# APOLLO ENTERPRISE SOLUTIONS, LTD. and SUBSIDIARY

**Consolidated Financial Statements**

**December 31, 2017 and 2016**

**With Independent Auditors' Report**

**APOLLO ENTERPRISE SOLUTIONS, LTD AND SUBSIDIARY**
**CONSOLIDATED FINANCIAL STATEMENTS**

## INDEX

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Apollo Enterprise Solutions, Ltd. and Subsidiary:

We have audited the accompanying consolidated financial statements of Apollo Enterprise Solutions, Ltd. and Subsidiary (the "Company"), which comprise the consolidated balance sheet as of December 31, 2017, and the related consolidated statements of operations, changes in stockholders' deficit and cash flows for the year then ended, and the related notes to the consolidated financial statements.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

**Auditors' Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

WithumSmith+Brown, PC 200 Jefferson Park, Suite 400, Whippany, New Jersey 07981-1070 T (973) 898 9494 F (973) 898 0686 withum.com

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**Substantial Doubt about the Company's Ability to Continue as a Going Concern**

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has incurred operating losses, is dependent on additional financing to fund operations, and has a working capital deficit of $14,346,639 as of December 31, 2017. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans in regard to these matters are also described in Note 2 to the consolidated financial statements. The consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classifications of assets or the amounts and classifications of liabilities that may result from the outcome of this uncertainty. Our opinion is not modified with respect to that matter.

**Prior Period Financial Statements**

The financial statements of the Company as of December 31, 2016 were audited by other auditors whose report dated March 31, 2017, included an emphasis-of-matter paragraph which described that substantial doubt existed about the Company's ability to continue as a going concern due to its recurring operating losses and dependence on additional financing to fund operations as discussed in Note 2 to the financial statements.

WithumSmith+Brown, PC

March 29, 2018

# APOLLO ENTERPRISE SOLUTIONS, LTD AND SUBSIDIARY
# CONSOLIDATED BALANCE SHEETS

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash | $ 13,318 | $ 24,416 |
| Accounts receivable, net of allowance for doubtful accounts of $542,980 and $346,500 at December 31, 2017 and 2016, respectively | 345,665 | 474,919 |
| Accounts receivable - related party | 73,413 | 16,667 |
| Prepaid expenses and other assets | 16,384 | 36,842 |
| Total current assets | 448,780 | 552,844 |
| | | |
| Contract work in-progress | - | 54,491 |
| Patents, less accumulated amortization | 891,895 | 998,624 |
| Deferred debt costs associated with line of credit - related party | 2,159,972 | 2,794,699 |
| Deferred offering costs | - | 25,000 |
| Security deposit | 60,000 | 100,000 |
| **Total assets** | **$ 3,560,647** | **$ 4,525,658** |
| | | |
| **LIABILITIES AND STOCKHOLDERS' DEFICIT** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ 910,469 | $ 907,910 |
| Accounts payable - related party | 266,841 | 937,667 |
| Accrued interest | 36,291 | 28,791 |
| Accrued interest - related party | 2,034,603 | 1,174,729 |
| Accrued payroll | - | 24,306 |
| Deferred revenue | 1,420,590 | 1,259,509 |
| Short-term notes payable, net of debt discount ($676,895 was due to a related party) | 741,566 | - |
| Short-term line of credit - related party | 9,385,059 | - |
| Total current liabilities | 14,795,419 | 4,332,912 |
| | | |
| Long-term liabilities: | | |
| Notes payable, net of debt discount ($592,955 was due to a related party) | - | 649,607 |
| Line of credit - related party | - | 5,952,100 |
| Total long-term liabilities | - | 6,601,707 |
| **Total liabilities** | 14,795,419 | 10,934,619 |
| | | |
| **Commitments and contingencies (Note 6)** | | |
| | | |
| **Stockholders' deficit** | | |
| Class A preferred stock, $0.0001 par value, 4,000,000 shares authorized, 96 shares issued and outstanding as of December 31, 2017 and 2016. $2,891 and $2,908 aggregate liquidation preference at December 31, 2017 and 2016, respectively. | 2,400 | 2,400 |
| Class A-1 preferred stock, $0.0001 par value, 420,000 shares authorized, -0- shares issued and outstanding as of December 31, 2017 and 2016. | - | - |
| Class A-2 preferred stock, $0.0001 par value, 1,200,000 shares authorized, 401 shares issued and outstanding as of December 31, 2017 and 2016. $11,734 and $11,441 aggregate liquidation preference at December 31, 2017 and 2016, respectively. | 10,030 | 10,030 |
| Junior preferred stock, $0.0001 par value, 3,500,000 shares authorized, 117,762 shares issued and outstanding as of December 31, 2017 and 2016. $2,944,050 aggregate liquidation preference at December 31, 2017 and 2016. | 2,929,044 | 2,929,044 |
| Common stock, $0.0001 par value, 310,880,000 shares authorized, 72,739,393 shares issued; 43,162,395 and 43,204,690 shares outstanding as of December 31, 2017 and 2016, respectively | 7,274 | 7,274 |
| Additional paid-in capital | 35,802,076 | 34,082,249 |
| Accumulated deficit | (49,982,633) | (43,437,005) |
| Treasury stock, common stock at cost, 29,630,329 and 29,534,703 shares as of December 31, 2017 and 2016, respectively | (2,963) | (2,953) |
| **Total stockholders' deficit** | (11,234,772) | (6,408,961) |
| **Total liabilities and stockholders' deficit** | **$ 3,560,647** | **$ 4,525,658** |

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

## APOLLO ENTERPRISE SOLUTIONS, LTD AND SUBSIDIARY
## CONSOLIDATED STATEMENTS OF OPERATIONS

| | For the years ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Revenues | $ 30,534 | $ 1,040,549 |
| Cost of goods sold | 53,823 | 231,449 |
| **Gross profit (loss)** | (23,289) | 809,100 |
| | | |
| Selling and general administrative expenses | 3,706,323 | 4,248,810 |
| **Operating loss** | (3,729,612) | (3,439,710) |
| | | |
| **Other income (expense):** | | |
| Other income | 55,000 | - |
| Change in warrant liability | - | (561,289) |
| Sublease income | - | 396 |
| Gain (loss) on foreign exchange transactions | (46,956) | 138,900 |
| Interest income | - | 3 |
| Interest expense | (2,824,060) | (1,355,328) |
| **Total other income (expense)** | (2,816,016) | (1,777,318) |
| **Net loss** | **$ (6,545,628)** | **$ (5,217,028)** |
| Basic and diluted net loss per ordinary share | $ (0.15) | $ (0.12) |
| Weighted average shares outstanding, basic and diluted | 43,181,363 | 43,205,699 |

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

# APOLLO ENTERPRISE SOLUTIONS, LTD AND SUBSIDIARY
# CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT

| | Class A Preferred Stock | | Class A-2 Preferred Stock | | Junior Preferred Stock | | Common Stock | | Additional Paid-in Capital | Accumulated Deficit | Treasury Stock | | Total Stockholders' Deficit |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | Shares | Amount | | | Shares | Amount | |
| **Balance at December 31, 2015** | **96** | **$ 2,400** | **401** | **$ 10,030** | **117,762** | **$ 2,929,044** | **72,739,393** | **$ 7,274** | **$ 22,870,217** | **$ (38,219,977)** | **(29,952,580)** | **$ (2,995)** | **$ (12,404,007)** |
| Sale of treasury stock and warrants | - | - | - | - | - | - | - | - | 218,811 | - | 500,300 | 50 | 218,861 |
| Repurchased treasury stock | - | - | - | - | - | - | - | - | (44,167) | - | (82,423) | (8) | (44,175) |
| Reclassification of warrant liability to equity upon amendment of all outstanding warrant agreements | - | - | - | - | - | - | - | - | 8,150,536 | - | - | - | 8,150,536 |
| Issuance of warrants in connection with line of credit agreements | - | - | - | - | - | - | - | - | 2,334,404 | - | - | - | 2,334,404 |
| Issuance of options for services | - | - | - | - | - | - | - | - | 552,448 | - | - | - | 552,448 |
| Net loss | - | - | - | - | - | - | - | - | - | (5,217,028) | - | - | (5,217,028) |
| **Balance at December 31, 2016** | **96** | **2,400** | **401** | **10,030** | **117,762** | **2,929,044** | **72,739,393** | **7,274** | **34,082,249** | **(43,437,005)** | **(29,534,703)** | **(2,953)** | **(6,408,961)** |
| Issuance of treasury stock for services | - | - | - | - | - | - | - | - | 9,996 | - | 37,037 | 4 | 10,000 |
| Repurchased treasury stock | - | - | - | - | - | - | - | - | (25,535) | - | (132,663) | (14) | (25,549) |
| Issuance of warrants in connection with line of credit agreements | - | - | - | - | - | - | - | - | 1,230,000 | - | - | - | 1,230,000 |
| Issuance of options for services | - | - | - | - | - | - | - | - | 505,366 | - | - | - | 505,366 |
| Net loss | - | - | - | - | - | - | - | - | - | (6,545,628) | - | - | (6,545,628) |
| **Balance at December 31, 2017** | **96** | **$ 2,400** | **401** | **$ 10,030** | **117,762** | **$ 2,929,044** | **72,739,393** | **$ 7,274** | **$ 35,802,076** | **$ (49,982,633)** | **(29,630,329)** | **$ (2,963)** | **$ (11,234,772)** |

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

## APOLLO ENTERPRISE SOLUTIONS, LTD AND SUBSIDIARY
## CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For the years ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| **Cash flows from operating activities** | | |
| Net loss | $ (6,545,628) | $ (5,217,028) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Amortization of patent costs | 106,728 | 105,855 |
| Amortization of debt discount | 1,956,687 | 831,762 |
| Stock-based compensation expense | 505,366 | 552,448 |
| Non-cash other income | 55,000 | - |
| Issuance of treasury stock for services | 10,000 | - |
| Issuance of warrants for services | - | 13,283 |
| Change in warrant liability | - | 561,289 |
| Write-off of deferred offering costs | 25,000 | - |
| Bad debt expense | 196,480 | - |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (12,735) | (474,919) |
| Accounts receivable - related party | (56,746) | 195,798 |
| Prepaid expenses | 20,458 | 18,869 |
| Contract work in-progress | - | 21,093 |
| Accounts payable and accrued expenses | (52,441) | (418,570) |
| Accounts payable - related party | 508,132 | 367,227 |
| Accrued interest | 7,500 | 28,791 |
| Accrued interest - related party | 859,874 | 494,775 |
| Accrued payroll | (24,306) | 3,629 |
| Deferred revenue | 161,081 | (31,053) |
| **Net cash used in operating activities** | (2,279,550) | (2,946,751) |
| | | |
| **Cash flows from investing activities** | | |
| Security deposit | 40,000 | - |
| **Net cash provided by investing activities** | 40,000 | - |
| | | |
| **Cash flows from financing activities** | | |
| Proceeds received from line of credit with related party | 2,254,001 | 2,360,600 |
| Proceeds received from issuance of treasury stock | - | 267,717 |
| Purchases of treasury stock | (25,549) | (44,175) |
| Payment of deferred offering costs | - | (25,000) |
| **Net cash provided by financing activities** | 2,228,452 | 2,559,142 |
| | | |
| **Net decrease in cash** | (11,098) | (387,609) |
| | | |
| **Cash at beginning of period** | 24,416 | 412,025 |
| **Cash at end of period** | $ 13,318 | $ 24,416 |
| | | |
| **Supplemental Schedule of Non-cash Financing Activities:** | | |
| Reclassification of warrant liability to equity upon amendment of outstanding warrant agreements | $ - | $ 8,150,536 |
| Drawdown on 4th line of credit in exchange for accounts payable to related party | $ 1,178,958 | $ - |
| Issurance of warrants for line of credit with related party | $ 1,230,000 | $ 2,334,404 |
| Repayment of convertible note with line of credit | $ - | $ 1,252,500 |

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

## NOTE 1 - NATURE OF OPERATIONS

Apollo Enterprise Solutions, Ltd ("AES, Ltd") was incorporated in Bermuda on September 27, 2012 for the purpose of effecting a reverse merger with its wholly-owned subsidiary, Apollo Enterprise Solutions, Inc. ("Apollo Inc.") (collectively, the "Company"). Once the merger was completed in October 2012, the Company pursued listing its shares on the Bermuda Stock Exchange ("BSX") and this was approved by the BSX on November 8, 2012.

AES' patented TruePay+™ System uses Agent Emulation® and Psychographic Persuasion™ technologies to advance the science of payment technologies for maximizing debt resolution. The TruePay+™ System assists creditors' agents and self-serve customers in resolving pre-delinquent and delinquent debt situations on an individualized basis according to customer profiles, using any device, at any time, from anywhere. The Company's customers access the proprietary AES TruePay+™ System as outsourced Software-as-a-Service ("SaaS"), to fully automate the origination of new debt products, modifications of existing debt arrangements, and collection of delinquent debt. The TruePay+™ System applies the customers' business rules to their own data and utilizes outside information such as credit bureau reports to formulate highly targeted origination, modification, and debt settlement offers to customers.

## NOTE 2 – BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") and include the accounts of AES, Ltd and its wholly-owned subsidiary, Apollo Inc. All intercompany balances and transactions have been eliminated in consolidation.

The functional currency of the Company is the U.S. Dollar. Monetary assets and liabilities denominated in non-U.S. currencies are translated at rates of exchange prevailing on the date of the consolidated balance sheets and revenues and expenses are translated at average rates of exchange for the period. Foreign currency remeasurement gains or losses on transactions in nonfunctional currencies are recognized within "Other (income) expenses" in the Consolidated Statements of Operations.

### Going Concern

The accompanying financial statements have been prepared assuming the Company will continue as a going concern, which contemplates, among other things, the realization of assets and satisfaction of liabilities in the normal course of business. The Company had net losses of approximately $6.5 million and $5.2 million for the years ended December 31, 2017 and 2016, respectively, and had net cash used in operating activities of approximately $2.2 million and $2.9 million for the years ended December 31, 2017 and 2016, respectively. These matters, among others, raise substantial doubt about the Company's ability to continue as a going concern.

During the years ended December 31, 2017 and 2016, the operations of the Company have been funded through the issuance of notes payable, convertible notes payable and lines of credit provided by a related party. The Company will attempt to secure additional equity or debt financing until such time as its operations are self sufficient. The Company cannot be certain that additional funding will be available on acceptable terms, or at all. To the extent that the Company raises additional funds by issuing equity securities, the Company's stockholders may experience significant dilution. Any debt financing, if available, may involve restrictive covenants that impact the Company's ability to conduct business. If the Company is not able to raise additional capital when required or on acceptable terms, the Company may have to significantly delay, scale back or discontinue the development and/or commercialization of one or more product candidates or relinquish or otherwise dispose of rights to technologies.

Management has determined that there is substantial doubt about the Company's ability to continue as a going concern within one year after the consolidated financial statements are issued. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, or amounts and classification of liabilities that might result from this uncertainty.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Use of Estimates**

The preparation of these consolidated financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and disclosed in the accompanying notes. Actual results may differ from those estimates and such differences may be material to the consolidated financial statements. The more significant estimates and assumptions by management include among others: revenue recognition, the allowance for doubtful accounts, the valuation allowance of deferred tax assets resulting from net operating losses, the recoverability and estimated useful life of patents, the valuation of the Company's common stock, and the valuation of warrants and options on the Company's common stock.

**Concentration of Credit Risk**

In the normal course of business, the Company is exposed to credit risk. Credit is generally granted to customers without collateral. Cash consists of checking accounts. While cash held by financial institutions may at times exceed federally insured limits, management believes that no material credit or market risk exposure exists due to the high quality of the institutions. The Company has not experienced any losses on such accounts.

In 2016, 97.6% of the Company's revenues were derived from one customer, which was considered a related party through July 12, 2016 due to an individual serving on the boards of both the Company and the customer. In 2016, the customer notified management of their desire to amend their existing contract with the Company.

**Accounts Receivable**

The Company estimates the allowance for doubtful accounts using a specific identification method considering the age of the receivable balance, the customer's historical payment history and current credit worthiness as well as any known or expected collectability issues. Management's evaluation includes reviewing past due accounts on a case-by-case basis, and determining whether a customer account should be reserved, based on the facts and circumstances surrounding each potentially uncollectible account. Uncollectible accounts are written-off in the period management believes it has exhausted every opportunity to collect payment from the customer. Bad debt expense is recorded in selling and general administrative expenses when events or circumstances indicate an additional allowance is necessary based on the specific identification approach. The allowance for doubtful accounts totaled approximately $543,000 and $347,000 as of December 31, 2017 and 2016, respectively. Actual collections of trade receivables could differ from management's estimates due to changes in future economic or industry conditions or specific customers' financial conditions.

As of December 31, 2017 and 2016, 87.0% and 94.7%, respectively, of net accounts receivable is due from one customer, a related party until July 12, 2016. As of December 31, 2017, the Company had an aggregate net receivable of approximately $308,000 from this customer, net of an allowance for doubtful accounts of approximately $543,000. The Company had additional uncollected invoices to this customer aggregating approximately $1.7 million at December 31, 2017, which are due, but which were not recognized in accounts receivable as the Company's revenue recognition policy had not been met as of December 31, 2017. On February 17, 2017, the Company filed a complaint against the customer in Superior Court in the State of California for breach of contract and other causes. The Company was seeking payment of amounts due, plus interest and reimbursement of associated legal fees and costs. On March 24, 2017, the customer petitioned the United States District Court for the Central District of California to move the Company's action to its jurisdiction and filed a counterclaim with the U.S. District Court for a declaration of patent invalidity and non-infringement, fraudulent inducement, unjust enrichment, breach of contract, and other causes. The Company has included its best estimate of an appropriate amount in the allowance for doubtful accounts to cover any additional costs of collection.

On February 27, 2018, the customer and the Company (collectively, the "Parties") agreed to settle all claims and disputes between the Parties and terminate the master services agreement and statements of work entered into between the Parties. The Company will recognize the settlement in the period of collection.

**Revenue Recognition**

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured.

The Company derives its revenue from granting exclusive and non-exclusive licenses to its patents; designing, developing, and installing customized software solutions; and providing software and hardware maintenance and support. The Company's fees primarily consist of license fees, software development and installation fees, software maintenance fees, revenue sharing fees based on debt collection results of customers, per transaction fees and service usage fees. The Company's contracts have different terms based on the scope and deliverables of the arrangement, the terms of which frequently require the Company to make judgments and estimates in recognizing revenue.

*Multiple-Element Patent License and Software Development Arrangement*

The Company's multiple-element patent license and software development arrangement involves the delivery of more than one element, including an exclusive license to develop products using our intellectual property patents; designing, developing, and installing customized software; providing post contract customer support ("PCS") on the customized software; and developing other front-end software.

Upon the signing of the arrangement, the Company provides the licensee the exclusive right to use the Company's intellectual property patents to develop specific products using the patents, including the right to sublicense or sell those products. The Company's only obligation is to pay for the cost of maintaining the patents, including defense of the patents. In exchange for the exclusive right to the Company's intellectual property patents, the Company receives non-refundable license fees that are paid by the customer over the term of the license arrangement.

The Company evaluates the multiple elements in the arrangement to determine whether each element is a separate unit of accounting. This determination is based on whether the deliverable has "stand-alone value" to the customer. Because the patent and software licenses do not have standalone value to the customer and the Company does not have vendor specific objective evidence of fair value of the PCS, fees for the licenses and customized software services are deferred and recognized as revenue on a ratable basis over the period that the PCS services are provided.

The Company also provides front-end software development services under this arrangement with fees based on the time and materials expended. A contract with customized software may be segmented if the Company satisfies the segmenting criteria in ASC 605-35. Segmenting a contract may result in different interim rates of profitability for each scope of service than if the Company had recognized revenue without segmenting. The services to develop front-end software are a separate contract segment that meets the segmenting criteria in ASC 605-35. Revenues from the front-end software development services segment are recognized as the services are performed, which is measured based on the time incurred.

**Fair Value Measurements**

Fair value is defined as the price that would be received for sale of an asset or paid for transfer of a liability, in an orderly transaction between market participants at the measurement date. US GAAP establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). These tiers include:

- Level 1, defined as observable inputs such as quoted prices for identical instruments in active markets;
- Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable such as quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active; and
- Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions, such as valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

**Fair Value of Financial Instruments**

ASC 820, *Fair Value Measurement and Disclosures*, requires all entities to disclose the fair value of financial instruments, both assets and liabilities for which it is practicable to estimate fair value, and defines fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. As of December 31, 2017 and 2016, the recorded values of cash, accounts receivable, prepaid expenses, accounts payable, and accrued expenses approximate the fair values due to the short-term nature of the instruments. The notes payable and line of credit-related party are considered financial instruments. However, the Company is unable to reasonably determine the fair value of these obligations.

**Patent Asset**

The Company capitalizes patent costs incurred when the costs provide probable future economic benefit to the Company. Such capitalized costs include external legal costs incurred in the defense of the Company's patents when it is believed that the future economic benefit of the patent will be increased and a successful defense is probable. All capitalized patent costs as of December 31, 2017 and 2016 result from capitalization of direct legal costs incurred to successfully defend the Company's 978 patent. Capitalized patent defense costs are amortized over 15 years, which is the estimated useful life of the related patent.

The patent asset is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If circumstances require that the patent asset be tested for possible impairment, the Company first compares the undiscounted cash flows expected to be generated by the asset to its carrying amount. If the carrying amount of the asset is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying amount exceeds its fair value. As of December 31, 2017, management expects the patent asset to be fully recoverable based upon projected cash flows from existing and potential customer contracts and licenses to third parties. Actual results may differ from management's estimates and such differences may result in changes to the carrying value of the patent asset.

**Accrued Expenses**

The Company incurs periodic expenses such as salaries, taxes, and professional fees. An entry to accrue expenses is necessary when expenses have been incurred by the Company prior to them being paid. When a vendor's invoice is not received, the Company is required to estimate its accrued expenses. This process involves reviewing quotations and contracts, identifying services that have been performed on the Company's behalf and estimating the level of service performed and the associated cost incurred for the service when the Company has not yet been invoiced or otherwise notified of the actual cost. The majority of the Company's service providers invoice monthly in arrears for services performed or when contractual milestones are met. The Company estimates accrued expenses as of each balance sheet date based on facts and circumstances known at that time. The Company periodically confirms the accuracy of its estimates with the service providers and makes adjustments if necessary.

**Accounting for Income Taxes**

Deferred tax assets and liabilities are recognized for the expected future consequences of events that have been reflected in the consolidated financial statements. Deferred tax assets and liabilities are determined based on the differences between the book and tax basis of assets and liabilities and net operating loss carryforwards, using tax rates expected to be in effect for the years in which the differences are expected to reverse. The Company records a valuation allowance to reduce deferred income tax assets when it is more likely than not that some portion or all of the deferred tax asset will not be realized.

The Company applies a more-likely-than-not recognition threshold for all tax uncertainties. ASC Topic 740 only allows the recognition of those tax benefits that have a greater than fifty percent likelihood of being sustained upon examination by the taxing authorities. As of December 31, 2017, the Company reviewed its tax positions and determined there were no outstanding, or retroactive tax positions with less than a 50% likelihood of being sustained upon examination by the taxing authorities, therefore this standard has not had a material effect on the Company.

**Employee Stock-based Compensation**

Stock-based compensation issued to employees and members of the Company's Board of Directors is measured at the date of grant based on the estimated fair value of the award. The grant date fair value of a stock-based award is recognized as an expense over the requisite service period of the award on a straight-line basis. The Company elected to change its policy surrounding forfeitures with the adoption of the guidance in ASU No. 2016-09 on January 1, 2017. The Company no longer estimates the number of awards expected to be forfeited but instead accounts for them as they occur.

For purposes of determining the variables used in the calculation of stock-based compensation issued to employees, the Company performs an analysis of current market data and historical data to calculate an estimate of implied volatility and the expected term of the option. The Company uses these estimates as variables in the Black-Scholes option-pricing model. Depending upon the number of stock options granted, any fluctuations in these calculations could have a material effect on the results presented in the Company's Consolidated Statements of Operations.

**Stock-based Compensation Issued to Non-employees**

Common stock issued to non-employees for acquiring goods or providing services is recognized at fair value when the goods are obtained or over the service period, which is generally the vesting period. If the award contains performance conditions, the measurement date of the award is the earlier of the date at which a commitment for performance by the non-employee is reached or the date at which performance is reached. A performance commitment is reached when performance by the non-employee is probable because of sufficiently large disincentives for nonperformance.

**Treasury Stock**

The Company accounts for treasury stock under the cost method and includes treasury stock as a component of stockholders' deficit.

**Net loss per share**

Basic net loss per share was calculated by dividing net loss by the weighted-average common shares outstanding during the period. Diluted net loss per share was calculated by dividing net loss by the weighted-average common shares outstanding during the period using the treasury stock method or the two-class method, whichever is more dilutive. The table below summarizes potentially dilutive securities that were not considered in the computation of diluted net loss per share because they would be anti-dilutive.

*Potentially dilutive securities*

| | For the years ended December 31, | |
|---|---|---|
| | **2017** | **2016** |
| Warrants (Note 8) | 46,844,254 | 34,520,574 |
| Options (Note 9) | 12,346,217 | 10,699,217 |
| Convertible preferred stock (Note 7) | 1,990,848 | 1,990,848 |

**Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606*). The new guidance will supersede and replace existing U.S. GAAP revenue recognition guidance. ASU 2014-09 provides new criteria for recognizing revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new guidance requires expanded disclosures to provide greater insight into both revenue that has been recognized and revenue that is expected to be recognized in the future from existing contracts. Quantitative and qualitative information will be provided about the significant judgments and changes in those judgments that management made to determine the revenue that is recorded. The standard will be effective for the Company in the first interim period after December 31, 2018. The Company is currently assessing the provisions of the guidance and has not determined the impact of adoption on its Consolidated Financial Statements.

On February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. Under the new guidance, lessees will be required to recognize all leases (with the exception of short-term leases) on the balance sheet as a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. The new standard is effective for fiscal year beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the effect the guidance will have on its Consolidated Financial Statements. The effect of adoption of this standard on the Company's consolidated financial statements will depend on the leases existing at January 1, 2018. Based on the Company's leases as of December 31, 2017, however, management expects that adoption of ASU 2016-02 will not have a material effect on the Company's results of operations, financial position and cash flows.

In March 2016, the FASB issued ASU No. 2016-09, *Share-Based Payment: Simplifying the Accounting for Share-Based Payments*. The standard addresses several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new standard is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2016. The Company adopted this guidance effective January 1, 2017. Excess tax benefits recorded upon adoption of this standard are not material to the Consolidated Balance Sheets. The Company elected to change its policy surrounding forfeitures, and beginning January 1, 2017, the Company no longer estimates the number of awards expected to be forfeited but instead accounts for them as they occur. The Company implemented this portion of the guidance using a modified retrospective approach. However, the cumulative adjustment was not material to additional paid-in capital and therefore was not recorded. Other provisions of ASU 2016-09 had no impact on the Company's Consolidated Financial Statements.

In March 2016, the FASB issued ASU No. 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*. This new standard simplifies the embedded derivative analysis for debt instruments containing contingent call or put options by removing the requirement to assess whether a contingent event is related to interest rates or credit risks. This new standard will be in fiscal years beginning after December 15, 2016, and interim periods within those years. The adoption of this standard is not expected to have a material impact on the Company's financial position, results of operations, or cash flows.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, which addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact on the Company's Consolidated Statements of Cash Flows.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses*, which requires the measurement of expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable forecasts. The main objective of this ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The standard is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The Company is currently evaluating the effect the guidance will have on its Consolidated Financial Statements.

In May 2017, the FASB issued Accounting Standards Update ("ASU") 2017-09, *Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting ("ASU 2017-09")*, which clarifies when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. The new standard will be effective on January 1, 2018; however, early adoption is permitted. The Company adopted ASU No. 2017-09 as of January 1, 2018. The adoption of this update did not impact the Company's financial statements.

## NOTE 4 – PATENTS

Patents consist of the following:

| | As of December 31, | |
|---|---|---|
| | **2017** | **2016** |
| Cumulative successful patent defense costs | $ 1,593,639 | $ 1,593,639 |
| Less: Accumulated amortization | 701,744 | 595,015 |
| Total patents, net | **$ 891,895** | **$ 998,624** |

Amortization expense was approximately $107,000 and $106,000 for the years ended December 31, 2017 and 2016, respectively, and is classified in selling and general administrative expenses in the accompanying Consolidated Statements of Operations. Estimated amortization expense for each of the succeeding five years from December 31, 2017 is approximately $106,000 per year.

## NOTE 5 – NOTES PAYABLE

Debt consists of the following:

| | December 31, | |
|---|---|---|
| | **2017** | **2016** |
| **Debt:** | | |
| *Notes Payable* | | |
| Principal, 10% per annum | $ 75,000 | $ 75,000 |
| Debt discount | (10,329) | (18,349) |
| Principal - related party, 10% per annum | 785,000 | 785,000 |
| Debt discount - related party | (108,105) | (192,044) |
| Carrying value of notes payable | 741,566 | 649,607 |
| *Line of Credit - Related Party* | | |
| Outstanding balance, 10% per annum | 9,385,059 | 5,952,100 |
| Carrying value of line of credit - related party | 9,385,059 | 5,952,100 |
| **Total debt** | **$ 10,126,625** | **$ 6,601,707** |
| **Current maturities of debt** | **$ 10,126,625** | **$ -** |
| **Long term debt** | **$ -** | **$ 6,601,707** |

The Company had unamortized deferred debt costs of approximately $2.2 million and $2.8 million associated with the line of credit at December 31, 2017 and 2016, respectively, which are being amortized to interest expense on a straight-line basis over the term of the line of credit. Non cash interest expense related to the amortization of the deferred debt costs was approximately $2,824,000 and $1,336,000 for the years ended December 31, 2017 and 2016, respectively.

**Convertible note – related party**

On December 1, 2014, the Company issued an unsecured convertible note with a principal balance of $1,252,000 to the Chief Executive Officer ("CEO"), who is a significant shareholder. Interest accrued on the unpaid principal balance at 10% per annum and, together with the outstanding principal, is due and payable in a single installment on December 1, 2016 (the "Maturity Date"). The holder may, at anytime, convert the outstanding principal balance of the note and accrued interest into shares of the Company's common stock at a fixed conversion price of $0.55 per share by providing notice to the Company on or before the Maturity Date.

At the time of issuance, the conversion price was below the quoted market price of the Company's common stock. As such, the Company recognized a beneficial conversion feature equal to the intrinsic value of the conversion price on the issuance date, resulting in a discount to the unsecured promissory note of approximately $367,000 with a corresponding credit to additional paid-in capital. The resulting debt discount is presented net of the related convertible note balance in the Consolidated Balance Sheets and is amortized to interest expense over the note's term using the effective interest method. Borrowing capacity under the LOC was used to retire the outstanding principal balance of the convertible note on December 1, 2016. See description of the Third LOC, below.

**Notes payable - related party**

In June and August 2012, the Company issued unsecured promissory notes in the principal amount of $860,000 and ten-year warrants to purchase 781,818 shares of common stock, with an exercise price of $0.55 per share, for aggregate gross proceeds of $860,000 from existing shareholders and members of management. The notes accrued interest at 6% per annum. Notes with an aggregate principal balance of $535,000 were due and payable, along with accrued interest, prior to December 31, 2012. The remaining note with a principal balance of $325,000 was due, along with accrued but unpaid interest, on March 1, 2014. Upon the occurrence of an event of default, the note holder may demand immediate payment of the outstanding principal and all accrued but unpaid interest.

The warrants issued concurrent with the unsecured promissory notes were initially classified as liabilities and measured at fair value, pursuant to ASC 815-40. Upon amendment of the warrants at June 30, 2016 (see Note 8), these warrants are indexed to the Company's stock pursuant to ASC 815-40 and were reclassified to stockholders' deficit. At initial issuance, the gross proceeds of $860,000 were first allocated to the warrants with the remaining balance allocated to the notes, resulting in an initial carrying value of the notes of approximately $551,000. The resulting debt discount is presented net of the related notes payable balance in the Consolidated Balance Sheets and is amortized to interest expense over each note's term using the effective interest method.

As of March 1, 2014, all amounts due under the unsecured promissory notes were outstanding. On that date, the Company effectively issued new unsecured promissory notes to the holders, by amending the existing matured notes, to extend the maturity date of all notes to January 1, 2016 and to increase the interest rate of each note, beginning March 1, 2014, to 10% per annum. No additional amounts were loaned to the Company. In consideration for the amendments, the holders were issued ten-year warrants to purchase 781,818 shares of common stock at $0.55 per share. The initial fair value of the warrants of approximately $552,000 was recorded as a debt discount and presented net of the related notes payable balance in the Consolidated Balance Sheets. The Company amortized this debt discount to interest expense over each note's term using the effective interest method.

On December 31, 2015, the Company and the holders of the unsecured promissory notes amended the outstanding notes by extending the maturity date of all notes to December 31, 2018. No additional amounts were loaned to the Company and all other terms remain the same. In consideration for the amendments, the holders were issued ten-year warrants to purchase 781,818 shares of common stock at $0.55 per share. The initial fair value of the warrants of approximately $282,000 was recorded as a debt discount and presented net of the related notes payable balance in the Consolidated Balance Sheets. The debt discount will be amortized to interest expense over each note's term using the effective interest method.

**Lines of credit – related party**

On December 1, 2012, the Company executed a line of credit ("First LOC") with its CEO for up to $1,600,000. Outstanding amounts under the First LOC accrued interest at 6% per annum and were due and payable on December 1, 2013. The First LOC was not repaid when due. Concurrent with the issuance of the First LOC, the Company issued the lender ten-year warrants to purchase 1,500,000 shares of common stock at $0.55 per share. The initial fair value of the warrants of approximately $622,000 was amortized to interest expense on a straight-line basis over the First LOC's term.

On March 1, 2014, the Company amended the First LOC with the lender to increase the borrowing capacity from $1,600,000 to $3,200,000, increase the interest rate on all outstanding amounts to 10% per annum, effective March 1, 2014, and extending the maturity date to January 1, 2016. As of March 1, 2014, the Company had $1,240,000 outstanding under the First LOC. As consideration for amending the First LOC, the Company issued the lender ten-year warrants to purchase 1,500,000 shares of common stock at $0.55 per share. The initial fair value of the warrants of approximately $1.1 million is recognized as deferred debt costs in the Consolidated Balance Sheets and is amortized to interest expense on a straight-line basis over the amended First LOC's term.

On December 31, 2015, the Company amended the First LOC with the lender to extend the maturity date to December 31, 2018. As consideration for amending the First LOC, the Company issued the lender ten-year warrants to purchase 2,829,435 shares of common stock at $0.55 per share. The initial fair value of the warrants of approximately $1 million is recognized as deferred debt costs in the Consolidated Balance Sheets and is being amortized to interest expense on a straight-line basis over the amended First LOC's term.

On July 13, 2016, the Company executed a second line of credit ("Second LOC") with its CEO for up to $1,000,000. Outstanding amounts under the Second LOC accrue interest at 10% per annum and are due and payable on July 12, 2018. In connection with the issuance of the Second LOC, the Company issued the lender ten-year warrants to purchase 943,145 shares of common stock at $0.47 per share. The initial fair value of the warrants of approximately $368,000 is being amortized to interest expense on a straight-line basis over the Second LOC's term.

On November 9, 2016, the Company executed a third line of credit ("Third LOC") with its CEO for up to $3,252,500. An aggregate of $1,252,500 from the Third LOC was used to extinguish the outstanding principal of the convertible debt upon its maturity on December 1, 2016. Outstanding amounts under the Third LOC accrue interest at 10% per annum and are due and payable on December 31, 2018. In connection with the issuance of the Third LOC, the Company issued the lender ten-year warrants to purchase 7,283,619 shares of common stock at $0.24 per share. The initial fair value of the warrants of approximately $2 million is being amortized to interest expense on a straight-line basis over the Third LOC's term.

On June 22, 2017, the Company executed a fourth line of credit ("Fourth LOC") with its CEO for up to $3,000,000. Outstanding amounts under the Fourth LOC accrue interest at 10% per annum and are due and payable on December 31, 2018. In connection with the issuance of the Fourth LOC, the Company issued the lender ten-year warrants to purchase 12,500,000 shares of common stock at $0.12 per share. The initial fair value of the warrants of approximately $1.2 million is being amortized to interest expense on a straight-line basis over the Fourth LOC's term.

As of December 31, 2017, approximately $1.1 million remains available under the Fourth LOC.

## NOTE 6 – COMMITMENTS AND CONTINGENCIES

**Leases**

The Company leases its office space located in Long Beach, California through July 2020. The Company provided a cash security deposit in the amount of $60,000 and $100,000, respectively, which was included in other non-current assets in the Company's Consolidated Balance Sheets as of December 31, 2017 and 2016.

As of December 31, 2017, the remaining contractual minimum lease payments on the lease were as follows:

| | | Operating leases |
|---|---|---|
| Years Ending December 31, | | |
| 2018 | $ | 93,641 |
| 2019 | | 96,448 |
| 2020 | | 53,390 |
| Total lease commitments | $ | 243,479 |

The Company recognizes rent expense on a straight-line basis over the lease period. Any differences between rent expense and rent paid due to scheduled rent increases or rent abatements are included in deferred rent on the accompanying Consolidated Balance Sheets. Rent expense is classified within selling and general administrative expenses within the Company's Consolidated Statement of Operations and was approximately $92,000 and $82,000 for the years ended December 31, 2017 and 2016, respectively.

**Legal**

In May 2016, a judgment was reached against the Company regarding litigation with a vendor for disputed past due amounts. In October 2017, the Company and vendor reached a settlement of the amounts owed under the judgment. The Company agreed to an aggregate settlement amount of $90,000 for release of all claims. The settlement amount is to be paid over eight monthly installments beginning in October 2017. The remaining unpaid settlement amount of $45,000 is accrued in accounts payable as of December 31, 2017. The Company recorded a gain of $55,000 in the year ended December 31, 2017, related to the settlement.

On February 17, 2017, the Company filed a complaint against a customer in Superior Court in the State of California for breach of contract and other causes. The Company was seeking payment amounts due under a master services agreement and statements of work plus interest and reimbursement of associated legal fees and costs. On March 24, 2017, the customer petitioned the United States District Court for the Central District of California to move the Company's action to its jurisdiction and filed a counterclaim with the U.S. District Court for a declaration of patent invalidity and non-infringement, fraudulent inducement, unjust enrichment, breach of contract, and other causes. The Company has included its best estimate of an appropriate amount in the allowance for doubtful accounts to cover any additional costs of collection. On February 27, 2018, the customer and the Company (collectively, the "Parties") agreed to settle all claims and disputes between the Parties and terminate the master services agreement and statements of work entered into between the Parties.

Except as set forth above, there are no pending legal proceedings against the Company that are expected to have a material adverse effect on cash flows, financial condition or results of operations. From time to time, the Company could become involved in disputes and various litigation matters that arise in the normal course of business. These may include disputes and lawsuits related to intellectual property, licensing, contract law and employee relations matters. Periodically, the Company reviews the status of significant matters, if any exist, and assesses its potential financial exposure. If the potential loss from any claim or legal claim is considered probable and the amount can be estimated, the Company accrues a liability for the estimated loss. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. As additional information becomes available, the Company reassesses the potential liability related to pending claims and litigation.

## NOTE 7 – STOCKHOLDERS' DEFICIT

**Common Stock**

As of December 31, 2017, the Company is authorized to issue 310,880,000 shares of common stock each with the par value of $0.0001 per share. No dividends shall be paid upon common stock of the Company.

**Preferred Stock**

As of December 31, 2017 and 2016, the Company was authorized to issue 9,120,000 shares of preferred stock, each with the par value of $0.0001 per share, consisting of (a) 4,000,000 shares of Class A preferred stock, (b) 420,000 shares of Class A-1 preferred stock, (c) 1,200,000 shares of Class A-2 preferred stock, and (d) 3,500,000 shares of Junior preferred stock. All preferred stock is non-redeemable.

Conversion into Common Stock

Each share of preferred stock is convertible, at any time at the option of the holder or automatically upon the date specified in writing through the vote of at least a simple majority of the outstanding shares of the class to be converted, into such number of shares of fully paid and non-assessable shares of common stock as is determined by dividing the then-original issue price, as adjusted, ("Original Issue Price") for such share of preferred stock by the conversion price, as adjusted, in effect on the date the certificate is surrendered for conversion ("Conversion Price"). The Original Issue Prices of a share of the Class A, A-1, A-2 and the Junior preferred stock are $25.00. The initial Conversion Prices for Class A, A-1, and A-2 preferred stock are $0.3120099714, $0.1826287244, and $0.50 per share, respectively. The initial Junior preferred stock conversion ratio shall be such as is necessary to convert the outstanding Junior preferred stock into 1,963,096 shares of common stock.

Dividends

Dividends shall accrue cumulatively on each share of preferred stock at a rate per annum of 6% of the respective Original Issue Price of Class A, A-1, and A-2 preferred stock. Dividends shall accrue on each share of preferred stock in accordance with the foregoing on a daily basis from the date upon which such shares of Class A, A-1 and A-2 preferred stock were first issued (the "Initial Issuance Date"), and shall accrue whether or not declared and shall be payable after the Company has achieved three (3) consecutive quarters of positive net income or upon the occurrence of a liquidity event, whichever is first. Any such dividend payment shall be made ratably among the holders of Class A, A-1 and A-2 preferred stock in proportion to the amount of the shares of Class A, A-1 and A-2 preferred stock held by such holders, respectively. No dividends shall be paid upon the Junior preferred stock of the Company.

The Company has not achieved the above specified performance metric, which would trigger payment of dividends. As of December 31, 2017, the amount of dividends payable if the Company were to have achieved three consecutive quarters of positive net income, would be approximately $2.6 million. Declaration and payment of dividends is subject to approval of the AES, Ltd. Board of Directors.

Liquidation

*Liquidation Rights of* Class *A, A-1, and A-2 Preferred Stock Holders.*

Upon the occurrence of any liquidation event of the Company whether voluntary or involuntary, each holder of Class A, A-1, and A-2 preferred stock shall be entitled to receive, prior and in preference to any payment or distribution, or segregation for payment or distribution, of any assets of the Company to the holders of shares of common stock or the Junior preferred stock (or the holders of any other equity securities of the Company) by reason of their ownership thereof, for each share of Class A, A-1, and A- 2 preferred stock, an amount of cash equal to (i) $25.00 (as adjusted for stock splits, reverse stock splits, recapitalization and similar transactions), plus (ii) any accrued and unpaid dividends on such shares (the "Class A, A-1 and A-2 Liquidation Amount"). If upon the occurrence of liquidation event, the assets and funds available for distribution to shareholders are insufficient to permit the payment to the holders of the shares of Class A, A-1 and A-2 preferred stock of the full preferential amounts described above, then the entire assets and funds of the Company legally available for distribution to shareholders shall be distributed ratably among the holders of shares of Class A, A-1 and A-2 preferred stock in proportion to the then aggregate liquidation amounts of the shares of Class A, A-1 and A-2 preferred stock held by such holders.

*Liquidation Rights of Junior Preferred Stock Holders.*

Upon completion of the distributions to the Class A, A-1 and A-2 Preferred stock holders and the holders of any new series of preferred stock authorized by the Board of Directors, each holder of Junior preferred stock shall be entitled to receive, prior and in preference to any payment or distribution, or segregation for payment or distribution, of any assets of the Company to the holders of shares of common stock by reason of their ownership thereof, for each share of Junior preferred stock, an amount of cash equal to $25.00 (as adjusted for stock splits, reverse stock splits, recapitalizations and similar transactions). If upon the occurrence of liquidation event and after the distributions as required above to the holders of the preferred stock and to the holders of any new series of preferred stock authorized by the Board of Directors, the assets and funds available for distribution to shareholders are insufficient to permit the payment to the holders of the shares of the Junior preferred stock of the full preferential amounts described above, the entire assets and funds of the Company legally available for distribution to shareholders shall be distributed ratably among the holders of shares of Junior preferred stock in proportion to the then aggregate liquidation amounts of the shares Junior preferred stock held by such holders.

Significant Stock Transactions

In January 2016, the Company sold 500,000 shares of treasury stock and a two-year warrant to purchase 250,000 shares of common shares at €0.60 per share, for aggregate gross proceeds of €250,000. In connection with the issuance, the Company also issued a three-year warrant to purchase 50,000 shares of common shares at €0.50 per share to a vendor as offering costs. The warrants were initially classified as liabilities and measured at fair value, pursuant to ASC 815-40. Upon amendment of the warrants at June 30, 2016 (see Note 8), these warrants are indexed to the Company's stock pursuant to ASC 815-40 and were reclassified to stockholders' deficit. The initial fair value of the warrants of approximately $62,000 was recorded as a liability, with the difference in net proceeds and the initial warrant liability recorded in shareholders' deficit.

**Treasury Stock**

Subsequent to AES, Ltd being formed in November 2012 to April 2013, the Company sold an aggregate of 33,400,000 shares of common stock to a third party for par value and immediately repurchased those shares at par value, thereby increasing the total number of common stock issued and creating treasury stock available for trading on Bermuda and Frankfurt Stock Exchanges in compliance with rules promulgated by the BSX.

**NOTE 8 — WARRANTS**

Freestanding warrants are recognized and measured in accordance with ASC 480, *Distinguishing Liabilities from Equity,* and ASC 815-40, *Derivatives and Hedging: Contracts in Own Equity*. Under this guidance, prior to June 30, 2016, all of the Company's outstanding warrants to purchase the Company's common stock were classified as liabilities for one or both of the following reasons: i) the warrant agreement contains an exercise price that is denominated in a currency other than the Company's functional currency, and ii) the warrant agreement requires the Company to maintain applicable listing requirements with any exchange where its common shares are listed.

The warrant liability is measured at fair value at each reporting period with changes in fair value recorded as a gain or loss within other (income) expense in the Company's Consolidated Statements of Operations until the warrants are exercised, expire, or other facts and circumstances lead the warrant liability to be reclassified as an equity instrument.

In June 2016, the Company obtained the consent of a majority of the outstanding warrant holders, via a written resolution, to amend the warrant agreements, removing the requirement for the Company to maintain applicable listing requirements with any exchange where its common shares are listed and denominating the strike price of all warrants in USD. After obtaining such consent, the Company's Board of Directors approved the amendments to the warrant agreements on June 30, 2016. The amended terms are effective and binding on all warrant holders. On June 30, 2016, as a result of the amendments, all outstanding warrants are indexed to the Company's common shares pursuant to ASC 815-40. As such, the warrant liability was remeasured, with changes in fair value through that date recognized within other (income) expense in the Company's Consolidated Statements of Operations. The warrant liability balance of $8,150,536 on June 30, 2016, after being remeasured, was reclassified to additional paid-in capital within stockholders' deficit.

The warrant liability was a Level 3 fair value measurement, recognized on a recurring basis. Both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains and losses for liabilities within the Level 3 category may include changes in fair value that were attributable to both observable inputs (e.g., changes in market interest rates) and unobservable inputs (e.g., probabilities of the occurrence of an early termination event).

**Changes in Level 3 liabilities measured at fair value:**

| | | |
|---|---|---|
| **Fair value of warrant liability at December 31, 2015** | $ | 7,527,108 |
| Issuance of new warrant liability | | 62,139 |
| Change in fair value of warrant liability | | 561,289 |
| Reclassification of warrant liability to equity upon amendment of all outstanding warrant agreements | | (8,150,536) |
| **Fair value of warrant liability at December 31, 2016** | $ | - |

There were no transfers between Levels 1, 2 or 3 during 2016. There was no warrant liability at December 31, 2017.

Management used a Monte Carlo Simulation, with one million trials, and Black-Scholes method to estimate the fair value of the warrant during the year ended December 31, 2016, with the following key inputs:

| | |
|---|---|
| Expected dividend yield | 0.00% |
| Expected stock-price volatility | 73.89% - 81.46% |
| Risk-free interest rate | 0.2% - 1.88% |
| Term of warrants (years) | 1 - 10 |

The following table represents a summary of the warrants outstanding at December 31, 2017 and 2016 and changes during the years then ended:

| | Warrants | | Weighted Average Exercise Price |
|---|---|---|---|
| Outstanding at December 31, 2015 | 26,440,166 | $ | 0.88 |
| Issued | 8,526,764 | | 0.28 |
| Expired/ Forfeited | (446,356) | | 0.72 |
| Outstanding at December 31, 2016 | 34,520,574 | | 0.72 |
| Issued | 12,500,000 | | 0.12 |
| Expired/ Forfeited | (176,320) | | 4.42 |
| Outstanding at December 31, 2017 | 46,844,254 | | 0.57 |
| Exercisable at December 31, 2017 | 46,844,254 | $ | 0.57 |

## NOTE 9 – STOCK-BASED COMPENSATION

Terms of the Company's share-based compensation are governed by the Company's Share Option/ Share Issuance Plan (the "Stock Plan".) The shares issuable under the Plan shall be authorized but unissued or reacquired Common Shares. The maximum number of common shares which may be issued over the term of the Stock Plan shall not exceed 10,000,000 shares, except that by authorization of the Board, the sanctioned number of shares subject to the plan shall automatically be increased by 2% of the number of fully diluted shares of the Company effective January 1 of each year, commencing on January 1, 2013. The Plans permit the Company to grant non-statutory stock options, incentive stock options and stock purchase rights to the Company's employees, outside directors and consultants. The exercise price for each option shall be equal to 100% of the fair market value of the common stock on the date of grant, as defined, and shall vest as determined by the Company's Board of Directors but shall not exceed a ten-year period.

*Options Issued to Officers, Directors and Employees as Compensation*

Pursuant to the terms of the Stock Plan, during the year ended December 31, 2016, the Company issued an aggregate of 1,710,000 options to its employees, directors and officers, with a weighted average grant date fair value of $0.46 per option. These option grants had a ten-year term and exercise prices range from $0.29 to $0.66 per share, as determined by the Company's Board of Directors, and no intrinsic value at the date of grant. Of the 1,710,000 options granted, 110,000 options vest within one year, and the remaining vest over 4 years. The unvested shares are subject to repurchase by the Company at the lower of (i) the exercise price or (ii) the fair market value per share at the time of the optionee's cessation of service. Also, during the year ended December 31, 2016, an aggregate of 1,271,324 options issued to its employees, directors and officers were forfeited, leaving an aggregate of 7,012,000 options outstanding.

During the year ended December 31, 2017, the Company issued an aggregate of 2,360,000 options to its employees, directors and officers, with a weighted average grant date fair value of $0.14 per option. These option grants had a ten-year term and exercise prices range from $0.20 to $0.23 per share, as determined by the Company's Board of Directors, and no intrinsic value at the date of grant. Of the 1,710,000 options granted, 150,000 options vest within one year, and the remaining vest over 4 years. The unvested shares are subject to repurchase by the Company at the lower of (i) the exercise price or (ii) the fair market value per share at the time of the optionee's cessation of service. Also, during the year ended December 31, 2017, an aggregate of 613,000 options issued to its employees, directors and officers were forfeited, leaving an aggregate of 8,759,000 options outstanding.

The Company recognized an expense for these option awards of approximately $508,000 and $550,000 for the years ended December 31, 2017 and 2016, respectively, within general and administrative expenses in the Consolidated Statements of Operations.

*Options Issued to Nonemployees for Services Received*

During the year ended December 31, 2016, the Company issued an aggregate of 100,000 options to a consultant, with a weighted average grant date fair value of $0.38 per share. These option grants had a ten-year term, vest over four years, had an exercise price of $0.38 per share, and no intrinsic value at the date of grant. During the year ended December 31, 2016, an aggregate of 50,000 options issued to its consultants were forfeited, leaving an aggregate of 3,687,217 options outstanding at December 31, 2016.

During the year ended December 31, 2017, an aggregate of 100,000 options issued to its consultants were forfeited, leaving an aggregate of 3,587,217 options outstanding at December 31, 2017.

The Company recognized an expense for the 2016 option awards of approximately $3,000 for the year ended December 31, 2016, within general and administrative expenses in the Consolidated Statements of Operations. The forfeiture of the option awards in 2017 was recognized as a reduction of general and administrative expenses of approximately $3,000 in the year ended December 31, 2017.

*Options Valuation*

The Company calculates the fair value of stock-based compensation awards granted to employees and nonemployees using the Black-Scholes option-pricing method. If the Company determines that other methods are more reasonable, or other methods for calculating these assumptions are prescribed by regulators, the fair value calculated for the Company's stock options could change significantly. Higher volatility and longer expected lives would result in an increase to stock-based compensation expense to non-employees determined at the date of grant. Stock-based compensation expense affects the Company's selling, general and administrative expenses.

The Black-Scholes option-pricing model requires the use of highly subjective and complex assumptions, which determine the fair value of stock-based awards. The assumptions used in the Black-Scholes option-pricing method for the years ended December 31, 2017 and 2016 is set forth below:

| | For the years ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Expected dividend yield | 0.00% | 0.00% |
| Expected stock-price volatility | 77.0% - 78.9% | 72.9% - 79.9% |
| Risk-free interest rate | 2.20% - 2.22% | 1.3% - 2.4% |
| Stock price | $0.17 -$0.21 | $0.26 - $0.72 |
| Expected term (years) | 6.20 | 6.50 |

- *Expected dividend.* The expected dividend is assumed to be zero as the Company has never paid dividends and have no current plans to pay any dividends on the Company's common stock.
- *Expected volatility.* As the Company's common stock has been thinly traded since being listed in Bermuda and Frankfurt, the expected volatility is derived from the average historical volatilities of publicly traded companies within the Company's industry that the Company considers to be comparable to the Company's business over a period approximately equal to the expected term.
- *Risk-free interest rate.* The risk-free interest rate is based on the U.S. Treasury yield in effect at the time of grant for zero coupon U.S. Treasury notes with maturities approximately equal to the expected term.
- *Expected term.* The expected term represents the period that the stock-based awards are expected to be outstanding. The Company's historical share option exercise experience does not provide a reasonable basis upon which to estimate an expected term because of a lack of sufficient data. Therefore, the Company estimates the expected term by using the simplified method provided by the SEC. The simplified method calculates the expected term as the average of the time-to-vesting and the contractual life of the options.

The Company elected to change its policy surrounding forfeitures with the adoption of the guidance in ASU No. 2016-09 on January 1, 2017. The Company no longer estimates the number of awards expected to be forfeited but instead accounts for them as they occur.

The following table represents a summary of the options granted to employees and non-employees outstanding at December 31, 2017 and 2016, and changes during the period then ended:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) |
|---|---|---|---|
| Outstanding at December 31, 2015 | 10,210,541 | $ 0.48 | 5.8 |
| Granted | 1,810,000 | $ 0.59 | 8.9 |
| Expired/ Forfeited | (1,321,324) | $ 0.54 | - |
| Outstanding at December 31, 2016 | 10,699,217 | $ 0.49 | 5.5 |
| Granted | 2,360,000 | $ 0.23 | 8.9 |
| Expired/ Forfeited | (713,000) | $ 0.51 | - |
| Outstanding at December 31, 2017 | 12,346,217 | $ 0.44 | 5.3 |
| Exercisable at December 31, 2017 | 8,329,967 | $ 0.46 | 3.6 |
| Expected to be vested | 4,016,250 | $ 0.39 | 8.8 |

Total unrecognized stock-based compensation cost related to unvested stock options as of December 31, 2017 was approximately $501,000 and is expected to be recognized over a weighted-average period of approximately 1.5 years.

**NOTE 10 – RELATED PARTY TRANSACTIONS**

The Company entered into several consulting agreements with certain management personnel and stockholders. Consulting expenses from such agreements were approximately $564,000 for each of the year ended December 31, 2017 and 2016, included within selling and general administrative expenses in the accompanying Consolidated Statements of Operations.

Other than as disclosed herein and in Notes 3, 5, 7 and 10, the Company has not entered into or been a participant in any transaction in which a related party had or will have a direct or indirect material interest.

**NOTE 11 – INCOME TAXES**

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"), which makes broad and complex changes to the U.S. tax code. Certain of these changes may be applicable to the Company, including but not limited to, reducing the U.S. federal corporate tax rate from 35 percent to 21 percent, creating a new limitation on deductible interest expense, eliminating the corporate alternative minimum tax ("AMT"), modifying the rules related to uses and limitations of net operating loss carryforwards generated in tax years ending after December 31, 2017, and changing the rules pertaining to the taxation of profits earned abroad. Changes in tax rates and tax laws are accounted for in the period of enactment. The Tax Act reduces the corporate tax rate to 21 percent, effective January 1, 2018. Consequently, the Company has recorded a decrease related to deferred tax assets, exclusive of the corresponding change in the valuation allowance, for the year ended December 31, 2017. Due to the full valuation allowance on the deferred tax assets, there is no net adjustment to deferred tax expense or benefit due to the reduction of the corporate tax rate.

As of December 31, 2017, the Company has net operating loss carryforwards of approximately $28.7 million available to reduce future taxable income, if any, for Federal and state income tax purposes. The U.S. federal and state net operating loss carryforwards will begin to expire in 2034 for federal purposes and 2037 for state purposes.

Under the Internal Revenue Code ("IRC") Section 382, annual use of the Company's net operating loss carryforwards to offset taxable income may be limited based on cumulative changes in ownership. The Company has not completed an analysis to determine whether any such limitations have been triggered as of December 31, 2017. The Company has no income tax affect due to the recognition of a full valuation allowance on the expected tax benefits of future loss carry forwards based on uncertainty surrounding realization of such assets.

The Company's provision for income taxes differs from the result obtained when applying the statutory rate of 34% to pre-tax book loss due to nondeductible expenses, the impact of the federal statutory tax rate change disclosed above, offset by a decrease in our valuation allowance.

The tax effects of the temporary differences and carry forwards that give rise to deferred tax assets consist of the following:

| | As of December 31, | |
|---|---|---|
| | **2017** | **2016** |
| Deferred tax assets/(liabilities): | | |
| Net operating loss carryforwards | $ 8,043,467 | $ 10,027,757 |
| Deferred revenue | 397,532 | 501,718 |
| Net patent asset | (40,662) | (19,100) |
| Other | 161,684 | 151,517 |
| | | |
| Total deferred tax assets | 8,562,021 | 10,661,892 |
| Valuation allowance | (8,562,021) | (10,661,892) |
| Deferred tax assets, net of allowance | $ - | $ - |

The Company applies the accounting guidance for uncertainty in income taxes pursuant to ASC 740-10. The Company did not record any accruals for income tax accounting uncertainties for the year ended December 31, 2017 and 2016, respectively. The Company does not have any unrecognized tax benefits that will significantly decrease or increase within 12 months of December 31, 2017.

The Company's policy is to recognize interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense. The Company did not accrue either interest or penalties from inception through December 31, 2017.

The Company's major tax jurisdictions are the United States, California, and Bermuda. All of the Company's tax years will remain open three and four years for examination by the Federal and state tax authorities, respectively, from the date of utilization of the net operating loss. The Company does not have any tax audits pending.

**NOTE 12 – SUBSEQUENT EVENTS**

The Company has evaluated subsequent events through March 29, 2018, the date of which these statements were available for issuance, and determined there were no other events that have occurred as of the filing of these financial statements that would require adjustments to or disclosures to the financial statements.