

Neonode, Inc  
Form 10-Q  
May 24, 2010

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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, 2010
- 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.

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(Exact name of registrant as specified in its charter)

Delaware 94-1517641  
(State or other jurisdiction (I.R.S.  
of incorporation or Employer Identification  
organization) No.)

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

(Address of principal executive offices and zip code)

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

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The number of shares of the registrant’s common stock outstanding as of May 18, 2010, was 426,985,185.

The number of shares of the registrant’s Series A Preferred stock outstanding as of May 18, 2010 was 68,120.

The number of shares of the registrant’s Series B Preferred stock outstanding as of May 18, 2010 was 9,875.

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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 31, 2010	December 31, 2009
	(Unaudited)	
Current assets:		
Cash	\$426	\$28
Accounts receivable	72	—
Prepaid expenses	124	58
Debt issuance costs	71	26
Other current assets	66	52
Total current assets	759	164
Property plant and equipment, net	20	20
Other assets	28	28
Total assets	\$807	\$212
<b>LIABILITIES AND STOCKHOLDERS' EQUITY DEFICIT</b>		
Current liabilities:		
Convertible debt, net of discounts	\$762	\$361
Accounts payable	843	699
Accrued expenses	880	993
Embedded derivatives of convertible debt and warrants	5,263	4,507
Total current liabilities	7,748	6,560
Commitments and contingencies (Note 7)		
Stockholders' deficit:		
Series A Preferred stock, 899,081 shares authorized with par value \$0.001 per share; 68,120 and 86,142 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively. (In the event of dissolution, each share of Series A Preferred stock has a liquidation preference equal to par value of \$0.001 over the shares of common stock)	664	841
Series B Preferred stock, 108,850 shares authorized with par value \$0.001 per share; 9,875 and 17,265 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively. (In the event of dissolution, each share of Series B Preferred stock has a liquidation preference equal to par value of \$0.001 over the shares of common stock)	—	—
Common stock, 698,000,000 shares authorized with par value \$0.001 per share; 426,985,185 and 416,472,328 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	427	416
Additional paid-in capital	74,860	73,048

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Accumulated other comprehensive loss	(91 )	(96 )
Accumulated deficit	(82,801 )	(80,557 )
Total stockholders' deficit	(6,941 )	(6,348 )
Total liabilities and stockholders' deficit	\$ 807	\$ 212

See notes to condensed consolidated financial statements.

## NEONODE INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share amounts) (Unaudited)

	Three months ended March 31,	
	2010	2009
Net revenues	\$ 146	\$—
Cost of revenues	62	—
Gross margin	84	—
Operating expenses:		
Product research and development	410	221
Sales and marketing	31	58
General and administrative	340	403
Amortization of fair value of stock issued to related parties for purchase of Neonode Technologies AB	1,584	1,584
Total operating expenses	2,365	2,266
Operating loss	(2,281 )	(2,266 )
Other income (expense), net:		
Interest and other expense, net	—	(30 )
Interest expense	(28 )	(3 )
Gain on conversion and forgiveness of accounts payable	—	30
Loss on troubled debt restructuring	—	(2,741 )
Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants	65	3
Total other income (expense), net	37	(2,742 )
Net loss from operations	(2,244 )	(5,008 )
Deemed dividend to preferred stockholders	—	(1,035 )
Net loss attributable to common stockholders	\$(2,244 )	\$(6,043 )
Foreign currency translation gain (loss)	5	(12 )
Comprehensive loss	\$(2,239 )	\$(5,020 )
Loss per common share:		
Basic and diluted loss per share	\$(0.01 )	\$(0.17 )
Basic and diluted – weighted average		

shares used in per share computations	418,771	36,515
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See notes to condensed consolidated financial statements.

NEONODE INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

	Three months ended March 31,	
	2010	2009
<b>Cash flows from operating activities:</b>		
Net loss	\$(2,244 )	\$(5,008 )
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Stock-based compensation expense	1,619	1,625
Stock issued in settlement	—	35
Loss on retirement of assets	—	30
Depreciation and amortization	2	2
Loss on troubled debt restructuring	—	2,741
Gain on conversion and forgiveness of accounts payable	—	(30 )
Debt discounts deferred financing fees and the valuation of conversion features and warrants	(65 )	(3 )
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable and other current assets	(86 )	(78 )
Prepaid expenses	(66 )	(14 )
Accounts payable and other accrued expenses	195	(180 )
Net cash used in operating activities	(645 )	(880 )
<b>Cash flows from investing activities:</b>		
Purchase of property, plant and equipment	(4 )	(17 )
Net cash used in investing activities	(4 )	(17 )
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of convertible debt	1,040	—
Proceeds from issuance of preferred stock	—	1,035
Net cash provided by financing activities	1,040	1,035
Effect of exchange rate changes on cash	7	(2 )
Net increase in cash	398	136
Cash at beginning of period	28	17
Cash at end of period	\$426	\$153
<b>Supplemental disclosure of cash flow information:</b>		
Interest paid	\$3	\$8
<b>Supplemental disclosure of non-cash transactions:</b>		
Fair value of conversion to common stock of Series A and B preferred stock issued to note and warrant holders related to corporate restructuring in excess of amounts recorded	\$—	\$2,741



in equity at December 31, 2008

Fair value of warrants reclassified to derivative liability due to adoption of new accounting standard	\$—	67
Fair value of 762,912 shares of common stock issued to convert accounts payable to equity	\$—	23
Deemed dividend to investors who received Series A preferred stock related to corporate restructuring at December 31, 2008 based in the fair value of the conversion to common stock at March 31, 2009	\$—	\$1,035
Fair value of conversion to common stock of 495,000 shares of Series A Preferred stock issued to related parties for 100% of Neonode Technologies AB recorded as compensation expense	\$—	\$4,555
Fair value of shares of common stock and warrants issued to brokers in connection with financing, recorded as debt issuance costs	\$52	\$—
Debt discount recorded as part of 2010 financing transaction	\$1,203	\$—
Accounts payable converted in 2010 convertible debt offering	\$163	\$—
Exchange of preferred stock for common stock	\$178	\$—

See 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, 2010 are not necessarily indicative of expected results for the full 2010 fiscal year.

The accompanying financial statements as of March 31, 2010 and for the three months ended March 31, 2010 and 2009 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 financial statements and notes contained in our consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2009.

Operations

We provide optical touchscreen solutions for handheld and small to mid-sized consumer and industrial electronic devices. We license our touchscreen technology to Original Equipment Manufacturers (“OEMs”) and Original Design Manufacturers (“ODMs”) who imbed our touchscreen technology into electronic devices that they develop and sell such as mobile phones, e-book readers, mobile internet devices, global positioning systems (GPS), digital picture frames and micro PCs. The cornerstone of our solution is our innovative optical infrared touchscreen technology, zForce™. We believe that keyboards and keypads with moving parts will become obsolete for handheld devices and that our touchscreen solutions will be at the forefront of a new wave of finger-based and pen input technologies that will enable the user to interact and operate everything from small mobile devices to large industrial applications using a combination of touches, swipes, and hand gestures.

Liquidity

The accompanying condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have incurred net operating losses and negative operating cash flows since inception. As of March 31, 2010, we had an accumulated deficit of \$82.8 million and a working capital deficit (current assets less current liabilities, not including embedded derivatives of convertible debt and warrant) of \$1.7 million. 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 raise additional funds through debt or equity. In the three months ended March 31, 2010, we completed a private placement of convertible notes and stock purchase warrants totaling \$1.0 million (see Note 3). In April and May 2010, we raised an additional \$533,000 through a private placement of convertible notes and stock purchase warrants under the same terms and conditions as the March 2010 private placement (see Note 11).

There is no assurance that we will be successful in obtaining sufficient funding in the future on acceptable terms, if at all. If we are unable to secure additional funding and/or our stockholders, if required, do not approve such financing, we would have to curtail certain expenditures which we consider necessary for optimizing the probability of success

of developing new products and executing our business plan. If we are unable to obtain additional funding for operations, we may not be able to continue operations as proposed, requiring us to modify our business plan, curtail various aspects of our operations or cease operations. The financial statements do not include any adjustments related to the recovery of assets and classification of liabilities that might be necessary should we be unable to continue as a going concern.

2. Summary of significant accounting policies

Fiscal Year

Our fiscal year is the calendar year.

Principles of Consolidation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 generally accepted accounting principles requires making estimates and assumptions that affect, at the date of the financial statements, the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Actual results could differ from these estimates. Significant estimates include but are not limited to collectibility of accounts receivable, estimated useful lives of long-lived assets, 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.

## Debt Issuance Costs

Debt issuance costs represents 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.

## Accounts Receivable and Allowance for Doubtful Accounts

Our net 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 did not record an allowance for doubtful accounts at March 31, 2010.

## Property, Plant and Equipment

Property, plant 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 one to five years as follows:

Tooling	1 year
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.

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, 2010, 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

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 loss. Gains or losses resulting from foreign currency transactions are included in other (expense) income. For the periods ended March 31, 2010 and 2009, we had no foreign currency transaction gains or losses.

### 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.

### 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 will 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, a reliance on a limited number of suppliers, 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 expense 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 products were delivered 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. On December 29, 2009, we signed an engineering services agreement with an OEM to provide engineering services over a three-month period in 2010 related to the development of a touchscreen application for a mobile phone product. The value of this agreement is approximately \$100,000, which has been recognized as revenue in the first quarter of 2010.

We also derive revenue from the licensing of internally developed intellectual property (IP). We entered into IP licensing agreements that generally provide licensees the right to incorporate our IP components in their products with terms and conditions that varied 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.

### 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 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 initially will defer all revenue related to the software license and maintenance fees until such time that we are able to establish VSOE for these elements of our software products. Revenue deferred under these arrangements will be recognized to revenue over the expected contract term. We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted. To date, we have not sold any software products.

Advertising

Advertising costs are expensed as incurred. We did not have any external advertising costs for the quarters ended March 31, 2010 and 2009.

## 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 it 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 financial statements or tax returns. We estimate income taxes based on rates in effect in each of the jurisdictions in which we operate. Deferred income tax assets and liabilities are determined based upon differences between the financial statement and income tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The realization of deferred tax assets is based on historical tax positions and expectations about future taxable income. Valuation allowances are recorded against net deferred tax assets where, in our opinion, realization is uncertain based on the “not more likely than not” criteria of the accounting guidance.

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of March 31, 2010 and December 31, 2009. 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 recognized no increase in the liability for unrecognized tax benefits. As of March 31, 2010 and December 31, 2009, 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, 2010 and 2009 exclude the potential common stock equivalents, as the effect would be anti-dilutive.

#### Comprehensive Loss

Our comprehensive loss includes cumulative foreign currency translation gains and losses which are reflected as a separate component in stockholders' deficit.

### 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 OCI was 7.19 and 8.40 Swedish Krona to one U.S. Dollar for the periods ended March 31, 2010 and 2009, respectively. The weighted average exchange rate for the consolidated balance sheets was 7.25 and 7.21 Swedish Krona to one U.S. Dollar as of March 31, 2010 and December 31, 2009, 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, payables and current portions of long-term debt are deemed to approximate fair value due to their short maturities. The carrying amounts of long-term debt cannot be reasonably determined since no quoted market prices exist for these instruments and quoted prices for similar instruments cannot be located.

### New Accounting Pronouncements

In September 2009, the FASB issued Accounting Standards Update (“ASU 2009-13”), Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”), which amends the revenue guidance under ASC Topic 605 Revenue Recognition, which describes the accounting for multiple element arrangements. ASU 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-13 is effective on a prospective basis for the Company’s fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the adoption of ASU 2009-13 and the impact that ASU 2009-13 will have on its condensed consolidated financial statements.

In September 2009, the FASB issued ASU 2009-14, Certain Revenue Arrangements That Include Software Elements (“ASU 2009-14”), which excludes tangible products containing software components and non-software components that function together to deliver product’s essential functionality from scope of ASC Topic 985 Software, which describes the accounting for software revenue recognition. ASU 2009-14 is effective on a prospective basis for the Company’s fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the impact that ASU 2009-14 will have on its condensed consolidated financial statements.

In January 2010, the FASB issued ASU 2010-6, Fair Value Measurements and Disclosures Improving Disclosures About Fair Value Measurement (“ASU 2010-6”), which affects the disclosures about recurring and non-recurring fair value measurements. The Company adopted the expanded disclosure requirements in the quarter ended March 31, 2010.

## 3. Convertible Debt

Our convertible debt consists of the following (in thousands):

	March 31, December 31, 2010	2009
Senior Convertible Secured Notes - 2007	\$ 139	\$ 139
Senior Convertible Secured Notes - 2009	987	987
Senior Convertible Secured Notes - 2010	1,203	--
Total	2,329	1,126
Less: unamortized debt discounts	(1,567 )	(765 )
Convertible debt	\$ 762	\$ 361

Future maturities of notes payable (in thousands):

	Future Maturity of Notes Payable
Year ended December 31, 2010	\$ 2,329
Total principal payments	\$ 2,329

## Senior Convertible Secured Notes- 2007

At March 31, 2010 and December 31, 2009, we had \$139,000 of three-year convertible promissory notes bearing the greater of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of \$3.50 per share. The Senior Convertible Secured Notes – 2007 are due August 26, 2010.

## 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 can be converted, at the holder's option, into 49,349,151 shares of our common stock at a conversion price of \$0.02 per share (the "September 2009 Convertible Notes"). Included in the convertible notes was approximately \$79,000 of related-party accruals that were converted to these notes. The convertible note holders have the right to have the conversion price adjusted to equal the lower stock price if we issue common stock or convertible notes at a lower conversion price than \$0.02 during the period that the notes are outstanding. The September 2009 Convertible Notes are due on December 31, 2010 and bear an annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes are outstanding. In addition, we issued 24,674,576 three-year warrants to the convertible note holders with an exercise price of \$0.04 per share. 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.

The embedded conversion feature of the convertible debt of the September 2009 Convertible Notes meets the definition of a derivative financial instrument and is classified as a liability in accordance with accounting guidance. The note holders have the right to convert the debt into shares of our common stock, and the notes include price protection whereby these notes are 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 can be convertible into is not fixed. The embedded conversion features are revalued on each balance sheet date and marked to market with the adjusting entry to non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations.

The fair value of the embedded conversion feature of the September 2009 Convertible Notes totaled \$2.2 million on the dates of issuance of the convertible debt. The \$2.2 million fair value of the conversion feature is included in the account entitled embedded derivatives of convertible debt and warrants on our consolidated balance sheet. We recorded a debt discount of \$987,000 and the excess fair value was recorded as an expense in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on our consolidated statement of operations (totaling \$1.2 million) for the year ended December 31, 2009. The embedded conversion feature was valued on the dates we received the proceeds using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model at the dates of issuance ranged from a term of 1 to 1.33 years, volatility of 226.79% to 247.52%, and a risk-free interest rate of 1.13%.

The \$987,000 debt discount is being amortized to expense over the 15-month term of the debt on a straight-line basis, which approximates the effective interest method. Included in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations for the period ended March 31, 2010 is \$189,000 related to three months of amortization of the debt discount.

On December 31, 2009, we issued a warrant to purchase 1,305,740 of our common stock at an exercise price of \$0.04 per share to an investor for services provided for the private placement of convertible notes and warrants in the 2009 financing transaction. The fair value of the 1,305,740 shares of common stock was \$26,000 on the date of issuance and was recorded as debt issuance costs and included in current assets in the accompanying consolidated balance sheet as of March 31, 2010 and December 31, 2009. Amortization for the three months ended March 31, 2010 was \$6,500. The warrants were valued using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model are a term of 2.7 years, volatility of 267.66%, and a risk-free interest rate of 1.13%.

#### Senior Convertible Secured Notes- 2010

In the three months ended March 31, 2010, we received \$1,040,000 in cash proceeds and converted \$163,000 of accounts payable related to a private placement of convertible notes and stock purchase warrants that can be converted, at the holder's option, into 60,160,564 shares of our common stock at a conversion price of \$0.02 per share and 30,080,282 stock purchase warrants that have an exercise price of \$0.04 per share. The convertible note holders have the right to have the conversion price adjusted to equal the lower stock price if we issue stock or convertible notes at a lower conversion price than \$0.02 during the period that the notes are outstanding. These convertible notes are due on December 31, 2010 and bear an annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes are 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. Mr. Bystedt, our Chief Executive Officer, purchased \$16,000 of convertible notes as part of the financing transaction that may be converted into 819,500 shares of our common stock and also received a warrant that, when exercised, can be converted into 409,750 shares of our common stock at a conversion price of \$0.04 per share. In addition, Iwo Jima SARL, a related party, converted \$163,000 of amounts owed to it for Mr. Bystedt's consulting services into convertible notes that may be converted into 8,167,614 shares of our common stock and also received a warrant that, when exercised, can be converted into 4,083,807 shares of our common stock at a conversion price of \$0.04 per share. A company controlled by Mats Dahlin, a member of the board of directors of our wholly owned subsidiary Neonode Technologies AB, Davisa Ltd, purchased a total of \$138,000 convertible notes as part of the financing transaction that may be converted, at the option of Davisa Ltd, into 6,903,700 shares of our common stock and also received warrants that, when exercised, can be converted into 3,451,850 shares of our common stock at a conversion price of \$0.04 per share. We are not obligated to register the common stock related to the convertible debt or the warrants.

The embedded conversion feature of the convertible debt issued in the 2010 convertible debt financing transaction meets the definition of a derivative financial instrument and is classified as a liability in accordance with accounting guidance. The note holders have the right to convert the debt into shares of our common stock, and the notes include price protection whereby these notes are 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 can be convertible into is not fixed. The embedded conversion features will be revalued on each balance sheet date and marked to market with the increase or decrease 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.

The value of the embedded conversion feature and warrants using the Black-Scholes option pricing model were \$1.1 million and \$849,000, respectively, on the date of issuance. We recorded a debt discount of \$1.2 million and recorded \$742,000 of additional interest expense to non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants. The assumptions used for the Black-Scholes option pricing model for the conversion feature on the date of issuance were a term of 0.78 to 0.95 years, volatility of 212.75%, and a risk-free interest rate of 0.41%. Because there are not enough unissued authorized shares to settle all currently outstanding equity instruments, the warrants issued with the debt are also recorded as a derivative liability. The assumptions used for the Black-Scholes option pricing model for the warrants on the date of issuance were a term of 3 years, volatility of 204.37%, and a risk-free interest rate of 1.60%.

On March 21, 2010, we issued 875,000 shares of our common stock and a warrant to purchase 875,000 of our common stock at an exercise price of \$0.04 per share to Davisa Ltd, a company controlled by Mr. Mats Dahlin, a member of the Board of Directors of Neonode Technologies AB, for services provided for the private placement of convertible note and warrant in the March 2010 financing transaction. The aggregate fair value of the shares and warrant is \$52,000, which was recorded as debt issuance costs and will be amortized to interest expense over the remaining term of the convertible notes. The warrants were valued using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model were a term of 2.9 years, volatility of 258.33%, and a risk-free interest rate of 1.13%. For the period ended March 31, 2010, we amortized \$1,000 of these debt issuance costs.



4. Stockholders' Deficit

Common Stock

On January 21, 2009, we signed a definitive settlement agreement with one of our investors in previous private placement transactions, Alpha Capital Anstalt ("Alpha"), whereby we issued Alpha 1,188,667 shares of our common stock valued at \$35,000 in exchange for a dismissal of all pending legal actions.

We converted approximately \$53,000 of our accounts payable to 762,912 shares of our common stock on January 26, 2009. The fair value of the shares of common stock issued to settle the accounts payable was \$23,000 based on our stock price on January 26, 2009 and the difference of \$30,000 is included in the account entitled gain on conversion and forgiveness of accounts payable on our consolidated statements of operations.

On March 21, 2010, we issued 875,000 shares of our common stock and a warrant to purchase 875,000 of our common stock at an exercise price of \$0.04 per share to an investor for services provided for the private placement of convertible note and warrant in the 2010 financing transaction. The fair value of the 875,000 shares of common stock is \$26,000 based on our common stock closing price on the date of issuance. The \$26,000 fair value is included in common stock and additional paid-in capital and debt issuance costs on the condensed consolidated balance sheets. The \$26,000 fair value of the warrants is included in embedded derivatives of convertible debt and warrants and debt issuance costs on the condensed consolidated balance sheets. The warrants were valued using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model at March 31, 2010 were a term of 3 years, volatility of 204.37%, and a risk-free interest rate of 1.60%.

During the period ended March 31, 2010, Series A Preferred stockholders exchanged 18,021.93 shares of Series A Preferred stock for 8,661,880 shares of our common stock, and Series B Preferred stockholders exchanged 7,389.85 shares of Series B Preferred stock for 975,977 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. Although the 2008 restructuring contemplated a conversion ratio that was finally approved on March 31, 2009 (see below), we did not guarantee that either our authorized share capital would be increased or that the conversion rate would be increased. 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. See below for the accounting ramifications of this conversion rate change.

### Series A Preferred Stock

On December 31, 2008, we issued the following Series A Preferred stock:

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

These transactions are discussed in more detail below.

On December 31, 2008, we issued 112,190.40 shares of Series A Preferred stock that at the date of issuance had a conversion rate of one share of common stock for each share of Series A Preferred stock to investors in a private placement transaction that raised \$1.1 million. \$1,035,000 of the funds raised were received in 2009. On March 31, 2009, the value of the 53,922,072 shares of common stock that these Series A Preferred shares are now convertible into was approximately \$2.1 million. The increase in the value of the Series A Preferred stock as a result of this modification was \$1,035,000, which we have recorded as a deemed preferred stock dividend (since the underlying transaction was a cash raise).

The fair value of the conversion feature of the 244,265.56 shares of Series A Preferred stock issued to the convertible debt holders that is now convertible to a total of 117,401,356 shares of our common stock was \$4.7 million based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. On December 31, 2008, the \$2.4 million fair value of the Series A Preferred stock issued prior to the change in conversion rate was included in the calculation of gain on troubled debt restructuring; therefore, on March 31, 2009, we recorded the \$2.3 million increase in the fair value as an increase in additional paid-in capital and as a loss on troubled debt restructuring on our consolidated statements of operations for the year ended December 31, 2009 as the final part of the restructuring that began in 2008 (since the underlying transaction was a debt extinguishment).

The fair value of the conversion feature of the 495,000 shares of Series A Preferred shares issued to the related parties to acquire Neonode Technologies AB that was converted to a total of 237,611,185 shares of our common stock was \$9.5 million based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. Because this transaction is essentially the issuance of shares to key employees for their continued service to enhance the Company, the \$9.5 million revised fair value of the common stock is being amortized to compensation expense at the rate of \$1.6 million per quarter for six quarters beginning January 1, 2009. For each of the periods ended March 31, 2010 and 2009, \$1,584,000 has been recorded as compensation expense in our condensed consolidated statements of operations.

Series B Preferred Stock:

The fair value of the conversion feature of the 92,795.94 shares of Series B Preferred shares issued to the warrant holders that is now convertible into 12,255,560 shares of our common stock was \$490,000, based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. On December 31, 2008, the \$2,000 fair value of the Series B Preferred stock issued prior to the change in conversion rate was included in the calculation of gain on troubled debt restructuring; therefore, on March 31, 2009, we recorded the \$488,000 increase in the fair value as an increase in additional paid-in capital and as a loss on troubled debt restructuring on our consolidated statements of operations for the year ended December 31, 2009 as the final part of the restructuring that began in 2008 (since the underlying transaction was a debt extinguishment).

## Conversion of Preferred Stock Issued in the December 31, 2008 Financing Transaction 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 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, 2010.

	Shares of Preferred Stock Not Exchanged as of March 31, 2010	Conversion Ratio	Shares of Common Stock after Conversion of all Outstanding Shares of Preferred Stock Not yet Exchanged at March 31, 2010
Series A Preferred stock	68,120.33	480.63	32,740,674
Series B Preferred stock	9,874.38	132.07	1,304,110
Total Remaining Not Exchanged	77,994.71		34,044,784

## 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. We had no level 1 assets or liabilities.

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

Level 3: Unobservable inputs. We valued warrants and embedded conversion features that were without observable market values and the valuation required a high level of judgment to determine fair value (level 3 inputs).

The following table shows the classification of our liabilities at March 31, 2010 that are subject to fair value measurements and the roll-forward of these liabilities from December 31, 2009 (in thousands):

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	March 31, 2010	Net Decrease in Fair Value	New Derivatives Added	December 31, 2009
Fair value of embedded conversion features and warrants	\$5,263	\$(1,215 )	\$1,971	\$4,507

6. 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, 2010, we had four equity incentive plans:

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

We also had one non-employee director stock option plan as of March 31, 2010:

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

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

	Weighted Average Number of Shares	Exercise Price Per Share	Weighted Average Exercise Price
Outstanding at January 1, 2010	497,095	\$ 1.42 - \$27.50	\$ 4.15
Granted	---	---	---
Cancelled or expired	---	\$ ---	---
Exercised	---	---	---
Outstanding at March 31, 2010	497,095	\$ 1.42 - \$27.50	\$ 4.15

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

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

We did not grant any stock options to employees or members of our Board of Directors (Board) during the three months ending March 31, 2010 and 2009. There was no other activity in our stock options during the three month periods ended March 31, 2010 and 2009.

Salary expense for the three months ended March 31, 2010 and 2009 includes a stock compensation charges relating to the above issuance of employee and director stock options. The fair value of the options at the date of issuance was calculated using the Black-Scholes option pricing model. The amount allocated to the unvested portion is amortized on a straight line basis over the remaining vesting period.

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

	Three months ended March 31, 2009	Three months ended March 31, 2010	Remaining unamortized expense at March 31, 2010
Stock-based compensation	\$41	\$35	\$ 194



The remaining unamortized expense related to stock options will be recognized on a straight line basis monthly as compensation expense over the remaining vesting period which approximates 1.4 years.

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.

### Stock Warrants

The following table summarizes outstanding warrants at March 31, 2010:

#### Outstanding Warrants as of March 31, 2010

Description	Issue Date	Exercise Price	Shares	Expiration Date
September 2007 Investor Warrants	9/26/2007	\$ 1.45	5,804	9/26/2012
May 2008 Broker Warrants	5/20/2008	\$ 0.02	45,133,832	5/20/2013
May 2008 Investor Warrants	5/22/2008	\$ 0.02	107,014,930	5/20/2013
August 2009 Employee Warrants	8/25/2009	\$ 0.02	15,660,000	8/25/2016
September 2009 Investor Warrants	9/15/2009	\$ 0.04	20,921,600	9/15/2012
October 2009 Investor Warrants	10/15/2009	\$ 0.04	3,052,976	10/15/2012
December 2009 Investor Warrants	12/15/2009	\$ 0.04	700,000	12/15/2012
Broker Warrants for 2009 Debt	12/31/2009	\$ 0.04	1,305,740	12/31/2012
March 2010 Investor Warrants	3/31/2010	\$ 0.04	30,080,282	3/31/2013
Broker warrants for 2010 Debt	3/21/2010	\$ 0.04	875,000	3/21/2013
Total warrants outstanding			224,750,164	

The outstanding warrants related to the 2008 financing transactions contain price protection features whereby these instruments are protected separately for the life of the warrants. Under the price protection clause, if we issue warrants or convertible instruments, with certain exceptions, at a lower exercise price or conversion price than the remaining outstanding warrants, the exercise price of such warrants would be reduced to the lower price and the warrants exercisable would increase so that the total required cash investment of the warrant holder remains unchanged. During the quarter ended September 2009, we issued convertible notes to investors in the September 2009 convertible debt financing transaction convertible at \$0.02 per share and this issuance triggered the price protection provision related to the original 2,118,599 previously outstanding price protected warrants; as such, we reduced the exercise price of the 2,118,599 warrants to \$0.02 per share and increased the warrant shares to 152,148,762. No further resets have occurred through March 31, 2010.

On January 1, 2009, we adopted the new accounting guidance that requires warrants with certain types of anti-dilution ratchet features be accounted for as liabilities, where previously they had been accounted for as equity. Prior to this new accounting guidance, these ratchet provisions were only evaluated under prior accounting guidance, and because these ratchet provisions are generally within a company's control, they did not trigger liability or derivative

accounting. We determined that the original 2,118,599 outstanding warrants that include ratchet features fall under the new accounting guidance and the fair value of the warrants must be recorded as a liability and marked-to-market each reporting period with the changes in the fair value recorded as income/expense in the consolidated statement of operations.

On January 1, 2009, the fair value of the outstanding warrants was \$67,000 and was recorded as a liability in the account entitled embedded derivatives of convertible debt and warrants with the corresponding reduction to additional paid-in capital. The assumptions used for the Black-Scholes option pricing model at January 1, 2009 were a term of 4.3 years, volatility of 143.12%, and a risk-free interest rate of 1.46%.

During the quarter ended March 31, 2009, we recorded an decrease related to the fair value of the outstanding warrants of \$3,000 a gain in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations. The fair value of the outstanding warrants was \$64,000 on March 31, 2009. The assumptions used for the Black-Scholes option pricing model for the quarter ended March 31, 2009 used a term of 3.5 years, volatility of 180%, and a risk-free interest rate of 1.8%.

As a result of the issuance of convertible notes in early October 2009, we no longer had enough unissued authorized shares to settle all outstanding equity instruments, including convertible preferred stock, convertible debt, options and warrants. Therefore, in accordance with the applicable accounting guidance, all non-employee warrants were required to be recorded as liabilities from that point and marked-to-market at each period until we have sufficient unissued authorized shares to settle all outstanding equity instruments. As a result, we reclassified the fair value of all non-employee warrants not already recorded as liabilities totaling \$837,000 as of October 1, 2009 from additional paid-in capital to embedded derivatives of convertible debt and warrants.

During the fourth quarter of 2009, we issued additional convertible debt with warrants and also warrants to a broker. As we no longer had enough unissued authorized shares to settle all outstanding equity instruments, we classified the warrants issued to the debt holder and broker as liabilities. The fair value of those warrants was \$214,000, which was recorded as an expense in the account entitled non-cash items related to debt discounts and deferred financing fees and valuation of conversion features and warrants on our consolidated statement of operations for the year ended December 31, 2009.

On December 31, 2009, we issued a warrant to purchase 1,305,740 of our common stock an exercise price of \$0.04 per share to an investor for services provided for the private placement of convertible notes and warrants in the 2009 financing transaction. The fair value of the 1,305,740 shares of common stock is \$26,000 on the date of issuance and was recorded as debt issuance costs and included in current assets in the accompanying consolidated balance sheet as of December 31, 2009. The warrants were valued using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model are a term of 2.7 years, volatility of 267.66%, and a risk-free interest rate of 1.13%.

During the quarter ended March 31, 2010, we issued additional convertible debt with warrants and also warrants to a broker. The fair value of those warrants on the dates of grant and as of March 31, 2010 was \$875,000 and \$619,000, respectively. As we no longer have sufficient unissued authorized shares to settle all outstanding equity instruments, the warrants have been classified as liabilities.

## 7. 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, 2010 and December 31, 2009, 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, 2010 and December 31, 2009, respectively.

#### Legal

On December 9, 2008, Empire Asset Management (“Empire”), a broker dealer that acted as our financial advisor and exclusive placement agent in previous private placement transactions, initiated a law suit against us in the Supreme Court of the State of New York alleging that the Corporation misrepresented the success of its business to induce Empire’s customers to invest in us. Empire is seeking compensatory damages in an unspecified amount for the harm allegedly suffered. We believe that the action has no merit and intends to defend vigorously against the action. Our Directors and Officer (“D&O”) insurance provider has extended coverage and will provide us with legal representation.

On May 11, 2009, Mr. David Berman initiated a lawsuit against us in the Supreme Court of the State of New York alleging that the Corporation misrepresented the success of its business to induce Mr. Berman to invest in us. Mr. Berman, who was a client of Empire, invested \$549,860 in our private placement offerings on March 4, 2008 and May 16, 2008, and purchased an additional 162,900 shares totaling \$251,082 in the aftermarket. We believe that the action has no merit and intend to defend vigorously against the action. On March 5, 2010, we filed a motion in the Supreme Court of the State of New York to dismiss this lawsuit. Our D&O insurance provider has extended coverage and will cover the costs of legal representation, subject to payment of the retention amount.

Our D&O insurance policy provides for a retention amount of \$150,000, and we accrued a provision for legal expense and accounts payable totaling \$150,000 at March 31, 2010 and December 31, 2009, respectively, related to the potential payment of the retention under our D&O insurance policy that includes our maximum cash liability for both the Empire and Berman lawsuits.

On October 2, 2009, Xerox Corporation (“Xerox”) initiated a law suit against the Company in the Superior Court of California alleging that the Company breached an equipment lease agreement with Xerox and demanding payment of \$108,592.81 plus interest, late payment charges, and legal costs. On December 14, 2009, Xerox obtained an entry of default against the Company without prior warning to the Company. We accrued the total amount of the lawsuit \$109,000 at March 31, 2010 and December 31, 2009. The Company has filed a motion to set aside the entry of default and a hearing on this motion is set for June 2, 2010. The Company intends to defend vigorously against the action.

#### 8. Net Loss Per Share

Basic net loss per common share for the three months ended March 31, 2010 and 2009 was computed by dividing the net loss attributable to common stockholders 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.

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Potential common stock equivalents of approximately 500,000 and 774,000 outstanding stock options, 225 million and 2.1 million outstanding stock warrants, 34 million and 423 million shares issuable upon conversion of preferred stock and 60.1 million and no shares issuable upon conversion of notes are excluded from the diluted earnings per share calculation for the periods ended March 31, 2010 and 2009, respectively, due to their anti-dilutive effect.

(in thousands, except per share amounts)	Three Months ended March 31,	
	2010	2009
<b>BASIC AND DILUTED</b>		
Weighted average number of common shares outstanding	418,771	36,515
Number of shares for computation of net loss per share	418,771	36,515
Net loss attributable to common stockholders	\$(2,244 )	\$(6,043 )
Net loss per share - basic and diluted	\$(0.01 )	\$(0.17 )

9. Segment Information

We have one reportable segment, as defined in accounting guidance. All of our sales for the quarter ended March 31, 2010 were to customer located outside the United States.

10. Related Party Transactions

Mr. Per Bystedt, our Chairman of the Board and Chief Executive Officer, is personally involved in our refinancing and capital raising activities. Mr. Bystedt is the beneficial holder of approximately 82.4 million shares of our common stock, or approximately 12%, of the Company's outstanding shares of common stock as of December 31, 2009 on a fully diluted basis, and is the beneficial owner of Iwo Jima SARL. Mr. Bystedt purchased \$16,000 of convertible notes as part of the 2010 convertible debt financing transaction that may be converted into 819,500 shares of our common stock and also received a warrant that, when exercised, can be converted into 419,750 shares of our common stock at a conversion price of \$0.04 per share. Mr. Bystedt through his company, Iwo Jima SARL, entered into a consulting agreement in lieu of an employment agreement with us whereby he has earned a total of \$55,000 for his services for the three months ended March 31, 2010. We did not pay any of the amount owed to Iwo Jima SARL during the three months ended March 31, 2010, and \$55,000 is included in our accrued expenses at March 31, 2010. In addition, Iwo Jima SARL converted \$163,000 of amounts owed to it for Mr. Bystedt's consulting services as of December 31, 2009 into convertible notes that may be converted into 8,167,614 shares of our common stock and also received a warrant that, when exercised, can be converted into 4,083,807 shares of our common stock at a conversion price of \$0.04 per share.

Mr. Thomas Eriksson, Chief Executive Officer of our wholly owned subsidiary, Neonode Technologies AB, and a member of our Board and is the beneficial owner of Wirelesstoys AB. Mr. Eriksson through his company, Wirelesstoys AB, entered into a consulting agreement in lieu of an employment agreement with us whereby he has earned a total of \$55,000 for his services for the three months ended March 31, 2010. We paid \$58,000 of the amount owed to Wirelesstoys AB during the three months ended March 31, 2010, and \$65,000 is included in our accrued expenses in the accompanying condensed consolidated balance sheet at March 31, 2010.

Mr. Magnus Goertz, one of our founders, and is the beneficial owner of Athemis Ltd. Mr. Goertz, through his company, Athemis Ltd, entered into a consulting agreement in lieu of an employment agreement with us whereby he has earned a total of \$55,000 for his services for the three months ended March 31, 2010. We paid \$21,000 of the amount owed to Athemis Ltd. during the three months ended March 31, 2010, and \$87,000 is included in our accrued expenses in the accompanying condensed consolidated balance sheet at March 31, 2010.

Mr. Mats Dahlin, a member of the Board of Directors of our wholly owned subsidiary, Neonode Technologies AB, is the beneficial owner of Davisa Ltd. Davisa Ltd purchased a total of \$138,000 convertible notes as part of the 2010 convertible debt financing transaction that may be converted, at the option of Davisa Ltd, into 6,903,700 shares of our common stock and also received warrants that, when exercised, can be converted into 3,451,850 shares of our common stock at a conversion price of \$0.04 per share. On March 23, 2010, we issued 875,000 shares of our common stock and a warrant to purchase 875,000 of our common stock an exercise price of \$0.04 per share to Davisa Ltd for services provided for the private placement of convertible note and warrant in the 2010 convertible debt financing transaction. During the quarter ended March 31, 2010, The Company incurred approximately \$11,000 for consulting services from Mr. Dahlin which is included in accrued expenses in the accompanying condensed consolidated balance sheet as of March 31, 2010.

11. Subsequent Events

In April and May 2010, we received a total of \$533,000 in proceeds related to a private placement of convertible notes and stock purchase warrants that can be converted, at the holder's option, into 26,625,000 shares of our common stock at a conversion price of \$0.02 per share and 13,312,500 stock purchase warrants that have an exercise price of \$0.04

per share. The convertible note holders have the right to have the conversion price adjusted to equal the lower stock price if we issue stock or convertible notes at a lower conversion price than \$0.02 during the period that the notes are outstanding. These convertible notes are due on December 31, 2010 and bear an annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes are 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.

The embedded conversion feature of the convertible debt issued in the April and May 2010 convertible debt financing transaction meets the definition of a derivative financial instrument and will be classified as a liability in accordance with accounting guidance. The note holders have the right to convert the debt into shares of our common stock, and the notes include price protection whereby these notes are 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 can be convertible into is not fixed. The embedded conversion features will be revalued on each balance sheet date and marked to market with the adjusting entry to non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations.

The value of the embedded conversion feature using the Black-Scholes option pricing model is \$533,000 and will be recorded as a debt discount. The assumptions used for the Black-Scholes option pricing model for the conversion feature on the date of issuance were a term of 0.66 years, volatility of 308.82%, and a risk-free interest rate of 1.13%. Because there are not enough unissued authorized shares to settle all currently outstanding equity instruments, the warrants issued with the debt will also be recorded as a derivative and expensed to non-cash items related to debt discounts and deferred financing fees and valuation of conversion features and warrants, totaling \$267,000. The assumptions used for the Black-Scholes option pricing model for the warrants on the date of issuance were a term of 3 years, volatility of 242.73%, and a risk-free interest rate of 1.13%.

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, other than already disclosed in this Note 11.

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

### Forward Looking Statements

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and the notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and financial statements for the year ended December 31, 2009 included in our Annual Report on Form 10K/A.

### Overview

We provide optical touchscreen solutions for small to midsized handheld consumer and industrial electronic devices. We license our touchscreen technology to Original Equipment Manufacturers (OEMs) and Original Design Manufacturers (ODMs) who imbed our multi-touch with pen support touchscreen technology into electronic devices that they develop and sell such as mobile phones, e-book readers, mobile internet devices, global positioning systems (GPS), digital picture frames and micro PCs. The cornerstone of our solution is our innovative optical infrared touchscreen technology, zForce™. We believe that keyboards and keypads with moving parts will become obsolete for handheld devices and that our touchscreen solutions will be at the forefront of a new wave of multi-touch finger-based and pen input technologies that will enable the user to interact and operate everything from small mobile devices to large industrial applications using a combination of touches, swipes, and hand gestures.

The accompanying unaudited condensed financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have incurred net operating losses and negative operating cash flows since inception. As of March 31, 2010, we had an accumulated deficit of \$82.8 million and a working capital deficit (current assets less current liabilities, not including non-cash warrant liability) of \$1.7 million. 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 raise additional funds through debt or equity. In the three months ended March 31, 2010, we completed a private placement of convertible notes and stock purchase warrants totaling \$1.2 million. In April and May 2010, we raised an additional \$533,000 through a private placement of convertible notes and stock purchase warrants under the same terms and conditions as the March 2010 private placement.

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

In addition to the immediate risks relating to our ability to continue as a going concern and to obtain funding under the current market conditions, we are subject to certain risks common to technology-based companies in similar stages of development. See “Risk Factors” in our Annual Report on Form 10K/A for the year ended December 31, 2009. Principal risks include risks relating to the uncertainty of growth in market acceptance for our technology, a history of losses since inception, our ability to remain competitive in response to new technologies, the costs to defend, as well as risks of losing, patents and intellectual property rights, a reliance on our future customers’ ability to develop and sell products that incorporate our technology, the concentration of our operations in a limited number of facilities, the uncertainty of demand for our technology in certain markets, our ability to manage growth effectively, our dependence on key members of our management and development team, our limited experience in conducting operations internationally, and our ability to obtain adequate capital to fund future operations.

#### Critical Accounting Policies and Estimates

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, 2010 and 2009 and as of March 31, 2010 and December 31, 2009 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.

#### 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 products were delivered 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. On December 29, 2009, we signed an engineering services agreement with an OEM to provide engineering services over a three-month period in 2010 related to the development of a touchscreen application for a mobile phone product. The value of this agreement is approximately \$100,000, which has been recognized as revenue in the first quarter of 2010.

We derive revenue from the licensing of internally developed intellectual property (“IP”). We entered into IP licensing agreements that generally provide licensees the right to incorporate our IP components in their products with terms and conditions that varied 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.

##### 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 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 initially will defer all revenue related to the software license and maintenance fees until such time that we are able to establish VSOE for these elements of our software products. Revenue deferred under these arrangements will be recognized to revenue over the expected contract term. We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted. To date, we have not sold any software products.

#### Product Research and Development

Research and Development (“R&D”) costs are expensed as incurred. R&D costs are accounted for in accordance with accounting guidance. Research and development costs consists mainly of personnel related costs in addition to some external consultancy costs such as testing, certifying, and measurements.

#### Long-lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with accounting guidance. If the estimated undiscounted cash flow related to these assets decreases in the future or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset.

#### Stock-Based Compensation Expense

We account for stock-based employee compensation arrangements in accordance with accounting guidance. We account for equity instruments issued to non-employees in accordance with accounting guidance, which requires that such equity instruments be recorded at their fair value and the unvested portion be re-measured each reporting period. When determining stock based compensation expense involving options and warrants, we determine the estimated fair value of options and warrants using the Black-Scholes option pricing model.

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