NEOMEDIA TECHNOLOGIES INC
Form 10-Q
November 14, 2008

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

FORM 10 - Q

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

For the quarterly period ended September 30, 2008

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

For the transition period from __________ to ____________

Commission File Number 0-21743

NeoMedia Technologies, Inc.
(Exact Name of Issuer as Specified In Its Charter)

Delaware	**36-3680347**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Two Concourse Parkway, Suite 500, Atlanta, GA 30328
(Address, including zip code, of principal executive offices)

678-638-0460
(Registrants' telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes x No¨

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller Reporting Company x

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

The number of outstanding shares of the registrant's Common Stock on November 14, 2008 was 1,303,376,229.

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FORWARD LOOKING STATEMENTS

This Form 10-Q contains “forward-looking statements” relating to NeoMedia Technologies, Inc, a Delaware corporation, which represent our current expectations or beliefs including, but not limited to, statements concerning our operations, performance, financial condition and growth. For this purpose, any statements contained in this Form 10-Q that are not statements of historical fact are forward-looking statements. Without limiting the generality of the foregoing, words such as “may”, “anticipation”, “intend”, “could”, “estimate”, or “continue” or the negative or other comparab terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, such as credit losses, dependence on management and key personnel, variability of quarterly results, the ability to continue our growth strategy and competition, certain of which are beyond our control. Should one or more of these risks or uncertainties materialize or should the underlying assumptions prove incorrect, actual outcomes and results could differ materially from those indicated in the forward-looking statements.

Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time and it is not possible for us to predict all of such factors, nor can we assess the impact of each such factor on the business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

PART I — FINANCIAL INFORMATION

ITEM 1. Financial Statements

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets (Unaudited)
(in thousands, except share and per share data)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets		
Cash and cash equivalents	$ 515	$ 1,415
Trade accounts receivable, net of allowance for doubtful accounts of $78 and $78, respectively	126	58
Other receivable	-	225
Inventories, net of allowance for obsolete & slow-moving inventory of $79 and $80, respectively	146	198
Investment in marketable securities	-	8
Prepaid expenses and other current assets	508	188
Assets held for sale	4	159
Total current assets	1,299	2,251
Property, equipment & leasehold improvements, net	63	85
Goodwill	3,418	3,418
Proprietary software	2,906	3,413
Patents and other intangible assets	2,396	2,608
Cash surrender value of life insurance policy	678	747
Other long term assets	640	1,002
Total assets	**$ 11,400**	**$ 13,524**
LIABILITIES AND SHAREHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$ 220	$ 322
Accrued expenses	6,828	6,015
Deferred revenues and customer prepayments	394	669
Notes payable	76	44
Accrued purchase price guarantee	4,614	4,549
Deferred tax liability	706	706
Derivative financial instruments	35,346	24,651
Debentures payable	7,536	7,500
Debentures payable at fair value	22,356	23,199
Series C Convertible Preferred stock, $0.01 par value, 25,000,000 shares authorized, 22,000 shares issued, 19,308 shares outstanding	19,308	20,097
Total liabilities	97,384	87,752
Commitments and contingencies (note 10)		
Shareholders' deficit		
	13,002	10,221

Common stock, $0.01 par value, 5,000,000,000 shares authorized, 1,303,376,229 and 1,025,295,693 shares issued and 1,300,224,960 and 1,022,144,424 shares outstanding, respectively				
Additional paid in capital		118,933		118,427
Accumulated deficit		(217,171)		(201,565)
Accumulated other comprehensive loss		31		(532)
Treasury stock, at cost, 201,230 shares		(779)		(779)
Total shareholders' deficit		(85,984)		(74,228)
Total liabilities and shareholders' deficit	**$**	**11,400**	**$**	**13,524**

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

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NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations (Unaudited)
(in thousands, except share and per share data)

	For the three months ended September 30, 2008	September 30, 2007
Revenues	$ 330	$ 287
Cost of sales	377	324
Gross Profit (Loss)	(47)	(37)
Sales and marketing	711	604
General and administrative	1,216	1,110
Research and development	406	435
Operating Profit (Loss)	(2,380)	(2,186)
Gain on extinguishment of debt	-	201
Interest income/(expense) due to fair value adjustment	975	(6,957)
Other interest income/(expense)-net	(498)	(229)
(Loss) on sale of assets	(6)	-
(Loss) from change in fair value of derivative financial instruments	(7,955)	(12,215)
Net (loss) from continuing operations	(9,864)	(21,386)
Gain (loss) from discontinued operations	31	(780)
(Loss) from disposal of 12Snap	-	-
(Loss) from impairment of assets of 12Snap, NeoMedia Telecom, and Micro Paint Repair	-	(3,967)
(Loss) from discontinued operations	31	(4,747)
Net (loss)	(9,833)	(26,133)
Accretion of dividends on convertible preferred stock	(398)	(428)
Net (loss) attributable to common shareholders	$ (10,231)	$ (26,561)
Comprehensive (loss):		
Net income (loss)	(9,833)	(26,133)
Other comprehensive loss		
Unrealized (loss) on marketable securities	-	(3)
Foreign currency translation adjustment	-	(53)
Comprehensive (loss)	$ (9,833)	$ (26,189)
(Loss) per share, basic and diluted:		
Continuing operations	$ (0.01)	$ (0.02)

Discontinued operations	$	(0.00)	$	(0.01)
Net (loss) per share, basic and diluted	$	(0.01)	$	(0.03)
Weighted average number of common shares used in per share calculation, basic and diluted		1,236,058,293		927,306,694

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

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations (Unaudited)
(in thousands, except share and per share data)

	For the nine months ended			
	September 30, 2008		September 30, 2007	
Revenues	$	801	$	1,310
Cost of sales		983		1,011
Gross Profit (Loss)		(182)		299
Sales and marketing		1,994		2,006
General and administrative		3,789		4,874
Research and development		1,623		1,360
Operating Profit (Loss)		(7,588)		(7,941)
Gain on extinguishment of debt		22		454
Interest income/(expense) due to fair value adjustment		3,684		(7,421)
Other interest income/(expense)-net		(2,172)		(2,420)
(Loss) on sale of assets		(90)		-
(Loss) from change in fair value of derivative financial instruments		(9,035)		(14,601)
Net (loss) from continuing operations		(15,179)		(31,929)
(Loss) from discontinued operations		(260)		(1,609)
(Loss) from disposal of 12Snap		-		(257)
(Loss) from impairment of assets of 12Snap, NeoMedia Telecom, and Micro Paint Repair		-		(6,434)
(Loss) from discontinued operations		(260)		(8,300)
Net (loss)		(15,439)		(40,229)
Accretion of dividends on convertible preferred stock		(1,196)		(1,289)
Net (loss) attributable to common shareholders	$	(16,635)	$	(41,518)
Comprehensive (loss):				
Net income (loss)		(15,439)		(40,229)
Other comprehensive loss				
Unrealized (loss) on marketable securities		-		(46)
Foreign currency translation adjustment		(14)		52
Comprehensive (loss)	$	(15,453)	$	(40,223)
(Loss) per share, basic and diluted:				
Continuing operations	$	(0.01)	$	(0.04)

Discontinued operations	$	(0.00)	$	(0.01)
Net (loss) per share, basic and diluted	$	(0.01)	$	(0.05)
Weighted average number of common shares used in per share calculation, basic and diluted		1,137,671,871		835,772,746

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

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

	For the nine months ended September 30, 2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (15,439)	$ (31,929)
Adjustments to reconcile net loss to net cash used in operating activities from continuing operations:		
Loss from discontinued operations	260	
Depreciation and amortization	786	870
Loss on sale of assets	90	-
Change in fair value from revaluation of warrants and embedded conversion features	9,035	14,601
Gain on early extinguishment of debt	(22)	(454)
Stock-based compensation	1,570	2,221
Interest (income) expense related to convertible debt	(1,512)	8,203
Change in value of life insurance policies	69	(86)
Changes in operating assets and liabilities:		
Receivables	157	545
Inventories	53	(187)
Prepaid expenses and other current assets	(623)	(32)
Accounts payable and accrued expenses	799	(112)
Deferred revenue and other current liabilities	(275)	(293)
Cash used in operating activities	(5,052)	(6,653)
CASH FLOWS FROM INVESTING ACTIVITIES		
Expenditures for property, plant, and equipment	(41)	(15)
Advances to discontinued subsidiaries	(255)	(2,282)
Proceeds from sale of investments	751	-
Payment of purchase price guarantee obligations	(14)	(2,579)
Acquisitions, net of cash acquired	-	1,100
Amounts received under notes receivable	-	671
Cash provided by (used in) investing activities	441	(3,105)
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings (repayments) of debt and capital lease obligations	32	(1,015)
Borrowing under convertible debt instrument	3,686	8,253
Net proceeds from exercise of stock options and warrants	-	17
Cash provided by financing activities	3,718	7,255
Net cash used	**(893)**	**(2,503)**
Effect of exchange rate changes on cash for continuing operations	(7)	(84)
Net increase (decrease) in cash and cash equivalents	(900)	(2,587)
Cash and cash equivalents at beginning of period	1,415	2,813
Cash and cash equivalents at end of period	**$ 515**	**$ 226**

Supplemental cash flow information:				
Interest paid during the period	$	34	$	636
Unrealized gain (loss) on marketable securities		-		(40)
Fair value of 258,620,948 shares issued to satisfy purchase price guarantee obligations		-		12,721
Fair value of 28,854,685 shares issued to satisfy purchase debt guarantee obligations		-		698
Accretion of dividends on Series C Convertible Preferred Stock		1,196		1,289
Series C Convertible Preferred Stock converted to common stock		789		780
Deemed dividend on preferred stock conversions		1,206		-

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

NeoMedia Technologies, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1 - General

Business– NeoMedia Technologies, Inc. ("we", "us", or "our") provides internet advertising solutions using wireless technologies to connect traditional print and broadcast media companies to active mobile content. Using camera-enabled mobile phones, barcode-reading software (NeoReader™), and an interoperable billing, clearing and settlement infrastructure (NeoServer-OMS/OMI), we embrace open standards, full interoperability, and are barcode symbology agnostic.

Our mobile phone technology, NeoReader™, reads and transmits data from 1-D, and 2-D barcodes to its intended destination. Our Optical Messaging and Interchange platforms (OMS and OMI) create, connect, record, and transmit the transactions embedded in the 1-D and 2-D barcodes, like web-URLs, text messages (SMS), and telephone calls, ubiquitously and reliably. We provide the industrial and carrier-grade infrastructure to enable reliable, scalable, and billable commerce. To provide a robust high-performance infrastructure for the processing of optical codes, we extend our offering with the award winning Gavitec technology. Gavitec's Mobile Ticketing and Couponing solutions allow users to enter information and opt-in to initiate mobile transactions.

Going Concern– The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, ("U.S. GAAP"), which contemplate our continuation as a going concern. Our code-reading business has historically incurred net losses and losses from operations. Net loss from continuing operations for the nine months ended September 30, 2008 and 2007 was $15.2 million and $31.9 million, respectively. Net cash used for operations during the same periods was $5.1 million and $6.7 million. We also have an accumulated deficit of $217.2 million and a working capital deficit of $96.1 million as of September 30, 2008. Although we have reduced cash outlays for payments associated with prior integration and discontinued operation liabilities, we will continue to have negative cash flows as we continue to execute on our business plan. The items discussed above raise substantial doubts about our ability to continue as a going concern. There can be no assurance that our continuing efforts to execute our business plan will be successful and if we will be able to continue as a going concern.

We will require additional financing in order to execute our operating plan and continue as a going concern. We cannot predict whether this additional financing will be in the form of equity, debt, or another form. We may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, we may be unable to implement our current plans for expansion, repay our debt obligations as they become due or respond to competitive pressures, any of which circumstances would have a material adverse effect on our business, prospects, financial condition and results of operations. Should financing sources fail to materialize, our management would seek alternate funding sources such as the sale of common and/or preferred stock, the issuance of debt, or the sale of our marketable assets. Our management's plan is to attempt to secure adequate funding to bridge the commercialization of our NeoReader™ business. If these financing sources or increased revenues and profits do not materialize, and we are unable to secure additional financing, we could be forced to further reduce or cease our business operations.

The financial statements do not include any adjustments relating to the recoverability and reclassification of recorded asset amounts or amounts and reclassification of liabilities that might be necessary, should we be unable to continue as a going concern.

Note 2 - Summary of Significant Accounting Policies

Basis of Presentation— The accompanying condensed balance sheet as of December 31, 2007, which was derived from audited consolidated financial statements, and the unaudited condensed consolidated financial statements as of and for the period ended September 30, 2008. have been prepared in accordance with U.S. GAAP for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair statement have been included. Our operations consist of one reportable segment. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007. The net effect of discontinued operations is reported separately from the results of our continuing operations. Operating results for the nine month periods ended September 30, 2008 and 2007 are not necessarily indicative of the results that may be expected for the full fiscal year.

During the year ended December 31, 2006, we completed acquisitions of Mobot, Sponge, Gavitec, 12Snap, and BSD. During 2006, we also subsequently divested of a substantial portion of our ownership in both Mobot and Sponge. During 2007, we made the strategic decision to sell 12Snap and Telecom Services (consisting of the business acquired from BSD) and these divestitures were completed on April 4, 2007 and October 30, 2007, respectively. The consolidated statements of operations presented herein reflect the results of 12Snap and BSD from January 1, 2007 through September 30, 2007 under the caption "Loss from discontinued operations". Gavitec results are included in NeoMedia's consolidated results from continuing operations for all periods presented.

Use of Estimates– The preparation of financial statement in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported therein. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may differ from those estimates.

Basic and Diluted Income (Loss) Per Share– Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. During the nine months ended September 30, 2008, we reported net loss per share, and as such basic and diluted loss per share were equivalent. We have excluded all outstanding stock options, warrants, convertible debt and convertible preferred stock from the calculation of diluted net loss per share because these securities are anti-dilutive for all periods presented.

In addition to net income (loss) per share, we have also reported per share amounts on the separate income statement components required by APB 30, "*Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*," as the disposal activities of our discontinued operations were initiated prior to our adoption of FAS 144. Because we have reported a loss from continuing operations for the nine months ended September 30, 2008, the effect of potentially dilutive securities has been excluded from the calculation of per share amounts for that period.

***Inventories* -** Inventories, consisting of material, material overhead, labor and processing costs, are stated at the lower of cost (first-in, first-out) or market.

***Recent Accounting Pronouncements* -** In May 2008, the FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60" ("SFAS No. 163"). This Statement interprets FASB Statement No. 60 and amends existing accounting pronouncements to clarify their application to the financial guarantee insurance contracts included within the scope of this Statement. SFAS No. 163 is not expected to have a material impact on the Company's consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162 ("SFAS No. 162"), "The Hierarchy of Generally Accepted Accounting Principles." This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. While this statement formalizes the sources and hierarchy of GAAP within the authoritative accounting literature, it does not change the accounting principles that are already in place. This statement will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." SFAS No. 162 is not expected to have a material impact on the Company's consolidated financial statements.

In April 2008, the FASB issued FSP SFAS No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP SFAS No. 142-3"). FSP SFAS No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142"). The intent of FSP SFAS No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R) and other applicable accounting literature. FSP SFAS No. 142-3 is effective for financial statements issued for fiscal years beginning after

December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. The Company has not determined the impact, if any, of the adoption of FSP SFAS No. 142-3.

Effective January 1, 2008, we adopted the provisions of FAS 157, *Fair Value Measurements,* except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in proposed FSP FAS 157-b. The partial adoption of FAS 157 did not have a material impact on our consolidated financial position, results of operations or cash flows. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. In February 2008, the FASB issued FASB Staff Position (“FSP”) 157-2, *Effective Date of FASB Statement No. 157,* which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

In March 2008, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133,* which requires additional disclosures about the objectives of the derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective for us beginning January 1, 2009. We are currently assessing the potential impact that adoption of SFAS No. 161 may have on our financial statements.

Effective January 1, 2008, we adopted the provisions of SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The adoption did not have a material impact on our consolidated financial position, results of operations or cash flows. SFAS No. 159 gives us the irrevocable option to carry many financial assets and liabilities at fair values, with changes in fair value recognized in earnings.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for us beginning January 1, 2009 and will apply prospectively to business combinations completed on or after that date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51,* which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for us beginning January 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We are currently assessing the potential impact that adoption of SFAS No. 160 may have on our financial statements.

Note 3 – Discontinued Operations

MicroPaint Repair, 12Snap & Telecom Services– During August 2006, we decided to sell our Micro Paint Repair (MPR) business unit; this sale was completed on November 15, 2007. During the first quarter of 2007, we also decided to sell our remaining non-core business units, consisting of 12Snap and Telecom Services. Our sale of 12Snap was completed in April 2007, and our sale of Telecom Services was completed in October 2007.

Sponge and Mobot Businesses– In the fourth quarter of 2006, we disposed of two subsidiaries, Sponge and Mobot. All assets and liabilities associated with these two subsidiaries were disposed of in the sale.

All costs related to the operations of Micro Paint Repair, Mobot, Sponge, 12Snap and Telecom Services are classified as discontinued operations for all periods presented in this Form 10-Q. Loss from the discontinued business units for the nine months ended September 30, 2007 reflects direct operations of the Micro Paint Repair, 12Snap, and Telecom Services units. For the nine months ended September 30, 2008, we incurred wind-down expenses for Micro Paint Repair – US. For the nine months ended September 30, 2008, we also set up a reserve for the remaining $0.3 million due from the sale of Micro Paint Repair, because the funds have not been received as of the date of this filing, and legal efforts to secure the remaining payment due have been unsuccessful.

There is no tax expense or benefit to report as a result of our net operating loss carry forward tax position.

The following table presents a summary of results of our discontinued operations for the three months and nine months ended September 30, 2008 and 2007:

	Micro Paint Repair	12Snap	Other	Total
Three Months Ended September 30, 2008				
Net sales	$ -	$ -	$ -	$ -
Income (Loss) from discontinued operations	31	-	-	31
Three Months Ended September 30, 2007				
Net sales	$ 287	$ -	$ 525	$ 812
Income (Loss) from discontinued operations	(913)	(92)	(3,742)	(4,747)

	Micro Paint Repair	12Snap	Other	Total
Nine Months Ended September 30, 2008				
Net sales	$ -	$ -	$ -	$ -
Income (Loss) from discontinued operations	(260)	-	-	(260)
Nine Months Ended September 30, 2007				
Net sales	$ 1,003	$ 2,621	$ 1,339	$ 4,963
Income (Loss) from discontinued operations	(2,122)	(2,394)	(3,784)	(8,300)

Note 4 - Financing

On February 17, 2006, the Company issued Series C Convertible Preferred Stock to YA Global Investments, L.P. (“YA Global”) and between August 24, 2006 and July 29, 2008, has entered into nine Secured Convertible Debentures with YA Global. In addition, in connection with these debentures and preferred stock, the Company also issued common stock warrants to YA Global.

Secured Convertible Debentures

In 2006 and 2007, the Company issued four Secured Convertible Debentures to YA Global. During the nine month period ended September 30, 2008, the Company issued five additional Secured Convertible Debentures to YA Global, dated April 11, 2008, May 16, 2008, May 29, 2008, July 10, 2008 and July 29, 2008.

	April 11, 2008	May 16, 2008	May 29, 2008
Face Amount	$ 390,000	$ 500,000	$ 790,000
Net Proceeds	$ 336,000	$ 441,000	$ 700,000

Common shares indexed to debenture	92,857,143	227,272,727	395,000,000
Common shares indexed to warrants	—	7,500,000	50,000,000
Total common shares indexed	92,857,143	234,772,727	445,000,000

	July 10, 2008	July 29, 2008	Total
Face Amount	$ 137,750	$ 2,325,000	$ 4,142,750
Net Proceeds	$ 123,750	$ 2,085,000	$ 3,685,750
Common shares indexed to debenture	51,018,519	930,000,000	1,696,148,389
Common shares indexed to warrants	—	450,000,000	507,500,000
Total common shares indexed	51,018,519	1,380,000,000	2,203,648,389

The underlying agreements for each of the nine debentures are essentially the same, except in regard to the interest rate, varying conversion prices per share, and the number of warrants that were issued in conjunction with each of the debentures. The table below summarizes the significant terms of each of the nine debentures outstanding at September 30, 2008.

The debentures are convertible into our common stock at the then effective conversion price, which varies relative to our trading stock price. The conversions are limited such that YA Global cannot exceed 4.99% ownership of NeoMedia. The debentures are secured by substantially all of our assets. The convertible debentures, at the option of the holder, afford YA Global anti-dilution protection should, at any time while the convertible debentures are outstanding, we offer, sell or grant any option to purchase or offer, sell or grant any right to re-price our securities, or otherwise dispose of or issue any common stock or common stock equivalents, or entitle any person to acquire shares of common stock at an effective price per share less than the then effective conversion price (excluding employee stock options); then, in such instance, the conversion price for the convertible debenture shall be reduced to the lower price. Any such adjustment in the effective conversion price for the convertible debentures could significantly dilute existing investors.

All of the convertible debentures are secured according to the terms of a Security Pledge Agreement dated August 23, 2006, which was entered into in connection with the first convertible debenture with YA Global and which provides YA Global with a security interest in substantially all of our assets.

The April 2008, May 2008 and July 2008 convertible debentures are included in the terms of an existing Registration Rights Agreement with YA Global dated August 24, 2007. That agreement requires the Company to (i) file a registration statement with the SEC registering the resale of the shares of common stock issuable upon conversion of the convertible debentures and the exercise of the related warrants and (ii) maintain effectiveness of the registration statement. Failure to meet these requirements will require the Company to pay liquidating damages amounting to 2% per month of the principal amount of the debentures, not to exceed aggregate damages of $1,000,000.

In connection with the August 2006 and December 2006 convertible debentures, we also entered into a Registration Rights Agreement with YA Global that required us to file a registration statement with the SEC registering the resale of the shares of common stock issuable upon conversion of the debentures and the exercise of the warrants, and achieve and maintain effectiveness of the registration statement. Although the required registration statement was declared effective on November 5, 2007, we failed to meet the timely filing requirements, and accordingly were subject to liquidated damages amounting to 2% of the outstanding amount of the convertible debentures, not to exceed $1.3 million. On March 27, 2007, we paid $0.5 million of liquidated damages from the proceeds of a new secured convertible debenture. The remaining $0.8 million of liquidated damages has been accrued. On March 27, 2007, we also paid from the proceeds of the new debenture $0.8 million of liquidated damages related to our failure to timely file the registration statement required in connection with the Series C preferred stock.

The convertible debentures contain various Events of Default, which could subject us to penalties, damages, and liabilities as specified in the agreements. Such Events include:

- Any case or action of bankruptcy or insolvency commenced by us or any subsidiary, against us or adjudicated by a court for the benefit of creditors;

- Any default in our obligations under a mortgage or debt in excess of $0.1 million; (we were in default of this provision as of August 24, 2008, due to non-payment of required principal and interest payments on the August 24, 2006 Debenture)

- Any cessation in the eligibility of our stock to be quoted on a trading market;

- Failure to timely file the registration statement covering the shares related to the conversion option, or failure to make the registration statement effective timely (we were in default of this provision as of December 31, 2006, with respect to the Series C convertible preferred stock, the August 2006 Debenture, and the December 2006 Debenture);

- Any failure to deliver share certificates within the specified time;

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- Any failure by us to pay in full the amount of cash due pursuant to a buy-in or failure to pay any amounts owed on account of an event of default within 10 days of the date due.

In addition, the debentures require that:

- We will reserve and keep available authorized and unissued registered shares available to be issued upon conversion;

- Without YA Global's consent, we cannot:

  - o issue or sell any shares of common stock or preferred stock without consideration or for consideration per share less than the closing bid price immediately prior to its issuance,

  - o issue or sell any preferred stock, warrant, option, right, contract, call, or other security or instrument granting the holder thereof the right to acquire common stock for consideration per share less than the closing bid price immediately prior to its issuance,

  - o enter into any security instrument granting the holder a security interest in any of our assets, or

  - o file any registration statements on Form S-8.

As of September 30, 2008, the significant terms of the nine convertible debentures are as follows:

	August 24, 2006	December 29, 2006	March 27, 2007	August 24, 2007
Principal amount	$ 5,000,000	$ 2,500,000	$ 7,458,651	$ 1,775,000
Fees paid	-	(270,000)	(780,865)	(200,000)
Accrued interest on prior obligations paid	-	-	(365,972)	-
Liquidated damages on prior obligations paid	-	-	(1,311,814)	-
Net proceeds to us	$ 5,000,000	$ 2,230,000	$ 5,000,000	$ 1,575,000
Interest rate	10%	10%	13%	14%
Maturity date (2 years)	8/24/2008**	12/29/2008**	3/27/2009	8/24/2009
Number of warrants issued	175,000,000	42,000,000	125,000,000	75,000,000
Exercise price of warrants	0.02	0.02	0.02	0.02
Warrants expire (5 years)	8/24/2011	12/29/2011	3/24/2012	8/24/2012
Convertible into our common stock at the lower of:				
Fixed conversion price per share	$ 0.15	$ 0.06	$ 0.05	$ 0.02
or percent of lowest closing bid price	90%	90%	90%	80%
	30 days	30 days	30 days	10 days

of lowest volume weighted average price preceding conversion				
Registration rights agreement:				
File registration with SEC within:	30 days	150 days	by 4/12/07	30 days of Demand
Achieve effectiveness of registration statement with SEC within	90 days	90 days	by 5/10/2007	90 days of Demand
Liquidated damages for failure to meet filing or effectiveness requirements	2% of principal, per month	2% of principal, per month	2% of principal, per month	2% of principal, per month
Security pledged as collateral	substantially all of our assets	substantially all of our assets	substantially all of our assets	substantially all of our assets

** As of September 24, 2008, the maturity date on the August 2006 and December 2006 debentures were extended to July 29, 2010. See additional information related to this extension in the sections below.

	April 11, 2008	May 16, 2008	May 29, 2008	July 10, 2008
Principal amount	$ 390,000	$ 500,000	$ 790,000	$ 137,750
Fees paid	(54,000)	(59,000)	(90,000)	(14,000)
Accrued interest on prior obligations paid	-	-	-	-
Liquidated damages on prior obligations paid	-	-	-	-
Net proceeds to us	$ 336,000	$ 441,000	$ 700,000	$ 123,750
Interest rate	15%	15%	15%	15%
Maturity date (2 years)	4/11/2010	5/16/2010	5/29/2010	7/10/2010
Number of warrants issued	-	7,500,000	50,000,000	-
Exercise price of warrants	-	0.0175	0.01	-
Warrants expire (7 years)	-	5/16/2015	5/29/2015	-
Convertible into our common stock at the lower of:				
Fixed conversion price per share	$ 0.015	$ 0.015	$ 0.01	$ 0.01
or percent of lowest closing bid price	80%	80%	80%	80%
of lowest volume weighted average price preceding conversion	10 days	10 days	10 days	10 days
Registration rights agreement:				
File registration with SEC within	30 days	30days	30 days	30 days
Achieve effectiveness of registration statement with SEC within	90 days	90 days	90 days	90 days
Liquidated damages for failure to meet filing or effectiveness requirements	2% of principal, per month	2% of principal, per month	2% of principal, per month	2% of principal, per month
Security pledged as collateral	substantially all of our assets	substantially all of our assets	substantially all of our assets	substantially all of our assets

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		July 29, 2008		Total of all financings
Principal amount	$	2,325,000	$	20,876,401
Fees paid		(240,000)		(1,707,865)
Accrued interest on prior obligations paid		-		(365,972)
Liquidated damages on prior obligations paid		-		(1,311,814)
Net proceeds to us	$	2,085,000	$	17,490,750
Interest rate		14%		
Maturity date (2 years)		7/29/2010		
Number of warrants issued		450,000,000		
Exercise price of warrants		0.02-0.075		
Warrants expire (7 years)		7/29/2015		
Convertible into our common stock at the lower of:				
Fixed conversion price per share	$	.02		
or percent of lowest closing bid price		95%		
of lowest volume weighted average price preceding conversion				
Registration rights agreement:				
File registration with SEC within		30 days		
Achieve effectiveness of registration statement with SEC within		90 days		
Liquidated damages for failure to meet filing or effectiveness requirements		2% of principal, per month		
Security pledged as collateral		Substantially all our assets		

Series C Convertible Preferred Stock

On February 17, 2006, we issued 22,000 shares of $1,000 Series C 8% convertible preferred stock to YA Global. The Series C convertible preferred stock is convertible into our common stock at the lower of $0.02 per share, or 97% of the lowest closing bid price of the common stock for the 30 trading days immediately preceding the conversion date. The fixed conversion price was reset from $0.50 to $0.02 on August 24, 2007, as an inducement for YA Global to enter into an additional financing arrangement with us at that time. The conversions are limited such that YA Global cannot exceed 4.99% ownership. The Series C convertible preferred stock has voting rights on an “as converted” basis, meaning YA Global is entitled to vote the number of shares of common stock into which the 8% cumulative Series C convertible preferred stock was convertible as of the record date for a meeting of shareholders.

As of September 30, 2008, YA Global has converted 2,692 shares of the original 22,000 shares of Series C preferred stock, leaving 19,308 shares outstanding, as follows:

Date Converted	Series C Shares Converted	Common Shares Issued
11/29/06	378	6,631,579
06/19/07	245	8,781,362
08/16/07	500	25,773,196
10/24/07	600	45,801,527
10/31/07	180	13,740,458
02/19/08	78	10,000,000
03/10/08	16	2,500,000
03/17/08	32	10,000,000
03/25/08	32	10,000,000
04/01/08	64	10,000,000
05/06/08	15.5	5,000,000
05/09/08	15	5,000,000
05/22/08	11	5,000,000
05/30/08	44	20,000,000
06/12/08	52.5	25,000,000
06/23/08	21	10,000,000
06/30/08	42	20,000,000
07/14/08	21	10,000,000
07/22/08	21	10,000,000
08/04/08	42	20,000,000
08/05/08	63	30,000,000
08/11/08	42	20,000,000
08/22/08	21	10,000,000
09/03/08	21	10,000,000
09/15/08	75	25,000,000
09/19/08	60	20,000,000
Total	2,692	388,228,122

The Series C convertible preferred stock provides anti-dilution protection such that, if at any time while the Series C preferred stock is outstanding, we offer, sell or grant any option to purchase or offer, sell or grant any right to re-price our securities, or otherwise dispose of or issue any common stock or common stock equivalents, or entitle any person to acquire shares of common stock at an effective price per share less than the then effective conversion price (excluding employee stock options), then, in such instance, the conversion price for the convertible preferred stock will be reduced to the lower price. Any such adjustment in the effective conversion price for the convertible preferred shares could significantly dilute existing investors.

In connection with the Series C convertible preferred stock, we also entered into a Registration Rights Agreement with YA Global that requires us to, among other requirements, file a registration statement with the SEC registering the resale of the shares of common stock issuable upon conversion of the preferred stock and the exercise of the warrants, and achieve and maintain effectiveness of the registration statement. Although the required registration statement was declared effective on November 5, 2007, we failed to meet the timely filing requirements, and accordingly were subject to liquidated damages amounting to 1% of the outstanding amount of Series C preferred stock per month, not to exceed $1.2 million. On March 27, 2007, we paid $0.8 million of liquidated damages from the proceeds of a new secured convertible debenture. The remaining $0.4 million of liquidated damages has been accrued by us.

Under the Series C Agreement, YA Global also received Series A, B and C warrants to purchase 20 million, 25 million, and 30 million shares of our common stock. The warrants, which are exercisable separately, originally had exercise prices of $0.50, $0.40 and $0.35, respectively, per share, subject to adjustment, including anti-dilution protection similar to that described above. As an inducement to YA Global to enter into subsequent financing arrangements with us, the exercise prices of these warrants were reduced on December 29, 2006 to $0.04 per share and were again reduced on August 24, 2007 to $0.02 per share, subject to all the original terms and conditions of the respective warrant agreements. The warrants have a five-year contractual life. We can force exercise of the warrants if the closing bid price of our common stock is more than $0.10 greater than the exercise price of the warrants for 15 consecutive trading days.

Warrants

As described above, YA Global holds warrants to purchase shares of our common stock that were issued in connection with the convertible debentures and the Series C convertible preferred stock. As discussed above, the exercise prices of warrants held by YA Global have been adjusted from time to time as an inducement for YA Global to enter into subsequent financing arrangements. At September 30, 2008, the warrants issued to YA Global, none of which have been exercised, were as follows:

Original Issue Date	Shares Underlying Warrant	Original Exercise Price	Restated Exercise Price December 29, 2006	Restated Exercise Price August 24, 2007
February 17, 2006	20,000,000	$ 0.50	$ 0.04	$ 0.02
February 17, 2006	25,000,000	0.40	0.04	0.02
February 17, 2006	30,000,000	0.35	0.04	0.02
August 24, 2006	25,000,000	0.15	0.04	0.02
August 24, 2006	50,000,000	0.25	0.04	0.02
August 24, 2006	50,000,000	0.20	0.04	0.02
August 24, 2006	50,000,000	0.05	n/a	0.02
December 29, 2006	42,000,000	0.06	n/a	0.02
March 27, 2007	125,000,000	0.04	n/a	0.02
August 24, 2007	75,000,000	0.02	n/a	n/a
May 16, 2008	7,500,000	0.0175	n/a	n/a
May 29, 2008	50,000,000	0.01	n/a	n/a
July 29, 2008	100,000,000	0.02	n/a	n/a
July 29, 2008	100,000,000	0.04	n/a	n/a
July 29, 2008	125,000,000	0.05	n/a	n/a
July 29, 2008	125,000,000	0.08	n/a	n/a
Total	999,500,000			

Default and Other Considerations

As of December 31, 2006, we were in default of the August 2006, December 2006 and Series C preferred stock instruments, due primarily to our failure to register the shares underlying the instruments by the prescribed deadline, and subsequently for failure to sell our Micro Paint Repair and Telecom Services businesses by September 30, 2007, as required by the August 2007 Debenture. Due to the then default status, YA Global had certain material rights that did not exist prior to default. Specifically, the full face value of the instruments were callable, and we were responsible for liquidated damages until the default was cured with the effectiveness of our registration statement on November 5, 2007, and the sale of Telecom Services and MPR, which were completed on October 30, 2007 and November 15, 2007, respectively.

In addition, the accounting for the convertible securities reflects certain specific accounting rules and regulations that are applicable under the default provision:

- Prior to the default, we were accreting dividends on the Series C convertible preferred stock, using the effective interest method, through periodic charges to additional paid in capital. Due to the default status, we accreted dividends to the full face value of the Series C convertible preferred stock during the fourth quarter of 2006.

- Prior to the default, we were accreting the debt discount on the August 2006 Debenture and the December 2006 Debenture, using the effective interest method, through periodic charges to interest expense. Due to the default status, during the fourth quarter of 2006, we accreted debt discount to the full face value of these secured convertible debentures.

- The Series C convertible preferred stock is now reported as demand debt in the current liabilities section of the balance sheet, pursuant to the guidance outlined in FAS 150.

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- The secured convertible debentures are reported as debt in the current liabilities section of the balance sheet rather than long term because the debentures are callable as demand debt due to the default.

As of August 23, 2008, we were in default on our August 23, 2006 Convertible Debenture due to non-payment of principal and interest in accordance with the terms of the agreement. Due to cross-default provisions in the other financing arrangements, all nine instruments were considered in default as of August 23, 2008. The event of default caused YA Global to have certain material rights that did not exist prior to default. Specifically, the full face value of the instruments is callable and additional default remedies such as default interest and conversion price provisions went into effect.

On September 24, 2008, the Company entered into a Letter Agreement with YA Global which extended the maturity dates on the August 23, 2006 and the December 26, 2006 agreements to July 29, 2010; however, this agreement was executed subsequent to the event of default occurring. All nine Secured Convertible Debentures contain cross-default provisions related to debt obligations exceeding $100,000. Therefore, the event of default on the August 23, 2006 financing arrangement caused an event of default on the other eight agreements. The extension was considered a one-time extension for the specific period indicated but was not considered a waiver of existing events of default.

We reviewed the requirements of Emerging Issues Task Force (EITF) Issue 02-4, Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement 15, and determined that the extension of the maturity date of the original issuance of our August 24, 2006 and December 27, 2006 financings met the criteria of a troubled debt restructuring outlined in Statement of Financial Accounting Standards (SFAS) No. 15, Accounting for Debtors and Creditors for Troubled Debt Restructurings. Accordingly, the extension will result in a change in the effective interest rate for the purpose of recording interest for the extended term of the note.

The accounting for the convertible securities reflects certain specific accounting rules and regulations that are applicable under the default provision:

- The secured convertible debentures are reported as debt in the current liabilities section of the balance sheet rather than long term because the debentures are callable as demand debt due to the default.
- Interest will accrue at the default interest rate for instruments which contain a default interest rate provision.
- For instruments which contain a default conversion rate, the number of shares of common stock indexed to the convertible instruments will increase due to the lower conversion price.

All Convertible Debenture arrangements with YA Global contain provisions for acceleration of principal and interest upon default. The following is a listing of Convertible Debenture agreements which also contain default interest rates and conversion prices:

	April 11, 2008	May 16, 2008	May 29, 2008	July 10, 2008	July 29, 2008
Default interest	24%	24%	24%	24%	20%
Convertible into our common stock at the lower of:					
Fixed conversion price per share	$ 0.015	$ 0.015	$ 0.01	$ 0.01	$ 0.02
or percent of lowest closing bid price	95%	80%	50%	50%	50%
of lowest volume weighted average price preceding conversion	30 days	10 days	10 days	10 days	10 days

Fair Value Considerations

In accordance with SFAS 133, 'Accounting for Derivative Instruments and Hedging Activities', we determined that the conversion features of the Series C convertible preferred stock, the August 2006 Debenture, and the December 2006 Debenture met the criteria of embedded derivatives and that the conversion features of these instruments needed to be bifurcated and accounted for as derivative instrument liabilities. These instruments do not meet the definition of "conventional convertible debt" because the number of shares which may be issued upon their conversion is not fixed, and there is no cap on the number of shares that could be issued upon conversion. Therefore, the conversion feature fails to qualify for equity classification under EITF 00-19, and must be accounted for as a derivative liability, at fair value. Changes in the fair value of the derivative liability for the embedded conversion option are charged or credited to income.

Beginning in 2007, each new financing arrangement is evaluated, on an instrument-by-instrument basis, under SFAS 155, '*Accounting for Certain Hybrid Financial Instruments an Amendment of FASB Statements No. 133 and 140'*, which permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. During the evaluation of the March 2007, August 2007, April 2008, May 2008 and July 2008 Debentures, we determined that (i) the hybrid debt instrument embodied certain derivative features whose risks and rewards were not clearly and closely related to the risks and rewards of the host debt instrument and (ii) warrants issued in connection with the March 2007, August 2007, April 2008, May 2008 and July 2008 Debentures did not meet all of the established criteria for equity classification. Additionally all the Debentures extended a right to the holder to accelerate repayment of the debt (default put) upon the occurrence of certain contingent events and the April 2008, May 2008 and July 2008 Debentures contain default interest and default conversion rate penalties. The default puts may be triggered by certain events that are not related to the debt characteristics of the debentures and those events are not within our control. As permitted by SFAS 155, we have elected not to bifurcate the embedded derivatives in the March 2007, August 2007, April 2008 or May 2008 Debentures and accordingly these convertible instruments are being carried in their entirety at their fair values, with the changes in the fair value of the secured convertible debentures charged or credited to income each period. We have elected to bifurcate the embedded derivatives in the August 2006, December 2006, and July 2008 Debentures as permitted by SFAS133. For each instrument recorded under SFAS133, we have combined all the embedded features that required bifurcation into one compound instrument that is carried at fair value as a component of derivative liabilities.

The warrants issued to YA Global in connection with the Series C preferred stock and in connection with the convertible debentures do not meet all of the established criteria for equity classification provided in EITF 00-19 and, accordingly, are recorded as derivative liabilities at fair value. In addition, certain other warrants issued by the Company do not meet the criteria for equity classification and are also carried as derivative liabilities. Changes in the fair value of the warrants are charged or credited to income or expense each period.

Derivative financial instruments arising from the issuance of convertible financial instruments are initially recorded, and continuously carried, at fair value. Upon conversion of any derivative financial instrument, the carrying amount of the derivative financial instrument and the carrying amount of the debt, including any unamortized premium or discount is credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized.

Initial Accounting for New Debentures

As discussed above, for the April 11, 2008, May 16, 2008 and May 29, 2008 convertible debentures, we elected not to bifurcate the embedded derivatives and accordingly, in accordance with FAS 155, these convertible instruments are being carried in their entirety at their fair values. In connection with the May 16, 2008 and May 29, 2008 convertible debentures, YA Global received 7,500,000 and 50,000,000 common stock warrants. The warrants were valued using the Black-Scholes-Merton valuation methodology because that model embodies all of the relevant assumptions that address the features underlying these instruments. Significant assumptions included in this model as of inception of the financing arrangements are as follows:

	May 16, 2008	May 29, 2008
Indexed shares	7,500,000	50,000,000
Exercise price	$ 0.0175	$ 0.01
Effective exercise price	$ 0.0030	$ 0.0030
Term (years)	7 years	7 years
Volatility	152%	152%
Risk free rate	3.43%	3.68%

As discussed above, for the July 10, 2008 and July 29, 2008 convertible debentures, since the embedded conversion feature and certain other embedded derivatives did not achieve equity classification, we combined all the embedded derivative features that required bifurcation into one compound instrument, bifurcated the compound embedded derivatives and recorded them as derivative liabilities under SFAS 133.

In connection with the July 29, 2008 convertible debenture, YA Global received four warrants to purchase an aggregate of 450,000,000 shares of common stock. The warrants were valued using the Black-Scholes-Merton valuation methodology because that model embodies all of the relevant assumptions that address the features underlying these instruments. Significant assumptions included in this model as of inception of the financing arrangements are as follows:

	Warrant 9-1a	Warrant 9-1b	Warrant 9-1c	Warrant 9-1d
Indexed shares	100,000,000	100,000,000	125,000,000	125,000,000
Exercise price	$ 0.02	$ 0.04	$ 0.05	$ 0.075
Effective exercise price (1)	$ 0.0025	$ 0.0025	$ 0.0025	$ 0.0025
Term (years)	7	7	7	7
Volatility	166%	166%	166%	166%
Risk free rate	3.68%	3.68%	3.68%	3.68%

(1) The results of the anti-dilution protection resulted in an effective exercise price which was lower than the stated exercise price.

At inception, a summary of the allocation of the components of the new debentures was as follows:

	April 11, 2008	May 16, 2008	May 29, 2008
Convertible debenture, at fair value	$ 637,270	$ 813,631	$ 1,389,544
Warrant derivative liability	-	21,750	145,000
Day-one derivative loss	(247,270)	(335,381)	(744,544)
Total gross proceeds	$ 390,000	$ 500,000	$ 790,000

	July 10, 2008	July 29, 2008	Total
Convertible debenture derivative liability	$ 289,611	$ 3,577,341	$ 6,707,397
Warrant derivative liability	-	1,080,000	1,246,750
Day-one derivative loss	(151,861)	(2,332,341)	(3,811,397)
Total gross proceeds	$ 137,750	$ 2,325,000	$ 4,142,750

The fair value of the debentures and warrants at inception was greater than the proceeds received which resulted in a day-one derivative loss.

Current Period Accounting Considerations and Valuations

Warrants:

Freestanding derivative instruments, consisting of warrants that were issued in connection with the Series C preferred stock and the convertible debentures as well as certain other warrants, are valued using the Black-Scholes-Merton valuation methodology because that model embodies all of the relevant assumptions that address the features underlying these instruments.

Significant assumptions used in this model as of September 30, 2008 are as follows:

	Series C Convertible Preferred Stock	August 2006 Debenture	December 2006 Debenture	March 2007 Debenture	August 2007 Debenture
Holder	YA Global	YA Global	YA Global	YA Global	YA Global
Instrument	Warrants	Warrants	Warrants	Warrants	Warrants
Exercise price	$ 0.02	$ 0.0017	$ 0.0017	$ 0.0017	$ 0.0017
Remaining term (years)	2.38	2.89	3.25	3.48	3.90
Volatility	155%	144%	139%	140%	143%
Risk-free rate	2.00%	2.00%	2.28%	2.28%	2.28%
Number of warrants	75,000,000	175,000,000	42,000,000	125,000,000	75,000,000

	May 16, 2008 Debenture	May 29, 2008 Debenture	July 29, 2008 Debenture		
Holder	YA Global	YA Global	YA Global	Other	
Instrument	Warrants	Warrants	Warrants	Warrants	Total
Exercise price	$ 0.0025	$ 0.0025	$ 0.0025	$ 0.0025	
Remaining term (years)	6.63	6.66	6.83	0.41 – 2.30	
Volatility	172%	172%	201%	157%-251%	
Risk-free rate	3.38%	3.38%	3.38%	1.60%-2.00%	
Number of warrants	7,500,000	50,000,000	450,000,000	8,471,000	1,007,971,000

Embedded Derivative Instruments – Series C Preferred Stock and August and December 2006 and July 2008 Convertible Debentures

Embedded derivative financial instruments arising from the convertible instruments consist of multiple individual features that were embedded in each instrument. For each convertible instrument, we evaluated all significant features and, as required under current accounting standards, aggregated the components into one compound derivative financial instrument for financial reporting purposes. For financings recorded in accordance with SFAS 133, the compound embedded derivative instruments are valued using the Flexible Monte Carlo methodology because that model embodies certain relevant assumptions (including, but not limited to, interest rate risk, credit risk, and conversion/redemption privileges) that are necessary to value these complex derivatives.

Assumptions used as of September 30, 2008 included exercise estimates/behaviors and the following other significant estimates:

	Series C Convertible Preferred Stock	August 2006 Debenture	December 2006 Debenture	July 10, 2008 Debenture	July 29, 2008 Debenture
Conversion prices	$ 0.0021	$ 0.0017	$ 0.0017	$ 0.0017	$ 0.0017
Remaining terms (years)	0.64	1.83	1.83	1.78	1.83
Equivalent volatility	303.61%	189.08%	189.08%	191.01%	189.08%
Equivalent interest-risk adjusted rate	8.00%	13.59%	13.59%	17.83%	11.40%
Equivalent credit-risk adjusted yield rate	7.84%	9.15%	9.15%	9.15%	9.15%

Equivalent amounts reflect the net results of multiple modeling simulations that the Monte Carlo Simulation methodology applies to underlying assumptions. The assumptions included in the calculation are highly subjective and subject to interpretation.

Hybrid Financial Instruments Carried at Fair Value – 2007 and 2008 Convertible Debentures

The March 2007, August 2007, April 11, 2008, May 16, 2008 and May 29, 2008 convertible debentures are recorded in accordance with FAS 155 and the entire hybrid instrument was initially recorded at fair value, with subsequent changes in fair value recognized in earnings. These financial instruments were valued using the common stock equivalent approach. Through the date of default, the common stock equivalent was calculated using the shares indexed to the financial instruments valued at the market price of our stock and the present value of the coupon. Subsequent to the event of default on August 24, 2008, the default conversion rate was used to calculate the number of shares indexed to the convertible instrument and the present value of the coupon was based on the default interest rate.

Current Period Valuations

For the Series C Convertible Preferred Stock and the August 2006 and December 2006 debentures, due to our previous default position with respect to these instruments, the carrying value of each instrument in effect as of December 31, 2006 was written up to its full face value during the fourth quarter of 2006. Because of the default related to the August 2006 debentures and the cross-default provisions of the debentures, the July 2008 debentures are carried at their full face value. For these instruments, the embedded derivative instruments, primarily the conversion features, have been separated and accounted for as derivative instrument liabilities, as discussed above. These derivative instrument liabilities are marked to market each reporting period.

The March 2007 Debenture, August 2007 Debenture, April 2008 Debenture and the May 2008 Debentures were each initially recorded at their full fair value pursuant to FAS 155. That fair value is marked-to-market each reporting period, with any changes in the fair value charged or credited to income.

The face value or fair value, as appropriate, of each instrument as of September 30, 2008 and December 31, 2007 was:

September 30, 2008	Carrying value	Fair value (in thousands)	Total
Series C Convertible Preferred Stock	$ 19,308	$ -	$ 19,308
August 2006 debenture	5,000	—	5,000
December 2006 debenture	2,500	—	2,500
March 2007 debenture	-	15,020	15,020
August 2007 debenture	-	3,593	3,593
April 2008 debenture	-	712	712
May 16 ,2008 debenture	-	1,176	1,176
May 29, 2008 debenture	-	1,855	1,855
July 10, 2008 debenture	2	-	2
July 29, 2008 debenture	34	-	34
Total	$ 7,536	$ 22,356	$ 28,892

December 31, 2007	Face value	Fair value (in thousands)	Total
Series C Convertible Preferred Stock	$ 20,097	$ -	$ 20,097
August 2006 debenture	5,000	-	5,000

December 2006 debenture		2,500		-		2,500
March 2007 debenture		-		18,798		18,798
August 2007 debenture		-		4,401		4,401
Total	$	7,500	$	23,199	$	30,699

We adopted the provisions of FAS 157 as of January 1, 2008, with respect to financial instruments. As required by FAS 157, assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to their fair value measurement. Our derivative financial instruments which are required to be measured at fair value on a recurring basis under FAS 155 or FAS 133 as of September 30, 2008 are all measured at fair value using Level 3 inputs. Level 3 inputs are unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following tabular presentation reflects the components of derivative financial instruments related to convertible financial instruments in the liability section on our balance sheet at September 30, 2008:

	Common Stock Warrants	Embedded Conversion Feature (in thousands)	Total
Series C Convertible Preferred Stock	$ 115	$ 16,387	$ 16,502
August 24, 2006 Debenture	437	8,470	8,907
December 29, 2006 Debenture	109	4,235	4,344
March 27, 2007 Debenture	325	-	325
August 24, 2007 Debenture	202	-	202
April 11, 2008 Debenture	-	-	-
May 16, 2008 Debenture	22	-	22
May 29, 2008 Debenture	145	-	145
July 10, 2008 Debenture	-	205	205
July 29, 2008 Debenture	1,350	3,319	4,669
Other instruments	5	20	25
Total	$ 2,710	$ 32,636	$ 35,346

For the March 2007, August 2007, April 2008 and May 2008 debentures, the embedded conversion feature is effectively embodied in the fair value of those instruments under SFAS 155.

The following table reflects the number of common shares into which the convertible instruments and warrants are convertible or exercisable at September 30, 2008:

	Common Stock Warrants	Embedded Conversion Feature	Total
Series C Convertible Preferred Stock	75,000,000	7,803,257,000	7,878,257,000
August 24, 2006 Debenture	175,000,000	2,941,176,000	3,116,176,000
December 29, 2006 Debenture	42,000,000	1,470,588,000	1,512,588,000
March 27, 2007 Debenture	125,000,000	4,387,442,000	4,512,442,000
August 24, 2007 Debenture	75,000,000	1,044,118,000	