CITIZENS INC
Form SC 13G/A
January 26, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 13G

UNDER THE SECURITIES EXCHANGE ACT OF 1934

(Amendment No. 15 to Schedule 13D on Schedule 13G)*

CITIZENS, INC.

(Name of Issuer)

Class A Common Stock, no par value

(Title of Class of Securities)

174740 10 0

(CUSIP Number)

December 31, 2011

(Date of Event Which Requires Filing of This Statement)

Check the appropriate box to designate the Rule pursuant to which this Schedule is field:

[ ]

Rule 13d-1(b)

[X]

Rule 13d-1(c)

[ ]

Rule 13d-1(d)

* The remainder of this cover page shall be filled out for a reporting person's initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter the disclosures provided in a prior cover page.

The information required on the remainder of this cover page shall not be deemed to be "filed" for the purpose of Section 18 of the Securities Exchange Act of 1934 ("Act") or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

Cusip No. 174740 10 0

SCHEDULE 13G

1	NAME OF REPORTING PERSONS Galindo, Arias & Lopez S.S. or I.R.S. IDENTIFICATION NO. OF ABOVE PERSONS N/A		
2	CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP*		**(a)** £ **(b)** ý
3	SEC USE ONLY		
4	CITIZENSHIP OR PLACE OF ORGANIZATION Republic of Panama		

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**5**	SOLE VOTING POWER 0
	6	SHARED VOTING POWER 0
	7	SOLE DISPOSITIVE POWER 0
		SHARED DISPOSITIVE POWER

8	5,962,512	
	AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON	
9	5,962,512	
	CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES*	
10		£
	PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)	
11	12.2%	
	TYPE OF REPORTING PERSON*	
12	PN	

Cusip No. 174740 10 0

SCHEDULE 13G

1	NAME OF REPORTING PERSONS Gala Trust and Management Services, Inc., formerly known as Gala Management Services, Inc. S.S. or I.R.S. IDENTIFICATION NO. OF ABOVE PERSONS N/A		
2	CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP*		**(a)** £ **(b)** ý
3	SEC USE ONLY		
4	CITIZENSHIP OR PLACE OF ORGANIZATION Republic of Panama		

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**5**	SOLE VOTING POWER 0
	6	SHARED VOTING POWER 0
	7	SOLE DISPOSITIVE POWER 0
		SHARED DISPOSITIVE POWER

8	3,768,572
9	AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON 3,768,572
10	CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES* £
11	PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9) 7.7%
12	TYPE OF REPORTING PERSON* CO

Cusip No. 174740 10 0

SCHEDULE 13G

1	NAME OF REPORTING PERSONS GAMASE Insureds Trust S.S. or I.R.S. IDENTIFICATION NO. OF ABOVE PERSONS N/A	
2	CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP*	**(a)** £ **(b)** ý
3	SEC USE ONLY	
4	CITIZENSHIP OR PLACE OF ORGANIZATION Republic of Panama	

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**5**	SOLE VOTING POWER 0
	6	SHARED VOTING POWER 0
	7	SOLE DISPOSITIVE POWER 0
		SHARED DISPOSITIVE POWER

8	3,494,536

	AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON	
9	3,494,536	
	CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES*	
10		£
	PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9)	
11	7.1%	
	TYPE OF REPORTING PERSON*	
12	OO	

Cusip No. 174740 10 0

SCHEDULE 13G

1	NAME OF REPORTING PERSONS Regal Trust (BVI) Ltd. S.S. or I.R.S. IDENTIFICATION NO. OF ABOVE PERSONS N/A		
2	CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP*		**(a)** £ **(b)** ý
3	SEC USE ONLY		
4	CITIZENSHIP OR PLACE OF ORGANIZATION British Virgin Islands		

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**5**	SOLE VOTING POWER 0
	6	SHARED VOTING POWER 0
	7	SOLE DISPOSITIVE POWER 0
		SHARED DISPOSITIVE POWER

8	2,193,940	
9	AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON 2,193,940	
10	CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (9) EXCLUDES CERTAIN SHARES*	£
11	PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (9) 4.5%	
12	TYPE OF REPORTING PERSON* CO	

Cusip No. 174740 10 0

SCHEDULE 13G

This Amendment (“Amendment No. 15”) is being jointly filed by each of the following persons pursuant to Rule 13d-1(k) of the Securities and Exchange Commission (the Commission) pursuant to Section 13 of the Securities Exchange Act of 1934, as amended (the Exchange Act): (1) Galindo, Arias & Lopez, a partnership organized under the laws of the Republic of Panama (GA&L), (2) Gala Trust and Management Services, Inc., formerly known as Gala Management Services, Inc., a corporation organized under the laws of the Republic of Panama (Gala Trust), (3) GAMASE Insureds Trust, a trust established under the laws of the Republic of Panama (GAMASE Insureds Trust), and (4) Regal Trust (BVI) Ltd., a corporation organized under the laws of the British Virgin Islands (Regal , together with GA&L, Gala Trust, and GAMASE Insureds Trust, collectively, the Reporting Persons and each, a Reporting Person).

This Amendment No. 15 amends the Schedule 13D originally filed by the Reporting Persons with the Commission on October 11, 2005 (the Original Schedule 13D), Amendment No. 1 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on February 24, 2006 (Amendment No. 1), Amendment No. 2 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on May 4, 2006 (Amendment No. 2), Amendment No. 3 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on September 1, 2006 (Amendment No. 3), Amendment No. 4 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on December 13, 2006 (Amendment No. 4), Amendment No. 5 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on March 20, 2007 (Amendment No. 5), Amendment No. 6 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on June 14, 2007 (Amendment No. 6), Amendment No. 7 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on August 23, 2007 (Amendment No. 7), Amendment No. 8 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on November 13, 2007 (Amendment No. 8), Amendment No. 9 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on March 5, 2008 (Amendment No. 9), Amendment No. 10 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on June 2, 2008 (Amendment No. 10), Amendment No. 11 to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on December 24, 2008 (Amendment No. 11), Amendment No. 12 on Schedule 13G to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on January 20, 2009 (Amendment No. 12), Amendment No. 13 on Schedule 13G to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on January 20, 2010 (Amendment No. 13) and Amendment No. 14 on Schedule 13G to the Original Schedule 13D originally filed by the Reporting Persons with the Commission on February 7, 2011 (Amendment No. 14). The Original Schedule 13D, Amendment No. 1, Amendment No. 2, Amendment No. 3, Amendment No. 4, Amendment No. 5, Amendment No. 6, Amendment No. 7, Amendment No. 8, Amendment No. 9, Amendment No. 10, Amendment No. 11, Amendment No. 12, Amendment No. 13 and Amendment No. 14 are collectively referred to as the Schedule 13G.

All terms used but not defined in this Amendment No. 15 are as defined in the Schedule 13G. The summary descriptions (if any) contained herein of certain agreements and documents are qualified in their entirety by reference to the complete text of such agreements and documents filed as Exhibits hereto or incorporated herein by reference.

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SCHEDULE 13G

ATTACHMENT

Item 1(a).

Name of Issuer

Citizens, Inc. (Issuer)

Item 1(b).

Address of Issuer s Principal Executive Offices

400 East Anderson Lane, Austin, Texas 78752

Item 2(a) and 2(b).

Name of Person Filing and Address of Principal Business Office or, if none, Residence

This Amendment to Schedule 13G is being jointly filed by each of the following persons pursuant to Rule 13d-1(k) of the Securities and Exchange Commission (the Commission) pursuant to Section 13 of the Securities Exchange Act of 1934, as amended (the Exchange Act): (1) Galindo, Arias & Lopez, a partnership organized under the laws of the Republic of Panama (GA&L), (2) Gala Trust and Management Services, Inc., formerly known as Gala Management Services, Inc., a corporation organized under the laws of the Republic of Panama (Gala Trust), (3) GAMASE Insureds Trust, a trust established under the laws of the Republic of Panama (GAMASE Insureds Trust), and (4) Regal Trust (BVI) Ltd., a corporation organized under the laws of the British Virgin Islands (Regal , together with GA&L, Gala Trust, and GAMASE Insureds Trust, collectively, the Reporting Persons and each, a Reporting Person), each with a principal business office address of c/o Gala Trust and Management Services, Inc., Scotia Plaza, 9th Floor, Federico

Boyd Avenue 18 and 51 Street, Panama 5, Republic of Panama, Attention: Tomas Herrera.

Item 2(c).

Citizenship

(i)

Galindo, Arias & Lopez, a partnership organized under the laws of the Republic of Panama

(ii)

Gala Trust and Management Services, Inc., a corporation organized under the laws of the Republic of Panama

(iii)

GAMASE Insureds Trust, a trust established under the laws of the Republic of Panama

(iv)

Regal Trust (BVI) Ltd., a corporation organized under the laws of the British Virgin Islands

Item 2(d).

Title of Class of Securities

Class A Common Stock, no par value

Item 2(e).

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174740 10 0

Item 3.

If This Statement is Filed Pursuant to Rules 13d-1(b), or 13d-2(b), Check Whether the Person Filing Is a:

Not Applicable

Item 4.

Ownership

Provide the following information regarding the aggregate number and percentage of the class of securities of the issuer identified in Item 1.

The Reporting Persons may be deemed to be a group as defined in Rule 13d-5(b) under the Exchange Act and, as such a group, may be deemed to beneficially own an aggregate of 5,962,512 shares of the Common Stock, which constitute approximately 12.2% of the outstanding shares of the Common Stock, based on 48,946,546 shares

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SCHEDULE 13G

of the Common Stock outstanding as of November 1, 2011 according to the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2011, filed with the Commission on November 3, 2011, on which are based all of the percentages of outstanding shares of Common Stock set forth herein. The foregoing and all other amounts of beneficial ownership set forth herein are calculated pursuant to Rule 13d-3 under the Exchange Act (Rule 13d-3).

GAMASE Insured Trust holds 3,494,536 shares of the Common Stock (constituting approximately 7.1% of the outstanding Common Stock) and may be deemed to beneficially own such shares pursuant to Rule 13d-3.

Gala Trust is the sole trustee of GAMASE Insureds Trust and GAMASE Agents Trust, a trust established under the laws of the Republic of Panama (GAMASE Agents Trust) which holds 274,036 shares of the Common Stock (constituting approximately 0.6% of the outstanding Common Stock) and may be deemed to beneficially own such shares pursuant to Rule 13d-3, and therefore may be deemed to beneficially own 3,768,572 shares of the Common Stock (constituting approximately 7.7% of the outstanding Common Stock) pursuant to Rule 13d-3.

Regal is the sole trustee of CICA Associates Trust, a trust established under the laws of the British Virgin Islands (Regal Associates Trust) which holds 309,583 shares of the Common Stock (constituting approximately 0.6% of the outstanding Common Stock) and sole trustee of CICA Policyholders Trust, a trust established under the laws of the British Virgin Islands (Regal Policyholders Trust) which holds 1,884,357 shares of the Common Stock (constituting approximately 3.8% of the outstanding Common Stock) and may be deemed to beneficially own all such shares pursuant to Rule 13d-3, and therefore may be deemed to beneficially own 2,193,940 shares of the Common Stock (constituting approximately 4.5% of the outstanding Common Stock) pursuant to Rule 13d-3.

GA&L owns a 100% interest in each of Gala Trust and Regal, and therefore may be deemed to beneficially own 5,962,512 shares (constituting approximately 12.2% of the outstanding Common Stock) pursuant to Rule 13d-3.

Galindo, Arias & Lopez:

(a)

Amount Beneficially Owned: 5,962,512 shares of Class A Common Stock.

(b)

Percent of Class:

12.2% on the Date of Event Which Requires Filing of this Statement.

(c)

Number of shares as to which such person has:

(i)

Sole power to vote or to direct the vote

0

(ii)

Shared power to vote or to direct the vote

0

(iii)

Sole power to dispose or to direct the disposition of

0

(iv)

Shared power to dispose or to direct the disposition of

5,962,512 shares

Gala Trust and Management Services, Inc.:

(a)

Amount Beneficially Owned: 3,768,572 shares of Class A Common Stock.

(b)

Percent of Class:

7.7% on the Date of Event Which Requires Filing of this Statement.

(c)

Number of shares as to which such person has:

(i)

Sole power to vote or to direct the vote

0

(ii)

Shared power to vote or to direct the vote

0

(v)

Sole power to dispose or to direct the disposition of

0

(vi)

Shared power to dispose or to direct the disposition of

3,768,572 shares

GAMASE Insureds Trust:

(a)

Amount Beneficially Owned: 3,494,536 shares of Class A Common Stock.

(b)

Percent of Class:

7.1% on the Date of Event Which Requires Filing of this Statement.

(c)

Number of shares as to which such person has:

(i)

Sole power to vote or to direct the vote

0

(ii)

Shared power to vote or to direct the vote

0

(vii)

Sole power to dispose or to direct the disposition of

0

(viii)

Shared power to dispose or to direct the disposition of

3,494,536 shares

Regal Trust (BVI) Ltd.:

(a)

Amount Beneficially Owned: 2,193,940 shares of Class A Common Stock.

(b)

Percent of Class:

4.5% on the Date of Event Which Requires Filing of this Statement.

(c)

Number of shares as to which such person has:

(i)

Sole power to vote or to direct the vote

0

(ii)

Shared power to vote or to direct the vote

0

(ix)

Sole power to dispose or to direct the disposition of

0

(x)

Shared power to dispose or to direct the disposition of

2,193,940 shares

Item 5.

Ownership of Five Percent or Less of a Class

If this statement is being filed to report the fact that as of the date hereof the reporting person has ceased to be the beneficial owner of more than five percent of the class of securities, check the following [X*]

This statement is being filed by Regal Trust (BVI) Ltd. to report the fact that as of the date hereof Regal Trust (BVI) Ltd. has ceased to be the beneficial owner of more than five percent of the class of securities.

Item 6.

Ownership of More Than Five Percent on Behalf of Another Person

Other than as set forth herein, no other person has the right to receive or the power to direct the receipt of dividends from, or proceeds from the sale of, in excess of 5% of the total outstanding Common Stock.

Item 7.

Identification and Classification of the Subsidiary Which Acquired the Security Being Reported on by the Parent Holding Company

Reference is made and incorporated herein to Item 4 above.

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SCHEDULE 13G

Item 8.

Identification and Classification of Members of the Group

Reference is made and incorporated herein to Item 4 above.

Item 9.

Notice of Dissolution of Group

Not Applicable.

Item 10.

Certifications

By signing below I certify that, to the best of my knowledge and belief, the securities referred to above were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect.

SIGNATURE

After reasonable inquiry and to the best of the undersigned s knowledge and belief, the undersigned certifies that the information set forth in this statement is true, complete and correct.

Date:

January 24, 2012

GALINDO, ARIAS & LOPEZ

By: /s/ Tomas Herrera
Name: Tomas Herrera
Title: Partner

GALA TRUST AND MANAGEMENT SERVICES, INC., formerly known as GALA MANAGEMENT SERVICES, INC.

By: /s/ Tomas Herrera
Name: Tomas Herrera
Title: Attorney-in-fact

GAMASE INSUREDS TRUST

By: /s/ Tomas Herrera
Name: Tomas Herrera
Title: Attorney-in-fact

REGAL TRUST (BVI) LTD.

By: /s/ Tomas Herrera
Name: Tomas Herrera
Title: Attorney-in-fact

POWER OF ATTORNEY

The undersigned director and/or officer of Gala Trust and Management Services, Inc**.,** formerly known as Gala Management Services, Inc. (the Company), does hereby constitute and appoint Tomas Herrera as the undersigned s true and lawful attorney-in-fact and agent to do any and all things in the undersigned s name and behalf in the undersigned s capacity as a director and/or officer of the Company, and to execute any and all instruments for the undersigned and in the undersigned s name and capacity as a director and/or officer that such person or persons may deem necessary or advisable to enable the Company to comply with the United States Securities Exchange Act of 1934, as amended, including specifically, but not limited to, power and authority to sign for the undersigned in the capacity as a director and/or officer of the Company any and all filings with the Securities and Exchange Commission and any and all amendments thereto, including post-effective amendments, and the undersigned does hereby ratify and confirm all that such person or persons shall do or cause to be done by virtue hereof.

/s/ Alfonso Arias
(Signature)

Printed Name: ALFONSO ARIAS

Dated and effective as of January 24, 2012

POWER OF ATTORNEY

The undersigned director and/or officer of GAMASE Insureds Trust (the Company), does hereby constitute and appoint Tomas Herrera as the undersigned s true and lawful attorney-in-fact and agent to do any and all things in the undersigned s name and behalf in the undersigned s capacity as a director and/or officer of the Company, and to execute any and all instruments for the undersigned and in the undersigned s name and capacity as a director and/or officer that such person or persons may deem necessary or advisable to enable the Company to comply with the United States Securities Exchange Act of 1934, as amended, including specifically, but not limited to, power and authority to sign for the undersigned in the capacity as a director and/or officer of the Company any and all filings with the Securities and Exchange Commission and any and all amendments thereto, including post-effective amendments, and the undersigned does hereby ratify and confirm all that such person or persons shall do or cause to be done by virtue hereof.

/s/ Alfonso Arias
(Signature)

Printed Name: ALFONSO ARIAS

Dated and effective as of January 24, 2012

POWER OF ATTORNEY

The undersigned director and/or officer of Regal Trust (BVI) Ltd. (the Company), does hereby constitute and appoint Tomas Herrera as the undersigned s true and lawful attorney-in-fact and agent to do any and all things in the undersigned s name and behalf in the undersigned s capacity as a director and/or officer of the Company, and to execute any and all instruments for the undersigned and in the undersigned s name and capacity as a director and/or officer that such person or persons may deem necessary or advisable to enable the Company to comply with the United States Securities Exchange Act of 1934, as amended, including specifically, but not limited to, power and authority to sign for the undersigned in the capacity as a director and/or officer of the Company any and all filings with the Securities and Exchange Commission and any and all amendments thereto, including post-effective amendments, and the undersigned does hereby ratify and confirm all that such person or persons shall do or cause to be done by virtue hereof.

/s/ Alfonso Arias
(Signature)

Printed Name: ALFONSO ARIAS

Dated and effective as of January 24, 2012

standing at September 30, 2009 and December 31, 2008, respectively 411 35 Additional paid in capital 72,269 61,016 Accumulated other comprehensive loss (85) -- Stock subscription receivable -- (1,035) Accumulated deficit (82,024) (64,602) Total stockholders' deficit (8,588) (1,053) Total liabilities and stockholders' deficit $430 $179

See notes to condensed consolidated financial statements.

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

	Three months ended September 2009	Three months ended September 2008	Nine months ended September 2009	Nine months ended September 2008
Total net sales	$--	$2,137	$--	$2,929
Cost of sales	--	5,330	--	14,323
Gross loss	--	(3,163)	--	(11,394)
Operating expenses:				
Product research and development	171	582	603	3,247
Sales and marketing	118	878	257	3,844
General and administrative	482	1,224	1,120	5,382
Amortization of fair value of stock issued to related parties for purchase of AB Cypressen	1,584	--	4,752	--
Total operating expenses	2,355	2,684	6,732	12,473
Operating loss	(2,355)	(5,847)	(6,732)	(23,867)
Other income (expense, net):				
Interest and other income (expense), net	--	5	(30)	17
Interest expense	(14)	(162)	(20)	(276)
Foreign currency loss	--	(1,044)	--	(850)
Gain on conversion and forgiveness of accounts payable	--	--	30	--
Loss on troubled debt restructuring	--	--	(2,741)	--
Non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants	(6,918)	(668)	(6,893)	(6,778)
Total other income (expense), net	(6,932)	(1,869)	(9,655)	(7,887)
Net loss	(9,287)	(7,716)	(16,387)	(31,754)
Deemed dividend to preferred stockholders	--	--	(1,035)	--
Net loss attributable to common stockholders	$(9,287)	$(7,716)	$(17,422)	$(31,754)
Foreign currency translation loss	(11)	--	(85)	--
Comprehensive loss	$(9,298)	$(7,716)	$(16,472)	$(31,754)
Loss attributable to common stockholders per common share:				
Basic and diluted loss per share	$(0.02)	$(0.26)	$(0.09)	$(1.16)
Basic and diluted - weighted average shares used in per share computations	375,553	30,010	191,151	27,428

See notes to condensed consolidated financial statements.

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

	Nine months ended September 30, 2009	2008
Cash flows from operating activities:	$(16,387)	$(31,754)
Net loss		
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock based compensation expense	5,170	1,074
Stock settlement expense	35	--
Depreciation and amortization	2	330
Loss on retirement of property and equipment	30	(16)
Loss on troubled debt restructuring	2,741	--
Write-down of inventory to net realizable value	--	9,823
Gain on conversion to equity and forgiveness of accounts payable	(30)	--
Debt discounts and deferred financing fees and the valuation of conversion features and warrants	6,894	6,778
Changes in operating assets and liabilities:		
Accounts receivable	--	905
Inventories	--	(3,688)
Other assets	(43)	80
Prepaid expenses	(16)	(653)
Accounts payable and accrued expenses	97	3,360
Deferred revenue	--	(2,088)
Other liabilities	--	728
Net cash used in operating activities	(1,507)	(15,121)
Cash flows from financing activities:		
Proceeds from sale of property and equipment	--	32
Purchase of property, plant and equipment	(17)	(205)
Net cash used in investing activities	(17)	(173)
Cash flows from financing activities:		
Proceeds from issuance of convertible debt	785	--
Proceeds from exercise of stock options	--	59
Proceeds from issuance of common stock	--	4,515
Proceeds from issuance of preferred stock	1,035	--
Equity issuance costs	--	(486)
Proceeds from exercise of option to invest in August note	--	375
Proceeds from exercise of re-priced warrants	--	4,756
Warrant re-pricing costs	--	(651)
Restricted cash	--	5,554
Net cash provided by financing activities	1,820	14,122
Effect of exchange rate changes on cash	(4)	80
Net increase (decrease) in cash and cash equivalents	292	(1,092)

Cash and cash equivalents at beginning of period	17	1,147
Cash and cash equivalents at end of period	$309	$55
Supplemental disclosure of cash flow information:		
Interest paid	$9	$218
Supplemental disclosure of non-cash transactions:		
Fair value of warrants issued in warrant re-pricing	$--	$13,786
Fair value of warrants issued to financial advisor	$--	$2,018
Fair value of warrants issued to bridge note holder	$--	$842
Conversion of September convertible notes	$--	$35
Value of August note surrendered towards the exercise of re-priced warrants	$--	$375
Fair value of conversion of common stock of Series A and B preferred stock issued to note and warrant holders related to corporate restructuring in excess of amounts recorded in equity at December 31, 2008	$2,741	$--
Fair value of warrants reclassified to derivative liability due to the adoption of new accounting standard	$67	$--
Deemed dividend to investors who received Series A preferred stock issued related to corporate restructuring at December 31, 2008 based on the fair value of the conversion to common stock at March 31, 2009	$1,035	$--
Debt discount recorded as a result of derivative conversion feature	$836	$--
Conversion of related party accrued expenses to converted to convertible notes payable	$51	$--
Fair value of 762,912 shares of common stock issued to convert accounts payable to equity	$23	--
Exchange of common stock for preferred stock	$2,692	$--
Fair value of conversion to common stock of 495,000 shares of Series A Preferred stock issued to related parties for 100% of Neonode Technologies AB recorded as compensation expense	$4,555	$--

See notes to condensed consolidated financial statements

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

1. Nature of the business and operations

Background and Organization

In the opinion of the Company, the accompanying condensed consolidated financial statements reflect all adjustments (which include normal recurring adjustments) and reclassifications necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America. Interim results are not necessarily indicative of fiscal year performance for a variety of reasons including, but not limited to, the impact of seasonal and short-term variations. The Company has continued to follow the accounting policies (including its critical accounting policies) set forth in the consolidated financial statements included in its 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”). These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Neonode Inc. was incorporated in the State of Delaware in 2006 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 Cypressen 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. The consolidated statements of operations and consolidated statements of cash flows include the accounts of Neonode AB for the period January 1, 2008 through December 9, 2008, the date Neonode AB filed for bankruptcy.

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, Wirelesstoys 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 495,000 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. Our consolidated balance sheet as of December 31, 2008 includes the accounts of Neonode Technologies AB which is comprised of cash totaling approximately $12,000. 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, and is comprised principally of engineers formerly employed by 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, 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 .

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 Tech 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 Stockholders is released from the lapsing repurchase right. Thus, the fair value of the common stock (as converted from Series A Preferred Stock during 2009) issued under the Share Exchange Agreement is being amortized to compensation expense over the 18-month vesting period beginning January 1, 2009.

Operations

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

Liquidity

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have incurred net operating losses and negative operating cash flows since inception. As of December 31, 2009, we had an accumulated deficit of approximately $80.6 million, a stockholders' deficit of approximately $6.3 million and a working capital deficit (current assets less current liabilities, not including non-cash liabilities related to warrants and embedded derivatives) of approximately $1.9 million. In addition, for the year ended December 31, 2009, we had cash used in operating activities of approximately $2.0 million. Our operations are subject to certain risks and uncertainties frequently encountered by companies in the early stages of operations. Such risks and uncertainties include, but are not limited to, technical and quality problems in new products, ability to raise additional funds, credit risks and costs for developing new products. Our ability to generate revenues in the future will depend substantially on our ability to enter into customer contracts with customers and to raise additional funds through debt or equity. During 2009, we raised approximately $2.0 million through convertible debt and equity offerings. Through May 5, 2010, we completed a private placement of convertible notes and stock purchase warrants totaling approximately $1.5 million.

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

Neonode AB Bankruptcy

On December 9, 2008, Neonode AB, our former wholly owned subsidiary located in Sweden, filed for liquidation under the bankruptcy laws in Sweden. Under Swedish bankruptcy law, effective with the bankruptcy filing, we no longer have an ownership interest in Neonode AB, and, as such, we are no longer responsible for the liabilities of Neonode AB and we no longer have title or an ownership interest in the assets of Neonode AB. The Swedish bankruptcy court appointed a Swedish legal firm as receiver with the expressed duty to liquidate all the assets of Neonode AB and enter into final settlements with the creditors of Neonode AB.

We accounted for our investment in Neonode AB in accordance with accounting guidance, which precludes consolidation of a majority-owned subsidiary where control does not rest with the majority owners - for instance, where the subsidiary is in bankruptcy. Accordingly, we deconsolidated Neonode AB from our consolidated financial statements on the date it filed for bankruptcy, December 9, 2008.

Our consolidated statements of operations and cash flows include the accounts of Neonode AB for the period January 1, 2008 through December 9, 2008, the date Neonode AB filed for bankruptcy. Since we no longer have an ownership interest in Neonode AB, we recorded a write-off of our receivable from Neonode AB totaling $2.8 million on the date Neonode AB filed for bankruptcy. We also recorded a gain on debt forgiveness of Neonode AB in bankruptcy totaling $9.8 million.

Our consolidated balance sheet does not include the accounts of Neonode AB at December 31, 2008.

2. Summary of significant accounting policies

Principles of Consolidation

The preparation of our consolidated financial statements are in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The consolidated balance sheet as of December 31, 2008 includes the accounts of our new wholly owned subsidiary based in Sweden; Neonode Technologies AB. Operating results for Neonode Technologies AB for 2008 were insignificant. The consolidated statement of operations and cash flows for the year ended December 31, 2008 include the accounts of Neonode Inc. and Neonode AB for the period January 1, 2008 through December 9, 2008, the date that Neonode AB filed for bankruptcy. For 2009, the audited consolidated statements of operations and comprehensive loss and cash flows include the results of operations of Neonode Technologies AB. The condensed consolidated balance sheets as of March 31, 2009, June 30, 2009 and September 30, 2009 includes the accounts of Neonode Inc. and Neonode Technologies AB. All inter-company accounts and transactions have been eliminated in consolidation.

Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles 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, the recoverability of long-lived assets, the fair value of embedded derivatives and securities such as shares, 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 considers all highly liquid investments with original maturities of three months of less to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

Our net accounts receivable are stated at net realizable value. Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of the customer when determining or modifying its credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer’s account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation, such as in the case of a bankruptcy filing, deterioration in the customer’s operating results or financial position or other material events impacting its business, we record a specific allowance to reduce the related receivable to the amount we expect to recover. Should all efforts fail to recover the related receivable, we will write-off the account. We also record an allowance for all customers based on certain other factors including the length of time the receivables are past due and historical collection experience with customers. For the years ended December 31, 2009 and 2008, we had no accounts receivable.

Property, Plant and Equipment

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

	Estimated useful lives
Tooling	1 year
Computer equipment	3 years
Furniture and fixtures	5 years

Equipment purchased under capital leases is amortized on a straight-line basis over the estimated useful life of the asset.

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

Long-lived Assets

We assess any impairment by estimating the future cash flow from the associated asset in accordance with relevant accounting guidance. If the estimated undiscounted future cash flow related to these assets decreases or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset. For the year ended December 31, 2009, we believe there is no impairment of our long-lived assets. There can be no assurance, however, that market conditions will not change or sufficient commercial demand for our products and services will materialize, which could result in impairment of long-lived assets in the future.

Foreign Currency Translation

The functional currency of our foreign subsidiary is the applicable local currency, the Swedish Krona. The translation from Swedish Krona to U.S. Dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for income statement accounts using a weighted average exchange rate during the period. Gains or losses resulting from translation are included as a separate component of accumulated other comprehensive loss. Gains or losses resulting from foreign currency transactions are included in other (expense) income . In addition, as Neonode AB entered into bankruptcy and we no longer control that entity, the foreign currency translation adjustment account relating to Neonode AB was written off into our statement of operations during the year ended 2008. Foreign currency transaction losses included in other (expense) income and were $0 and $848,000 during the years ended December 31, 2009 and 2008, respectively.

Liability for Warrants and Embedded Derivatives

We do not enter into derivative contracts for purposes of risk management or speculation. However, from time to time, we enter into contracts that are not considered derivative financial instruments in their entirety but that include embedded derivative features, such as conversion features. Such embedded derivatives are assessed at inception of the contract and every reporting period, depending on their characteristics, are accounted for as separate derivative financial instruments pursuant to accounting guidance, if such embedded conversion features, if freestanding, would meet the classification of a liability. Accounting guidance requires that we analyze all material contracts and determine whether or not they contain embedded derivatives. Any such embedded conversion features that meet the above criteria are then bifurcated from their host contract and recorded on the consolidated balance sheet at fair value and the changes in the fair value of these derivatives are recorded each period in the consolidated statements of operations as an increase or decrease to non-cash charges for conversion features and warrants.

Similarly, if warrants meet the criteria in accordance with accounting guidance to be classified as liabilities, then the fair value of the warrants are recorded on the consolidated balance sheet at their fair values, and any changes in such fair values are recorded each period in the consolidated statements of operations as an increase or decrease to non-cash charges for conversion features and warrants.

Concentration of Credit and Business Risks

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

Risk and Uncertainties

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

We are subject to certain risks common to technology-based companies in similar stages of development. Principal risks include risks relating to the uncertainty of market acceptance for our products, a history of losses since inception, our ability to remain competitive in response to new technologies, the costs to defend, as well as risks of losing, patents and intellectual property rights, a reliance on a limited number of suppliers, the concentration of our operations in a limited number of facilities, the uncertainty of demand for our products in certain markets, our ability to manage growth effectively, our dependence on key members of our management and development team, our limited experience in conducting operations internationally, and our ability to obtain adequate capital to fund future operations.

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

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

Neonode AB Mobile Phone Business and Licensing of Our Intellectual Property:

We recognized revenue from product sales when title transferred and risk of loss had passed to the customer, which was generally upon shipment of products to our customers. We estimated expected sales returns and recorded the amount as a reduction of revenues and cost of sales at the time of shipment. Our policy complied with the accounting guidance, which required revenue recognition from the sale of our mobile phones when all of the following conditions were met: (1) evidence existed of an arrangement with the customer, typically consisting of a purchase order or contract; (2) our products were delivered and risk of loss passed to the customer; (3) we completed all of the necessary terms of the contract; (4) the amount of revenue to which we were entitled was fixed or determinable; and (5) we believed it was probable that we would be able to collect the amount due from the customer. To the extent that one or more of these conditions had not been satisfied, we deferred recognition of revenue. Judgments were required in evaluating the credit worthiness of our customers. Credit was not extended to customers and revenue was not recognized until we determined that collectibility was reasonably assured.

In 2008, our revenues generated by the sale of Neonode AB’s mobile phones consisted primarily of sales to distributors. From time to time, we allowed certain distributors price protection subsequent to the initial product shipment. Price protection allowed the distributor a credit (either in cash or as a discount on future purchases) if there was a price decrease during a specified period of time or until the distributor resold the goods. Future price adjustments were difficult to estimate since we did not have a sufficient history of making price adjustments. Therefore, we deferred recognition of revenue derived from sales to these customers until they resold our products to their customers. Although revenue recognition and related cost of sales were deferred, we recorded an accounts receivable at the time of initial product shipment. As standard terms were generally FOB shipping point, payment terms were enforced from the shipment date, and legal title and risk of inventory loss passed to the distributor upon shipment.

For products sold to distributors with agreements allowing for price protection and product returns, we recognized revenue based on our best estimate of when the distributor sold the product to its end customer. Our estimate of such distributor sell-through was based on information received from our distributors. Revenue was not recognized upon shipment since, due to various forms of price concessions; the sales price was not substantially fixed or determinable at that time.

Revenue from products sold directly to end-users though our web sales channels were generally recognized when title and risk of loss has passed to the buyer, which typically occurs upon shipment. Reserves for sales returns were estimated based primarily on historical experience and were provided at the time of shipment.

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Generally, our customers were responsible for the payment of all shipping and handling charges directly with the freight carriers.

Neonode AB derived revenue from the licensing of internally developed intellectual property (IP). We entered into IP licensing agreements that generally provided licensees the right to incorporate our IP components in their products with terms and conditions that varied by licensee. The IP licensing agreements generally included a nonexclusive license for the underlying IP. Fees under these agreements may have included 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. On December 1, 2008, we transferred the Neonode AB intellectual property including patents, copyrights and trademarks to Neonode Inc. pursuant to an intercompany debt pledge agreement.

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 defer and recognize service revenue over the contractual period or as services are rendered. We 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. Our policy complies with the accounting guidance. Judgments are required in evaluating the creditworthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectibility is reasonably assured. Our sales transactions are denominated in U.S. dollars or Euros. The software component of our hardware products is considered incidental. Therefore, we do not recognize software revenue related to our hardware products separately from the hardware product sale. To date, we have not sold any hardware products.

When selling hardware, we expect our agreements with OEMs and ODMs to incorporate clauses reflecting the following understandings:

- all prices are fixed and determinable at the time of sale;
- title and risk of loss pass at the time of shipment (FOB shipping point);
- collectibility of the sales price is probable (the customer is creditworthy, the customer is obligated to pay and such obligation is not contingent on the ultimate sale of the customer’s integrated solution);
- the customer’s obligation to us will not be changed in the event of theft or physical destruction or damage of the product;
- we do not have significant obligations for future performance to directly assist in the resale of the product by the OEMs; and
- there is no contractual right of return other than for defective products.

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Software Products:

We may derive revenues from the following sources: (1) software, which includes our Neno™ software licenses and (2) engineering services, which include consulting. We 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. These documents include post delivery support, upgrades, and similar services.

For software license arrangements that do not require significant modification or customization of the underlying software, we recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured. We initially defer all revenue related to the software license and maintenance fees until such time that we are able to establish VSOE for these elements of our software products. Revenue deferred under these arrangements is recognized to revenue over the expected contract term. We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted. To date, we have not sold any software products.

Engineering Services:

We may sell engineering consulting services to our customers on a flat rate or hourly rate basis. We recognize revenue as the engineering services stipulated under the contact are completed and accepted by our customers. On December 29, 2009, we signed an engineering services agreement with an OEM to provide engineering services over a three-month period in 2010 related to the development of a touchscreen application for a mobile phone product. The value of this agreement is approximately $100,000, which will be recognized as revenue in 2010.

Warranty Reserves

Our mobile phone products were generally warranted against defects for 12 months following the sale. We have a 12-month warranty from the manufacturer of the mobile phones. Reserves for potential warranty claims not covered by the manufacturer were provided at the time of revenue recognition and were based on several factors, including current sales levels and our estimate of repair costs. Shipping and handling charges were expensed as incurred. Upon filing for bankruptcy on December 9, 2008, the warranty obligations related to Neonode AB's previous sales of mobile phone products were transferred to the Swedish bankruptcy court along with all the assets and liabilities of Neonode AB.

We do not anticipate that our technology products will have any warranty obligations associated with licenses related to these technologies.

Advertising

Advertising costs are expensed as incurred. External advertising costs amounted to $0 and $452,000 for the years ended December 31, 2009 and 2008, respectively, including $430,000, $18,000, and $4,000 for the quarters ended March 31, 2008, June 30, 2008, and September 30, 2008, respectively.

Research and Development

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

Stock Based Compensation Expense

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

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

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

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

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

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

Income Taxes

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

Based on the uncertainty of future pre-tax income, we fully reserved our net deferred tax assets as of September 30, 2009 and December 31, 2008. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such a determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

Effective January 1, 2007, we adopted the relevant accounting guidance related to uncertain tax positions, which provisions include a two-step approach to recognizing, de-recognizing and measuring uncertain tax positions. As a result, we recognized no increase in the liability for unrecognized tax benefits. For the year ended December 31, 2009, we had no unrecognized tax benefits.

Net Loss Per Share

Net loss per share amounts have been computed based on the weighted average number of shares of common stock outstanding during the period. Net loss per share, assuming dilution amounts from common stock equivalents, is computed based on the weighted average number of shares of common stock and potential common stock equivalents outstanding during the period. The weighted average number of shares of common stock and potential common stock equivalents used in computing the net loss per share for years ended December 31, 2009 and 2008 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 reflected in stockholders’ deficit.

Cash Flow Information

Cash flows in foreign currencies have been converted to U.S. dollars at an approximate weighted average exchange rate for the respective reporting periods. The weighted average exchange rate for the consolidated statements of operations was 7.65 and 6.58 Swedish Krona to one U.S. Dollar for the years ended December 31, 2009 and 2008, respectively. The weighted average exchange rate for the consolidated balance sheets was 7.21 and 7.84 Swedish Krona to one U.S. Dollar as of December 31, 2009 and 2008, respectively. For the quarters ended March 31, 2009, June 30, 2009, and September 30, 2009, the weighted average exchange rate for the consolidated statements of operations was 8.39, 8.15, and7.87 Swedish Krona to one U.S. Dollar. The weighted average exchange rate for the consolidated balance sheets was 8.32, 7.75, and 7.02 Swedish Krona to one U.S. Dollar as of March 31, 2009, June 30, 2009, and September 30, 2009, respectively. For the quarters ended March 31, 2008, June 30, 2008, and September 30, 2008, the weighted average exchange rate for the consolidated statements of operations was 6.28, 6.14, and 6.19 Swedish Krona to one U.S. Dollar. The weighted average exchange rate for the consolidated balance sheets was 5.96, 5.98, and 6.75 Swedish Krona to one U.S. Dollar as of March 31, 2008, June 30, 2008, and September 30, 2008, 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 and cash equivalents, payables and current portions of long-term debt are deemed to approximate fair value due to their short maturities. The carrying amounts of long-term debt cannot be reasonably determined since no quoted market prices exist for these instruments and quoted prices for similar instruments cannot be located.

New Accounting Pronouncements

In June 2009, the FASB issued guidance on the hierarchy of generally accepted accounting principles, specifically as it relates to the codification of accounting standards (the "Codification"). The Codification, which was launched on July 1, 2009, became the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants Emerging Issues Task Force and related literature. The Codification eliminates the GAAP hierarchy contained in previous accounting guidance and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. This new guidance is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We have adopted the Codification with no impact to our consolidated financial statements.

In August 2009, the FASB issued Accounting Standard Update ("ASU") No. 2009-05, Measuring Liabilities at Fair Value, which provides additional guidance on how companies should measure liabilities at fair value under ASC 820. The ASU clarifies that the quoted price for an identical liability should be used. However, if such information is not available, an entity may use, the quoted price of an identical liability when traded as an asset, quoted prices for similar liabilities or similar liabilities traded as assets, or another valuation technique (such as the market or income approach). The ASU also indications that the fair value of a liability is not adjusted to reflect the impact of contractual restrictions that prevent its transfer and indicates circumstances in which quoted market prices for an identical liability or quoted price for an identical liability traded as an asses may be considered level 1 fair value measurements. This ASU is effective October 1, 2009. During 2009, the Company adopted this standard, but it did not have a material impact on the consolidated financial statements.

3. Convertible Debt and Leases

Our convertible debt and leases consist of the following (in thousands):

	September 30, 2009	December 31, 2008
Senior Convertible Secured Notes September 2009	$837	$--
Senior Convertible Secured Notes September 2007	139	139
Capital lease	--	85
	976	224
Unamortized debt discount	(800)	--
Convertible long-term debt and leases, net of debt discount	176	224
Less: short term portion	(139)	(17)
Convertible long-term debt and leases, net of debt discount and short term portion	$37	$207

Future maturities of notes payable (in thousands) as of September 30, 2009:

Year ended December 31,	Future Maturity of Notes Payable
2009 (3 months remaining)	$ --
2010	976
Total principal payments	$ 976

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Capital Lease

We leased Xerox office equipment and returned the leased equipment to Xerox during the quarter ended March 31, 2009, thus eliminating the lease obligation. Xerox filed a lawsuit to collect the remainder of the lease payments. We have filed a motion to dismiss the lawsuit and during the quarter ended March 31, 2010 have accrued approximately $109,000 related to the lawsuit during the quarter ended December 31, 2009.

September 2009 Senior Convertible Secured Notes Financing transaction

During the period from August 25, 2009 through September 30, 2009 and during the period from October 1, 2009 through December 31, 2009, we completed a private placements of convertible notes of $837,000 and $150,000, respectively, that can be converted, at the holder's option, into a total of 49,349,151 shares of our common stock at a conversion price of $0.02 per share (the "September 2009 Convertible Notes"). Included in the convertible notes was approximately $79,000 of related-party accruals that were converted to these notes. The convertible note holders have the right to have the conversion price adjusted to equal the lower stock price if we issue common stock or convertible notes at a lower conversion price than $0.02 during the period that the notes are outstanding. The September 2009 Convertible Notes are due on December 31, 2010 and bear an annual interest rate of 7%, payable on June 30 and December 31 of each year that the convertible notes are outstanding. In addition, we issued 24,674,576 three-year warrants to the convertible note holders with an exercise price of $0.04 per share. The warrants may be exercised and converted to common stock, at the warrant holder's option, beginning on the six-month anniversary date of issuance until the warrant expiration date. We are not obligated to register the common stock related to the convertible debt or the warrants.

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

The fair value of the embedded conversion features of the September 2009 Convertible Notes totaled $1.9 million and $275,000 on the dates of issuance of the convertible debt for the quarters ended September 30, 2009 and December 31, 2009, respectively. The fair value of the conversion features is included in the account entitled embedded derivatives of convertible debt and warrants on our consolidated balance sheets as of September 30, 2009 and December 31, 2009. We recorded a debt discount of $837,000 and $150,000 for the quarters ended September 30, 2009 and December 31, 2009, respectively, and the excess fair value was recorded as an expense in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on our consolidated statement of operations and comprehensive loss, totaling $1.1 million and $125,000 for the quarters ended September 30, 2009 and December 31, 2009, respectively. The embedded conversion features were valued on the dates we received the proceeds using the Black-Scholes option pricing model. The assumptions used for the Black-Scholes option pricing model at the dates of issuance ranged from a term of 1 to 1.33 years, volatility of 226.79% to 247.52%, and a risk-free interest rate of 1.13%.

The embedded conversion feature is revalued on each balance sheet date and marked to market using the Black-Scholes option pricing model. The value of the conversion features was $1.7 million and $959,000 at September 30, 2009 and December 31, 2009, respectively, and is included on our consolidated balance sheets on those dates in the account entitled embedded derivatives of convertible debt and warrants. The $226,000 and $990,000 reduction in the fair value from the dates of issuance is included as income in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on our consolidated statement of operations and comprehensive loss for the quarters ended September 30, 2009 and December 31, 2009, respectively. The assumptions used for the Black-Scholes option pricing model at September 30, 2009 and December 31, 2009 ranged from a term of 1 to 1.33 years, volatility of 226.79% to 247.52%, and a risk-free interest rate of 0.45%.

The debt discounts are being amortized to expense over the 15-month term of the debt on a straight-line basis, which approximates the effective interest method. Included in the account entitled non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants on the consolidated statements of operations and comprehensive loss for the quarters ended September 30, 2009 and December 31, 2009 is $37,000 and $185,000 , respectively related to amortization of the debt discounts.

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

2008 Troubled Debt Restructuring

Conversion of Senior Convertible Notes to Series A Preferred Stock:

We determined that, based on the capitalization of the Company, the value of the notes held by the note holders entitled the note holders to shares representing approximately twenty-five percent of the Company. However, since we did not have a sufficient number of unissued shares of common stock to convert all of the outstanding notes into shares of common stock as well as enter into the other Refinancing Agreements, we decided to exchange the existing notes for 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, the note holders would own in the aggregate an amount of shares equal to approximately 25% of the Company after completion of our refinancing and capital raising activities. Nevertheless, pursuant to the Note Conversion Agreements, we did not guarantee that either the Company’s authorized share capital would be increased or that the conversion rate would be increased (see Note 9). On December 31, 2008, 24 out of 27 convertible and promissory note holders agreed to the surrender of notes and accrued interest on such notes in the aggregate amount of $6,195,805 in consideration for the issuance of 244,265.56 shares of Series A Preferred stock. The carrying value of the convertible notes, promissory notes, and debt discount plus the fair value of the related embedded conversion features amounted to $5.9 million immediately prior to conversion, using the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the common stock anti-dilution feature were a term of 0.23 years, volatility of 357.2%, and a risk-free interest rate of 0.11%. The fair value of the Series A Preferred stock on the date of conversion was $10 per share, as we also raised $1.2 million in cash at $10 per share from both inside and outside investors, with outside investors comprising approximately 51% of the total. This conversion resulted in troubled debt restructuring accounting in accordance with accounting guidance, and we recorded a non-cash gain on conversion of $3.3 million (see below). The remaining $139,000 convertible notes outstanding after the conversion transaction have a due date of August 26, 2010 and bear an annual interest rate of the greater of 8% or LIBOR plus 3%, payable quarterly in cash or shares of our common stock at our option.

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Conversion of Warrants to Series B Preferred Stock:

On December 29, 2008, we commenced entering into Warrant Conversion Agreements with the holders of warrants for the purchase of shares, notes and/or additional warrants of the Company for the issuance of up to 108,850 shares of Series B Preferred Stock in exchange for the surrender of the warrants by the warrant holders. If all of the existing warrants were to have been converted into shares of common stock of the Company, the Company would have had to issue 14,365,434 shares of common stock. Since we did not have a sufficient number of unissued shares of common stock to convert all of the outstanding warrants into shares of common stock as well as enter into the other Refinancing Agreements, we decided to exchange the existing warrants for shares of Series B Preferred Stock at a ratio such that assuming an increase in the Company's authorized share capital and an increase in the conversion rate, the warrant holders would own in the aggregate 14,365,434 shares of common stock after completion of our refinancing and capital raising activities. Nevertheless, pursuant to the Warrant Conversion Agreements, we did not guarantee that either the Company's authorized share capital would be increased or that the conversion rate would be increased (see Note 9). On December 31, 2008, 92 out of 129 holders of warrants for the purchase of shares, notes, and/or additional warrants agreed to the surrender of 12,255,560 warrants in exchange for the issuance of 92,795 shares of Series B Preferred Stock. The fair value of the converted warrants which were previously recorded as liabilities amounted to $112,000 immediately prior to the exchange, using the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the warrants prior to the exchange were a term of 4.4 years, volatility of 152.3%, and a risk-free interest rate of 1.37%. The fair value of the Series B Preferred stock on the date of exchange was $0.0245 per share, which is based upon a fully diluted price per share using our market capitalization on that date. This transaction resulted in troubled debt restructuring accounting in accordance with accounting guidance, and we recorded a non-cash gain on conversion of $109,000. The remaining outstanding warrants no longer meet the classification of liabilities according to accounting guidance since the toxic securities (the anti-dilution feature) from September 26, 2007 financing are no longer applicable, and, as such, the remainder of the warrants previously recorded as a liability on the consolidated balance sheet has been reclassified to equity at December 31, 2008 at the fair value of $67,000.

These transactions were accounted for as a troubled debt restructuring modification of terms pursuant to relevant accounting guidance. On December 31, 2008, the gain resulting from the conversions of the Notes, embedded conversion features and a warrant, calculated in accordance with accounting guidance, was determined as follows:

Conversion of carrying value of Senior Secured Notes, net of discount	$2,661
Conversion of carrying value of embedded conversion features	3,051
Conversion of carrying value of warrants	93
Total conversion of carrying value of debt, embedded conversion features and warrants	5,805
Decreases to gain:	
Fair value of Series A and B Preferred stock issued in exchange	2,445
Gain on Troubled Debt Restructuring	$3,360

On both a basic and diluted income per share basis, the $3.4 million gain was $0.12 per share for the year ended December 31, 2008.

Prior Outstanding Debt and Warrants Converted to Preferred Stock on December, 31, 2008

1) Senior Convertible Secured August Bridge Notes

On August 8, 2007, we made an offering of convertible notes pursuant to a Note Purchase Agreement (August Bridge Notes or Bridge Notes), dated as of July 31, 2007, amended most recently on March 24, 2008. The August Bridge

Notes were originally convertible into the units described below. We received $3,250,000 from the Bridge Note offering and issued an option to an investor/financial advisor to invest $750,000, at the same terms and conditions as the Bridge Notes. The August Bridge Notes originally matured on December 31, 2007; however, the maturity date of these notes was extended to December 31, 2008 and the option to invest expired on December 31, 2008.

The August Bridge Notes were due December 31, 2008, bore 8% per annum interest and were convertible into purchase units that are made up of a combination of shares of our common stock, convertible debt and warrants. The note holders had a right to convert their notes plus accrued interest into purchase units anytime before December 31, 2008. Each purchase unit of $3,000 is comprised of one $1,500 three-year promissory note bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of $3.50 per share, 600 shares of our common stock and 5 year warrants to purchase 696.5 shares of our common stock at a price of $1.27 per share. For accounting purposes, the embedded conversion feature was determined to meet the definition of a derivative and was recorded as liability. This was because the holder of the notes could convert debt and accrued interest, when interest is at the greater of 8% or LIBOR plus 3%, and therefore, the total number of shares into which the instrument could be convertible was not fixed. Accordingly, the embedded conversion feature was bifurcated from the debt host instrument and treated as a liability, with the offset to debt discount. The related warrants were also recorded as a liability for the same reason.

On December 31, 2008, all of the Bridge Notes plus accrued interest were converted into 123,641 shares of our Series A Preferred stock. Please see above section, 2008 Troubled Debt Restructuring, for accounting treatment.

2) August Bridge Notes Extension Warrants

On September 26, 2007, the August Bridge Note holders that had not converted their debt were given three year warrants to purchase up to 219,074 shares (1st Extension Warrants) of our common stock at a price of $3.92 per share in exchange for an agreement to extend the term of their notes from the original date of December 31, 2007 until June 30, 2008. The fair value of the warrants issued to the holders of the remaining Bridge Notes was calculated at September 26, 2007 as $706,000, using the Black-Scholes option pricing model. The assumptions used for calculating the fair value of the 1st Extension Warrants were a term of 3 years, volatility of 116%, and a risk-free interest rate of 4.16%. The 1st Extension Warrants were classified as a liability pursuant to the relevant accounting guidance. The fair value of the warrants was recorded as a debt issuance cost and is allocated to interest expense based on the effective interest rate method over the nine month term of the notes with the offsetting entry to a liability. As a result of the extension of the loan maturity period, the agreement to delay conversion of the bridge notes and the issuance of the 1st Extension Warrants, the modifications were significant enough to trigger debt extinguishment accounting resulting in a debt extinguishment charge for the year ended December 31, 2007 amounting to $442,000. The liability for the 1st Extension Warrants issued to the August Bridge Note holders is revalued at the end of each reporting period and the change in the liability is recorded in the account entitled non-cash financing items.

On December 31, 2008, all of the 1st Extension Warrants related to the Bridge Notes were exchanged into 1,659 shares of our Series B Preferred stock.

On December 31, 2008, we compared the fair value of the Series B Preferred stock issued upon conversion of the outstanding 219,074 1st Extension Warrants related to the Bridge Notes. The carrying value of the warrants was calculated using the Black-Scholes option pricing model. The resulting gain is included in the Non-cash items related to gain on troubled debt restructuring in our Consolidated Statements of Operations for the year ended December 31, 2008.

On May 21, 2008, the August Bridge Note holders that had not converted their debt were given additional three year warrants (2nd Extension Warrants) to purchase up to 510,294 shares of our common stock at a price of $1.45 per share in exchange for an agreement to extend the term of their notes from June 30, 2008 until December 31, 2008. The 2nd Extension Warrants were classified as a liability pursuant to relevant accounting guidance. The liability for the 2nd Extension Warrants issued to the August Bridge Note holders is revalued at the end of each reporting period using the Black-Scholes option pricing model and the change in the liability is recorded as "Non-cash financing items." The assumptions used when calculating the fair value of the 2nd Extension Warrants were a term of 3 years, volatility of 125.57% and a risk-free interest rate of 2.68%.

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On December 31, 2008, all of the 2nd Extension Warrants related to the Bridge Notes were exchanged for 3,864 shares of our Series B Preferred stock.

- On December 31, 2008, we calculated the fair value of the Series B Preferred stock issued upon conversion of the outstanding 510,294 2nd Extension Warrants related to the Bridge Notes. The carrying value of the warrants was calculated using the Black-Scholes option pricing model. The resulting gain is included in the Non-cash items related to gain on troubled debt restructuring in our consolidated statements of operations for the year ended December 31, 2008.

3) Option to Invest in Bridge Notes

In conjunction with the issuance of the August Bridge Notes, we issued and investor an option to invest up to $750,000 under the same terms and conditions as the August Bridge Notes. The initial fair value of the option to purchase $750,000 of the August Bridge Notes amounted to $716,000 based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the original option to invest were a term of 0.39 years, volatility of 99%, and interest rate of 4.16%. The initial fair value of the option to invest was recorded as a deferred financing fee to be allocated to interest expense using the effective interest rate method over the nine month term of the notes with the offset recorded as other current liability. The liability for the option to purchase additional August Bridge Notes is revalued at the end of each reporting period and the change in the liability is recorded in the account entitled non-cash items relating to debt discounts and deferred financing fees and the valuation of conversion features and warrants.

The fair value of the option to purchase $750,000 of the August Bridge Notes originally issued on August 8, 2007 and due to expire on December 31, 2007 was extended until March 15, 2008 on December 31, 2007 and revalued based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the extended option to invest were a term of 0.21 years, volatility of 99% and interest rate of 3.36%. The fair value of the extension totaled $475,000 and was recorded as a deferred financing fee to be allocated to interest expense using the effective interest rate method over the 12 month remaining term of the August Bridge Notes with the offset recorded as other current liability.

The fair value of the option to purchase $750,000 of the August Bridge Notes originally issued on August 8, 2007 and extended until March 15, 2008 was extended until June 30, 3008 on March 15, 2008 and revalued based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the extended option to invest were a term of 0.25 years, volatility of 79% and interest rate of 1.38%. The fair value of the extension totaled $823,000 and was recorded as a deferred financing fee to be allocated to interest expense using the effective interest rate method over the nine months remaining term of the August Bridge Notes with the offset recorded as other current liability.

On April 17, 2008, the option holder exercised $375,000 of the original $750,000 option amount and was issued a note on the same terms and conditions as the August Bridge Notes. The option to invest the $375,000 unexercised portion was extended until December 31, 2008 in conjunction with the May 2008 financing. The fair value of the unexercised option to purchase $375,000 of the August Bridge Notes was revalued based on the Black-Scholes option pricing model. The assumptions used when calculating the fair value of the extended option to invest were a term of 0.5 years, volatility of 107% and interest rate of 1.23%. The fair value of the extension totaled $324,000 and was recorded as a deferred financing fee to be allocated to interest expense using the effective interest rate method over the six months remaining term of the August Bridge Notes with the offset recorded as other current liability. The exercise of $375,000 of the original $750,000 option reduced the liability for the option by $314,000.

On May 21, 2008, as part of the May 21, 2008 warrant repricing financing transaction described below, the $375,000 of Bridge Note debt was cancelled and was converted into 295,275 shares common stock and 590,550 warrants at an exercise price of $1.45 per share.

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On December 31, 2008, all of the 590,550 5-year warrants were exchanged for 4,471 shares of our Series B Preferred stock. The option to invest the remaining unexercised $375,000 of the original $750,000 option to invest terminated on December 31, 2008 without the option holder exercising the option.

- On December 31, 2008, we calculated the fair value of the Series B Preferred stock issued upon conversion of the outstanding 590,550 Warrants. The carrying value of the warrants was calculated using the Black-Scholes option pricing model. The resulting gain is included in the non-cash items related to gain on troubled debt restructuring in our consolidated statements of operations for the year ended December 31, 2008.

4) Senior Convertible Secured Notes September 26, 2007 Financing

On September 26, 2007, we sold $5.7 million of securities in a private placement, comprised of $2.9 million of three-year promissory notes bearing the greater of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of $3.50 per share, 952,499 shares of our common stock, and 5 year warrants to purchase 1,326,837 shares of our common stock at a price of $3.92 per share.

In addition, on September 26, 2007, certain holders of the August Bridge Notes converted an aggregate of $454,900 of debt and accrued interest into units offered in the September 26, 2007 financing. The debt holders of the August Bridge Notes that were converted received (i) $227,450 three-year promissory notes bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of $3.50 per share, (ii) 75,817 shares of our common stock, and (iii) 5-year warrants to purchase 105,612 shares of our common stock at a price of $3.92 per share. The fair value of the 5-year warrants totaled $340,000 and was calculated using the Black-Scholes option pricing model.

The total issuance of securities and debt on September 26, 2007 to investors and Bridge Note holders who converted was (i) $3.1 million of three-year promissory notes bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of $3.50 per share, (ii) 1,028,316 shares of our common stock, and (iii) 5-year warrants to purchase 1,432,449 shares of our common stock at a price of $3.92 per share.

The embedded conversion feature of the convertible debt issued on September 26, 2007 met the definition of a derivative financial instrument and is classified as a liability in accordance with accounting guidance. The note holder has the right to convert the debt and accrued interest and the interest rate is calculated at the greater of 8% or LIBOR plus 3%, and therefore, the total number of shares of our common stock into which the convertible note can be convertible is not fixed. Accordingly, the embedded conversion features are revalued on each balance sheet date and marked to market with the adjusting entry to non-cash financial items. The fair value of the conversion feature related to the September 26, 2007 convertible notes totaled $1.4 million at September 26, 2007 and was recorded as a debt discount. On the issuance date, we allocated the proceeds first to the warrants based on their fair value with the remaining balance allocated between debt, $771,000, and equity, $669,000, based on their relative fair values.

For the year ended December 31, 2008, $1.1 million of the debt discount is included in gain on troubled debt restructuring and $12,000 is included in interest expense in the consolidated statements of operations.

On December 31, 2008, $3.1 million of the Senior Secured Convertible Notes plus accrued interest were converted into 120,624 shares of our Series A Preferred stock. After conversion, $139,000 of the Senior Secured convertible Notes due August 31, 2010 remains outstanding. Please see above section, 2008 Troubled Debt Restructuring, for accounting treatment.

- The liability related to the embedded conversion feature was $0 at December 31, 2008 because the right for us to repurchase the notes expired on September 25, 2008 and, as such, the embedded conversion feature was no longer applicable.

The warrants issued in conjunction with the September 26, 2007 financing met the definition of a liability pursuant to relevant accounting guidance. The fair value of the warrants issued in conjunction with issuance of shares of our common stock and convertible debt totaled $4.3 million on its issuance date and was recorded as a liability. The fair value of the warrants on the date of issuance was calculated using the Black-Scholes option pricing model using a term of 5 years, volatility of 116%, and a risk-free interest rate of 4.2%.

All of the warrants, except for warrants to purchase 5,804 shares of our common stock, related to the Senior Convertible Secured Notes from September 2007 were exchanged for 8,994 shares of our Series B Preferred stock at December 31, 2008.

At December 31, 2008, the remaining outstanding 5,804 warrants no longer met the classification of liabilities in accordance with accounting guidance since the anti-dilution feature related to September 26, 2007 financing expired when the value of outstanding notes payable dropped below $2,000,000. The fair value of the warrants was measured at year end and the change in the fair value is included in the consolidated statements of operations in the non-cash items related to debt discounts and deferred financing fees and the valuation of conversion features and warrants. The fair value of $174,000 is included in equity as of December 31, 2008.

As part of the September 26, 2007 Private Placement, we issued 142.875 unit purchase warrants to Empire Asset Management Company (Empire) for financial advisory services provided in connection with the placement. Each unit purchase warrant has a strike price of $3,250 and is comprised of a $1,500 three-year promissory note, bearing the higher of 8% or LIBOR plus 3% interest per annum, convertible into shares of our common stock at a conversion price of $3.50 per share, 500 shares of our common stock and a five-year warrant to purchase 696.5 shares of our common stock at a purchase price of $3.92 per share. At the date of issuance, the fair value of the unit purchase warrants issued to Empire totaled $614,000 and was included in the issuance costs related to the September financing. The assumptions used for the Black-Scholes option pricing model were a term of five years, volatility of 99%, and a risk-free interest rate of 4.2%. The liability for the option to purchase additional units is revalued at the end of each reporting period and the change in the liability is recorded as "Non-cash financing items."

On December 31, 2008, all of the Unit Purchase Warrants related to the Senior Convertible Secured Notes were exchanged for 5,990 shares at no exercise price of our Series B Preferred stock. Please see above section, 2008 Troubled Debt Restructuring, for accounting treatment.

- On December 31, 2008, the liability related to the Unit Purchase Warrants amounted to $0, resulting in a $509,000 decrease for the year ended December 31, 2008 compared to the fair value of these unit purchase warrants of $509,000 at December 31, 2007. The $509,000 gain is included in the non-cash items related to gain on troubled debt restructuring in our consolidated statements of operations for the year ended December 31, 2008.

5) May 21, 2008 Warrant Repricing

On May 21, 2008, we offered our existing warrant holders an opportunity to exercise Neonode common stock purchase warrants on a discounted basis and to receive two new five-year common stock purchase warrants with an exercise price of $1.45 for each outstanding warrant exercised. In all, 8,009,586 new warrants were issued, including 590,550 to the option holder who converted the $375,000 of debt. The warrants were classified as a liability pursuant to accounting guidance. The warrants were recorded in the account entitles liability for warrants to purchase common stock and are valued at fair value at the end of each reporting period using the Black-Scholes option pricing model. The fair value of the warrants totaled $13.8 million. The assumptions used for the calculation of the fair value were a term of 5 years, volatility of 110.28%, and interest rate of 3.09%.

On December 31, 2008, 6,618,889 of the warrants were exchanged for 50,117 shares of our Series B Preferred stock. Please see above section, 2008 Troubled Debt Restructuring, or accounting treatment. 1,476,068 of the warrants issued related to the Warrant Repricing remain outstanding after the December 31, 2008 restructuring and warrant conversion.

- On December 31, 2008, the remaining 1,476,068 outstanding warrants no longer met the classification of liabilities in accordance with accounting guidance and, as such, these warrants previously recorded as a liability on the consolidated balance sheet were reclassified to equity using the $44,000 fair value on December 31, 2008. The assumptions used when calculating the fair value of the warrants at December 31, 2008 were a term of 4.3 years, volatility of 143.1%, and a risk-free interest rate of 1.46%.

6) Loan Agreement with Almi Företagspartner

On April 6, 2005, our formerly wholly owned subsidiary, Neonode AB, entered into a loan agreement with Almi Företagspartner (“Almi”) in the amount of SEK 2,000,000, with 72,000 warrants to purchase Neonode Inc. shares. The loan had an expected credit period of 48 months with an annualized interest rate of 2%. We were not required to make any repayments of principal for the first nine months. Quarterly repayments of principal thereafter amounted to SEK 154,000. We had the right to redeem the loan at any time prior to expiration subject to a prepayment penalty of 1%, on an annualized basis, of the outstanding principal amount over the remaining term of the loan. A floating charge (chattel mortgage) of SEK 2,000,000 was pledged as security. On December 9, 2008, Neonode AB filed for liquidation under the Swedish bankruptcy laws and the note with Almi is no longer an obligation of ours after that date. The Almi note was written off when Neonode AB filed for bankruptcy on December 9, 2008 and is included in the gain on debt forgiveness of Neonode AB on the Consolidated Statements of Operations for the year ended December 31, 2008.

The warrants had a term of five years with a strike price of $10.00. The warrants were callable by us for $0.10 should the price of our common stock trade over $12.50 on a public exchange for 20 consecutive days. The warrants were analyzed under the accounting guidance, and were determined to be equity instruments. In accordance with accounting guidance, because the warrants are equity instruments, we have allocated the proceeds of the second Almi loan between the debt and detachable warrants based on the relative fair values of the debt security and the warrants themselves. To calculate the debt discount related to the warrants, the fair market value of the warrants was calculated using the Black-Scholes options pricing model. The assumptions used for the Almi loan debt discount were a term of five years, volatility of 30% and a risk-free interest rate of 4.50%.The aggregate debt discount amounted to $42,000 and i amortized over the expected term of the loan agreement.

On December 31, 2008, Almi exchanged all 72,000 warrants for 545 shares of our Series B Preferred stock.

7) Common Stock

On March 4, 2008, we issued 1,800,000 shares of common stock to investors of a private placement at a price of $2.50 per share. The issuance of these shares triggered the anti-dilution feature related to common stock issued in the September 26, 2007 financing transaction. As a result we were required to issue an additional 207,492 shares of our common stock to investors in the September 26, 2007 financing. On December 31, 2008, as part of the refinancing and capital raising transactions, we issued 4,421,072 shares of our common stock to investors in the September 26, 2007 financing to satisfy the anti-dilution features contained in the financing agreement. Because we reduced the outstanding debt to less than $2.0 million, the anti-dilution features contained in the financing agreement are no longer outstanding as of December 31, 2008.

On December 31, 2008, the liability related to the common stock anti-dilution feature amounted to $0, resulting in a $1.4 million decrease since the initial valuation.

8) Warrants

As part of the May 21, 2008 financing transaction, we issued 400,480 warrants at a price of $1.27 per share and an additional 800,959 warrants at a price of $1.45 per share to Empire for financial advisory services provided in connection with the transaction. At the date of issuance, the fair value of the warrants issued to Empire totaled $2.0 million and was included in the issuance costs related to the May 21, 2008 financing transaction. The assumptions used for the Black-Scholes option pricing model were a term of 5 years, volatility of 110.28%, and a risk-free interest rate of 3.09%.

On December 31, 2008, 559,228 of the warrants were exchanged for 4,234 shares of our Series B preferred stock. On December 31, 2008, 161,074 of the $1.27 warrants and 481,457 of the $1.45 Warrants remain outstanding after restructuring.

- On December 31, 2008, the remaining 642,531 outstanding warrants no longer met the classification of liabilities in accordance with accounting guidance and, as such, the warrants previously recorded as a liability on the consolidated balance sheet were reclassified to equity using the fair value of the warrants on December 31, 2008. The assumptions used when calculating the fair value of the warrants at December 31, 2008 were a term of 4.3 years, volatility of 143.1%, and a risk-free interest rate of 1.46%.

4. Fair Value Measurement of Assets and Liabilities

The three levels of the fair-value hierarchy are described as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities. We had no level 1 assets or liabilities.

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

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

The following table shows the classification of our liabilities at September 30, 2009 that are subject to fair value measurements and the roll-forward of these liabilities from December 31, 2008 (in thousands):

	September 30, 2009	Net Increase in Fair Value	New Derivatives Added	December 31, 2008
Fair value of embedded conversion features and warrants	$ 7,760	$ 5,793	$ 1,967	$ -

5. Stockholders’ Equity

Common Stock

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

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

On January 28, 2008, a holder of convertible notes issued on September 26, 2007 elected to convert an aggregate amount of debt and accrued interest amounting to $35,000. The conversion resulted in the issuance of 10,000 shares of common stock at $3.50. The debt discounts, conversion features and deferred financing fees that related to the loans that were converted amounted to an aggregate of $20,000. The net amount of $15,000 was recorded in equity.

On March 4, 2008, we sold $4.5 million in securities in a private placement to accredited investors. We sold 1,800,000 shares (Investor Shares) of our common stock, for $2.50 per share. After placement agent fees and offering expenses, we received net cash proceeds of approximately $4,000,000.

In addition, we issued an aggregate of 207,492 shares of common stock to investors who participated in the September 26, 2007 private placement pursuant to anti-dilution provisions contained in the September 26, 2007 Private Placement Subscription Agreement. Empire acted as financial advisor in the private placement and received compensation in connection with the private placement of approximately $450,000 in cash and 120,000 shares of our common stock valued at $152,400 on the date of issuance.

On May 21, 2008, we completed a $5.1 million, net cash proceeds to us of $4.1 million, private placement, primarily to prior security holders, directors, affiliates of management and institutional investors. We offered our existing warrant holders an opportunity to exercise Neonode common stock purchase warrants on a discounted basis. In all, 4,004,793 outstanding warrants were exercised at a strike price of $1.27 per warrant (including $375,000 of surrender of debt). We issued 4,004,793 shares of our common stock and two new common stock purchase warrants, with an exercise price of $1.45, for each outstanding warrant exercised. A total of 8,009,586 new common stock purchase warrants were issued to investors who surrendered or purchased shares under the warrant exchange offer. We also extended the maturity date of $2.85 million of convertible debt that was due on June 30, 2008 until December 31, 2008 by issuing the note holders 510,293 common stock purchase warrants, with an exercise price of $1.45. Empire acted as financial advisor for the transaction and was paid a cash fee of approximately $510,000 and received a warrant to purchase 400,480 shares of our common stock at $1.27 per share and a warrant to purchase 800,959 shares of our common stock at $1.45 per share.

On September 4, 2008, we issued 107,638 shares of our common stock to one of our Swedish employees in settlement of a severance payment dispute totaling $20,400.

On November 17, 2008, we issued 549,808 shares of our common stock to our US based employees upon their termination from employment for payment of their accrued vacation liability totaling $35,700.

On December 31, 2008, we issued 4,421,072 shares of our common stock to investors who participated in the September 26, 2007 private placement pursuant to anti-dilution provisions contained in the September 26, 2007 Private Placement Subscription Agreement.

Preferred Stock

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

- Dividends and Distributions.

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

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

- Liquidation Preference.

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

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

- Voting.

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

- Conversion.

Initially, each share of Series A Preferred stock and each share of Series B Preferred stock was convertible into one share of our common stock. Any modification to the conversion rate requires shareholder approval. Although the restructuring contemplated a conversion ratio that was finally approved on March 31, 2009, we did not guarantee that either our authorized share capital would be increased or that the conversion rate would be increased. On March 31, 2009, our shareholders approved a resolution to increase the authorized share capital, and to increase the conversion ratio to 480.63 shares of common stock for each share of Series A Preferred stock and to 132.07 shares of our common stock for each shares of Series B Preferred stock, thus completing the restructuring begun in December 2008. See below for the accounting ramifications of this conversion rate change.

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 September 30, 2009:

	Shares of Preferred Stock Not Exchanged as of September 30, 2009	Conversion Ratio	Shares of Common Stock after Conversion of all Outstanding Shares of Preferred Stock Not yet Exchanged at September 30, 2009
Series A Preferred stock	96,545.30	480.63	46,402,568
Series B Preferred stock	17,266.30	132.07	2,280,360
Total Remaining Not Exchanged	113,811.60	-	48,682,928

Series A Preferred Stock

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

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

These transactions are discussed in more detail below.

On December 31, 2008, we issued 112,190.40 shares of Series A Preferred stock that at the date of issuance had a conversion rate of one share of common stock for each share of Series A Preferred stock to investors in a private placement transaction that raised $1.1 million. $1,035,000 of the funds raised were received in 2009. On March 31, 2009, the value of the 53,922,072 shares of common stock that these Series A Preferred shares are now convertible into was approximately $2.1 million. The increase in the value of the Series A Preferred stock as a result of this modification was $1,035,000, which we have recorded as a deemed preferred stock dividend (since the underlying transaction was a cash raise). As of December 31, 2009, 103,000 shares of Series A Preferred stock have been converted to 49,504,890 shares of common stock.

The fair value of the conversion feature of the 244,265.56 shares of Series A Preferred stock issued to the convertible debt holders that will now be convertible to a total of 117,401,356 shares of our common stock was $4.7 million based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. On December 31, 2008, the $2.4 million fair value of the Series A Preferred stock issued prior to the change in conversion rate was included in the calculation of gain on troubled debt restructuring; therefore, on March 31, 2009, we recorded the $2.3 million increase in the fair value as an increase in additional paid-in capital and as a loss on troubled debt restructuring on our consolidated statements of operations for the year ended December 31, 2009 as the final part of the restructuring that began in 2008 (since the underlying transaction was a debt extinguishment). As of December 31, 2009, convertible debt holders exchanged 171,380.62 shares of Series A Preferred stock that had been issued to them and were issued 82,370,667 shares of our common stock.

The fair value of the conversion feature of the 495,000 shares of Series A Preferred shares issued to the related parties to acquire Neonode Technologies AB that was converted to a total of 237,611,185 shares of our common stock was $9.5 million based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. Because this transaction is essentially the issuance of shares to key employees for their continued service to enhance the Company, the $9.5 million revised fair value of the common stock is being amortized to compensation expense at the rate of $1.6 million per quarter for six quarters beginning January 1, 2009. For the nine months ended September 30, 2009, $4.8 million has been recorded as compensation expense in our consolidated statements of operations and comprehensive loss.

Series B Preferred Stock:

The fair value of the conversion feature of the 92,795.94 shares of Series B Preferred shares issued to the warrant holders that is now convertible into 12,255,560 shares of our common stock was $490,000, based on our stock price on March 31, 2009, the date our shareholders approved the increased conversion ratio. On December 31, 2008, the $2,000 fair value of the Series B Preferred stock issued prior to the change in conversion rate was included in the calculation of gain on troubled debt restructuring; therefore, on March 31, 2009, we recorded the $488,000 increase in the fair value as an increase in additional paid-in capital and as a loss on troubled debt restructuring on our consolidated statements of operations and comprehensive loss for the year ended December 31, 2009 as the final part of the restructuring that began in 2008 (since the underlying transaction was a debt extinguishment). As of December 31, 2009, the holders of the Series B Preferred stock exchanged 75,530.64 of the 92,795.94 shares of Series B Preferred stock that had been issued to them and were issued 9,975,382 shares of our common stock.

6. Stock-Based Compensation

We have several approved stock option plans for which stock options and restricted stock awards are available to grant to employees, consultants and directors. All employee and director stock options granted under our stock option plans have an exercise price equal to the market value of the underlying common stock on the grant date. There are no vesting provisions tied to performance conditions for any options, as vesting for all outstanding option grants was based only on continued service as an employee, consultant or director. All of our outstanding stock options and restricted stock awards are classified as equity instruments.

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Stock Options

As of December 31, 2009, 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), out of which we will not grant any additional equity awards; and
· The 2006 Equity Incentive Plan (the 2006 Plan).

We also had one non-employee director stock option plan as of December 31, 2009: