NEOMEDIA TECHNOLOGIES INC
Form 10-Q
August 09, 2007

U. S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10 - Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2007

OR

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

Commission File Number 0-21743

NEOMEDIA TECHNOLOGIES, INC.
(Exact Name of Issuer as Specified In Its Charter)

Delaware	**36-3680347**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
2201 Second Street, Suite 600, Fort Myers, Florida	**33901**
(Address of Principal Executive Offices)	(Zip Code)

239-337-3434
Issuer's Telephone Number (Including Area Code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes **x** No **o**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer **o** Accelerated Filer **x** Non-accelerated Filer **o**

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

As of August 7, 2007, there were 900,699,016 shares of common stock and 21,377 shares of Series C Convertible Preferred Stock outstanding.

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PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In Thousands, Except Share and Per Share Data)

ASSETS		**June 30, 2007** (unaudited)		**December 31, 2006 ***
Current assets:				
Cash and cash equivalents	$	151	$	2,813
Trade accounts receivable, net of allowance for doubtful accounts of $2 and $68, respectively		265		187
Other receivables		732		550
Inventories, net of allowance for obsolete & slow-moving inventory of $59 and $53 respectively		280		80
Investment in marketable securities		14		57
Prepaid expenses and other current assets		186		102
Assets held for sale		10,820		19,420
Total current assets		12,448		23,209
Leasehold improvements & property and equipment, net		150		191
Goodwill		3,418		3,418
Capitalized patents, net		2,689		2,839
Proprietary software, net		3,770		4,138
Other Intangible assets, net		44		42
Cash surrender value of life insurance policy		925		863
Other long-term assets		3,705		3,425
Total assets	$	27,149	$	38,125
LIABILITIES AND SHAREHOLDERS' DEFICIT				
Current liabilities:				
Accounts payable	$	2,976	$	2,442
Liabilities held for sale		3,446		10,257
Taxes payable		5		5
Accrued expenses		3,404		4,016
Deferred revenues and other		347		575
Notes payable		15		15
Accrued purchase price guarantee		4,684		19,667
Derivative financial instruments		24,112		25,417
Deferred tax liability		587		706
Debentures payable		18,801		7,500
Preferred stock, $0.01 par value, 25,000,000 shares authorized, 22,000 issued, 21,377 shares outstanding, liquidation value of $21,377.		21,377		21,657
Total liabilities		79,754		92,257
Commitments and contingencies (Note 12)				

Shareholders' deficit:				
Common stock, $0.01 par value, 5,000,000,000 shares authorized, 901,823,027 and 639,233,173 shares issued and 900,181,681 and 637,591,747 outstanding, respectively		9,002		6,376
Additional paid-in capital		114,846		101,911
Accumulated deficit		(175,026)		(160,930)
Accumulated other comprehensive loss		(648)		(710)
Treasury stock, at cost, 201,230 shares of common stock		(779)		(779)
Total shareholders' equity		(52,605)		(54,132)
Total liabilities and shareholders' deficit	$	27,149	$	38,125

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

* Amounts have been reclassified from the audited December 31, 2006 consolidated balance sheet to reflect assets and liabilities held for sale in relation to the Company's discontinued operations. (see note 1)

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
and Comprehensive Income (Loss) (Unaudited)
(In Thousands, Except Share and per Share Data)

	Three Months Ended June 30, 2007	2006
Net sales	$ 624	$ 489
Cost of sales	374	407
Gross profit	250	82
Sales and marketing expenses	543	1,512
General and administrative expenses	1,324	1,971
Research and development costs	419	497
Income (loss) from operations	(2,036)	(3,898)
Gain (loss) on extinguishment of debt	253	106
Interest income (expense), net	(957)	(48)
Gain (loss) on derivative financial instruments	1,122	11,026
INCOME (LOSS) FROM CONTINUING OPERATIONS	**(1,618)**	**7,186**
DISCONTINUED OPERATIONS (Note 4)		
Income (loss) from operations of discontinuing operations	(722)	(2,053)
Income (loss) from disposal of 12 Snap	(257)	---
INCOME (LOSS) FROM DISCONTINUED OPERATIONS	(979)	(2,053)
NET INCOME (LOSS)	(2,597)	5,133
Accretion of dividends on convertible preferred stock	(428)	(479)
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDERS	**(3,025)**	**4,654**
Comprehensive Loss:		
Net income (loss)	(2,597)	5,133
Other comprehensive income (loss):		
Unrealized gain/(loss) on marketable securities	(17)	114
Foreign currency translation adjustment	96	(320)
COMPREHENSIVE INCOME (LOSS)	**$ (2,518)**	**$ 4,927**
Income (loss) per share from continuing operations--basic and diluted	**$ (0.00)**	**$ 0.01**
Income (loss) per share from discontinued operations--basic and diluted	**$ (0.00)**	**$ (0.00)**
Net income (loss) per share--basic and diluted	**$ (0.00)**	**$ 0.01**
Weighted average number of common shares--basic	**892,526,955**	**632,402,254**

Weighted average number of common shares---diluted	**892,526,955**	**799,536,925**

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

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NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
and Comprehensive Income (Loss) (Unaudited)
(In Thousands, Except Share and per Share Data)

	Six Months Ended June 30, 2007	2006
Net sales	$ 1,023	$ 687
Cost of sales	687	537
Gross profit	336	150
Sales and marketing expenses	1,402	2,706
General and administrative expenses	3,764	3,329
Research and development costs	925	982
Income (loss) from operations	(5,755)	(6,867)
Gain (loss) on extinguishment of debt	253	(1,858)
Interest income (expense), net	(2,655)	(31)
Gain (loss) on derivative financial instruments	(2,386)	15,794
INCOME (LOSS) FROM CONTINUING OPERATIONS	**(10,543)**	**7,038**
DISCONTINUED OPERATIONS (Note 4)		
Income (loss) from operations of discontinued operations	(3,296)	(3,223)
Income (loss) from disposal of 12 Snap	(257)	---
INCOME (LOSS) FROM DISCONTINUED OPERATIONS	(3,553)	(3,223)
NET INCOME (LOSS)	**(14,096)**	**3,815**
Accretion of dividends on convertible preferred stock	(861)	(616)
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDERS	**(14,957)**	**3,199**
Comprehensive Income (Loss):		
Net income (loss)	(14,096)	3,815
Other comprehensive income (loss):		
Unrealized gain (loss) on marketable securities	(43)	263
Foreign currency translation adjustment	105	(542)
COMPREHENSIVE INCOME (LOSS)	**($14,034)**	**$ 3,536**
Income (loss) per share from continuing operations--basic and diluted	**$ (0.01)**	**$ 0.01**
Income (loss) per share from discontinued operations--basic and diluted	**$ (0.00)**	**$ (0.00)**
Net income (loss) per share--basic and diluted	**$ (0.01)**	**$ 0.01**
Weighted average number of common shares--basic	**789,247,203**	**580,485,463**

Weighted average number of common shares--diluted	**789,247,203**	**757,912,587**

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

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)
(In Thousands)

	Six Months Ended June 30, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Gain (loss) from continuing operations	($10,543)	$ 7,038
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	572	487
(Gain) loss on early extinguishment of debt	(253)	1,858
Change in fair value from revaluation of warrants and embedded conversion features	2,386	(15,794)
Stock-based compensation expense	1,661	1,770
Interest expense related to convertible debt	1,245	—
Increase in value of life insurance policies	(62)	(9)
Changes in operating assets and liabilities		
Trade and other accounts receivable	(110)	(655)
Inventories	(200)	3
Prepaid expenses and other current assets	(84)	(511)
Accounts payable and accrued liabilities	471	(381)
Deferred revenue and other current liabilities	(347)	1,655
Net cash used in operating activities	(5,264)	(4,539)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Cash received from sale of (paid to acquire) CSI International, Inc., Mobot, Inc., Sponge Ltd., Gavitec AG, and 12Snap AG, net of cash acquired	1,100	(13,867)
Acquisition of property and equipment	(15)	(272)
Acquisition of patents and other intangible assets	—	(11)
Advances to discontinued subsidiaries Micro Paint, 12Snap, Telecom Services, Mobot, and Sponge	(2,219)	(2,792)
Acquisition related costs	—	(164)
Payment of purchase price guarantee obligations	(2,484)	—
Amounts received (issued) under notes receivable	450	(500)
Net cash used in investing activities	(3,168)	(17,606)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowing under convertible debt instrument, net of fees of $781 in 2007	6,678	—
Repayments on notes payable and convertible debt instrument	(1,015)	(387)
Net proceeds from issuance of common stock, net of issuance costs of $24 in 2006	—	210
Net proceeds from issuance of Series C convertible preferred stock, net of issuance costs of $2,725 in 2006	—	14,066
Net proceeds from exercise of stock options and warrants	17	8,316
Net cash provided by financing activities	5,680	22,205
EFFECT OF EXCHANGE RATE CHANGES ON CASH FOR CONTINUING OPERATIONS	90	(1,094)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS FROM CONTINUING OPERATIONS		(2,662)		(1,034)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		2,813		1,704
CASH AND CASH EQUIVALENTS, END OF PERIOD	**$**	**151**	**$**	**670**
SUPPLEMENTAL CASH FLOW INFORMATION:				
Interest paid during the period	$	401	$	48
Supplemental disclosure of investing and financing activities:				
Unrealized gain (loss) on marketable securities		(43)		263
Fair value of 258,620,948 shares issued to satisfy purchase price guarantee obligations		12,721		—
Prepaid acquisition costs applied to purchase price		—		168
Fair value of shares and notes receivable from Pickups Plus, Inc. acquired in exchange for Series C Convertible Preferred Stock		—		594
Carrying value of promissory note and accrued interest paid in exchange for Series C Convertible Preferred Stock		—		(3,208)
Fair value of shares issued to acquire CSI International, Inc., Mobot, Inc., Sponge Ltd., Gavitec AG, 12Snap AG, and BSD Software, Inc.		—		46,964
Change in net assets resulting from acquisitions of CSI International, Inc., Mobot, Inc., Sponge Ltd., Gavitec AG, 12Snap AG, and BSD Software, Inc.		—		62,656
Accretion of dividends on Series C Convertible Preferred Stock		433		616
Fair value of outstanding warrants reclassified to liabilities		—		13,884
Portion of change in fair value of outstanding warrants converted to liabilities recorded to paid-in capital		—		3,790
Initial fair value of Series C Convertible Preferred Stock (host instrument only)		—		4,908
Deferred stock-based financing costs associated with Series C Convertible Preferred Stock		—		3,198
Difference between net proceeds and recorded fair value of Series C Convertible Preferred Stock		—		4,041
Advance receivable from Mobot, Inc. forgiven upon acquisition		—		1,500

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

NEOMEDIA TECHNOLOGIES, INC. AND SUBSIDIARIES
UNAUDITED NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION AND NATURE OF BUSINESS OPERATIONS

Basis of Presentation

The condensed consolidated financial statements include the financial statements of NeoMedia Technologies, Inc. and its wholly-owned subsidiaries (“NeoMedia” or the “Company”). The condensed balance sheet as of December 31, 2006, which has been derived from audited financial statements, and the unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete condensed consolidated financial statements. These condensed consolidated financial statements and related notes should be read in conjunction with the Company’s Form 10-K for the fiscal year ended December 31, 2006. In the opinion of management, these condensed consolidated financial statements reflect all adjustments which are of a normal recurring nature and which are necessary to present fairly the condensed consolidated financial position of NeoMedia as of June 30, 2007, the results of operations for the three and six month periods ended June 30, 2007 and 2006, and cash flows for the six month periods ended June 30, 2007 and 2006. The results of operations for the three and six month periods ended June 30, 2007 are not necessarily indicative of the results which may be expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated in preparation of the condensed consolidated financial statements.

Going Concern

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. Net loss for the three and six month periods ended June 30, 2007 was $2,597,000, and $14,096,000, respectively. Net cash used in operations for the six months ended June 30, 2007 was $5,264,000, and net cash used for discontinued operations (including operating, investing, and financing activities, as well as effect of exchange rates on cash for discontinued subsidiaries) was $2,219,000. NeoMedia also has an accumulated deficit of $175,026,000, and a working capital deficit of $67,306,000 as of June 30, 2007, of which $24,112,000 relates to the fair value of derivative financial instruments.

The items discussed above raise substantial doubts about the Company's ability to continue as a going concern. If the Company's financial resources are insufficient, the Company may require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity, debt, or another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations. The financial statements do not include any adjustments relating to the recoverability and reclassification of recorded asset amounts or amounts and reclassification of liabilities that might be necessary, should the Company be unable to continue as a going concern.

Should financing sources fail to materialize, management would seek alternate funding sources such as the sale of common and/or preferred stock, the issuance of debt, or the sale of its marketable assets. Management's plan is to secure adequate funding to bridge the commercialization of its core code-reading business.

NeoMedia plans to attempt to address its working capital deficiency by completing the proposed sales of the Micro Paint Repair and NeoMedia Telecom business units, and continuing to reduce its workforce and overhead expenses in non-critical areas. In addition, NeoMedia will attempt to generate additional revenue and profit from the launch of its core code-reading products and the value optimization of its patent portfolio.

In the event that these financing sources do not materialize, or that NeoMedia is unsuccessful in increasing its revenues and profits, NeoMedia will be forced to further reduce its costs, may be unable to repay its debt obligations as they become due, or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations. Additionally, if these funding sources or increased revenues and profits do not materialize, and NeoMedia is unable to secure additional financing, NeoMedia could be forced to reduce or curtail its business operations unless it is able to engage in a merger or other corporate finance transaction with a better capitalized entity.

Nature of Business Operations

NeoMedia is a pioneer in mobile enterprise and marketing technology, bridging the physical and electronic world with innovative direct-to-mobile-Web technology solutions. NeoMedia's flagship qode® service links users to the wireless, electronic world. NeoMedia is headquartered in Fort Myers, Florida, with an office in Aachen, Germany. The qode® suite of easy-to-use, market-driven products and applications is based on a strong foundation of patented technology, comprising the qode® (www.qode.com) platform, qode® reader and qode® window, all of which provide One Click to Content™ connectivity for products, print, packaging and other physical objects to link directly to specific desired content on the mobile Internet.

Prior to 2006, NeoMedia was structured and evaluated by its Board of Directors and management as three distinct business units: NeoMedia Internet Switching Software (NISS), NeoMedia Micro Paint Repair (NMPR), and NeoMedia Consulting and Integration Services (NCIS).

During the first quarter of 2006, NeoMedia acquired 12Snap AG (“12Snap”) of Munich, Sponge Ltd. (“Sponge”) of London, Gavitec AG of Aachen, Germany (“Gavitec”), Mobot, Inc. (“Mobot”) of Lexington, Massachusetts, and BSD Software, Inc. of Calgary, Canada (“BSD”), and wound down its NCIS business unit. As a result, during the year ended December 31, 2006, NeoMedia operated under the following three business units:

- NeoMedia Mobile (NMM) - encompassing NeoMedia's physical-world-to-internet and mobile marketing technologies and products;

- NeoMedia Telecom Services (NTS) - encompassing the billing, clearinghouse and information management services of Triton Global Business Services, the operating subsidiary of BSD, acquired in March 2006; and

- NeoMedia Micro Paint Repair (NMPR) - encompassing the micro paint and auto aftermarket accessories manufactured and distributed by NeoMedia.

During August 2006, NeoMedia announced that it intended to sell its MicroPaint Repair business. During the fourth quarter of 2006, NeoMedia divested of its Mobot and Sponge subsidiaries. During January 2007, NeoMedia made the strategic decision with respect to its corporate structure in 2007 and beyond, deciding to shed its remaining non-core 12Snap and NTS business units to focus on the area that management believes will deliver the most value - the core code-reading business. During April 2007, NeoMedia sold the 12Snap business.

As a result of the divestitures of 12Snap, Mobot and Sponge, and the proposed divestitures of MicroPaint Repair and NeoMedia Telecom Services, beginning in the first quarter of 2007 NeoMedia evaluated its business as one consolidated business, focusing on its core code-reading business and related intellectual property.

For purposes of these financial statements, NeoMedia Micro Paint Repair, NeoMedia Telecom Services, 12Snap, Sponge, and Mobot are considered discontinued operations as of June 30, 2007 and for the three and six month periods ended June 30, 2007 and 2006. NeoMedia Micro Paint Repair, NeoMedia Telecom Services, 12Snap, Sponge, and Mobot qualified as separate operating business units because they (i) engaged in business activities that earned revenues and incurred expenses, (ii) had operating results that were regularly reviewed by decision makers for the purposes of allocating resources to the segment, and (iii) had separate discreet financial information.

Reclassifications and Other

Certain amounts in the 2006 condensed consolidated financial statements have been reclassified to conform to the 2007 presentation, most notably, net sales were formerly reported as separate line items “Technology license, service and products,” and “Micro Paint Repair Products and Services.” As a result of the winding down of the former NCIS business unit and the proposed sale of the MicroPaint Repair business unit, revenue from continuing operations now consists of license revenue and is being reported under the caption “Net sales.”

In addition, due to the Company’s decision to sell the Telecom Services and Micro Paint Repair business units, and the completed divestitures of 12Snap, Mobot and Sponge, results of operations from each of these units have been reclassified under the caption “Discontinued Operations” for all periods shown on the accompanying condensed consolidated statement of operations, and assets and liabilities relating to these units are combined into the captions “Assets held for sale” and “Liabilities held for sale,” respectively, on the accompanying condensed consolidated balance sheet. Additionally, the statements of cash flows for the six months ended June 30, 2006 have been reclassified to exclude the cash flows of the discontinued business units.

While preparing the Company’s quarterly report on form 10-Q for the second quarter of 2007, the Company became aware of amounts that were incorrectly reported in it’s 2006 forms 10-Q and 10-K for the third quarter of 2006 and year end 2006, respectively. This issue has been reviewed by the Company pursuant to the SEC Staff Accounting Bulleting No. 99 and the FASB Statement of Financial Accounting Standards No. 154, and determined to be not material to the 2006 financial reports. The Company further determined that the correction of the prior year misstatement in the current year financial reports would be material to the current year financial statements. Pursuant to the SEC Staff Accounting Bulleting No. 108 (“SAB 108”), the Company has corrected its December 31, 2006 consolidated audited balance sheet presented in this second quarter 2007 10-Q filing to reflect the corrected amounts. Pursuant to SAB 108, correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. The year end December 31, 2006 amounts adjusted are a reduction of Derivative Liabilities of $402,000, an increase to Additional Paid-In Capital of $1,370,000, and an increase to Accumulated Deficit of $968,000.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following significant accounting policies were not applicable as of the filing of the Company’s last annual report for the year ended December 31, 2006. For a complete discussion of the Company’s significant accounting policies, please refer to the Company’s annual report on Form 10-K for the fiscal year ended December 31, 2006.

Financial Accounting Standards Board Interpretation No. 48

The Company adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48, “Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109” (“FIN 48”), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, “Accounting for Income Taxes,” and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Based on its evaluation, the Company has concluded that there are no significant uncertain tax positions requiring recognition in its financial statements. The Company's evaluation was performed for the tax years ended December 31, 2003, 2004, 2005 and 2006, the tax years which remain subject to examination by major tax jurisdictions as of June 30, 2007.

The Company may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to the Company's financial results. In the event the Company has received an assessment for interest and/or penalties, it has been classified in the financial statements as interest expense.

Revenue Recognition

NeoMedia derives revenues from the following sources: (1) license revenues relating to patents and internally-developed software, (2) hardware, software, and service revenues related to mobile marketing campaign design and implementation, and (3) sales from its proprietary Micro Paint Repair solution.

(1) Technology license fees, including intellectual property licenses, represent revenue from the licensing of NeoMedia's proprietary software tools and applications products. NeoMedia licenses its development tools and application products pursuant to non-exclusive and non-transferable license agreements. The basis for license fee revenue recognition is substantially governed by the American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"), as amended, and Statement of Position 98-9, Modification of SOP 97-2, "Software Revenue Recognition, With Respect to Certain Transactions.". License revenue is recognized if persuasive evidence of an agreement exists, delivery has occurred, pricing is fixed and determinable, and collectibility is probable. The Company defers revenue related to license fees for which amounts have been collected but for which revenue has not been recognized in accordance with the above, and recognizes the revenue over the appropriate period.

(2) Technology service and product revenue, which includes sales of software and technology equipment and service fee is recognized based on guidance provided in SEC Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition in Financial Statements," as amended (SAB 104). Software and technology equipment resale revenue is recognized when persuasive evidence of an arrangement exists, the price to the customer is fixed and determinable, delivery of the service has occurred and collectibility is reasonably assured. Service revenues including maintenance fees for providing system updates for software products, user documentation and technical support are recognized over the life of the contract. The Company's subsidiaries, Mobot (sold during 2006), and Gavitec follow this policy. The Company defers revenue related to technology service and product revenue for which amounts have been invoiced and or collected but for which the requisite service has not been provided. Revenue is then recognized over the matching service period.

(3) Technology service also includes mobile marketing services to its customers which mobile marketing projects are recognized after the completion of the project and accepted by the customer. All response and messaging based revenues are recognized at the time such responses are received and processed and the Company recognizes its premium messaging revenues on a net basis based on guidance provided in Emerging Issues Task Force Issues No. 99-19 (EITF 99-19), "Reporting Revenue Gross as Principal or Net as an Agent" and No. 01-09 (EITF 01-09), "Accounting for Consideration Given by a Vendor to a Customer." Consulting and management revenues and revenues for periodic services are recognized as services are performed. NeoMedia uses stand-alone pricing to determine an element's vendor specific objective evidence ("VSOE") in order to allocate an arrangement fee amongst various pieces of a multi-element contract. The Company's subsidiaries Sponge (sold during 2006) and 12Snap (sold during 2007) follow this policy. Telecom revenues from NeoMedia's subsidiary BSD are recognized at the time that calls are accepted by the clearinghouse for billing to customers on a net basis, based on guidance in EITF 99-19. The Company defers revenue related to mobile marketing service fees for which amounts have been invoiced and/or collected but for which revenue has not been recognized. Revenue is then recognized over the matching service period.

(4) Revenue for licensing and exclusivity on NeoMedia's MicroPaint Repair systems is recognized equally over the term of the contract, which is currently one year. A portion of the initial fee paid by the customer is allocated to licensing, training costs and initial products sold with the system. Revenue is recognized upon completion of training and shipment of the products, provided there is VSOE in a multiple element arrangement. Ongoing product and service revenue is recognized as products are shipped and services performed. The Company defers revenue related to micro paint repair licensing for which amounts have been invoiced and/or collected and revenue is then recognized over the estimated contract period, which is currently one year.

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(5) Sales taxes represent amounts collected on behalf of specific regulatory agencies that require remittance on a specified date. These amounts are collected at the time of sales and are detailed on invoices provided to customers. In compliance with the Emerging Issues Task Force consensus on issue number 06-03 (EITF 06-03), NeoMedia accounts for sales taxes on a net basis.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" (FAS 155). This Statement amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."
This Statement:

a. Permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation
b. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133
c. Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation
d. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives
e. Amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

FAS 155 is effective for fiscal years beginning after September 15, 2006. The Company has adopted FAS 155 on an individual instrument basis and is currently applying FAS 155 to certain of its debt obligations. The Company will evaluate and determine on a case by case basis whether to apply FAS 155.

Effect Of Recently Issued Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles ("GAAP"), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This statement is effective for fiscal years beginning after November 15, 2007. The Company may adopt this statement for its 2007 fiscal year. The Company is currently evaluating the impact of adopting this statement; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108"), *Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements."* SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 provides that once a current year misstatement has been quantified, the guidance in SAB No. 99, *Financial Statements - Materiality*, should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. Under certain circumstances, prior year financial statements will not have to be restated and the effects of initially applying SAB 108 on prior years will be recorded as a cumulative effect adjustment to beginning Retained Earnings on January 1, 2006, with disclosure of the items included in the cumulative effect. NeoMedia applied the provisions of SAB 108 with the preparation of NeoMedia's annual financial statements for the calendar year ending December 31, 2006. The application of the provisions of SAB 108 did not have a material impact on the Company's financial statements for the three and six month periods ending June 30, 2007.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities”. The objective of this statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected by the Board to expand the use of fair value measurement, which is consistent with the Board’s long-term measurement objectives for accounting for financial instruments. This statement is effective for fiscal years beginning after November 15, 2007. The Company may adopt this statement for its 2007 fiscal year. The Company is currently evaluating the impact of adopting this statement; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

In December 2006, FASB Staff Position No. EITF 00-19-2 was issued. This FASB Staff Position (FSP) addresses an issuer’s accounting for registration payment arrangements. This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. The guidance in this FSP amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, and FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to include scope exceptions for registration payment arrangements. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. The Company follows the guidance in FSP 00-19-2 in assessing its liabilities related to the liquidated damages arising from the Company’s default position on the convertible financing arrangements.

In June 2007, the FASB ratified the consensus on Emerging Issues Task Force (EITF) Issue No. 06−11, "Accounting for Income Tax Benefits of Dividends on Share−Based Payment Awards" ("EITF 06−11"). EITF 06−11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for non−vested equity−classified employee share−based payment awards as an increase to additional paid−in capital. EITF 06−11 is effective for fiscal years beginning after September 15, 2007. While the Company is currently evaluating the provisions of EITF 06−11, the adoption is not expected to have any significant effect on the Company's consolidated financial position or results of operations.

In November 2006, the FASB ratified EITF Issue No. 06−7, “Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities” (“EITF No. 06−7”). At the time of issuance, an embedded conversion option in a convertible debt instrument may be required to be bifurcated from the debt instrument and accounted for separately by the issuer as a derivative under SFAS No. 133, based on the application of EITF No. 00−19. Subsequent to the issuance of the convertible debt, facts may change and cause the embedded conversion option to no longer meet the conditions for separate accounting as a derivative instrument, such as when the bifurcated instrument meets the conditions of EITF No. 00−19 to be classified in stockholders' equity. Under EITF No. 06−7, when an embedded conversion option previously accounted for as a derivative under Statement of Financial Accounting Standards (“SFAS”) No. 133 no longer meets the bifurcation criteria under that standard, an issuer shall disclose a description of the principal changes causing the embedded conversion option to no longer require bifurcation under SFAS No. 133 and the amount of the liability for the conversion option reclassified to stockholders' equity. EITF No. 06−7 should be applied to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in SFAS No. 133 in interim or annual periods beginning after December 15, 2006, regardless of whether the debt instrument was entered into prior or subsequent to the effective date of EITF No. 06−7. The adoption of EITF 06−7 did not have a material impact on our financial position, results of operations or cash flows.

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In November 2006, the FASB ratified EITF Issue No. 06−6, Application of EITF Issue No. 05−7, ‘Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues ’ (“EITF 06−6”). EITF 06−6 addresses the modification of a convertible debt instrument that changes the fair value of an embedded conversion option and the subsequent recognition of interest expense for the associated debt instrument when the modification does not result in a debt extinguishment pursuant to EITF 96−19. The Company does not expect the adoption of EITF 06−6 to have a material impact on its consolidated financial position, results of operations or cash flows.

On January 1, 2007, the Company adopted the consensus reached in Emerging Issues Task Force (“EITF”) Issue No. 06−2, “Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43.” EITF Issue No. 06−2 provides recognition guidance on the accrual of employees’ rights to compensated absences under a sabbatical or other similar benefit arrangement. The adoption of EITF Issue No. 06−2 did not have a material impact on our financial position, results of operations, or cash flows.

In September 2006, the Emerging Issues Task Force, or EITF, reached a consensus on Issue No. 06−1, Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End−Customer to Receive Service from the Service Provider. EITF Issue No. 06−1provides guidance regarding whether the consideration given by a service provider to a manufacturer or reseller of specialized equipment should be characterized as a reduction of revenue or an expense. This issue is effective for our annual reporting period ending December 31, 2007. Entities are required to recognize the effects of applying this issue as a change in accounting principle through retrospective application to all prior periods unless it is impracticable to do so. We are in the process of evaluating the impact of this issue on our consolidated financial statements. The Company does not expect the adoption of EITF 06−1 to have a material impact on its consolidated financial position, results of operations or cash flows.

3. ACQUISITIONS

On February 17, 2006, NeoMedia acquired all of the outstanding shares of Mobot in exchange for $3,500,000 cash and $6,500,000 in stock, represented by 16,931,493 shares of NeoMedia common stock. On February 23, 2006, NeoMedia acquired all of the outstanding shares of Sponge in exchange for $6,141,000 cash and £6,550,000 in stock (approximately $13.1 million at the time of the agreement), represented by 33,097,135 shares of NeoMedia common stock. On February 23, 2006, NeoMedia acquired all of the outstanding shares of Gavitec in exchange for $1,800,000 cash and $5,200,000 in stock, represented by 13,660,511 shares of NeoMedia common stock. On February 28, 2006, NeoMedia acquired all of the outstanding shares of 12Snap in exchange for $2,500,000 cash and $19,500,000 in stock, represented by 49,294,581 shares of NeoMedia common stock. On March 21, 2006, NeoMedia acquired BSD for 7,123,698 shares of NeoMedia common stock.

On November 14, 2006, NeoMedia divested of 92.5% of its ownership interest in Mobot. On December 6, 2006, NeoMedia sold 82% of its ownership interest in Sponge. On April 4, 2007, NeoMedia divested of 90% of its ownership interest in 12Snap.

The consolidated statements of operations presented herein reflect the results of these acquired subsidiaries as follows: Mobot results are included from February 18, 2006 through December 6, 2006 under the caption “Loss from discontinued operations”; Sponge results are included from February 24, 2006 through November 14, 2006 under the caption “Loss from discontinued operations”; 12Snap results are included from February 24, 2006 through April 4, 2007 under the caption “Loss from discontinued operations”; BSD results are included from March 22, 2006 through June 30, 2007 under the caption “Loss from discontinued operations”; and Gavitec results are included in NeoMedia’s consolidated results from continuing operations from February 24, 2006 through June 30, 2007. Pro-forma results of operations are presented at the end of this Note 3.

The following disclosures reflect activity related to acquisitions since the filing of NeoMedia’s last annual report for the year ended December 31, 2006. For a complete discussion of the Company’s acquisition activity, please refer to the Company’s annual report on Form 10-K for the fiscal year ended December 31, 2006.

Gavitec

The acquisition agreement between NeoMedia and Gavitec stipulated that, in the event that NeoMedia’s stock price at the time the consideration shares became saleable (either upon effectiveness of a registration statement containing the shares, or under Rule 144) was less than $0.389, NeoMedia was obligated to compensate Gavitec shareholders in cash for the difference between the price at the time the shares became saleable and $0.389. On January 23, 2007, NeoMedia entered into an agreement with the former shareholders of Gavitec, whereby this purchase price obligation was to be satisfied through the payment by NeoMedia of (i) $1,800,000 in cash, payable no later than February 28, 2007 (subsequently extended to March 31, 2007), and (ii) 61,000,000 shares of NeoMedia common stock to be issued no later than February 28, 2007. NeoMedia also agreed to pay interest accrued on the purchase price in the amount of $481,000 and reimburse $100,000 of costs related to the acquisition to the primary former shareholder of Gavitec no later than February 28, 2007. NeoMedia issued the shares and made cash payments of $2,113,000 during March 2007. Accordingly, as of June 30, 2007, the balance on the accrual was $268,000, representing the remaining interest payments which are past due and have not been paid.

12Snap

During the first quarter of 2007, NeoMedia initiated an action plan to sell its 12Snap business. During the three months ended March 31, 2007, and the year ended December 31, 2006, NeoMedia recorded impairment charges of $2,467,000 and $18,327,000, respectively, to adjust the carrying value of the 12Snap asset group to the expected net proceeds from the sale of the assets. Prior to the impairment charge, the asset group consisted primarily of goodwill and other intangible assets recorded upon purchase of 12Snap by NeoMedia during the first quarter of 2006. In connection with its decision to sell the 12Snap business in the first quarter of 2007, NeoMedia revised its expected cashflow to reflect the estimated net cash proceeds that the Company anticipated receiving in a sale transaction. The operations of 12Snap are classified as discontinued operations during the three and six months ended June 30, 2007 and 2006. The criteria for discontinued operations classification were met during the three and six months ended June 30, 2007. (See Note 4)

Pursuant to the terms of the original purchase agreement, in the event that NeoMedia's stock price at the time the consideration shares became saleable (either upon effectiveness of a registration statement containing the shares, or under Rule 144) was less than $0.3956, NeoMedia was obligated to compensate 12Snap shareholders in cash for the difference between the price at the time the shares became saleable and $0.3956. On February 22, 2007, the shares became eligible for resale under Rule 144. The actual calculated purchase price obligation to NeoMedia based on the volume weighted average closing price of NeoMedia common stock for the ten days up to and including February 22, 2007 was $16,233,000. Because the amount of the purchase price guarantee became measurable and highly probable of occurrence beyond a reasonable doubt, as of December 31, 2006, NeoMedia reduced the fair value of the initial stock consideration by the amount of the contingency. On March 19, 2007, NeoMedia issued 197,620,948 shares of its common stock in satisfaction of a portion of the purchase price obligation totaling $9,427,000. Additionally, NeoMedia has made cash payments against the liability totaling $372,000, and further reduced the balance through the forgiveness of $1,760,000 of the obligation in connection with the sale of 12Snap. The balance on the purchase price obligation as of June 30, 2007 was $4,684,000, which includes $8,000 in accrued interest. The Company is currently negotiating payment terms for the balance of the obligation.

On April 4, 2007, NeoMedia reached an agreement with Bernd Michael (the "Buyer"), a private investor and former shareholder of 12Snap prior to NeoMedia's acquisition of 12Snap, pursuant to which the Buyer acquired from NeoMedia 90% of the shares of 12Snap, pursuant to the following material terms:

- $1,100,000 was paid by the Buyer to the Company in cash at closing, of which $1,015,000 was applied toward amounts owed to silent partners of 12Snap
- $500,000 was placed into an escrow account for 90 days to secure warranty claims;
- Buyer waived his portion of the purchase price guarantee obligation in the amount of $880,000;
- Buyer returned to NeoMedia 2,525,818 NeoMedia shares previously issued to the Buyer;
- 12Snap management waived their portion of the purchase price guarantee obligation in the amount of $880,000;
- 12Snap management returned to NeoMedia 5,225,039 shares of NeoMedia common stock previously issued to 12Snap management;
- NeoMedia retained a 10% ownership in 12Snap, subject to an option agreement pursuant to which NeoMedia has the right to sell and Buyer has the right to acquire the remaining 10% stake held by NeoMedia for a purchase price of $750,000 after December 31, 2007; and
- 12Snap and NeoMedia will execute a cooperation agreement pursuant to which 12snap will remain a NeoMedia preferred partner and enjoy most favored prices, and 12snap will perform certain research and development functions for NeoMedia.

NeoMedia recorded impairment charges of $0 and $2,467,000 during the three and six months ended June 30, 2007, respectively, to adjust the carrying value of 12Snap's assets to the final fair market value. As prescribed by Statement of Financial Accounting Standards No. 52, NeoMedia realized a loss on the disposal of 12 Snap in the three and six months ended June 30, 2007, in the amount of $257,000.

Pro Forma Financial Information (Unaudited)

Pro-forma results of operations as if NeoMedia was combined with Gavitec as of January 1, 2006 are as follows:

	Total Net Sales		Loss from Continuing Operations		Loss per Share from Continuing Operations		Weighted Average Common Shares Outstanding	
<u>Six Months Ended June 30, 2006</u>								
NeoMedia	$ 687		$ 7,038		$ 0.01		580,485,463	
Gavitec	486		(565)					
Pro forma adjustments	(397)	(A)	422	(A)	$ 0.00	(A)(B)	20,224,490	(B)
Pro forma combined	$ 776		$ 6,895		$ 0.00		600,709,953	

<u>**Basis of Presentation**</u>: NeoMedia acquired Mobot, Sponge, Gavitec, 12Snap, and BSD during the first quarter of 2006. During November and December 2006, NeoMedia divested of Mobot and Sponge. During April 2007, NeoMedia divested of 12Snap. During the first quarter of 2007, NeoMedia decided to sell its Telecom Services business, comprised of the operations of BSD. Because the results of BSD, 12Snap, Mobot, and Sponge have already been removed from NeoMedia's continuing operations and classified as discontinued operations for the six months ended June 30, 2006, these entities have not been included in the pro forma results shown above. However, the pro forma shares issued as consideration for the acquisitions of Gavitec, 12Snap, and BSD are reflected in the pro forma loss per share and weighted average common shares outstanding. The pro forma shares issued as consideration for the acquisitions of 12Snap, Mobot and Sponge, and NeoMedia shares returned in the sale of Sponge, are not reflected in the pro forma weighted average common shares outstanding, since for pro forma purposes the acquisition and disposal transactions are assumed to have occurred on January 1, 2006. Since the results of Gavitec were included in NeoMedia's consolidated financial results for the entire three and six month periods ended June 30, 2007, and the entire three month period ended June 30, 2006, separate pro forma results are not presented for these periods.

(A) Adjustment is to reflect operations of Gavitec from February 23, 2006 (closing date of acquisition) through June 30, 2006, and to reflect amortization of Gavitec intangible assets for the period January 1, 2006 through February 23, 2006. Results of operations for Gavitec from February 23, 2006 through June 30, 2006 are included in NeoMedia's operations for the six months ended June 30, 2006.

(B) Adjustment for shares that would have been issued in connection with the acquisitions of Gavitec and BSD if they had occurred on January 1, 2006. The adjustment between the reported and the pro forma number of weighted average shares outstanding is caused by (i) the weighting of the pro forma shares for the six months ended June 30, 2006, whereas in the reported number the shares were only outstanding from the closing date of each acquisition through June 30, 2006, and (ii) the number of pro forma shares being higher than the actual shares issued due to a lower stock price on the pro forma date of issuance than the actual date of issuance. Using the stock price around January 1, 2006, the pro forma number of shares that would have been issued was:

	Gavitec	BSD	Total
Total stock consideration	$ 5,400,000	$ 2,279,263	$ 7,679,263

Stock price on pro forma acquisition date	$ 0.290	$ 0.290	
Pro forma number of consideration shares	18,620,690	7,859,527	26,480,217

Tax Implications of Acquisitions

For income tax purposes, amounts assigned to particular assets acquired and liabilities assumed in the business combinations are different than amounts used for financial reporting. The differences in assigned values for financial reporting and tax purposes result in temporary differences. In applying SFAS 109, "Accounting for Income Taxes", the Company is required to recognize the tax effect of these temporary differences and, accordingly, a deferred tax liability has been recognized. The Company determined that it's pre-existing and acquired deferred tax assets, and those acquired, including those subject to limitations, were more likely than not to be realized to offset the deferred tax liability. In most cases the reduction in the valuation allowance resulted in an asset and was used to offset the deferred tax liability arising from the business combinations, pursuant to SFAS 109. A deferred tax liability was recognized where a net liability remained.

In addition, the acquisitions of Sponge, Gavitec, 12Snap, and BSD involve a change of control of foreign entities, and as a result any net operating loss carryforward in existence prior to the acquisition may have limited or no use for NeoMedia.

Intangible Assets

As of June 30, 2007, NeoMedia had intangible assets used in its continuing operations with original historical cost as follows:

	(US dollars in thousands)		
	Gavitec	**Other**	**Total**