

Neonode, Inc  
Form 10-K  
March 30, 2012

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

FORM 10-K

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

For the fiscal year ended December 31, 2011

or

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

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

Commission File No. 0-8419

NEONODE INC.

(Exact name of Registrant as specified in its charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

94-1517641  
(I.R.S. Employer  
Identification Number)

Sweden Linnegatan 89, SE-115 23 Stockholm, Sweden  
USA 2700 Augustine Dr, Suite 100, Santa Clara, CA 95054  
(Address of principal executive offices and Zip Code)

Sweden + 46 8 667 17 17  
USA + 1 925 768 0620  
(Registrant's Telephone Numbers, including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class                       | Name of Each Exchange on Which<br>Registered |
|-------------------------------------------|----------------------------------------------|
| Common Stock, par value \$0.001 per share | NONE                                         |

Securities registered pursuant to Section 12(g) of the Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☒

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

The approximate aggregate market value of the common stock held by non-affiliates of the registrant, based on the closing price for the registrant's common stock on June 30, 2011 (the last business day of the second quarter of the registrant's current fiscal year) as reported on the OTCBB, was \$60,343,310.

The number of shares of the registrant's common stock outstanding as of March 22, 2012 was 32,956,300.

The number of shares of the registrant's Series A Preferred stock outstanding as of March 22, 2012 was 83.

The number of shares of the registrant's Series B Preferred stock outstanding as of March 22, 2012 was 95.

### DOCUMENTS INCORPORATED BY REFERENCE

Part III (Items 10, 11, 12, 13 and 14) incorporates by reference portions of the Registrant's Proxy Statement for its Annual Meeting of Stockholders, which will be filed not later than 120 days after December 31, 2011. Exhibits incorporated by reference are referred to in Part IV.

NEONODE INC.

2011 ANNUAL REPORT ON FORM 10-K

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## SPECIAL NOTE ON FORWARD LOOKING STATEMENTS

Certain statements set forth in or incorporated by reference in this Annual Report on Form 10-K constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, without limitation, our expectations regarding the adequacy of anticipated sources of cash, planned capital expenditures, the effect of interest rate increases, and trends or expectations regarding our operations. Words such as “may,” “will,” “should,” “believes,” “anticipates,” “expects,” “intends,” “plans,” “estimates” and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Such statements are based on currently available operating, financial and competitive information and are subject to various risks and uncertainties. Readers are cautioned that the forward-looking statements reflect management’s estimates only as of the date hereof, and we assume no obligation to update these statements, even if new information becomes available or other events occur in the future. Actual future results, events and trends may differ materially from those expressed in or implied by such statements depending on a variety of factors, including, but not limited to those set forth under “Item 1A Risk Factors” and elsewhere in this Annual Report on Form 10-K.

## PART I

### ITEM 1. BUSINESS

Neonode Inc., “we”, “us”, “our”, the “Company”, provide optical infrared touchscreen solutions for handheld and small to midsized 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. The cornerstone of our solution is our innovative optical infrared touchscreen technology zForce®, which can be applied on any flat surface such as Liquid Crystal Displays (LCD), Electronic Paper Displays (EPD) or as a Mouse Pad, and can be incorporated into all types of devices, enabling touch detection for any type of object (finger, pen, glove or brush). In addition the zForce touch solution has a low total weight and building height, thus enabling greater industrial design flexibility. Since nothing is layered on top of the display, the zForce solution provides 100% optical transparency, which improves image quality, reduces glare, and improves battery life.

We have recently developed our Multi-Sensing technology to help OEMs and device manufacturers differentiate themselves in a competitive market. Ready to be implemented into a wide range of commercial devices such as smart phones, tablets and automotive displays, our Multi-Sensing technology can be used for, but is not limited to, intuitive gaming, industrial design, and 3D modeling. This cutting-edge technology identifies any object and determines its size, pressure, depth, speed and the proximity of an object to a surface. It uses light with zero latency that can sense and determine objects like a pen, brush, bare/gloved finger or larger objects like a hand, at very high speed. The zForce multi-touch product, based on our Multi-Sensing technology, is our latest release and is currently being integrated into products such as mobile phones, e-Readers, household appliances, printers and office equipment, GPS devices, automobile consoles, games and toys and tablet PC’s.

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

Our website is [www.neonode.com](http://www.neonode.com). Through our website, we make available free of charge all of our Securities and Exchange Commission (“SEC”), filings, including our annual reports on Form 10-K, our proxy statements, our quarterly reports on Form 10-Q, and our current reports on Form 8-K as well as Form 3, Form 4, and Form 5 Reports for our directors, officers, and principal stockholders, together with amendments to those reports filed or furnished pursuant to Sections 13(a), 15(d), or 16 under the Securities Exchange Act of 1934, as amended, or the Exchange Act. These reports are available immediately after their electronic filing with the SEC. Our website also includes corporate governance information, including our Code of Conduct, our Code of Ethics for the CEO and Senior Financial Officers, and our Board Committee Charters.

On March 25, 2011, we filed a Certificate of Amendment of our Amended and Restated Certificate of Incorporation affecting a reverse stock split of the Company's issued and outstanding shares of common stock and preferred stock at a ratio of twenty-five-to-one (the "Reverse Split"). The Certificate of Amendment provided that each twenty-five (25) outstanding shares of the Corporation's common stock, par value \$0.001 per share, was exchanged and combined, automatically, without further action, into one (1) share of common stock, and each twenty-five (25) outstanding shares of the Corporation's preferred stock, par value \$0.001 per share, was exchanged and combined, automatically, without further action, into one (1) share of preferred stock. The Reverse Split was declared effective on March 28, 2011 and has been reflected in this Annual Report on Form 10-K.

## Our History

Neonode Inc, formerly known as SBE, Inc., was incorporated in the State of Delaware on September 4, 1997.

On August 10, 2007, SBE, Inc. consummated a reverse merger transaction with Neonode Inc. (the "Merger"), and SBE, Inc.'s name was subsequently changed to "Neonode Inc." upon the completion of the Merger. Prior to the Merger, Neonode Inc. had been incorporated in the State of Delaware in 2006 and was the parent of Neonode AB, a company founded in February 2004 and incorporated in Sweden. Following the closing of the Merger, the business and operations of Neonode Inc. prior to the Merger became the primary business and operations of the newly-combined company. The newly-combined company's headquarters is located in Stockholm, Sweden.

Through our previously wholly-owned subsidiary, Neonode AB, we developed our touchscreen technology and an optical touchscreen mobile phone product, the N2. We began shipping the N2 to our first customers in July 2007 but faced difficult circumstances in finding a viable market for our N2 mobile phone and subsequently discontinued the manufacturing of mobile phones and the operations of Neonode AB.

## Technologies

Our touchscreen solutions are based on our patented zForce and Neno™ hardware and software technology. zForce is our optical infrared touchscreen technology that supports one-handed navigation, allowing the user to operate the functionality with finger gestures passing over the screen. Neno is our software-based user interface.

zForce has been patented in several countries including the U.S. and has several patents-pending in the U.S. It uses infrared light that is projected over the screen. Infrared light pulses are sent out up to 1,000 times per second to capture a frame and detect touch activation. Up to 1000 coordinates are produced by using mathematical algorithms to calculate the exact position of a touch object when a user's fingers move across the screen. This input method is unique to Neonode and is enabled by the zForce technology.

Currently, there are two dominant types of touchscreen technologies available in the market - capacitive and resistive. Capacitive technology is the technology that the Apple iPhone uses and resistive technology is what is found on most stylus-based PDAs. Resistive technology is pressure sensitive technology. Best used for detailed work and for selection of a particular spot on a screen, resistive technology is not useful for sweeping gestures or motion, such as zooming in and out. Capacitive technology, which can be found on a laptop computer mouse pad, is very good for sweeping gestures and motion. The screen actually reacts to the finger's tiny electric impulses. Capacitive touchscreens work best if the user has unimpeded contact between his finger and the screen.

Our zForce optical touchscreen technology has a number of key advantages over each of these technologies, including:

- No additional layers are added to the screen that may dilute the screen contrast and clarity. Layering technology is required to activate the capacitive and resistive technologies and can be very costly;
- The zForce grid technology is more responsive than the capacitive screen technology and, as a result, is quicker and less prone to misreads. It allows movement and sweeping motions as compared to point-sensitive, stylus-based resistive screens;
- zForce, an abbreviation for zero force necessary, obviates the need to use any force to select or move items on the screen as would be the case with a stylus;
- zForce is cost-efficient due to the lower cost of materials and an extremely simple manufacturing process when compared to the expensive layered capacitive and resistive screens;
- zForce allows multiple methods of input, such as simple finger taps to hit keys, sweeps to zoom in or out, and gestures to write text or symbols directly on the screen;
- zForce is one of the few viable touchscreen solutions that will operate as well on the new revolutionary reflective display panels that will offer paper-like reading experience in almost any ambient lighting condition while greatly reducing power consumption. Manufacturers of reflective display panels are targeting e-Reader, mobile phone and tablet PC markets because these devices require the clear viewing screen and low power consumption of the reflective display panels; and
- zForce incorporates some of the best functionalities of both the capacitive and resistive touchscreen technologies. It works in all climates and, unlike the competing technologies, can be used with thick gloves. In addition, zForce allows for waterproofing of the device.

Because of its uniqueness and flexibility, we believe that our zForce technology presents a very significant licensing opportunity for Neonode. The market is vast, given the current rapid increase in touchscreen-based devices such as e-Readers, automotive, mobile phones, Tablet PCs, media players, printers and GPS navigation devices.

#### Neonode NN1001 Single Chip Touch Controller

The NN1001 is the next generation touch technology solution that we have developed in collaboration with Texas Instruments. It is designed to simplify the integration to reduce bill of material (BOM) cost, as well as increase the performance where integrated. It also adds superior functionality, such as multi-touch and gestures for any object, and delivers a greater user experience on every level. The Single Chip Touch Controller outperforms capacitive touch solutions at a fraction of the cost.

- The NN1001 has a scanning speed of 1000 Hz (latency down to 1ms) and consumes less than 1mW at 100Hz.

- The NN1001 tracks any high-speed multi-touch gesture with any object (finger, gloved finger and passive pens) with high accuracy.
- The NN1001 connects to any microcontroller or application processor with a high speed SPI interface. The controller works in single or multiple configurations supporting screen sizes up to 20 inch.
- The NN1001 supports advanced power management and implements the Neonode AlwaysON™ technology where the touch is active even when the device is in sleep or off mode.

#### Markets

We currently provide touchscreen solutions for navigation for many of the world's premier e-Reader OEMs. We have aggressively expanded the markets for our touch technology beyond e-Readers and have also entered into technology license agreements with some of the world's leading OEMs operating in the mobile phone, automotive, office equipment (such as printers), GPS, and tablet markets. We are currently engaged in product development activities with these customers. In addition, we are in technology development and contract negotiations with OEMs operating in the automotive, household appliance, games and toys, and electronic gaming equipment markets.

In general, high-performance capacitive touchscreens cost a lot to manufacture, while low-performance resistive touchscreens are cheaper to make. Thanks to extensive experience and expertise, Neonode has solved this production-cost problem by developing zForce — the market's most innovative optical touch technology that may be customized for the various markets in which we have focused our marketing efforts.

#### zForce

- Operates on all screen types and provides a crystal-clear viewing experience in any lighting condition, even bright sunlight
- Runs on Electronic Paper Displays that creates a readable experience close to ink on paper because it reflects light like ordinary paper
  - Operates on LCD (Liquid Crystal Displays)
- Supports high-resolution pen writing in combination with finger navigation that includes, e.g., gestures, multi-touch, and sweeps
  - Provides a 100% clear viewing experience—unlike traditional resistive and capacitive touchscreens
    - Can be applied to any flat surface.

In addition, zForce enables:

- Touch detection for any object
  - A smooth touch experience with no necessary pressure for touch detection
  - Greater industrial design flexibility for equipment and device manufacturers.
    - Pressure sensing
- 3D scanning and proximity sensing

zForce includes features that benefit Neonode's customers by facilitating the creation of top-quality products at lower production costs, which enable faster time to market.

#### Tablets and e-Readers

As a result of these benefits and features, zForce is the world's most-used optical touch technology for e-Readers today with customers such as Amazon, Barnes & Noble, Sony and Kobo, all of whom have integrated our zForce technology into their e-Readers.

In addition, we have customers currently developing tablets.

#### Mobile Phones

Our innovative touch technology is suitable for mobile phones and virtually all other hand held devices.

## Automotive

Touch interface displays in vehicles must operate in a wide range of ambient lighting and temperature conditions. A resistive screen may be operated with gloves on, but the membrane layer reduces transparency and can cause glare. The zForce solution is well-placed to make inroads in the automotive market since it provides a brighter, more readable display, with a full operating temperature range, that can easily be used while wearing gloves.

## Printers and Office Equipment

Photo printers and combination printer/scanner/fax machines typically require feature-rich menus and settings, and OEMs have increasingly replaced mechanical buttons with resistive touchscreen displays. zForce offers an improved user experience, with brighter display, ultra light touch, and support for gestures (such as swipe to access menus and screens), all without increasing cost.

## Home Electronics

Machines in the kitchen and laundry room are still mostly controlled by mechanical buttons, dials and membrane switches. New designs can use zForce with or without an underlying display. For example, touch sensitive buttons can be achieved by placing the light guide around a pre-printed array. A touch panel can include illumination without a display. A feature-rich device like a high-end dryer can be made much more streamlined and user friendly with a touch display.

## Intellectual Property

We believe that innovation in product engineering, sales, marketing, support, and customer relations, and protection of this proprietary technology and knowledge, will impact our future success. In addition to certain patents that are pending, we rely on a combination of copyright, trademark, trade secret laws and contractual provisions to establish and protect the proprietary rights in our products.

We have been issued three United States (U.S.) patents including our inventions covering the activating function in response to a touch-and-glide operation on a touch sensitive surface and on a substrate formed or resting display arrangement. We have been issued patents in five countries outside the U.S. for our invention titled “On a substrate formed or resting display arrangement.” We have eight provisional patent applications, and fifteen non-provisional patent applications pending in the U.S. In addition, we have fourteen pending patent applications in countries outside the U.S. and one Patent Cooperation Treaty (PCT) application.

We have been granted trademark protection for the word NEONODE in the U.S., the European Union (EU), Sweden, Norway, and Australia. In addition we have filed an application for the word NEONODE in the U.S. to cover additional goods including touchscreen controller Application Specific Integrated Circuits (ASIC). We have been granted protection for the figurative mark NEONODE in the U.S., the EU and Sweden. Additional applications for the figurative trademark are still pending in Switzerland, China and Russia. We have been granted trademark protection for the word zForce in the U.S. and EU. In addition we have filed an application for the word zForce in the U.S. to cover additional goods including touchscreen controller ASICs. We filed applications for the trademarks ALWAYS ON, ALWAYS ON TOUCH and MULTI-SENSING in the U.S.

The Company’s user interface software described in some of the aforementioned patent applications may also be protected by copyright laws in most countries, including Sweden and the EU (which do not grant patent protection for the software itself), if the software is new and original. Protection can be claimed from the date of creation.

Consistent with our efforts to maintain the confidentiality and ownership of our trade secrets and other confidential information, and to protect and build our intellectual property rights, we require our employees and consultants, and certain customers, manufacturers, suppliers and other persons with whom we do business or may potentially do business, to execute confidentiality and invention assignment agreements upon commencement of a relationship with us, typically extending for a period of time beyond termination of the relationship.

## Distribution, Sales and Marketing

We consider both OEMs and ODMs and their contract manufacturers to be our primary customers. Both the OEMs, ODMs and their contract manufacturers may determine the design and pricing requirements and make the overall decision regarding the use of our user interface solutions in their products. The use and pricing of our interface solutions will be governed by a technology licensing agreement.

Our sales staff solicits prospective customers and our sales personnel receive substantial technical assistance and support from our internal engineering resources because of the highly technical nature of our product solutions. We expect that sales will frequently result from multi-level sales efforts that involve senior management, design engineers, and our sales personnel interacting with our potential customers' decision-makers throughout the product development and order process.

Our sales are normally negotiated and executed in U.S. Dollars or Euros.

Our sales force and marketing operations are managed out of our corporate headquarters in Stockholm, Sweden, and our current sales force is comprised of sales offices located in Sweden, South Korea, the Netherlands and the U.S.

#### Research and Development

We continue to invest in research and development of current and emerging technologies that we deem critical to maintaining our competitive position in the touchscreen user interface markets. Many factors are involved in determining the strategic direction of our product development focus, including trends and developments in the marketplace, competitive analyses, market demands, business conditions, and feedback from our customers and strategic partners. In both fiscal years 2011 and 2010, we spent \$1.9 million in each year on research and development activities.

We carefully monitor innovations in other technologies and are constantly seeking new areas for application of zForce. We have developed a technology roadmap that we believe will result in a steady stream of new innovations and areas of use.

Our research and development is predominantly in-house, but is also done in close collaboration with external partners and specialists. Our development areas can be divided into the following areas:

Software  
Optical  
Mechanical  
Electrical  
Industrial Design

#### Recent Developments

- On March 12, 2012, we signed a technology license agreement with IDT Technology Limited, a subsidiary of Oregon Scientific for the use of our touch technology in a children's tablet device.
- On February 29, 2012, we filed a Certificate of Correction with the Secretary of State of Delaware effectively reducing the amount of our authorized shares from 848,000,000 shares of Common Stock and 2,000,000 shares of Preferred Stock to 70,000,000 shares of Common Stock and 1,000,000 shares of Preferred Stock. This correction reflects the new capital structure of the Company following its 1-for-25 reverse split that became effective at the close of business on March 25, 2011.
- On February 21, 2012, we announced the release of our newly developed Multi-Sensing technology that provides a new way for machines to communicate with the human senses, and enables a far more augmented and profound user experience than traditional touch. Multi-Sensing was developed to help OEMs and device manufacturers differentiate themselves in a competitive market. Ready to be implemented into a wide range of commercial devices such as smart phones, tablets and automotive touch displays, Neonode's Multi-Sensing technology can be

used for, but is not limited to, intuitive gaming, industrial design, and 3D modeling. This cutting-edge technology identifies any object and determines its size, pressure, depth, speed and the proximity of an object to a surface. It uses light with zero latency that can sense and determine objects like a pen, brush, bare/gloved finger or larger objects like a hand, at very high speed.

- On January 30, 2012, our Board of Directors adopted an amendment to our 2006 Equity Incentive Plan (the “2006 Plan”) to increase the number of shares of common stock authorized by issuance under the 2006 Plan by an additional two million (2,000,000) shares.
- On January 19, 2012, we signed a technology license agreement with an OEM related to the use of our touchscreen technology for a universal color touch display for Tablet PCs. In conjunction with the signing of this technology license agreement, the OEM agreed to pay us \$65,000 in non-recurring engineering development fees. We are deferring the engineering development fee revenue until such time as the engineering work has been completed. We expect to complete all services under this contract in 2012.
- On January 15, 2012, we signed a technology license agreement with a global top 5 printer OEM to use our touchscreen technology in a series of printers. In conjunction with the signing of this technology license agreement, the OEM agreed to pay us \$50,000 in non-recurring engineering development fees. We are deferring the engineering development fee revenue until such time as the engineering work has been completed. We expect to complete all services under this contract in 2012.
- On January 10, 2012, the U.S. Patent and Trademark Office issued to us patent number 8,095,879 for sweep gesture user interfaces. The patent covers activating a function in response to a touch-and-glide operation on a touch sensitive surface. This patent complements Neonode’s U.S. patents 7,880,732 and 8,068,101 for small to midsize touchscreen devices. The patented technology is marketed and sold as Neonode’s offer to OEMs and ODMs.
- On January 4, 2012, we signed a technology license agreement with a global OEM to use our touchscreen technology in a series of GPS devices.
- On December 14, 2011, following the consummation of a financing in which the gross proceeds to the Company were in excess of \$5 million, the remaining outstanding principal balance of Convertible Notes (approximately \$3.7 million), plus accrued interest (approximately \$130,000), was automatically converted into 1,513,228 shares of our common stock. In addition, we issued 99,461 shares of common stock related to the bonus interest feature associated with the mandatory conversion of the debt. As of December 31, 2011, all of the March and April 2011 Convertible Notes, plus accrued interest, was paid in cash or converted into shares of common stock.
- On December 13, 2011, we sold 3,000,000 shares of common stock of the Company, par value \$0.001 per share, in a public offering pursuant to a Registration Statement on Form S-3. The shares were sold at a price of \$4.00 per share. The net proceeds to the Company from this offering were \$11.2 million, after deducting the underwriting discount but before deducting other estimated offering expenses of approximately \$0.4 million payable by the Company. As part of the offering, the underwriter, Cowen and Company, LLC (the “Underwriter”), sold 1,000,000 shares held by Per Bystedt, our executive chairman, and Thomas Eriksson, our chief executive officer (together, the “Selling Stockholders”). In addition, the Underwriter exercised its over-allotment option and sold an additional 600,000 shares held by the Selling Shareholders. The Company did not receive any proceeds from the sale of any shares by the Selling Stockholders or upon the exercise by the Underwriter of its over-allotment option. The Company anticipates using the net proceeds from the offering primarily for general corporate purposes, including capital expenditures and working capital.

- In October and November 2011 note holders of \$575,000 of the original approximately \$4.2 million Convertible Notes exercised their right to convert their notes and accrued interest and were issued 232,125 shares of our common stock.
- In March 2011 we issued convertible notes (the “Convertible Notes”) to investors who loaned the Company an aggregate of approximately \$4.2 million. The Convertible Notes were subject to automatic conversion into shares of our common stock, at a conversion price of \$2.50 per share, in the event we consummated a financing in the amount of at least \$5 million or our common stock was traded at a price of \$6.25 or higher for five (5) consecutive trading days.

## Overview of the Touchscreen Market and Competition

### Competing Touchscreen Technologies:

Today there are different touchscreen technologies available in the market. All of them with different or slightly different profiles, power consumption, level of maturity, and cost price:

- Resistive -- uses conductive and resistive layers separated by thin space;
- Surface acoustic wave -- uses ultrasonic waves that pass over the touchscreen panel;
- Capacitive and projected capacitive -- a capacitive touchscreen panel is coated with a material, typically indium tin oxide, that conducts a continuous electrical current across the sensor. When the sensor's 'normal' capacitance field (its reference state) is altered by another capacitance field, e.g., someone's finger, electronic circuits located at each corner of the panel measure the resultant 'distortion' in the sine wave characteristics to detect a touch;
- Infrared -- uses infrared beams that are broken by finger or heat from the finger sensed from a camera to detect a touch;
- Strain gauge -- uses a spring mounted on the four corners and strain gauges are used to determine deflection when the screen is touched;
- Optical imaging -- uses two or more image sensors placed around the edges (mostly the corners) of the screen and a light source to create a shadow of the finger;
- In-cell optical touch technology -- embeds photo sensors or conductive sensors directly into an LCD glass. By integrating the touch function directly into an LCD glass, the LCD acts like a low resolution camera to “see” the shadow of the finger;
- Dispersive signal technology -- uses sensors to detect the mechanical energy in the glass that occur due to a touch; and
- Acoustic pulse recognition -- uses more than two piezoelectric transducers located at some positions of the screen to turn the mechanical energy of a touch (vibration) into an electronic signal.

### Touchscreen Technologies Competitors:

| Company             | Technology                            |
|---------------------|---------------------------------------|
| 3M                  | Capacitive, Dispersive Signal Touch   |
| Synaptics           | Capacitive sensors and IC controllers |
| ATMEL               | Capacitive touch IC controllers       |
| Cypress             | Capacitive touch IC controllers       |
| Maxim               | Capacitive touch IC controllers       |
| Nextwindow          | Optical with camera sensor            |
| Zytronic            | Capacitive                            |
| Tyco Electronics    | Capacitive, Resistive, Surface Wave,  |
| Touch International | Resistive and Capacitive              |

|                      |                                                                        |
|----------------------|------------------------------------------------------------------------|
| Mass Multimedia Inc. | All touchscreen technologies                                           |
| Young Fast           | Capacitive sensor and module maker                                     |
| TPK                  | Capacitive (provides the capacitive touch sensor for the Apple iPhone) |

Today's market leading touch technologies, i.e., resistive and capacitive technologies make use of a "touch sensor/window" or an overlay in combination with a controller IC to function. In comparison zForce use a "lightguide" (to reflect and focus light) together with some standard IC components to operate.

Neonode licenses the complete solution to its customers thus there is no need for a 3rd party to assemble the touch sensor with the controller (called module maker), a step that adds costs to the complete solution.

Below is a comparison table for resistive, capacitive (2 types) and zForce touch technologies. Some of zForce's unique selling points include low power, low cost and low weight in combination with a 100 % transparent touch window.

#### Technology License Agreements

As of December 31, 2011, we have entered into twelve technology license agreements compared to four technology license agreements as of December 31, 2010. We have signed three additional technology license agreements with customers subsequent to December 31, 2011. The products related to these license agreements are e-Readers, Tablet PCs, mobile phones, commercial and consumer printers, automotive consoles and GPS devices.

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

Our accounts receivable as of December 31, 2011 was due from five customers. Our revenues for the year ended December 31, 2011 was earned from seven customers. Our customers are located in the U.S., Europe and Asia. Customers which accounted for 10% or more of our net revenues during the year ended December 31, 2011 are as follows:

- Amazon accounted for 40%
- Barnes & Noble accounted for 26%
- Sony Corporation accounted for 21%
- KOBO Inc. accounted for 11%

Our accounts receivable as of December 31, 2010 was due from six customers. Our net revenues for the year ended December 31, 2010 was earned from seven customers, of which two customers accounted for approximately 84% of our net revenues for the year.

## Employees

On December 31, 2011, we had thirty full-time employees and one part-time employee. We augment our staff with consultants on an “as needed” basis. There were a total of twenty-two full-time and one part-time employee located in our corporate headquarters in Stockholm, Sweden. Six employees are located in a branch office in the United States, one employee is a resident of South Korea, and one employee is a resident of Israel. None of our employees are represented by a labor union. We have experienced no work stoppages. We believe our employee relations are positive.

## ITEM

### 1A.

## RISK

## FACTORS

In addition to the other information in this Annual Report on Form 10-K, stockholders or prospective investors should carefully consider the following risk factors:

### Risks Related To Our Business

We may require additional capital to fund our operations, which capital may not be available on commercially attractive terms or at all.

Although we recently raised over \$11 million in a public offering, we may in the future require sources of capital in addition to cash on hand to continue operations and to implement our business plan. We project that we have sufficient liquid assets to continue operating for at least the next twelve months. However, if our operations do not become cash flow positive, we will be forced to seek credit line facilities from financial institutions, additional private equity investment, or debt arrangements. No assurances can be given that we will be successful in obtaining such additional financing on reasonable terms, or at all. If adequate funds are not available when needed on acceptable terms, or at all, we may be unable to adequately fund our business plan, which could have a negative effect on our business, results of operations, and financial condition. In addition, if funds are available, the issuance of equity securities or securities convertible into equity could dilute the value of shares of our common stock and cause the market price to fall, and the issuance of debt securities could impose restrictive covenants that could impair our ability to engage in certain business transactions.

We have never been profitable and we anticipate significant additional losses in the future.

Neonode Inc. was formed in 1997 and reconstituted in 2006 as a holding company, owning and operating Neonode AB, which had been formed in 2004. We had been primarily engaged in the business of developing and selling mobile phones. Following the liquidation of Neonode AB, we implemented a new strategy for our business. We have a limited operating history on which to base an evaluation of our business and prospects. Our prospects must be

considered in light of the risks and uncertainties encountered by companies in the early stages of development, particularly companies in new and rapidly evolving markets. We were not successful in selling mobile phones and have refocused our business on licensing our touchscreen technology. We may not be successful in growing our technology licensing business. Our success will depend on many factors, including, but not limited to:

- the growth of touchscreen interface usage;
- the efforts and success of our OEM and other customers;

- the level of competition faced by us; and
- our ability to meet customer demand for engineering support, new technology and ongoing service.

Our limited operating history and the emerging nature of our market, together with the other risk factors set forth in this report, make prediction of our future operating results difficult. There can also be no assurance that we will ever achieve significant revenues or profitability or, if significant revenues and profitability are achieved, that they could be sustained.

Our operating results may fluctuate significantly as a result of a variety of factors, many of which are outside of our control.

We are subject to the following factors, among others, that may negatively affect our operating results:

- the announcement or introduction of new products or technologies by our competitors;
- our ability to upgrade and develop our products and infrastructure to accommodate growth;
- our ability to attract and retain key personnel in a timely and cost effective manner;
- technical difficulties;
- the amount and timing of operating costs and capital expenditures relating to the expansion of our business, operations, and infrastructure; and
- general economic conditions as well as economic conditions specific to the hand-held device and/or touchscreen industry.

As a result of our limited operating history and the nature of the markets in which we compete, it is extremely difficult for us to forecast accurately. We have based our current and future expense levels largely on our investment plans and estimates of future events, although certain of our expense levels are, to a large extent, fixed. We may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. Accordingly, any significant shortfall in revenues relative to our planned expenditures would have an immediate adverse effect on our business, results of operations and financial condition. Further, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing, service, or marketing decisions that could have a material and adverse effect on our business, results of operations, and financial condition. Due to the foregoing factors, our revenues and operating results are and will remain difficult to forecast.

If we fail to develop and introduce new products and services successfully and in a cost effective and timely manner, we will not be able to compete effectively and our ability to generate revenues will suffer.

We operate in a highly competitive, rapidly evolving environment, and our success depends on our ability to develop and introduce new products, technology, and services that our customers and end users choose to buy. If we are unsuccessful at developing and introducing new products, technology, and services that are appealing to our customers and end users with acceptable quality, prices and terms, we will not be able to compete effectively and our ability to generate revenues will suffer.

The development of new products, technology, and services is very difficult and requires high levels of innovation. The development process is also lengthy and costly. If we fail to anticipate our end users' needs or technological trends accurately or if we are unable to complete the development of products and services in a cost effective and timely fashion, we will be unable to introduce new products and services into the market or successfully compete with other providers.

As we introduce new or enhanced products or integrate new technology into new or existing products, we face risks including, among other things, disruption in customers' ordering patterns, inability to deliver new products to meet customers' demand, possible product and technology defects, and potentially unfamiliar sales and support environments. Premature announcements or leaks of new products, features, or technologies may exacerbate some of these risks. Our failure to manage the transition to newer products or the integration of newer technology into new or existing products could adversely affect our business, results of operations, and financial condition.

We are dependent on the ability of our customers to design, manufacture and sell their products that incorporate our touchscreen technologies.

Our products and technologies are licensed to other companies which must be successful in designing, manufacturing and selling the products that incorporate our technologies. If our customers are not able to design, manufacture or sell their products, or are delayed in producing their products, our revenues, profitability, and liquidity, as well as our brand image, may be adversely affected.

We must significantly enhance our sales and product development organizations.

We will need to improve the effectiveness and breadth of our sales efforts in order to increase market awareness and sales of our technologies, especially as we expand into new market segments. Competition for qualified sales personnel is intense, and we may not be able to hire the kind and number of sales personnel we are targeting. Likewise, our efforts to improve and refine our products require skilled engineers and programmers. Competition for professionals capable of expanding our research and development efforts is intense due to the limited number of people available with the necessary technical skills. If we are unable to identify, hire, or retain qualified sales, marketing, and technical personnel, our ability to achieve future revenue may be adversely affected.

We will need to increase the size of our organization, and we may be unable to manage our growth effectively.

Our failure to manage growth effectively could have a material and adverse effect on our business, results of operations and financial condition. We anticipate that expansion of our organization will be required to address internal growth to handle licensing and research activities. This expansion may place a significant strain on management, operational, and financial resources. To manage the expected growth of our operations and personnel, we must both improve our existing operational and financial systems, procedures, and controls, and implement new systems, procedures, and controls. We must also expand our finance, administrative, and operations staff. Our current personnel, systems, procedures, and controls may not adequately support future operations. Management may be unable to hire, train, retain, motivate, and manage the necessary personnel, or to identify, manage and exploit existing and potential strategic relationships and market opportunities.

We are dependent on the services of our key personnel.

We are dependent on our current management for the foreseeable future. The loss of the services of any member of management could have a materially adverse effect on our operations and future prospects.

We are dependent on a limited number of customers.

Our accounts receivable as of December 31, 2011 was due from five customers. Our net revenues for the year ended December 31, 2011 was earned from seven customers. Our customers are located in the U.S., Europe and Asia. Customers which accounted for 10% or more of our net revenues during the year ended December 31, 2011 are as follows:

- Amazon accounted for 40%
- Barnes & Noble accounted for 26%
- Sony Corporation accounted for 21%
- KOBO Inc. accounted for 11%



In the future, the loss of any of these customers, a reduction in net revenues to any of these customers for any reason, or a failure of any of these customers to fulfill their financial or other obligations due to us could have a material adverse affect on our business, financial condition, and future revenue stream.

If third parties infringe our intellectual property or if we are unable to secure and protect our intellectual property, we may expend significant resources enforcing our rights or suffer competitive injury.

Our success depends in large part on our proprietary technology and other intellectual property rights. We rely on a combination of patents, copyrights, trademarks and trade secrets, confidentiality provisions, and licensing arrangements to establish and protect our proprietary rights. Our intellectual property, particularly our patents, may not provide us with a significant competitive advantage. If we fail to protect or to enforce our intellectual property rights successfully, our competitive position could suffer, which could harm our results of operations.

Our pending patent and trademark applications for registration may not be allowed, or others may challenge the validity or scope of our patents or trademarks, including patent or trademark applications or registrations. Even if our patents or trademark registrations are issued and maintained, these patents or trademarks may not be of adequate scope or benefit to us or may be held invalid and unenforceable against third parties.

We may be required to spend significant resources to monitor and police our intellectual property rights. Effective policing of the unauthorized use of our products or intellectual property is difficult and litigation may be necessary in the future to enforce our intellectual property rights. Intellectual property litigation is not only expensive, but time-consuming, regardless of the merits of any claim, and could divert attention of our management from operating the business. Despite our efforts, we may not be able to detect infringement and may lose competitive position in the market before they do so. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, which could make it easier for competitors to capture market share.

Despite our efforts to protect our proprietary rights, existing laws, contractual provisions and remedies afford only limited protection. Intellectual property lawsuits are subject to inherent uncertainties due to, among other things, the complexity of the technical issues involved, and we cannot assure you that we will be successful in asserting our intellectual property rights. Attempts may be made to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Accordingly, we cannot assure you that we will be able to protect our proprietary rights against unauthorized third party copying or use. The unauthorized use of our technology or of our proprietary information by competitors could have an adverse effect on our ability to sell our products.

We have an international presence in countries whose laws may not provide protection of our intellectual property rights to the same extent as the laws of the United States, which may make it more difficult for us to protect our intellectual property.

As part of our business strategy, we target customers and relationships with suppliers and original equipment manufacturers in countries with large populations and propensities for adopting new technologies. However, many of these countries do not address misappropriation of intellectual property nor deter others from developing similar, competing technologies or intellectual property. Effective protection of patents, copyrights, trademarks, trade secrets and other intellectual property may be unavailable or limited in some foreign countries. In particular, the laws of some foreign countries in which we do business may not protect our intellectual property rights to the same extent as the laws of the United States. As a result, we may not be able to effectively prevent competitors in these regions from infringing our intellectual property rights, which could reduce our competitive advantage and ability to compete in those regions and negatively impact our business.



Changes in financial accounting standards or practices may cause unexpected fluctuations in and adversely affect our reported results of operations.

Any change in financial accounting standards or practices that cause a change in the methodology or procedures by which we track, calculate, record and report our results of operations or financial condition or both could cause fluctuations in, and adversely affect, our reported results of operations and cause our historical financial information not to be reliable as an indicator of future results.

Further deterioration in the state of the global economy and financial market conditions could adversely affect our ability to conduct business and our results of operations.

Global economic and financial market conditions, including severe disruptions in the credit markets and the continuing impact of the recent global economic recession may materially impact our customers and other parties with whom we do business. Continued or further deterioration in general economic and financial market conditions could materially adversely affect our financial condition and results of operations. Specifically, the impact of these volatile and negative conditions may include decreased demand for our products and services, decreased ability to accurately forecast future product trends and demand, and a negative impact on our ability to timely collect receivables from our customers. The foregoing economic conditions may lead to increased levels of bankruptcies, restructurings, and liquidations for our customers, scaling back of research and development expenditures, delays in planned projects, and shifts in business strategies for many of our customers. Such events could, in turn, adversely affect our business through loss of revenues.

Wars, terrorist attacks or other threats beyond our control could negatively impact consumer confidence, which could harm our operating results.

Wars, terrorist attacks or other threats beyond our control could have an adverse impact on the United States, Europe and the world economy in general, and consumer confidence and spending in particular, which could harm our business, results of operations and financial condition.

#### Risks Related to Owning Our Stock

If we continue to experience losses, we could experience difficulty meeting our business plan and our stock price could be negatively affected.

If we are unable to gain market acceptance of our touchscreen technologies, we will experience continuing operating losses and negative cash flow from our operations. Any failure to achieve or maintain profitability could negatively impact the market price of our common stock. We anticipate that we will continue to incur product development, sales and marketing, and administrative expenses. As a result, we will need to generate significant quarterly revenues if we are to achieve and maintain profitability. A substantial failure to achieve profitability could make it difficult or impossible for us to grow our business. Our business strategy may not be successful, and we may not generate significant revenues or achieve profitability. Any failure to significantly increase revenues would also harm our ability to achieve and maintain profitability. If we do achieve profitability in the future, we may not be able to sustain or increase profitability on a quarterly or annual basis.

Our certificate of incorporation and bylaws and the Delaware General Corporation Law contain provisions that could delay or prevent a change in control.

Our board of directors has the authority to issue up to 1,000,000 shares of Preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of

the holders of common stock will be subject to, and may be materially adversely affected by, the rights of the holders of any Preferred stock that may be issued in the future. The issuance of Preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. Furthermore, certain other provisions of our certificate of incorporation and bylaws may have the effect of delaying or preventing changes in control or management, which could adversely affect the market price of our common stock. In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, an anti-takeover law.

Our stock price has been volatile, and your investment in our common stock could suffer a decline in value.

There has been significant volatility in the market price and trading volume of equity securities, which is unrelated to the financial performance of the companies issuing the securities. These broad market fluctuations may negatively affect the market price of our common stock. You may not be able to resell your shares at or above the price you pay for those shares due to fluctuations in the market price of our common stock caused by changes in our operating performance or prospects, and other factors.

Some specific factors that may have a significant effect on our common stock market price include:

- actual or anticipated fluctuations in our operating results or future prospects;
- our announcements or our competitors' announcements of new products;
- the public's reaction to our press releases, our other public announcements, and our filings with the SEC;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles;
- changes in our growth rates or our competitors' growth rates;
- developments regarding our patents or proprietary rights or those of our competitors;
- our inability to raise additional capital as needed;
- concern as to the efficacy of our products;
- changes in financial markets or general economic conditions;
- sales of common stock by us or members of our management team; and
- changes in stock market analyst recommendations or earnings estimates regarding our common stock, other comparable companies, or our industry generally.

Future sales of our common stock by our stockholders could negatively affect our stock price.

Sales of a substantial number of shares of our common stock in the public market by our stockholders, or the perception that these sales might occur, could depress the market price of our common stock and could impair our ability to raise capital through the sale of additional equity securities. All of the shares of common stock sold in our recent public offering are freely tradable without restrictions or further registration under the Securities Act of 1933, as amended, or the Securities Act, and thus the price of our common stock may decline.

Future sales of our common stock by us could adversely affect its price, and our future capital-raising activities could involve the issuance of equity securities, which would dilute your investment and could result in a decline in the trading price of our common stock.

We may sell securities in the public or private equity markets if and when conditions are favorable, even if we do not have an immediate need for additional capital at that time. Sales of substantial amounts of common stock, or the perception that such sales could occur, could adversely affect the prevailing market price of our common stock and our ability to raise capital. We may issue additional common stock in future financing transactions or as incentive compensation for our executive management and other key personnel, consultants and advisors. Issuing any equity securities would be dilutive to the equity interests represented by our then-outstanding shares of common stock. The market price for our common stock could decrease as the market takes into account the dilutive effect of any of these issuances. Furthermore, we may enter into financing transactions at prices that represent a substantial discount to the market price of our common stock. A negative reaction by investors and securities analysts to any discounted sale of our equity securities could result in a decline in the trading price of our common stock.

We will have broad discretion in using the net proceeds from our recent public offering, and the benefits from our use of the proceeds may not meet investors' expectations.

Our management will have broad discretion over the allocation of our net proceeds from our recent public offering as well as over the timing of their use without stockholder approval. We have not yet determined how the net proceeds from our recent public offering will be used, other than for working capital and other general corporate purposes. As a result, investors will be relying upon management's judgment with only limited information about our specific intentions for the use of our net proceeds from this offering. Our failure to apply these proceeds effectively could cause our business to suffer.

If securities analysts do not publish research or if securities analysts or other third parties publish inaccurate or unfavorable research about us, the price of our common stock could decline.

The trading market for our common stock will rely in part on the research and reports that securities analysts and other third parties choose to publish about us. We do not control these analysts or other third parties. The price of our common stock could decline if one or more securities analysts downgrade our common stock or if one or more securities analysts or other third parties publish inaccurate or unfavorable research about us or cease publishing reports about us.

Our common stock is currently traded on the OTC Bulletin Board Market. Our stock price and liquidity may continue to be impacted.

Our common stock is traded on the OTC Bulletin Board market, which is generally considered a less efficient and less prestigious market than other markets, such as the Nasdaq Capital Market. The price and liquidity of our stock may continue to be adversely affected as a result of our common stock trading on the OTC Bulletin Board Market.

ITEM 1B.  
UNRESOLVED  
STAFF  
COMMENTS

None.

ITEM 2.  
PROPERTIES

Neonode Technologies AB has a lease with Vasakronan Fastigheter AB for 2,207 square feet of office space located at Linnegatan 89, Stockholm, Sweden for approximately \$6,000 per month including property tax (excluding VAT). The annual payment for this space equates to approximately \$66,000 per year including property tax (excluding VAT). This lease has a notice period of 3 months.

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

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

On March 22, 2012, we entered into a 39 month lease with 2350 Mission Investors LLC for approximately 3,185 square feet of office space located at 2350 Mission College Blvd, Suite 190, Santa Clara, CA 95054 USA. The initial lease payment is approximately \$7,000 per month, increasing to \$7,700 per month over the term of the lease. The annual payment for this space equates to approximately \$84,000 per year.

ITEM 3.  
LEGAL  
PROCEEDINGS

None

ITEM 4.  
MINE SAFETY  
DISCLOSURES

Not applicable

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## PART II

ITEM MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS  
5. AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock has been quoted on the Over the Counter Bulletin Board Market (OTCBB) under the symbol NEON.OB. As of December 31, 2011, there were approximately 2,611 shareholders of record of our common stock.

|             | Fiscal Quarter Ended |         |              |             |
|-------------|----------------------|---------|--------------|-------------|
|             | March 31             | June 30 | September 30 | December 31 |
| Fiscal 2011 |                      |         |              |             |
| High        | \$3.35               | \$4.40  | \$4.70       | \$5.97      |
| Low         | \$1.25               | \$2.95  | 3.40         | \$4.00      |
| Fiscal 2010 |                      |         |              |             |
| High        | \$1.00               | \$1.25  | \$2.00       | \$2.00      |
| Low         | \$0.50               | \$0.50  | 0.75         | \$1.50      |

There are no restrictions on our ability to pay dividends; however, it is currently the intention of our Board of Directors to retain all earnings, if any, for use in our business and we do not anticipate paying cash dividends in the foreseeable future. Any future determination as to the payment of dividends will depend, among other factors, upon our earnings, capital requirements, operating results and financial condition.

ITEM 6.  
SELECTED  
FINANCIAL  
DATA

Not applicable.

ITEM 7.  
MANAGEMENT'S  
DISCUSSION  
AND ANALYSIS  
OF FINANCIAL  
CONDITION  
AND RESULTS  
OF OPERATIONS

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 do not assume any obligation to update these statements. Actual events or results may differ materially from the results discussed in or implied by the forward-looking statements. The following discussion should be read in conjunction with the Company's consolidated financial statements for the years ended December 31, 2011 and 2010 and the related notes included therein.

Overview

Neonode Inc provides optical infrared touchscreen solutions for handheld and small to midsized 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. The cornerstone of our solution is our innovative optical infrared touchscreen technology zForce®. zForce can be applied on any flat surface such as Liquid Crystal Displays (LCD), Electronic Paper Displays (EPD) or as a Mouse Pad and can be incorporated into all types of devices, enabling touch detection for any type of object (finger, pen, glove or brush). In addition the zForce touch solution has a low total weight and building height, thus enabling greater industrial design flexibility. Since nothing is layered on top of the display, the zForce solution provides 100% optical transparency, which improves image quality, reduces glare, and improves battery life.

We have recently developed our Multi-Sensing technology to help OEMs and device manufacturers differentiate themselves in a competitive market. Ready to be implemented into a wide range of commercial devices such as smart phones, tablets and automotive displays, our Multi-Sensing technology can be used for, but is not limited to, intuitive gaming, industrial design, and 3D modeling.

Our technology licensing model allows us to focus on the development of solutions for multi-touch enabled screens and thus we do not have to contend with the financial and logistical burden of manufacturing products, which is handled by our ODM/OEM clients. We license the right to use zForce and software which, together with standard components from partners, create a complete optical touchscreen solution. zForce is currently being integrated into products such as mobile phones, automotive products, e-Readers, printers, GPS devices and Tablet PC's. It should be noted that our licensing model provides the added benefit of allowing us to grow revenues exponentially without the need of increasing costs at anywhere near the same rate to support the revenue growth.

We have incurred net operating losses and negative operating cash flows since inception. As of December 31, 2011, we had an accumulated deficit of \$129.3 million. During the years ended December 31, 2011 and 2010, we raised approximately \$15.5 million and \$4.0 million, respectively, of net cash proceeds through the sale of our securities and convertible debt. We may incur additional losses on a quarterly basis during 2012, but do expect to generate net income and positive operating cash flows for the year ended December 31, 2012. We believe we have sufficient cash to operate for the remainder of 2012, and thereafter, expect to receive sufficient cash from customer license agreements currently in place to operate for at least the next twelve months.

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

In addition, we are subject to certain risks common to technology-based companies in similar stages of development. See "Risk Factors" above. 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 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 preparation of our consolidated financial statements are in conformity with generally accepted accounting principles in the United States ("GAAP") and include the accounts of Neonode Inc. and its wholly-owned subsidiary based in Sweden, Neonode Technologies AB.

All inter-company accounts and transactions have been eliminated in consolidation. The accounting policies affecting our financial condition and results of operations are more fully described in Note 2 to our consolidated financial statements. Certain of our accounting policies require the application of judgment by management in selecting appropriate assumptions for calculating financial estimates, which inherently contain some degree of uncertainty. Management bases its estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances. The historical experience and assumptions form the basis for making judgments about the reported carrying values of assets and liabilities and the reported amounts of revenue and expenses that may

not be readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following are some of the more critical accounting policies and related judgments and estimates used in the preparation of our consolidated financial statements.

## Estimates

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

## Concentration of Cash Balance Risks

Cash balances are maintained at various banks in the U.S. and Sweden. At times, deposits held with financial institutions in the United States of America may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation ("FDIC"), which provides basic deposit coverage with limits up to \$250,000 per owner. In addition to the basic insurance deposit coverage, the FDIC is providing temporary unlimited coverage for non-interest bearing transaction accounts through December 31, 2012. The Swedish government provides insurance coverage up to 100,000 euro per customer and covers deposits in all types of accounts. As of December 31, 2011, the Company has approximately \$1.2 million in excess of this limit.

## Revenue Recognition

### Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue from these services when all of the following conditions are met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our services were performed and risk of loss passed to the customer; (3) we completed all of the necessary terms of the contract; (4) the amount of revenue to which we were entitled was fixed or determinable; and (5) we believed it was probable that we would be able to collect the amount due from the customer. To the extent that one or more of these conditions has not been satisfied, we defer recognition of revenue. Generally, we recognize revenue as the engineering services stipulated under the contact are completed and accepted by our customers.

### Licensing Revenues:

We also derive revenue from the licensing of internally developed intellectual property ("IP"). We enter into IP licensing agreements that generally provide licensees the right to incorporate our IP components in their products with terms and conditions that vary by licensee. The IP licensing agreements generally include a nonexclusive license for the underlying IP. Fees under these agreements may include license fees relating to our IP and royalties payable following the sale by our licensees of products incorporating the licensed technology. The license for our IP has standalone value and can be used by the licensee without maintenance and support. As of December 31, 2011, Neonode meets all the accounting requirements for revenue recognition as per unit royalty products are distributed or licensed by the Company's customers. For technology license arrangements that do not require significant modification or customization of the underlying technology, we recognize technology license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of technology; (2) customer distributes or license the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured.



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

Explicit return rights are not offered to customers. There have been no returns through December 31, 2011.

#### Hardware Products:

We may from time-to-time develop custom hardware products for our customers that incorporate our touch technology. Our policy is to recognize revenue from hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We will estimate expected sales returns and record the amount as a reduction of revenue and cost of hardware and other revenue at the time of shipment. To date, we have not sold any hardware products.

#### Software Products:

We may derive revenues from software licensing sales. We will account for the licensing of software in accordance with accounting guidance and such guidance requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ("VSOE") of fair value exists for those elements.

For software license arrangements that do not require significant modification or customization of the underlying software, we will recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured.

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

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

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

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

We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted. To date, we have not sold any software products.

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

#### Accounts Receivable and Allowance for Doubtful Accounts

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

#### Debt Issuance Costs

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

#### Advertising

Advertising costs are expensed as incurred. Advertising costs for the years ended December 31, 2011 and 2010 were approximately \$241,000 and \$28,000, respectively.

#### Product Research and Development

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

#### Property and Equipment

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

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

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

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



### Long-Lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with 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 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 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 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.

### Foreign Currency Translation and Transaction Gains and Losses

The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona. The translation from Swedish Krona to U.S. Dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for income statement accounts using a weighted average exchange rate during the period. Gains or losses resulting from translation are included as a separate component of accumulated other comprehensive income (loss). Gains or losses resulting from foreign currency transactions are included in general and administrative expenses in the accompanying consolidated statements of operations and were \$44,000 and \$23,000 during the years ended December 31, 2011 and 2010, respectively. For the years ended December 31, 2011 and 2010, our foreign currency translation gains totaled \$76,000 and \$33,000, respectively.

### Liabilities 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 that contain anti-dilution rights. Such embedded derivatives are assessed at inception of the contract and every reporting period, depending on their characteristics, and 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.

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.

### 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 is recorded as a debt discount and amortized to expense over the life of the related debt using the straight line method, which approximates 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.

#### 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 the year ended December 31, 2011 and 2010, respectively, exclude the potential common stock equivalents, as the effect would be anti-dilutive.

#### Comprehensive Loss

Our comprehensive loss includes foreign currency translation gains and losses. The cumulative amount of translation gains and losses are reflected as a separate component in stockholders’ equity (deficit) and comprehensive income (loss).

#### Income taxes

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

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of December 31, 2011 and 2010. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such a determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

Effective January 1, 2007, we adopted the provisions of the accounting, which provisions included a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions accounted for in accordance with the accounting guidance.

#### 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 was 6.50 and 7.21 Swedish Krona to one U.S. Dollar for the years ended December 31, 2011 and 2010, respectively. The exchange rate for the consolidated balance sheets was 6.92 and 6.78 Swedish Krona to one U.S.

Dollar as of December 31, 2011 and 2010, respectively.

## Fair Value of Financial Instruments

We disclose the estimated fair values for all financial instruments for which it is practicable to estimate fair value. Financial instruments including cash, accounts receivable, payables and derivatives are deemed to approximate fair value due to their short maturities. The carrying amounts of convertible debt cannot be reasonably determined since no quoted market prices exist for these instruments and quoted prices for similar instruments cannot be located.

## Deferred Revenue

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

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

## New Accounting Pronouncements

In September 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU 2009-13"), Multiple-Deliverable Revenue Arrangements, 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 adopted ASU 2009-13 on January 1, 2011 and determined that the adoption of this guidance did not have a material effect on the 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 adopted ASU 2009-14 on January 1, 2011 and determined that the adoption of this guidance did not have a material effect on the consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-4, Fair Value Measurement ("ASU 2011-04"). ASU 2011-04 amends existing guidance to achieve convergence in measurement and disclosure between U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 is effective for fiscal year 2012. The Company is currently evaluating the impact that ASU 2011-04 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income ("ASU 2011-05"). The provisions of ASU 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The statement(s) are required to be presented with equal prominence as the other primary financial statements. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity but does not change the items that must be reported in other comprehensive income or when an

item of other comprehensive income must be reclassified to net income. Certain provisions of ASU No. 2011-05 are effective for the Company's interim reporting period beginning on or after December 15, 2011, with retrospective application required. The adoption of ASU No. 2011-05 is expected to result in presentation changes to the Company's consolidated statements of operations and the addition of a consolidated statement of comprehensive income (loss). The adoption of ASU No. 2011-05 will have no impact on the Company's consolidated balance sheet.

## Results of Operations

### Net Revenue

Net revenue for the year ended December 31, 2011 was \$6.1 million, compared to \$440,000 for the year ended December 31, 2010. Our net revenue for the year ended December 31, 2011 included \$5.8 million from technology license fees and \$287,000 in non-recurring engineering services related to our touchscreen solution for various customers. Under the terms of one of our contracts entered into in 2010, the customer prepaid \$3.0 million of technology licenses prior to shipment of its first product. The \$3.0 million pre-payment was included in deferred revenue as of December 31, 2010 and will be amortized to revenue as units are sold. For the year ended December 31, 2011, \$1.5 million in license fees related to products shipped in 2011 have been recognized as revenue, and as of December 31, 2011, \$1.5 million remains in deferred revenue. Our net revenue for the year ended December 31, 2010 was \$440,000 and includes \$387,000 in fees for engineering design services, \$50,000 for the sale of components, and \$3,000 from technology license fees related to our touchscreen solution for our customers.

As of December 31, 2011, we had twelve signed technology license agreements with global OEMs. Six of our customers are currently shipping products and we anticipate others will initiate product shipments as they complete their final product development and manufacturing cycle throughout 2012. Sony Corporation is currently shipping the “Sony Reader Wi-Fi PRS-T1” model. Koobe Inc. began shipping the “Jin Yong e-Reader” in limited quantities to the Chinese market in December 2010 but ceased shipments in the first quarter of 2011. Kobo Inc. is currently shipping the “Kobo eReader Touch”; Barnes & Noble Inc. is currently shipping “The Simple Touch Reader” Nook e-Reader; Amazon is currently shipping the Kindle Touch and Kindle Touch 3G e-Readers; and Onyx began shipping e-Reader products in December 2011. All of these products incorporate Neonode’s zForce touch technology.

In the first quarter of 2012, we signed technology license agreements with four new customers in the GPS, Tablet PC, printing and office equipment, and imaging markets. In addition, we are currently developing prototype products and are engaged in product engineering design discussions with numerous global OEMs who are in the process of qualifying our touchscreen technology for incorporation in various products such as printer products, GPS devices, e-Readers, Tablet PCs, touch panels for automobiles, household appliances, mobile phones and games and toys. The development and product release cycle for these products typically takes six to eighteen months.

Current and future drivers of the touchscreen market include mobile phones, printers, automotive, household appliances, tablet PCs, e-Readers, navigation screens, etc. The proliferation and mass market acceptance of touchscreens have prompted new applications and uses for existing and new offerings, thus making the production and utilization of these modules one of the fastest growing tech segments. The typical sales cycle is nine to eighteen months with new customers while existing customer lead times are typically six to nine months. During the initial cycle, there are three phases: evaluation, design, and commercialization. In the evaluation phase, prospects validate the Neonode technology using a Neonode evaluation kit and may produce short runs of prototype products. During the design phase, true product development and solution definition begins. This phase tends to be the longest and delays typically occur which may extend the term of the overall cycle. In the final phase, commercialization, the customer enters into full production mode, ships products to the market and Neonode earns its license revenue.

### Gross Margin

Gross margin was \$5.2 million and \$172,000 for the years ended December 31, 2011 and 2010, respectively. Our cost of revenues includes the direct cost of production of the components plus the costs of Company employed engineering personnel plus engineering consultants to complete the engineering design contract.



## Product Research and Development

Product research and development (R&D) expenses for each of the years ended December 31, 2011 and 2010 were \$1.9 million. R&D costs mainly consist of personnel related costs in addition to some external consultancy costs such as testing, certifying and measurements.

We continue to pursue and expand R&D expenditures on the development of our touchscreen and other technologies. We have a development roadmap based on our touchscreen and other technologies. As of December 31, 2011, our R&D department had eighteen full-time employees compared to eight full-time employees and one part-time consultant at December 31, 2010.

## Sales and Marketing

Sales and marketing expenses for the year ended December 31, 2011 were \$1.8 million, compared to \$566,000 for the year ended December 31, 2010. This increase in 2011 as compared to 2010 is primarily related to an increase in sales personnel, marketing, trade shows and travel expenses. As of December 31, 2011, our sales and marketing department has nine full-time employees, compared to three employees at December 31, 2010.

Our sales activities focus primarily on OEM customers who will integrate our touchscreen technology into their products. Our OEM customers will then sell and market their products incorporating our technology to their customers.

## General and Administrative

General and administrative (G&A) expenses for the year ended December 31, 2011 were \$3.5 million, compared to \$3.6 million for the year ended December 31, 2010. This slight decrease in 2011 as compared to 2010 is primarily related to a decrease in non-cash fair value of warrants issued to employees that was partially offset by an increase in patent related legal fees and financial consultant costs.

As of December 31, 2011 and 2010, we had three employees and one part-time consultant in our G&A department fulfilling management and accounting responsibilities.

## Amortization of Fair Value of Stock Issued to Related Parties for Purchase of Neonode Technologies AB

On December 29, 2008, we entered into a Share Exchange Agreement with Neonode Technologies AB and the stockholders of Neonode Technologies AB: Iwo Jima SARL, Wirelesstoy AB, and Athemis Ltd (the "Neonode Technologies AB Stockholders"), pursuant to which we agreed to acquire all of the issued and outstanding shares of Neonode Technologies AB in exchange for the issuance of 19,800 shares of the Company's Series A Preferred stock. Pursuant to the terms of the Share Exchange Agreement, upon the closing of the transaction, Neonode Technologies AB became a wholly owned subsidiary of the Company. The Neonode Technologies AB Stockholders are or were employees of us and/or Neonode AB, and as such were related parties.

The fair value of the conversion feature of the 19,800 shares of Series A Preferred shares issued to the related parties to acquire Neonode Technologies AB that were converted into a total of 9,516,447 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 was 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 has been amortized to compensation expense at the rate of \$1.6 million per quarter for six quarters beginning January 1, 2009. The amortization of the \$9.5 million in compensation expense related the value of the stock issued to the related parties to acquire Neonode

Technologies AB was completed on June 30, 2010. For the year ended December 31, 2010, \$3.2 million has been recorded as compensation expense in our consolidated statement of operations.

## Interest and Other Expense

Interest expense for the year ended December 31, 2011 was \$288,000, compared to \$179,000 for the year ended December 31, 2010. The increase is primarily due to an increase in the debt outstanding from \$2.8 million at December 31, 2010 to \$4.2 million for the majority of the year ended December 31, 2011.

## Foreign Currency Translation and Transaction Gains and Losses

The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona. The translation from Swedish Krona to U.S. Dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for income statement accounts using a weighted average exchange rate during the period. Gains or losses resulting from translation are included as a separate component of accumulated other comprehensive loss. Gains or losses resulting from foreign currency transactions are included in general and administrative expenses in the accompanying consolidated statements of operations and were \$44,000 and \$23,000 during the years ended December 31, 2011 and 2010, respectively. Foreign currency translation gains were \$76,000 and \$33,000 during the years ended December 31, 2011 and 2010, respectively.

## Non-Cash Items Related to Debt Discounts and Deferred Financing Fees and the Valuation of Conversion Features and Warrants

Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants for the year ended December 31, 2011 was \$14.7 million, compared to \$20.0 million for the year ended December 31, 2010. The amount in the current year includes \$8.6 million in net change in derivative liabilities, \$4.3 million of debt discount and debt issuance cost amortization, \$1.5 million in excess amount of debt discount recognized as interest expense associated with derivatives, and \$0.4 million associated with the fair value of shares issued for bonus interest related to the automatic conversion of the Senior Convertible Secured Notes - 2011. The amount in the prior year includes \$16.3 million in net change in derivative liabilities, \$2.7 million of debt discount and debt issuance cost amortization, and \$1.0 million in excess amount of debt discount recognized as interest expense associated with derivatives.

## Loss on extinguishment of debt

Loss on extinguishment of debt for the year ended December 31, 2010 of \$2.4 million was primarily the result of the warrant repricing and debt extension financing transaction that was consummated in the prior year. During September and October 2010, all of the holders of the convertible notes and the holders of the stock purchase warrants issued in the 2009 and 2010 Senior Secured Convertible Debt Financing Transactions agreed to extend the maturity date of their convertible debt from December 31, 2010 to June 30, 2011. In addition, holders of 2,766,857 stock purchase warrants also agreed to exercise their previously granted three-year warrants for a discounted exercise price. In accordance with relevant accounting guidance, the transaction qualified for debt extinguishment accounting.

## Income Taxes

Our effective tax rate was 0% in the year ended December 31, 2011 and 2010, respectively. We recorded valuation allowances in 2011 and 2010 for deferred tax assets related to net operating losses due to the uncertainty of realization.

## Net Loss

As a result of the factors discussed above, we recorded a net loss of \$17.1 million for the year ended December 31, 2011, compared to a net loss of \$31.6 million in the comparable period in 2010.

#### Off-Balance Sheet Arrangements

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

## Liquidity and Capital Resources

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

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

We have six current active customers for our touchscreen technology and an additional nine customers with signed license agreements currently in the product development stage. In most circumstances, our target customers will have to successfully integrate our technology into their products and then sell those products to their customers before we will receive any cash from our technology license agreements.

Our cash is subject to interest rate risk. We invest primarily on a short-term basis. Our financial instrument holdings at December 31, 2011 were analyzed to determine their sensitivity to interest rate changes. The fair values of these instruments were determined by net present values. In our sensitivity analysis, the same change in interest rate was used for all maturities and all other factors were held constant. If interest rates increased by 10%, the expected effect on net loss related to our financial instruments would be immaterial. The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona, and is subject to foreign currency exchange rate risk. Any increase or decrease in the exchange rate of the U.S. Dollar compared to the Swedish Krona will impact Neonode's future operating results.

At December 31, 2011, we had cash of \$12.9 million, as compared to \$911,000 at December 31, 2010. In the year ended December 31, 2011, \$3.5 million of cash was used in operating activities, primarily as a result of our net loss increased by the following non-cash items (in thousands):

|                                                                                                  |    |        |
|--------------------------------------------------------------------------------------------------|----|--------|
| Depreciation and amortization                                                                    | \$ | 26     |
| Stock-based compensation expense                                                                 |    | 550    |
| Debt discounts and deferred financing fees and the valuation of conversion features and warrants |    | 14,735 |
| Total adjustments to reconcile net loss to net cash used in operating activities                 | \$ | 15,311 |

Working capital (current assets less current liabilities) was \$13.6 million at December 31, 2011, compared to an adjusted working capital (current assets less current liabilities not including non-cash liabilities related to warrants and embedded derivatives) deficit of \$3.2 million at December 31, 2010.

In the years ended December 31, 2011 and 2010, we purchased \$114,000 and \$14,000, respectively of fixed assets, consisting primarily of computers and engineering equipment.

During the year ended December 31, 2010, we received proceeds from a private placement of convertible notes totaling \$1.6 million and converted \$163,000 of accounts payable to convertible debt that were converted, at the holder's option, into 3,521,423 shares of our common stock at a conversion price of \$0.50 per share. The convertible note holders had the right to have the conversion price adjusted to equal the lower stock price if we issued common stock or convertible notes at a lower conversion price than \$0.50 during the period that the notes were outstanding. These convertible notes that were due on December 31, 2010 were extended until June 30, 2011 and bore an annual

interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes were outstanding. In addition, we issued 1,760,711 three year warrants to the convertible note holders with an exercise price of \$1.00 per share (see below).

During March and April 2011, we received an aggregate of \$4.2 million in cash proceeds related to a private placement of convertible notes, bearing interest at a rate of seven percent (7%) per annum, that was scheduled to mature on March 1, 2014, and that was convertible at the holder's option into 1,691,320 shares of our common stock at a conversion price of \$2.50 per share. The loan would automatically convert into shares of our common stock in the event that on or before the loan due date either (a) the Company's common stock traded at a price per share of \$6.25 or higher for five (5) consecutive trading days, or (b) the Company consummated a financing in the amount of at least \$5 million. In the event that the loan principal and accrued interest was not repaid by the Company by the due date, and the Investor had not previously converted the loan, the investor's sole remedy for such non-payment was the payment of additional annual interest at a rate of 10% per year. The accrued interest was payable in stock, using the \$2.50 conversion price, or cash, at the holder's option, on September 30 and December 31 of each year.

In March 2011, the Company entered into a warrant agreement with investors who participated in the Company's 2009 and 2010 financing transactions and who had been issued common stock purchase warrants with exercise prices of \$0.50 per share, \$1.00 per share, and \$1.38 per share (the "2009 and 2010 Warrants"). Pursuant to the warrant agreement, each warrant holder who exercised some or all of its outstanding 2009 and 2010 Warrants at the applicable exercise price (\$0.50 per share, \$1.00 per share, and/or \$1.38 per share), received a number of March 2011 Warrants equal to fifty percent (50%) of the number of 2009 and 2010 Warrants exercised by such warrant holder. The warrant holders exercised an aggregate of 493,426 outstanding 2009 and 2010 Warrants, for an aggregate investment of \$515,000 and received 493,426 shares of common stock and 246,713 new five-year common stock purchase warrants, with an exercise price of \$3.13 per share. The March 2011 Warrants may be exercised by cash payment or through cashless exercise by the surrender of warrant shares having a value equal to the exercise price of the portion of the warrants being exercised.

On December 13, 2011, the Company sold 3,000,000 shares of common stock of the Company, par value \$0.001 per share, in a public offering pursuant to a Registration Statement on Form S-3. The net proceeds to the Company from this offering was \$11.2 million, after deducting the underwriting discount but before deducting other estimated offering expenses of approximately \$0.4 million payable by the Company.

In the future, we may require sources of capital in addition to cash on hand to continue operations and to implement our strategy. If our operations do not become cash flow positive, we may be forced to seek credit line facilities from financial institutions, additional private equity investment or debt arrangements. No assurances can be given that we will be successful in obtaining such additional financing on reasonable terms, or at all. If adequate funds are not available on acceptable terms, or at all, we may be unable to adequately fund our business plans and it could have a negative effect on our business, results of operations and financial condition. In addition, if funds are available, the issuance of equity securities or securities convertible into equity could dilute the value of shares of our common stock and cause the market price to fall, and the issuance of debt securities could impose restrictive covenants that could impair our ability to engage in certain business transactions.

ITEM 7A.  
QUANTITATIVE  
AND  
QUALITATIVE  
DISCLOSURES  
ABOUT  
MARKET RISK

Not applicable



FINANCIAL  
STATEMENTS

|                                                                                                                                 |      |
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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
Neonode Inc.

We have audited the accompanying consolidated balance sheets of Neonode Inc. (a Delaware corporation) and subsidiary (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity (deficit) and comprehensive loss, and cash flows for each of the years in the two-year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Neonode Inc. and subsidiary at December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

/s/ KMJ Corbin & Company LLP

Costa Mesa, California  
March 30, 2012

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

|                                                                                                                                                                                                                                                                                                                                       | As of<br>December 31,<br>2011 | As of<br>December 31,<br>2010 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|-------------------------------|
| <b>ASSETS</b>                                                                                                                                                                                                                                                                                                                         |                               |                               |
| Current assets:                                                                                                                                                                                                                                                                                                                       |                               |                               |
| Cash                                                                                                                                                                                                                                                                                                                                  | \$ 12,940                     | \$ 911                        |
| Accounts receivable                                                                                                                                                                                                                                                                                                                   | 3,345                         | 151                           |
| Debt issuance costs, net                                                                                                                                                                                                                                                                                                              | --                            | 4                             |
| Prepaid expenses and other current assets                                                                                                                                                                                                                                                                                             | 234                           | 161                           |
| Total current assets                                                                                                                                                                                                                                                                                                                  | 16,519                        | 1,227                         |
| Property and equipment, net                                                                                                                                                                                                                                                                                                           | 108                           | 24                            |
| Total assets                                                                                                                                                                                                                                                                                                                          | \$ 16,627                     | \$ 1,251                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>                                                                                                                                                                                                                                                                                 |                               |                               |
| Current liabilities:                                                                                                                                                                                                                                                                                                                  |                               |                               |
| Accounts payable                                                                                                                                                                                                                                                                                                                      | \$ 447                        | \$ 442                        |
| Accrued expenses                                                                                                                                                                                                                                                                                                                      | 601                           | 643                           |
| Deferred revenue                                                                                                                                                                                                                                                                                                                      | 1,906                         | 540                           |
| Convertible debt, net of discounts                                                                                                                                                                                                                                                                                                    | --                            | 2,772                         |
| Embedded derivatives of convertible debt and warrants                                                                                                                                                                                                                                                                                 | --                            | 6,718                         |
| Total current liabilities                                                                                                                                                                                                                                                                                                             | 2,954                         | 11,115                        |
| Total liabilities                                                                                                                                                                                                                                                                                                                     | 2,954                         | 11,115                        |
| Commitments and contingencies (Note 11)                                                                                                                                                                                                                                                                                               |                               |                               |
| Stockholders' equity (deficit):                                                                                                                                                                                                                                                                                                       |                               |                               |
| Series A Preferred stock, 444,541 shares authorized with par value of \$0.001 per share;                                                                                                                                                                                                                                              |                               |                               |
| 83 and 166 shares issued and outstanding at December 31, 2011 and 2010, 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)                                                                               | --                            | --                            |
| Series B Preferred stock, 54,425 shares authorized with par value of \$0.001; 114 and 141 shares issued and outstanding at December 31, 2011 and 2010, 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, 70,000,000 and 848,000,000 shares authorized at December 31, 2011 and 2010, respectively, with par value of \$0.001; 32,778,993 and 21,816,602 shares issued and outstanding at December 31, 2011 and 2010, respectively                                                                                                |                               |                               |
|                                                                                                                                                                                                                                                                                                                                       | 33                            | 22                            |

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|                                                      |            |            |
|------------------------------------------------------|------------|------------|
| Additional paid-in capital                           | 142,955    | 102,360    |
| Accumulated other comprehensive income (loss)        | 13         | (63 )      |
| Accumulated deficit                                  | (129,328 ) | (112,183 ) |
| Total stockholders' equity (deficit)                 | 13,673     | (9,864 )   |
| Total liabilities and stockholders' equity (deficit) | \$ 16,627  | \$ 1,251   |

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

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

|                                                                                                                                 | Year ended<br>December 31, |             |
|---------------------------------------------------------------------------------------------------------------------------------|----------------------------|-------------|
|                                                                                                                                 | 2011                       | 2010        |
| Net revenues                                                                                                                    | \$6,067                    | \$440       |
| Cost of revenues                                                                                                                | 908                        | 268         |
| Gross margin                                                                                                                    | 5,159                      | 172         |
| Operating expenses:                                                                                                             |                            |             |
| Product research and development                                                                                                | 1,858                      | 1,873       |
| Sales and marketing                                                                                                             | 1,812                      | 566         |
| General and administrative                                                                                                      | 3,533                      | 3,588       |
| Amortization of fair value of stock issued to related parties for purchase of<br>Neonode Technologies AB (formerly AB Cypresen) | --                         | 3,168       |
| Total operating expenses                                                                                                        | 7,203                      | 9,195       |
| Operating loss                                                                                                                  | (2,044 )                   | (9,023 )    |
| Other expense:                                                                                                                  |                            |             |
| Interest and other expense                                                                                                      | (288 )                     | (179 )      |
| Loss on extinguishment of debt                                                                                                  | --                         | (2,416 )    |
| Non-cash items related to debt discounts and deferred financing fees<br>and the valuation of conversion features and warrants   | (14,735 )                  | (19,963 )   |
| Total other expense                                                                                                             | (15,023 )                  | (22,558 )   |
| Loss before provision for income taxes                                                                                          | (17,067 )                  | (31,581 )   |
| Provision for income taxes                                                                                                      | 78                         | 45          |
| Net loss                                                                                                                        | \$(17,145 )                | \$(31,626 ) |
| Loss per common share:                                                                                                          |                            |             |
| Basic and diluted loss per share                                                                                                | \$(0.64 )                  | \$(1.73 )   |
| Basic and diluted – weighted average shares used in per share computations                                                      | 26,784                     | 18,293      |

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

NEONODE INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT) AND COMPREHENSIVE LOSS  
(Amounts in thousands)

|                                                                                                                                                       | Common<br>stock<br>shares<br>issued | Common<br>stock<br>amount | Additional<br>paid-in<br>capital | Series<br>A<br>Preferred<br>stock<br>shares<br>issued | Series<br>B<br>Preferred<br>stock<br>amount | Series<br>C<br>Preferred<br>stock<br>amount | Accumulated<br>other<br>comprehensive<br>income<br>(loss) | Accumulated<br>deficit | Total<br>Stockholders' equity<br>(deficit) | Other<br>comprehensive<br>loss |
|-------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|---------------------------|----------------------------------|-------------------------------------------------------|---------------------------------------------|---------------------------------------------|-----------------------------------------------------------|------------------------|--------------------------------------------|--------------------------------|
| Balances,<br>January 1, 2010                                                                                                                          | 16,659                              | \$ 17                     | \$ 74,288                        | 3                                                     | \$ -                                        | 1                                           | \$ -                                                      | \$ (96 )               | \$ (80,557 )                               | \$ (6,348 )                    |
| Employee<br>stock option<br>and warrant<br>compensation<br>expense                                                                                    | -                                   | -                         | 2,262                            | -                                                     | -                                           | -                                           | -                                                         | -                      | 2,262                                      |                                |
| Amortization<br>of fair value of<br>stock issued to<br>related parties<br>for purchase of<br>Neonode<br>Technologies<br>AB (formerly<br>AB Cypressen) | -                                   | -                         | 3,168                            | -                                                     | -                                           | -                                           | -                                                         | -                      | 3,168                                      |                                |
| Reclassification<br>of derivative<br>liabilities to<br>additional<br>paid-in capital                                                                  | -                                   | -                         | 19,286                           | -                                                     | -                                           | -                                           | -                                                         | -                      | 19,286                                     |                                |
| Common stock<br>issued to settle<br>lawsuit                                                                                                           | 498                                 | -                         | 647                              | -                                                     | -                                           | -                                           | -                                                         | -                      | 647                                        |                                |
| Exchange of<br>Series A<br>Preferred Stock<br>for common<br>stock                                                                                     | 1,577                               | 2                         | (2 )                             | (3 )                                                  | -                                           | -                                           | -                                                         | -                      | -                                          |                                |
| Exchange of<br>Series B<br>Preferred Stock<br>for common                                                                                              | 73                                  | -                         | -                                | -                                                     | (1 )                                        | -                                           | -                                                         | -                      | -                                          |                                |

|                                                                                                                  |        |    |         |   |   |   |   |       |           |           |              |
|------------------------------------------------------------------------------------------------------------------|--------|----|---------|---|---|---|---|-------|-----------|-----------|--------------|
| stock                                                                                                            |        |    |         |   |   |   |   |       |           |           |              |
| Proceeds for<br>issuance of<br>warrants                                                                          | -      | -  | 49      | - | - | - | - | -     | -         | 49        |              |
| Common stock<br>issued upon<br>conversion of<br>debt including<br>beneficial<br>conversion<br>feature<br>amounts | 186    | -  | 179     | - | - | - | - | -     | -         | 179       |              |
| Common stock<br>issued to<br>brokers                                                                             | 57     | -  | 65      | - | - | - | - | -     | -         | 65        |              |
| Common stock<br>issued to<br>investors in the<br>2010 warrant<br>repricing<br>financing<br>transaction           | 2,767  | 3  | 2,418   | - | - | - | - | -     | -         | 2,421     |              |
| Foreign<br>currency<br>translation<br>adjustment                                                                 | -      | -  | -       | - | - | - | - | 33    | -         | 33        | 33           |
| Net loss                                                                                                         | -      | -  | -       | - | - | - | - | -     | (31,626 ) | (31,626 ) | \$ (31,626 ) |
| Comprehensive<br>loss                                                                                            |        |    |         |   |   |   |   |       |           |           | (31,593 )    |
| Balances,<br>December 31,<br>2010                                                                                | 21,817 | 22 | 102,360 | - | - | - | - | (63 ) | (112,183) | (9,864 )  |              |
| Stock option<br>and warrant<br>compensation<br>expense to<br>employees and<br>vendors                            | -      | -  | 550     | - | - | - | - | -     | -         | 550       |              |
| Common stock<br>issued upon<br>exercise of                                                                       | 543    | 1  | 514     | - | - | - | - | -     | -         | 515       |              |

|                                                                                                    |       |   |        |   |   |   |   |    |   |        |    |
|----------------------------------------------------------------------------------------------------|-------|---|--------|---|---|---|---|----|---|--------|----|
| warrants                                                                                           |       |   |        |   |   |   |   |    |   |        |    |
| Proceeds from sale of common stock, net of offering costs                                          | 3,000 | 3 | 10,784 | - | - | - | - | -  | - | 10,787 |    |
| Reclassification of derivative liabilities to additional paid-in capital                           | -     | - | 20,075 | - | - | - | - | -  | - | 20,075 |    |
| Fair value of warrants issued in connection with issuance of 2011 Senior Secured Convertible Debt  | -     | - | 937    | - | - | - | - | -  | - | 937    |    |
| Exchange of Series A Preferred Stock for common stock                                              | 40    | - | -      | - | - | - | - | -  | - | -      |    |
| Exchange of Series B Preferred Stock for common stock                                              | 6     | - | -      | - | - | - | - | -  | - | -      |    |
| Common stock issued upon conversion of outstanding convertible debt and accrued and bonus interest | 7,313 | 7 | 7,615  | - | - | - | - | -  | - | 7,622  |    |
| Common stock issued for settlement of accrued expenses                                             | 60    | - | 120    | - | - | - | - | -  | - | 120    |    |
| Foreign currency                                                                                   | -     | - | -      | - | - | - | - | 76 | - | 76     | 76 |

|                                   |        |       |            |   |      |   |      |       |              |           |              |
|-----------------------------------|--------|-------|------------|---|------|---|------|-------|--------------|-----------|--------------|
| translation<br>adjustment         |        |       |            |   |      |   |      |       |              |           |              |
| Net loss                          | -      | -     | -          | - | -    | - | -    | -     | (17,145 )    | (17,145 ) | \$ (17,145 ) |
| Comprehensive<br>loss             | -      | -     | -          | - | -    | - | -    | -     | -            | -         | \$ (17,069 ) |
| Balances,<br>December 31,<br>2011 | 32,779 | \$ 33 | \$ 142,955 | - | \$ - | - | \$ - | \$ 13 | \$ (129,328) | \$ 13,673 |              |

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

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

|                                                                                                                           | Years ended December 31, |            |
|---------------------------------------------------------------------------------------------------------------------------|--------------------------|------------|
|                                                                                                                           | 2011                     | 2010       |
| Cash flows from operating activities:                                                                                     |                          |            |
| Net loss                                                                                                                  | \$(17,145)               | \$(31,626) |
| Adjustments to reconcile net loss to net cash used in operating activities:                                               |                          |            |
| Stock-based compensation expense to employees and vendors                                                                 | 550                      | 5,430      |
| Fair value of common stock issued in settlements                                                                          | --                       | 647        |
| Depreciation and amortization                                                                                             | 26                       | 11         |
| Loss on extinguishment of debt                                                                                            | --                       | 2,416      |
| Debt discounts and deferred financing fees and the valuation of conversion features and warrants                          | 14,735                   | 19,963     |
| Changes in operating assets and liabilities:                                                                              |                          |            |
| Accounts receivable                                                                                                       | (3,228)                  | (146)      |
| Prepaid expenses and other current assets                                                                                 | (79)                     | (16)       |
| Accounts payable and accrued expenses                                                                                     | 322                      | (414)      |
| Deferred revenue                                                                                                          | 1,366                    | 540        |
| Net cash used in operating activities                                                                                     | (3,453)                  | (3,195)    |
| Cash flows from investing activities:                                                                                     |                          |            |
| Purchase of property and equipment                                                                                        | (114)                    | (14)       |
| Net cash used in investing activities                                                                                     | (114)                    | (14)       |
| Cash flows from financing activities:                                                                                     |                          |            |
| Proceeds from issuance of convertible debt                                                                                | 4,228                    | 1,597      |
| Repayment of convertible debt                                                                                             | (25)                     | --         |
| Proceeds from exercise of warrants                                                                                        | 515                      | 49         |
| Proceeds from issuance of common stock, warrant repricing and preferred stock                                             | 10,787                   | 2,421      |
| Net cash provided by financing activities                                                                                 | 15,505                   | 4,067      |
| Effect of exchange rates on cash                                                                                          | 91                       | 25         |
| Net increase in cash                                                                                                      | 12,029                   | 883        |
| Cash at beginning of year                                                                                                 | 911                      | 28         |
| Cash at end of year                                                                                                       | \$ 12,940                | \$ 911     |
| Supplemental disclosure of cash flow information:                                                                         |                          |            |
| Interest paid in cash                                                                                                     | \$27                     | \$180      |
| Supplemental disclosure of non-cash transactions:                                                                         |                          |            |
| Exchange of preferred stock for common stock                                                                              | \$--                     | \$806      |
| Reclassification of derivative liabilities to additional paid-in-capital upon conversion of debt and exercise of warrants | \$20,075                 | \$19,286   |
| Value of shares of common stock and warrants issued to                                                                    |                          |            |

|                                                                    |          |         |
|--------------------------------------------------------------------|----------|---------|
| brokers in connection with financing, recorded as debt             |          |         |
| issuance costs and debt discount                                   | \$--     | \$129   |
| Debt issuance costs recorded as part of 2011 financing transaction | \$35     | \$--    |
| Debt discount recorded as part of convertible debt financing       |          |         |
| transactions, including warrants issued in financing transactions  | \$4,228  | \$1,761 |
| Accounts payable converted in 2010 convertible debt offering       | \$--     | \$163   |
| Accrued expenses settled with shares of common stock               | \$120    | \$--    |
| Conversion of debt and accrued interest to shares of common stock  | \$7,222  | \$179   |
| Debt issuance costs recorded in connection of debt                 |          |         |
| extinguishment transactions                                        | \$20,075 | \$4,336 |
| Reduction of derivative liabilities upon conversion of debt and    |          |         |
| exercise of warrants                                               | \$--     | \$8     |

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

NEONODE INC.

Notes to the Consolidated Financial Statements

1. Nature of the business and operations

Background and Organization

Neonode Inc. was incorporated in the State of Delaware in 1997 as the parent of Neonode AB, a company founded in February 2004 and incorporated in Sweden. On December 29, 2008, we entered into a Share Exchange Agreement with AB Cypresen nr 9683 (renamed Neonode Technologies AB), a Swedish engineering company, and Neonode Technologies AB became our wholly owned subsidiary. Together, Neonode Inc. and Neonode Technologies AB are known as “we,” “us,” “our”, or the “Company.”

On December 9, 2008, our former wholly owned subsidiary, Neonode AB, filed for liquidation under the Swedish bankruptcy laws. Effective with Neonode AB’s bankruptcy filing on December 9, 2008, Neonode Inc. is no longer in the mobile phone business and there are no known financial obligations related to the accounts payable or other debts of Neonode AB for which Neonode Inc has responsibility.

On December 29, 2008, we entered into a Share Exchange Agreement with Neonode Technologies AB and the stockholders of Neonode Technologies AB: Iwo Jima SARL, Wirelesstoy AB, and Athemis Ltd (the “Neonode Technologies AB Stockholders”), pursuant to which we agreed to acquire all of the issued and outstanding shares of Neonode Technologies AB in exchange for the issuance of 19,800 shares of Neonode Inc Series A Preferred stock. Pursuant to the terms of the Share Exchange Agreement, upon the closing of the transaction, Neonode Technologies AB became a wholly owned subsidiary of the Company. The Neonode Technologies AB Stockholders are or were employees of us and/or Neonode AB, and as such are related parties. Neonode Technologies AB did not have any operations in 2008. The acquisition of Neonode Technologies AB by us did not qualify as a business combination but rather as a merger of entities under common control; accordingly the acquired assets of Neonode Technologies AB are recorded at their historical cost basis of \$12,000.

Neonode Technologies AB was formed on December 29, 2008 following the bankruptcy filing on December 9, 2008 of Neonode AB. Based on Swedish tax considerations, we determined that it would be more efficient to form a new company which would be acquired by Neonode Inc. rather than to re-hire each of the former employees of Neonode AB on an individual basis. Furthermore, we determined that based on the importance to the Company of retaining the technology and business expertise of the beneficial owners of Neonode Technologies AB and of ensuring our ability to continue to develop our technology, in exchange for complete ownership of Neonode Technologies AB, we were prepared to issue to the Neonode Technologies AB Stockholders shares representing approximately 49.5% of the Company. However, since we did not have a sufficient number of unissued shares of common stock at that time to issue shares of common stock representing 49.5% of the Company as well as enter into the other Refinancing Agreements, we decided that in exchange for all of the shares of Neonode Technologies AB we would issue shares of Series A Preferred stock at a ratio such that assuming an increase in the Company’s authorized share capital and an increase in the conversion rate to 480.63 shares of common stock for each shares of Series A Preferred stock, the Neonode Technologies AB Stockholders would own in the aggregate an amount of shares equal to approximately 49.5% of the Company after completion of our refinancing and capital raising activities. Nevertheless, pursuant to the Share Exchange Agreement, we did not guarantee that either the Company’s authorized share capital would be increased or that the conversion rate would be increased to 480.63 shares of common stock for each shares of Series A Preferred stock (See Note 9).

The fair value of the Series A Preferred Stock issued to the Neonode Technologies AB Stockholders in excess of the \$12,000 cash balance is accounted for as compensation. Pursuant to the Share Exchange Agreement, the beneficial owners of the Neonode Technologies AB Stockholders agreed to remain employees of Neonode Technologies AB for a period of 18 months. In addition, each of the beneficial owners of the Neonode Technologies AB Stockholders signed a repurchase agreement with the Company granting the Company a lapsing repurchase right to purchase the Series A Preferred stock held by such Neonode Technologies AB Stockholder in the event the beneficial owner's employment with Neonode Technologies AB is terminated other than for cause prior to the expiration of 18 months from December 29, 2008. Each month, 1/18 of the Series A Preferred shares held by the Neonode Technologies AB Stockholders was released from the lapsing repurchase right. Thus, the fair value of the common stock (as converted from Series A Preferred Stock during 2009 was \$9.5 million) issued under the Share Exchange Agreement was amortized on a straight-line basis to compensation expense over the 18-month vesting period that began on January 1, 2009.

On March 25, 2011, we filed a Certificate of Amendment of our Amended and Restated Certificate of Incorporation affecting a reverse stock split of the Company's issued and outstanding shares of common stock and preferred stock at a ratio of twenty-five-to-one (the "Reverse Split"). The Certificate of Amendment provided that each twenty-five (25) outstanding shares of the Corporation's common stock, par value \$0.001 per share, was exchanged and combined, automatically, without further action, into one (1) share of common stock, and each twenty-five (25) outstanding shares of the Corporation's preferred stock, par value \$0.001 per share, was exchanged and combined, automatically, without further action, into one (1) share of preferred stock. The Reverse Split was declared effective on March 28, 2011 and has been reflected in this Annual Report on Form 10-K.

## Operations

Neonode Inc, licenses optical touch 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 touch technology into electronic devices that they develop and sell. The cornerstone of our solution is our innovative optical touch, zForce®, which can be applied on any flat surface such as Liquid Crystal Displays (LCD), Electronic Paper Displays (EPD) or as a Mouse Pad, and can be incorporated into all types of devices, enabling touch detection for any type of object (finger, pen, glove or a brush). In addition the zForce touch solution has a minimal total weight and building height, thus enabling greater industrial design flexibility. Since nothing is layered on top of the display, the zForce solution provides 100% optical transparency, which improves image quality, reduces glare, and improves battery life.

Our technology licensing model allows us to focus on the development of solutions for multi-touch enabled screens, and thus we do not have to contend with the financial and logistical burden of manufacturing products, which is handled by our ODM/OEM clients. We license the right to use zForce and software which, together with standard components from partners, creates a complete optical touchscreen solution. The zForce multi-touch product is our latest release and is currently being integrated into products such as mobile phones, e-Readers, household appliances, printers and office equipment, GPS devices, automobile consoles, games and toys and tablet PC’s. Our licensing model provides the added benefit of allowing us to grow revenues without the need of increasing costs at anywhere near the same rate to support the revenue growth.

## Liquidity

Our operations are subject to certain risks and uncertainties frequently encountered by companies in the early stages of operations. Such risks and uncertainties include, but are not limited to, technical and quality problems in new products, ability to raise additional funds, credit risks and costs for developing new products. Our ability to generate revenues in the future will depend substantially on our ability to enter into contracts with customers and to raise additional funds through debt or equity financings. During 2011, we raised approximately \$15.5 million through debt and equity offerings (see Notes 6 and 9). We believe we have sufficient cash to operate for the remainder of 2012, and thereafter expect to receive sufficient cash from customer license agreements currently in place to operate for at least the next twelve months.

## 2. Summary of significant accounting policies

### Principles of Consolidation

The preparation of our consolidated financial statements is in conformity with accounting principles generally accepted in the United States of America (“GAAP”) and include the accounts of Neonode Inc. and its wholly owned Swedish subsidiary Neonode Technologies AB. All intercompany accounts and transactions have been eliminated in consolidation.

### Reclassification

Certain amounts in the 2010 financial statements have been reclassified to conform to the current year presentation.

### Estimates

The preparation of financial statements in conformity with GAAP 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 receivables, recoverability of long-lived assets, the valuation allowance related to our deferred tax assets, the fair value of derivative liabilities, and the fair value of securities such as options and warrants issued for stock-based compensation and in certain financing transactions.

#### Cash and Cash Equivalents

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

## Concentration of Cash Balance Risks

Cash balances are maintained at various banks in the U.S. and Sweden. At times, deposits held with financial institutions in the United States of America may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation ("FDIC"), which provides basic deposit coverage with limits up to \$250,000 per owner. In addition to the basic insurance deposit coverage, the FDIC is providing temporary unlimited coverage for non-interest bearing transaction accounts through December 31, 2012. The Swedish government provides insurance coverage up to 100,000 euro per customer and covers deposits in all types of accounts. As of December 31, 2011, the Company has approximately \$1.2 million in excess of insurance limits.

## Accounts Receivable and Allowance for Doubtful Accounts

Our accounts receivable are stated at net realizable value. Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of the customer when determining or modifying its credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer's account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation, such as in the case of a bankruptcy filing, deterioration in the customer's operating results or financial position or other material events impacting its business, we record a specific allowance to reduce the related receivable to the amount we expect to recover. Should all efforts fail to recover the related receivable, we will write-off the account. We also record an allowance for all customers based on certain other factors including the length of time the receivables are past due and historical collection experience with customers. An allowance for doubtful accounts was not necessary at December 31, 2011 and 2010.

## Debt Issuance Costs

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

## Property and Equipment

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

|                        | Estimated useful lives |
|------------------------|------------------------|
| Computer equipment     | 3 years                |
| Furniture and fixtures | 5 years                |

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

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

## Long-Lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with relevant accounting guidance. If the estimated undiscounted future cash flow related to these assets decreases or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset. At December 31, 2011, we believe there is no impairment of our long-lived assets. There can be no assurance, however, that market conditions will not change or sufficient commercial demand for our products and services will materialize, which could result in impairment of long-lived assets in the future.

#### Foreign Currency Translation and Transaction Gains and Losses

The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona. The translation from Swedish Krona to U.S. Dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for income statement accounts using a weighted average exchange rate during the period. Gains or losses resulting from translation are included as a separate component of accumulated other comprehensive income (loss) in the accompanying consolidated statements of stockholders' equity (deficit) and comprehensive loss. Gains or losses resulting from foreign currency transactions are included in general and administrative expenses in the accompanying consolidated statements of operations and were \$44,000 and \$23,000 during the years ended December 31, 2011 and 2010, respectively. Foreign currency translation gains were \$76,000 and \$33,000 during the years ended December 31, 2011 and 2010, respectively.

#### Liabilities 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 that contain anti-dilution rights. Such embedded derivatives are assessed at inception of the contract and every reporting period, depending on their characteristics, and 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.

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.

#### Concentration of Credit and Business Risks

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

Our accounts receivable as of December 31, 2011 was due from five customers. Our net revenues for the year ended December 31, 2011 was earned from seven customers. Our customers are located in the U.S., Europe and Asia. Customers which accounted for 10% or more of our net revenues during the year ended December 31, 2011 are as follows:

- Amazon accounted for 40%
- Barnes & Noble accounted for 26%
- Sony Corporation accounted for 21%
- KOBO Inc. accounted for 11%

Our accounts receivable as of December 31, 2010 was due from six customers. Our revenues for the year ended December 31, 2010 was earned from seven customers of whom two customers accounted for approximately 84% of our net revenues for the year. Customers which accounted for 10% or more of our net revenues during the year ended December 31, 2010 are as follows:

- Sony Corporation accounted for 46%
- Sony Ericsson Mobile Communications AB accounted for 38%

#### Risk and Uncertainties

Our long-term success is dependent on our obtaining sufficient capital to fund our operations and to develop our products, and on our bringing such products to the worldwide market and obtaining sufficient sales volume to be profitable. To achieve these objectives, we may be required to raise additional capital through public or private financings or other arrangements. If additional capital is needed we 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 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 our consolidated 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 it deems appropriate.

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

#### Revenue Recognition

##### Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue from these services when all of the following conditions are met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our services were performed and risk of loss passed to the customer; (3) we completed all of the necessary terms of the contract; (4) the amount of revenue to which we were entitled was fixed or determinable; and (5) we believed it was probable that we would be able to collect the amount due from the customer. To the extent that one or more of these conditions has not been satisfied, we defer recognition of revenue. Generally, we recognize revenue as the engineering services stipulated under the contract are completed and accepted by our customers.

##### Licensing Revenues:

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

Prior to September 30, 2011, we deferred the technology license fee revenue until such time as the warranty period stipulated in the license agreement expired because we did not have sufficient historical experience in estimating potential warranty costs. From June 2010 to December 31, 2011, we entered into 12 technology license contracts with customers. During that time there were no warranty related costs incurred for any customer products after they have been released to market. During the quarter ended September 30, 2011, the Company performed an analysis and

determined that it had sufficient historical evidence regarding estimated warranty costs and therefore began recognizing technology license fee revenues, net of warranty costs, if any, as the products incorporating the Neonode technology are distributed or licensed by our customers, assuming all other revenue recognition criteria has been met. Our customers report to us the quantities of products distributed by them after the end of the reporting period stipulated in the contract, generally 30 to 45 days after the end of the month or quarter. The effect of this change in accounting estimate was to increase net revenues by \$236,000 during the year ended December 31, 2011, and decrease net loss per share by \$0.01 for the year ended December 31, 2011.

Explicit return rights are not offered to customers. There have been no returns through December 31, 2011.

#### Hardware Products:

We may from time-to-time develop custom hardware products for our customers that incorporate our touchscreen technology. Our policy is to recognize revenue from hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We will estimate expected sales returns and record the amount as a reduction of revenue and cost of hardware and other revenue at the time of shipment. To date, we have not sold any hardware products.

#### Software Products:

We may derive revenues from software licensing sales. We will account for the licensing of software in accordance with accounting guidance and such guidance requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (“VSOE”) of fair value exists for those elements.

For software license arrangements that do not require significant modification or customization of the underlying software, we will recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured.

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

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

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

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

We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted. To date, we have not sold any software products.

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

#### Deferred Revenue

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

#### Advertising

Advertising costs are expensed as incurred. Advertising costs amounted to approximately \$241,000 and \$28,000 for the years ended December 31, 2011 and 2010, respectively.

## Product Research and Development

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

## Stock-Based Compensation Expense

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

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

When determining stock-based compensation expense involving options and warrants, we determine the estimated fair value of options and warrants using the Black-Scholes option pricing model.

#### Accounting for Debt Issued with Detachable Stock Purchase Warrants and Beneficial Conversion Features

We account for debt issued with stock purchase warrants by allocating the proceeds of the debt between the debt and the detachable warrants based on the relative fair values of the debt security without the warrants and the warrants themselves, if the warrants are equity instruments. The relative fair value of the warrants is recorded as a debt discount and amortized to expense over the life of the related debt using the straight-line method, which approximates the effective interest method. At each balance sheet date, we make a determination if these warrant instruments should be classified as liabilities or equity, and reclassify them if the circumstances dictate.

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

#### Income Taxes

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

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of December 31, 2011 and 2010. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such a determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

Effective January 1, 2007, we adopted the relevant accounting guidance related to uncertain tax positions, which provisions include a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions. As a result, we did not recognize a liability for unrecognized tax benefits. As of December 31, 2011 and 2010, 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 years ended December 31, 2011 and 2010. 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 years ended December 31, 2011 and 2010 exclude the potential common stock equivalents, as the effect would be anti-dilutive (see Note 15).

#### Comprehensive Loss

Our comprehensive loss includes foreign currency translation gains and losses. The cumulative amount of translation gains and losses are reflected as a separate component in the consolidated statements of stockholders' equity (deficit) and comprehensive loss.

#### 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 was 6.50 and 7.21 Swedish Krona to one U.S. Dollar for the years ended December 31, 2011 and 2010, respectively. The exchange rate for the consolidated balance sheets was 6.92 and 6.78 Swedish Krona to one U.S. Dollar as of December 31, 2011 and 2010, respectively.

### Fair Value of Financial Instruments

We disclose the estimated fair values for all financial instruments for which it is practicable to estimate fair value. Financial instruments including cash, accounts receivable, payables and 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 (see Note 6).

### New Accounting Pronouncements

In September 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU 2009-13"), Multiple-Deliverable Revenue Arrangements, 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 adopted ASU 2009-13 on January 1, 2011 and determined that the adoption of this guidance did not have a material effect on the 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 adopted ASU 2009-14 on January 1, 2011 and determined that the adoption of this guidance did not have a material effect on the consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-4, Fair Value Measurement ("ASU 2011-04"). ASU 2011-04 amends existing guidance to achieve convergence in measurement and disclosure between U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 is effective for fiscal year 2012. The Company is currently evaluating the impact that ASU 2011-04 will have on its consolidated financial statements.

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

### 3. Prepaid Expenses and Other Current Assets

Prepaid expense and other current assets consist of the following (in thousands):

|                                                 | As of December 31, |       |
|-------------------------------------------------|--------------------|-------|
|                                                 | 2011               | 2010  |
| Prepaid insurance                               | \$46               | \$32  |
| Prepaid rent                                    | 49                 | 11    |
| Receivable from suppliers                       | 1                  | 15    |
| VAT receivable                                  | 110                | 62    |
| Other                                           | 28                 | 41    |
| Total prepaid expenses and other current assets | \$234              | \$161 |

#### 4. Property and Equipment

Property and equipment consist of the following (in thousands):

|                                                          | As of December 31, |      |
|----------------------------------------------------------|--------------------|------|
|                                                          | 2011               | 2010 |
| Computers, software, furniture and fixtures              | \$151              | \$42 |
| Less accumulated depreciation                            | (43)               | (18) |
| Property and equipment, net                              | \$108              | \$24 |
| Depreciation and amortization expense for the year ended | \$26               | \$11 |

#### 5. Accrued Expenses

Accrued expenses consist of the following (in thousands):

|                                                     | As of December 31, |       |
|-----------------------------------------------------|--------------------|-------|
|                                                     | 2011               | 2010  |
| Earned salary, payroll taxes, vacation and benefits | \$560              | \$205 |
| Accrued consulting fees and other                   | 41                 | 438   |
| Total accrued expenses                              | \$601              | \$643 |

#### 6. Convertible Debt

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

|                                         | As of December 31, |         |
|-----------------------------------------|--------------------|---------|
|                                         | 2011               | 2010    |
| Senior Convertible Secured Notes - 2010 | \$-                | \$1,750 |
| Senior Convertible Secured Notes - 2009 | -                  | 937     |
| Senior Convertible Secured Notes - 2007 | -                  | 85      |
| Total convertible debt                  | \$-                | \$2,772 |

##### Senior Convertible Secured Notes- 2007

At December 31, 2011 and December 31, 2010, we had \$0 and \$85,000, respectively, of convertible promissory notes ("Senior Convertible Secured Notes-2007") bearing the greater of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at an original conversion price of \$87.50 per share. The Senior Convertible Secured Notes – 2007 were originally due August 26, 2010. On September 22, 2010, we entered into a debt modification agreement with the two holders of an aggregate of \$126,362 of convertible promissory notes that were due on August 26, 2010. Based on the terms of the modification, this transaction qualified as a debt extinguishment under the relevant accounting guidance. As part of the debt extinguishment, the maturity date of the convertible promissory notes was extended until April 26, 2011. We entered into a debt-for-equity repayment plan whereby we retired the convertible promissory notes in equal installments by issuing our common stock priced at a 15% discount from the average market closing price for the five days ending on the 25th of each month over the eight month period beginning September 26, 2010 ending on April 26, 2011. The holders of the notes had the right to convert the outstanding balance priced at \$2.25 per share if the market value of our common stock was greater than \$2.50 per share for five consecutive days.

During the year ended December 31, 2011, we issued the note holders 31,570 shares of our common stock pursuant to the debt-for-equity repayment plan and retired the remaining note principal balance on April 26, 2011. We recorded \$84,657 of note principal reduction and \$1,054 of interest payment.

## September 2009 Senior Convertible Secured Notes Financing Transaction

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

The embedded conversion feature of the Convertible Notes – 2009 met the definition of a derivative financial instrument and was classified as a liability in accordance with relevant accounting guidance. The note holders had the right to convert the debt into shares of our common stock, and the notes included price protection whereby these notes were protected for as long as the notes remained outstanding against future private placements made at lower share prices, and therefore, the total number of shares of our common stock that the convertible notes could be convertible into was not fixed. The embedded conversion features were revalued on each balance sheet date and marked-to-market with the change recorded to non-cash items related to debt discounts, deferred financing fees and the valuation of conversion features and warrants in the consolidated statements of operations. As a result of the conversions and repayments during the year ended December 31, 2011, the Company reclassified approximately \$4.6 million of the related derivative liabilities to additional paid-in capital. As of December 31, 2011, the fair value of the remaining embedded conversion features was \$0 due to the repayment or conversion of all the Convertible Notes - 2009. The Company recorded a loss of \$2.3 million due to the change in the fair value of the embedded conversion features of these Convertible Notes – 2009 during the year ended December 31, 2011.

During the years ended December 31, 2011 and 2010, we recorded a total of \$15,000 and \$62,000, respectively, in interest expense related to the principal balance of the Convertible Notes – 2009.

## Senior Convertible Secured Notes- 2010

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

convertible debt or the warrants. During the year ended December 31, 2011, we issued 3,557,171 shares of our common stock to holders of Convertible Notes – 2010 who converted principal of \$1,750,143 and \$28,442 of related accrued interest. As of December 31, 2011, all of the Convertible Notes – 2010 have been converted to shares of our common stock.

The embedded conversion feature of the Convertible Notes – 2010 met the definition of a derivative financial instrument and was classified as a liability in accordance with accounting guidance. The note holders had the right to convert the debt into shares of our common stock, and the notes include price protection whereby these notes were protected for as long as the notes remained outstanding against future private placements made at lower share prices, and therefore, the total number of shares of our common stock that the convertible notes could be convertible into was not fixed. The embedded conversion features was 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 in the consolidated statements of operations. As a result of the conversions during the year ended December 31, 2011, the Company reclassified approximately \$8.7 million of the related derivative liabilities to additional paid-in capital. As of December 31, 2011, the fair value of the remaining embedded conversion features is \$0 as all the Convertible Notes – 2010 were converted. The Company recorded a loss of approximately \$4.4 million due to the change in the fair value of the embedded conversion feature of these Convertible Notes – 2010 during the year ended December 31, 2011.

During the year ended December 31, 2011 and 2010, we recorded a total of approximately \$28,000 and \$109,000, respectively, in interest expense related to the principal balance of the Convertible Notes – 2010.

## Warrant Repricing and Debt Extension Financing Transaction - 2010

During September and October 2010, all of the holders of the convertible notes and the holders of the stock purchase warrants issued in the 2009 and 2010 Senior Secured Convertible Debt Financing Transactions agreed to extend the maturity date of their convertible debt from December 31, 2010 to June 30, 2011 under the same terms and conditions as the original notes. Holders of 2,766,857 stock purchase warrants also agreed to exercise their previously granted three-year warrants with an exercise price of \$1.00 for a discounted exercise price of \$0.88 per share. They received 2,766,857 shares of our common stock and 2,766,857 replacement three-year warrants with an exercise price of \$1.38 for each warrant exercised. We raised a total of \$2.4 million by these warrant exercises. In accordance with relevant accounting guidance, we noted that the transaction qualified for debt extinguishment accounting. As a result, the remaining debt discounts were written off and charged to interest expense and fair value of the replacement warrants were recorded to loss on extinguishment of debt, which was deemed to be the date that the convertible debt holder signed the modification agreement. As the Company did not have sufficient unissued authorized shares to cover all dilutive instruments until the increase in authorized shares on December 13, 2010, these replacement warrants were initially recorded as derivative liabilities at their grant date fair value. On December 13, 2010, the Company increased its authorized shares and then had sufficient authorized shares to cover all dilutive instruments and as such the replacement warrants were re-valued on that date (totaling \$4,335,785) and the Company reclassified the replacement warrants to additional paid-in-capital in accordance with relevant accounting guidance.

## Senior Convertible Secured Notes- 2011

During March and April 2011, we received approximately \$4.2 million in cash proceeds related to a private placement of convertible notes ("Senior Convertible Secured Notes – 2011"), bearing interest at a rate of seven percent (7%) per annum, that was scheduled to mature on March 1, 2014 and that were convertible at the holder's option into 1,691,320 shares of our common stock at a conversion price of \$2.50 per share. The notes were automatically convertible into shares of the Company's common stock in the event that on or before the note due date either (a) the Company's common stock was traded at a price per share of \$6.25 or higher for five (5) consecutive trading days, or (b) the Company consummated a financing in the amount of at least \$5 million. The accrued interest was payable in stock, using the \$2.50 conversion price, or cash, at the holder's option, on June 30 and December 31 of each year.

In connection with the March and April 2011 financing transactions the Company valued the warrants issued to the convertible note holders on a relative fair value basis using the Black-Scholes option pricing model, totaling \$937,000. This relative fair value of the warrants was recorded as a debt discount. The embedded conversion features to the notes has been determined to meet the definition of a derivative liability and as of the date of issuance was valued at \$4.8 million. In accordance with relevant accounting guidance, the Company recorded an additional debt discount up to the full amount of the notes, recorded the derivative liability for the embedded conversion feature at \$4.8 million and recorded the fair value in excess of face amount of debt as interest expense on the issuance date of \$1.5 million. The debt discount was amortized in full upon the conversion of the notes to common stock on December 14, 2011. As of December 31, 2011, the fair value of the embedded conversion feature was \$0 due to the conversion of all the Senior Convertible Secure Notes – 2011. The Company recorded a loss of \$1.9 million due to the change in fair value of the embedded conversion feature for the year ended December 31, 2011 which is included in the accompanying consolidated statement of operations as a component of the non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants.

During the year ended December 31, 2011, the Company issued 27,851 shares of unregistered common stock to note holders of the Senior Convertible Secured Notes – 2011 private placement financing transaction in lieu of cash for their \$69,628 accrued interest payment that was due June 30, 2011. In addition, the Company paid \$10,277 of the accrued interest in cash to note holders who declined to convert their interest payment to stock.

During the year ended December 31 2011, the Company issued 422,830 new five-year common stock purchase warrants to the investors, with an exercise price of \$3.13 per share (the “March 2011 Warrants”), with each investor receiving a number of March 2011 Warrants that is equal to twenty-five percent (25%) of the investor’s note to the Company. The March 2011 Warrants may be exercised by cash payment or through cashless exercise by the surrender of warrant shares having a value equal to the exercise price of the portion of the warrants being exercised.

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

On December 13, 2011, following a public offering pursuant to a Registration Statement on Form S-3, the Company received gross proceeds in excess of \$5 million. Pursuant to the terms, as defined, in the Senior Convertible Secure Notes – 2011 agreements, the remaining outstanding principal balance immediately following such date, plus accrued interest, was automatically convertible into shares of common stock at a conversion price of \$2.50 per share. In accordance with the terms of the agreement, the Company automatically converted approximately \$3.7 million of remaining principal and approximately \$130,000 of accrued interest into 1,513,237 shares of the Company’s common stock. In addition, the Company issued 99,461 shares of common stock related to the bonus interest feature associated with the mandatory conversion of the debt. The fair value of the shares issued were computed based on the stock price of the Company’s common stock on December 14, 2011 and were valued at \$397,845 and recorded as additional interest expense in non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants in the consolidated statement of operations. As a result of the conversions and repayments of the Senior Convertible Secure Notes - 2011 during the year ended December 31, 2011, the Company reclassified approximately \$6.7 million of derivative liabilities to additional paid-in capital. The Company recorded a loss of \$1.9 million for the year ended December 31, 2011 due to the change in fair value of the embedded conversion features. As of December 31, 2011, the fair value of the embedded conversion features was \$0. As of December 31, 2011, all of the Senior Convertible Secure Notes - 2011 plus accrued interest was paid or converted into shares of common stock.

During the year ended December 31, 2011 we recorded a total of approximately \$232,000, in interest expense related to the principal balance of the Senior Convertible Secured Notes – 2011.

## 7. Fair Value Measurements

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 Company estimated the fair value of these warrants and embedded conversion features using the Black-Scholes option pricing model using the following assumptions:

|                          |                                               |
|--------------------------|-----------------------------------------------|
|                          | For the year<br>ended<br>December 31,<br>2010 |
| Annual<br>dividend yield | -<br>0.50 – 4.8                               |

|                                            |               |
|--------------------------------------------|---------------|
| Expected life<br>(years)                   |               |
| Risk-free<br>interest rate                 | 0.18% - 1.90% |
| Expected<br>volatility                     | 117% - 221%   |
| For the year<br>ended December<br>31, 2011 |               |
| Annual dividend<br>yield                   | -             |
| Expected life<br>(years)                   | 0.08 – 3.0    |
| Risk-free interest<br>rate                 | 0.08% - 1.27% |
| Expected<br>volatility                     | 110% - 263%   |

The following table shows the classification of our liabilities that were subject to fair value measurements and the roll-forward of these liabilities for the years ended December 31, 2011 and 2010 (in thousands):

Fair Value of Embedded Conversion Features and Warrants

|                                                                                           |    |          |
|-------------------------------------------------------------------------------------------|----|----------|
| January 1, 2010                                                                           | \$ | 4,507    |
| Ne Derivatives added in connection with issuance of debt<br>and equity                    |    | 5,236    |
| Derivatives reclassified to equity in connection with repayment<br>and conversion of debt |    | (19,286) |
| Net increase in fair value                                                                |    | 16,261   |
| December 31, 2010                                                                         | \$ | 6,718    |

|                                                                                        |          |
|----------------------------------------------------------------------------------------|----------|
| Ne Derivatives added in connection with issuance of debt and equity                    | 4,762    |
| Derivatives reclassified to equity in connection with repayment and conversion of debt | (20,075) |
| Net increase in fair value                                                             | 8,595    |
| December 31, 2011                                                                      | \$ --    |

#### 8. Deferred Revenue

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

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

#### 9. Stockholders' Equity (Deficit)

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

##### Common Stock

During the year ended December 31, 2011, Series A Preferred stockholders exchanged 82.79 shares of Series A Preferred stock for 39,790 shares of our common stock, and Series B Preferred stockholders exchanged 26.04 shares of Series B Preferred stock for 6,282 shares of our common stock.

During the year ended December 31, 2011, the Company issued a total of 5,408,657 shares of common stock as a result of the conversion of approximately \$2.7 million of the Senior Convertible Secured Notes – 2009 and 2010 private placement financing transactions debt principal and accrued interest.

During the year ended December 31, 2011, the Company received proceeds of approximately \$515,000 from the exercise of 493,426 warrants for shares of common stock.

During the year ended December 31, 2011, we issued the note holders of Senior Convertible Secured Notes- 2007 31,570 shares of our common stock pursuant to the debt-for-equity repayment plan and retired the remaining note principal balance and accrued interest totaling \$86,000 on April 26, 2011.

During the year ended December 31, 2011, the Company issued 60,000 shares of common stock and issued a 3-year warrant to purchase 20,000 shares of common stock at an exercise price of \$2.00 per share in satisfaction of certain accrued expenses totaling \$120,000.

On April 25, 2011, Davisa Ltd (a related party) exercised warrants to purchase 50,000 shares of common stock. The Company recorded an additional \$50,000 as stock based compensation to compensate Davisa Ltd by waiving the \$1.00 exercise price and issued 50,000 shares of our common stock to Davisa Ltd for services provided in connection

with the private placement of convertible notes and warrants in the March 2011 financing transaction.

During the year ended December 31, 2011, the Company issued 27,851 shares of unregistered common stock to note holders of the Senior Convertible Secured Notes – 2011 private placement financing transaction in lieu of cash for their \$69,628 accrued interest payment that was due June 30, 2011 (see Note 6).

During the year ended December 31, 2011, we issued the note holders of Senior Convertible Secured Notes- 2011 a total of 1,844,814 shares of our common stock and retired the note principal balance and accrued interest totaling \$4.6 million. Included in the total shares issued of 1,844,814 is 99,461 shares of common stock issued for bonus interest (as defined) totaling \$399,000.

During the year ended December 31, 2011, we issued 3.0 million shares of our common stock to investors who completed an equity financing transaction that closed on December 13, 2011 in which we raised \$12.0 million and received \$11.2 million in cash, net of direct selling costs but before other direct offering costs of approximately \$0.4 million.

On March 21, 2010, we issued 35,000 shares of our common stock and a warrant to purchase 35,000 shares of our common stock at an exercise price of \$1.00 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 35,000 shares of common stock is \$26,000 based on our common stock closing price on the date of issuance. The \$26,000 fair value of the warrants is included in common stock and additional paid-in capital in the consolidated balance sheets and was originally recorded as debt issuance costs and subsequently amortized to interest expense on the consolidated statement of operations for the year ended December 31, 2010 (See Note 6).

On May 27, 2010, we issued 3,136 shares of our common stock to a holder of two convertible promissory notes who elected to convert and retire the \$1,600 of convertible promissory notes plus accrued interest at the \$0.50 conversion price pursuant to the note agreements (see Note 6).

On September 8, 2010, we issued 16,894 shares of our common stock to the holder of a convertible promissory note that was due on August 26, 2010. We retired the \$12,500 convertible promissory note and \$170 of accrued interest (see Note 6).

On September 13, 2010, we issued 450,263 shares of our common stock in settlement of the Empire lawsuit and we settled all outstanding warrants held by Empire. In addition, our insurance carrier paid a cash settlement to Empire. The value of the shares issued to Empire were \$562,828 (based on the trading price of \$1.25 per share on the date of settlement) and were charged to settlement expense included in general and administrative expenses in the accompanying consolidated statement of operations for the year ended December 31, 2010. The fair value of Empire's warrants was reclassified to additional paid-in-capital at the date of settlement.

On September 22, 2010, we issued 120,111 shares of our common stock to a holder of two convertible promissory notes who elected to convert and retired the \$59,000 of convertible promissory notes plus accrued interest at the \$0.50 conversion price pursuant to the note agreements (see Note 6).

On September 23, 2010, we issued 6,933 shares of our common stock and a warrant to purchase 6,933 shares of our common stock at an exercise price of \$1.00 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 shares of common stock and warrants totaling \$24,000 are recorded as interest expense with an offsetting amount to equity (see Note 6).

On September 25, 2010, we issued 15,000 shares of our common stock and a warrant to purchase 15,000 shares of our common stock at an exercise price of \$1.00 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 shares of common stock and warrants totaling \$52,000 are recorded as interest expense with an offsetting amount to equity (see Note 6).

On September 29, 2010, we issued 11,462 shares of our common stock for the conversion of principal and interest of senior convertible secured notes originally issued in 2007 (see Note 6).

During September 2010, we issued 348,464 shares of our common stock for the exercise of warrants in connection with the 2009 and 2010 convertible debt financings. The warrants were exercised at \$0.88 per share based on the warrant repricing and debt extension agreement (see Note 6).

On October 11, 2010, we issued 48,000 shares of our common stock in settlement of the Berman lawsuit and canceled all outstanding warrants held by Berman. In addition, our insurance carrier paid a cash settlement to Berman and we paid an additional cash settlement to Berman. The value of the shares issued to Berman were valued at \$84,000 (based on the trading price of \$1.75 per share on the date of settlement) and were charged to settlement expense included in general and administrative expenses in the accompanying consolidated statement of operations for the year ended December 31, 2010.

On October 18, 2010, we issued 1,235,636 shares of our common stock for the exercise of warrants in connection with the 2009 and 2010 convertible debt financings. The warrants were exercised at \$0.88 per share based on the warrant repricing and debt extension agreement (see Note 6).

On October 27, 2010, we issued 12,966 shares of our common stock for the conversion of principal and interest of senior convertible secured notes originally issued in 2007 (see Note 6).

On November 4, 2010, we issued 792,086 shares of our common stock for the exercise of warrants in connection with the 2009 and 2010 convertible debt financings. The warrants were exercised at \$0.88 per share based on the warrant repricing and debt extension agreement (see Note 6).

On November 19, 2010, we issued 390,672 shares of our common stock for the exercise of warrants in connection with the 2009 and 2010 convertible debt financings. The warrants were exercised at \$0.88 per share based on the warrant repricing and debt extension agreement (see Note 6).

On December 13, 2010, we increased the number of our authorized shares of common stock from 698,000,000 to 848,000,000.

On December 13, 2010, we issued 9,866 shares of our common stock for the conversion of principal and interest of senior convertible secured notes originally issued in 2007 (see Note 6).

On December 29, 2010, we issued 12,002 shares of our common stock for the conversion of principal and interest of senior convertible secured notes originally issued in 2007 (see Note 6).

#### Preferred Stock

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

- Dividends and Distributions.

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

them.

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

· Liquidation Preference.

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

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

· Voting

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

· Conversion

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

Conversion of Preferred Stock Issued to Common Stock

On April 24, 2009, we initiated the process of allowing the shareholders of our preferred stock to convert the Series A and B Preferred stock to shares of our common stock. In order to convert the preferred stock to common stock each 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 December 31, 2011.

|                               | Shares of<br>Preferred<br>Stock Not<br>Exchanged as<br>of December<br>31, 2011 | Conversion<br>Ratio | Shares of<br>Common<br>Stock after<br>Conversion of<br>all Outstanding<br>Shares of<br>Preferred<br>Stock Not yet<br>Exchanged at<br>December 31,<br>2011 |
|-------------------------------|--------------------------------------------------------------------------------|---------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------|
| Series A Preferred stock      | 83                                                                             | 480.63              | 39,892                                                                                                                                                    |
| Series B Preferred stock      | 114                                                                            | 132.07              | 15,056                                                                                                                                                    |
| Total remaining not exchanged | 197                                                                            |                     | 54,948                                                                                                                                                    |

#### 10. 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.

##### Amortization of Fair Value of Stock Issued to Related Parties for Purchase of Neonode Technologies AB

On December 29, 2008, we entered into a Share Exchange Agreement with Neonode Technologies AB and the stockholders of Neonode Technologies AB: Iwo Jima SARL, Wirelesstoy AB, and Athemis Ltd (the “Neonode Technologies AB Stockholders”), pursuant to which we agreed to acquire all of the issued and outstanding shares of Neonode Technologies AB in exchange for the issuance of 19,800 shares of the Company’s Series A Preferred stock. Pursuant to the terms of the Share Exchange Agreement, upon the closing of the transaction, Neonode Technologies AB became a wholly owned subsidiary of the Company. The Neonode Technologies AB Stockholders are or were employees of us and/or Neonode AB, and as such are related parties.

The fair value of the conversion feature of the 19,800 shares of Series A Preferred shares issued to the related parties to acquire Neonode Technologies AB that was converted to a total of 9,516,447 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 was 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 has been amortized to compensation expense at the rate of \$1.6 million per quarter for six quarters beginning January 1, 2009. The amortization of the \$9.5 million in compensation expense related the value of the stock issued to the related parties to acquire Neonode Technologies AB was completed on June 30, 2010. For the year ended December 31, 2010 \$3.2 million has been recorded as compensation expense in our consolidated statements of operations.

##### Stock Options

As of December 31, 2011, 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”), from which we will not grant any additional equity awards; and
- The 2006 Equity Incentive Plan (the “2006 Plan”).

We also have one non-employee director stock option plan as of December 31, 2011:

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

The following table details the outstanding options to purchase shares of our common stock pursuant to each plan at December 31, 2011:

| Plan          | Options Outstanding |
|---------------|---------------------|
| 1996 Plan     | 800                 |
| 1998 Plan     | 1,120               |
| Neonode Plan  | 7,064               |
| 2006 Plan     | 9,000               |
| Director Plan | 1,340               |
| <b>Total</b>  | <b>19,324</b>       |

The following table summarizes information with respect to all options to purchase shares of common stock outstanding under the 1996 Plan, the 1998 Plan, the 2006 Plan, the Neonode Plan and the Director Plan at December 31, 2011:

| Range of Exercise Price | Options Outstanding<br>Number Outstanding at 12/31/11 | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Options Exercisable<br>Number Exercisable at 12/31/11 | Weighted Average Exercise Price |
|-------------------------|-------------------------------------------------------|-----------------------------------------------------|---------------------------------|-------------------------------------------------------|---------------------------------|
| 0.00 - \$               |                                                       |                                                     |                                 |                                                       |                                 |
| \$35.39                 | 7,064                                                 | 0.05                                                | \$ 35.39                        | 7,064                                                 | \$ 35.39                        |
| 35.40 - \$              |                                                       |                                                     |                                 |                                                       |                                 |
| \$58.25                 | 780                                                   | 1.95                                                | \$ 58.25                        | 780                                                   | \$ 58.25                        |
| 58.26 - \$              |                                                       |                                                     |                                 |                                                       |                                 |
| \$86.25                 | 3,200                                                 | 3.01                                                | \$ 86.25                        | 3,200                                                 | \$ 86.25                        |
| 86.26 - \$              |                                                       |                                                     |                                 |                                                       |                                 |
| \$100.00                | 80                                                    | 0.25                                                | \$ 100.00                       | 80                                                    | \$ 100.00                       |
| 100.01 - \$             |                                                       |                                                     |                                 |                                                       |                                 |
| \$125.00                | 7,400                                                 | 2.57                                                | \$ 122.75                       | 7,400                                                 | \$ 122.75                       |
| 125.01 - \$             |                                                       |                                                     |                                 |                                                       |                                 |
| \$368.75                | 800                                                   | 0.25                                                | \$ 368.75                       | 800                                                   | \$ 368.75                       |
|                         | 19,324                                                | 1.59                                                | \$ 92.19                        | 19,324                                                | \$ 92.19                        |

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

|                                                               | Weighted<br>Average<br>Number of<br>Shares | Exercise Price<br>Per Share | Weighted-Average<br>Exercise Price |
|---------------------------------------------------------------|--------------------------------------------|-----------------------------|------------------------------------|
| Outstanding at January 1, 2010                                | 19,884                                     | \$35.39 – 687.50            | \$ 103.63                          |
| Granted                                                       | --                                         | \$--                        | \$ --                              |
| Cancelled or expired                                          | (80 )                                      | \$348.75                    | \$ 348.75                          |
| Exercised                                                     | --                                         | \$--                        | \$ --                              |
| Outstanding at December 31, 2010                              | 19,804                                     | \$35.39 – 687.50            | \$ 101.36                          |
| Granted                                                       | --                                         | \$--                        | \$ --                              |
|                                                               |                                            | 135.00-                     |                                    |
| Cancelled or expired                                          | (480 )                                     | \$687.50                    | \$ 523.23                          |
| Exercised                                                     | --                                         | \$--                        | \$ --                              |
| Outstanding, vested and expected to vest at December 31, 2011 | 19,324                                     | \$35.39 – 368.75            | \$ 92.19                           |

The aggregate intrinsic value of the 19,324 stock options that are outstanding, vested and expected to vest at December 31, 2011 is \$0.

During the years ended December 31, 2011 and December 31, 2010, the Company recorded \$87,000 and \$142,000, respectively, of compensation expense related to the vesting of stock options granted in 2007. The fair value of the stock-based compensation was calculated using the Black-Scholes option pricing model as of the grant date of the stock option.

The 1996 Plan terminated effective January 17, 2006, and the 1998 Plan terminated effective June 15, 2008. 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). The options issued under the plan to the Non-Swedish Participant are five year options. We will not grant any additional equity awards out of the Neonode Plan.

On January 30, 2012, the Board of Directors of Neonode Inc. adopted an amendment to the 2006 Plan to increase the number of shares of common stock authorized by issuance under the 2006 Plan by an additional two million (2,000,000) shares.

We did not grant any options to purchase shares of our common stock to employees or members of our Board of Directors during the year ended December 31, 2011.

#### Warrants

We issued 80,000 five-year stock purchase warrants at an exercise price of \$2.50 per share to our legal advisor during the year ended December 31, 2011. We also issued 20,000 three-year stock purchase warrants at an exercise price of \$2.00 per share to one of our U.S. based employees during the year ended December 31, 2011. In addition, we issued 20,000 three-year stock purchase warrants at an exercise price of \$4.05 per share to an engineering consultant during the year ended December 31, 2011. These warrants to purchase an aggregate of 120,000 shares of our common stock vested on the date of grant. The vested warrant granted to our legal advisor has a fair value on the date of grant of \$193,000 and is included in general and administrative expense for the year ended December 31, 2011. The vested warrant granted to our employee has a fair value on the date of grant of \$37,000 and is included in product research and development expense for the year ended December 31, 2011. The vested warrant granted to our engineering consultant has a fair value on the date of grant of \$73,000 and is included in product research and development expense for the year ended December 31, 2011.

We issued 20,000 three-year stock purchase warrants at an exercise price of \$3.90 per share with a vesting period over 24 months to an employee during the year ended December 31, 2011. The unvested warrant granted to an employee has a fair value on the date of grant of \$75,000. This amount will be expensed over the vesting period and \$11,000 of expense related to this warrant is included in product research and development expense for the year ended December 31, 2011. The fair value of stock-based compensation related to the issuance of warrants is calculated using the Black-Scholes option pricing model as of the grant date of the underlying warrant.

The stock-based compensation expense for the year ended December 31, 2011 reflects the fair value of the vested portion of options and warrants granted to employees. Stock-based compensation expense for the year ended December 31, 2010 also includes \$3.2 million of amortization of the value of stock issued to related parties for the purchase of Neonode Technologies AB. Stock-based compensation expense in the accompanying consolidated statements of operations is as follows (in thousands):

|                          | Year ended<br>December 31,<br>2010 | Year ended<br>December 31,<br>2011 | Remaining unamortized<br>expense at<br>December 31, 2011 |
|--------------------------|------------------------------------|------------------------------------|----------------------------------------------------------|
| Stock-based compensation | \$ 5,430                           | \$ 550                             | \$ 155                                                   |

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

See Note 7 for assumptions used to value warrants and embedded conversion features during the years ended December 31, 2011 and 2010.

A summary of all warrant activity is set forth below:

|                                                |             | December 31, 2011                     |                                                      |
|------------------------------------------------|-------------|---------------------------------------|------------------------------------------------------|
|                                                | Warrants    | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual Life |
| Outstanding and exercisable                    |             |                                       |                                                      |
| January 1, 2010                                | 7,751,795   | \$ 0.57                               | 3.56                                                 |
| Issued                                         | 6,240,500   | \$ 1.27                               | -                                                    |
| Expired/forfeited                              | -           | -                                     | -                                                    |
| Exercised                                      | (8,852,806) | \$ 0.62                               | -                                                    |
| December 31, 2010                              | 5,139,489   | \$ 1.27                               | 3.23                                                 |
| Issued                                         | 809,543     | \$ 3.08                               | 4.06                                                 |
| Expired/forfeited                              | --          | --                                    | --                                                   |
| Exercised                                      | (543,426)   | \$ 1.04                               | 2.74                                                 |
| Outstanding and exercisable, December 31, 2011 | 5,405,606   | \$ 1.57                               | 2.45                                                 |

During the year ended December 31, 2010, we issued additional convertible debt with warrants and also warrants to a broker. Prior to December 13, 2010, we did not have sufficient unissued authorized shares to settle all outstanding equity instruments, the warrants were classified as liabilities (see Notes 6 and 7).

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. The warrants issued to the holders in this financing were originally recorded as derivative liabilities as we did not have sufficient authorized unissued shares of common stock to settle all outstanding equity instruments. On December 13, 2010, the Company increased its authorized shares of common stock to cover all potentially dilutive instruments outstanding. As a result, on December 9, 2010, the Company reclassified the fair value of the warrants on that date, totaling \$4.3 million to additional paid in capital, as warrants no longer qualified as derivative instruments.

On September 22, 2010, we issued 5-year warrants to purchase 6,400 of our common stock an exercise price of \$1.00 per share to holders of our Senior Convertible Secured Notes – 2007 to extend the maturity date of the notes until April 26, 2011. The fair value of the warrants to purchase 6,400 shares of common stock was \$28,000 on the date of issuance and was recorded as expense component of the loss on extinguishment of debt in the accompanying consolidated statement of operations for the year ended December 31, 2010. 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 4.98 years, volatility of 162.45%, and a risk-free interest rate of 1.95%.

On September 24, 2010, we issued a warrant to purchase 6,933 of our common stock an exercise price of \$1.00 per share to an investor for services provided for the private placement of convertible notes and warrants in the 2010 financing transaction (see Note 6).

On September 27, 2010, we issued a warrant to purchase 15,000 of our common stock an exercise price of \$1.00 per share to an investor for services provided for the private placement of convertible notes and warrants in the 2010 financing transaction (see Note 6).

We granted 440,000 stock purchase warrants to our U.S. based employees or members of our Board during the year ended December 31, 2010. The stock purchase warrants have an exercise price equal to \$1.38 to \$1.63 per shares, which was the market price on the date of grant, October 15, 2010 and December 3, 2010. These stock purchase warrants have a three to five-year term. Warrants to purchase 320,000 shares of our common stock are vested on the date of grant and a warrant to purchase 120,000 shares of our common stock vests over 24 months at the rate of 5,000 shares per month, beginning December 2010. The vested warrants granted to employees had a fair value on the date of grant of \$660,000. Approximately \$470,000 and \$99,000 of the fair value is included in general and administrative expense for the years ended December 31, 2010 and 2011, respectively, and the remaining \$90,750 will be amortized to expense on a straight-line monthly basis over the period ending December 31, 2012. The fair value of stock-based compensation related to the employee warrants is calculated using the Black-Scholes option pricing model as of the grant date of the underlying warrant.

We sold 1,200,000 stock purchase warrants to our Swedish based employees or members of our Board during the year ended December 31, 2010 for approximately \$49,000. The stock purchase warrants have an exercise price equal to \$1.38 per shares, which was the market price on the date of grant, October 15, 2010. These stock purchase warrants have a three-year term and were vested on the date of the sale. The stock underlying the stock purchase warrants granted to employees or members of our Board has not been registered for resale. The vested warrants granted to employees had a fair value on the date of grant of \$1.7 million and is included in general and administrative expense for the year ended December 31, 2010. The fair value of stock-based compensation related to the employee warrants is calculated using the Black-Scholes option pricing model as of the grant date of the underlying warrant.



During September and October 2010, we entered into two different types of amendments with the holders of the convertible notes and stock purchase warrants issued in the Fall of 2009 and Spring of 2010 financing transactions. All of the holders of the convertible notes entered into an amendment pursuant to which the due date of the convertible notes was extended until June 30, 2011. A majority of the holders of the stock purchase warrants entered into an amendment pursuant to which they exercised their previously granted warrants at a discounted exercise price of \$0.88 per share and was granted a replacement three-year warrant for each original warrant exercised. A total of 2,766,857 of the original warrants were exercised at the discounted exercise price of \$0.88 per share and a total of \$2,384,554 was raised by the Company through these exercises of the original warrants. We issued a total of 2,766,857 shares of common stock and replacement warrants to the exercising warrant holders with an exercise price of \$1.38 per share.

In the year ended December 31, 2011, the Company issued 422,830 new five-year common stock purchase warrants, with an exercise price of \$3.13 per share (see Note 6).

In March 2011, the Company entered into a warrant agreement with investors who participated in the Company's 2009 and 2010 financing transactions and who had been issued common stock purchase warrants with exercise prices of \$0.50 per share, \$1.00 per share, and \$1.38 per share (the "2009 and 2010 Warrants"). Pursuant to the warrant agreement, each warrant holder who exercised some or all of its outstanding 2009 and 2010 Warrants at the applicable exercise price (\$0.50 per share, \$1.00 per share, and/or \$1.38 per share), received a number of March 2011 Warrants equal to fifty percent (50%) of the number of 2009 and 2010 Warrants exercised by such warrant holder. The warrant holders exercised an aggregate of 493,426 outstanding 2009 and 2010 Warrants, for an aggregate investment of \$515,000 and received 493,426 shares of common stock and 246,713 new five-year common stock purchase warrants, with an exercise price of \$3.13 per share. The March 2011 Warrants may be exercised by cash payment or through cashless exercise by the surrender of warrant shares having a value equal to the exercise price of the portion of the warrants being exercised.

On April 25, 2011, Davisa Ltd. (a related party) exercised warrants to purchase 50,000 shares of common stock. During the year ended December 31, 2011, the Company recorded an additional \$50,000 as stock based compensation to compensate Davisa Ltd. by waiving the \$1.00 exercise price, and issued 50,000 shares of our common stock to Davisa Ltd. for services provided for the private placement of convertible notes and warrants in the March 2011 financing transaction.

The fair value of stock-based awards 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 and warrants. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of our stock price. These factors could change in the future, which would affect fair values of stock options granted in such future periods, and could cause volatility in the total amount of the stock-based compensation expense reported in future periods.

Below is a summary of Outstanding Warrants to Purchase  
Common Stock as of December 31, 2011:

| Description | Issue Date | Exercise Price | Shares | Expiration Date |
|-------------|------------|----------------|--------|-----------------|
|-------------|------------|----------------|--------|-----------------|

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|                                     |            |    |       |           |            |
|-------------------------------------|------------|----|-------|-----------|------------|
| September 2007 Investor Warrant     | 9/26/2007  | \$ | 31.75 | 233       | 9/26/2012  |
| August 2009 Employee Warrants       | 8/25/2009  | \$ | 0.50  | 440,000   | 8/25/2016  |
| January 2010 Investor Warrant       | 1/28/2010  | \$ | 1.00  | 40,000    | 1/28/2013  |
| 2007 Debt Extension Warrants        | 9/22/2010  | \$ | 1.00  | 16,000    | 9/22/2015  |
| September 2010 Repricing Warrant    | 9/28/2010  | \$ | 1.38  | 25,000    | 9/28/2013  |
| October 2010 Repricing Warrants     | 10/18/2010 | \$ | 1.38  | 2,434,830 | 10/18/2013 |
| October 2010 Employee Warrants      | 10/15/2010 | \$ | 1.38  | 1,440,000 | 10/15/2013 |
| December 2010 Employee Warrants     | 12/3/2010  | \$ | 1.63  | 200,000   | 12/3/2015  |
| January 2011 Employee Warrant       | 1/21/2011  | \$ | 2.00  | 20,000    | 1/21/2014  |
| February 2011 Legal Advisor Warrant | 2/22/2011  | \$ | 2.50  | 80,000    | 2/22/2016  |
| March 2011 Investor Warrants        | 3/9/2011   | \$ | 3.13  | 620,443   | 3/9/2016   |
| March 2011 Investor Warrants        | 4/7/2011   | \$ | 3.13  | 49,100    | 4/7/2016   |
| May 2011 Consultant Warrant         | 5/17/2011  | \$ | 4.05  | 20,000    | 5/17/2014  |
| September 2011 Employee Warrant     | 9/12/2011  | \$ | 3.90  | 20,000    | 9/12/2014  |
| Total Warrants Outstanding          |            |    |       | 5,405,606 |            |

## 11. 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 December 31, 2011 and 2010, 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 indemnification provisions as of December 31, 2011 and 2010, respectively.

### Operating Leases

Neonode Technologies AB has a lease with Vasakronan Fastigheter AB for 2,207 square feet of office space located at Linnegatan 89, Stockholm, Sweden for approximately \$6,000 per month including property tax (excluding VAT). The annual payment for this space equates to approximately \$66,000 per year including property tax (excluding VAT). This lease has a notice period of 3 months.

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

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

On March 22, 2012, we entered into a 39 month lease with 2350 Mission Investors LLC for approximately 3,185 square feet of office space located at 2350 Mission College Blvd, Suite 190, Santa Clara, CA 95054 USA. The initial lease payment is approximately \$7,000 per month, increasing to approximately \$7,700 per month over the term of the lease. The annual payment for this space equates to approximately \$84,000 per year including property.

A summary of future minimum payments under operating lease commitments as of December 31, 2011 is as follows (in thousands):

| Year ending December 31, | Total  |
|--------------------------|--------|
| 2012                     | \$ 267 |
| 2013                     | 223    |
| 2014                     | 181    |
| 2015                     | 60     |
|                          | \$ 731 |

## 12. Segment Information

The Company has one reportable segment, which is comprised of the touchscreen technology licensing business. All of our sales for the years ended December 31, 2011 and 2010 were to customers located in the U.S., Europe and Asia.

The following table presents net revenues by geographic region for the years ended December 31, 2011 and 2010 (dollars in thousands):

|                                       | 2011     |            | 2010   |            |
|---------------------------------------|----------|------------|--------|------------|
|                                       | Amount   | Percentage | Amount | Percentage |
| Net revenues made in the U.S.         | \$ 4,792 | 79%        | \$ --  | --%        |
| Net revenues made outside of the U.S. | \$ 1,275 | 21%        | \$ 440 | 100%       |
|                                       | \$ 6,067 | 100%       | \$ 440 | 100%       |

## 13. Income Taxes

Income (loss) before income taxes was distributed geographically as follows (in thousands):

|          | Year Ended<br>December 31,<br>2011 | Year Ended<br>December 31,<br>2010 |
|----------|------------------------------------|------------------------------------|
| Domestic | \$ (16,867)                        | \$ (29,590)                        |
| Foreign  | (200)                              | (1,991)                            |
| Total    | \$ (17,067)                        | \$ (31,581)                        |

The provision for income taxes is as follows for the year ended December 31:

|               | 2011  | 2010  |
|---------------|-------|-------|
| Current       |       |       |
| Federal       | \$ -- | \$ -- |
| State         | 2     | 1     |
| Foreign       | 76    | 44    |
| Total current | \$ 78 | \$ 45 |



The effective income tax rate differs from the statutory federal income tax rate for the following reasons:

|                                                                                                           | Year Ended<br>December 31,<br>2011 |    | Year Ended<br>December 31,<br>2010 |    |
|-----------------------------------------------------------------------------------------------------------|------------------------------------|----|------------------------------------|----|
| Amount at standard tax rates                                                                              | 34                                 | %  | 34                                 | %  |
| Non-deductible loss on revaluation of embedded conversion features and extinguishment of convertible debt | (29                                | )% | (24                                | )% |
| Foreign losses at different rates                                                                         | 2                                  | %  | --                                 |    |
| Stock compensation                                                                                        | --                                 |    | (5                                 | )% |
|                                                                                                           | 7                                  | %  | 5                                  | %  |
| Valuation allowance                                                                                       | (7                                 | )% | (5                                 | )% |
| Effective tax rate                                                                                        | --                                 |    | --                                 |    |

Significant components of the deferred tax balances are as follows (in thousands):

|                               | December 31, |          |
|-------------------------------|--------------|----------|
|                               | 2011         | 2010     |
| Deferred tax assets:          |              |          |
| Accruals                      | \$ 26        | \$ 85    |
| Stock compensation            | 1,080        | 897      |
| Net operating losses          | 4,116        | 2,455    |
| Total deferred tax assets     | \$ 5,222     | \$ 3,437 |
| Valuation allowance           | (5,222)      | (3,437)  |
| Total net deferred tax assets | \$ --        | \$ --    |

Valuation allowances are recorded to offset certain deferred tax assets due to management's uncertainty of realizing the benefits of these items. Management applies a full valuation allowance for the accumulated losses of Neonode Inc, and its subsidiary Neonode Technologies AB, since it is not determinable using the "more likely than not" criteria that there will be any future benefit of our deferred tax assets. This is mainly due to our history of operating losses. Due to the reorganization, the Company believes that the US net operating losses and credits would be subject to the provisions of Section 382 and therefore subject to strict limitations. The Company has not completed a study of the limitations and therefore has not included these loss carryforwards or credits in the analysis of the deferred tax assets. The Company has federal, state and foreign net operating losses of \$2,824,000, \$6,699,000 and \$323,000, respectively. The federal loss carryforward begins to expire in 2029, the California loss carryforward begins to expire in 2029 and the foreign loss carryforward indefinitely. On December 9, 2008, Neonode AB filed for liquidation under the Swedish bankruptcy laws and effective with the filing we are no longer responsible for the liabilities and no longer have any ownership interest in the assets of Neonode AB, including any tax net operating loss carryforwards.

Effective January 1, 2007, we adopted the provisions of accounting guidance which includes a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions accounted for in accordance with accounting guidance. A reconciliation of the unrecognized tax benefits for the year ended December 31, 2011 is as follows:

|                                                              |    |     |
|--------------------------------------------------------------|----|-----|
| Balance at January 1, 2011                                   | \$ | --- |
| Additions for tax positions of prior years                   |    | --- |
| Reductions for tax position of prior years                   |    | --- |
| Additions based on tax positions related to the current year |    | --- |
| Decreases - Settlements                                      |    | --- |
| Reductions - Settlements                                     |    | --- |
| Balance at December 31, 2011                                 | \$ | --- |

It is the Company's policy to classify accrued interest and penalties as part of the accrued tax liability in the provision for income taxes. For the year ended December 31, 2011, we did not recognize any interest or penalties related to unrecognized tax benefits.

Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. As of December 31, 2011, we had no accrued interest and penalties related to uncertain tax matters.

As of December 31, 2011, we had no uncertain tax positions that would be reduced as a result of a lapse of the applicable statute of limitations. We do not anticipate the adjustments would result in a material change to our financial position.

We file income tax returns in the U.S. federal jurisdiction, California and Sweden. The 1997 through 2010 tax years are open and may be subject to potential examination in one or more jurisdictions. We are not currently under any federal, state or foreign income tax examinations.

#### 14. Employee Benefit Plans

We do not have any defined contribution or other pension plans for our employees.

#### 15. Net Loss Per Share

Basic net loss per common share for the years ended December 31, 2011 and 2010 was computed by dividing the net loss for the relevant period by the weighted average number of shares of common stock outstanding. Diluted loss per common share is computed by dividing net loss by the weighted average number of shares of common stock and common stock equivalents outstanding.

Potential common stock equivalents of approximately 5.4 million and 5.1 million outstanding stock warrants, 55,000 and 100,000 shares issuable upon conversion of preferred stock and 0 and 0.2 million shares issuable upon conversion of notes are excluded from the diluted earnings per share calculation for the year ended December 31, 2011 and 2010, respectively, due to their anti-dilutive effect.

| (in thousands, except per share amounts)             | Year ended December 31, |            |
|------------------------------------------------------|-------------------------|------------|
|                                                      | 2011                    | 2010       |
| <b>BASIC AND DILUTED</b>                             |                         |            |
| Weighted average number of common shares outstanding | 26,784                  | 18,293     |
| Net loss                                             | \$(17,145)              | \$(31,626) |
| Net loss per share basic and diluted                 | \$(0.64)                | \$(1.73)   |



## 17. Related Party Transactions

Mr. Per Bystedt, our Chairman and former Chief Executive Officer, invested a total of \$75,000 of the \$4.2 million raised in the Senior Convertible Secure Notes -2011 financing transaction and was issued 7,500 March 2011 Warrants to purchase our common stock at an exercise price of \$3.13 per share. On December 14, 2011, the Company converted the \$75,000 note and \$5,337 of accrued interest, and issued Mr. Bystedt 33,208 shares of our common stock.

On March 31, 2011, Mr. Bystedt and Iwo Jima SARL, a company controlled by Mr. Bystedt, converted \$295,434 of 2009 and 2010 convertible notes that were due on June 30, 2010 plus \$5,086 of accrued interest to 601,041 shares of our common stock.

On June 30, 2011, the Company issued Mr. Bystedt 572 shares of restricted common stock in lieu of a \$1,429 cash interest payment related to the convertible note he purchased in March 2011 (see Note 6).

Employees and relatives of employees of the Company, other than Mr. Bystedt, invested a total of \$218,000 of the \$4.2 million raised in the March and April 2011 private placement financing transaction and received convertible notes that were converted into 87,364 shares of our common stock and we issued a total of 21,841 March 2011 Warrants to purchase our common stock at an exercise price of \$3.13 per share.

Davisa Ltd., a company controlled by Mr. Mats Dahlin who is now a member of the board of directors of the Company and of our wholly owned subsidiary Neonode Technologies AB, participated in the March 2011 warrant exercise agreement and exercised 186,400 warrants with an exercise price of \$0.50 per share for \$93,200. Davisa Ltd. received 186,400 shares of our common stock and 93,200 March 2011 Warrants to purchase our common stock at an exercise price of \$3.13 per share.

On March 9, 2011, Davisa Ltd converted \$215,724 of 2009 and 2010 convertible notes that were due on June 30, 2011 plus \$2,811 of accrued interest to 437,070 shares of our common stock.

On April 25, 2011, Davisa Ltd. exercised warrants to purchase 50,000 shares of common stock. The Company recorded an additional \$50,000 as stock based compensation to compensate Davisa Ltd. by waiving the \$1.00 exercise price, and issued 50,000 shares of our common stock to Davisa Ltd. for services provided for the private placement of convertible notes and warrants in the March 2011 financing transaction.

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

## 18. Subsequent Events

On January 5, 2012, the Company signed a technology license agreement with a global OEM to use the Company's touchscreen technology in a series of GPS devices.

On January 10, 2012, the U.S. Patent and Trademark Office issued to the Company patent number 8,095,879 for sweep gesture user interfaces. The patent covers activating a function in response to a touch-and-glide operation on a touch sensitive surface. This patent complements Neonode's U.S. patents 7,880,732 and 8,068,101 for small to midsize touchscreen devices. The patented technology is marketed and sold as Neonode's offer to OEMs and ODMs.

On January 15, 2012, the Company signed a technology license agreement with a global top 5 printer OEM to use the Company's touchscreen technology in a series of printers. In conjunction with the signing of this technology license agreement, the OEM agreed to pay the Company \$50,000 in non-recurring engineering development fees. We are deferring the engineering development fee revenue until such time as the engineering work has been completed. We expect to complete all services under this contract in 2012.

On January 19, 2012, we signed a technology license agreement with an OEM related to use of our touchscreen technology for a universal color touch display for Tablet PCs. In conjunction with the signing of this technology license agreement, the OEM agreed to pay us \$65,000 in non-recurring engineering development fees. We are deferring the engineering development fee revenue until such time as the engineering work has been completed. We expect to complete all services under this contract in 2012.

On January 30, 2012, the Board of Directors of Neonode Inc. adopted an amendment to the 2006 Plan to increase the number of shares of common stock authorized by issuance under the 2006 Plan by an additional two million (2,000,000) shares.

On February 21, 2012, the Company announced the release of its newly developed Multi-Sensing technology that provides a new way for machines to communicate with the human senses, and enables a far more augmented and profound user experience than traditional touch.

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

On March 9, 2012, Series B Preferred stockholders exchanged 19 shares of Series B Preferred stock for 2,509 shares of our common stock.

On March 12, 2012, we signed a technology license agreement with IDT Technology Limited, a subsidiary of Oregon Scientific for the use of our touchscreen technology in a tablet for children.

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

On March 22, 2012, we entered into a 39 month lease with 2350 Mission Investors LLC for approximately 3,185 square feet of office space located at 2350 Mission College Blvd, Suite 190, Santa Clara, CA 95054 USA. The initial monthly lease payment is approximately \$7,000 per month, increasing to approximately \$7,700 per month over the term of the lease.

ITEM 9.  
CHANGES IN AND  
DISAGREEMENTS  
WITH  
ACCOUNTANTS  
ON ACCOUNTING  
AND FINANCIAL  
DISCLOSURE

None.

ITEM 9A.  
CONTROLS  
AND  
PROCEDURES

Disclosure Controls and Procedures

Under the supervision of and with the participation of our management, including the Company's Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2011. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective.

During the audit of our consolidated financial statements for the year ended December 31, 2011, management determined that we had certain material weaknesses relating to the segregation of duties within our accounting functions and our quarterly and annual financial close processes. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of a Company's annual or interim financial statements will not be prevented or detected on a timely basis. Because these material weaknesses as to internal control over financial reporting also bear upon our disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer were unable to conclude that our disclosure controls and procedures were effective.

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

Internal Control over Financial Reporting

Report of Management on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system has been designed to provide reasonable, not absolute, assurance to our management and Board of Directors that the objectives of our control system with respect to the integrity, reliability and fair presentation of published financial statements are met. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints. Because of the inherent limitations in all control systems, no evaluation of controls can provide

absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, we used the criteria established in the framework on Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission. Based on our assessment, which was conducted according to the COSO criteria, we have concluded that our internal control over financial reporting was not effective in achieving its objectives as of December 31, 2011 due to material weaknesses that existed in our internal controls relating to the segregation of duties within our accounting functions and our quarterly and annual financial close processes.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis. Based on management’s assessment of our internal control over financial reporting as of December 31, 2011, the following material weaknesses existed as of that date:

1. We did not have adequate segregation of duties within our accounting functions, which is a basic internal control. Due to our size and nature, segregation of all conflicting duties may not always be possible and may not be economically feasible. However, to the extent possible, the initiation of transactions, the custody of assets and the recording of transactions should be performed by separate individuals. Management evaluated the impact of our failure to have adequate segregation of duties within our accounting functions and concluded that this control deficiency represented a material weakness.
2. We did not maintain adequate internal controls or employ adequate resources with sufficient technical expertise in the area of accounting for income taxes to ensure the completeness, accuracy, and review of our consolidated income tax provision and disclosures. Management evaluated the impact of our failure to have adequate controls in this area and concluded that this control deficiency represented a material weakness.
3. We did not maintain effective controls over the financial statement disclosures. Specifically, controls were not designed and in place to ensure that disclosures relate to the December 2011 conversion of debt and the related reclassification of derivative liabilities to additional paid-in capital were sufficient. Management evaluated the impact of our failure to have adequate controls in this area and concluded that this control deficiency represented a material weakness.
4. We did not maintain adequate design of our internal controls related to the preparation and review of the consolidated statement of cash flows. Management evaluated the impact of our failure to have adequate controls in this area and concluded that this control deficiency represented a material weakness.
5. We did not maintain adequate internal controls related to the translation of our subsidiary's operations into U.S. Dollars in our financial consolidation worksheets, specifically related to our accumulated other comprehensive income (loss). Management evaluated the impact of our failure to have adequate controls in this area and concluded that this control deficiency represented a material weakness.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal controls over financial reporting. Management's report was not subject to attestation by our Company's independent registered public accounting firm pursuant to the rule of the Securities and Exchange commission that permits us to provide only management's assessment in this annual report.

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

- adding personnel to our accounting department, consultants, or other resources (including those with public company reporting experience) to enhance our policies and procedures, including those related to complex accounting issues;
- exploring the suitability of further upgrades to our accounting system;
- preparing written policies and procedures for accounting and financial reporting to establish a formal process to close our books and account for all transactions; and
- Management will perform an assessment of the effectiveness of our internal control over financial reporting and implement appropriate internal controls on weaknesses determined, if any, documenting, and then testing, the effectiveness of those controls.

ITEM 9B.  
OTHER

INFORMATION

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this Item is incorporated herein by reference from the Company's definitive 2012 Proxy Statement.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this Item is incorporated herein by reference from the Company's definitive 2012 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this Item is incorporated herein by reference from the Company's definitive 2012 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required by this Item is incorporated herein by reference from the Company's definitive 2012 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this Item is incorporated herein by reference from the Company's definitive 2012 Proxy Statement.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

#### Financial Statements

The consolidated financial statements of the registrant are listed in the index to the consolidated financial statements and filed under Item 8 of this report.

#### Financial Statement Schedules

Not Applicable

#### Exhibit Description

| #     |                                                                                                                                                                                                                                                            |
|-------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.1   | Underwriting Agreement with Cowen and Company, LLC, dated as of December 7, 2011 (incorporated by reference to Exhibit 1.1 of our Current Report on Form 8-K filed on December 8, 2011).                                                                   |
| 2.1   | Agreement and Plan of Merger and Reorganization between SBE, Inc. and Neonode Inc., dated January 19, 2007 (incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on January 22, 2007 )                                         |
| 2.2   | Amendment No. 1 to the Agreement and Plan of Merger and Reorganization between SBE, Inc. and Neonode Inc., dated May 18, 2007, effective May 25, 2007 ( incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed on May 29, 2007 ) |
| 3.1   | Amended and Restated Certificate of Incorporation of Neonode Inc., dated April 17, 2009 (incorporated by reference to Exhibit 10.22 of our Quarterly Report on Form 10-Q filed on August 4, 2009).                                                         |
| 3.1.1 | Certificate of Amendment, dated December 13, 2010 (incorporated by reference to Exhibit 3.1.1 of our Annual Report on Form 10-K filed on March 31, 2011) .                                                                                                 |
| 3.1.2 | Certificate of Amendment, dated March 18, 2011 (incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K filed on March 28, 2011).                                                                                                       |
| 3.1.3 | Certificate of Correction, dated February 28, 2012 (filed herewith).                                                                                                                                                                                       |
| 3.2   | Bylaws, as amended through December 5, 2007 (incorporated by reference as Exhibit 3.2 of our Annual Report on Form 10-K filed on April 15, 2008)                                                                                                           |
| 4.1   | Certificate of Designations, Preferences and Rights of the Series A and Series B Preferred Stock dated 29 December 2008 (incorporated by reference as                                                                                                      |

Exhibit 4.1 of our Current Report on Form 8-K filed on December 31, 2008)

4.2 Certificate of Increase of Designation of Series B Preferred Stock dated 2 January 2009 (incorporated by reference as Exhibit 4.2 of our Quarterly Report on Form 10-Q filed on October 31, 2011)

4.3 Certificate of Increase of Designation of Series B Preferred Stock dated 28 January 2009 (incorporated by reference as Exhibit 4.3 of our Quarterly Report on Form 10-Q filed on October 31, 2011)

10.1 Employment Agreement with Thomas Eriksson (incorporated by reference to Exhibit 10.20 to our Annual Report on Form 10-K filed on April 15, 2009) +

10.2 Employment Agreement with David W. Brunton, dated July 1, 2010 (filed herewith).

10.3 Convertible Note Agreement, dated January 18, 2010 (incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on February 23, 2010 )

10.4 Convertible Promissory Note (incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K filed on February 23, 2010 )

10.5 Form of Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.3 of our Current Report on Form 8-K filed on February 23, 2010 )

|         |                                                                                                                                                                            |
|---------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.6    | Form of Amendment Convertible Note Agreement(incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on October 18, 2010 )                       |
| 10.7    | Form of Amendment Convertible Note Agreement(incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K filed on October 18, 2010 )                       |
| 10.8    | Form of Common Stock Purchase Warrant (incorporated by reference to Exhibit 10.3 of our Current Report on Form 8-K filed on October 18, 2010 )                             |
| 10.9    | Consulting Agreement with Per Bystedt, dated January 28, 2011 (incorporated by reference as Exhibit 10.16 of our Annual Report on Form 10-K filed on March 31, 2011) +     |
| 10.10   | Form of Convertible Loan Agreement for the March 2011 Financing (incorporated by reference to Exhibit 10.18 of our Annual Report on Form 10-K filed on March 31, 2011)     |
| 10.11   | Form of Convertible Promissory Note for the March 2011 Financing (incorporated by reference to Exhibit 10.19 of our Annual Report on Form 10-K filed on March 31, 2011)    |
| 10.12   | Form of Common Stock Purchase Warrant for the March 2011 Financing (incorporated by reference to Exhibit 10.20 of our Annual Report on Form 10-K filed on March 31, 2011). |
| 21      | Subsidiaries of the registrant                                                                                                                                             |
| 23.1    | Consent of Independent Registered Public Accounting Firm                                                                                                                   |
| 31.1    | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002                                                                     |
| 31.2    | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act Of 2002                                                                     |
| 32      | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                     |
| 101.INS | XBRL Instance Document                                                                                                                                                     |
| 101.SCH | XBRL Taxonomy Extension Schema Document                                                                                                                                    |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                      |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                       |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document                                                                                                                            |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                     |

+ Management contract or compensatory plan or arrangement

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NEONODE INC.  
(Registrant)

Date: March 30, 2012

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

## POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each of the undersigned officers and directors of the registrant constitutes and appoints, jointly and severally, Thomas Eriksson and David W. Brunton, and each of them, as lawful attorneys-in-fact and agents for the undersigned and for each of them, each with full power of substitution and resubstitution, for and in the name, place and stead of each of the undersigned officers and directors, in any and all capacities, to sign any and all amendments to this report, and to file the same, with all exhibits thereto and all other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing necessary or appropriate to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that each of said attorneys-in-fact or any of them, or any of their substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements for the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacity and dates indicated.

| Name                                     | Title                                                                                                             | Date           |
|------------------------------------------|-------------------------------------------------------------------------------------------------------------------|----------------|
| /s/ Thomas Eriksson<br>Thomas Eriksson   | Chief Executive Officer,<br>and Director<br>(Principal Executive Officer)                                         | March 30, 2012 |
| /s/ David W. Brunton<br>David W. Brunton | Chief Financial Officer, Vice President, Finance<br>and Secretary<br>(Principal Financial and Accounting Officer) | March 30, 2012 |
| /s/ John Reardon<br>John Reardon         | Director                                                                                                          | March 30, 2012 |
| /s/ Mats Dahlin<br>Mats Dahlin           | Director                                                                                                          | March 30, 2012 |
| /s/ Lars Lindqvist                       | Director                                                                                                          | March 30, 2012 |

Lars Lindqvist

/s/ Per Bystedt  
Per Bystedt

Director and Chairman of the Board

March 30, 2012