Net Element, Inc.
Form 10-Q
August 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from __________ to __________

Commission file number: **001-34887**

Net Element, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**90-1025599**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3363 NE 163rd Street, Suite 705	
North Miami Beach, Florida	**33160**
(Address of principal executive offices)	(Zip Code)

(305) 507-8808

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer (Do not check if a smaller reporting company) ¨	Smaller reporting company x

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

The number of outstanding shares of common stock, $.0001 par value, of the registrant as of August 13, 2014 was 38,350,329.

Defined Terms

Net Element, Inc. is a corporation organized under the laws of the State of Delaware. As used in this Quarterly Report on Form 10-Q (this “Report”), unless the context otherwise requires, the terms “Company,” “we,” “us” and “our” refer to Net Element, Inc. and, as applicable, its majority-owned and consolidated subsidiaries.

All amounts of shares and consideration for shares (including, without limitation, purchase prices, exercise prices and conversion prices) described in this Report for periods prior to October 2, 2012 (which was the closing date of the Company’s merger with Net Element, Inc.) have been adjusted to give effect to the conversion ratio for shares of Net Element, Inc. common stock that were cancelled and converted into shares of the Company’s common stock pursuant to the Merger Agreement. Pursuant to the terms of the Merger Agreement, upon completion of the Merger, each share of then-issued and outstanding common stock of Net Element, Inc. was automatically cancelled and converted into the right to receive one-fortieth (1/40) of a share of the Company’s common stock. For additional information regarding the Merger, see Note 4 of the accompanying notes to unaudited condensed consolidated financial statements.

Forward-Looking Statements

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Any statements contained in this Report that are not statements of historical fact may be deemed forward-looking statements. Forward-looking statements generally are identified by the words “expects,” “anticipates,” “believes,” “intends,” “estimates,” “aims,” “plans,” “ “will,” “continue,” “seeks,” “should,” “believe,” “potential” or the negative of such terms and similar expressions. Forward-loo statements are based on current plans, estimates and projections, and therefore you should not place too much reliance on them. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement in light of new information or future events, except as expressly required by law. Forward-looking statements involve inherent risks and uncertainties, most of which are difficult to predict and are generally beyond the Company’s control. The Company cautions you that a number of important factors could cause actual results or outcomes to differ materially from those expressed in, or implied by, the forward-looking statements. These factors include, among other factors:

- the impact of any new or changed laws, regulations, card network rules or other industry standards affecting our business including the U.S. government decision to impose sanctions or other legal restrictions that may restrict our ability to do business in Russia;
- the impact of any significant chargeback liability and liability for merchant or customer fraud, which we may not be able to accurately anticipate and/or collect;
- our ability to secure or successfully migrate merchant portfolios to new bank sponsors if current sponsorships are terminated;
-

- our and our bank sponsors' ability to adhere to the standards of the Visa® and MasterCard® payment card associations;
- our reliance on third-party processors and service providers;
- our dependence on independent sales groups ("ISGs") that do not serve us exclusively to introduce us to new merchant accounts;
- our ability to pass along increases in interchange costs and other costs to our merchants;
- our ability to protect against unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise;
- the effect of the loss of key personnel on our relationships with ISGs, card associations, bank sponsors and our other service providers;
- the effects of increased competition, which could adversely impact our financial performance;
- the impact of any increase in attrition due to an increase in closed merchant accounts and/or a decrease in merchant charge volume that we cannot anticipate or offset with new accounts;
- the effect of adverse business conditions on our merchants;
- our ability to adopt technology to meet changing industry and customer needs or trends;
- the impact of any decline in the use of credit cards as a payment mechanism for consumers or adverse developments with respect to the credit card industry in general;
- the impact of any adverse conditions in industries in which we obtain a substantial amount of our bankcard processing volume;
- the impact of seasonality on our operating results;
- the impact of any failure in our systems due to factors beyond our control;
- the impact of any material breaches in the security of third-party processing systems we use;
- the impact of any new and potential governmental regulations designed to protect or limit access to consumer information;
- the impact on our profitability if we are required to pay federal, state or local taxes on transaction processing;
- the impact on our growth and profitability if the markets for the services that we offer fail to expand or if such markets contract;
- our ability (or inability) to continue as a going concern;
- the willingness of the Company's majority stockholders, and/or other affiliates of the Company, to continue investing in the Company's business to fund working capital requirements;
- the Company's ability (or inability) to obtain additional financing in sufficient amounts or on acceptable terms when needed;
- the impact on our operating results as a result of impairment of our goodwill and intangible assets;
- our material weaknesses in internal control over financial reporting and our ability to maintain effective controls over financial reporting in the future; and

- the other factors those described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and in Part II, Item 1A of this Report and the Company's subsequent filings with the U.S. Securities and Exchange Commission (the "Commission").

If these or other risks and uncertainties (including those described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and in Part II, Item 1A of this Report and the Company's subsequent filings with the Commission materialize, or if the assumptions underlying any of these statements prove incorrect, the Company's actual results may be materially different from those expressed or implied by such statements. We undertake no obligation to publicly revise any forward-looking statement to reflect circumstances or events after the date of this Report to reflect the occurrence of unanticipated events. You should, however, review the factors and risks described in the reports we file from time-to-time with the Commission after the date of this Report.

World Wide Web addresses contained in this Report are for explanatory purposes only and they (and the content contained therein) do not form a part of and are not incorporated by reference into this Report.

Net Element, Inc.

Form 10-Q

For the Three months ended June 30, 2014

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PART I — FINANCIAL INFORMATION

NET ELEMENT, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash	$1,271,716	$ 126,319
Accounts receivable, net	4,374,431	10,619,289
Advances to aggregators, net	4,246	1,109,538
Prepaid expenses and other assets	831,058	834,025
Total current assets	6,481,451	12,689,171
Fixed assets, net	63,234	137,267
Intangible assets, net	3,052,847	2,964,424
Goodwill	6,671,750	6,671,750
Other long term assets	308,299	-
Investment in affiliate	-	46,113
Total assets	$16,577,581	$ 22,508,725
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	$2,609,509	$ 3,190,215
Deferred revenue	158,012	239,398
Accrued expenses	2,713,911	3,484,963
Short term loans	256,402	8,478,810
Notes payable (current portion)	98,493	3,816,093
Due to related parties	318,301	1,451,357
Total current liabilities	6,154,628	20,660,836
Notes payable (net of current portion)	16,635,581	17,255,531
Total liabilities	22,790,209	37,916,367
STOCKHOLDERS' DEFICIT		
Preferred stock ($.01 par value, 1,000,000 shares authorized and no shares issued and outstanding)	-	-
Common stock ($.0001 par value, 100,000,000 shares authorized and 38,350,329 and 32,273,298 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively)	3,836	3,229
Paid in capital	116,455,522	103,815,550
Stock subscription receivable	(2,320,102)	-
Accumulated other comprehensive income (loss)	990,531	(170,550)
Accumulated deficit	(121,176,387)	(118,930,828)
Noncontrolling interest	(166,028)	(125,043)

Total stockholders’ deficit	(6,212,628)	(15,407,642)
Total liabilities and stockholders’ deficit	$16,577,581	$ 22,508,725

See accompanying notes to unaudited condensed consolidated financial statements.

NET ELEMENT, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three months ended June 30, 2014	Three months ended June 30, 2013	Six months ended June 30, 2014	Six months ended June 30, 2013
Net revenues	$4,912,035	$5,607,609	$9,755,514	$6,475,759
Costs and expenses:				
Cost of revenues	3,345,087	4,133,953	6,873,580	4,409,500
General and administrative (includes $700,468 and $150,000 and $752,518 and $150,000 of share based compensation for the three and six months ended June 30, 2014 and 2013, respectively)	2,545,552	3,486,950	5,687,731	6,265,775
Provision for (recovery of) loan losses	(1,540,415)	5,792,487	(1,438,704)	6,199,072
Goodwill impairment charge	-	11,200,000	-	11,200,000
Depreciation and amortization	624,790	616,964	1,216,491	652,674
Total costs and operating expenses	4,975,014	25,230,354	12,339,098	28,727,021
Loss from operations	(62,979)	(19,622,745)	(2,583,584)	(22,251,262)
Interest expense, net	(1,770,255)	(920,353)	(2,831,736)	(1,069,987)
Gain on change in fair value and settlement of beneficial conversion derivative	5,569,158	-	5,569,158	-
Loss on debt extinguishment	(3,962,406)	-	(3,962,406)	-
Gain on debt restructure	1,596,000	-	1,596,000	-
Loss from asset disposal	(28,320)	-	(28,320)	-
Other expense	(6,394)	(5,809)	(46,326)	(90,359)
Income (loss) from continuing operations before income taxes	1,334,804	(20,548,907)	(2,287,214)	(23,411,608)
Income taxes	-	-	-	-
Income (loss) from continuing operations	1,334,804	(20,548,907)	(2,287,214)	(23,411,608)
Net income attributable to the noncontrolling interest	12,965	570,730	41,655	570,542
Net income (loss) from continuing operations attributable to Net Element, Inc.	1,347,769	(19,978,177)	(2,245,559)	(22,841,066)
Loss from operations of discontinued entities	-	(253,520)	-	(624,462)
Net income (loss)	1,347,769	(20,231,697)	(2,245,559)	(23,465,528)
Foreign currency translation	(122,217)	(238,685)	1,161,080	(264,758)
Comprehensive income (loss)	$1,225,552	$(20,470,382)	$(1,084,479)	$(23,730,286)
Income (loss) per share - basic and diluted continuing operations	$0.04	$(0.71)	$(0.07)	$(0.81)
Income (loss) per share - basic and diluted discontinued operations	-	(0.01)	-	(0.02)
Total income (loss) per share	$0.04	$(0.72)	$(0.07)	$(0.83)

Weighted average number of common shares outstanding - basic and diluted	32,368,577	28,133,699	32,421,286	28,178,805

See accompanying notes to unaudited condensed consolidated financial statements

NET ELEMENT, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six months ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net loss	$(2,245,559)	$(23,465,528)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Non-cash compensation	752,518	150,000
Depreciation and amortization	1,216,491	652,674
(Recovery of) provision for loan losses	(1,438,704)	6,199,072
Impairment of goodwill	-	11,200,000
Amortization of debt discount	1,644,626	-
Loss attributable to investment in subsidiary	46,113	-
Noncontrolling interest	(41,655)	(570,542)
Deferred revenue	(81,386)	-
Loss on disposal of fixed assets	28,320	-
Gain on change in fair value of derivative	(5,569,158)	-
Loss on debt extinguishment	3,962,406	-
Gain on debt restructure	(1,596,000)	-
Changes in assets and liabilities, net of acquisitions and the effect of consolidation of equity affiliates		
Accounts receivable	5,771,525	2,568,788
Advances to aggregators	2,675,228	-
Note receivable	-	(720,000)
Prepaid expenses and other assets	(305,374)	(211,715)
Accounts payable	(552,372)	710,273
Accrued expenses	(882,971)	(543,173)
Adjustments for operating activities of continuing operations	5,629,607	19,435,377
Adjustments for operating activities of discontinued operations	-	(18,118)
Total adjustments	5,629,607	19,417,259
Net cash provided by (used in) operating activities	3,384,048	(4,048,269)
Cash flows from investing activities - net of acquisitions:		
Collections from notes receivable	-	4,694,605
Investment in subsidiary	-	(200,000)
Acquisition of intangible assets	-	35,410
Purchase of fixed assets	-	(24,760)
Purchase of portfolio and client acquisition costs	(1,260,339)	-
Disposal of fixed assets	(941)	-
Net cash provided by (used in) investing activities of continuing operations	(1,261,280)	4,505,255
Net cash used in investing activities of discontinued operations	-	(36,947)
Net cash provided by (used in) investing activities	(1,261,280)	4,468,308
Cash flows from financing activities - net of acquisitions:		

Repayment to financial institutions	(7,756,017)	(5,175,611)
Proceeds from indebtedness	8,879,898	-
Note payable (non-current)	(3,030,666)	2,000,000
Change in restricted cash	-	2,056,821
Cash paid for share repurchases	-	(482,413)
Due to related parties	(1,793,423)	(1,157,242)
Net cash used by financing activities from continuing operations	(3,700,208)	(2,758,445)
Net cash provided by financing activities from discontinued operations	-	973,871
Net cash provided by financing activities	(3,700,208)	(1,784,574)
Effect of exchange rate changes on cash	2,722,837	(202,769)
Net increase (decrease) in cash	1,145,397	(1,567,304)
Cash at beginning of period	126,319	3,579,737
Cash at end of period	$1,271,716	$2,012,433
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	$324,716	$644,113
Taxes	$230,191	$-
Issuance of stock upon conversion of indebtedness	$10,637,092	$-
Issued and outstanding common stock (10% of TOT Group’s common stock)	$-	$609,000
Assumed debt	-	20,631,000
Total value of consideration for Unified Payments acquisition	$-	$21,240,000
Stock subscription in connection with acquisition of Aptito	$-	$718,750

See accompanying notes to unaudited condensed consolidated financial statements.

NET ELEMENT, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Net Element, Inc. ("We", "us", "our" or the "Company") is a financial technology-driven group specializing in mobile payments and other transactional services in emerging countries and in the United States. We operate in a single operating segment, that being a provider of transactional services and mobile payment solutions. Geographic areas in which we operate include the United States, where through our U.S. based subsidiaries we generate revenues from transactional services and other payment technologies for small and medium-sized businesses ("SME"). Through TOT Group Russia and Net Element Russia, we provide transactional services, mobile payments transactions and other payment technologies in emerging countries including Russian Federation and the Commonwealth of Independent States ("CIS").

Business

Our transactional services enable its merchant vendors to accept credit cards as well as other forms of payment, including debit cards, checks, gift cards and loyalty programs in traditional card-present, or swipe transactions, as well as card-not-present transactions, such as those done over the phone or through the internet or a mobile device. We market and sell our services through both independent sales groups ("ISGs"), which are non-employee, external sales organizations and other third party resellers of our products and services and directly to merchants through electronic media, telemarketing and other programs, including utilizing partnerships with other companies that market products and services to small businesses. In addition, we partner with banks such as BMO Harris Bank, N.A.in the United States to sponsor us for membership in the VisaÒ, MasterCardÒ or other card associations and to settle transactions with merchants. We perform core functions for small merchants such as application processing, underwriting, account set-up, risk management, fraud detection, merchant assistance and support, equipment deployment and chargeback services. Our mobile payments business provides carrier-integrated mobile payments solutions. Our relationships with mobile operators give us substantial geographic coverage, a strong capacity for innovation in mobile payments and messaging, and the ability to offer our clients In-App, P-SMS, Online and Carrier Billing.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") and reflect all adjustments, which are of a normal and recurring nature, that are, in the opinion of management, necessary for a fair presentation of our condensed consolidated financial position and results of operations for the related periods. All significant intercompany transactions and balances have been eliminated in consolidation. The consolidated results of operations for any interim periods are not necessarily indicative of results to be expected for the full year.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of expenses for the period presented. Actual results could differ from those estimates.

Significant estimates include (i) the valuation of acquired merchant portfolios (ii) the recoverability of indeterminate-lived assets, (iii) the remaining useful lives of long-lived assets, and (iv) the sufficiency of merchant, aggregator, legal, and other reserves. On an ongoing basis, we evaluate the sufficiency and accuracy of our estimates. Actual results could differ from those estimates.

Cash and Cash Equivalents

We maintain our U.S. dollar-denominated cash in several non-interest bearing bank deposit accounts. Prior to January 1, 2014, all U.S. non-interest bearing transaction accounts were fully insured, regardless of the balance in the account, at all FDIC insured institutions. At June 30, 2014, the bank balances exceed FDIC insured institution limits of $250,000 by approximately $712,565. The bank balances at December 31, 2013 did not exceed FDIC limits.

We maintain approximately $310,000 and $46,000 in uninsured Russian, Ukraine and Cayman Islands bank accounts as of June 30, 2014 and December 31, 2013, respectively.

Other Current Assets

We maintain an inventory of terminals, which we use to service both merchants and independent sales agents. Where the terminals are sold for a fee, we record an expense for the cost of these terminals, plus any set up fees at the time of the sale. In cases where we provide the terminals as a multi-year incentive, the cost of the terminal plus any set up fees are deferred and amortized over the expected customer contract period, generally three years. At June 30, 2014, we have $473,090 in terminals and Apple® iPads and related equipment purchased, of which $248,050 has been placed with merchants. At December 31, 2013 we had $446,658 in terminals and iPads of which $170,378 had been placed. Amortization of these terminals amounted to $12,751 and $2,657 for the three months ended June 30, 2014 and 2013, and $27,419 and $2,657 for the six months ended June 30, 2014 and 2013.

Fixed Assets

We depreciate our furniture, servers, software and equipment over a term of three to ten years. Computers and software are depreciated over terms between two and five years. Leasehold improvements are depreciated over the shorter of the economic life or term of each lease. All of our assets are depreciated on a straight-line basis for financial statement purposes.

Expenditures for repairs and maintenance are charged to operating expense as incurred. Expenditures that increase the value or productive capacity of assets are capitalized. At the time of retirements, sales, or other dispositions of property and equipment, the original cost and related accumulated depreciation are removed from the respective accounts, and the gains or losses are presented as other expenses.

Intangible Assets

Included in our intangible assets are merchant portfolios, which represent the net book value of an acquired merchant customer base, and are amortized on a straight-line basis over their respective useful lives, generally three to five years. Merchant portfolios are assessed for impairment if events or circumstances indicate that their respective carrying values are not recoverable from the future anticipated undiscounted net cash flows attributable to such assets. In such cases, the amount of any potential impairment would be measured as the excess, if any, of carrying value over the fair value of such assets.

On July 30, 2013, our subsidiary, TOT Payments, LLC, brought an action against First Data Corporation ("FDR"). In its complaint, TOT Payments claims that FDR breached its obligations pursuant to a 2006 Marketing Agreement.

Because the FDR case was dismissed, management has decided that the possibility of recovering fees is remote and therefore wrote off the remaining net asset value of the FDR Portfolio, for an impairment charge of $872,354 during the year ended December 31, 2013.

We also capitalize direct expenses associated with filing of patents and patent applications and amortize the capitalized intellectual property costs over five years beginning when the patent is approved.

Additionally, we capitalize the fair value of intangible assets acquired in business combinations. We perform valuations of assets acquired and liabilities assumed on each acquisition accounted for as a business combination and allocate the purchase price of each acquired business to its respective net tangible and intangible assets. Acquired intangible assets include: merchant portfolios, trade names, non-compete agreements, customer relationships and technology.

Accrued Residual Commissions

We pay commissions to independent sales groups (“ISGs”) based on the processing volume of the merchants enrolled. The commission payments are based on varying percentages of the volume processed by us on behalf of the merchants. Percentages vary based on the program type and transaction volume of each merchant. We report commission payments as a cost of revenues in the accompanying condensed consolidated statement of operations and comprehensive loss. The residual commission payable to ISGs and independent sales agents was $399,460 and $451,374 at June 30 2014 and December 31, 2013, respectively. We pay commissions on annual fees and defer and amortize those fees over a twelve month period. We pay our agents these commissions, in advance of recognizing the revenue. At December 31, 2013 we deferred $115,700 of commissions on annual fees, which were included in prepaid expenses in the accompanying condensed consolidated balance sheet and will recognize the deferred fees over the next twelve months. As of June 30, 2014 and December 31, 2013 we had $67,490 and $115,700 respectively, in deferred commissions. Commission payables are included in accounts payable in the accompanying condensed consolidated balance sheets.

Capitalized Customer Acquisition Costs, Net

Capitalized customer acquisition costs consist of up-front cash payments made to certain ISG’s for the establishment of new merchant relationships. Capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins (future net cash flows) associated with merchant contracts. The up-front payment to the ISG is based on the estimated gross margin for the first year of the merchant contract. The deferred customer acquisition cost asset is recorded at the time of payment and the capitalized acquisition costs are primarily amortized on a straight-line basis over a period of three years.

Management evaluates the capitalized customer acquisition cost for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net undiscounted cash flows from underlying merchant relationships to the carrying amount of capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the carrying value of the capitalized customer acquisition costs, the impairment loss is charged to operations.

During the three and six months ended June 30, 2014, we recorded $65,277 and $152,056, respectively, in additional capitalized customer acquisition costs and $35,386 and $78,928, respectively, in related additional amortization. During the three and six months ended June 30, 2013, we recorded $282,380 in additional capitalized customer acquisition costs and $20,220, in related additional amortization, as operations did not begin for TOT Payments until April 16, 2013. The balance of customer acquisition costs, net of amortization is $453,639 and $380,511 at June 30, 2014 and December 31, 2013, respectively, and reflected in intangible assets in the accompanying condensed consolidated balance sheets.

Fair Value Measurements

Our financial instruments consist primarily of cash, accounts receivable, merchant portfolios, notes receivable, accounts payable and debt instruments. The carrying values of cash, accounts receivable and trade payables are considered to be representative of their respective fair values due to the short-term nature of these instruments. The carrying amount of the debt of $16,734,074 at June 30, 2014 and $21,071,624 at December 31, 2013 approximates fair value because our current borrowing rate does not materially differ from market rates for similar bank borrowings. The long-term debt is classified as a Level 2 item within the fair value hierarchy.

We measure certain nonfinancial assets and liabilities at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. We use a three-level fair value hierarchy to prioritize the inputs used to measure fair value and maximizes the use of observable inputs and minimizes the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

Level 1 — Quoted market prices in active markets for identical assets or liabilities as of the reporting date

Level 2 — Observable market based inputs or unobservable inputs that are corroborated by market data

Level 3 — Unobservable inputs that are not corroborated by market data

These non-financial assets and liabilities include intangible assets and liabilities acquired in business combinations as well as impairment calculations, when necessary. The fair value of the assets acquired and liabilities assumed in connection with the Unified Payments acquisition, as discussed in Note 4, were measured at fair value at the acquisition date. The fair values of our merchant portfolios are primarily based on Level 3 inputs and are generally estimated based upon independent appraisals that include discounted cash flow analyses based on our most recent cash flow projections, and, for years beyond the projection period, estimates based on assumed growth rates. Assumptions are also made regarding appropriate discount rates, perpetual growth rates, and capital expenditures, among others. In certain circumstances, the discounted cash flow analyses are corroborated by a market-based approach that utilizes comparable company public trading values, and, where available, values observed in private market transactions. The inputs used by management for the fair value measurements include significant unobservable inputs, and therefore, the fair value measurements employed are classified as Level 3. The goodwill impairment (see Note 4) primarily was based on observable inputs using company specific information and is classified as Level 3.

Concentrations

Our total revenue was $ 9,755,514 for the six months ended June 30, 2014. Of this amount, $8,664,561 was derived from processing of Visa®, MasterCard®, Discover® and American Express® card transactions and $1,086,705 was derived from processing of mobile electronic payments.

The transaction processing revenues were derived from processing merchant customer transactions, which are processed primarily by two “third-party” processing networks. For the three months ended June 30, 2014, we processed 56% of total revenue with Total System Services, Inc. (TSYS) as a settlement platform using Cynergy Data, LLC (Cynergy) as a conduit to TSYS, and 28% with Vantiv, Inc. (Vantiv) as a settlement platform.

Our mobile electronic payment revenues were derived from merchant customer transactions, which are processed primarily by two mobile operators. For the three months ended June 30, 2014, we processed 4% of its total revenue with Megaphone, and 4% with Mobile TeleSystems OJSC (MTS).

Foreign Currency Transactions

We are subject to exchange rate risk in its foreign operations Russia, the functional currency of which is Russian Ruble. In Russia, we generate service fee revenues and incurs product development, engineering, website development, interest expense, and general and administrative costs and expenses. The Russian engineering operations pay a majority of their operating expenses in their local currencies, exposing us to exchange rate risk.

We do not engage in any currency hedging activities.

Revenue Recognition

We recognize revenue when the following four basic criteria have been met: (1) persuasive evidence of a sales arrangement exists, (2) performance of services or delivery of goods has occurred, (3) the sales price is fixed or determinable, and (4) collectability is reasonably assured. We consider persuasive evidence of a sales arrangement to be the receipt of a billable transaction from aggregators, signed contract or website advertising insertion order. Collectability is assessed based on a number of factors, including transaction history with the customer and the credit worthiness of the customer. If it is determined that the collection is not reasonably assured, revenue is not recognized until collection becomes reasonably assured, which is generally upon receipt of cash. We record cash received in advance of revenue recognition as deferred revenue.

Our revenues for the three and six month periods ended June 30, 2014 and 2013 are principally derived from the following sources:

Transactional Processing Fees: Transactional processing fees are generated primarily from TOT Payments which is our US credit card processing company.

Our transactional processing company derives revenues primarily from the electronic processing of services including: credit, debit and electronic benefits transfer card processing authorized and captured through third party networks, check conversion and guarantee, electronic gift certificate processing, and equipment leasing and sales. These revenues are recorded as bankcard and other processing transactions when processed.

Typically, fees charged to merchants for these processing services are based on a variable percentage of the dollar amount of each transaction and in some instances, additional fees are charged for each transaction. Merchant customers also may be charged miscellaneous fees, including statement fees, annual fees, monthly minimum fees, fees for handling chargebacks, gateway fees, and fees for other miscellaneous services.

Service Fees: Service fees are generated primarily from TOT Money’s mobile payment processing and service fees.

We have multiple element arrangements that include bundled transactions with merchants encompassing annual PCI (payment card industry) fees, annual membership fees, and monthly processing fees.

We account for bundled transactions in accordance with Accounting Standard Update No 2009-13, "Multiple–Deliverable Revenue Arrangements" (ASU 2009-13). ASU 2009-13 requires the use of the relative selling price method of allocating total consideration to units of accounting in a multiple element arrangement and eliminates the residual method. This accounting principle requires an entity to allocate revenue in an arrangement using estimated selling price deliverables if it does not have vendor specific objective evidence (VSOE) or third party evidence (TPE) of selling price.

VSOE is the price charged when the same or similar product or service is sold separately. We define VSOE as a median price of recent stand-alone transactions that are priced within a narrow range. TPE is determined based on the prices charged by our competitors for a similar deliverable when sold separately.

We evaluate each deliverable in its arrangements to determine whether it represents a separate unit of accounting. A deliverable constitutes a separate unit of accounting when it has stand-alone value to our customers. Our products (i.e., terminals) and services qualify as separate units of accounting under ASU 2009-13.

The fair value for annual fees is based on the annual contract renewal price and is deemed to represent stand-alone selling price based upon VSOE. The fair value for processing is based on prices charged by our competitors for similar deliverables when sold separately and is deemed to represent stand-alone selling price based upon TPE.

Deferred revenue represents primarily amounts received in advance for annual fee billings and are recognized on a pro rata basis over the annual service period.

Generally, we (i) are the primary obligor in its arrangements with its merchant customers, (ii) have latitude in establishing the price of its services, (iii) have the ability to change the product and perform parts of the services, (iv) have discretion in supplier selection, (v) have latitude in determining the product and service specifications to meet the needs of its merchant customers, and (vi) assume credit risk. In such cases, We report revenues as gross of fees deducted by its sponsoring member banks, as well as fees deducted from card-issuing member banks and card associations (Visa® and MasterCard®) on behalf of its sponsoring member banks for interchange and assessments. These fees charged by the card associations to process the credit card transactions are recorded separately as cost of sales and interchange fees in the accompanying condensed consolidated statement of operations and comprehensive loss.

Revenues from TOT Money are recognized as a percentage of amounts billed to mobile operators. Revenue is recognized when TOT Money's billing system is able to create a billable transaction for a mobile operator. Billable transactions are created and submitted to TOT Money by content aggregators.

Each month, mobile operators provide TOT Money with detail supporting the transactions received by the mobile operator. TOT Money reconciles the data provided by the mobile operator to its internal billing system. Pursuant to the mobile operator agreements, any total billing difference under 5% is considered immaterial and TOT Money accepts the mobile operator data as accurate. Any differences from content providers that exceed 5% of the amount billed are researched, reconciled and addressed with the mobile operator.

Funds received by TOT Money from mobile operators include amounts due to aggregators for supplying us with billable transactions from content providers. Revenues are presented net of aggregator payments on the condensed consolidated financial statements of TOT Money as the collections are considered to be agency fees. TOT Money serves as agent to the mobile operators, performing a service for a fee.

Cost of services for TOT Money is comprised primarily of fees for short numbers provided by the mobile operators that are used to provide traffic from content providers.

Cost of services for TOT Payments is comprised primarily of processing fees paid to third parties attributable to providing transaction processing and other services to the Company’s merchant customers. Interchange fees and cost of services are recognized as incurred, which generally occurs in the same period in which the corresponding revenue is recognized. Interchange fees are set by the card networks, and are paid to the card-issuing bank. Interchange fees are calculated as a percentage of the dollar volume processed plus a per transaction fee. We also pay Visa® and MasterCard® network dues.

Net Income (Loss) per Share

Basic net income (loss) per common share is computed by dividing net income (loss) applicable to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of shares issuable upon exercise of common stock options or warrants. In periods when losses are reported, the weighted-average number of common shares outstanding excludes common stock equivalents because their inclusion would have an anti-dilutive effect. At June 30, 2014 and 2013, the Company had 8,398,900 warrants issued and outstanding that are anti-dilutive in effect.

Impairment of Long-Lived Assets

We review our long-lived assets for impairment whenever events or changes indicate that the carrying amount of an asset or group of assets may not be recoverable. During the six months ended June 30, 2014 and 2013, the Company did not recognize any charges for impairment of goodwill and intangible assets.

Reclassification of Prior Period Presentation

Certain prior period amounts have been reclassified for consistency with the current period presentation. These reclassifications had no effect on the reported results of operations.

Income Taxes

We account for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the condensed consolidated financial statements. Under this method, deferred tax assets and liabilities are determined on the basis of the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

We recognize net deferred tax assets to the extent that our management believes these assets are more likely than not to be realized. In making such a determination, management considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax-planning strategies, and results of recent operations. If management determines that we would be able to realize our deferred tax assets in the future in excess of their net recorded amount, an adjustment would be made to the deferred tax asset valuation allowance, which would reduce the provision for income taxes.

We account for uncertainty in income taxes using a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement. We classify the liability for unrecognized tax benefits as current to the extent that we anticipate payment (or receipt) of cash within one year. Interest and penalties related to uncertain tax positions are recognized and recorded as necessary in the provision for income taxes. Our evaluation of uncertain tax positions was performed for the tax years ended December 31, 2008 and forward, the tax years, which remain subject to examination as of June 30, 2014. See Note 17 for discussion of our uncertain tax positions.

Recently Issued Accounting Guidance

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), Revenue from Contracts with Customers (Topic 606). Under ASU 2014-09, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 will be effective for the Company for annual reporting periods beginning after December 15, 2016 and early application of ASU 2014-09 is not permitted for public companies. The Company is evaluating ASU 2014-09 to determine if this guidance will have a material impact on the Company's condensed consolidated financial statements.

NOTE 2. BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION

Following the consolidation principles promulgated by U.S. GAAP, our condensed consolidated financial statements include Continuing Operations:

The following entities make up our continuing operations: (1) TOT Group, Inc., a 100% owned subsidiary formed in Delaware; (2) Netlab Systems, LLC, a wholly owned subsidiary formed in Florida; (3) NetLab Systems IP, LLC, a wholly owned subsidiary formed in Florida; (4) OOO Net Element Russia ("Net Element Russia"), a wholly owned subsidiary formed in Russia; (5) Net Element Services, LLC, a wholly owned subsidiary formed in Florida; and (6) A&R Music Holdings, LLC, a wholly owned subsidiary formed in Florida (operations discontinued January 31, 2013).

The subsidiaries listed above are the parent companies of several other subsidiaries, which hold the Company's underlying investments or operating entities.

TOT Group is the parent company of TOT Payments, LLC (TOT Payments), a wholly owned subsidiary formed in Florida, Aptito, LLC, a 80% owned subsidiary formed in Florida (acquired June 18, 2013), TOT Group Ukraine LLC, a 51% subsidiary formed in Ukraine, TOT Group Cyprus, a wholly owned subsidiary formed in Cyprus, TOT Group Europe LTD, a wholly owned subsidiary formed in the United Kingdom, TOT Group UK, a wholly owned subsidiary formed in the United Kingdom, TOT Group Kazakhstan, LLC, a 51% owned subsidiary formed in Kazakhstan, and OOO TOT Group Russia, a wholly owned subsidiary formed in Russia.

- TOT Payments, LLC is the parent company of:
  - Process Pink, LLC, a wholly owned subsidiary formed in Florida;

- TOT HPS, LLC, a wholly owned subsidiary formed in Florida;
- TOT FBS, LLC, a wholly owned subsidiary formed in Florida;
- TOT New Edge, LLC, a wholly owned subsidiary formed in Florida; and
- TOT BPS, LLC, a wholly owned subsidiary formed in Florida.

• OOO TOT Group Russia, is the parent company of its wholly owned subsidiary OOO TOT Money (a company formed in Russia) (30% of TOT Money was owned by Net Element Russia until September 15, 2013 when this interest was transferred to OOO TOT Group Russia).

• Netlab Systems, LLC is the parent company of Tech Solutions LTD.

• A&R Music Holdings (f/k/a Music1) was the parent company of A&R Music Live, LLC ("A&R Music Live") (operations discontinued January 31, 2013).

• Net Element Russia is the parent company of OOO TOT Group and OOO Music1 (Russia) (operations discontinued September 25, 2013). Net Element Russia owned 30% of OOO TOT Money until September 15, 2013 when this interest was transferred to OOO TOT Group Russia.

All material intercompany accounts and transactions have been eliminated in this consolidation.

Discontinued Operations:

The following entities make up our discontinued operations: OOO Music1 (formerly a subsidiary of NETE Russia and divested on September 25, 2013); (2) Ya Talant (divested on September 25, 2013); (3) Splinex (also the parent company of IT Solutions, LTD and also divested on September 25, 2013); (4) MotorSport (also the parent of Motorsport.com, Inc. also divested on September 25, 2013); (5) Openfilm, LLC. (also the parent of Openfilm Studios, LLC (company closed June 2013) and Openfilm, Inc. (divested September 25, 2013)); and (6) Zivos, LLC (Ukraine) (divested September 25, 2013).

In addition, the condensed consolidated statements of operations and comprehensive income (loss) and statements of cash flows contain activity through September 25, 2013 for discontinued operations of our on-line media businesses. On September 25, 2013, we entered into a Contribution Agreement with T1T Lab, LLC, a Florida limited liability company ("T1T Lab"), and T1T Group, LLC, a Delaware limited liability company ("T1T Group"), pursuant to which on September 25, 2013, we contributed to T1T Lab all of its membership and participation interests in its subsidiaries Openfilm, LLC, Motorsport, LLC, Splinex, LLC, LegalGuru, LLC and MUSIC 1 LLC (a/k/a OOO Music1) in exchange for a 10% interest in T1T Lab and T1T Lab assumed $2,162,158 in liabilities (including $2,000,000 owed by us to K1 Holding Limited pursuant to a promissory note dated May 13, 2013) related to the Disposed Subsidiaries.

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On February 11, 2014, we agreed to transfer to T1T Group our 10% interest in T1T Labs in consideration for us being released from our obligations to T1T Lab (including the obligations to make capital contributions to T1T Lab).

There are no amounts reported on the condensed consolidated balance sheets for the discontinued entities at June 30, 2014 and December 31, 2013 given the divesture occurred on September 25, 2013. Prior periods have been adjusted to report the net assets and results from operations of these discontinued entities as discontinued operations.

NOTE 3. LIQUIDITY AND GOING CONCERN CONSIDERATIONS

Our Company's condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. We had a net loss of approximately $2.2 million for the six months ended June 30, 2014, an accumulated deficit of approximately $121.2 million and working capital of approximately $0.3 million at June 30, 2014.

The independent auditors' report on our Company's consolidated financial statements for the year ended December 31, 2013 contained an explanatory paragraph expressing substantial doubt as to our Company's ability to continue as a going concern.

Failure to successfully continue developing our payment processing operations and maintain contracts with merchants, mobile phone carriers and content providers to use TOT Group's services could harm our revenues and materially adversely affect our financial condition and results of operations. The inability to timely receive the subscription receivable may impact our ability to fully implement our business plan. We face all of the risks inherent in a new business, including the need for significant additional capital, management's potential underestimation of initial and ongoing costs, and potential delays and other problems in connection with developing our technologies and operations.

We are continuing with our plan to further grow and expand its payment processing operations in emerging markets, particularly in Russia and surrounding countries. Management believes that its current operating strategy will provide the opportunity for us to continue operations; however, there is no assurance this will occur. The inability to renew or replace the Alpha Bank factoring line of credit would impact our ability to fully implement our business plan. The accompanying condensed consolidated financial statements do not include any adjustments as a result of these uncertainties.

NOTE 4. MERGER AND ACQUISITION TRANSACTIONS

Unified Payments

On April 16, 2013, we entered into a Contribution Agreement (the “Contribution Agreement”) with Unified Payments, LLC, a Delaware limited liability company, TOT Group, Oleg Firer, individually, and Georgia Notes 18 LLC, a Florida limited liability company. Pursuant to the Contribution Agreement, on April 16, 2013, certain subsidiaries of TOT Group, which were formed for the purpose of effectuating the transactions contemplated by the Contribution Agreement, acquired substantially all of the business assets of Unified Payments. Unified Payments provides comprehensive turnkey, payment-processing solutions to small and medium size business owners (merchants) and independent sales organizations across the United States. As consideration for Unified Payments’ and its subsidiaries’ contribution of their assets to TOT Group subsidiaries, (a) we contributed to a subsidiary of TOT Group 70% of the equity interests in our subsidiary, OOO TOT Money (through which we operate our mobile commerce payment processing business); (b) TOT Group issued to Unified Payments 10% of TOT Group’s issued and outstanding common stock which was valued at approximately $600,000 (valued based on a discounted cash flow analysis of TOT Group adjusted for a lack of marketability discount); and (c) TOT Group assumed approximately $20.6 million in liabilities of Unified Payments and its subsidiaries. Had the acquisition occurred on January 1, 2013, revenue and net loss from operations would have increased by $5,662,740 and $1,081,218, respectively.

The following table summarizes the fair value of consideration paid and the allocation of purchase price to the fair value of tangible and intangible assets and liabilities, including the estimated useful lives of acquired assets:

	(in Millions)
Purchase Consideration:	
Assumption of Debt	$ 20.6
Issuance of TOT Group Stock (10%)	0.6
Total Consideration Transferred	$ 21.2
Purchase Price Allocation to Identifiable assets acquired and liabilities assumed	
Current Assets	$ 0.9
Merchant Portfolios	4.4
Other Intangible Assets	1.0
Currrent Liabilities	(2.1)
Total Identifiable Net Assets	4.2
Goodwill	17.0
Total Purchase Price Allocation	$ 21.2

Intangible assets and merchant portfolios are being amortized in a manner consistent with the pattern in which the related benefits are expected to be consumed. Goodwill arising from the acquisition represents the estimated value of Unified Payments' presence in key high growth markets, its assembled workforce, its management team's industry-specific project management expertise and synergies expected to be achieved from the combined operations of Unified Payments and TOT Money.

As part of its June 30, 2013 financial statement closing process, as well as our review of the independent valuation performed in connection with the Unified Payments business combination, management determined that the reported goodwill of its TOT Payments unit as of June 30, 2013 was impaired. The carrying amount of this reporting unit was negative as of June 30, 2013, thus we performed Step 2 of the goodwill impairment test as of June 30, 2013. The fair value of the reporting unit was determined based on a combination of the income approach (discounted cash flow analysis) and market approach. The result of the Step 2 analysis indicated that the TOT Payments reporting unit's goodwill was impaired by approximately $11.2 million as of June 30, 2013. We recorded a non-cash, goodwill impairment charge of $11,200,000 million for the three months ended June 30, 2013. At December 31, 2013, we performed its impairment test again and determined that no further impairment was necessary.

On September 4, 2013, we entered into a letter agreement, dated as of August 28, 2013, with Oleg Firer, Steven Wolberg, Georgia Notes 18 LLC and Vladimir Sadovskiy, pursuant to which we agreed, subject to approval of our shareholders, to issue such number of shares of Common Stock equal to 10% of our issued and outstanding Common Stock as of the date of issuance of such shares in exchange for our acquisition of the outstanding 10% noncontrolling interest in TOT Group, Inc. Pursuant to this agreement, we are obligated to issue to Mr. Firer (who is Chief Executive Officer and a director of the Company) 4.5% of our issued and outstanding Common Stock as of the date of issuance of such shares, and to Mr. Wolberg (who is Chief Legal Officer and Secretary of the Company) 2% of our issued and outstanding Common Stock as of the date of issuance of such shares.

Effective June 30, 2014, we executed Amendment No. 1 with Oleg Firer, Steven Wolberg, Georgia Notes 18, LLC and Vladimir Sadovskiy. Prior to the date of this Amendment No. 1, the parties intended that the number of shares of our common stock (the “Shares”) to be issued would be calculated to reflect shares that constituted a 10% ownership interest in the Company on a pre-share issuance basis. As and with effect from the Effective Date, the parties agree that the number of Shares to be issued pursuant to the Exchange Agreement shall be calculated to reflect Shares that constitute a 10% ownership interest in the Company on the post-share issuance basis.

As of June 30, 2014, the number of shares, market price and total value for the 10% interest issued by the Company for the acquisition of the 10% minority interest of TOT Group, Inc. were 3,135,856 shares, $4.28 weighted average per share and $13,415,197, respectively. We recorded a non-cash compensation charge for this transaction was $13,922,910, which consists of the $13,415,197 total value of the shares issued, the negative book value of the 10% noncontrolling interest in TOT Group, Inc. of $1,107,713, less the fair value of the 10% TOT Group stock of $600,000.

Aptito

On June 18, 2013, Aptito, an indirect subsidiary, entered into an Asset Purchase Agreement with Aptito.com, Inc., a New York corporation (“Seller”), pursuant to which Aptito acquired on such date substantially all of the business assets of Seller. The business assets sold to Aptito by Seller include the development, implementation and sales of an all-in-one, cloud-based, digital point-of-sale software and customer relations management and payments platform, including the Restaurant mPOS, a tablet-based point-of-sale solution that combines traditional point-of-sale functionality with mobile ordering, payments, social media, intelligent offers, mobile applications, loyalty and transactional data all in one solution using Seller’s (and now Aptito’s) cloud-based payments platform.

As consideration for the acquired business assets, (a) Aptito assumed and simultaneously repaid $145,000 of outstanding indebtedness (with an original principal balance totaling $200,000); and (b) we agreed to issue to Seller 125,000 restricted shares of our common stock, which shares vested quarterly over 12 months (valued at $718,750). The total purchase consideration was $918,750 and ascribed to goodwill. At June 30, 2014, 125,000 shares with a value of $718,750 have been vested.

Our subsidiary, TOT Group, which owns an 80% membership interest in Aptito, has an option to purchase Seller's 20% membership interest in Aptito at any time after December 31, 2014 or at any time upon a change of control (as defined in Aptito's limited liability company agreement) of Aptito, with the purchase price based on the fair market value of Aptito as of the end of the calendar month immediately preceding TOT Group's request for a valuation in accordance with the terms of the option, payable in cash, cancellation of indebtedness, shares of common stock or a combination of the foregoing.

Had the acquisition occurred on January 1, 2013, revenue and net loss from operations would have increased by $55,091 and $112,602, respectively.

NOTE 5. DISCONTINUED OPERATIONS

On September 25, 2013, we entered into a Contribution Agreement (the "Divestiture Contribution Agreement") with T1T Lab and T1T Group, pursuant to which, on September 25, 2013, we contributed to T1T Lab all of our membership and participation interests in its subsidiaries Openfilm, LLC, Motorsport, LLC, Splinex, LLC, LegalGuru, LLC and MUSIC 1 LLC (a/k/a OOO Music1) (collectively, the "Disposed Subsidiaries"). The Disposed Subsidiaries constitute all of our interests in online media businesses and operations (referred to herein collectively as our "entertainment assets"). As described further below, following the transactions effectuated pursuant to the Divestiture Contribution Agreement, we indirectly owned a minority interest in the Disposed Subsidiaries through its 10% membership interest in T1T Lab. We disposed of our entertainment assets in order to focus our business operations on mobile payments, transactional services and related technologies and to reduce the significant expenses associated with developing and maintaining the entertainment assets.

Pursuant to the Divestiture Contribution Agreement, we contributed to T1T Lab all of our membership and participation interests in the Disposed Subsidiaries and agreed to make an initial capital contribution to T1T Lab in the amount of $1,259,000 (recorded as part of Due to related Parties (current portion) on the condensed consolidated balance sheet), payable in full or in installments when requested by T1T Lab but in no event later than within the 12-month period after September 25, 2013 (unless such period is mutually extended in writing by us and T1T Group).

Subject to T1T Lab's prior written approval, a portion of our initial capital contribution may be made in the form of future services provided by us, with the value of such services to be agreed upon in writing between us and T1T Group prior to providing such services. The amount of our initial capital contribution is a negotiated amount required for T1T Lab to acquire the Disposed Subsidiaries. In exchange for such contributions, we were issued a 10% membership interest in T1T Lab and T1T Lab assumed $2,162,158 in liabilities (including $2,000,000 owed by us to K 1 Holding Limited pursuant to a promissory note dated May 13, 2013) related to the Disposed Subsidiaries. In addition, all intercompany loans payable by the Disposed Subsidiaries to us, on the one hand, and by us to the Disposed Subsidiaries, on the other hand, were forgiven by the parties. The investment, which amounted to $46,113, was accounted for under the cost method since we owns 10% of T1T Lab, LLC and do not influence the operations of T1T Lab, LLC.

On February 11, 2014, we agreed to transfer to T1T Group our 10% interest in T1T Labs in consideration for us being released from our obligations to T1T Lab (including the obligations to make capital contributions to T1T Lab).

T1T Group is wholly-owned by Enerfund, LLC (which is wholly-owned by Mike Zoi, a stockholder of the Company).

Based on the foregoing, and in conformity with applicable accounting guidance, the Disposed Subsidiaries qualify as a discontinued operation. Accordingly, financial results of the Disposed Subsidiaries have been reported as discontinued operations in the accompanying condensed consolidated statements of operations and comprehensive loss for all periods presented.

For the three months ended June 30, 2013 our discontinued operations contained revenues of $8,110, loss before income taxes of $253,520, an income tax provision of $0 and Net Loss from discontinued operations of $0. For the six months ended June 30, 2013 our discontinued operations contained revenues of $14,475, loss before income taxes of $624,462, an income tax provision of $0 and Net Loss from discontinued operations of $0.

As of June 30, 2014 and December 31, 2013, there were no assets or liabilities of discontinued operations because the entities were divested on September 25, 2013.

NOTE 6. NOTES RECEIVABLE

As of June 30, 2014 and December 31, 2013 we had net notes receivable as follows:

	June 30, 2014	December 31, 2013
Note receivable from former general director	$ -	$ 1,834,302
Less: Allowance for uncollectible note receivable	-	(1,834,302)
Total note receivable, net	$ -	$ -

Former General Director TOT Money

We commenced our carrier-integrated mobile payment payments solutions operations, through our subsidiary TOT Money, during the third quarter of 2012. These operations consist of TOT Money paying aggregators for content to be provided to mobile operators. Aggregators are businesses that contract for content from several content providers and provide processing volume to TOT Money. During the fourth quarter of 2012 and the six months ended June 30, 2013, TOT Money's former general director was providing advances to aggregators based on projected processing volumes. Although we have a history of transactions with most aggregators, we do not obtain financial statements or bank references to complete a full credit review of each aggregator. In addition, aggregator advances are unsecured. As of December 31, 2012, we established a 10% reserve on these aggregator advances based on actual and estimated processing volumes subsequent to these dates, and concluded that the net aggregator advances were recoverable as of December 31, 2012.

During the second quarter of 2013, our new CEO and newly appointed management of TOT Group Russia completed its analysis of its aggregator and mobile operator relationships. As part of this review, management determined that the former general director of TOT Money provided advances to aggregators, which exceeded the future processing volumes to be provided by these aggregators. As a result, management concluded that a significant portion of these advanced amounts would not be recoverable in the form of future business from the aggregators. The former general director assumed responsibility for a certain amount of these advances and entered into a settlement agreement for $3.8 million, which was fully reserved and then deemed uncollectible on February 10, 2014 when the former general director resigned.

NOTE 7. ACCOUNTS RECEIVABLE AND ADVANCES TO AGGREGATORS

Accounts receivable consist of amounts due from processors and Russian mobile operators. Total accounts receivable amounted to $4,374,431 and $10,619,289 at June 30, 2014 and December 31, 2013 respectively, consisting primarily of $2,824,391 and $9,118,849 of amounts due from Russian mobile operators and $1,550,040 and $1,498,620 of TOT Payments, Inc. merchant receivables at June 30, 2014 and December 31, 2013 respectively.

The $1,550,040 and $1,498,620 of merchant receivables are presented net of a $103,031 and $2,111,303 allowance for amounts due from certain merchants. There were additional charges to bad debts for $201,407 for ACH rejects in the normal course of operations and a ($1,640,110) recovery as a result of an adjustment to the allowance for bad debts for its Russian operations.

The cycle of the TOT Payments processing business begins when TOT Payments charges merchants for processing services, based on a variable percentage of the dollar amount of each transaction and in some instances, additional fees are charged for each transaction. Merchant customers also may be charged miscellaneous fees, including statement fees, annual fees monthly minimum fees, fees for handling chargebacks, gateway fees, and fees for other miscellaneous service.

The cycle of the Russian TOT Money mobile payment processing business begins with TOT Money advancing funds to aggregators for data traffic to be provided to mobile operators. Aggregators provide transactions to TOT Money for processing and billing to contract mobile operators. The mobile operator contracts and associated receivables are with the three largest mobile telecommunications companies in Russia: Mobile TeleSystems OJSC, MegaFon OJSC and OJSC VimpelCom. We do not reserve for these accounts receivable given payment history that the Company has with each mobile operator and the size of each mobile operator company. The collection cycle with mobile operators is approximately 45 days.

We monitor all accounts receivable, notes receivable and transactions with mobile operators and aggregators on a monthly basis to ensure collectability and the adequacy of loss provisions. Considerations include payment history, business volume history, financial statements of borrower, projections of borrower and other standard credit review documentation. Management uses its best judgment to adequately reserve for future losses after all available information is reviewed.

NOTE 8. FIXED ASSETS

Fixed assets are stated at cost less accumulated depreciation and amortization as follows:

	Useful life (in years)	June 30, 2014	December 31, 2013
Furniture and equipment	3 - 10	$ 137,540	$ 236,432
Computers	2 - 5	145,237	254,280
Leasehold improvements*		-	-
Total		282,777	490,712
Less: Accumulated depreciation		(219,543)	(353,445)
Total fixed assets, net		$ 63,234	$ 137,267

Depreciation expense was $29,135 and $41,957 for the three months ended June 30, 2014 and 2013, respectively, and $40,415 and $84,018 for the six months ended June 30, 2014 and 2013, respectively.

NOTE 9. INTANGIBLE ASSETS

Merchant Portfolios

The following table reflects our merchant portfolio at cost and net carrying value as of June 30, 2014:

	Cost	Remaining Useful Life in Months	Accumulated Amortization	Net
TOT BPS, LLC	$ 1,852,851	15	$ 1,469,862	$ 382,989
TOT HPS, LLC	102,050	15	80,951	21,099
TOT FBS, LLC	968,010	22	557,627	410,383
UPS Portfolios	1,095,000	33-34.5	40,833	1,054,167
	$ 4,017,911		$ 2,149,273	$ 1,868,638

The useful lives of merchant portfolios represent management's best estimate over which we will recognize the economic benefits of these intangible assets. During the three months ended June 30, 2014 we purchased the rights to residuals resulting in a net increase of its cash flow of approximately $60,000. We paid approximately 18.5 times the monthly cash flow for the right to these residuals which are reflected in UPS Portfolios. We are amortizing the cost of this portfolio over 36 months.

We capitalize certain development costs. Specifically, costs to develop software. A capitalized project would be closer to a full product launch than an incremental or point release update. Costs for maintenance and minor updates are expensed as incurred. Capitalized costs are amortized over 24 months on a straight-line basis. We also capitalize projects from the point of start to the point the application, service or website is publicly launched. Amortization is straight-line over 24 months. Impairment is reviewed quarterly to ensure only viable active project costs are capitalized. The balances at June 30, 2014 and December 31, 2013 were $228,203, and $243,825 respectively.

In connection with the Unified Payments acquisition in 2013, two key executives signed covenants not to compete. These covenants have a three-year life.

At June 30, 2014, we had $3,052,847 of intangible assets of which $2,551,181 is attributed to TOT Group. Shown below are the details of intangible assets as of June 30, 2014:

	IP Sofware	Portfolios	Client Acquisition Costs	Covenant Not to Compete	Total
Balance at December 31, 2013	$ 243,825	$ 1,698,421	$ 380,511	$ 641,667	$ 2,964,424
Additions	-	-	86,779	-	86,779
Amortization	(7,461)	(441,975)	(43,542)	(70,000)	(562,978)
Impairment	-	-	-	-	-
Balance at March 31, 2014	$ 236,364	$ 1,256,446	$ 423,748	$ 571,667	$ 2,488,225
Additions		1,095,000	65,277		1,160,277
Amortization	(7,461)	(482,808)	(35,386)	(70,000)	(595,655)
Impairment	-	-	-	-	-
Balance at June 30, 2014	$ 228,903	$ 1,868,638	$ 453,639	$ 501,667	$ 3,052,847

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Amortization expense was $595,655 and $581,379 for the three months ended June 30, 2014 and 2013, respectively, and $1,158,633 and $581,379 for the six months ended June 30, 2014 and 2013, respectively.

The following table presents the estimated aggregate future amortization expense of other intangible assets:

2014	$1,049,438
2015	1,004,125
2016	612,805
2017	273,669
2018	112,810
Total	$3,052,847

NOTE 10. SHORT TERM LOANS

At June 30, 2014 and December 31, 2013, we had approximately $256,402 and $8,478,810, respectively, in short term loans payable under factoring and credit agreements with Alfa-Bank that was entered into by our Russian subsidiary, TOT Money.

In September 2012, TOT Money entered into a factoring agreement with Alfa-Bank. Pursuant to the agreement, as amended, TOT Money assigned to Alfa-Bank its accounts receivable as security for financing for up to 300 million Russian rubles (approximately $9.8 million in U.S. dollars). The amount loaned by Alfa-Bank pursuant to the agreement with respect to any particular account receivable is limited to 80% of the amount of the account receivable assigned to Alfa-Bank. Pursuant to the agreement, Alfa-Bank is required to track the status of TOT Money's accounts receivable, monitor timeliness of payment of such accounts receivable and provide related services. The agreement expired on May 20, 2014 and is currently in process of being renewed. Interest on the factoring arrangement ranged from 9.70% to 11.95% annually of the amounts borrowed, with servicing fees ranging from 10 Russian rubles (approximately $0.33 in U.S. dollars) to 100 Russian rubles (approximately $3.28 million in U.S. dollars) per account receivable. TOT Money's obligations under the agreement also are secured by a guarantee given by AO SAT & Company. AO SAT & Company is an affiliate of Kenges Rakishev, who is the Chairman of the Board of Directors of the Company.

In August, 2012, TOT Money entered into a Credit Agreement with Alfa-Bank. Pursuant to the Credit Agreement, Alfa-Bank agreed to provide a line of credit to TOT Money with the credit line limit set at 300 million Russian rubles (approximately $9.8 million in U.S. dollars). The interest rate on the initial amount borrowed of 53.9 million rubles (approximately $1.8 million in U.S. dollars) under the Credit Agreement is 3.55% per annum. The loan was secured by 55.0 million rubles of restricted cash (approximately $1.8 million in U.S. dollars). Alfa-Bank has the unilateral right to change the interest rate on amounts borrowed under the Credit Agreement from time to time in the event of changes in certain market rates or in Alfa-Bank's reasonable discretion, provided that the interest rate may not exceed 14% per annum. Interest must be repaid on a monthly basis on the 25th of each month. Amounts borrowed under the Credit Agreement must be repaid within six months of the date borrowed. The line of credit expired on May 20, 2014. TOT Money's obligations under the Credit Agreement are secured by a pledge of TOT Money's deposits in its deposit account with Alfa-Bank and by a guarantee given by AO SAT & Company. The balance outstanding on the line of credit was $0 at December 31, 2013. We did not renew this Credit Agreement upon its expiration on May 20, 2014.

NOTE 11. ACCRUED EXPENSES

At June 30, 2014 and December 31, 2013, accrued expenses amounted to $2,713,911 and $3,484,963, respectively. Accrued expenses represent expenses that are owed at the end of the period and have not been billed by the provider or are estimates of services provided. The following table details the items comprising the balances outstanding as of June 30, 2014 and December 31, 2013.

	June 30, 2014	December 31, 2013
Accrued professional fees	$425,040	$ 711,340
Short term loan advances	-	240,000
Accrued income and VAT taxes	-	350,743
Promotional expense	180,014	261,311
Accrued interest	260,702	