NEOMEDIA TECHNOLOGIES INC
Form 10-Q
August 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 – Q

(Mark One)

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

For the quarterly period ended June 30, 2014

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 000-21743

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.)

1515 Walnut Street, Suite 100, 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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 Exchange Act). Yes ¨ No x

The number of outstanding shares of the registrant's Common Stock on August 12, 2014 was 1,190,287,218.

NeoMedia Technologies, Inc.

Form 10-Q

For the Quarterly Period Ended June 30, 2014

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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, 2014 (Unaudited)	December 31, 2013 (Restated)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 64	$ 267
Accounts receivable	149	295
Prepaid expenses and other current assets	67	107
Total current assets	280	669
Property and equipment, net	2	5
Goodwill	3,418	3,418
Patents and other intangible assets, net	1,076	1,213
Other long-term assets	20	-
Total assets	$ 4,796	$ 5,305
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	$ 435	$ 236
Accrued expenses	461	291
Deferred revenues and customer prepayments	1,689	2,252
Notes payable	50	56
Derivative financial instruments - warrants	40	620
Derivative financial instruments - Series C and D preferred stock and debentures payable	51	296
Debentures payable - carried at fair value	34,942	38,250
Total current liabilities	37,668	42,001
Commitments and contingencies		
Series C convertible preferred stock, $0.01 par value, 27,000 shares authorized, 4,597 and 4,816 shares issued and outstanding, respectively, and a liquidation value of $4,597 and $4,816 at June 30, 2014 and December 31, 2013, respectively	4,597	4,816
	348	348

Series D convertible preferred stock, $0.01 par value, 25,000 shares authorized, 3,481 and 3,481 shares issued and outstanding, respectively, and a liquidation value of $348 and $348, respectively, at June 30, 2014 and December 31, 2013		
Shareholders' deficit:		
Common stock, no par value, 7,500,000,000 shares authorized, 488,057,870 and 332,321,819 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	4,985	4,985
Additional paid in capital	191,400	190,946
Accumulated deficit	(233,321)	(236,910)
Accumulated other comprehensive loss	(102)	(102)
Treasury stock, at cost, 2,012 shares of common stock	(779)	(779)
Total shareholders' deficit	(37,817)	(41,860)
Total liabilities and shareholders' deficit	$ 4,796	$ 5,305

See accompanying notes.

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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,	
	2014	2013 (Restated)	2014	2013 (Restated)
Revenue	$654	$1,667	$1,657	$2,269
Cost of revenues	87	269	245	300
Gross profit	567	1,398	1,412	1,969
Sales and marketing expenses	40	47	55	108
General and administrative expenses	742	665	1,345	1,522
Research and development costs	145	172	322	384
Other operating income	-	(227)	-	(227)
Operating income (loss)	(360)	741	(310)	182
Gain (loss) from change in fair value of hybrid financial instruments	(628)	(433)	(1,173)	24,054
Gain (loss) from change in fair value of derivative liability - warrants	207	258	580	3,424
Gain (loss) from change in fair value of derivative liability - Series C and D preferred stock and debentures	107	55	244	1,998
Gain on extinguishment of Debt	4,247	-	4,247	-
Interest income	-	16	-	16
Net income	3,573	637	3,588	29,674
Deemed dividends on convertible preferred stock	-	(16)	-	(16)
Deemed dividends on convertible debentures	-	(681)	-	(681)
Net income (loss) available to common shareholders	$3,573	$(60)	$3,588	$28,977
Comprehensive income (loss):				
Net income (loss)	3,573	637	3,588	29,674
Foreign currency adjustment	-	22	-	133
Comprehensive income (loss):	$3,573	$659	$3,588	$29,807
Net income (loss) per common share, basic and diluted:				

Basic	$0.01	$0.00	$0.70	$0.14
Fully diluted	$0.009	$0.00	$0.63	$0.11
Weighted average number of common shares:				
Basic	359,568,430	270,512,776	351,339,588	215,354,974
Fully diluted	398,000,130	308,944,476	389,771,288	253,786,674

See accompanying notes.

NeoMedia Technologies, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	For the six months ended June 30, 2014	2013 (Restated)
Cash Flows from Operating Activities:		
Net income (loss)	$ 3,588	$ 29,674
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	141	253
(Gain) loss from change in fair value of hybrid financial instruments	1,173	(24,054)
(Gain) loss from change in fair value of derivative liability - warrants	(580)	(3,424)
(Gain) loss from change in fair value of derivative liability - Series C and D preferred stock and debentures	(244)	(1,998)
Stock-based compensation	-	1
Gain on Extinguishment of Debt	(4,247)	-
Changes in operating assets and liabilities:		
Accounts receivable	146	(441)
Prepaid expenses and other assets	20	80
Accounts payable and accrued expenses	369	142
Deferred revenues and customer prepayments	(563)	(1,108)
Net cash used in operating activities	(197)	(875)
Cash Flows from Investing Activities:		
Net cash used in investing activities	-	-
Cash Flows from Financing Activities:		
Borrowing under short-term debenture note payable	50	-
Payments on short-term notes payable	(56)	-
Net cash (used) provided by financing activities	(6)	-
Effect of exchange rate changes on cash	-	334
Net change in cash and cash equivalents	(203)	(541)
Cash and cash equivalents, beginning of period	267	611
Cash and cash equivalents, end of period	$ 64	$ 70
Supplemental cash flow information:		
Non-cash financing activities:		
Series C preferred stock converted to common stock	$ 219	$ 24

Convertible debentures converted to common stock	234	2,561
Deemed dividend on Series C preferred stock issued	-	16
Deemed dividend on convertible debentures converted	-	681

See accompanying notes.

NeoMedia Technologies, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

June 30, 2014

(Unaudited)

Note 1 – General

NeoMedia Technologies, Inc. a Delaware corporation (the “Company,” “NeoMedia,” “we,” “us,” “our,” and similar terms), wa founded in 1989 and is headquartered in Boulder, Colorado. We have positioned ourselves to lead the development of mobile barcode technology and services solutions that enable the mobile barcode ecosystem world-wide. NeoMedia harnesses the power of the mobile phone in innovative ways with state-of-the-art mobile barcode solutions. With this technology, mobile devices with cameras become barcode scanners, enabling a range of practical applications including mobile marketing and mobile commerce. In addition, we offer licensing of our extensive intellectual property portfolio.

Note 2 – Summary of Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared without audit pursuant to the rules and regulations of the United States Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with US GAAP have been condensed or omitted pursuant to such rules and regulations, although we believe that the disclosures made are adequate to make the information not misleading. We believe these statements include all adjustments, which are of a normal and recurring nature, considered necessary for a fair presentation of the financial statements. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the financial statements and notes thereto included in our annual report on Form 10-K filed with the SEC on March 17, 2014. The results of operations for the six months ended June 30, 2014 are not necessarily indicative of the results to be expected for the full year. In addition, as we communicated in a Periodic Report on Form 8-K on July 29, 2014, we are going to be restating certain of our financial statements by filing amendments to our previously filed Form 10-K for December 31, 2013 (and interim periodic reports on Form 10-Q within 2013) and the previously filed Form 10-Q for March 31, 2014. We and the SEC have concluded that certain modifications in the Company’s valuation methodology, deemed as accounting estimates by the Company, contained errors with respect to the valuation of convertible debentures issued by the Company, in that such methodology did not capture the debentures’ potentially dilutive effect upon their conversion into common stock. Please see the disclosure immediately below entitled “Restatement to 2013 Interim Reporting and of the December 31, 2013 Balance Sheet” for further information as these changes in valuation methodology has affected our previously filed interim report on Form 10-Q for June 30, 2013.

Basis of Presentation – The condensed consolidated financial statements include the accounts of NeoMedia and its wholly owned subsidiaries. We operate as one reportable segment. All intercompany accounts, transactions and profits have been eliminated in consolidation. Certain prior period amounts in the condensed consolidated financial statements and notes thereto have been reclassified to conform to the current year's presentation.

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. Changes in facts and circumstances may result in revised estimates, which are recorded in the period in which they become known.

Going Concern – We have historically incurred operating losses, and we may continue to generate 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 condensed consolidated financial statements have been prepared in conformity with US GAAP, which contemplates our continuation as a going concern. Our net income for the six months ended June 30, 2014 was $3.6 million as compared to net income of $30 million for the same period in 2013. The operating results for the six months ended June 30, 2014 included $3.9 million of net gains related to financing instruments, and the operating results for the same period in 2013 included $29.5 million of net gains related to financing instruments.

Net cash used in operations during the six months ended June 30, 2014 was $197,000 as compared to net cash used in operations of $875,000 during the six months ended June 30, 2013. As of June 30, 2014, we have an accumulated deficit of $233.3 million. We also have a working capital deficit of $37.4 million, including $35 million in current liabilities for our derivative and debenture financing instruments.

We currently do not have sufficient cash or commitments for financing to sustain our operations for the next twelve months if we are unable to generate sufficient cash flows from operations. Our plan is to develop new client and customer relationships and substantially increase our revenue derived from our products/services and IP licensing. If our revenues do not reach the level anticipated in our plan, we may require additional financing in order to execute our operating plan. 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 financing sources are not available, 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 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 shares of common stock outstanding. During the first six months of 2014, there were 155,729 million shares of common stock issued for these conversions. We cannot predict if or when each holder may or may not elect to convert into shares of common stock.

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.

Restatement to 2013 Interim Reporting – As noted above and disclosed initially in our Periodic Report on Form 8-K on July 29, 2014, during the three month period ended March 31, 2014, for fair value accounting of the derivative financial instruments and debentures payable, we reassessed the valuation techniques used to estimate the liability fair values. Based on the assessment, including discussions with the third-party valuation firm assisting us with the calculation, we determined that the valuation technique should be modified to consider the potentially dilutive impact on the stock price resulting from the issuance of additional shares of common stock upon the conversion of the instruments as well as the resulting value in comparison to our market capitalization.

We agree with the SEC’s assertion that certain modifications in our valuation methodology contained errors with respect to the valuation of convertible debentures issued by us. We are restating the June 30, 2013 three month and six month periods to reflect the change in valuation technique and correction of the fair value accounting of the derivative financial instruments and debentures payable. In addition, we are also restating our December 31, 2013 Balance Sheet as it pertains to the Fair Value of our Warrants, Preferred Series C & D and Convertible Debentures to amounts as stated below from how they were reported as of December 31, 2013 in our 10-K:

	December 31, 2013	Adjustments	December 31, 2013

	(as previously reported)		(Restated)
Derivative Financial Instruments – warrants	$ 684	$ 64	$ 620
Derivative Financial Instruments – Series C and D PS and DP	$ 23,606	$ 23,310	$ 296
Debentures payable – carried at fair value	$ 257,451	$ 219,201	$ 38,250
Total Liabilities	$ 284,576	$ 242,575	$ 42,001
Accumulated deficit	$ (479,485)	$ 242,575	$ (236,910)
Total shareholders' deficit	$ (284,435)	$ 242,575	$ (41,860)

The tables below reflect the changes in restating the derivative liabilities for the three months and six months ended June 30, 2013:

Derivative Liability Restatement for the 3 months ended June 30, 2013:

	3 Mos. June 30, 2013 (as previously reported)	Adjustments	3 Mos. June 30, 2013 (as Restated)
Gain (loss) from change in fair value of hybrid financial instruments	$ (29,569)	$ 29,136	$ (433)
Gain (loss) from change in fair value of derivative liability – warrants	$ 289	$ (31)	$ 258
Gain (loss) from change in fair value of derivative liability – Series C & D	$ (1,849)	$ 1,904	$ 55
Net income (loss)	$ (30,372)	$ 31,009	$ 637
Net income (loss) available to common shareholders	$ (30,372)	$ (30,312)	$ (60)
Comprehensive income (loss)	$ (30,595)	$ 31,254	$ 659

Derivative Liability Restatement for the 6 months ended June 30, 2013:

	6 Mos. June 30, 2013 (as previously reported)	Adjustments	6 Mos. June 30, 2013 (as Restated)
Gain (loss) from change in fair value of hybrid financial instruments	$ (22,795)	$ 46,849	$ 24,054
Gain (loss) from change in fair value of derivative liability – warrants	$ 3,411	$ 13	$ 3,424
Gain (loss) from change in fair value of derivative liability – Series C & D	$ (2,149)	$ 4,147	$ 1,998
Net income (loss)	$ (21,284)	$ 50,958	$ 29,674
Net income (loss) available to common shareholders	$ (21,284)	$ 50,261	$ 28,977

Comprehensive income (loss)	$ (21,618)	$ 51,425	$ 29,807

Statement of Cash Flows:

	6 Mos. June 30, 2013 (as previously reported)	Adjustments	6 Mos. June 30, 2013 (as Restated)
Net income (loss)	$ (21,284)	$ 50,958	$ 29,674
Gain (loss) from change in fair value of hybrid financial instruments	$ 2,149	$ (26,203)	$ (24,054)
Gain (loss) from change in fair value of derivative liability – warrants	$ (3,411)	$ (13)	$ (3,424)
Gain (loss) from change in fair value of derivative liability – Series C & D Preferred Shares	$ 22,795	$ (24,793)	$ (1,998)
Net cash used in operating activities	$ (874)	$ (1)	$ (875)

Merger and Reverse Stock Split – On May 11, 2014, the Company completed an Agreement and Plan of Merger (the "Merger Agreement") with Qode Services Corporation ("Qode"), a wholly owned subsidiary of the Company. Under the terms of the Merger Agreement, Qode was merged into the Company and ceased to exist upon completion of the merger. The Company continued as the surviving corporation. Under the terms of the Merger Agreement, the Company's charter was amended to provide for an increase in the amount of common stock authorized shares, and each share of the Company's common stock issued and outstanding immediately prior to the merger continued to remain outstanding and remain unchanged, except that (i) the par value changed from $0.001 per share to no par value per share, and (ii) each fifteen shares of common stock issued and outstanding were combined and converted into 1 share of common stock (the "Reverse-Split"). The amount of authorized shares of common stock was also increased from 5 billion to 7.5 billion shares. Prior period amounts have been retroactively adjusted for the Reverse-Split in order to be comparable and conform to the current period presentation.

Extinguishment of Debenture - In connection with the completion of the merger, the holder of the secured convertible debentures agreed to enter into amendments to decrease the aggregate face amount of debt by $5.0 million. The forgiveness of debt on the secured convertible debentures exceeded a significance threshold relative to cash flows prescribed by ASC Topic 470-50, *Debt Modifications and Extinguishments*. Accordingly, the modifications of the amounts due under these arrangements were accounted for as extinguishments, whereby the existing debentures were considered to be retired and new debentures issued. The fair value of the forgiven balance of $4.247 million was determined as of May 11, 2014 and recorded as a gain on extinguishment of debt in the condensed consolidated statements of operations. See Note 4 – Financings for additional discussion.

Basic and Diluted Net Income (Loss) Per Common Share – The components of basic and diluted income (loss) per share attributable to NeoMedia Technologies, Inc. common stock shareholders were as follows (in thousands, except share and per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013 (restated)	2014	2013 (restated)
Numerator:				
Net income (loss) available to common shareholders	$3,573	$(60)	$3,588	$28,977
Effect of dilutive securities				
Hybrid financial instruments	-	(433)	(29,151)	(24,054)
Derivative liability - warrants	-	258	(40)	(3,424)
Derivative liability - Series C and D preferred stock and debentures	-	55	(1,992)	(2,149)
Numerator for diluted income (loss) per common share	$3,573	$(180)	$(27,595)	$(650)
Denominator:				
Weighted average shares used to compute basic income (loss) per common share	359,568,430	270,512,776	351,339,588	215,354,974

Effect of dilutive securities:				
Hybrid financial instruments	32,949,714	32,949,714	32,949,714	32,949,714
Derivative liability - warrants	2,083,292	2,083,292	2,083,292	2,083,292
Derivative liability - Series C and D preferred stock and debentures	3,398,694	3,398,694	3,398,694	3,398,694
Denominator for diluted income (loss) per common share	398,000,130	308,944,476	389,771,288	253,786,674
Basic income (loss) per common share	$ .010	$ 0.00	$ 0.01	$ 0.14
Diluted income (loss) per common share	$ .009	$ 0.00	$ 0.09	$ 0.11

Recent Accounting Pronouncements **–** From time to time, new accounting pronouncements are issued that we adopt as of the specified effective date. ASU Update 2014-09 Revenue From Contracts With Customers (Topic 606) issued May 28, 2014 by FASB and IASB converged guidance on recognizing revenue in contracts with customers with an effective date after December 15, 2016 will be evaluated as to impact and implemented accordingly.

Note 3 – Accrued Liabilities

Accrued liabilities consist of the following as of June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
	(in thousands)	
Accrued operating expenses	$ 237	$ 112
Accrued payroll related expenses	43	65
Accrued legal fees	181	114
Total	$ 461	$ 291

Note 4 – Financing

At June 30, 2014, financial instruments arising from our financing transactions with YA Global Investments, L.P. ("YA Global"), an accredited investor, included shares of our Series C Convertible Preferred Stock issued in February 2006, Series D Convertible Preferred Stock issued in January 2010, a series of four consolidated secured convertible debentures (the "Consolidated Debentures") issued July 1, 2013 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 – We had originally entered into financing transactions with YA Global, which included a series of twenty-seven secured convertible debentures issued between August 2006 and July 2012. Effective July 1, 2013, the terms of the debentures held by YA Global were modified to consolidate the principal and interest amounts outstanding under all of the outstanding secured convertible debentures previously issued by us to YA Global, such that, upon the issuance of the Consolidated Debentures and cancellation of the prior debentures, the amount of outstanding debentures issued to YA Global decreased from twenty-seven to six debentures. The maturity dates of these secured convertible debentures were also extended from August 1, 2014 to August 1, 2015.

On April 25, 2014, the Company entered into a Reaffirmation and Ratification Agreement with YA Global. Under the terms of the agreement, YA Global agreed to reduce the outstanding principal for certain of the Consolidated Debentures by $5.0 million. The reduction of principal resulted in debt extinguishment income of $4.247 million for the quarter ended June 30, 2014. The agreement also summarizes and affirms all principal amounts presently outstanding and owed by the Company to YA Global under all of the outstanding financing documents and debentures issued by the Company to YA (the "Financing Documents"). Pursuant to the agreement, the Company (i) ratified the terms of the Financing Documents and agreed that they remain in full force and effect, (ii) confirmed that the collateral rights granted to YA Global under the Financing Documents secure the obligations created thereunder, (iii) confirmed that the occurrence of an "event of default" under any of the Financing Documents would constitute an "event of default" under all of the Financing Documents, and (iv) agreed to execute and deliver to YA Global all such additional documents as reasonably required by YA Global to correct any document deficiencies, or to vest or perfect the Financing Documents and the collateral granted therein, and authorized YA Global to file any financing statements and take any other actions necessary to perfect YA Global's security interests in any such collateral. As part of the $5 million debt reduction, the Debentures were reduced from six to three.

In addition, a secured debenture was issued on May 27, 2014 for $50,000 to YA Global. Interest is payable annually at 12%. The note is due May 15, 2016. The funds are being used for working capital.

The underlying agreements for each of the Consolidated Debentures are very similar in form. The Consolidated 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"). 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 executed in connection with each of the 2010, 2011 and 2012 financings. The 2013 modification and consolidation of the outstanding secured convertible debentures as well as the execution of an Amended and Restated Patent Security Agreement in October 2013 reaffirmed the Pledged Property, Patent Collateral and other collateral pledged as security for our obligations to YA Global.

We evaluated the financing transactions in accordance with ASC 815, *Derivatives and Hedging*, and determined that the conversion features of the Series C and Series D preferred stock and the Consolidated 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 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, while electing the fair value option for the Consolidated Debentures. 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 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. On July 1, 2013, in addition to consolidating the secured debentures into six Consolidated Debentures, the maturity date was extended to August 1, 2015. Four of the Consolidated Debentures are non-interest bearing while the remaining two Consolidated Debentures accrue interest at 9.5% as outlined in further detail below. We evaluated the impact of the modification on the accounting for the Consolidated Debentures in accordance with ASC 470-50-40-6 through 12 to determine whether extinguishment accounting was appropriate. 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.

Debentures assigned to other investors by YA Global were also modified effective July 1, 2013 to extend the maturity date to August 1, 2015 and revise the conversion price to the lower of $2.00 or 90% of the lowest volume-weighted average price for 125 days prior to the conversion.

The following table summarizes the significant terms of each of the debentures for which the entire hybrid instrument is recorded at fair value as of June 30, 2014:

				Conversion Price – Lower of Fixed Price or Percentage of VWAP for Look-back period		
Debenture Issuance Year	Face Amount (in thousands)	Interest Rate	Fixed Price	Anti-Dilution Adjusted Price	%	Look-back Period
2006	$ 1,962	9.5 %	$2.00	$0.001235	90 %	125 Days
2007	547	9.5 %	$2.00	$0.001235	90 %	125 Days
2007	272	-	$2.00	$0.001170	95 %	125 Days
2008	1,187	9.5 %	$2.00	$0.001235	90 %	125 Days
2008	830	-	$2.00	$0.001170	95 %	125 Days
2009	91	9.5 %	$2.00	$0.001235	90 %	125 Days
2011	1,614	9.5 %	$2.00	$0.001235	90 %	125 Days
2012	210	-	$2.00	$0.001170	95 %	125 Days
2013	22,084	9.5 %	$2.00	$0.001235	90 %	125 Days

2013	7,127	-	$2.00	$0.001170	95 %	125 Days
Total	$ 35,924					

We bifurcate the compound embedded derivatives related to the Series C and Series D Convertible Preferred Stock and carry these financial instruments as liabilities in the accompanying balance sheet. Election to carry the instruments at fair value in their entirety is not available since their terms have not been modified. 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 recorded within income each period.

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 instrument and the related derivative 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. The trading market price of our common stock (and the conversion price) has been less than its par value from time to time. Until May 11, 2014 we were 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 until May 11, 2014 are based upon the value received for the shares issued, with the difference between that value and the par value being recorded as a deemed dividend.

Based upon the terms of the merger agreement effective May 11, 2014, the company's shares of common stock have no par value. We are no longer limited to issuing shares of common stock at a price less than par value. The methodology used to issue the shares of common stock upon conversion of convertible debentures and preferred stock is based upon the value received for the shares of common stock issued. The value received is recorded as additional paid in capital and no deemed dividends are required to be recorded.

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

	Preferred shares issued	Preferred shares converted	Preferred shares remaining	Common shares issued
	(in thousands)			
Series C Preferred Stock	22	17	5	97,468
Series D Preferred Stock	25	22	3	16,344

The outstanding principal and accrued interest for the debentures as of June 30, 2014 is reflected in the following table in addition to the principal and interest converted since inception and the number of shares of common stock issued upon conversion.

Outstanding principal and accrued interest at June 30, 2014	Principal and accrued interest converted since inception	Common Shares issued

	(in thousands)		
Debentures	$38,929	$ 11,981	372,828

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 Convertible 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 we have 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 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 $1.6 million during the first quarter of 2013 as reflected in the gain from change in fair value of derivative liabilities - warrants.

Effective May 2014, in connection with the merger and a concurrent reverse stock split of 15 to 1 as described in Note 2, the exercise price of the warrants increased to $0.0015 from $0.0001 per share. These changes resulted in a decrease in the value of the warrants of approximately $207,000 during the quarter ended June 30, 2014, as reflected in the gain from the change in fair value of derivative liabilities – warrants.

Fair value disclosures for Series C and D Bifurcated Embedded Derivative Instruments – 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.

Assumptions used in calculating the preferred share values as of June 30, 2014 included a remaining equivalent term of 1.09 years, annualized volatility of 205%, stated dividend of 8%, equivalent credit-risk adjusted rate of 13.0% and conversion price of $0.001261. Equivalent amounts reflect the net results of multiple modeling simulations that the Monte Carlo Simulation methodology applies to underlying assumptions. During the three months ended March 31, 2014, we modified the valuation technique to consider the potentially dilutive impact on the stock price resulting from the issuance of additional common shares upon the conversion of the preferred shares and convertible debentures.

The following table reflects the face value of the instruments 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, 2014 and December 31, 2013.

June 30, 2014

	Face	Carrying

	Value	Value	Embedded Conversion Feature	Common Stock Shares
	(in thousands)			
Series C Preferred Stock	$4,597	$ 4,597	$ 48	3,159,450
Series D Preferred Stock	348	348	3	239,244
Total	$4,945	$ 4,945	$ 51	3,921,570

December 31, 2013

Face Carrying