,479,826 |

| December 31, 2012 | Face Value (in thousands) | Carrying Value | Accrued Interest | Embedded Conversion Feature | Common Stock Shares |
|---|---|---|---|---|---|
| Series C Preferred Stock | $4,840 | $ 4,840 | $ - | $ 1,988 | 923,953 |
| Series D Preferred Stock | $348 | $ 348 | $ - | 143 | 66,457 |
| Debentures: | | | | | |
| 2006 | $53 | $ 53 | $ 7 | 16 | 11,871 |
| Total | $53 | $ 53 | $ 7 | $ 2,147 | 1,002,281 |

The terms of the embedded conversion features in the convertible instruments presented above provide for variable conversion rates that are indexed to our quoted Common Stock price. As a result, the number of indexed shares is subject to continuous fluctuation. For presentation purposes, the number of shares of Common Stock into which the embedded conversion feature of the Series C and Series D Preferred Stock was convertible as of June 30, 2013 and December 31, 2012 was calculated as face value plus assumed dividends (if declared), divided by the lesser of the fixed rate or the calculated variable conversion price using the 125 day look-back period. The number of shares of Common Stock into which the embedded conversion feature in the convertible debentures was convertible as of June 30, 2013 and December 31, 2012 was calculated as the face value of each instrument divided by the variable conversion price using the appropriate look-back period.

As discussed above, on February 4, 2013, the terms of the debentures held by YA Global were modified to extend the stated maturity dates to August 1, 2014 and those debentures are accounted for as hybrid instruments and are carried in their entirety at fair value. The debentures outstanding at June 30, 2013 of $53,000 shown above represent a portion of the debentures issued to YA Global which had previously been transferred by YA Global to other parties. These debentures were not modified and matured on July 29, 2012. At June 30, 2013 the debentures had not yet been converted or repaid.

Changes in the fair value of derivative instrument liabilities related to the bifurcated embedded derivative features of convertible instruments not carried at fair value are reported as “Gain (loss) from change in fair value of derivative liability – Series C and Series D Preferred Stock and debentures” in the accompanying consolidated statements of operations.

Gain (loss) from change in fair value of derivative liability- Series C and D Preferred Stock and debentures

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Series C Preferred Stock | $(1,700) | $11,915 | $(1,989) | $(3,202) |
| Series D Preferred Stock | (123) | 1,946 | (144) | (1,346) |
| | | | | |
| Debentures: | | | | |
| 2006 | (26) | 18,815 | (16) | (3,070) |
| 2008 | - | 13,391 | - | (1,350) |
| 2009 | - | 4,964 | - | (486) |
| 2010 | - | 11,901 | - | (34) |
| 2011 | - | 8,896 | - | (4,825) |
| 2012 | - | 3,523 | - | 15 |
| Gain (loss) from change in fair value of derivative liability | (1,849) | 75,351 | (2,149) | (14,298) |

Hybrid Financial Instruments Carried at Fair Value –- Since inception, the March 2007, August 2007, April 2008, May 2008 and April 2012 convertible debentures have been recorded in their entirety at fair value as hybrid instruments in accordance with FASB ASC 815-15-25-4 with subsequent changes in fair value charged or credited to income each period. As of May 25, 2012, we elected the fair value option for all other convertible debentures held by YA Global upon a re-measurement date that was triggered by significant modifications of the financial instruments.

Because these debentures are carried in their entirety at fair value, the value of the embedded conversion feature is embodied in those fair values. At inception, the March 2007, August 2007, April 2008 and May 2008 debentures were valued using the Common Stock equivalent approach. For the April 26, 2012 debenture and, effective May 25, 2012 for all other debentures, the Company changed its method of estimating the fair value of the hybrid instrument to consider the present value of the cash flows of the instrument, using a risk-adjusted interest rate, enhanced by the value of the conversion option, valued using a Monte Carlo model. This method was considered by our management to be the most appropriate method of encompassing the credit risk and exercise behavior that a market participant would consider when valuing the hybrid financial instrument. Inputs used to value the hybrid instruments as of June 30, 2013 included: (i) present value of future cash flows for the debenture using a risk adjusted interest rate of 6.50%, (ii) remaining term of 1.09 years, (iii) equivalent volatility of 136%, equivalent interest rate of 9.5%, equivalent credit-risk adjusted rate of 6.50% and anti-dilution adjusted conversion prices ranging from $0.00032- $0.00038.

The following table reflects the face value of the financial instruments, the fair value of the hybrid financial instrument and the number of common shares into which the instruments are convertible as of June 30, 2013 and December 31, 2012.

| June 30, 2013 | Face Value | Fair Value | Common Stock Shares |
|---|---|---|---|
| | (in thousands) | | |
| Debentures: | | | |
| 2006 | $6,493 | $18,926 | 27,030,155 |
| 2007 | 7,373 | 22,423 | 32,303,705 |
| 2008 | 6,308 | 21,825 | 31,327,015 |
| 2009 | 1,062 | 3,548 | 5,004,868 |
| 2010 | 3,806 | 9,691 | 13,786,842 |
| 2011 | 1,551 | 3,194 | 4,581,445 |
| 2012 | 1,543 | 3,299 | 4,724,768 |
| Total | $28,136 | $82,906 | 118,758,798 |

| December 31, 2012 | Face Value | Fair Value | Common Stock Shares |
|---|---|---|---|
| | (in thousands) | | |
| Debentures: | | | |
| 2006 | $6,180 | $14,758 | 5,196,283 |
| 2007 | 6,856 | 17,172 | 6,098,480 |
| 2008 | 6,468 | 15,492 | 5,487,497 |
| 2009 | 1,644 | 3,565 | 1,243,390 |
| 2010 | 3,806 | 7,178 | 2,512,724 |
| 2011 | 1,954 | 3,080 | 1,084,237 |
| 2012 | 1,979 | 3,047 | 1,073,527 |
| Total | $28,887 | $64,292 | 22,696,138 |

Changes in the fair value of convertible instruments that are carried in their entirety at fair value are reported as "Gain (loss) from change in fair value of hybrid financial instruments" in the accompanying consolidated statements of operations. The changes in fair value of these hybrid financial instruments were as follows:

Gain (loss) from change in fair value of hybrid financial instruments

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| 2006 | $(7,202) | $1,734 | $(5,315) | $1,734 |
| 2007 | (7,821) | 24,068 | (5,492) | (989 ) |
| 2008 | (8,296) | 9,663 | (6,639) | 3,550 |
| 2009 | (1,207) | 433 | (1,281) | 433 |
| 2010 | (3,138) | 896 | (2,515) | 896 |
| 2011 | (842 | | | |