

Neonode, Inc  
Form 10-Q  
May 15, 2012

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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, 2012

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.)

2350 Mission College  
Blvd, Suite 190, Santa  
Clara, CA 95054 USA  
(Address of principal  
executive offices and  
zip code)

(408) 496-6722  
(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

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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

(do not check if a 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 the registrant’s common stock outstanding as of May 7, 2012, was 32,965,738.

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NEONODE INC.

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## PART I. Financial Information

## Item 1. Financial Statements

NEONODE INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands, except share and per share amounts)

|   | March<br>31, 2012 | December<br>31, 2011 |
|---|-------------------|----------------------|
|   | (Unaudited)       |                      |
| <b>ASSETS</b>   |                   |                      |
| Current assets:   |                   |                      |
| Cash  | \$ 13,307         | \$ 12,940            |
| Accounts receivable   | 1,091             | 3,345                |
| Prepaid expenses and other current assets   | 268               | 234                  |
| Total current assets  | 14,666            | 16,519               |
| Property and equipment, net   | 298               | 108                  |
| Total assets  | \$ 14,964         | \$ 16,627            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                   |                      |
| Current liabilities:  |                   |                      |
| Accounts payable  | \$ 319            | \$ 447               |
| Accrued expenses  | 565               | 601                  |
| Deferred revenue  | 1,917             | 1,906                |
| Total current liabilities   | 2,801             | 2,954                |
| Total liabilities   | 2,801             | 2,954                |
| Commitments and contingencies (Note 8)  |                   |                      |
| Stockholders' equity:   |                   |                      |
| Series A Preferred stock, 444,541 shares authorized with par value \$0.001 per share;<br>83 shares issued and outstanding at March 31, 2012 and<br>December 31, 2011. (In the event of dissolution,<br>each share of Series A Preferred stock has a liquidation preference equal to<br>par value of \$0.001 over the shares of common stock)                      | -                 | -                    |
| Series B Preferred stock, 54,425 shares authorized with par<br>value \$0.001 per share; 95 and 114 shares issued and outstanding<br>at March 31, 2012 and December 31, 2011, respectively. (In the event of<br>dissolution, each share of Series B Preferred stock has a liquidation<br>preference equal to par value of \$0.001 over the shares of common stock) | -                 | -                    |
| Common stock, 70,000,000 shares authorized with par value \$0.001 per share;<br>32,956,300 and 32,778,993 shares issued and outstanding at<br>March 31, 2012 and December 31, 2011, respectively  | 33                | 33                   |
| Additional paid-in capital  | 142,989           | 142,955              |
| Accumulated other comprehensive income  | 57                | 13                   |
| Accumulated deficit   | (130,916 )        | (129,328 )           |
| Total stockholders' equity  | 12,163            | 13,673               |
| Total liabilities and stockholders' equity  | \$ 14,964         | \$ 16,627            |

See accompanying notes to condensed consolidated financial statements.



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

|   | Three months ended |            |
|---|--------------------|------------|
|   | 2012               | 2011       |
|   | March 31,          |            |
|   | 2012               | 2011       |
| Net revenues  | \$1,164            | \$539      |
| Cost of revenues  | 249                | 155        |
| Gross margin  | 915                | 384        |
| Operating expenses:   |                    |            |
| Product research and development  | 687                | 276        |
| Sales and marketing   | 799                | 352        |
| General and administrative  | 995                | 864        |
| Total operating expenses  | 2,481              | 1,492      |
| Operating loss  | (1,566 )           | (1,108 )   |
| Other expense, net:   |                    |            |
| Interest expense  | --                 | (54 )      |
| Non-cash items related to debt discounts, deferred financing fees and the valuation of conversion features and warrants | --                 | (8,554 )   |
| Total other expense, net  | --                 | (8,608 )   |
| Loss before provision for income taxes  | (1,566 )           | (9,716 )   |
| Provision for income taxes  | 22                 | 5          |
| Net loss  | \$(1,588 )         | \$(9,721 ) |
| Loss per common share:  |                    |            |
| Basic and diluted loss per share  | \$(0.05 )          | \$(0.43 )  |
| Basic and diluted – weighted average shares used in per share computations  | 32,809             | 22,406     |

See accompanying notes to condensed consolidated financial statements.

NEONODE INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
 (In thousands)  
 (Unaudited)

|  | Three Months Ended March 31,<br>2012 | 2011       |
|--|--------------------------------------|------------|
| Net loss                                 | \$ (1,588)                           | \$ (9,721) |
| Other comprehensive income (loss):       |                                      |            |
| Foreign currency translation adjustments | 44                                   | (39)       |
| Total comprehensive loss                 | \$ (1,544)                           | \$ (9,760) |

See accompanying notes to condensed consolidated financial statements.

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

|   | Three months ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2012                            | 2011       |
| Cash flows from operating activities:   |                                 |            |
| Net loss  | \$(1,588 )                      | \$(9,721 ) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities:           |                                 |            |
| Stock-based compensation expense  | 34                              | 289        |
| Depreciation and amortization   | 18                              | 4          |
| Debt discounts, deferred financing fees and the valuation of conversion features and warrants       | --                              | 8,554      |
| Changes in operating assets and liabilities:  |                                 |            |
| Accounts receivable   | 2,273                           | 56         |
| Prepaid expenses and other current assets   | (26 )                           | 38         |
| Accounts payable and accrued expenses   | (199 )                          | (220 )     |
| Deferred revenue  | 11                              | (385 )     |
| Net cash provided by (used in) operating activities   | 523                             | (1,385 )   |
| Cash flows from investing activities:   |                                 |            |
| Purchase of property and equipment  | (201 )                          | (16 )      |
| Net cash used in investing activities   | (201 )                          | (16 )      |
| Cash flows from financing activities:   |                                 |            |
| Proceeds from issuance of convertible debt  | --                              | 3,737      |
| Proceeds from warrant exercises   | --                              | 515        |
| Net cash provided by financing activities   | --                              | 4,252      |
| Effect of exchange rate changes on cash   | 45                              | 59         |
| Net increase in cash  | 367                             | 2,910      |
| Cash at beginning of period   | 12,940                          | 911        |
| Cash at end of period   | \$13,307                        | \$3,821    |
| Supplemental disclosure of cash flow information:   |                                 |            |
| Interest paid   | \$--                            | \$--       |
| Income taxes paid   | \$22                            | \$4        |
| Supplemental disclosure of non-cash transactions:   |                                 |            |
| Debt discount recorded as part of convertible debt financing transactions including warrants issued | \$-                             | \$3,737    |
| Debt issuance costs related to 2011 financing   | \$-                             | \$35       |
| Accrued expenses converted to common stock  | \$-                             | \$120      |
| Conversion of debt and accrued interest to common stock   | \$-                             | \$2,650    |
| Reduction of derivative liabilities upon conversion of debt   | \$-                             | \$12,489   |

See accompanying notes to condensed consolidated financial statements



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

## 1. Interim Period Reporting

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, 2012 are not necessarily indicative of expected results for the full 2012 fiscal year.

The accompanying condensed consolidated financial statements as of March 31, 2012 and for the three months ended March 31, 2012 and 2011 have been prepared by us, 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 audited consolidated financial statements and notes contained in our consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2011.

### Operations

Neonode Inc., “we”, “us”, “our”, the “Company”, develops and licenses the next generation of MultiSensing™ user interfaces and optical multi-touch solutions for some of the world’s largest consumer brands. The cornerstone of our offer to customers is our patented zForce® MultiSensing touch technology which provides a far more augmented and profound user experience than traditional touch. zForce MultiSensing is suited for small to mid-sized consumer and industrial electronic devices and supports unlimited gestures, multi-touch and sweep navigation. zForce MultiSensing applies on any surface and integrates with all types of devices. zForce MultiSensing uses infrared light with zero latency that responds with any object - like a pen, finger, brush or gloved finger (with sizes down to 1 mm), at a very high scanning speed of 1000 Hz.

Neonode licenses zForce MultiSensing to Original Equipment Manufacturers (“OEMs”) and Original Design Manufacturers (“ODMs”) who embed our technology into electronic devices that they develop and sell and is currently being integrated into products such as mobile phones, e-Readers, household appliances, printers and office equipment, GPS devices, automobile consoles, games and toys, and tablet devices.

Our technology licensing model allows us to focus on the development of solutions for multi-touch enabled screens, and thus we do not have to contend with the financial and logistical burden of manufacturing products, which is handled by our ODM/OEM clients. We license the right to use zForce and software which, together with standard components from partners, create a complete optical touch solution. Our licensing model provides the added benefit of allowing us to grow revenues without the need of increasing costs at anywhere near the same rate to support the revenue growth.

### Liquidity

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 into contracts with customers and to raise additional funds through debt or equity financings. During 2011, we raised approximately \$15.5 million through debt

and equity offerings (see Notes 3 and 4). We believe we have sufficient cash to operate through the first quarter of 2013, and thereafter expect to receive sufficient cash from customer license agreements currently in place to operate for at least the next twelve months.

## 2. Summary of Significant Accounting Policies

### Fiscal Year

Our fiscal year is the calendar year.

### Principles of Consolidation

The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of Neonode Inc. and its wholly owned Swedish subsidiary Neonode Technologies AB. All inter-company accounts and transactions have been eliminated in consolidation.

## Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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, recoverability of long-lived assets, the valuation allowance related to our deferred tax assets, the fair value of embedded derivatives, and the fair value of securities, such as options and warrants issued for stock-based compensation and in certain financing transactions.

## Cash and Cash Equivalents

We have not had any liquid investments other than normal cash deposits with bank institutions to date. If in the future the Company purchases cash equivalents, the Company will consider all highly liquid investments with original maturities of three months or less to be cash equivalents.

## Concentration of Cash Balance Risks

Cash balances are maintained at various banks in the U.S. and Sweden. At times, deposits held with financial institutions in the United States of America may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation ("FDIC"), which provides basic deposit coverage with limits up to \$250,000 per owner. In addition to the basic insurance deposit coverage, the FDIC is providing temporary unlimited coverage for noninterest bearing transaction accounts through December 31, 2012. The Swedish government provides insurance coverage up to 100,000 euro per customer and covers deposits in all types of accounts. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk related to the deposits. As of March 31, 2012, the Company has approximately \$11.9 million in excess of insurance limits.

## Accounts Receivable and Allowance for Doubtful Accounts

Our accounts receivable are stated at net realizable value. 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 the customer when determining or modifying its 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 historical collection experience with customers. We determined that an allowance for doubtful accounts was not necessary at March 31, 2012 or December 31, 2011.

## Debt Issuance Costs

Debt issuance costs represent costs incurred in connection with the issuance of the convertible notes payable. Debt issuance costs are amortized over the term of the financing instrument on a straight-line basis, which approximates the effective interest method.

## Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method based upon estimated useful lives of the assets ranging from three to five years as follows:

|                        |         |
|------------------------|---------|
| Computer equipment     | 3 years |
| Furniture and fixtures | 5 years |

Equipment purchased under capital leases is amortized on a straight-line basis over the estimated useful life of the asset or the term of the lease, whichever is shorter.

Upon retirement or sale of property and equipment, cost and accumulated depreciation and amortization are removed from the accounts and any gains or losses are reflected in the consolidated statement of operations. Maintenance and repairs are charged to expense as incurred.

### Long-lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with relevant accounting guidance. If the estimated undiscounted future cash flow related to these assets decreases or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. At March 31, 2012, we believe there is no impairment of our long-lived assets. There can be no assurance, however, that market conditions will not change or sufficient commercial demand for our products and services will materialize, which could result in impairment of long-lived assets in the future.

### Foreign Currency Translation and Transaction Gains and Losses

The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona. The translation from Swedish Krona to U.S. Dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for income statement accounts using a weighted-average exchange rate during the period. Gains or losses resulting from translation are included as a separate component of accumulated other comprehensive income (loss). Gains or losses resulting from foreign currency transactions are included in general and administrative expense in the accompanying condensed consolidated statements of operations and were \$62,000 and \$65,000 during the three months ended March 31, 2012 and 2011, respectively. Foreign currency translation gain (loss) was \$44,000 and \$(39,000) for the three months ended March 31, 2012 and 2011, respectively.

### 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 as conversion 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 accounting guidance, if such embedded conversion features, if freestanding, would meet the classification of a liability. Accounting guidance 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 criteria in accordance with accounting guidance to be classified as liabilities, 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.

On December 14, 2011, all of the outstanding convertible debt and accrued interest was paid or converted into shares of the Company's common stock. As of December 31, 2011, the fair value of the embedded conversion features was \$0.

### Concentration of Credit and Business Risks

In the short term, we anticipate that we will depend on a limited number of customers for substantially all of our future revenue. Failure to anticipate or respond adequately to technological developments in our industry, changes in customer or supplier requirements or changes in regulatory requirements or industry standards, or any significant delays in the development or introduction of products or services, could have a material adverse effect on our business, operating results and cash flows.

On December 14, 2011, all of the outstanding convertible debt and accrued interest was paid or converted into shares of the Company's common stock. As of December 31, 2011, the fair value of the embedded conversion features was \$0.

- Amazon accounted for 55%
- Sony Corporation accounted for 16%

Our accounts receivable as of December 31, 2011 was due from five customers, two of which accounted for 87% of our accounts receivable as of December 31, 2011. Our net revenues for the three months ended March 31, 2011 was earned from two customers, of which Sony Corporation accounted for approximately 97% of our net revenues.

#### Risk and Uncertainties

Our long-term success is dependent on our obtaining sufficient capital to fund our operations and to develop our products, and on our bringing such products to the worldwide market and obtaining sufficient sales volume to be profitable. 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 our stockholders and may contain restrictive covenants.

We are subject to certain risks common to technology-based companies in similar stages of development. Principal risks include risks relating to the uncertainty of market acceptance for our products, 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, 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 products 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.

We are exposed to a number of economic and industry factors that could result in portions of our technology becoming obsolete or not gaining market acceptance. These factors include, but are not limited to, technological changes in our markets, our ability to meet changing customer requirements, competitive pressures in products and prices, and the ability of our customers to manufacture and sell their products that incorporate our technology.

A significant portion of our business is conducted in currencies other than the U.S. dollar (the currency in which its financial statements are reported), primarily the Swedish Krona and, to a lesser extent, the Euro. We incur a significant portion of our expenses in Swedish Krona, including a significant portion of our product development expenses and a substantial portion of our general and administrative expenses. As a result, appreciation of the value of the Swedish Krona relative to the other currencies, particularly the U.S. dollar, could adversely affect operating results. We do not currently undertake hedging transactions to cover our currency exposure, but we may choose to hedge a portion of our currency exposure in the future as deemed appropriate.

Our future success depends on market acceptance of our technology as well as our ability to introduce new versions of our technology to meet the evolving needs of our customers.

#### Revenue Recognition

##### Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue from these services when all of the following conditions are met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our services were performed and risk of loss passed to the customer; (3) we completed all of the necessary terms of the contract; (4) the amount of revenue to which we were entitled was fixed or determinable; and (5) we believed it was probable that we would 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. Generally, we recognize revenue as the engineering services stipulated under the contact are completed and accepted by our customers.

##### Licensing Revenues:

We also derive revenue from the licensing of internally developed intellectual property ("IP"). We enter into IP licensing agreements that generally provide licensees the right to incorporate our IP components in their products with terms and conditions that vary by licensee. The IP licensing agreements generally include a nonexclusive license for the underlying IP. Fees under these agreements may include license fees relating to our IP and royalties payable following the sale by our licensees of products incorporating the licensed technology. The license for our IP has standalone value and can be used by the licensee without maintenance and support. As of September 30, 2011, Neonode meets all the accounting requirements for revenue recognition as per unit royalty products are distributed or licensed by the Company's customers. For technology license arrangements that do not require significant modification or customization of the underlying technology, we recognize new technology license revenue when: (1)

we enter into a legally binding arrangement with a customer for the license of technology; (2) customer distributes or license the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured.

Prior to September 30, 2011, we deferred the technology license fee revenue until such time as the warranty period stipulated in the license agreement expired because we did not have sufficient historical experience in estimating potential warranty costs. From June 2010 to December 31, 2011, we entered into 12 technology license contracts with customers. During that time there were no warranty related costs incurred for any customer products after they have been released to market. During the quarter ended September 30, 2011, the Company performed an analysis and determined that it had sufficient historical evidence regarding estimated warranty costs and therefore began recognizing technology license fee revenues, net of warranty costs, if any, as the products incorporating the Neonode technology are distributed or licensed by our customers, assuming all other revenue recognition criteria has been met. Our customers report to us the quantities of products distributed by them after the end of the reporting period stipulated in the contract, generally 30 to 45 days after the end of the month or quarter.

Explicit return rights are not offered to customers. There have been no returns through March 31, 2012.



#### Hardware Products:

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 will 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. To date, we have not sold any hardware products.

#### Software Products:

We may derive revenues from software licensing sales. We will account for the licensing of software in accordance with accounting guidance and such guidance 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.

For software license arrangements that do not require significant modification or customization of the underlying software, we will 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 allocate revenues to all deliverables based on their relative selling price using a specific hierarchy. The hierarchy is as follows: vendor-specific objective evidence (“VSOE”), third-party evidence of selling price (“TPE”) or best estimate of selling price (“BESP”).

When a sale involves multiple elements, we will allocate the entire fee from the arrangement to each respective element based on VSOE of fair value and recognize revenue when each element’s revenue recognition criteria are met. VSOE of fair value for each element is established based on the price charged when the same element is sold separately. We have established VSOE for our software licenses based on historical stand-alone sales to third parties or from the stated renewal rates contained in the customer contracts. Maintenance service revenue is recognized on a straight-line basis over the support period.

We have not yet demonstrated VSOE for the professional services that are rendered in conjunction with our software license sales. In accordance with the hierarchy we would attempt to establish the selling price of professional services using TPE. Our product contains significant differentiation such that the comparable pricing of products with similar functionality cannot be obtained. We are typically not able to obtain TPE for professional services.

When we are unable to establish selling prices using VSOE or TPE, we use BESP. The objective of BESP is to determine the price at which we would transact a sale if professional services were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for highly customized offerings.

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. To date, we have not sold any software products.

#### Deferred Revenue

From time-to-time the Company receives pre-payments from its customers related to future services or future license fee revenues. The Company defers these revenues until the services have been provided or until the license fees are earned.

### Advertising

Advertising costs are expensed as incurred. Advertising costs for the quarters ended March 31, 2012 and 2011 amounted to approximately \$197,000 and \$45,000, respectively.

### Product Research and Development

Research and development (“R&D”) costs are expensed as incurred. R&D costs consist mainly of personnel related costs in addition to some external consultancy costs such as testing, certifying and measurements.

### Stock-Based Compensation Expense

We measure the cost of employee services received in exchange for an award of equity instruments, including share options, based on the fair value of the award on the grant date, and recognize the value as compensation expense over the period the employee is required to provide services in exchange for the award, usually the vesting period, net of estimated forfeitures.

We account for equity instruments issued to non-employees at their fair value and the unvested portion is re-measured each reporting period as long as the instrument requires variable accounting.

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 Detachable Stock Purchase Warrants and Beneficial Conversion Features

We account for debt issued with stock purchase warrants by allocating 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, if the warrants are equity instruments. The relative fair value of the warrants are recorded as a debt discount and amortized to expense over the life of the related debt using the effective interest method. At each balance sheet date, we make a determination if these warrant instruments should be classified as liabilities or equity, and reclassify them if the circumstances dictate.

In certain instances, the Company enters into convertible notes that provide for an effective or actual rate of conversion that is below market value, and the embedded conversion feature does not qualify for derivative treatment (a "BCF"). In these instances, we account for the value of the BCF as a debt discount, which is then amortized to expense over the life of the related debt using the straight-line method which approximates the effective interest method.

#### Income Taxes

We recognize deferred tax liabilities and assets for the expected future tax consequences of items that have been included in the consolidated 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 when, in our opinion, realization is uncertain based on the "not more likely than not" criteria of the accounting guidance.

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of March 31, 2012 and December 31, 2011. 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 relevant accounting guidance related to uncertain tax positions, which provisions include a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions. As a result, we did not recognize a liability for unrecognized tax benefits. As of March 31, 2012 and December 31, 2011, we had no unrecognized tax benefits.

#### Net Loss Per Share

Net loss per share amounts have been computed based on the weighted-average number of shares of common stock outstanding during the period. Net loss per share, assuming dilution amounts from common stock equivalents, is computed based on the weighted-average number of shares of common stock and potential common stock equivalents outstanding during the period. The weighted-average number of shares of common stock and potential common stock

equivalents used in computing the net loss per share for periods ended March 31, 2012 and 2011 exclude the potential common stock equivalents, as the effect would be anti-dilutive (See Note 10).

#### Comprehensive Income (Loss)

Accounting Standards Codification (“ASC”) Topic 220, Comprehensive Income, establishes standards for reporting and displaying comprehensive income (loss) and its components in the condensed consolidated financial statements. Accumulated other comprehensive income (loss) includes foreign currency translation gains or losses as a result of consolidation.

#### Cash Flow Information

Cash flows in foreign currencies have been converted to U.S. dollars at an approximate weighted-average exchange rate for the respective reporting periods. The weighted-average exchange rate for the consolidated statements of operations and comprehensive loss was 6.75 and 6.50 Swedish Krona to one U.S. Dollar for the periods ended March 31, 2012 and 2011, respectively. The exchange rate for the consolidated balance sheets was 6.62 and 6.92 Swedish Krona to one U.S. Dollar as of March 31, 2012 and December 31, 2011, respectively.

### Fair Value of Financial Instruments

We disclose the estimated fair values for all financial instruments for which it is practicable to estimate fair value. Financial instruments including cash, accounts receivable, payables and accrued expenses are deemed to approximate fair value due to their short maturities.

### New Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Updates ("ASU") No. 2011-4, Fair Value Measurement ("ASU 2011-04"). ASU 2011-04 amends existing guidance to achieve convergence in measurement and disclosure between U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 is effective for fiscal year 2012. The adoption of ASU 2011-04 did not impact the Company's results of operations or its financial position.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income ("ASU 2011-05"). The provisions of ASU 2011-05 allow an entity the option to present the total of comprehensive income (loss), the components of net income (loss), and the components of other comprehensive income (loss) either in a single continuous statement of comprehensive income (loss) or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income (loss) along with total net income (loss), each component of other comprehensive income (loss) along with a total for other comprehensive income (loss), and a total amount for comprehensive income (loss). The statement(s) are required to be presented with equal prominence as the other primary financial statements. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income (loss) as part of the statement of changes in stockholders' equity but does not change the items that must be reported in other comprehensive income (loss) or when an item of other comprehensive income (loss) must be reclassified to net income (loss). Certain provisions of ASU No. 2011-05 are effective for the Company's interim reporting period beginning on or after December 15, 2011, with retrospective application required. The adoption of ASU No. 2011-05 resulted in presentation changes to the Company's consolidated statements of operations and the addition of consolidated statements of comprehensive income (loss). The adoption of ASU No. 2011-05 did not impact the Company's results of operations or its financial position.

### 3. Convertible Debt

#### Senior Convertible Secured Notes- 2007

At December 31, 2011, all of convertible promissory notes ("Senior Convertible Secured Notes-2007") have been converted in shares of our common stock. The Senior Convertible Secured Notes – 2007 were originally due August 26, 2010. On September 22, 2010, we entered into a debt modification agreement with the two holders of an aggregate of \$126,362 of convertible promissory notes that were due on August 26, 2010. Based on the terms of the modification, this transaction qualified as debt extinguishment accounting under the relevant accounting guidance. As part of the debt extinguishment, the maturity date of the convertible promissory notes was extended until April 26, 2011. We entered into a debt-for-equity repayment plan whereby we were retiring the convertible promissory notes in equal installments by issuing our common stock priced at a 15% discount from the average market closing price for the five days ending on the 25th of each month over the eight month period beginning September 26, 2010 ending on April 26, 2011. The holders of the notes had the right to convert the outstanding balance priced at \$2.25 per share if the market value of our common stock is greater than \$2.50 per share for five consecutive days.

During the three months March 31, 2011, we issued the note holders 24,720 shares of our common stock pursuant to the debt-for-equity repayment plan. We recorded \$47,386 of note principal reduction and \$948 interest payment and an issued 24,720 shares of our common stock to the note holders.

September 2009 Senior Convertible Secured Notes Financing transaction

During the period from August 25, 2009 through December 15, 2009, we completed a private placement of convertible notes totaling \$987,000 that were converted, at the holder's option, into shares of our common stock at a conversion price of \$0.50 per share (the "Convertible Notes - 2009"). The convertible note holders had the right to have the conversion price adjusted to equal the lower stock price if we issued common stock or convertible notes at a lower conversion price than \$0.50 per share during the period that the notes were outstanding. The Convertible Notes - 2009 that were originally due on December 31, 2010 were extended to June 30, 2011 (see below under Warrant Repricing and Debt Extension Financing Transaction – 2010) and bore annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes were outstanding. In addition, we issued 986,983 three-year warrants to the convertible note holders with an exercise price of \$1.00 per share. The warrants may be exercised and converted to common stock, at the warrant holder's option, beginning on the six-month anniversary of the date of issuance until the warrant expiration date. We are not obligated to register the common stock related to the convertible debt or the warrants. During the three months ended March 31, 2011 we issued 1,851,486 shares of our common stock to holders of Convertible Notes – 2009 who converted principal of \$912,036 and \$13,707 of related accrued interest. As a result of the conversions during the three months ended March 31, 2011, the Company reclassified \$4.5 million of the related derivative liabilities to additional paid-in capital. On June 30, 2011, we paid in cash the remaining outstanding principal balance of \$25,000 of Convertible Notes – 2009. As of June 30, 2011, all of the Convertible Notes – 2009 have been paid in full with cash or have been converted to shares of our common stock.

The embedded conversion feature of the Convertible Notes – 2009 met the definition of a derivative financial instrument and was classified as a liability in accordance with relevant accounting guidance. The note holders had the right to convert the debt into shares of our common stock, and the notes included price protection whereby these notes were protected for as long as the notes remained outstanding against future private placements made at lower share prices, and therefore, the total number of shares of our common stock that the convertible notes can be convertible into was not fixed. The embedded conversion features were revalued on each balance sheet date and marked-to-market with the change recorded to non-cash items related to debt discounts, deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations and comprehensive loss. The Company recorded a loss of \$2.3 million due to the change in the fair value of the embedded conversion features of these Convertible Notes – 2009 during the three months ended March 31, 2011. As of December 31, 2011, the fair value of the remaining embedded conversion features was \$0 due to the repayment or conversion of all the Convertible Notes - 2009 to shares of our common stock.

During the three months ended March 31, 2011 we recorded a total of \$15,000 in interest expense related to the principal balance of the Convertible Notes – 2009.

#### Senior Convertible Secured Notes- 2010

During the period from January through June 30, 2010, we received \$1,597,000 in cash proceeds and converted \$163,000 of accounts payable related to a private placement of convertible notes (the “Convertible Notes – 2010”) and stock purchase warrants that were convertible, at the holder’s option, into shares of our common stock at a conversion price of \$0.50 per share and we issued 1,760,712 stock purchase warrants that had an exercise price of \$1.00 per share. The convertible note holders had the right to have the conversion price adjusted to equal the lower stock price if we issued stock or convertible notes at a lower conversion price than \$0.50 during the period that the notes were outstanding. These convertible notes were originally due on December 31, 2010 and were extended to June 30, 2011(see below under Warrant Repricing and Debt Extension Financing Transaction – 2010) and bore annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes were outstanding. The warrants may be exercised and converted to common stock, at the warrant holder’s option, beginning on the six-month anniversary date of issuance until the warrant expiration date. We are not obligated to register the common stock related to the convertible debt or the warrants. During the year ended December 31, 2011, we issued 3,557,171 shares of our common stock to holders of Convertible Notes – 2010 who converted principal of \$1,750,143 and \$28,442 of related accrued interest. As of December 31, 2011, all of the Convertible Notes – 2010 have been converted to shares of our common stock.

During the three months ended March 31, 2011 we recorded a total of \$28,000 in interest expense related to the principal balance of the Convertible Notes – 2010.

The embedded conversion feature of the convertible debt issued in the 2010 convertible debt financing transaction met the definition of a derivative financial instrument and was classified as a liability in accordance with accounting guidance. The note holders had the right to convert the debt into shares of our common stock, and the notes included price protection whereby these notes were protected for as long as the notes remain outstanding against future private placements made at lower share prices, and therefore, the total number of shares of our common stock that the convertible notes may be convertible into was not fixed. The embedded conversion features were revalued on each balance sheet date and marked to market with the increase or decrease included in fair value 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. As of March 31, 2011, the fair value of the remaining embedded conversion features was \$570,000. The Company recorded a loss of \$4.2 million due to the change in the fair value of the embedded conversion feature of these Convertible Notes – 2010 during the three months ended March 31, 2011. As of December 31, 2011, the fair value of the remaining embedded conversion features is \$0 as all the Convertible Notes –

2010 were converted to shares of our common stock.

Senior Convertible Secured Notes- 2011

In March 2011, we received \$3.7 million in cash proceeds and commitments for an additional \$491,000 related to a private placement of convertible notes, bearing interest at a rate of seven percent (7%) per annum, that matured on March 1, 2014, and that could be converted at the holder's option into 1,691,320 shares of our common stock at a conversion price of \$2.50 per share (the "Convertible Secured Notes – 2011"). The Company received the \$491,000 in cash proceeds related to the unpaid commitments in April and May 2011. The notes would automatically be converted into shares of the Company's common stock in the event that on or before the note due date either (a) the Company's common stock is traded at a price per share of \$6.25 or higher for five (5) consecutive trading days, or (b) the Company consummates a financing in the amount of at least \$5 million. In the event that the loan principal and accrued interest was not repaid by the Company by the due date, and the investor has not previously converted the note, the investor's sole remedy for such non-payment shall be the payment of additional annual interest at a rate of 10% per year. The accrued interest was payable in stock, using the \$2.50 conversion price, or cash, at the holder's option, on June 30 and December 31 of each year.



In addition, the Company as of March 31, 2011 issued 373,730 new five-year common stock purchase warrants, with an exercise price of \$3.13 per share (the "March 2011 Warrants"), with each investor receiving a number of March 2011 Warrants that was equal to twenty-five percent (25%) of the investor's note to the Company. The Company issued an additional 49,100 warrants in April 2011 related to the collection of the payment totaling \$491,000. The March 2011 Warrants may be exercised by cash payment or through cashless exercise by the surrender of warrant shares having a value equal to the exercise price of the portion of the warrants being exercised.

In connection with the March 2011 financing transaction the Company valued the warrants issued to the convertible note holders on a relative fair value basis using the Black-Scholes option pricing model, totaling \$813,000. This relative fair value of the warrants was recorded as a debt discount. The embedded conversion features to the notes was determined to meet the definition of a derivative liability and as of the date of issuance was valued at \$4.1 million. In accordance with relevant accounting guidance, the Company recorded an additional debt discount (\$2.9 million) up to the full amount of the notes, recorded the derivative liability for the embedded conversion feature at \$4.1 million and recorded the fair value in excess of face amount of debt as interest expense on the issuance date of \$1.2 million. The debt discount was amortized in full upon the conversion of the notes to common stock on December 14, 2011. As of December 31, 2011, the fair value of the embedded conversion feature was \$0 due to the conversion of all the Senior Convertible Secure Notes – 2011.

During the three months ended March 31, 2011 the amount of interest expense recorded related to the amortization of the debt discount was immaterial. As of March 31, 2011, the fair value of the embedded conversion feature was \$5.0 million and as such, the Company recorded a loss on the change in fair value of the embedded conversion feature of \$900,000, which is included in the accompanying consolidated condensed statement of operations as a component on non-cash items related to debt discounts, deferred financing fees and valuation of conversion features and warrants.

In October and November 2011, note holders of \$575,000 of the original \$4.2 million Senior Convertible Secure Notes – 2011 exercised their right to convert their notes and accrued interest and were issued 232,125 shares of our common stock.

On December 13, 2011, following a public offering pursuant to a Registration Statement on Form S-3, the Company received gross proceeds in excess of \$5 million. Pursuant to the terms, as defined, in the Senior Convertible Secure Notes – 2011 agreements, the remaining outstanding principal balance plus accrued interest, was automatically converted into shares of common stock at a conversion price of \$2.50 per share. In accordance with the terms of the agreement, the Company automatically converted approximately \$3.7 million of remaining principal and approximately \$130,000 of accrued interest into 1,513,237 shares of the Company's common stock. In addition, the Company issued 99,461 shares of common stock related to the bonus interest feature associated with the mandatory conversion of the debt. As of December 31, 2011, the fair value of the embedded conversion features was \$0. As of December 31, 2011, all of the Senior Convertible Secure Notes - 2011 plus accrued interest was paid or converted into shares of common stock.

#### 4. Stockholders' Equity

On February 29, 2012, the Company filed a Certificate of Correction with the Secretary of State of Delaware effectively reducing the amount of its authorized shares from 848,000,000 shares of Common Stock and 2,000,000 shares of Preferred Stock to 70,000,000 shares of Common Stock and 1,000,000 shares of Preferred Stock. This correction reflects the new capital structure of the Company following its 1-for-25 reverse split that became effective at the close of business on March 25, 2011.

Common Stock

During the three months ended March 31, 2012, Series B Preferred stockholders exchanged 19 shares of Series B Preferred stock for 2,509 shares of our common stock.

On March 16, 2012, John Reardon, a member of our board of directors, exercised a warrant to purchase 200,000 shares of common stock using the net exercise provision allowed in the warrant and received 174,798 shares of our common stock.

#### Preferred Stock

The terms of the Series A and Series B Preferred stock are as follows:

- Dividends and Distributions.

Series A Preferred: The holders of shares of Series A Preferred stock are entitled to participate with the holders of our common stock with respect to any dividends declared on the common stock in proportion to the number of shares of common stock issuable upon conversion of the shares of Series A Preferred stock held by them.

Series B Preferred: The holders of shares of Series B Preferred stock are entitled to participate with the holders of our common stock with respect to any dividends declared on the common stock in proportion to the number of shares of common stock issuable upon conversion of the shares of Series B Preferred stock held by them.

· Liquidation Preference.

Series A Preferred: In the event of any liquidation, dissolution, or winding up of our operations, either voluntary or involuntary, subject to the rights of any other series of Preferred stock to be established by the Board of Directors (the "Senior Preferred Stock"), the holders of Series A Preferred stock shall be entitled to receive, after any distribution to the holders of Senior Preferred Stock and prior to and in preference to any distribution to the holders of common stock, \$0.001 for each share of Series A Preferred stock then outstanding.

Series B Preferred: In the event of any liquidation, dissolution, or winding up of our operations, either voluntary or involuntary, subject to the rights of the Series A Preferred stock and Senior Preferred Stock, the holders of Series B Preferred stock shall be entitled to receive, after any distribution to the holders of Senior Preferred Stock and prior to and in preference to any distribution to the holders of common stock, \$0.001 for each share of Series B Preferred stock then outstanding.

· Voting.

The holders of shares of Series A Preferred stock and Series B Preferred stock shall have one vote for each share of Series A Preferred stock and Series B Preferred stock held by them.

· Conversion.

Initially, each share of Series A Preferred stock and each share of Series B Preferred stock was convertible into one share of our common stock. Any modification to the conversion rate requires shareholder approval (see below). On March 31, 2009, our shareholders approved a resolution to increase the authorized share capital, and to increase the conversion ratio to 480.63 shares of common stock for each share of Series A Preferred stock and to 132.07 shares of our common stock for each shares of Series B Preferred stock, thus completing the restructuring begun in December 2008.

Conversion of Preferred Stock Issued to Common Stock

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

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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 choose not to convert their preferred stock to shares of our common stock. The following table summarizes the Preferred stock not yet converted as of March 31, 2012.

|                               | Shares of Preferred Stock Not Exchanged as of March 31, 2011 | Conversion Ratio | Shares of Common Stock after Conversion of all Outstanding Shares of Preferred Stock Not yet Exchanged at March 31, 2011 |
|-------------------------------|--|------------------|--|
| Series A Preferred stock      | 83   | 480.63           | 39,892   |
| Series B Preferred stock      | 95   | 132.07           | 12,547   |
| Total Remaining Not Exchanged | 178  |                  | 52,439   |

## 5. Fair Value Measurement of Assets and Liabilities

Accounting guidance defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements about fair value measurements. The accounting guidance 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.

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. As of March 31, 2012 and December 31, 2011, we had no level 1 assets or liabilities.

Level 2: Inputs other than Level 1 that are observable, either directly or indirectly. As of March 31, 2012 and December 31, 2011, we had no level 2 assets or liabilities.

Level 3: : Inputs other than Level 1 that are observable, either directly or indirectly. As of March 31, 2012 and December 31, 2011, we had no level 3 assets or liabilities.

|                         | For the Three<br>Months<br>Ended<br>March 31,<br>2011 |
|-------------------------|---|
| Annual dividend yield   | --  |
| Expected life (years)   | 0.25 – 5.0  |
| Risk-free interest rate | 0.08% -<br>1.27%                                      |
| Expected volatility     | 110% -<br>224%  |

The assumptions above were used to value warrants granted to employees and consultants as well as the embedded conversion features associated with convertible debt for the period ended March 31, 2011.

On December 14, 2011, all of the outstanding convertible debt and accrued interest was paid or converted into shares of the Company's common stock. As of December 31, 2011, the fair value of the embedded conversion features was \$0.

## 6. Deferred Revenue

Engineering development fees are recorded as deferred revenue until such time as the engineering services have been provided.

As of March 31, 2012 and December 31, 2011, we have \$1.5 million and \$1.5 million, respectively, of deferred license fee revenue related to a prepayment for future license fees from one customer and a total of \$0.4 million and \$0.4 million of deferred engineering development fees from eight and four customers, respectively. We are deferring the engineering development fee revenue until such time as the engineering work has been completed. We expect to complete all services under these contracts by the fourth quarter of 2012.

## 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, 2012, we had two equity incentive plans:

The 1998 Non-Officer Stock Option Plan (the 1998 Plan), which expired in June 2008 ;  
The 2006 Equity Incentive Plan (the 2006 Plan).

We also had one non-employee director stock option plan as of March 31, 2012:

The 2001 Non-Employee Director Stock Option Plan (the Director Plan) which expired in March 2011.

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

|                                | Number of<br>Options<br>Outstanding | Exercise<br>Price<br>Per Share | Weighted<br>Average<br>Exercise<br>Price |
|--------------------------------|-------------------------------------|--------------------------------|--|
| Outstanding at January 1, 2012 | 19,324                              | 35.39 -<br>\$368.75            | \$92.19                                  |
| Granted                        | ---                                 | ---                            | ---                                      |
| Cancelled or expired           | (7,864 )                            | 35.39 -<br>\$368.75            | \$69.31                                  |
| Exercised                      | ---                                 | ---                            | ---                                      |
| Outstanding at March 31, 2012  | 11,460                              | 58.25 -<br>\$125.00            | \$107.89                                 |

The aggregate intrinsic value of the 11,460 stock options that are outstanding, vested and expected to vest at March 31, 2012 is \$0.

The 1998 Plan terminated effective June 15, 2008 and the Director Plan terminated effective March 2011. 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 vested 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 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.

During the three months ended March 31, 2011, the Company recorded \$34,000 of stock option expense related to the vesting of stock options.

We did not grant any options to purchase shares of our common stock to employees or members of our Board of Directors during the three months ended March 31, 2012 and 2011.

#### Warrants

On December 3, 2010, we issued 120,000 warrants at an exercise price of \$1.625 per share to an employee. The fair value of the warrants was \$198,000 on the date of grant, using the Black-Scholes option pricing model, which is to be amortized over 24 months. During the three months ended March 31, 2012 and 2011, we recorded \$25,000 of stock based compensation expense related to vesting of such warrants.

We issued 80,000 five-year stock purchase warrants at an exercise price of \$2.50 per share to our legal advisor during the three months ended March 31, 2011. We also issued 20,000 three-year stock purchase warrants at an exercise price of \$2.00 per share to our US based employee during the three months ended March 31, 2011. The warrants to purchase an aggregate of 100,000 shares of our common stock vested on the date of grant. The vested warrants granted to employees and legal advisor had an aggregate fair value on the date of grant of \$230,000 and is included in general and administrative expense for the three months ended March 31, 2011. The fair value of stock-based compensation related to the employee warrants is calculated using the Black-Scholes option pricing model as of the grant date of the underlying warrant.

On September 12, 2011, we issued 20,000 warrants at an exercise price of \$3.90 per share to an employee. The fair value of the warrants was \$75,000 on the date of grant, using the Black-Scholes option pricing model, which is to be

amortized over 24 months. During the three months ended March 31, 2012, we recorded \$9,000 of stock based compensation expense related to vesting of such warrants.

The stock-based compensation expense reflects the fair value of the vested portion of options and warrants for the recipients at the date of issuance plus the amortization of the unvested portion of the stock options, and warrants. Stock-based compensation expense related to stock options and warrants in the accompanying consolidated statements of operations is as follows (in thousands):

|                          | Three<br>months<br>ended<br>March 31,<br>2011 | Three<br>months<br>ended<br>March 31,<br>2012 | Remaining<br>unamortized<br>expense at<br>March 31,<br>2012 |
|--------------------------|---|---|---|
| Stock-based compensation | \$ 289  | \$ 34   | \$ 121  |

The remaining unamortized expense related to stock options and warrants will be recognized on a straight line basis monthly as compensation expense over the remaining vesting period which approximates 18 months.

See Note 5 for assumptions used to value warrants and embedded conversion features during the three months ended March 31, 2011.

A summary of all warrant activity is set forth below:



|   | March 31, 2012 |                                 |   |
|---|----------------|---------------------------------|---|
|   | Warrants       | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life |
| Outstanding and exercisable                 |                |                                 |   |
| January 1, 2012                             | 5,405,606      | \$ 1.57                         | 2.45  |
| Issued                                      | --             | \$ --                           | --  |
| Expired/forfeited                           | --             | --                              | --  |
| Exercised                                   | (200,000)      | \$ 0.50                         | --  |
| Outstanding and exercisable, March 31, 2012 | 5,205,606      | \$ 1.61                         | 2.12  |

On March 16, 2012, John Reardon, a member of our board of directors, exercised a warrant to purchase 200,000 shares of common stock using the net exercise provision allowed in the warrant and received 174,798 shares of our common stock.

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.

Below is a summary of Outstanding Warrants to Purchase  
Common Stock as of March 31, 2012:

| Description                         | Issue Date | Exercise Price | Shares    | Expiration Date |
|-------------------------------------|------------|----------------|-----------|-----------------|
| September 2007 Investor Warrant     | 9/26/2007  | \$ 31.75       | 233       | 9/26/2012       |
| August 2009 Employee Warrants       | 8/25/2009  | \$ 0.50        | 240,000   | 8/25/2016       |
| January 2010 Investor Warrant       | 1/28/2010  | \$ 1.00        | 40,000    | 1/28/2013       |
| 2007 Debt Extension Warrants        | 9/22/2010  | \$ 1.00        | 16,000    | 9/22/2015       |
| September 2010 Repricing Warrant    | 9/28/2010  | \$ 1.38        | 25,000    | 9/28/2013       |
| October 2010 Repricing Warrants     | 10/18/2010 | \$ 1.38        | 2,434,830 | 10/18/2013      |
| October 2010 Employee Warrants      | 10/15/2010 | \$ 1.38        | 1,440,000 | 10/15/2013      |
| December 2010 Employee Warrants     | 12/3/2010  | \$ 1.63        | 200,000   | 12/3/2015       |
| January 2011 Employee Warrant       | 1/21/2011  | \$ 2.00        | 20,000    | 1/21/2014       |
| February 2011 Legal Advisor Warrant | 2/22/2011  | \$ 2.50        | 80,000    | 2/22/2016       |
| March 2011 Investor Warrants        | 3/9/2011   | \$ 3.13        | 620,443   | 3/9/2016        |
| March 2011 Investor Warrants        | 4/7/2011   | \$ 3.13        | 49,100    | 4/7/2016        |
| May 2011 Consultant Warrant         | 5/17/2011  | \$ 4.05        | 20,000    | 5/17/2014       |
| September 2011 Employee Warrant     | 9/12/2011  | \$ 3.90        | 20,000    | 9/12/2014       |
| Total Warrants Outstanding          |            |                | 5,205,606 |                 |

## 8. Commitments and Contingencies

## Indemnities and Guarantees

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, 2012 and December 31, 2011, 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, 2012 and December 31, 2011, respectively.

## Operating Leases

Neonode Technologies AB has a lease with Vasakronan Fastigheter AB for 2,207 square feet of office space located at Linnegatan 89, Stockholm, Sweden for approximately \$6,000 per month including property tax (excluding VAT). The annual payment for this space equates to approximately \$72,000 per year including property tax (excluding VAT). This lease has a notice period of 3 months.

Neonode Technologies AB has a lease with Vasakronan Fastigheter AB for 2,723 square feet of office space located at Linnegatan 89D, Stockholm, Sweden for approximately \$8,000 per month including property tax (excluding VAT). The annual payment for this space equates to approximately \$93,000 per year including property tax (excluding VAT). This lease is valid through December 31, 2014, with a 9-month notice period. The contract will be extended for an additional 3 years if it is not terminated according to the terms in the contract.

On March 18, 2011, we entered into a twelve month lease with CA-Santa Clara Office Center Limited Partnership for 1,718 square feet of office space located at 2700 Augustine Drive, Suite 100, Santa Clara, California, USA for \$2,647 per month. The lease expired on April 30, 2012.

On March 22, 2012, we entered into a three year lease with 2350 Mission Investors LLC for 3,185 square feet of office space located at 2350 Mission College Blvd, Suite 190, Santa Clara, CA 95054 USA commencing May 1, 2012. The initial lease payment is approximately \$7,000 per month, increasing to approximately \$7,700 per month over the term of the lease. The annual payment for this space equates to approximately \$84,000 per year including property taxes.

## 9. Segment Information

The Company has one reportable segment, which is comprised of the touchscreen technology licensing business. All of our sales for the three months ended March 31, 2012 and 2011 were to customers located in the U.S., Europe and Asia.

The following table presents net revenues by geographic region for the three months ended March 31, 2012 and 2011 (dollars in thousands):

|                                       | 2012     |            | 2011   |            |
|---------------------------------------|----------|------------|--------|------------|
|                                       | Amount   | Percentage | Amount | Percentage |
| Net revenues made in the U.S.         | \$ 974   | 84%        | \$ --  | --%        |
| Net revenues made outside of the U.S. | \$ 190   | 16%        | \$ 539 | 100%       |
|                                       | \$ 1,164 | 100%       | \$ 539 | 100%       |

## 10. Net Loss Per Share

Basic net loss per common share for the three months ended March 31, 2012 and 2011 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 attributable to common stockholders by the weighted average number of shares of common stock and common stock equivalents outstanding.

Potential common stock equivalents of 3.2 million and 2.1 million outstanding stock warrants under the treasury stock method, 52,000 and 55,000 shares issuable upon conversion of preferred stock and 0 and 1.8 million shares issuable

upon conversion of notes are excluded from the diluted earnings per share calculation for the periods ended March 31, 2012 and 2011, respectively, due to their anti-dilutive effect.

| (in thousands, except per share amounts)               | Three Months ended |            |
|--|--------------------|------------|
|  | March 31,<br>2012  | 2011       |
| <b>BASIC AND DILUTED</b>                               |                    |            |
| Weighted average number of common shares outstanding   | 32,809             | 22,406     |
| Number of shares for computation of net loss per share | 32,809             | 22,406     |
| Net loss   | \$(1,588 )         | \$(9,721 ) |
| Net loss per share - basic and diluted                 | \$(0.05 )          | \$(0.43 )  |

## 11. Related Party Transactions

On March 16, 2012, John Reardon, a member of our board of directors, exercised a warrant to purchase 200,000 shares of common stock using the net exercise provision allowed in the warrant and received 174,798 shares of our common stock.

## 12. Subsequent Events

On April 2, 2012, a warrant holder exercised a warrant to purchase 15,000 shares of common stock using the net exercise provision allowed in the warrant and received 9,438 shares of our common stock.

On May 1, 2012, the Company began trading its common stock on the NASDAQ Stock Market Capital Markets under trading symbol NEON.

We have evaluated subsequent events through the filing date of this Form 10-Q, and have determined that no further subsequent events have occurred that would require recognition in the consolidated financial statements or disclosure in the notes thereto.

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

### Forward Looking Statements

This Quarterly Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, adopted pursuant to the Private Securities Litigation Reform Act of 1995. Statements that are not purely historical may be forward-looking. You can identify some forward-looking statements by the use of words such as "believes," "anticipates," "expects," "intends" and similar expressions. Forward-looking statements involve inherent risks and uncertainties regarding events, conditions and financial trends that may affect our future plans of operation, business strategy, results of operations and financial position. A number of important factors could cause actual results to differ materially from those included within or contemplated by such forward-looking statements, including, but not limited to 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, For a discussion of these and other factors that

could cause actual results to differ from those contemplated in the forward-looking statements, please see the discussion under “Risk Factors” contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in our publicly available filings with the Securities and Exchange Commission. Forward-looking statements reflect our analysis only as of the date hereof. Actual events or results may differ materially from the results discussed in or implied by the forward-looking statements. We do not undertake any responsibility to update or revise any of these factors or to announce publicly any revisions to forward-looking statements, whether as a result of new information, future events or otherwise. .

The following Management’s Discussion and Analysis 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 consolidated financial statements for the year ended December 31, 2011 included in our Annual Report on Form 10-K.

#### Overview

Neonode Inc., “we”, “us”, “our”, the “Company”, develops and licenses the next generation of MultiSensing™ user interfaces and optical multi-touch solutions for some of the world’s largest consumer brands. The cornerstone of our offer to customers is our patented zForce® MultiSensing touch technology which provides a far more augmented and profound user experience than traditional touch. zForce MultiSensing is suited for small to midsize consumer and industrial electronic devices and supports unlimited gestures, multi-touch and sweep navigation. zForce MultiSensing applies on any surface and integrates with all types of devices. zForce MultiSensing uses infrared light with zero latency that responds with any object - like a pen, finger, brush or gloved finger (with sizes down to 1 mm), at a very high scanning speed of 1000 Hz.

Neonode licenses zForce MultiSensing to Original Equipment Manufacturers (“OEMs”) and Original Design Manufacturers (“ODMs”) who embed our technology into electronic devices that they develop and sell and is currently being integrated into products such as mobile phones, e-Readers, household appliances, printers and office equipment, GPS devices, automobile consoles, games and toys, and tablet devices.

Our technology licensing model allows us to focus on the development of solutions for multi-touch enabled screens, and thus we do not have to contend with the financial and logistical burden of manufacturing products, which is handled by our ODM/OEM clients. We license the right to use zForce and software which, together with standard components from partners, create a complete optical touch solution. Our licensing model provides the added benefit of allowing us to grow revenues without the need of increasing costs at anywhere near the same rate to support the revenue growth.

#### Critical Accounting Policies

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The condensed consolidated financial statements for the three months ended March 31, 2012 and 2011, and as of March 31, 2012 and December 31, 2011 include the accounts of Neonode Inc. and our wholly owned subsidiary, Neonode Technologies AB. All inter-company accounts and transactions have been eliminated in consolidation.

#### Accounts Receivable and Allowance for Doubtful Accounts

Our accounts receivable are stated at net realizable value. 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 the customer when determining or modifying its 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 historical collection experience with customers. We determined that an allowance for doubtful accounts was not necessary at March 31, 2012 and December 31, 2011.

#### Long-lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with relevant accounting guidance. If the estimated undiscounted future cash flow related to these assets decreases or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. At March 31, 2012, we believe there is no impairment of our long-lived assets. There can be no assurance, however, that market conditions will not change or sufficient commercial demand for our products and services will materialize, which could result in impairment of long-lived assets in the future.

#### 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 as conversion 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 accounting guidance, if such embedded conversion features, if freestanding, would meet the classification of a liability. Accounting guidance 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 criteria in accordance with accounting guidance to be classified as liabilities, 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.



### Concentration of Credit and Business Risks

In the short term, we anticipate that we will depend on a limited number of customers for substantially all of our future revenue. Failure to anticipate or respond adequately to technological developments in our industry, changes in customer or supplier requirements or changes in regulatory requirements or industry standards, or any significant delays in the development or introduction of products or services, could have a material adverse effect on our business, operating results and cash flows.

Our accounts receivable as of March 31, 2012 was due from eight customers, two of which accounted for 76% of our accounts receivable as of March 31, 2012. Our net revenues for the three months ended March 31, 2012 was earned from ten customers. Our customers are located in the U.S., Europe and Asia. Customers which accounted for 10% or more of our net revenues during the three months ended March 31, 2012 are as follows:

- Amazon accounted for 55%
- Sony Corporation accounted for 16%

Our accounts receivable as of December 31, 2011 was due from five customers, two of which accounted for 87% of our accounts receivable as of December 31, 2011. Our net revenues for the three months ended March 31, 2011 was earned from two customers, of which Sony Corporation accounted for approximately 97% of our net revenues for the three months ended March 31, 2011.

### Revenue Recognition

#### Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue from these services when all of the following conditions are met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our services were performed and risk of loss passed to the customer; (3) we completed all of the necessary terms of the contract; (4) the amount of revenue to which we were entitled was fixed or determinable; and (5) we believed it was probable that we would 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. Generally, we recognize revenue as the engineering services stipulated under the contract are completed and accepted by our customers.

#### Licensing Revenues:

We also derive revenue from the licensing of internally developed intellectual property ("IP"). We enter into IP licensing agreements that generally provide licensees the right to incorporate our IP components in their products with terms and conditions that vary by licensee. The IP licensing agreements generally include a nonexclusive license for the underlying IP. Fees under these agreements may include license fees relating to our IP and royalties payable following the sale by our licensees of products incorporating the licensed technology. The license for our IP has standalone value and can be used by the licensee without maintenance and support. As of September 30, 2011, Neonode meets all the accounting requirements for revenue recognition as per unit royalty products are distributed or licensed by the Company's customers. For technology license arrangements that do not require significant modification or customization of the underlying technology, we recognize new technology license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of technology; (2) customer distributes or license the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured.

Prior to September 30, 2011, we deferred the technology license fee revenue until such time as the warranty period stipulated in the license agreement expired because we did not have sufficient historical experience in estimating potential warranty costs. From June 2010 to December 31, 2011, we entered into 12 technology license contracts with customers. During that time there were no warranty related costs incurred for any customer products after they have been released to market. During the quarter ended September 30, 2011, the Company performed an analysis and determined that it had sufficient historical evidence regarding estimated warranty costs and therefore began recognizing technology license fee revenues, net of warranty costs, if any, as the products incorporating the Neonode technology are distributed or licensed by our customers, assuming all other revenue recognition criteria has been met. Our customers report to us the quantities of products distributed by them after the end of the reporting period stipulated in the contract, generally 30 to 45 days after the end of the month or quarter.

Explicit return rights are not offered to customers. There have been no returns through March 31, 2012.

**Hardware Products:**

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 will 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. To date, we have not sold any hardware products.

#### Software Products:

We may derive revenues from software licensing sales. We will account for the licensing of software in accordance with accounting guidance and such guidance 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.

For software license arrangements that do not require significant modification or customization of the underlying software, we will 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.

On January 1, 2011, we adopted new authoritative guidance on a prospective basis for revenue arrangements containing multiple deliverables. This guidance requires us to allocate revenues to all deliverables based on their relative selling price using a specific hierarchy. The hierarchy is as follows: vendor-specific objective evidence (“VSOE”), third-party evidence of selling price (“TPE”) or best estimate of selling price (“BESP”).

When a sale involves multiple elements, we will allocate the entire fee from the arrangement to each respective element based on VSOE of fair value and recognize revenue when each element’s revenue recognition criteria are met. VSOE of fair value for each element is established based on the price charged when the same element is sold separately. We have established VSOE for our software licenses based on historical stand-alone sales to third parties or from the stated renewal rates contained in the customer contracts. Maintenance service revenue is recognized on a straight-line basis over the support period.

We have not yet demonstrated VSOE for the professional services that are rendered in conjunction with our software license sales. In accordance with the hierarchy we would attempt to establish the selling price of professional services using TPE. Our product contains significant differentiation such that the comparable pricing of products with similar functionality cannot be obtained. We are typically not able to obtain TPE for professional services.

When we are unable to establish selling prices using VSOE or TPE, we use BESP. The objective of BESP is to determine the price at which we would transact a sale if professional services were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for highly customized offerings.

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. To date, we have not sold any software products.

The adoption of this guidance did not have a material effect on our consolidated financial statements.

#### Product Research and Development

Research and development (“R&D”) costs are expensed as incurred. R&D costs consist mainly of personnel related costs in addition to some external consultancy costs such as testing, certifying and measurements.

#### Stock-Based Compensation Expense

We measure the cost of employee services received in exchange for an award of equity instruments, including share options, based on the fair value of the award on the grant date, and recognize the value as compensation expense over the period the employee is required to provide services in exchange for the award, usually the vesting period, net of

estimated forfeitures.

We account for equity instruments issued to non-employees at their fair value and the unvested portion is re-measured each reporting period as long as the instrument requires variable accounting.

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 Detachable Stock Purchase Warrants and Beneficial Conversion Features

We account for debt issued with stock purchase warrants by allocating 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, if the warrants are equity instruments. The relative fair value of the warrants are recorded as a debt discount and amortized to expense over the life of the related debt using the effective interest method. At each balance sheet date, we make a determination if these warrant instruments should be classified as liabilities or equity, and reclassify them if the circumstances dictate.

In certain instances, the Company enters into convertible notes that provide for an effective or actual rate of conversion that is below market value, and the embedded conversion feature does not qualify for derivative treatment (a "BCF"). In these instances, we account for the value of the BCF as a debt discount, which is then amortized to expense over the life of the related debt using the straight-line method which approximates the effective interest method.

## Results of Operations

### Net Revenues

Net revenues for the three months ended March 31, 2012 and 2011 was \$1.2 million and \$539,000, respectively. Our net revenues for the three months ended March 31, 2012 included \$896,000 from license fees related to the shipment of eReaders plus \$268,000 in fees for engineering design services related to our touch screen solution for another customer. Our net revenues for the three months ended March 31, 2011 included \$521,000 from license fees related to the shipment of eReaders by Sony Corporation (Sony) plus \$18,000 in fees for engineering design services related to our touch screen solution for another customer.

On June 18, 2010, in conjunction with the signing of the technology license agreement with Sony, they issued an initial purchase order for \$475,000 of touchscreen licenses. We recorded the \$475,000 pre-payment as deferred revenue until the initial warranty period expired. Sony began shipping its first eReader product on September 1, 2010. During the three months ended March 31, 2011, we recognized the \$475,000 of deferred revenue related to the Sony initial purchase order plus \$46,000 related to additional licenses purchased during the three months ended March 31, 2011.

As of March 31, 2012, we have signed sixteen technology license agreements with global OEMs and customers. We signed one new license agreement with a global OEM subsequent to March 31, 2012. In addition, we are currently developing prototype products and are engaged in product engineering design discussions with numerous global OEMs who are in the process of qualifying our touchscreen technology for incorporation in various products such as printer products, GPS devices, e-Readers, tablets, touch panels for automobiles, household appliances, mobile phones and games and toys. The development and product release cycle for these products typically takes six to eighteen months.

Drivers of the touch screen market include mobile phones, printers, laptops, tablets, eReaders, navigation screens, etc. The proliferation and mass market acceptance of touch screens have prompted new applications and uses for existing and new offerings, thus making the production and utilization of these modules one of the fastest growing tech segments. The typical sales cycle is 9-18 months with new customers while existing customer lead times are typically 6-9 months. During the initial cycle, there are three phases: evaluation, design, and commercial. In the evaluation phase, prospects validate the Neonode technology using a Neonode evaluation kit and may produce short runs. During the design phase, true product development begins, with solution definition occurring as well. This phase tends to be the longest and it should be noted that this phase is where delays typically occur, drawing out the term of the overall cycle. In the final phase, commercialization, the customer enters into full production mode, and Neonode earns license revenue.

### Gross Margin

Gross margin was \$915,000 and \$384,000 for the three months ended March 31, 2012 and 2011, respectively. Our cost of revenues includes the direct cost of production of the components plus the costs of Company employed engineering personnel plus engineering consultants to complete the engineering design contract.

### Product Research and Development

Product research and development expenses for the three month period ending March 31, 2012 were \$687,000 compared to \$276,000 for the same period in 2011. R&D costs mainly consist of personnel related costs in addition to some external consultancy costs such as testing, certifying and measurements. Factors that contributed to the increase in R&D costs include an increase in the amount of time our engineering department spends engaged in the R&D

activities. These other costs related to customer specific activities are included in our cost of revenue. R&D costs increased to \$249,000 for the three months ended March 31, 2012 compared to \$155,000 for the same period in 2011.

#### Sales and Marketing

Sales and marketing expenses for the three month period ended March 31, 2012 were \$799,000 compared to \$352,000 for the same period in 2011. This increase in 2012 as compared to 2011 is primarily related to an increase in sales and marketing staff, marketing activities and travel related costs.

#### General and Administrative

General and administrative expenses for the three months ended March 31, 2012 were \$995,000 compared to \$864,000 for the same period in 2011. This increase in 2012 as compared to 2011 is primarily related to salary expense, legal expenses related to patent filings, corporate and SEC compliance and customer contracts.

## Interest Expense

Interest expense for the three month period ended March 31, 2011 was \$54,000. We did not have any interest expense for the three month period ended March 31, 2012 . We had \$3.9 million of convertible debt outstanding at March 31, 2011. All the convertible debt and accrued interest was converted to shares of our common stock on December 14, 2011.

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

In connection with the March 2011 financing transaction the Company determined that the embedded conversion feature to the notes meet the definition of a derivative liability, and as of the date of issuance was valued at \$4.1 million. In accordance with relevant accounting guidance, the Company recorded a full debt discount up to the face amount of the notes (\$3.7 million), recorded the derivative liability for the embedded conversion feature of \$4.1 million and recorded the excess value of \$1.2 million on the issuance as non-cash interest expense.

During the three months ended March 31, 2011, the Company recorded an aggregate loss of \$7.4 million as a change in fair value of derivative liabilities.

On December 14, 2011, all of the outstanding convertible debt and accrued interest was paid or converted into shares of the Company's common stock. As of December 31, 2011, the fair value of the embedded conversion features was \$0.

## Income Taxes

Our tax provision for the three months ended March 31, 2012 and 2011 represents income taxes withheld by one of our foreign customers. We recorded valuation allowances for the three month periods ending March 31, 2012 and 2011 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 \$1.6 million for the three month period ended March 31, 2012, compared to a net loss of \$9.7 million in the comparable period in 2011.

## 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:

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- 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.

Our cash is subject to interest rate risk. We invest primarily on a short-term basis. Our financial instrument holdings at March 31, 2012, 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, 2012, we had cash of \$13.3 million as compared to \$12.9 million at December 31, 2011. In the three month period ended March 31, 2012, \$523,000 of cash was provided by operating activities. Our net loss for the three months ended March 31, 2012 increased by the following non-cash items (in thousands):



|  |    |    |
|--|----|----|
| Depreciation and amortization  | \$ | 18 |
| Stock-based compensation expense                                     |    | 34 |
| Total net non-cash items included in cash provided by our operations | \$ | 52 |

Working capital was \$11.9 million (current assets less current liabilities) at March 31, 2012, compared to working capital of \$13.6 million at December 31, 2011.

In the three months ended March 31, 2012, we purchased \$201,000 of equipment, primarily computers and furniture related to our Stockholm office.

Historically, the majority of our cash has been provided by borrowings from senior secured notes and bridge notes that have been convertible into shares of our common stock or from the sale of our common stock and common stock purchase warrants to private investors. During 2011, we raised approximately \$15.5 million through debt and equity offerings. We believe we now have sufficient cash to operate through the first quarter of 2013 and thereafter expect to receive sufficient cash from customer license agreements currently in place to operate for at least the next twelve months.

In the future, we may require sources of capital in addition to cash on hand to continue operations and to implement our strategy. If our operations do not become cash flow positive, 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 3. Quantitative and Qualitative Disclosures about Market Risk

Not Applicable

### Item 4. 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 end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective.

During the three months ended March 31, 2012, management determined that we had material weaknesses relating to the segregation of duties within our accounting functions and our quarterly and annual financial close processes. 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. 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 that our disclosure controls and procedures were effective.

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

#### Internal Control over Financial Reporting

There were no changes in our internal controls over financial reporting during the period covered by this report that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

We are currently taking 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 accounting department, consultants, or other resources (including those with public company reporting experience) to enhance our policies and procedures, including those related to complex accounting issues;
- exploring the suitability of further upgrades to our accounting system;
- preparing written policies and procedures for accounting and financial reporting to establish a formal process to close our books and account for all transactions; and

## PART II. Other Information

## ITEM 1. Legal Proceedings

We are not currently involved in any material legal proceedings. However, from time to time, we may become subject to additional legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes

## ITEM 1A. Risk Factors

Please refer to Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011.

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

## Exhibits

| Exhibit # | Description   |
|-----------|---|
| 3.1       | Amended and Restated Certificate of Incorporation of Neonode Inc., dated April 17, 2009 (incorporated by reference to Exhibit 10.22 of our Quarterly Report on Form 10-Q filed on August 4, 2009).  |
| 3.1.1     | Certificate of Amendment, dated December 13, 2010 (incorporated by reference to Exhibit 3.1.1 of our Annual Report on Form 10-K filed on March 31, 2011)  |
| 3.1.2     | Certificate of Amendment, dated March 18, 2011 (incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K filed on March 28, 2011)   |
| 3.1.3     | Certificate of Correction, dated February 29, 2011 (incorporated by reference to Exhibit 3.1.3 of our Annual Report on Form 10-K filed on March 31, 2011)   |
| 3.2       | Bylaws, as amended through December 5, 2007 (incorporated by reference to Exhibit 3.2 of our Annual Report on Form 10-K filed on April 15, 2008)  |
| 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  |
| 32.1      | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101       | The following materials from the Company's Form 10-Q for the quarter ended March 31, 2012 and 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Operations; (iii) Consolidated statements of Comprehensive Loss; (iv) Consolidated Statements of Cash Flows; and (v) Notes to Consolidated Financial Statements* |

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, 2012.

Neonode Inc.  
Registrant

Date: May 15, 2012

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