

Edgar Filing: NEOMEDIA TECHNOLOGIES INC - Form 10QSB

NEOMEDIA TECHNOLOGIES INC  
Form 10QSB  
November 05, 2004

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

-----  
FORM 10 - QSB  
(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

OR

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

COMMISSION FILE NUMBER 0-21743

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

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

36-3680347  
(I.R.S. Employer  
Identification No.)

2201 SECOND STREET, SUITE 402, FORT MYERS, FLORIDA  
(Address of Principal Executive Offices)

33901  
(Zip Code)

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

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

As of October 25, 2004, there were 371,137,314 outstanding shares of  
the issuer's Common Stock.

PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NEOMEDIA TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEET (UNAUDITED)  
(IN THOUSANDS, EXCEPT SHARE DATA)

SEPTEMBER 30,  
2004  
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ASSETS

Current assets:

Cash and cash equivalents

\$ 1,732

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Trade accounts receivable, net of allowance for doubtful accounts of \$54	208
Inventories, net of allowance for obsolete & slow-moving inventory of \$13	111
Prepaid expenses and other current assets	432
	-----
Total current assets	2,483
Property and equipment, net	122
Capitalized patents, net	2,229
Capitalized and purchased software costs, net	94
Excess of purchase price over tangible assets of CSI	3,056
Investment in IPoint-media, Ltd.	1,000
Other long-term assets	737
	-----
Total assets	\$ 9,721
	=====
LIABILITIES AND SHAREHOLDERS' DEFICIT	
Current liabilities:	
Accounts payable	\$ 1,667
Amounts payable under settlement agreements	477
Liabilities of discontinued business unit	664
Sales taxes payable	131
Accrued expenses	1,490
Deferred revenues and other	475
Investment payable	1,000
Notes payable	2,117
	-----
Total current liabilities	8,021
	-----
Shareholders' equity:	
Preferred stock, \$0.01 par value, 25,000,000 shares authorized, none issued and outstanding	--
Common stock, \$0.01 par value, 1,000,000,000 shares authorized, 390,382,372 shares issued and 361,204,990 outstanding	3,612
Additional paid-in capital	81,012
Deferred stock-based compensation	(458)
Accumulated deficit	(81,640)
Accumulated other comprehensive loss - foreign currency translation adjustment	(47)
Treasury stock, at cost, 201,230 shares of common stock	(779)
	-----
Total shareholders' equity	1,700
	-----
Total liabilities and shareholders' equity	\$ 9,721
	=====

The accompanying notes are an integral part of this condensed consolidated balance sheet.

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	THREE MONTHS ENDED SEPTEMBER	
	2004	2003
	-----	-----
NET SALES:		
License fees	\$ 96	\$
Resale of software and technology equipment and service fees	138	
Micro paint repair products and services	237	
	-----	-----
Total net sales	471	
	-----	-----
COST OF SALES:		
License fees	79	
Resale of software and technology equipment and service fees	147	
Micro paint repair products and services	151	
	-----	-----
Total cost of sales	377	
	-----	-----
GROSS PROFIT (LOSS)	94	
Sales and marketing expenses	514	
General and administrative expenses	516	1
Research and development costs	114	
	-----	-----
Loss from operations	(1,050)	(2)
OTHER INCOME (EXPENSE)		
Gain (loss) on extinguishment of debt	6	
Amortization of debt discount	(334)	
Interest expense, net	(62)	
	-----	-----
NET LOSS	(1,440)	(2)
Other comprehensive loss:		
Foreign currency translation adjustment	(31)	
	-----	-----
COMPREHENSIVE LOSS	\$ (1,471)	\$ (2)
	=====	=====
LOSS PER SHARE--BASIC AND DILUTED	\$ (0.00)	\$ (
	=====	=====
WEIGHTED AVERAGE NUMBER OF COMMON SHARES--BASIC AND DILUTED	342,990,471	151,698
	=====	=====

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

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	NINE MONTHS ENDED SEPTEMBER	
	2004	2003
NET SALES:		
License fees	\$ 256	\$ 1,
Resale of software and technology equipment and service fees	501	1,
Micro paint repair products and services	512	
	-----	-----
Total net sales	1,269	2,
	-----	-----
COST OF SALES:		
License fees	249	
Resale of software and technology equipment and service fees	480	1,
Micro paint repair products and services	376	
	-----	-----
Total cost of sales	1,105	1,
	-----	-----
GROSS PROFIT (LOSS)	164	
Sales and marketing expenses	1,461	
General and administrative expenses	1,293	3,
Research and development costs	354	
	-----	-----
Loss from operations	(2,944)	(3,
OTHER INCOME (EXPENSE)		
Gain (loss) on extinguishment of debt	129	
Amortization of debt discount	(2,500)	
Interest expense, net	(178)	(
	-----	-----
NET LOSS	(5,493)	(4,
Other comprehensive loss:		
Foreign currency translation adjustment	(47)	
	-----	-----
COMPREHENSIVE LOSS	\$ (5,540)	\$ (4,
	=====	=====
LOSS PER SHARE--BASIC AND DILUTED	\$ (0.02)	\$ (0
	=====	=====
WEIGHTED AVERAGE NUMBER OF COMMON SHARES--BASIC AND DILUTED	324,471,293	89,440,
	=====	=====

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

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## NEOMEDIA TECHNOLOGIES, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED) (IN THOUSANDS)

	NINE MO SEPTE
	2004
	-----
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>	
Net loss	(\$5,493)
Adjustments to reconcile net loss to net cash used in operating activities:	
Amortization of discount on note payable	2,500
Depreciation and amortization	367
Provision for doubtful accounts	24
Expense (decrease of fair value) for repriced options	(240)
Fair value of expense portion of stock-based compensation granted for professional services	545
Interest expense allocated to debt	3
Discount related to issuance of employee common stock	--
Loss on payment of accounts payable in stock	--
(Increase)/decrease in value of life insurance policies	17
Changes in operating assets and liabilities	
Trade accounts receivable, net	(8)
Inventory	(54)
Other current assets	90
Accounts payable, amounts due under financing agreements, liabilities in excess of assets of discontinued business unit, accrued expenses and stock liability	(1,211)
Deferred revenue other current liabilities	(40)
	-----
Net cash used in operating activities	(3,500)
	-----
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>	
Capitalization of software development and purchased intangible assets	(109)
Acquisition of property and equipment	(103)
	-----
Net cash used in investing activities	(212)
	-----
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>	
Net proceeds from issuance of common stock, net of issuance costs of \$620 in 2004 and \$308 in 2003	5,926
Net proceeds from cash advances payable through the issuance of common stock	--
Net proceeds from exercise of stock options and warrants	581
Borrowings under notes payable and long-term debt	8,000
Repayments on notes payable and long-term debt	(6,687)
Transfer to restricted cash for long-term debt	--
Cash paid to acquire CSI International, Inc. (net of cash acquired)	(2,390)
	-----
Net cash provided by financing activities	5,430
	-----
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(47)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,671
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	61
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CASH AND CASH EQUIVALENTS, END OF PERIOD

\$ 1,732

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## SUPPLEMENTAL CASH FLOW INFORMATION:

Interest paid/(received) during the period	\$ 50
Income taxes paid	--
Non-cash investing and financing activities:	
Reduction in accounts payable and accruals for debt paid in stock	190
Fair value of stock and warrants issued with debt	--
Fair value of stock issued for services and deferred to future periods	585
Fair value of shares issued to acquire CSI Int'l (net of costs of registration)	695
Change in net assets resulting from acquisition of CSI (net of cash acquired)	3,090
Gain on extinguishment of debt	129
Direct costs associated with Standby Equity Distribution Agreement	1,447

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

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

### 1. BASIS OF PRESENTATION AND NATURE OF BUSINESS OPERATIONS

#### BASIS OF PRESENTATION

The condensed consolidated financial statements include the financial statements of NeoMedia Technologies, Inc. and its wholly-owned subsidiaries ("NeoMedia" or the "Company"). The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-QSB and do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete consolidated financial statements. These condensed consolidated financial statements and related notes should be read in conjunction with the Company's Form 10-KSB for the fiscal year ended December 31, 2003. In the opinion of management, these condensed consolidated financial statements reflect all adjustments which are of a normal recurring nature and which are necessary to present fairly the consolidated financial position of NeoMedia as of September 30, 2004, the results of operations for the three-month and nine-month periods ended September 30, 2004 and 2003, and cash flows for the nine-month periods ended September 30, 2004 and 2003. The results of operations for the three-month and nine-month periods ended September 30, 2004 and 2003 are not necessarily indicative of the results which may be expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated in preparation of the condensed consolidated financial statements.

#### NATURE OF BUSINESS OPERATIONS

NeoMedia is structured as three distinct business units: NeoMedia Internet Software Service (NISS), NeoMedia Consulting and Integration Services (NCIS), and NeoMedia Micro Paint Repair (NMPR).

NISS (physical world-to-Internet offerings) is the core business and is based in the United States, with development and operating facilities in Fort Myers, Florida. NISS develops and supports NeoMedia's physical world to Internet core technology, including the linking "switch" and application platforms. NISS

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also manages NeoMedia's intellectual property portfolio, including the identification and execution of licensing opportunities surrounding the patents.

NCIS (systems integration service offerings) is the original business line upon which NeoMedia was organized. This unit resells client-server equipment and related software, and general and specialized consulting services. Systems integration services also identifies prospects for custom applications based on NeoMedia's products and services. These operations are based in Lisle, Illinois.

NMPR (micro paint repair offerings) is the business unit encompassing the recently-acquired CSI International chemical line. NMPR is attempting to commercialize its unique micro-paint repair solution. The Company completed its acquisition of CSI on February 6, 2004.

### RECLASSIFICATIONS

Certain amounts in the 2003 condensed consolidated financial statements have been reclassified to conform to the 2004 presentation.

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### ACQUISITION OF CSI INTERNATIONAL, INC. ("CSI")

On February 6, 2004, NeoMedia acquired 100% ownership of CSI International, Inc., of Calgary, Alberta, Canada, a private technology products company in the micro paint repair industry. NeoMedia paid a purchase price including an issuance of 7,000,000 shares of its common stock, and cash of \$2,500,000 in exchange for all outstanding shares of CSI. The shares were valued at \$0.10 per share, which was the market price of NeoMedia's common stock on the Over-the-counter Bulletin Board exchange around the acquisition date. NeoMedia also incurred direct costs of the business combination totaling \$5,000, which are included in the purchase price for purposes of allocating assets acquired and liabilities assumed.

The acquisition was accounted for under the purchase method. The actual purchase price was based on cash paid, the fair value of NeoMedia stock around the date of the acquisition, and direct costs associated with the combination. The purchase price was allocated as follows:

	(Dollars in Thousands)
Value of 7 Million Shares Issued (\$0.10 per share)	\$700
Cash paid	2,500
Direct costs of acquisition	5
Total Fair Value of Purchase Price	\$3,205
Assets Purchased:	
Cash	\$115
Accounts receivable, net	67
Inventory	54
Other current assets	12
Investments	25
Property, plant & equipment	8
Excess of purchase price over net tangible assets	3,059
Total Assets Purchased	3,340

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Less Liabilities Assumed:	
Accounts payable	(23)
Accrued liabilities	(12)
Notes payable	(100)
	-----
Total Liabilities Assumed	(135)
	-----

The combination is being accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price is preliminary and is subject to revision as the Company continues to evaluate the allocations. The Company has not amortized the excess of purchase price over net tangible assets since the allocation is not yet final. With limited operation history of CSI, the Company expects to evaluate the results of operations of CSI in the coming months in order to accurately finalize the allocation. The Company expects to finalize this process in the second half of 2004. If the excess of purchase price over net tangible assets is determined to be allocated fully or partially to intangible assets with definite lives upon final allocation, the Company will determine the economic useful lives based on its best estimate and amortize such assets accordingly. The Company will continue to evaluate this asset for impairment until such time as the purchase price allocation is final.

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The accompanying consolidated statement of operations presented herein contains the results of operations for CSI for the period February 6, 2004, through September 30, 2004.

Pro-forma results of operations as if NeoMedia and CSI had combined as of January 1, 2004 are as follows:

	THREE MONTHS ENDED SEPTEMBER 30, 2004				NINE MONTHS	
	(A)					
	NEOMEDIA	CSI INT'L	PRO-FORMA ADJUST- MENTS	PRO-FORMA COMBINED	NEOMEDIA	CS INT
	-----	-----	-----	-----	-----	-----
Total net sales	\$471	--	--	(A) \$471	\$1,269	5
Loss from operations	(\$1,050)	--	--	(A) (\$1,050)	(\$2,944)	(1,0
Net loss	(\$1,440)	--	--	(A) (\$1,440)	(\$5,493)	(1,0
Net loss per share-basic and diluted	(\$0.00)			(\$0.00)	(\$0.02)	
Weighted average number of common shares - basic and diluted	342,990,471		--	342,990,471	324,471,293	

Pro-forma Adjustments



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- (A) - Adjustments are to reflect operations of CSI from February 6, 2004 through September 30, 2004, which are included in NeoMedia's operations for the three months ended September 30, 2004.
- (B) - To adjust weighted average shares outstanding as if the 7,000,000 shares issued as part of the purchase price of CSI on February 6, 2004, had been issued on January 1, 2004

Pro-forma results of operations as if NeoMedia and CSI had combined as of January 1, 2003 are as follows:

	THREE MONTHS ENDED SEPTEMBER 30, 2003				NINE MONTHS	
	-----				-----	
	NEOMEDIA	CSI INT'L	(A) (A) PRO-FORMA ADJUST- MENTS	PRO-FORMA COMBINED	NEOMEDIA	CS INT
	-----	-----	-----	-----	-----	-----
Total net sales	\$461	\$158	--	\$619	\$2,009	\$
Income (loss) from operations	(\$2,157)	\$28	--	(\$2,129)	(\$3,843)	
Net income (loss)	(\$2,205)	\$28	--	(\$2,177)	(\$4,060)	
Net loss per share-basic and diluted	(\$0.01)			(\$0.01)	(\$0.05)	
Weighted average number of common shares - basic and diluted	151,698,465		7,000,000 (C)	158,698,465	89,440,869	

### Pro-forma Adjustments

- (C) - To adjust weighted average shares outstanding as if the 7,000,000 shares issued as part of the purchase price of CSI on February 6, 2004, had been issued on January 1, 2003

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### STANDBY EQUITY DISTRIBUTION AGREEMENT WITH CORNELL CAPITAL PARTNERS, LP ("CORNELL")

On February 11, 2003, NeoMedia and Cornell entered into an Equity Line of Credit Agreement under which Cornell agreed to purchase up to \$10 million of NeoMedia's common stock over a two-year period, with the timing and amount of the purchase at the Company's discretion. The maximum amount of each purchase was \$150,000 with a minimum of seven days between purchases. The shares were valued at 98% of the lowest closing bid price during the five-day period following the delivery of a notice of purchase by NeoMedia. The Company paid 5% of the gross proceeds of each purchase to Cornell.

On October 27, 2003, the Company and Cornell entered into a \$20 million Standby Equity Distribution Agreement. The terms of the agreement are identical to the terms of the previous Equity Line of Credit, except that the maximum "draw" under the new agreement is \$280,000 per week, not to exceed \$840,000 in any 30-day period, and Cornell will purchase up to \$20 million of the Company's common stock over a two-year period. As a consideration fee for Cornell to enter into the agreement, the Company issued 10 million warrants to Cornell with an

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exercise price of \$0.05 per share, and a term of five years. Cornell exercised the warrants in January 2004, resulting in \$500,000 cash receipts to the Company. In November 2003, the Company filed a Form SB-2 to register 200 million shares under this \$20 million Standby Equity Distribution Agreement. In January 2004, the Form SB-2 was declared effective by the Securities and Exchange Commission. In April 2004, the Company filed a Form SB-2 to register 40 million shares underlying warrants granted to Cornell in connection with a promissory note issued by the Company to Cornell (see "Notes Payable to Cornell" below). In May 2004, the Form SB-2 was declared effective by the Securities and Exchange Commission.

During the nine months ended September 30, 2004, the Company sold 87,787,740 shares of its common stock to Cornell under the Standby Equity Distribution Agreement. The following table summarizes funding received from Cornell during the nine months ended September 30, 2004:

	THREE MONTHS ENDED MARCH 31, 2004	THREE MONTHS ENDED JUNE 30, 2004	THREE MONTHS ENDED SEPTEMBER 30, 2004	NINE MONTHS ENDED SEPTEMBER 30, 2004
Number of shares sold to Cornell	21,282,203	29,819,873	36,685,664	87,787,740
Gross Proceeds from sale of shares to Cornell	\$ 2,332,000	\$ 2,308,000	\$ 2,734,270	\$ 7,374,270
Less: discounts and fees*	(500,000)	(465,000)	(483,000)	(1,448,000)
Net Proceeds from sale of shares to Cornell	\$ 1,832,000	\$ 1,843,000	\$ 2,251,270	\$ 5,926,270

\* - Per Standby Equity Distribution Agreement, stock is valued at 98% of the lowest closing bid price during the week it is sold

### PROMISSORY NOTES PAYABLE TO CORNELL

On January 20, 2004, the Company borrowed from Cornell the gross amount of \$4,000,000 before Cornell discounts and fees. Of the \$4,000,000 funding, \$2,500,000 was used to fund the acquisition of CSI International, Inc. during February 2004. Cornell withheld a \$315,000 retention fee related to the issuance of stock to pay off the debt in the future. The Company paid this note in full during the third quarter of 2004.

On April 8, 2004, the Company borrowed from Cornell the gross amount of \$1,000,000 before Cornell discounts and fees. Cornell withheld a \$76,000 retention fee related to the issuance of stock to pay off the debt in the future. The Company paid this note in full during the third quarter of 2004.

On July 2, 2004, the Company borrowed from Cornell the gross amount of \$1,000,000 before Cornell discounts and fees. Cornell withheld a \$76,000 retention fee related to the issuance of stock to pay off the debt in the future. The Company paid this note in full during the third quarter of 2004.

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On August 6, 2004, the Company borrowed from Cornell the gross amount of \$2,000,000 before Cornell discounts and fees. Cornell withheld a retention fee of \$153,000 related to the issuance of stock to pay off the debt in the future. As of September 30, 2004, the Company had not made any payments against the principal. The note matures on December 13, 2004. The note accrues interest at a rate of 12% per annum, increasing to 14% per annum upon maturity, if not paid off. The Company has the option to repay any remaining principal of the note in cash. The Company expects to pay the remaining note balance by applying the proceeds from the sale of stock under the terms of the Standby Equity Distribution Agreement toward the outstanding principal on the notes.

The Company also granted to Cornell 40,000,000 warrants to purchase shares of NeoMedia stock with an exercise price of \$0.05 per share during January 2004. In April 2004, the Company filed a Form SB-2 to register 40 million shares underlying warrants granted to Cornell in connection with a promissory note issued by the Company to Cornell. In May 2004, the Form SB-2 was declared effective by the Securities and Exchange Commission. The fair value of the warrants using the Black/Scholes pricing model was \$5,000,000. In accordance with APB 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants", the Company has compared the relative fair values of the warrants and the face value of the notes, and has allocated a value of \$2.5 million to the warrants. Of the \$2.5 million, \$2 million was allocated to the \$4 million note issued in January 2004 and \$0.5 million against the \$1 million note in April 2004. The \$2.5 million was recorded as a discount against the carrying value of the note. The \$2.5 million that was allocated to the notes is considered a discount on the promissory notes, and therefore was amortized over the life of the notes using the effective interest method, in accordance with Staff Accounting Bulletin No. 77, Topic 2.A.6, "Debt Issue Costs" of SFAS 141, "Business Combinations". Accordingly, the Company recorded an amortization of discount of \$334,000 and \$2,500,000 related to the warrants during the three months and nine months ended September 30, 2004, respectively.

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iPOINT-MEDIA LTD.

On September 7, 2004, NeoMedia and iPoint-media Ltd. ("iPoint-media") of Tel Aviv, Israel, entered into a business development agreement whereby NeoMedia will provide the following services to iPoint-media:

- NeoMedia and iPoint-media will jointly pursue select opportunities in the areas of distributing video, audio and data over an interactive broadband media access platform.
- NeoMedia may serve as a reseller of iPoint-media's products and services in North America on a non-exclusive basis with special focus on the government (including state and local).
- NeoMedia will seek to introduce iPoint-media to NeoMedia's other channel and alliance partners which may have interest in doing business with iPoint-media.
  - o NeoMedia and iPoint-media will reciprocate contracts to each of the respective parties' partners and clients for opportunities of synergy where reseller of finder's fee compensation may apply.
  - o NeoMedia will make available appropriate resources for market analysis and tactical evaluations for achieving business goals surrounding iPoint-media operations in North America.

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- o NeoMedia will provide resources in order to market iPoint-media technology in strategic industry verticals including government and telecommunications.
  - o NeoMedia will contribute sales activities, both conceptual/planning and direct, for iPoint-media products including branding and repackaging initiatives, if desired by iPoint, to further advance distribution of the iPoint-media product suite.
  - o NeoMedia will supply resources to manage accounts and perform post sale support activities for iPoint-media technology implementations.
- Where appropriate, NeoMedia will support iPoint-media's efforts to assist in securing approvals for iPoint-media's technology within appropriate government and industry standards groups.

In exchange for entering into the service agreement, NeoMedia received 7% ownership in iPoint-media, consisting of 28,492 shares of iPoint-media common stock. NeoMedia had not performed any services under the agreement as of September 30, 2004.

In addition to the business development agreement, NeoMedia acquired an additional 10% ownership of iPoint-media, consisting of 40,704 shares of common stock, for \$1 million cash. The \$1 million investment is being funded to NeoMedia in the form of a note payable to Cornell Capital Partners in the amount of \$1,085,000, with net proceeds to NeoMedia of \$1,000,000. The note was funded on October 18, 2004, and the funds were subsequently transferred to iPoint. As a result, as of September 30, 2004, NeoMedia has recorded an "Investment in IPoint-media, Ltd" of \$1,000,000 in the accompanying condensed consolidated balance sheet, and "Investment payable" of \$1,000,000 in the accompanying condensed consolidated balance sheet.

iPoint-media was founded in April 2001 as a spin off from Imagine Visual Dialog LTD, whose shareholders include Israeli-based Nisko group, a leading Israeli holding company, Singapore-based Keppel T&T, and marketing and advertising group WPP. iPoint-media specializes in Customer Interaction Management and is the world's 1st developer of IP Video Call Centers for Deutsche Telecom. Muki Geller, the founder of Imagine Visual Dialog, is the founder, President & CEO of iPoint-media. iPoint-media is located in Tel Aviv, Israel, with a European customer support center in The Netherlands. iPoint-media's mission is to become the video access platform and application engine of choice for service providers.

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### OPTION REPRICING PROGRAM

During May 2003, the Company re-priced approximately 8.0 million stock options under a 6-month repricing program. Under the terms of the program, the exercise price for outstanding options under the Company's 2002, 1998, and 1996 Stock Option Plans was restated to \$0.01 per share. During June 2004, the deadline for the option repricing was extended to December 31, 2004 by the Stock Option Committee of NeoMedia's Board of Directors. In accordance with FASB Interpretation, FIN 44, "Accounting for Certain Transactions Involving Stock Transactions", the award has been accounted for as variable from May 19, 2003 through the period ended September 30, 2004. The closing price of the Company's common stock on September 30, 2004, June 30, 2004, March 31, 2004, and December

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31, 2003 was \$0.068, \$0.067, \$0.09, and \$0.137 per share, respectively. As a result, the Company recorded a charge/(reduction) to general and administrative expense of (\$163,000), (\$80,000), and \$3,000 during the three months ended March 31, 2004, June 30, 2004, and September 30, 2004, respectively. The adjustment was recorded in order to reflect the increase/(decrease) of the fair value of options still unexercised under the repricing program under variable accounting.

### OTHER EVENTS

On August 31, 2004, the Company's Board of Directors named Charles T. Jensen as the Company's permanent Chief Executive Officer. Jensen, president and Chief Operating Officer of NeoMedia since June 2002, had also been acting CEO since that time. Jensen joined NeoMedia in 1995 as Chief Financial Officer, and acted in that capacity until June 2002.

On August 30, 2004, the Company entered into a consulting agreement with an unrelated third party, under which the consultant provides tax advisory services to the Company. As consideration for the contract, the Company issued 183,129 shares of common stock to the consultant. The fair value of the stock at the time of issuance was \$13,000. The Company recognized \$13,000 in expense relating the contract during the nine months ended September 30, 2004.

On August 2, 2004, NeoMedia announced that it signed a distribution agreement with Motor Dealer's Association (MDA) Co-Auto Ltd., the largest buying consortium for new car franchised dealers in Western Canada. The agreement provides exclusive rights for MDA Co-Auto to market NeoMedia's micro paint repair system to its member dealers. MDA Co-Auto has 1,050 member dealers in British Columbia, Alberta, Saskatchewan, Manitoba and the Yukon.

On July 30, 2004, the Company entered into a consulting agreement with an unrelated third party, under which the consultant agreed to provide sales and marketing services relating to the Company's PaperClick business for the period from July 2004 through September 2004. As consideration for the contract, the Company issued 258,104 shares of common stock to the consultant. The fair value of the stock at the time of issuance was \$18,000. The Company recognized this amount as sales and marketing expense during the three months ended September 30, 2004.

On June 25, 2004, the Company issued 322,228 shares of its common stock valued at \$24,000, plus \$8,000 cash to an unrelated distributor of the Company's micro paint repair products, in exchange for the forfeiture by the distributor of exclusive distribution rights in the greater Edmonton, Alberta, Canada area. The distributor had purchased the exclusivity rights in 1992 from CSI International, Inc.

On February 6, 2004, the Company entered into a consulting agreement with an unrelated third party, under which the consultant will provide sales and marketing services relating to the Company's Micro Paint business unit over a period of three years. As consideration for the contract, the Company issued

6,055,556 options with an exercise price of \$0.01 to the consultant. The fair value of the options at the time of issuance was \$550,000. The Company is recognizing the fair value as sales and marketing expense over the term of the contract (three years). Accordingly, the Company recognized \$50,000 and \$131,000 in expense relating the contract during the three and nine months ended September 30, 2004, respectively.

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During January 2004, the Company entered into a consulting agreement with James J. Keil, a member of the Company's board of directors, for consulting services to be provided over a period of six months in connection with NeoMedia's sales strategies and processes. The contract calls for monthly payments of \$4,500 during the term of the contract. The Company recognized \$27,000 in general and administrative expense relating to the contract during the nine months ended September 30, 2004.

### SUBSEQUENT EVENTS

On October 18, 2004, the Company borrowed from Cornell the gross amount of \$1,085,000 before Cornell discounts and fees. Cornell withheld a retention fee of \$85,000 related to the issuance of stock to pay off the debt in the future. The note matures on January 20, 2005. The note accrues interest at a rate of 12% per annum, increasing to 14% per annum upon maturity, if not paid off. The Company has the option to repay any remaining principal of the note in cash. The Company expects to pay the remaining note balance by applying the proceeds from the sale stock under the terms of the Standby Equity Distribution Agreement toward the outstanding principal on the notes. The Company invested the proceeds from the note in iPoint pursuant to the investment agreement between NeoMedia and iPoint (see "iPoint-Media Ltd." for description of agreement).

On October 27 2004, NeoMedia announced that it had entered into a marketing alliance with Science Applications International Corporation (SAIC) to jointly establish, launch, promote and manage the new worldwide mobile "PaperClick WordRegistry," a linking and switching platform for use on Web-enabled cell phones and PDA's. When used with PaperClick Mobile Go-Window, NeoMedia's new wireless product which creates a text-entry window on a phone or PDA screen, registered words (or registered phrases) are entered to bring up an automatic link to specific targeted products and promotions. No date has been set for the launch of the WordRegistry.

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### PRO-FORMA INFORMATION REQUIRED BY SFAS 148

At September 30, 2004, the Company has five stock-based employee compensation plans (the 2003 Stock Incentive Plan, the 2003 Stock Option Plan, the 2002 Stock Option Plan, the 1998 Stock Option Plan, and the 1996 Stock Option Plan). The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net loss, except when options granted under those plans had an exercise price less than the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2004	2003	2004	2003
Net Loss, as reported	(\$1,440)	(\$2,205)	(\$5,493)	(\$4,060)

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Compensation recognized under APB 25	--	623	9	623
Compensation recognized under SFAS 123	(372)	(925)	(1,073)	(1,361)
Pro-forma net loss	(\$1,812)	(\$2,507)	(\$6,557)	(\$4,798)
Net Loss per share:				
Basic and diluted - as reported	(\$0.00)	(\$0.01)	(\$0.02)	(\$0.05)
Basic and diluted - pro-forma	(\$0.01)	(\$0.02)	(\$0.02)	(\$0.05)

### SEGMENT REPORTING

The Company is structured and evaluated by its Board of Directors and Management as three distinct business units:

NeoMedia Internet Switching Services (NISS), is based in the United States, with development and operating facilities in Fort Myers, Florida. NISS develops and supports the Company's physical world to Internet core technology, including NeoMedia's linking "switch" and application platforms. NISS also manages the Company's valuable intellectual property portfolio, including the identification and execution of licensing opportunities surrounding the patents.

NeoMedia Consulting and Integration Services (NCIS) is the Company's systems integration business unit. This unit resells client-server equipment and related software, and general and specialized consulting services. NCIS also identifies prospects for custom applications based on NeoMedia's products and services. The operations are based in Lisle, Illinois.

NeoMedia Micro Paint Repair (NMPR) is the business unit encompassing the Company's recently-acquired CSI International micro paint repair line. NMPR is attempting to commercialize its micro-paint repair solution. The Company completed its acquisition of CSI on February 6, 2004

The Company's reportable segments are strategic business units that offer different technology and marketing strategies. NCIS operates principally in the United States. NISS operates principally in the United States and Europe. NMPR is headquartered in Ft. Myers, Florida, and currently sells into Canada, the United States, Australia, and New Zealand. During the three and nine months ended September 30, 2004, NeoMedia derived 44% and 36%, respectively, of its revenue from customers based in Canada.

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Consolidated net sales, net operating losses for the three-month and nine-month periods ended September 30, 2004 and 2003, and identifiable assets as of September 30, 2004, were as follows:

(in thousands)			
THREE MONTHS ENDED		NINE MONTHS ENDED	
SEPTEMBER 30,		SEPTEMBER 30,	
2004	2003	2004	2003
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### NET SALES:

NeoMedia Consulting & Integration Services	\$230	\$448	\$711	\$1,971
NeoMedia Internet Switching Service	4	13	46	38
NeoMedia Micro Paint Repair	237	--	512	--
	\$471	\$461	\$1,269	\$2,009

### NET LOSS:

NeoMedia Consulting & Integration Services	(\$189)	(\$1,855)	(\$682)	(\$3,310)
NeoMedia Internet Switching Service	(482)	(350)	(1,326)	(750)
NeoMedia Micro Paint Repair	(421)	--	(985)	--
Amortization of Cornell Debt Discount	(348)	--	(2,500)	--
	(\$1,440)	(\$2,205)	(\$5,493)	(\$4,060)

### IDENTIFIABLE ASSETS:

NeoMedia Consulting & Integration Services	\$264
NeoMedia Internet Switching Service	2,332
NeoMedia Micro Paint Repair	3,313
Corporate	3,812
	\$9,721

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

#### NISS (PHYSICAL-WORLD-TO-INTERNET OFFERINGS) BUSINESS UNIT DEVELOPMENTS.

Over the past several years, NeoMedia's focus has been aimed toward the commercialization of its Internet Switching Systems (NISS) business unit. NISS consists of the patented PaperClick™ technology that enables users to link directly from the physical to the digital world, as well as the patents surrounding certain physical-world-to-web linking processes. NeoMedia's mission is to invent, develop, and commercialize technologies and products that effectively leverage the integration of the physical and electronic to provide clear functional value for its end-users, competitive advantage for their business partners and return-on-investment for their investors.

On September 8, 2003, NeoMedia announced its PaperClick for Camera Cell Phones™ product, which reads and decodes UPC/EAN or other bar codes to link users to the Internet, providing information and enabling e-commerce on a compatible camera cell phone, such as the Nokia 3650 model. During the second quarter of 2004, NeoMedia introduced its PaperClick Mobile Go-Window™, a horizontal bar on the screen of a wireless device where users can enter numeric strings from UPC or other bar codes to link directly to targeted online information via patented PaperClick technology and software. The PaperClick Mobile Go-Window™ currently works with Palm(TM) Tungsten C PDA, the Handspring(TM) Treo 270 and 600 Smartphones, Pocket PC(R), Java MIDP 2.0 (Mobile Independent Device



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Profile) standard, and Microsoft Windows Mobile(TM)-based Smartphones.

On October 30, 2003, NeoMedia unveiled the go-to-market strategy for its PaperClick suite of products. Over the past several months, NeoMedia has signed contracts with several key partners outlined in the strategy, including agents Big Gig Strategies and SRP Consulting, resellers AURA Digital Communications and Relyco, systems integrator Science Applications International Corporation (SAIC), and European advertising agency 12Snap. In June 2004, NeoMedia entered into a collaborative agreement with Intel Corporation for NeoMedia's PaperClick mobile connectivity platform to operate on the recently introduced Intel PXA27x processor family-based cellular phones.

On June 3, 2004, NeoMedia announced that it signed a teaming agreement with IPSO, an integrator of proprietary solutions developed by its provider companies for financial institution members and a leader in meeting Check 21 standards. Enacted by Congress and signed into law last year, Check 21 requires banks to begin accepting substitute checks (called IRDs for image replacement documents) in lieu of original checks as of October 29, 2004. NeoMedia and IPSO could partner on proposals and presentations surrounding Check 21.

During October 2004, NeoMedia and SAIC entered into a marketing alliance to jointly establish, launch, promote and manage the new worldwide mobile "PaperClick WordRegistry," a linking and switching platform for use on Web-enabled cell phones and PDA's. When used with PaperClick Mobile Go-Window, NeoMedia's new wireless product which creates a text-entry window on a phone or PDA screen, registered words (or registered phrases) are entered to bring up an automatic link to specific targeted products and promotions. No date has been set for the launch of the WordRegistry.

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### NMPR (MICRO PAINT REPAIR) BUSINESS UNIT DEVELOPMENTS.

On February 6, 2004, NeoMedia acquired 100% ownership of CSI International, Inc., of Calgary, Alberta, Canada, a private technology products company in the micro paint repair industry. NeoMedia currently has approximately 50 active paint repair end-user system agreements.

On June 1, 2004, NeoMedia announced that it had entered into a distribution agreement with Micro Paint Systems (Australasia) Limited of New Zealand for exclusive distribution rights to NeoMedia's micro paint repair products in Australia and New Zealand. The agreement is contingent upon a minimum purchase of 500 systems over five years in that territory. NeoMedia received an initial payment on signing of the contract, which included the fee for four initial systems.

On June 22, 2004, NeoMedia announced its new product called "Silver Solutions," a process created specifically to mend the popular high metallic and pearl paint finishes on new cars.

On July 7, 2004, NeoMedia announced the appointment of Arthur W. Gilfus to the newly-created position of global vice president of sales for the Micro Paint Repair Business Unit.

On July 16, 2004, NeoMedia announced that its NeoMedia Micro Paint Repair business unit added five more licensees as part of a private label contract with Crackmaster Distributors Ltd., a Canadian auto aftermarket company.

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On August 2, 2004, NeoMedia announced that it signed a distribution agreement with Motor Dealer's Association (MDA) Co-Auto Ltd., the largest buying consortium for new car franchised dealers in Western Canada. The agreement provides exclusive rights for MDA Co-Auto to market NeoMedia's micro paint repair system to its member dealers. MDA Co-Auto has 1,050 member dealers in British Columbia, Alberta, Saskatchewan, Manitoba and the Yukon.

### NCIS (SYSTEMS INTEGRATION) BUSINESS UNIT DEVELOPMENTS.

NCIS (systems integration service offerings) is the original business line upon which the Company was organized. This unit resells client-server equipment and related software, and general and specialized consulting services. Systems integration services also identifies prospects for custom applications based on NeoMedia's products and services. These operations are based in Lisle, Illinois.

### SEC INQUIRY

During 2003, NeoMedia received requests from the SEC's Southeast Regional Office for certain documents including those concerning negotiations and arrangements with certain strategic partners and consultants, patents, recent issuances of securities, investor relations, and the stock ownership by NeoMedia's officers and directors. NeoMedia responded promptly and fully and will cooperate with any further requests. The SEC's letter states that the staff's inquiry is informal and should not be construed as an indication of any violation of law or as a reflection on any person, entity, or security.

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### ACQUISITIONS

CSI INTERNATIONAL, INC. On February 6, 2004, NeoMedia acquired 100% ownership of CSI International, Inc., of Calgary, Alberta, Canada, a private company in the micro paint repair industry. NeoMedia paid 7,000,000 shares of its common stock, plus \$2.5 million cash in exchange for all outstanding shares of CSI. NeoMedia has centralized the administrative functions in its Ft. Myers, Florida headquarters, and maintains a sales office in Calgary, Alberta, Canada.

BSD SOFTWARE, INC. On December 9, 2003, NeoMedia signed a non-binding letter of intent ("LOI") to acquire Triton Global Business Services Inc. and its parent company, BSD Software Inc. (Pink Sheets: BSDS), both of Calgary, Alberta, Canada. The LOI outlined terms, including an exchange of one share of NeoMedia common stock for each share of BSD Software, not to exceed 40 million shares. The transaction is dependent on due diligence by both companies, approval by NeoMedia's Board of Directors, BSD Software's Board of Directors and shareholders, and any required regulatory approvals. Triton, formed in 1998 and acquired by BSD in 2002, is an Internet Protocol-enabled provider of live and automated operator calling services, e-business support, billing and clearinghouse functions and information management services to telecommunications, Internet and e-business service providers. The companies are currently completing their due diligence.

NeoMedia's operating results have been subject to variation and will continue to be subject to variation, depending upon factors, such as the mix of business among services and products, the cost of material, labor and technology, particularly in connection with the delivery of business services,

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the costs associated with initiating new contracts, the economic condition of NeoMedia's target markets, and the cost of acquiring and integrating new businesses.

### CRITICAL ACCOUNTING POLICIES

The U.S. Securities and Exchange Commission ("SEC") issued Financial Reporting Release No. 60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" ("FRR 60"), suggesting companies provide additional disclosure and commentary on their most critical accounting policies. In FRR 60, the SEC defined the most critical accounting policies as the ones that are most important to the portrayal of a company's financial condition and operating results, and require management to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, NeoMedia's most critical accounting policies include: inventory valuation, which affects cost of sales and gross margin; and the valuation of intangibles, which affects amortization and write-offs of goodwill and other intangibles. NeoMedia also has other key accounting policies, such as policies for revenue recognition, including the deferral of a portion of revenues on sales to distributors, allowance for bad debt, and stock-based compensation. The methods, estimates and judgments NeoMedia uses in applying these most critical accounting policies have a significant impact on the results it reports in its consolidated financial statements..

**Intangible Asset Valuation.** The determination of the fair value of certain acquired assets and liabilities is subjective in nature and often involves the use of significant estimates and assumptions. Determining the fair values and useful lives of intangible assets especially requires the exercise of judgment. While there are a number of different generally accepted valuation methods to estimate the value of intangible assets acquired, NeoMedia primarily uses the weighted-average probability method outlined in SFAS 144. This method requires significant management judgment to forecast the future operating results used in the analysis. In addition, other significant estimates are required such as residual growth rates and discount factors. The estimates NeoMedia has used are consistent with the plans and estimates that NeoMedia uses to manage its business, based on available historical information and industry averages. The

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judgments made in determining the estimated useful lives assigned to each class of assets acquired can also significantly affect NeoMedia's net operating results.

**Allowance for Bad Debt.** NeoMedia maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. Allowance for doubtful accounts is based on NeoMedia's assessment of the collectibility of specific customer accounts, the aging of accounts receivable, NeoMedia's history of bad debts, and the general condition of the industry. If a major customer's credit worthiness deteriorates, or NeoMedia's customers' actual defaults exceed historical experience, NeoMedia's estimates could change and impact its reported results.

**Stock-based Compensation.** NeoMedia records stock-based compensation to outside consultants at fair market value in general and administrative expense. NeoMedia does not record expense relating to stock options granted to employees with an exercise price greater than or equal to market price at the time of grant. NeoMedia reports pro-forma net loss and loss per share in accordance with the requirements of SFAS 123 and 148. This disclosure shows net loss and loss per share as if NeoMedia had accounted for its employee stock options under the

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fair value method of those statements. Pro-forma information is calculated using the Black-Scholes pricing method at the date of grant. This option valuation model requires input of highly subjective assumptions. Because NeoMedia's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing model does not necessarily provide a reliable single measure of fair value of its employee stock options.

**Estimate of Litigation-based Liability.** NeoMedia is defendant in certain litigation in the ordinary course of business (see "Legal Proceedings"). NeoMedia accrues liabilities relating to these lawsuits on a case-by-case basis. NeoMedia generally accrues attorney fees and interest in addition to the liability being sought. Liabilities are adjusted on a regular basis as new information becomes available. NeoMedia consults with its attorneys to determine the viability of an expected outcome. The actual amount paid to settle a case could differ materially from the amount accrued.

**Revenue Recognition.** NeoMedia derives revenues from three primary sources: (1) license revenues and (2) resale of software and technology equipment and service fee revenues, and (3) sale of its proprietary micro paint repair solution.

- (1) License fees, including Intellectual Property licenses, represent revenue from the licensing of NeoMedia's proprietary software tools and applications products. NeoMedia licenses its development tools and application products pursuant to non-exclusive and non-transferable license agreements. Resales of software and technology equipment represent revenue from the resale of purchased third party hardware and software products and from consulting, education, maintenance and post contract customer support services.

The basis for license fee revenue recognition is substantially governed by American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"), as amended. License revenue is recognized if persuasive evidence of an agreement exists, delivery has occurred, pricing is fixed and determinable, and collectibility is probable.

- (2) Revenue for resale of software and technology equipment and service fee is recognized based on guidance provided in Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements," as amended (SAB 104). Software and technology equipment resale revenue is recognized when all of the components necessary to run software or

hardware have been shipped. Service revenues including maintenance fees for providing system updates for software products, user documentation and technical support are recognized over the life of the contract. Software license revenue from long-term contracts has been recognized on a percentage of completion basis, along with the associated services being provided. Other service revenues, including training and consulting, are recognized as the services are performed. NeoMedia uses stand-alone pricing to determine an element's vendor specific objective evidence (VSOE) in order to allocate an arrangement fee amongst various pieces of

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a multi-element contract. NeoMedia records an allowance for uncollectible accounts on a customer-by-customer basis as appropriate.

In December 2003, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition." SAB 104 supersedes SAB 101, "Revenue Recognition in Financial Statements." SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." Additionally, SAB 104 rescinds the SEC's Revenue Recognition in Financial Statements Frequently Asked Questions and Answers ("the FAQ") issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The adoption of SAB 104 did not impact the consolidated financial statements.

- (3) Revenue for training and certification on NeoMedia's Micro Paint Repair systems is recognized equally over the term of the contract, which is currently one year. A portion of the initial fee paid by the customer is allocated to training costs and initial products sold with the system, and is recognized upon completion of training and shipment of the products. Ongoing product and service revenue is recognized as products are shipped and services performed.

### RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004 AS COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2003

Net sales. Total net sales for the three months ended September 30, 2004 were \$471,000, which represented an increase of \$10,000, or 2%, from \$461,000 for the three months ended September 30, 2003. This increase resulted from revenue generated by the Company's micro paint repair business unit acquired in February 2004. This increase in micro paint revenue was offset by reduced resales of Sun Microsystems equipment due to increased competition and general economic conditions. NeoMedia could realize an increase in license fees over the next 12 months if the Company is successful in implementing its PaperClick go-to-market strategy, or if pending court cases involving its intellectual property are resolved in NeoMedia's favor. NeoMedia could also realize a material increase in micro paint repair revenue if the Company is successful in implementing its business plan for that business unit.

License fees. License fees were \$96,000 for the three months ended September 30, 2004, compared with \$69,000 for the three months ended September 30, 2003, an increase of \$27,000, or 39%. The increase was due to higher sales of internally developed software licenses in 2004. NeoMedia could realize an increase in license fees over the next 12 months if the Company is successful in implementing its PaperClick go-to-market strategy, or if pending court cases involving its intellectual property are resolved in NeoMedia's favor.

Resales of software and technology equipment and service fees. Resales of software and technology equipment and service fees decreased by \$254,000, or

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65%, to \$138,000 for the three months ended September 30, 2004, as compared to \$392,000 for the three months ended September 30, 2003. This decrease primarily resulted from reduced resales of Sun Microsystems equipment due to increased competition and general economic conditions. NeoMedia intends to continue to pursue additional resales of equipment, software and services. NeoMedia expects resales to more closely resemble the results for the three months ended September 30, 2004, rather than the three months ended September 30, 2003.

Micro paint repair products and services. Sales of micro paint repair products and services were \$237,000 for the three months ended September 30, 2004. NeoMedia acquired this business on February 6, 2004, and as a result there were no sales of micro paint repair products and services during the three months ended September 30, 2003. NeoMedia could realize a material increase in micro paint repair revenue if the Company is successful in implementing its business plan for that business unit.

Cost of license fees. Cost of license fees was \$79,000 for the three months ended September 30, 2004, an increase of \$3,000, or 4%, compared with \$76,000 for the three months ended September 30, 2003. The increase resulted from increased amortization of capitalized patent costs during 2004.

Cost of resales of software and technology equipment and service fees. Cost of resales of software and technology equipment and service fees was \$147,000 for the three months ended September 30, 2004, a decrease of \$231,000, or 61%, compared with \$378,000 for the three months ended September 30, 2003. The decrease resulted from decreased resales in 2004 compared with 2003. Cost of resales as a percentage of related resales was 107% in 2004, compared to 96% in 2003. This increase is due to revenue declining more rapidly than the fixed portion of costs of resales. NeoMedia expects costs of resales to fluctuate with the mix of sales of equipment, software, and services over the next 12 months.

Cost of micro paint repair products and services. Cost of micro paint repair products and services was \$151,000 for the three months ended September 30, 2004. NeoMedia acquired this business on February 6, 2004, and as a result there were no cost of sales of micro paint repair products and services during the three months ended September 30, 2003. Cost of micro paint repair products and services as a percentage of related sales was 64%. NeoMedia expects cost of micro paint repair products and services to increase over the next 12 months as revenue continues to increase with the roll-out.

Gross Profit. Gross profit was \$94,000 for the three months ended September 30, 2004, an increase of \$87,000, or 1,243%, compared with gross profit of \$7,000 for the three months ended September 30, 2003. This increase was primarily the result of increased sales of higher-margin micro paint repair products and internally developed software licenses during 2004.

Sales and marketing. Sales and marketing expenses were \$514,000 for the three months ended September 30, 2004, compared to \$146,000 for the three months ended September 30, 2003, an increase of \$368,000 or 252%. The increase is a result of the addition of the micro paint business sales force in February 2004, and cost associated with marketing and promotion of the Company's PaperClick and micro paint repair products. NeoMedia expects sales and marketing expense to increase over the next 12 months with the continued development and anticipated rollout of the PaperClick and Micro Paint Repair product suites.

General and administrative. General and administrative expenses decreased by \$1,424,000, or 73%, to \$516,000 for the three months ended September 30, 2004, compared to \$1,940,000 for the three months ended September 30, 2003. The decrease resulted primarily from non-cash expenses relating to the Company's option repricing program, expense for stock options issued with exercise prices below market price, and higher stock-based professional service expense in 2003

as compared with 2004. NeoMedia expects general and administrative expense to increase over the next 12 months with the recent acquisition of CSI International and the potential acquisition of BSD Software.

Research and development. During the three months ended September 30, 2004, NeoMedia charged to expense \$114,000 of research and development costs, an increase of \$36,000 or 46% compared to \$78,000 for the three months ended September 30, 2003. The increase is primarily due to the addition of one developer and development computer systems during 2004. NeoMedia expects research and development costs to increase over the next 12 months with the continued development efforts, and the anticipated rollout of NeoMedia's PaperClick product suite.

Gain on extinguishment of debt. During the six months ended June 30, 2004, NeoMedia recognized a gain on extinguishment of debt of \$6,000, an increase of \$30,000 or 125% compared to a loss of \$24,000 during the three months ended September 30, 2003. These gains resulted from a difference between the cash or market value of stock issued to settle the debt and the carrying value of the debt at the time of settlement.

Amortization of debt discount. During the three months ended September 30, 2004, NeoMedia recognized an amortization of debt issuance cost of \$334,000 relating to the amortization of the fair value of warrants granted to Cornell Capital Partners in connection with promissory notes issued to Cornell by NeoMedia during January 2004. NeoMedia did not recognize any such expense during the three months ended September 30, 2003. During the nine months ended September 30, 2004, NeoMedia amortized the full \$2.5 million discount value relating to the Cornell warrants, and as a result does not expect to recognize such expense in the next 12 months.

Interest expense. Interest expense consists primarily of interest accrued for creditors as part of financed purchases, past due balances, notes payable and interest earned on cash equivalent investments. Interest expense increased by \$38,000, or 158%, to \$62,000 for the three months ended September 30, 2004 from \$24,000 for the three months ended September 30, 2003, due to higher expense associated with notes payable in 2004 compared with 2003.

Net Loss. The net loss for the three months ended September 30, 2004 was \$1,440,000, which represented a decrease of \$765,000, or 35% from a loss of \$2,205,000 for the three months ended September 30, 2003. The decrease resulted primarily from expenses relating to the Company's option repricing program and expense for stock options issued with exercise prices below market price in 2003, combined with increased gross profit from the company's micro paint repair business. These items were offset by increased sales and marketing expenses relating to the rollout of the Company's micro paint repair and PaperClick business units.

#### RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED JUNE 30, 2004 AS COMPARED TO THE NINE MONTHS ENDED JUNE 30, 2003

Net sales. Total net sales for the nine months ended September 30, 2004 were \$1,269,000, which represented a decrease of \$740,000, or 37%, from \$2,009,000 for the nine months ended September 30, 2003. This decrease primarily resulted from reduced resales of Sun Microsystems equipment due to increased competition and general economic conditions, offset by new sales from the Company's micro paint repair business acquired during February 2004. NeoMedia could realize an increase in license fees over the next 12 months if the Company

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is successful in implementing its PaperClick go-to-market strategy, or if pending court cases involving its intellectual property are resolved in NeoMedia's favor. NeoMedia could also realize a material increase in micro paint repair revenue if the Company is successful in implementing its business plan for that business unit.

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License fees. License fees were \$256,000 for the nine months ended September 30, 2004, compared with \$338,000 for the nine months ended September 30, 2003, a decrease of \$82,000, or 24%. The decrease was due to lower sales of internally developed software licenses in 2004. NeoMedia could realize an increase in license fees over the next 12 months if the Company is successful in implementing its PaperClick go-to-market strategy, or if pending court cases involving its intellectual property are resolved in NeoMedia's favor.

Resales of software and technology equipment and service fees. Resales of software and technology equipment and service fees decreased by \$1,170,000, or 70%, to \$501,000 for the nine months ended September 30, 2004, as compared to \$1,671,000 for the nine months ended September 30, 2003. This decrease primarily resulted from reduced resales of Sun Microsystems equipment due to increased competition and general economic conditions. NeoMedia intends to continue to pursue additional resales of equipment, software and services. NeoMedia expects resales to more closely resemble the results for the nine months ended September 30, 2004, rather than the nine months ended September 30, 2003.

Micro paint repair products and services. Sales of micro paint repair products and services were \$512,000 for the nine months ended September 30, 2004. NeoMedia acquired this business on February 6, 2004, and as a result there were no sales of micro paint repair products and services during the nine months ended September 30, 2003. NeoMedia could realize a material increase in micro paint repair revenue if the Company is successful in implementing its business plan for that business unit.

Cost of license fees. Cost of license fees was \$249,000 for the nine months ended September 30, 2004, an increase of \$22,000, or 10%, compared with \$227,000 for the nine months ended September 30, 2003. The increase resulted from increased amortization of capitalized patent costs during 2004.

Cost of resales of software and technology equipment and service fees. Cost of resales of software and technology equipment and service fees was \$480,000 for the nine months ended September 30, 2004, a decrease of \$1,086,000, or 69%, compared with \$1,566,000 for the nine months ended September 30, 2003. The decrease resulted from decreased resales in 2004 compared with 2003. Cost of resales as a percentage of related resales was 96% in 2004, compared to 94% in 2003. This increase is due to revenue declining more rapidly than the fixed portion of costs of resales. NeoMedia expects costs of resales to fluctuate with the mix of sales of equipment, software, and services over the next 12 months.

Cost of micro paint repair products and services. Cost of micro paint repair products and services was \$376,000 for the nine months ended September 30, 2004. Cost of micro paint repair products and services as a percentage of related sales was 73%. NeoMedia acquired this business on February 6, 2004, and as a result there were no cost of sales of micro paint repair products and services during the nine months ended September 30, 2003. NeoMedia expects cost of micro paint repair products and services to increase over the next 12 months as revenue continues to increase with the roll-out.

Gross Profit. Gross profit was \$164,000 for the nine months ended September 30, 2004, a decrease of \$52,000, or 24%, compared with gross profit of



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\$216,000 for the nine months ended September 30, 2003. This decrease was primarily the result of reduced resales of Sun Microsystems equipment due to increased competition and general economic conditions, offset by profit from the micro paint repair business acquired in February 2004.

**Sales and marketing.** Sales and marketing expenses were \$1,461,000 for the nine months ended September 30, 2004, compared to \$407,000 for the nine months ended September 30, 2003, an increase of \$1,054,000 or 259%. This increase resulted primarily from the addition of recently-acquired micro paint business sales force and cost associated with marketing, as well as promotion of the Company's PaperClick and Micro Paint Repair products. NeoMedia expects sales and marketing expense to increase over the next 12 months with the continued development and anticipated rollout of the PaperClick and Micro Paint Repair product suites.

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**General and administrative.** General and administrative expenses decreased by \$2,116,000, or 62%, to \$1,293,000 for the nine months ended September 30, 2004, compared to \$3,409,000 for the nine months ended September 30, 2003. The decrease resulted primarily from non-cash expenses relating to the Company's option repricing program, expense for stock options issued with exercise prices below market price, and higher stock-based professional service expense in 2003 as compared with 2004. NeoMedia expects general and administrative expense to increase over the next 12 months with the recent acquisition of CSI International and the potential acquisition of BSD Software

**Research and development.** During the nine months ended September 30, 2004, NeoMedia charged to expense \$354,000 of research and development costs, an increase of \$111,000 or 46% compared to \$243,000 for the nine months ended September 30, 2003. The increase is primarily due to the addition of a developer and development computer systems during 2004. NeoMedia expects research and development costs to increase over the next 12 months with the continued development efforts, and the anticipated rollout of NeoMedia's PaperClick product suite.

**Gain on extinguishment of debt.** During the nine months ended September 30, 2004, NeoMedia recognized a gain on extinguishment of debt of \$129,000, resulting from the payment of debt at a discount to the book value of the debt, an increase of \$153,000, or 638%, compared with a loss on extinguishment of debt of \$24,000 for the nine months ended September 30, 2003. These gains resulted from a difference between the cash or market value of stock issued to settle the debt and the carrying value of the debt at the time of settlement.

**Amortization of debt discount.** During the nine months ended September 30, 2004, NeoMedia recognized an amortization of debt issuance cost of \$2,500,000 relating to the fair value of warrants granted to Cornell Capital Partners in connection with promissory notes issued to Cornell by NeoMedia during January 2004. NeoMedia did not recognize any such expense during the nine months ended September 30, 2003. During the nine months ended September 30, 2004, NeoMedia amortized the full \$2.5 million discount value relating to the Cornell warrants, and as a result does not expect to recognize such expense in the next 12 months.

**Interest expense.** Interest expense consists primarily of interest accrued for creditors as part of financed purchases, past due balances, notes payable and interest earned on cash equivalent investments. Interest expense decreased by \$15,000, or 8%, to \$178,000 for the nine months ended September 30, 2004 from \$193,000 for the nine months ended September 30, 2003, due to reduced expense associated with vendor settlements and debt in 2004 compared with 2003.

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Net Loss. The net loss for the nine months ended September 30, 2004 was \$5,493,000, which represented a \$1,433,000, or 35% increase from a \$4,060,000 loss for the nine months ended September 30, 2003. The increase resulted primarily from the amortization of debt issuance cost of \$2,500,000 in 2004, offset by reduced general and administrative costs in 2004.

### LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was \$3,500,000 for the nine months September 30, 2004, compared with \$2,057,000 for the nine months ended September 30, 2003. NeoMedia's net cash flow used in investing activities for the nine months ended September 30, 2004 and 2003 was \$212,000 and \$64,000, respectively. Net cash provided by financing activities for the nine months ended September 30, 2004 and 2003 was \$5,430,000 and \$3,099,000, respectively.

During the nine months ended September 30, 2004 and 2003, NeoMedia's net loss totaled \$5,493,000 and \$4,060,000, respectively. As of September 30, 2004, NeoMedia had accumulated losses from operations of \$81,640,000, had a working capital deficit of \$5,538,000, and \$1,732,000 in cash balances.

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The accompanying consolidated financial statements have been prepared assuming NeoMedia will continue as a going concern. Accordingly, the consolidated financial statements do not include any adjustments that might result from NeoMedia's inability to continue as a going concern.

NeoMedia may obtain up to \$20 million over the next year and a half through its Standby Equity Distribution Agreement with Cornell Capital Partners. As of September 30, 2004, NeoMedia had drawn \$7 million against the Standby Equity Distribution Agreement in the form of promissory notes which may be repaid from the proceeds of sale of common stock.

In addition, if the average closing bid price of NeoMedia's common stock for any five day period exceeds \$0.10, NeoMedia may force the exercise of 40 million warrants held by Cornell, resulting in additional cash to the Company of \$2 million. In the absence of any major sales from its Micro Paint Repair or PaperClick products, management believes that it has sufficient funding to sustain operations through December 31, 2004, however, there can be no assurances that the market for NeoMedia's stock will support the sale of sufficient shares of NeoMedia's common stock to raise sufficient capital to sustain operations for such a period, or that actual revenue will meet management's expectations. If necessary funds are not available, NeoMedia's business and operations would be materially adversely affected and in such event, NeoMedia would attempt to reduce costs and adjust its business plan.

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### ITEM 3. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. NeoMedia's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of NeoMedia's "disclosure controls and procedures" (as defined in Sections 13a-14(c) of the Securities Exchange Act of 1934) as of the end of the period reported in this annual report (the "Evaluation Date"), concluded that NeoMedia's disclosure controls and procedures were effective and designed to ensure that material information relating to NeoMedia and its consolidated

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subsidiaries is accumulated and would be made known to them by others within those entities as appropriate to allow timely decisions regarding required disclosures.

**CHANGES IN INTERNAL CONTROLS.** NeoMedia does not believe that there are significant deficiencies in the design or operation of its internal controls that could adversely affect its ability to record, process, summarize and report financial data. Although there were no significant changes in NeoMedia's internal controls or in other factors that could significantly affect those controls subsequent to the Evaluation Date, NeoMedia's senior management, in conjunction with its Board of Directors, continuously reviews overall company policies and improves documentation of important financial reporting and internal control matters. NeoMedia is committed to continuously improving the state of its internal controls, corporate governance and financial reporting.

**LIMITATIONS ON THE EFFECTIVENESS OF CONTROLS.** NeoMedia's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that its disclosure or internal controls will prevent all errors or fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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### PART II -- OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

NeoMedia is involved in the following legal actions arising in the normal course of business, both as claimant and defendant.

##### AIRCLIC, INC., SCANBUY, INC., AND LSCAN TECHNOLOGIES, INC.

On January 23, 2004, NeoMedia filed a patent infringement lawsuit against AirClic, Inc., Scanbuy, Inc., and LScan Technologies, Inc. in the Northern District of Illinois, claiming that each of the parties has manufactured, or has manufactured for it, and has used, or actively induced others to use, technology which allows customers to use a built-in UPC bar code scanner to scan individual items and access information, thereby infringing NeoMedia's patents. The complaint states that on information and belief, AirClic, Scanbuy and LScan have had actual and constructive notice of the existence of the patents-in-suit, and, despite such notice, failed to cease and desist their acts of infringement, and continue to engage in acts of infringement of the patents-in-suit. On April 15, 2004, the court dismissed the suit against AirClic and Scanbuy for lack of personal jurisdiction.

On April 19, 2004, AirClic filed a declaratory judgment action against NeoMedia in the Eastern District of Pennsylvania. NeoMedia answered and counterclaimed on May 18, 2004. AirClic answered NeoMedia's counterclaim on June 10, 2004. On April 20, 2004, NeoMedia re-filed its suit against AirClic in Pennsylvania for patent infringement. AirClic answered and counterclaimed on May 13, 2004. NeoMedia filed its answer to AirClic's counterclaims on June 2, 2004. NeoMedia filed an amended complaint on July 1, 2004, and AirClic answered and counterclaimed on July 20, 2004. NeoMedia's answer to AirClic's counterclaims was filed on August 3, 2004.

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NeoMedia voluntarily dismissed the suit against LScan in the Northern District of Illinois and re-filed the suit on May 26, 2004, in the Eastern District of Pennsylvania. After LScan failed to answer, NeoMedia filed and served its motion for default judgment on July 6, 2004.

On March 29, 2004, Scanbuy filed suit against NeoMedia in the Southern District of New York alleging that NeoMedia infringed Scanbuy's copyrights, violated the Lanham Act and committed deceptive trade practices and tortious interference. Scanbuy filed an amended complaint on June 23, 2004. NeoMedia filed its answer and affirmative defenses on July 23, 2004. On April 20, 2004, NeoMedia re-filed its suit against Scanbuy in the Southern District of New York alleging patent infringement. Scanbuy filed its answer on June 2, 2004. NeoMedia filed its answer and affirmative defenses on July 23, 2004.

### VIRGIN ENTERTAINMENT GROUP

On January 2, 2004, NeoMedia filed a patent infringement lawsuit against Virgin(R) Entertainment Group, Inc., Virgin Megastore Online and Virgin Megastore ("Virgin"). The complaint for Patent Infringement and Damages was filed in the United States District Court for the Northern District of Illinois, by Baniak Pine & Gannon, NeoMedia's intellectual property law firm. The complaint claims that Virgin has infringed four of NeoMedia's patents - U.S. Patents Nos. 5,933,829, 5,978,773, 6,108,656, and 6,199,048. The complaint alleges that the Virgin Megaplay Stations located in Virgin's Megastores infringe NeoMedia's patents by using Virgin's Megascan technology to allow customers to scan UPC codes from in-store CDs and DVDs to access Internet-based product information, such as music and movie previews, and album and video art. The complaint also alleges that Virgin had notice of NeoMedia's patents since the latter part of 2002 or before, yet it continued with its infringing

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activities. The complaint seeks compensatory damages for Virgin's infringement, with those damages to be trebled due to the willful and wanton nature of the infringement. NeoMedia also seeks to preliminarily and permanently enjoin Virgin from its infringing activities. Virgin answered NeoMedia's complaint on March 1, 2004.

### OTHER LITIGATION

On September 12, 2002, R. R. Donnelley & Sons Company filed a summons in the Circuit Court of The Twentieth Judicial Circuit in and for Lee County, Florida, seeking payment of approximately \$92,000 in past due professional services bills, plus interest and attorney fees. During July 2003, NeoMedia settled the suit for cash payments over a period of approximately one year. NeoMedia had an accrued liability of approximately \$27,000 relating to this matter as of September 30, 2004.

On October 28, 2002, Merrick & Klimek, P.C., filed a complaint against NeoMedia seeking payment of approximately \$170,000 in past due legal services. The amount in question is subject to an unsecured promissory note that matured unpaid on February 28, 2002. On May 1, 2003, NeoMedia settled the suit for cash payments totaling approximately \$196,000, to be paid at a rate of \$30,000 per quarter until the balance is satisfied. NeoMedia had a remaining liability of approximately \$54,000 relating to this matter as of September 30, 2004, which was included in notes payable.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS (A), (B), (C) AND (D)

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None.

### ITEM 3. DEFAULT UPON SENIOR SECURITIES

(a) NeoMedia is in default on an unsecured promissory note payable held by Merrick & Klimek, P.C. During 2002, Merrick & Klimek, P.C. sued NeoMedia for nonpayment of the note. During 2003, the two parties settled the suit and NeoMedia is making installment payments against the balance through December 31, 2004.

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### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On September 14, 2004, NeoMedia filed a proxy statement in which the Company is asking its shareholders to vote on the re-election of current directors. The meeting is schedule for October 29, 2004.

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) EXHIBITS:

EXHIBIT NO. -----	DESCRIPTION -----	LOCATION -----
31.1	Certification by Chief Executive Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Provided herewith
31.2	Certification by Chief Financial Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Provided herewith
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Provided herewith
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Provided herewith

#### (b) REPORTS ON FORM 8-K:

NeoMedia filed a Form 8-K on September 17, 2004, reporting that it had entered into a business development agreement with, and invested \$1 million in, iPoint-media Ltd., in exchange for 17% ownership in iPoint-media.

NeoMedia filed a Form 8-K on September 7, 2004, reporting that its

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Board of Directors named Charles T. Jensen as the Company's permanent Chief Executive Officer.

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### SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NEOMEDIA TECHNOLOGIES, INC.  
Registrant

Date: November 4, 2004  
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By: /s/ Charles T. Jensen  
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Charles T. Jensen, President, Chief Executive Officer, Chief Operating Officer, and Director

Date: November 4, 2004  
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By: /s/ David A. Dodge  
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David A. Dodge, Vice President,  
Chief Financial Officer, and Controller

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