Neonode, Inc
Form 10-Q
September 13, 2007

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 July 31, 2007

o Transition report pursuant to section 13 or 15(d) of the
Securities and Exchange Act of 1934

For the transition period from _______ to ________

Commission file number 0-8419

NEONODE, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-1517641
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Biblioteksgatan 11. SE-111 46 Stockholm, Sweden
(Address of principal executive offices and zip code)

Sweden 46-8-678 18 50
USA (925) 355-2000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Exchange Act Rule 12b-2.

Large Accelerated Filer o Accelerated Filer o Non Accelerated Filer x

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

The number of shares of registrant's common stock outstanding as of August 31, 2007 was 22,673,940.

PART I Financial Information

NEONODE, INC.

INDEX TO JULY 31, 2007 FORM 10-Q

Item 1	Financial Statements	
Condensed Balance Sheets as of July 31, 2007 (unaudited) and October 31, 2006		3
Condensed Statements of Operations for the three and nine months ended July 31, 2007 and 2006 (unaudited)		4
Condensed Statements of Cash Flows for the nine months ended July 31, 2007 and 2006 (unaudited)		5
Notes to Condensed Financial Statements		6
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3	Quantitative and Qualitative Disclosures about Market Risk	31
Item 4	Controls and Procedures	31
PART II	**Other Information**	
Item 1A	Risk Factors	31
Item 6	Exhibits	44
SIGNATURES		45
EXHIBITS		

PART I. Financial Information

Item 1. Financial Statements

NEONODE, INC.
CONDENSED BALANCE SHEETS
(In thousands)

	July 31, 2007 (unaudited)	October 31, 2006 (A)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 407	$ 1,147
Trade accounts receivable, net	—	930
Note receivable	1,009	—
Other	165	177
Current assets from discontinued operations (B)	—	739
Total current assets	1,581	2,993
Property, plant and equipment, net	85	231
Capitalized software costs, net	90	1,314
Other	4	5
Non-current assets from discontinued operations (B)	—	325
Total assets	$ 1,760	$ 4,868
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	$ 114	$ 557
Accrued payroll and employee benefits	7	105
Capital lease obligations - current portion	35	33
Deferred revenues	359	432
Other accrued expenses	48	144
Current liabilities from discontinued operations (B)	—	21
Total current liabilities	563	1,292
Capital lease obligations, net of current portion	51	65
Long-term liabilities from discontinued operations (B)	—	190
Total long-term liabilities	51	255
Total liabilities	614	1,547
Commitments (note 7)		
Stockholders' equity:		
Common stock	35,986	35,186
Accumulated deficit	(34,840)	(31,865)
Total stockholders' equity	1,146	3,321
Total liabilities and stockholders' equity	$ 1,760	$ 4,868

(A) Derived from audited financial statements

(B) See Note 1 to the condensed financial statements for information related to discontinued operations

See notes to condensed financial statements.

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

	Three months ended July 31, 2007	Three months ended July 31, 2006	Nine months ended July 31, 2007	Nine months ended July 31, 2006
Net revenue	$ 26	$ 21	$ 75	$ 31
Operating expenses				
Amortization and impairment of acquired software and intellectual property	830	6,518	1,205	8,564
Product research and development	225	351	836	1,420
Sales and marketing	87	236	360	854
General and administrative	638	552	1,824	2,090
Total operating expenses	1,780	7,657	4,225	12,928
Operating loss from continuing operations	(1,754)	(7,636)	(4,150)	(12,897)
Interest income	13	9	17	38
Provision for income taxes	(1)	(1)	(5)	(6)
Loss from continuing operations	(1,742)	(7,628)	(4,138)	(12,865)
Loss from discontinued operations	—	(214)	(181)	(734)
Gain on sale of discontinued operations	—	—	1,343	—
Net income (loss) from discontinued Operations (B)	(1,742)	(214)	1,162	(734)
Net loss	$ (1,742)	$ (7,842)	$ (2,976)	$ (13,599)
Basic and diluted income (loss) per share				
Continuing operations	$ (0.77)	$ (3.77)	$ (1.85)	$ (6.20)
Discontinued operations (B)	$ —	$ (0.11)	$ 0.52	$ (0.35)
Basic and diluted loss per share	$ (0.77)	$ (3.87)	$ (1.33)	$ (6.55)
Basic and diluted - weighted average shares used in per share computations	2,264	2,025	2,235	2,077

(B) See Note 1 to the condensed financial statements for information related to discontinued operations

See notes to condensed financial statements.

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

	Nine months ended July 31, 2007	Nine months ended July 31, 2006
Cash flows from operating activities:		
Net loss	$ (2,975)	$ (5,757)
Adjustments to reconcile net loss to net cash used by operating activities:		
Equity based compensation expense	799	1,108
Depreciation and amortization	711	2,165
Impairment of capitalized software	661	256
Gain on sale of hardware business	(1,343)	—
Changes in operating assets and liabilities:		
Accounts receivable	930	(31)
Inventories	—	95
Other assets	12	74
Trade accounts payable	(443)	174
Other accrued liabilities	(279)	97
Net cash used by operating activities	(1,927)	(1,819)
Cash flows from investing activities:		
Purchases of property, plant and equipment	(4)	(167)
Capitalized software costs	—	(40)
Loan to Neonode, Inc.	(1,009)	—
Cash proceeds from sale of hardware business	2,200	—
Net cash provided (used) in investing activities	1,187	(207)
Cash flows from financing activities:		
Stock offering expense	—	(2)
Proceeds from exercise of stock options	—	39
Net cash provided by financing activities	—	37
Net increase (decrease) in cash and cash equivalents	(740)	(1,989)
Cash and cash equivalents at beginning of period	1,147	3,632
Cash and cash equivalents at end of period	$ 407	$ 1,643
SUPPLEMENTAL SCHEDULE OF NON-CASH ACTIVITIES:		
Non-cash reduction in liabilities related to sale of hardware business	$ 209	$ —
Non-cash reduction in assets related to sale of hardware business	$ 1,066	$ —

See notes to condensed financial statements.

NEONODE, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

1. Interim Period Reporting:

The following condensed financial statements of Neonode, Inc (the Company) (name was SBE, Inc prior to merger with Cold Winder and name change to Neonode Inc.) as of October 31, 2006, are derived from audited financial statements, and the unaudited interim condensed financial statements , include all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations and cash flows for the interim periods. The balance sheets as of July 31, 2007 and October 31, 2006 and the statements of operations for the three and nine months ended July 31, 2007 and 2006 have been adjusted to reflect the effect of our discontinued operations related to the sale of our hardware business. The results of operations for the three and nine months ended July 31, 2007 are not necessarily indicative of expected results for the full 2007 fiscal year.

Certain information and footnote disclosures normally contained in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes contained in our Annual Report on Form 10-K for the year ended October 31, 2006. Our independent registered public accountants stated in their opinion for the year ended October 31, 2006 that there is substantial doubt about our ability to continue as a going concern.

Liquidity

The accompanying 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. As reflected in the accompanying financial statements, as of July 31, 2007, we had cash on hand of $407,000 with cash used in operations of approximately $1.9 million in the nine months ended July 31, 2007 and an accumulated deficit of approximately $34.8 million. Our ability to continue as a going concern is dependent on our ability to execute our business plan and become cash flow positive.

Reverse Stock Split

On April 2, 2007, we effected a one-for-five reverse stock split. The one-for-five reverse stock split has been reflected in the weighted average shares outstanding used to calculate the loss per share amounts presented in these financial statements. In addition, all amounts in the financial statements have been adjusted to reflect the one-for-five reverse stock split.

Merger with Neonode

On August 10, 2007, we completed the previously announced merger with Cold Winter, Inc. (formerly Neonode Inc.), a Delaware corporation (Cold Winter) pursuant to the terms of the Agreement and Plan of Merger and Reorganization, dated January 19, 2007 and amended on May 16, 2007 (the Merger Agreement). As a result of the merger, we changed our name to Neonode Inc. Our stockholders approved the transaction in a special meeting of stockholders held on August 10, 2007. Our headquarters is now located in Stockholm, Sweden with a U.S. office in San Ramon, California.

Merger Consideration

In exchange for the 5.8 million outstanding shares of Cold Winter common stock and the assumption of outstanding options and warrants to purchase an additional 7.9 million shares of Cold Winter common stock, we issued approximately 20.4 million shares of our common stock. As of the closing of the merger, Cold Winter stockholders, option holders and warrant holders own approximately 90.5% of post-merger Neonode common stock on a fully-diluted basis and the stockholders, option holders and warrant holders of pre-merger Neonode own approximately 9.5% of post-merger Neonode common stock on a fully-diluted basis. The securities offered in the merger were not registered under the Securities Act of 1933 and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements. Post-merger Neonode’s common stock began trading on the Nasdaq Capital Market under the new ticker symbol “NEON” on August 13, 2007.

Accounting Treatment of Merger

For accounting purposes, Cold Winter is considered to be the acquirer in this transaction. Accordingly, the purchase price will be allocated among the fair values of our assets and liabilities, while the historical results of Cold Winter will be reflected in the results of the combined company. We have adopted the fiscal year end of Cold Winter, which is December 31, and as such our next quarterly report on Form 10-Q will be for the quarter ending September 30, 2007.

Sale of Embedded Hardware Business

On March 30, 2007, we sold all of the assets associated with our hardware business (excluding cash, accounts receivable and other excluded assets specified in the asset purchase agreement) to One Stop Systems, Inc. (One Stop Systems or One Stop) for $2.2 million in cash plus One Stop Systems’ assumption of the lease of the building housing our corporate headquarters and certain equipment leases. We received $1.7 million in cash on the date of the sale and received an additional $500,000 in cash on June 5, 2007. Our hardware business represented substantially all of our revenue to date.

The balance sheets as of July 31, 2007 and October 31, 2006 and the statements of operations for the three and nine months ended July 31, 2007 and 2006 have been adjusted to reflect the effect of our discontinued operations related to the sale of our hardware business.

We recorded a $1.3 million gain on the sale of our hardware business to One Stop. The gain is based on the difference between the proceeds received from and liabilities assumed from/by One Stop and the carrying value of the assets transferred to One Stop.

		Gain on the sale of hardware business (in thousands)
Cash and escrow receivable	$	2,200
Liabilities assumed		209
Total consideration		2,409
Less basis of assets transferred in sale		
Inventory		741
Plant property & equipment		277
Other assets		48
Total basis of transferred assets		1,066
Gain on Sale	$	1,343

Sale of Storage Software Business

On August 15, 2007, Neonode Inc. entered into an Asset Purchase Agreement (the Purchase Agreement) with Riding Tide Software, LLC (Buyer), a newly-formed limited liability company owned by Nick Bellinger, a former stockholder of PyX Technologies, Inc., a company we acquired in 2005.

Under the Purchase Agreement, we agreed to sell all of the assets associated with our enterprise storage software business (the Storage Assets) to Buyer for $90,000 in cash plus 70% of the monthly net revenues received by Buyer in the 12 months following the pursuant to the PyX OEM Agreement, dated as of June 14, 2004, between Buyer (as our successor in interest) and Pelco. The Storage Assets were sold to Buyer on an “as is” basis and Buyer has agreed to indemnify us for any damages we suffer relating to the Storage Assets that accrue or arise after the closing. As a result of the sale, the company recognized an impairment of the software capitalized asset of $661,000.

On August 20, 2007, we completed the sale of the Storage Assets pursuant to the Purchase Agreement.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as certain disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Actual results could differ from these estimates. Significant estimates and judgments made by us include matters such as warranty obligations, indemnification obligations, collectibility of accounts receivable, realizability of inventories and recoverability of capitalized software and deferred tax assets.

2. Inventories:

All of the inventory related to the embedded hardware business was transferred to One Stop upon consummation of the asset sale transaction on March 30, 2007. The net book value of the inventory sold to One Stop was $741,000 at March 30, 2007.

3. Capitalized Software:

Capitalized software costs comprised the following (in thousands):

		July 31, 2007		October 31, 2006
Purchased software	$	14,217	$	14,217
Less accumulated amortization		(14,127)		(12,903)
	$	90	$	1,314

Capitalized software costs consist of software relating to current products and the design of future Internet Small Computer System Interface (iSCSI) software products acquired with our acquisition of PyX Technologies, Inc. (PyX) on July 26, 2005. We did not capitalize any purchased software in the nine months ended July 31, 2007 compared to $40,000 in the nine months ended July 31, 2006. Amortization of capitalized software costs totaled $188,000 and $563,000 for the three and nine months ended July 31, 2007, respectively, and $1.0 million and $3.3 million for the three and nine months ended July 31, 2006, respectively.

In the three months ended July 31, 2006, we recorded an asset impairment charge of $5.5 million against our earnings for the period, reducing our PyX software asset to $2.6 million. We recorded an asset impairment charge related to our capitalized software asset totaling $661,000 in the three months ended July 31, 2007, reducing our software asset to $90,000, which is the cash sales price we received when we sold our storage business on August 15, 2007. See Note 9 - *Sale of Storage Software Business*. The asset impairment charge is included in amortization and impairment of acquired software and intellectual property.

4. Net Loss Per Share:

Basic and diluted loss per common share for the three and nine months ended July 31, 2007 and 2006 was computed by dividing the net loss for each period by the weighted average number of shares of common stock outstanding for each period. Common stock equivalents for the three and nine months ended July 31, 2007 and 2006 were anti-dilutive, and as such were not included in the calculation of diluted net income per share.

	Three months ended July 31,		Nine months ended July 31,	
(in thousands)	2007	2006	2007	2006
Common Stock Equivalents				
Employee stock options	803	—	390	189

Loss per share is calculated as follows:

	Three months ended July 31,		Nine months ended July 31,	
(in thousands, except per share amounts)	2007	2006	2007	2006
BASIC AND DILUTED				
Weighted average number of common shares outstanding	2,264	2,025	2,235	2,077
Number of shares for computation of net loss per share	2,264	2,025	2,235	2,077
Net loss from continuing operations	$ (1,742)	$ (7,628)	$ (4,138)	$ (12,865)
Net loss per share from continuing operations	$ (0.77)	$ (3.77)	$ (1.85)	$ (6.20)
Net income (loss) from discontinued operations	$ —	$ (214)	$ 1,162	$ (734)
Net income (loss) per share from discontinued operations	$ —	$ (0.11)	$ 0.52	$ (0.35)
Net loss per share	$ (0.77)	$ (3.87)	$ (1.33)	$ (6.55)

(a) In loss periods, all common share equivalents would have had an anti-dilutive effect on net loss per share and therefore were excluded.

5. Stock-Based Compensation: (adjusted for one for five reverse stock split effective April 2, 2007)

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

Stock Options

As of July 31, 2007, we had four equity incentive plans:

- The 1996 Stock Option Plan (the 1996 Plan), which expired in January 2006;
- the 1998 Non-Officer Stock Option Plan (the 1998 Plan);
- the PyX 2005 Stock Option Plan (the PyX Plan), which we assumed in our acquisition of PyX, but under which we have not granted and will not grant any additional equity awards; and
- the 2006 Equity Incentive Plan (the 2006 Plan).

We also had one non-employee director stock option plan as of July 31, 2007:

- The 2001 Non-Employee Director Stock Option Plan (the Director Plan).

The following table details the outstanding options to purchase shares of our common stock pursuant to each plan at July 31, 2007:

Plan	Shares Reserved	Options Outstanding	Available for Issue	Outstanding Options Vested
1996 Plan	546,000	91,000	—	86,999
1998 Plan	130,000	46,800	32,095	46,800
PyX Plan	407,790	204,240	—	203,510
2006 Plan	300,000	42,000	17,954	41,249
Director Plan	68,000	56,750	—	56,750
Total	1,451,790	440,790	50,049	435,308

The 1996 Plan terminated effective January 17, 2006 and, although we can no longer issue stock options out of the 1996 Plan, the outstanding options at the date of termination will remain outstanding and vest in accordance with their terms. Options granted under the Director Plan vest over a one to four-year period, expire five to seven years after the date of grant, and have exercise prices reflecting the market value of our common stock on the date of grant. Stock options granted under the 1996 Plan, 1998 Plan, 2006 Plan and the PyX Plan are exercisable over a maximum term of ten years from the date of grant, vest in various installments over one to four-year periods and have exercise prices reflecting the market value of our common stock on the date of grant.

We granted options to purchase 58,150 and 66,150 shares of our common stock to employees or members of our Board of Directors (Board) during the three and nine months ended July 31, 2007, respectively, compared to grants of options to purchase 37,000 and 797,500 shares of our common stock to employees and members of the Board for the three and nine months ended July 31, 2006, respectively. The fair value of stock-based compensation related to the employee and director stock options is calculated using the Black-Scholes option pricing model as of the grant date of the underlying stock options. We accelerated the vesting of stock options and restricted stock for employees and members of our Board which resulting in $180,000 in additional compensation charges related to the acceleration of the vesting of these stock options in the three and nine months ended July 31, 2007.

Employee and director stock-based compensation expense related to stock options in the accompanying condensed statements of operations (in thousands) is as follows:

	Three months ended July 31, 2006	Nine months ended July 31, 2006	Three months ended July 31, 2007	Nine months ended July 31, 2007	Remaining unamortized expense
Stock option compensation	$ 278	$ 1,002	$ 278	$ 633	$ —

The calculation of stock-based compensation and the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Options Granted During Nine Months Ended July 31, 2006	Options Granted During Nine Months Ended July 31, 2007
Expected life (in years)	5.15	3.23
Risk-free interest rate	4.50%	5.75%
Volatility	112.50%	119.53%
Dividend yield	0.00%	0.00%
Forfeiture rate	6.01%	10.10%

The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from our stock options. The Black-Scholes model also requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term and forfeiture rate of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior, as well as expected behavior on outstanding options. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of our stock price. These factors could change in the future, which would affect the stock-based compensation expense in future periods.

We award stock option grants to certain non-employee strategic business advisors as part of their fee structure. The fair value of these option grants is estimated on the date of grant using the Black-Scholes option-pricing model and is recalculated on a periodic basis based on market price until vested. For the three and nine months ended July 31, 2007, we recorded $1,000 and $3,500, respectively, of compensation expense related to non-employee stock options compared to $2,900 and $51,900 of compensation expense to non-employees for the three and nine months ended July 31, 2006, respectively. We cancelled all agreements with our non-employee strategic business advisors on July 31, 2007. The advisors have 90 days from termination of their agreements to exercise vested stock options. All unvested stock options were cancelled.

The following table summarizes our stock option activity for the nine months ended July 31, 2007:

	Number of options	Weighted Average Exercise Price
Outstanding at October 31, 2006	577,974	$ 10.49
Granted Stock Options	66,150	2.53
Exercised	—	—
Cancelled	(203,334)	13.34
Outstanding at July 31, 2007	440,790	$ 9.45
As of July 31, 2007:		
Options exercisable	435,308	$ 9.41
Shares available for grant	50,049	

The weighted average grant date fair value of options granted during the nine months ended July 31, 2007 and 2006 was $2.55 and $7.20, respectively. The total intrinsic value of options exercised during the nine months ended July 31, 2007 and 2006 was $0 and $38,400, respectively.

Restricted Stock Awards

On March 21, 2006, our Board approved restricted stock grants to all current employees. The shares of restricted stock granted vest 25% on the first anniversary of the initial grant date with the remainder vesting monthly thereafter for the following six months. For the three and nine months ended July 31, 2007, we recorded $31,600 and $23,500 to salary expense related to these restricted stock grants and we recorded $44,100 and $53,400 of salary expense related to restricted stock grants for the three and nine months ended July 31, 2006, respectively. The salary expense related to restricted stock grants is recorded net of cancellations of grants to employees who terminated their employment prior to vesting.

	Weighted Average Shares Unvested Stock Units	Average Grant Date Fair Value
Unvested at November 1, 2006	48,400	$ 5.20
Granted	—	—
Vested	(22,000)	5.20
Cancelled	(26,400)	5.20
Unvested at July 31, 2007	—	$ 5.20

Stock-For-Pay Plan

On January 12, 2006, our Board approved a company-wide reduction in employee base salaries, effective January 16, 2006. In order to continue to motivate and retain our employees despite such salary reductions, the Board approved stock grants to all of our employees pursuant to the 1996 Plan and 2006 Plan. A total of 65,335 shares of our common stock were issued to employees in the nine months ended July 31, 2007 pursuant to the stock-for-pay plan, compared to 566,642 shares of our common stock for the same nine month period in 2006. For the three and nine months ended July 31, 2007, we recorded approximately $20,700 and $124,800, respectively, of stock-based compensation expense associated with such stock grants. For the three and nine months ended July 31, 2006, we recorded approximately $144,000 and $463,000, respectively, of stock-based compensation expense associated with stock grants.

In addition, the Board suspended all cash payments of Board fees until further notice. A total of 7,344 shares of our common stock were issued to members of our Board in the nine months ended July 31, 2007 pursuant to the stock-for-pay plan, compared to 113,360 shares of our common stock for the same nine month period in 2006. For the three and nine months ended July 31, 2007, we recorded $17,900 and $19,300, respectively, of stock-based compensation expense related to the directors' stock-for-pay plan. For the three and nine months ended July 31, 2006, we recorded approximately $43,000 and $114,000, respectively, of stock-based compensation expense associated with the stock-for-pay plan.

The following table summarizes stock-based compensation expense related to employee stock options, restricted stock awards, stock-for-pay and non-employee consultant awards for the three and nine months ended July 31, 2007 and 2006, which was allocated to product costs and operating expense as follows (in thousands):

	Three months July 31, 2007	Three months July 31, 2006
Discontinued operations	$ —	$ 152
Product research and development	81	102
Sales and marketing	12	23
General and administrative	255	274
Total	$ 348	$ 551

	Nine months July 31, 2007	Nine months July 31, 2006
Discontinued operations	$ 176	$ 495
Product research and development	139	316
Sales and marketing	18	125
General and administrative	467	724
Total	$ 800	$ 1,660

6. Revenue Recognition and Concentration of Risk:

Our policy is to recognize revenue for hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We defer and recognize service revenue over the contractual period or as services are rendered. Our policy complies with the guidance provided by Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements*, issued by the Securities and Exchange Commission (SEC).

We account for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. We will defer all revenues related to the sale of our software products until such time as we establish VSOE for the undelivered elements related to our iSCSI software products or fulfill the undelivered elements. Deferred revenues represent post-delivery engineering support and the right to receive specified upgrades or enhancements of our iSCSI software on a when-and-if-available basis.

Substantially all of our revenue has been generated by the hardware business that we sold to One Stop, and the statements of operations for the three and nine months ended July 31, 2007 and 2006 have been adjusted to reflect the effect of our discontinued operations related to the sale of our hardware business.

Net revenue from continuing operations for the third quarter of fiscal 2007 was $26,000, compared to $21,000 in the third quarter of fiscal 2006. For the first nine months of fiscal 2007, net revenue from continuing operations was $75,000, which represented a 142% increase over net revenue of $31,000 for the same period in fiscal 2006. All of our revenue from continuing operations is generated from the sales and servicing of our storage software.

For the three and nine month period ended July 31, 2007 and 2006, most of our sales included in the loss from discontinued operations in the statements of operations were attributable to sales of wireless communications products and were derived from a limited number of original equipment manufacturer (OEM) customers. We sold our hardware business in our second fiscal quarter, so we did not have any net revenue from discontinued operations for the third quarter of fiscal 2007, compared to $1.5 million from our hardware business in the third quarter of fiscal 2006. For the nine month period ended July 31, 2007, net revenue from discontinued operations was $1.5 million, which represented a 68% decrease from net revenues of $4.7 million for the same period in fiscal 2006.

7. Warranty Obligations and Other Guarantees:

The following is a summary of our agreements that we have determined are within the scope of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others— an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34.*

We accrue the estimated costs to be incurred in performing warranty services at the time of revenue recognition and shipment of the products to our customers. The warranty reserve is related to hardware products that we sold to One Stop. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, the warranty accrual will increase, resulting in decreased gross margin.

The following table sets forth an analysis of our warranty reserve (in thousands):

	Nine months ended July 31	
	2007	2006
Warranty reserve at beginning of period	$ 13	$ 22
Less: Cost to service warranty obligations	(13)	(1)
Plus: Increases to reserves	—	1
Total warranty reserve, included in other accrued expenses	$ —	$ 22

We have agreed to indemnify each of our executive officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. However, we have a directors' and officers' liability insurance policy that should enable us to recover a portion of future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal and have no liabilities recorded for these agreements as of July 31, 2007 and October 31, 2006, respectively.

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with business partners, contractors, customers and landlords. Under these provisions we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by us with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments we could be required to make under these indemnification provisions is unlimited. We have