NEOMEDIA TECHNOLOGIES INC
Form 10-Q/A
May 01, 2007

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

FORM 10 - Q/A
Amendment No. 1
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2006

OR

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

Commission File Number 0-21743

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

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**36-3680347** (I.R.S. Employer Identification No.)
2201 Second Street, Suite 600, Fort Myers, Florida (Address of Principal Executive Offices)	**33901** (Zip Code)

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

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

Large Accelerated Filer o Accelerated Filer x Non-accelerated Filer o

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

As of October 23, 2006, there were 663,369,101 outstanding shares of the issuer's Common Stock, and 22,000 outstanding shares of the issuer's Series C convertible preferred stock.

EXPLANATORY NOTE

Restatement of Prior Reported Amounts

This form 10-Q/A is being filed to restate the revenue and cost of goods sold reported by NeoMedia filed on form 10-Q for the three and nine months ended September 30, 2006 (the "Original Filing"). This amendment amends and restates the Original Filing solely as a result of, and to reflect, the restatement, and no other information in the Original Filing is amended hereby except for an update to NeoMedia's revenue recognition policy.

The restatement of revenue and cost of goods sold is required because while preparing NeoMedia's annual report for the year ended December 31, 2006, the Company became aware that it incorrectly applied the principles of EITF 99-19. The Company, in reviewing its accounting practices with respect to revenue recognition of its subsidiary NeoMedia Telecom Services, became aware that it incorrectly applied the principles of EITF 99-19, "Reporting Revenue Gross as a Principal vs. Net as an Agent." As a result, the Company had overstated its net sales and its cost of goods sold during the three and nine months ended September 30, 2006. These amounts are reflected on the statement of operations. The adjustment does not affect net income (loss) during any period. The adjustment does not affect the statement of cash flows or balance sheet.

The NeoMedia Telecom Services business was acquired in March 2006 through the acquisition by the Company of BSD Software. Therefore the adjustment does not affect any results reported during the three and nine months ended September 30, 2005.

As a result, the Company has restated certain financial information that was previously reported in its unaudited quarterly reports on Form 10-Q for the three and nine month periods ended September 30, 2006. The following tables provide a reconciliation of amounts previously reported by the Company.

		Previously Reported	Restatement Adjustment		Restated Amount
Three months ended September 30, 2006					
Net sales	$	6,249	($2,658)	$	3,591
Cost of sales		4,112	(2,658)		1,454
Nine months ended September 30, 2006					
Net sales	$	14,129	($5,285)	$	8,844
Cost of sales		8,887	(5,285)		3,602

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In Thousands, Except Share Data)

	September 30, 2006 (unaudited)	December 31, 2005 *
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,133	$ 1,704
Trade accounts receivable, net of allowance for doubtful accounts of $96 and $203, respectively	6,097	130
Inventories, net of allowance for obsolete & slow-moving inventory of $0	53	2
Investment in marketable securities	255	104
Prepaid expenses and other current assets	753	121
Assets held for sale	3,451	4,058
Total current assets	13,742	6,119
Leasehold improvements & property and equipment, net	564	110
Goodwill	50,082	—
Other Intangible assets, net	21,405	3,274
Cash surrender value of life insurance policy	797	769
Loan to Mobot	—	1,500
Other long-term assets	1,232	639
Total assets	$ 87,822	$ 12,411
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 5,550	$ 1,502
Amounts payable under settlement agreements	97	97
Liabilities of discontinued business unit	676	676
Liabilities held for sale	750	669
Taxes payable	1,178	85
Accrued expenses	4,771	1,833
Deferred revenues and other	1,925	307
Notes payable	2,340	3,015
Derivative financial instruments	26,677	—
Total current liabilities	43,964	8,184
Long term debentures payable	73	—
Preferred stock, $0.01 par value, 25,000,000 shares authorized, 22,000 issued and outstanding, liquidation value of $22,000.	2,931	—

Shareholders' equity:				
Common stock, $0.01 par value, 5,000,000,000 shares authorized, 656,853,390 and 475,387,910 shares issued and 655,211,964 and 467,601,717 outstanding, respectively		6,552		4,676
Additional paid-in capital		155,359		106,287
Deferred equity financing costs		—		(13,256)
Accumulated deficit		(119,618)		(92,524)
Accumulated other comprehensive loss		(660)		(177)
Treasury stock, at cost, 201,230 shares of common stock		(779)		(779)
Total shareholders' equity		40,854		4,227
Total liabilities and shareholders' equity	$	87,822	$	12,411

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

* - Derived from NeoMedia's audited financial statements for the year ended December 31, 2005 and reclassified assets and liabilities held for sale related to the Micro Paint business unit.

1

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
and Comprehensive Income (Loss) (Unaudited)
(In Thousands, Except Share and per Share Data)

	Three Months Ended September 30	
	2006	**2005** (*)
Net sales	$ 3,591	$ 193
Cost of sales	1,454	116
Gross profit	2,137	77
Sales and marketing expenses	2,795	589
General and administrative expenses	2,659	765
Research and development costs	1,013	123
Stock based compensation expense	2,320	93
Loss from operations	(6,650)	(1,493)
Gain on extinguishment of debt	—	1
Interest income (expense), net	(112)	(77)
Write-off of deferred equity financing costs	(13,256)	—
Change in fair value from revaluation of warrants and embedded conversion features	(9,271)	—
NET LOSS FROM CONTINUING OPERATIONS	**(29,289)**	**(1,569)**
DISCONTINUED OPERATIONS (Note 4)		
Net loss from Micro Paint business to be sold	(1,620)	(381)
NET LOSS	(30,909)	(1,950)
Accretion of dividends on convertible preferred stock	(604)	—
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	**(31,513)**	**(1,950)**
Comprehensive Loss:		
Net loss	(30,909)	(1,950)
Other comprehensive loss:		
Unrealized loss on marketable securities	(312)	(4)
Foreign currency translation adjustment	108	15
COMPREHENSIVE LOSS	**$ (31,113)**	**$ (1,939)**
Loss per share from continuing operations—basic and diluted	**$ (0.05)**	**$ (0.00)**
Loss per share from discontinued operations—basic and diluted	**$ (0.00)**	**$ (0.00)**
Net loss per share—basic and diluted	**$ (0.05)**	**$ (0.00)**
Loss per share attributable to common shareholders — basic and diluted	**$ (0.05)**	**$ (0.00)**

Weighted average number of common shares—basic and diluted	**644,720,857**	**456,695,836**

* - Reclassifiied operations related to the Micro Paint business unit to discontinued operations (Note 4).

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

2

NeoMedia Technologies, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
and Comprehensive Income (Loss) (Unaudited)
(In Thousands, Except Share and per Share Data)

	Nine Months Ended September 30	
	2006	**2005** (*)
Net sales	$ 8,844	$ 762
Cost of sales	3,602	440
Gross profit	5,242	322
Sales and marketing expenses	6,719	1,332
General and administrative expenses	6,752	2,143
Research and development costs	2,309	365
Stock based compensation expense	4,948	593
Loss from operations	(15,486)	(4,111)
Gain (loss) on extinguishment of debt	(1,858)	172
Interest income (expense), net	(191)	(223)
Write-off of deferred equity financing costs	(13,256)	—
Change in fair value from revaluation of warrants and embedded conversion features	6,523	—
NET LOSS FROM CONTINUING OPERATIONS	(24,268)	(4,162)
DISCONTINUED OPERATIONS (Note 4)		
Net loss from Micro Paint business to be sold	(2,826)	(1,307)
NET LOSS	(27,094)	(5,469)
Accretion of dividends on convertible preferred stock	(1,220)	—
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	(28,314)	(5,469)
Comprehensive Loss:		
Net loss	(27,094)	(5,469)
Other comprehensive loss:		
Unrealized loss on marketable securities	(49)	(133)
Foreign currency translation adjustment	(434)	24
COMPREHENSIVE LOSS	$ (27,577)	$ (5,578)
Loss per share from continuing operations—basic and diluted	$ (0.04)	$ (0.01)
Loss per share from discontinued operations—basic and diluted	$ (0.00)	$ (0.00)
Net loss per share—basic and diluted	$ (0.04)	$ (0.01)
Loss per share attributable to common shareholders — basic and diluted	$ (0.05)	$ (0.01)

Weighted average number of common shares—basic and diluted	**602,132,555**	**451,487,240**

* - Reclassified operations related to the Micro Paint business unit to discontinued operations (Note 4).

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

3

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

	Nine Months Ended September 30,	
	2006	**2005**
CASH FLOWS FROM OPERATING ACTIVITIES:		(*)
Net loss from continuing operations	($24,268)	($4,162)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,209	359
Loss on early extinguishment of debt	1,858	—
Change in fair value from revaluation of warrants and embedded conversion features	(6,523)	—
Write-off of deferred equity financing costs	13,256	—
Stock-based compensation expense	4,948	593
Interest expense allocated to debt	22	—
Increase in value of life insurance policies	(28)	(13)
Changes in operating assets and liabilities		
Trade accounts receivable, net	(918)	(28)
Inventory	55	—
Other current assets	(252)	(671)
Accounts payable, amounts due under settlement agreements, liabilities in excess of assets of discontinued business unit and accrued expenses	553	(283)
Deferred revenue other current liabilities	707	(118)
Net cash used in operating activities	(8,381)	(4,323)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Cash paid to acquire Mobot, Inc., Sponge Ltd., Gavitec AG, and 12Snap AG, net of cash acquired	(11,891)	—
Acquisition of property and equipment	(339)	(54)
Capitalization of software development and purchased intangible assets	(160)	(1,639)
Investment in iPoint-media	—	(500)
Advances to discontinued Micro Paint Repair subsidiary	(1,633)	(1,924)
Acquisition related costs	(164)	—
Amounts issued under notes receivable	(500)	—
Net cash used in investing activities	(14,687)	(4,117)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowing under notes payable and convertible debt instrument	5,000	9,932
Repayments on notes payable and convertible debt instrument	(2,530)	(5,811)
Net proceeds from issuance of common stock, net of issuance costs of $24 in 2006 and $105 in 2005	210	6,262
Net proceeds from issuance of Series C convertible preferred stock, net of issuance costs of $2,725 in 2006	14,066	—
Net proceeds from exercise of stock options and warrants	8,419	909

Cash commitment fee for $100 million Standby Equity Distribution Agreement		—		(1,000)
Net cash provided by financing activities		25,165		10,292
EFFECT OF EXCHANGE RATE CHANGES ON CASH FOR CONTINUING OPERATIONS		(668)		—
NET INCREASE IN CASH AND CASH EQUIVALENTS FROM CONTINUING OPERATIONS		1,429		1,852
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		1,704		2,606
CASH AND CASH EQUIVALENTS, END OF PERIOD	**$**	**3,133**	**$**	**4,458**
SUPPLEMENTAL CASH FLOW INFORMATION:				
Interest paid during the period		48		47
Non-cash investing and financing activities:				
Unrealized gain (loss) on marketable securities		(361)		—
Prepaid acquisition costs applied to purchase price		168		—
Fair value of shares and notes receivable from Pickups Plus, Inc. acquired in exchange for Series C Convertible Preferred Stock		594		—
Carrying value of promissory note and accrued interest paid in exchange for Series C Convertible Preferred Stock		(3,208)		—
Fair value of shares issued to acquire Mobot, Inc., Sponge Ltd., Gavitec AG, 12Snap AG, and BSD Software, Inc.		46,964		—
Change in net assets resulting from acquisitions of Mobot, Inc., Sponge Ltd., Gavitec AG, 12Snap AG, and BSD Software, Inc.		62,240		—
Accretion of dividends on Series C Convertible Preferred Stock		1,824		—
Fair value of outstanding warrants reclassified to liabilities		13,884		—
Portion of change in fair value of outstanding warrants converted to liabilities recorded to paid-in capital		3,790		—
Fair value of Series C Convertible Preferred Stock (host instrument only)		4,908		—
Deferred stock-based financing costs associated with Series C Convertible Preferred Stock		3,198		—
Difference between net proceeds and recorded fair value of Series C Convertible Preferred Stock		4,041		—
Advance receivable from Mobot, Inc. forgiven upon acquisition		1,500		—
Gain (loss) on extinguishment of debt paid in common stock		—		349
Fair value of stock issued for services and deferred to future periods		—		239
Direct costs associated with Standby Equity Distribution Agreement and Equity Line of Credit		—		1,204
Fair value of warrants issued as fees related to the $100 million Standby Equity Distribution Agreement		—		12,256

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

*2005 cash flows have been reclassified to remove the cash flows from the NeoMedia Micro Paint Repair business unit, which has been reclassified to discontinued operations and assets and liabilities held for sale.

4

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

1. BASIS OF PRESENTATION AND NATURE OF BUSINESS OPERATIONS

Basis of Presentation

The condensed consolidated financial statements include the financial statements of NeoMedia Technologies, Inc. and its wholly-owned subsidiaries ("NeoMedia" or the "Company"). The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete consolidated financial statements. These condensed consolidated financial statements and related notes should be read in conjunction with the Company's Form 10-KSB for the fiscal year ended December 31, 2005. In the opinion of management, these condensed consolidated financial statements reflect all adjustments which are of a normal recurring nature and which are necessary to present fairly the consolidated financial position of NeoMedia as of September 30, 2006, the results of operations for the three and nine month periods ended September 30, 2006 and 2005, and cash flows for the nine month periods ended September 30, 2006 and 2005. The results of operations for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results which may be expected for the entire fiscal year. All significant intercompany accounts and transactions have been eliminated in preparation of the condensed consolidated financial statements.

Going Concern

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. Net loss for the nine months ended September 30, 2006 was $27,094,000, which includes a gain from the change in fair value from revaluation of warrants and embedded conversion features of $6,523,000 and a charge for the write-off of the deferred equity financing costs of $13,256,000. NeoMedia also reported net losses of $9,147,000 and $7,230,000 for the years ended December 31, 2005 and 2004, respectively, and has an accumulated deficit of $119,618,000 and a working capital deficit of $30,222,000 as of September 30, 2006.

In addition, NeoMedia has material liquidity events that could adversely affect its ability to continue as a going concern, primarily:

- In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees.

- During the nine months ended September 30, 2006, NeoMedia made cash payments totaling $2.1 million to silent partners of 12Snap, as partial payment under silent partner agreements entered into by 12Snap prior to the acquisition of 12Snap by NeoMedia. The agreements call for additional cash payments of approximately $2.5 million on or before December 31, 2006.

If the Company's financial resources are insufficient, the Company may require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity, debt, or another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations. The financial statements do not include any adjustments relating to the recoverability and reclassification of recorded asset amounts or amounts and reclassification of liabilities that might be necessary, should the Company be unable to continue as a going concern.

During August 2006, NeoMedia announced its intent to sell its Micro Paint Repair business unit. NeoMedia expects to receive cash proceeds from the sale of the division, which will be used to fund the operations and growth of the NeoMedia Mobile and NeoMedia Telecom Services businesses.

Should these financing sources fail to materialize, management would seek alternate funding sources such as the sale of common and/or preferred stock, the issuance of debt, or the sale of its marketable assets. Management's plan is to secure adequate funding to bridge the profitability from the NeoMedia Mobile and NeoMedia Telecom Services businesses.

Nature of Business Operations

Historically, NeoMedia has been structured and evaluated by its Board of Directors and management as three distinct business units: NeoMedia Internet Switching Software (NISS), NeoMedia Micro Paint Repair (NMPR), and NeoMedia Consulting and Integration Services (NCIS).

NCIS is the original business line upon which the Company was founded. This unit resells client-server equipment and related software, and general and specialized consulting services. Because of decreased demand for systems integration products, and increased consolidation and competition in the industry in general, during 2005 resources allocated to the NCIS business unit were increasingly used in sales and business development efforts associated with the NISS business unit. During February 2006, NeoMedia's Board of Directors elected to formally wind down the NCIS business unit. As a result, during February 2006, NeoMedia closed its Lisle, Illinois facility out of which the NCIS business unit was based. NeoMedia does, however, plan to continue servicing existing contracts and customers.

During the first quarter of 2006, following the completion of the acquisitions of 12Snap AG (“12Snap”), Sponge Ltd. (“Sponge”), Gavitec AG (“Gavitec”), Mobot, Inc. (“Mobot”), and BSD Software, Inc. (“BSD”), as well as the winding down of the NCIS business unit, NeoMedia restructured into the following three business units:

- NeoMedia Mobile (NMM) - encompassing NeoMedia's physical-world-to-internet and mobile marketing technologies branded under Qode®, 12Snap, Sponge, Gavitec and Mobot. During the second quarter of 2006, NeoMedia rebranded its PaperClick suite of products under the brand name Qode®.

- NeoMedia Telecom Services (NTS) - encompassing the billing, clearinghouse and information management services of Triton Global Business Services, the operating subsidiary of BSD Software, which was acquired in March 2006

- NeoMedia Micro Paint Repair (NMPR) - encompassing the micro paint and auto aftermarket accessories manufactured and distributed by NeoMedia

On August 30, 2006, NeoMedia signed a non-binding letter of intent to sell its Micro Paint Repair business unit to Jose Sada, a technology partner of NeoMedia Micro Paint Repair, backed by Global Emerging Markets Group of New York City. The letter of intent calls for completion of the transaction on or before November 24, 2006.

Reclassifications

Certain amounts in the 2005 condensed consolidated financial statements have been reclassified to conform to the 2006 presentation, most notably, “License revenue” and “Resales of software and technology equipment and service fees”, which were formerly reported as separate line items on NeoMedia's consolidated statement of operations, are now condensed into the category entitled, “Technology license, service & products.” This is primarily due to the winding down of the former NCIS business unit and consolidation of revenues relating to the NCIS unit into the NMM unit, as well as the addition of new revenue streams from Mobot, Sponge, Gavitec, 12Snap, and BSD that fall into the same general category.

In addition, due to the pending sale of the Micro Paint Repair business unit, results of operations from this unit have been reclassified to restate into the caption “Net loss from Micro Paint business to be sold” for all periods shown, and assets and liabilities relating to this unit are combined into the captions “Assets held for sale” and “Liabilities held for sale,” respectively. Additionally, the statement of cash flows for the nine months ended September 30, 2005 has been restated to exclude the cash flows of the discontinued Micro Paint Repair business unit.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

As a result of the addition of the operations of Mobot, Sponge, Gavitec, 12Snap and BSD, and the issuance of the Series C convertible preferred stock and a convertible debenture during the nine months ended September 30, 2006, NeoMedia is presenting certain significant accounting policies that were not applicable as of the filing of its last annual report for the year ended December 31, 2005.

Stock-based Compensation

Beginning January 1, 2006, NeoMedia began to account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment* . Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted. Stock-based compensation expense is calculated using the Black-Scholes-Merton option pricing model on the date of grant. This option valuation model requires input of highly subjective assumptions. Because NeoMedia's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing model does not necessarily provide a reliable single measure of fair value of its employee stock options.

Fair Value of Derivatives

The Company generally does not use derivative financial instruments to hedge exposures to cash-flow risks or market-risks that may affect the fair values of its financial instruments. However, certain other financial instruments, such as warrants and embedded conversion features that are indexed to the Company's common stock, are classified as liabilities when either (a) the holder possesses rights to net-cash settlement or (b) physical or net-share settlement is not within the control of the Company. In such instances, net-cash settlement is assumed for financial accounting and reporting, even when the terms of the underlying contracts do not provide for net-cash settlement. Such financial instruments are initially recorded at fair value and subsequently adjusted to fair value through a change to earnings at the close of each reporting period.

The caption "Derivative Financial Instruments" consists of (i) the fair values associated with derivative features embedded in the Series C convertible preferred stock, (ii) the fair values of the detachable warrants that were issued in connection with the preferred stock and the convertible debenture financing arrangements, and (iii) the fair value of detachable warrants that were outstanding prior to the issuance of the preferred stock and the convertible debenture financing arrangements.

Sales Taxes Payable

Sales taxes payable represents amounts collected on behalf of specific regulatory agencies that require remittance on a specified date. These amounts are collected at the time of sales and are detailed on invoices provided to customers. At September 30, 2006 sales taxes payable were $1,178,000, of which $851,000 were delinquent sales taxes assumed by NeoMedia in connection with its acquisitions, certain of which are subject to payment plans. In compliance with the Emerging Issues Task Force consensus on issue number 06-03, NeoMedia accounts for sales taxes on a net basis.

Revenue Recognition

NeoMedia derives revenues from the following sources: (1) license revenues relating to patents and internally-developed software, (2) hardware, software, and service revenues related to mobile marketing campaign design and implementation, and (3) sale of its proprietary Micro Paint Repair solution.

(1) Technology license fees, including Intellectual Property licenses, represent revenue from the licensing of NeoMedia's proprietary software tools and applications products. NeoMedia licenses its development tools and application products pursuant to non-exclusive and non-transferable license agreements. The basis for license fee revenue recognition is substantially governed by American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"), as amended, and Statement of Position 98-9, Modification of SOP 97-2, "Software Revenue Recognition, With Respect to Certain Transactions.". License revenue is recognized if persuasive evidence of an agreement exists, delivery has occurred, pricing is fixed and determinable, and collectibility is probable. The Company defers revenue related to license fees for which amounts have been collected but for which revenue has not been recognized in accordance with the above, and recognizes the revenue over the appropriate period.

(2) Technology service and product revenue, which includes sales of software and technology equipment and service fee is recognized based on guidance provided in SEC Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition in Financial Statements," as amended (SAB 104). Software and technology equipment resale revenue is recognized when persuasive evidence of an arrangement exists, the price to the customer is fixed and determinable, delivery of the service has occurred and collectibility is reasonably assured. Service revenues including maintenance fees for providing system updates for software products, user documentation and technical support are recognized over the life of the contract. The Company's subsidiaries, Mobot (sold during 2006), and Gavitec follow this policy. The Company defers revenue related to technology service and product revenue for which amounts have been invoiced and or collected but for which the requisite service has not been provided. Revenue is then recognized over the matching service period.

(3) Technology service also includes mobile marketing services to its customers which mobile marketing projects are recognized after the completion of the project and accepted by the customer. All response and messaging based revenues are recognized at the time such responses are received and processed and the Company recognizes its premium messaging revenues on a net basis based on guidance provided in Emerging Issues Task Force Issues No. 99-19 (EITF 99-19), "Reporting Revenue Gross as Principal or Net as an Agent" and No. 01-09 (EITF 01-09), "Accounting for Consideration Given by a Vendor to a Customer." Consulting and management revenues and revenues for periodic services are recognized as services are performed. NeoMedia uses stand-alone pricing to determine an element's vendor specific objective evidence ("VSOE") in order to allocate an arrangement fee amongst various pieces of a multi-element contract. The Company's subsidiaries 12Snap and Sponge (sold during 2006) follow this policy. Telecom revenues from NeoMedia's subsidiary BSD are recognized at the time that calls are accepted by the clearinghouse for billing to customers on a net basis, based on guidance in EITF 99-19. The Company defers revenue related to mobile marketing service fees for which amounts have been invoiced and/or collected but for which revenue has not been recognized. Revenue is then recognized over the matching service period.

(4) Revenue for licensing and exclusivity on NeoMedia's Micro Paint Repair systems is recognized equally over the term of the contract, which is currently one year. A portion of the initial fee paid by the customer is allocated to licensing, training costs and initial products sold with the system. Revenue is recognized upon completion of training and shipment of the products, provided there is VSOE in a multiple element arrangement. Ongoing product and service revenue is recognized as products are shipped and services performed. The Company defers revenue related to micro paint repair licensing for which amounts have been invoiced and/or collected and revenue is then recognized over the estimated contract period, which is currently one year.

3. ACQUISITIONS

During the nine months ended September 30, 2006, NeoMedia completed acquisitions of Mobot, Sponge, Gavitec, 12Snap, and BSD.

Acquisition of Mobot

On February 9, 2006, NeoMedia and Mobot signed a definitive merger agreement, subject to closing conditions, under which NeoMedia acquired all of the outstanding shares of Mobot in exchange for $3,500,000 cash and 16,931,493 shares of NeoMedia common stock (2,604,845 of which are being held in escrow for a period of one year from the closing date for the purpose of securing the indemnification obligations outlined in the purchase agreement). On February 17, 2006, NeoMedia and Mobot completed the closing requirements and the acquisition became effective. In addition to cash and stock, at closing NeoMedia forgave notes payable totaling $1,500,000 due from Mobot. This amount is considered other additional consideration in the purchase price allocation. Pursuant to the terms of the merger agreement, the number of shares of NeoMedia common stock that were issued as stock consideration was calculated using a share price of $0.3839, which was the volume-weighted average closing price of NeoMedia common stock for the ten days up to and including February 8, 2006. The merger agreement between NeoMedia and Mobot also contained a provision that, in the event that NeoMedia's stock price at the time the consideration shares become saleable is less than $0.3839, NeoMedia would be obligated to compensate Mobot shareholders in cash for the difference between the price at the time the shares become saleable and $0.3839. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have had a cash liability of $4.8 million resulting from this clause.

Mobot is a pioneer in visual search and recognition technology designed to make marketing effective and innovative using mobile devices. Launched in 2004 to help companies cultivate rewarding relationships with mobile phone users, Mobot gives marketers, content providers and carriers the tools to make it easy for any consumer with a camera phone to interact with their offerings. Mobot's customers include, amongst others, ELLEgirl magazine, for which Mobot "turned on" advertisements throughout the magazine that linked to content and customer loyalty promotions on the mobile Internet; The Light Agency, who distributes Mobot's visual search and recognition technology to the U.K. grocery sector through its award-winning mobile phone-based loyalty program with the Sainsburys-owned convenience store chain Jackson's; and Warner Music Group's U.S. sales and retail marketing company WEA Corp., running a snap-and-enter contest in music stores for music fans to win tailored offers, samples and discounts.

NeoMedia completed the acquisitions of Mobot, Sponge, Gavitec, and 12Snap in an effort to gain entry into the rapidly evolving global mobile marketing industry.

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

		(Dollars in Thousands)
Value of 16,931,493 shares issued at $0.395 per share(1)	$	6,688
Cash paid		3,500
Direct costs of acquisition		8
Advances to Mobot forgiven at acquisition		1,500
Total Fair Value of Purchase Price		11,696
Assets Purchased:		
Cash and cash equivalents	$	328
Accounts receivable		68
Other current assets		49
Property, plant & equipment		30
Intangible assets		13
Customer contracts and relationships		440
Capitalized software platform		4,200
Copyrighted materials		90
Goodwill		6,778
Total Assets Purchased		11,996
Less Liabilities Assumed:		
Accounts payable	$	51
Accrued liabilities		132
Deferred revenue		117
Total Liabilities Assumed		300

(1) - Shares were valued using the average stock price for two days before and two days after the measurement date, as defined in SFAS 141 and EITF 99-12

The combination was accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price to the assets acquired and liabilities assumed was based on an independent valuation report obtained by the Company. The allocation is subject to change resulting from the purchase price guarantee contingency described above.

The values assigned to intangible assets, aside from goodwill, are subject to amortization. The intangible assets were assigned the following lives for amortization purposes:

Intangible asset	Estimated useful life (in years)
Customer contracts and relationships	5
Copyrighted materials	5
Capitalized software platform	7

Goodwill was not assigned a life and will be tested for impairment as defined by Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

The accompanying consolidated statement of operations presented herein for the nine months ended September 30, 2006, contains the results of operations for Mobot for the period from February 18, 2006, through September 30, 2006. The accompanying consolidated statement of operations presented herein for the three months ended September 30, 2006, contains the results of operations for Mobot for the entire nine month period. Pro-forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented at the end of this Note 3.

Acquisition of Sponge

On February 20, 2006, NeoMedia and Sponge signed a definitive share purchase agreement, subject to closing conditions, under which NeoMedia acquired all of the outstanding shares of Sponge in exchange for $6,141,000 cash and 33,097,135 shares of NeoMedia common stock (3,400,490 of which are being held in escrow for a period of one year from the closing date for the purpose of securing the indemnification obligations outlined in the purchase agreement). The agreement also calls for Sponge to earn an additional £2,500,000 (approximately $4.4 million) in the form of NeoMedia common stock if, during the two-year period beginning at closing, the Sponge business earns in excess of £1,300,000 (approximately $2.3 million) in net profits. On February 23, 2006, NeoMedia and Sponge completed the closing requirements and the acquisition became effective. Pursuant to the terms of the merger agreement, the number of shares of NeoMedia common stock to be issued as consideration was calculated using a share price of $0.384, which was the volume-weighted average closing price of NeoMedia common stock for the ten days up to and including February 8, 2006. In the event that NeoMedia's stock price (at the time the consideration shares are saleable) is less than $0.384, NeoMedia is obligated to compensate Sponge shareholders in cash for the difference between the price at the time the shares become saleable and $0.384. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $9.4 million resulting from this clause.

Founded in 2001, Sponge has grown to become a U.K. market leader in providing mobile applications to agencies and media groups, and gain recognition as one of Europe's top independent developers of mobile applications and content. Today, Sponge counts more than 40 agencies, including WPP, Aegis and BBH, as clients, and supplies services for over 100 world-class brands, including Coca Cola® , Heineken® and Diageo. Sponge also supplies a range of mobile services to media groups, including News International, Trinity Mirror, Endemol and IPC. For Walker's (Frito-Lay) potato chips, Sponge enabled a promotion that offered consumers of Walker's — the U.K.'s largest snack brand — to win an iPod every 5 minutes for 4 weeks, by texting a unique code found on-pack into the Sponge platform. More than 5% of the total U.K. population participated in the campaign, which has been expanded to Belgium and the Netherlands on the basis of its success in the U.K. A total of 23% of the U.K. population interacted with Sponge applications in 2005.

NeoMedia completed the acquisitions of Mobot, Sponge, Gavitec, and 12Snap in an effort to gain entry into the rapidly evolving global mobile marketing industry.

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

		(Dollars in Thousands)
Value of 33,097,135 shares issued at $0.395 per share[1]	$	13,073
Cash paid		6,141
Direct costs of acquisition		194
Total Fair Value of Purchase Price		19,408
Assets Purchased:		
Cash and cash equivalents	$	177
Accounts receivable		617
Other current assets		35
Property, plant & equipment		53
Customer contracts and relationships		400
Capitalized software platform		1,300
Brand name		800
Copyrighted materials		50
Goodwill		16,692
Total Assets Purchased		20,124
Less Liabilities Assumed:		
Accounts payable	$	190
Accrued liabilities		322
Other current liabilities		204
Total Liabilities Assumed		716

(1) - Shares were valued using the average stock price for two days before and two days after the measurement date, as defined in SFAS 141 and EITF 99-12

The combination is being accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price to the assets acquired and liabilities assumed is based on an independent valuation report obtained by the Company. The allocation is subject to change resulting from the purchase price guarantee contingency described above.

The values assigned to intangible assets, aside from goodwill, are subject to amortization. The intangible assets were assigned the following lives for amortization purposes:

Intangible asset	Estimated useful life (in years)
Customer contracts and relationships	5
Copyrighted materials	5
Capitalized software platform	7
Brand name	10

Goodwill was not assigned a life and will be tested for impairment as defined by Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

The purchase agreement calls for the management of Sponge to earn an additional £2,500,000 (approximately $4.4 million) in the form of NeoMedia common stock if, during the two-year period beginning on February 23, 2006, the Sponge business earns in excess of £1,300,000 (approximately $2.3 million) in net profits, plus £1 of NeoMedia common stock for each £1 that earnings exceed £1,300,000 during the two-year period. No shares are to be issued pro rata if the earnings target is not met.

At the end of the two-year measurement period (February 22, 2008), if the earnings target is met, the financial impact on NeoMedia of the issuance of additional shares would be a proportionate increase of approximately $4.4 million in the long-term assets acquired from Sponge, with a corresponding increase in depreciation expense from the point of issuance forward. If the earnings target is not met, no additional shares would be issued and there would be no financial impact to NeoMedia. Pursuant to SFAS 141, NeoMedia has not allocated a value to the contingent consideration in the initial purchase price. Accordingly the final purchase price will not be determined until the conclusion of this contingency.

The accompanying consolidated statement of operations presented herein for the nine months ended September 30, 2006, contains the results of operations for Sponge for the period from February 24, 2006, through September 30, 2006. The accompanying consolidated statement of operations presented herein for the three months ended September 30, 2006, contains the results of operations for Sponge for the entire three month period. Pro-forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented at the end of this Note 3.

Acquisition of Gavitec

On February 17, 2006, NeoMedia and Gavitec signed a definitive sale and purchase agreement, subject to closing conditions, under which NeoMedia acquired all of the outstanding shares of Gavitec in exchange for $1,800,000 cash and 13,660,511 shares of NeoMedia common stock (1,366,051 of which are being held in escrow until December 31, 2006 for the purpose of securing the indemnification obligations outlined in the purchase agreement). Pursuant to the terms of the merger agreement, the number of shares of NeoMedia common stock to be issued as consideration was calculated using a share price of $0.389, which was the volume-weighted average closing price of NeoMedia common stock for the ten days up to and including February 16, 2006. On February 23, 2006, NeoMedia and Gavitec completed the closing requirements and the acquisition became effective. In the event that NeoMedia's stock price (at the time the consideration shares are saleable) is less than $0.389, NeoMedia is obligated to compensate Gavitec shareholders in cash for the difference between the price at the time the shares become saleable and $0.389. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $3.9 million resulting from this clause.

Gavitec was founded in 1997 as a specialized provider and manufacturer of products and solutions for mobile marketing and mobile information technology. As a technology leader in code-reading systems and software for mobile applications, Gavitec offers its clients standardized or individual solutions in the areas of mobile marketing, mobile ticketing, mobile couponing, and mobile payment systems. Gavitec has run an in-market pilot program in Switzerland for its mobile macro-payment system with the leading Swiss retail bank PostFinance, Unisys, seven selected retailers including Migros, CoOp and McDonald's and approximately a thousand consumers. Participants receive a personal Data Matrix code via text message to their mobile phone. Then to complete a purchase, participants hold their cell phone over Gavitec's EXIO code reader and enter their PIN code to debit their PostFinance account. Gavitec has also run trials with “Coast Mobile” in conjunction with the British Broadcasting Corporation (BBC) and News International's The Times newspaper, along with a number of other interactive mobile campaigns.

NeoMedia completed the acquisitions of Mobot, Sponge, Gavitec, and 12Snap in an effort to gain entry into the rapidly evolving global mobile marketing industry.

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

		(Dollars in Thousands)
Value of 13,660,511 shares issued at $0.386 per share(1)	$	5,273
Cash paid		1,800
Direct costs of acquisition		114
Total Fair Value of Purchase Price		7,187
Assets Purchased:		
Cash and cash equivalents	$	74
Accounts receivable		173
Inventory		106
Other current assets		53
Property, plant & equipment		15
Intangible assets		3
Capitalized software platform		4,600
Copyrighted materials		50
Goodwill		2,611
Total Assets Purchased		7,685
Less Liabilities Assumed:		
Accounts payable	$	113
Accrued liabilities		24
Deferred revenue		117
Other current liabilities		244
Total Liabilities Assumed		498

(1) - Shares were valued using the average stock price for two days before and two days after the measurement date, as defined in SFAS 141 and EITF 99-12

The combination is being accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price to the assets acquired and liabilities assumed is based on an independent report obtained by the Company. The allocation is subject to change resulting from the purchase price guarantee contingency described above.

The values assigned to intangible assets, aside from goodwill, are subject to amortization. The intangible assets were assigned the following lives for amortization purposes:

Intangible asset	Estimated useful life (in years)
Copyrighted materials	5
Capitalized software platform	7
Brand name	10

Goodwill was not assigned a life and will be tested for impairment as defined by Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

The accompanying consolidated statement of operations presented herein for the nine months ended September 30, 2006, contains the results of operations for Gavitec for the period from February 24, 2006, through September 30, 2006. The accompanying consolidated statement of operations presented herein for the three months ended September 30, 2006, contains the results of operations for Gavitec for the entire three month period. Pro-forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented at the end of this Note 3.

Acquisition of 12Snap

On February 10, 2006, NeoMedia and 12Snap signed a definitive sale and purchase agreement, subject to closing conditions, under which NeoMedia acquired all of the outstanding shares of 12Snap in exchange for $2,500,000 cash and 49,294,581 shares of NeoMedia common stock. On February 28, 2006, NeoMedia and 12Snap completed the closing requirements and the acquisition became effective. Pursuant to the terms of the merger agreement, the number of shares of NeoMedia common stock to be issued as consideration was calculated using a share price of $0.3956, which was the volume-weighted average closing price of NeoMedia common stock for the ten days up to and including February 9, 2006. In the event that NeoMedia's stock price (at the time the consideration shares are saleable) is less than $0.3956, NeoMedia is obligated to compensate 12Snap shareholders in cash for the difference between the price at the time the shares become saleable and $0.3956. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $14.6 million resulting from this clause.

12snap AG is headquartered in Munich with branches in Düsseldorf, New York, London, Milan, Stockholm and Vienna. As an expert in innovative marketing and entertainment for mobile phones, 12snap combines know-how in mobile applications, mobile loyalty and mobile marketing. In the mobile marketing space, 12snap creates and implements national and pan-European mobile marketing campaigns for international brands; its mobile loyalty business unit offers customer loyalty programs for companies and brands, and its mobile applications business unit is the center for development and software. 12snap sells and licenses a wide spectrum of mobile solutions to satisfy the demands of the current growing market and the new uses of the third mobile phone generation from dynamic video services and multiplayer games to personalized messaging applications. 12snap has 75 employees, and services to companies including McDonald's, MTV® , Coca-Cola, Ferrero, Wella, adidas, Unilever and Gillette® .

NeoMedia completed the acquisitions of Mobot, Sponge, Gavitec, and 12Snap in an effort to gain entry into the rapidly evolving global mobile marketing industry.

The actual purchase price was based on cash paid, the fair value of NeoMedia stock around the date of the 12 Snap acquisition, and direct costs associated with the combination. The purchase price has initially allocated as follows:

		(Dollars in Thousands)
Value of 49,294,581 shares issued at $0.394 per share(1)	$	19,422
Cash paid		2,500
Direct costs of acquisition		114
Total Fair Value of Purchase Price		22,036
Assets Purchased:		
Cash and cash equivalents	$	465
Investment in marketable securities		951
Accounts receivable		2,683
Other current assets		554
Property, plant & equipment		224
Intangible assets		93
Customer contracts and relationships		400
Capitalized software platform		4,400
Brand name		1,600
Copyrighted materials		50
Goodwill		19,391
Total Assets Purchased		30,811
Less Liabilities Assumed:		
Accounts payable	$	977
Accrued liabilities		1,990
Deferred revenue		1,434
Other current liabilities		225
Notes payable		4,149
Total Liabilities Assumed		8,775

(1) - Shares were valued using the average stock price for two days before and two days after the measurement date, as defined in SFAS 141 and EITF 99-12

The combination is being accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price to the assets acquired and liabilities assumed is based on an independent valuation report obtained by the Company. The allocation is subject to change resulting from the purchase price guarantee contingency described above.

The values assigned to intangible assets, aside from goodwill, are subject to amortization. The intangible assets were assigned the following lives for amortization purposes:

Intangible asset	Estimated useful life (in years)
Customer contracts and relationships	5
Copyrighted materials	5
Capitalized software platform	7
Brand name	10

16

Goodwill was not assigned a life and will be tested for impairment as defined by Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

The accompanying consolidated statement of operations presented herein for the nine months ended September 30, 2006, contains the results of operations for 12Snap for the period from March 1, 2006, through September 30, 2006. The accompanying consolidated statement of operations presented herein for the three months ended September 30, 2006, contains the results of operations for 12Snap for the entire three month period. Pro-forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented at the end of this Note 3.

Acquisition of BSD

On March 21, 2006, NeoMedia completed its acquisition of BSD Software, Inc. of Calgary, Alberta, Canada for 7,123,698 shares of NeoMedia common stock. Pursuant to the terms of the merger agreement, the number of shares of NeoMedia common stock to be issued as consideration was calculated using a share price of $0.3467, which was the volume-weighted average closing price of NeoMedia common stock for the five days preceding March 21, 2006. BSD owns 90% of the outstanding shares of Triton Global Business Services, Inc., a provider of live and automated operator calling services and e-business support, including billing, clearinghouse and information management services, to companies in the telecommunications industry.

NeoMedia completed the acquisitions of BSD for the purpose of increasing its revenue and profit through establishment of a Telecom Services business unit, as well as gaining access to the Canadian telecom industry in order to penetrate that market with the products of the NeoMedia Mobile division.

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

		(Dollars in Thousands)
Value of 7,123,698 shares issued at $0.352 per share[1]	$	2,508
Direct costs of acquisition		7
Total Fair Value of Purchase Price		2,515
Assets Purchased:		
Cash and cash equivalents	$	55
Accounts receivable		1,733
Other current assets		13
Property, plant & equipment		61
Customer contracts and relationships		1,300
Copyrighted materials		130
Goodwill		4,402
Total Assets Purchased		7,694
Less Liabilities Assumed:		
Accounts payable	$	2,424
Accrued liabilities		1,224
Notes payable		1,531
Total Liabilities Assumed		5,179

(1) - Shares were valued using the average stock price for two days before and two days after the measurement date, as defined in SFAS 141 and EITF 99-12

17

The combination is being accounted for as a purchase business combination as defined by Statement of Financial Accounting Standards No. 141, Business Combinations. The allocation of the purchase price to the assets acquired and liabilities assumed is based on an independent valuation report obtained by the Company.

The values assigned to intangible assets, aside from goodwill, are subject to amortization. The intangible assets were assigned the following lives for amortization purposes:

Intangible asset	Estimated useful life (in years)
Customer contracts and relationships	5
Copyrighted materials	5

Goodwill was not assigned a life and will be tested for impairment as defined by Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

The accompanying consolidated statement of operations presented herein for the nine months ended September 30, 2006, contains the results of operations for BSD for the period from March 22, 2006, through September 30, 2006. The accompanying consolidated statement of operations presented herein for the three months ended September 30, 2006, contains the results of operations for BSD for the entire three month period. Pro-forma results of operations for the three and nine months ended September 30, 2006 and 2005 are presented at the end of this Note 3.

Pro Forma Financial Information

Pro-forma results of operations as if NeoMedia was combined with Mobot, Sponge, Gavitec, 12Snap and BSD as of January 1, 2006 are as follows:

	Three Months Ended September 30, 2006							
	NeoMedia	Mobot	Sponge	Gavitec	12Snap	BSD	Pro Forma Adjust-ments	Pro-forma Combined
Total net sales	$ 3,591	$ 125	$ 265	$ 246	$ 2,226	$ 547	($3,409)(A)	$ 3,591
Net income (loss)	($30,909)	($388)	($420)	($359)	($166)	$ 228	$ 1,105(A)	($30,909)
Net income (loss) per share-basic and diluted	($0.05)						—	($0.05)
Weighted average common shares outstanding	644,720,857						—	644,720,857

	Nine Months Ended September 30, 2006							
	NeoMedia	Mobot	Sponge	Gavitec	12Snap	BSD	Pro Forma Adjust-ments	Pro-forma Combined
Total net sales	$ 8,844	$ 344	$ 1,488	$ 953	$ 8,457	$ 1,441	($8,591)(B)	$ 12,936
Net income (loss)	($27,094)	($1,007)	($458)	($428)	($51)	$ 474	$ 1,305(B)	($27,259)
Net income (loss) per share-basic and diluted	($0.04)						$ —(B)(C)	($0.04)
Weighted average common shares outstanding	602,132,555						58,652,190(C)	660,784,745

(A) - Adjustment to back out the operations of each subsidiary, which were included in NeoMedia's consolidated operations for the entire three month period ended September 30, 2006

(B) - Adjustments are to reflect operations of each acquisition from the closing date through September 30, 2006 and amortization of intangible assets for the period January 1, 2006 through the respective closing dates. Results of operations for each acquisition from its respective closing date through September 30, 2006 are included in NeoMedia's operations for the nine months ended September 30, 2006. Closing dates for each acquisition were:

Mobot (February 17, 2006); Sponge and Gavitec (February 23, 2006); 12Snap (February 28, 2006); and BSD (March 21, 2006).

(C) - Adjustment for shares that would have been issued in connection with acquisitions if they had occurred on January 1, 2006. Using the stock price around January 1, 2006, the pro forma number of shares that would have been issued was:

	Mobot	Sponge	Gavitec	12Snap	BSD	Total
Total stock consideration	$ 6,500,000	$ 11,400,000	$ 5,400,000	$ 19,500,000	$ 2,279,263	$ 45,079,263
NeoMedia stock price around January 1, 2006 (measurement date)	$ 0.290	$ 0.290	$ 0.290	$ 0.290	$ 0.290	
Pro forma number of shares of NeoMedia to be issued as purchase price consideration	22,413,793	39,310,345	18,620,690	67,241,379	7,859,528	155,445,735

19

The adjustment between the reported and the pro forma number of weighted average shares outstanding is caused by (i) the weighting of the pro forma shares for the entire nine month period ended September 30, 2006, whereas in the reported number the shares were only outstanding from the closing date through September 30, 2006, and (ii) the number of pro forma shares being higher than the actual shares issued due to a lower stock price on the pro forma date of issuance.

Pro-forma results of operations as if NeoMedia was combined with Mobot, Sponge, Gavitec, 12Snap and BSD as of January 1, 2005 are as follows:

	Three Months Ended September 30, 2005							
	NeoMedia	**Mobot**	**Sponge**	**Gavitec**	**12Snap**	**(B) BSD**	**Pro Forma Adjust-ments**	**Pro-forma Combined**
Total net sales	$ 193	$ 56	$ 609	$ 198	$ 2,114	$ 425	—	$ 3,595
Net income (loss)	($1,950)	($818)	$ 53	($492)	($140)	($134)	($723)(A)	($4,204)
Net income (loss) per share-basic and diluted	($0.00)						($0.01)(A)(B)	($0.01)
Weighted average common shares outstanding	456,695,836						172,717,482(B)	629,413,318

	Nine Months Ended September 30, 2005							
	NeoMedia	**Mobo**	**Sponge**	**Gavitec**	**12Snap**	**(B) BSD**	**Pro-forma Adjust-ments**	**Pro forma Combined**
Total net sales	$ 762	$ 144	$ 1,544	$ 590	$ 5,600	$ 1,343	—	$ 9,983
Net income (loss)	($5,469)	($918)	$ 172	($747)	($816)	$ 127	($2,170)(A)	($9,821)
Net income (loss) per share-basic and diluted	($0.01)						($0.01)(A)(B)	($0.02)
Weighted average common shares outstanding	451,487,240						172,717,482(B)	624,204,722

(A) - Adjustment for amortization of intangible assets for the periods presented.

(B) - Adjustment for shares that would have been issued in connection with acquisitions if they had occurred on January 1, 2006. Using the stock price around January 1, 2006, the pro forma number of shares that would have been issued was:

	Mobot	Sponge	Gavitec	12Snap	BSD	Total
Total stock consideration	$ 6,500,000	$ 11,400,000	$ 5,400,000	$ 19,500,000	$ 2,279,263	$ 45,079,263
NeoMedia stock price around January 1, 2005 (measurement date)	$ 0.261	$ 0.261	$ 0.261	$ 0.261	$ 0.261	
Pro forma number of shares of NeoMedia to be issued as purchase price consideration	24,904,215	43,678,161	20,689,655	74,712,644	8,732,808	172,717,483

20

Tax Implications of Acquisitions

For income tax purposes, amounts assigned to particular assets acquired and liabilities assumed in the business combinations are different than amounts used for financial reporting. The differences in assigned values for financial reporting and tax purposes result in temporary differences. In applying SFAS 109, “Accounting for Income Taxes”, the Company is required to recognize the tax effect of these temporary differences and, accordingly, a deferred tax liability has been recognized. The Company determined that its pre-existing and acquired deferred tax assets, and those acquired, including those subject to limitations, were more likely than not to be realized to the extent of the deferred tax liability. The reduction in the valuation allowance resulting in an asset was used to offset the deferred tax liability arising from the business combinations, pursuant to SFAS 109.

In addition, the acquisitions of Sponge, Gavitec, 12Snap, and BSD involve a change of control of foreign entities, and as a result any net operating loss carryforward in existence prior to the acquisition may have limited or no use for NeoMedia.

Intangible Assets

As of September 30, 2006, NeoMedia had intangible assets with a cost as follows:

	12 Snap	Sponge	Gavitec	Mobot	BSD	Other	Total
Customer Contracts	$ 400	$ 400	$ —	$ 440	$ 1,300	$ —	$ 2,540
Proprietary Software	4,516	1,300	4,603	4,210	—	937	15,566
Brand Name	1,600	800	—	5	—	—	2,405
Copyrighted Materials	50	50	50	90	130	—	370
Patents	—	—	—	10	—	4,888	4,898
Goodwill	19,391	16,799	2,712	6,778	4,402	—	50,082
Total	$ 25,957	$ 19,349	$ 7,365	$ 11,533	$ 5,832	$ 5,825	$ 75,861

Accumulated amortization on NeoMedia's intangible assets as of September 30, 2006, was:

	12 Snap	Sponge	Gavitec	Mobot	BSD	Other	Total
Customer Contracts	$ 47	$ 48	$ —	$ 54	$ 152	$ —	$ 301
Proprietary Software	367	112	393	370	—	667	1,909
Brand Name	93	48	—	2	—	—	143
Copyrighted Materials	6	6	6	11	15	—	44
Patents	—	—	—	2	—	1,974	1,976
Goodwill	—	—	—	—	—	—	—
Total	$ 513	$ 214	$ 399	$ 439	$ 167	$ 2,641	$ 4,373

The carrying value of NeoMedia's intangible assets as of September 30, 2006 was:

	12 Snap	Sponge	Gavitec	Mobot	BSD	Other	Total
Customer Contracts	$ 353	$ 352	$ —	$ 386	$ 1,148	$ —	$ 2,239
Proprietary Software	4,149	1,188	4,210	3,839	—	269	13,655
Brand Name	1,507	752	—	3	—	—	2,262
Copyrighted Materials	44	44	44	79	115	—	326
Patents	—	—	—	8	—	2,914	2,922
Goodwill	19,391	16,799	2,712	6,778	4,402	—	50,082
Total	$ 25,444	$ 19,135	$ 6,966	$ 11,093	$ 5,665	$ 3,183	$ 71,486

Estimated future amortization expense on NeoMedia's intangible assets is expected to be:

	Customer Contracts	Proprietary Software	Brand Name	Copyrighted Materials	Patents	Goodwill	Total
2006	$ 127	$ 556	$ 60	$ 19	$ 76	$ —	$ 838
2007	508	2,224	241	74	304	—	3,351
2008	508	2,224	182	74	304	—	3,292
2009	508	2,224	182	74	304	—	3,292
2010	356	2,224	182	74	304	—	3,140
Thereafter	232	4,204	1,414	11	1,630	—	7,491
Total	$ 2,239	$ 13,656	$ 2,261	$ 326	$ 2,922	$ —	$ 21,404

It is important to note that actual amortization expense could differ materially from the table due to subjective factors such as changes in assumptions of useful lives or impairment charges.

22

The weighted average remaining life for the intangible assets was approximately 6.8 years as of September 30, 2006.

Letter of Intent to Acquire Hip Cricket

On August 24, 2006, NeoMedia terminated a non-binding letter of intent to acquire HipCricket, Inc. ("HipCricket"), due to an inability of the parties to come to terms on a definitive purchase price. On February 16, 2006, NeoMedia and Hip Cricket signed the letter of intent, under which NeoMedia intended to acquire all of the outstanding shares of Hip Cricket in exchange for $500,000 cash and $4,000,000 of NeoMedia common stock, subject to due diligence and signing of a mutually agreeable definitive purchase agreement by both parties.

In addition to signing the letter of intent, NeoMedia loaned HipCricket the principal amount of $500,000 in the form of a) a promissory note, dated February 16, 2006, in the amount of $250,000 and (b) that certain promissory note, dated March 20, 2006, in the amount of $250,000. The notes accrue interest at a rate of 8% per annum. The notes were to be applied toward the cash portion of the purchase price upon signing of a definitive purchase agreement for the acquisition of all of the outstanding shares of HipCricket by NeoMedia, as contemplated in the letter of intent. Due to the termination of the letter of intent, and pursuant to the terms of the notes, the face amount of the notes, plus any and all interest accrued thereon, will become payable and due on November 22, 2006. In the event the Notes are not repaid by November 22, 2006, the notes will convert into shares of HipCricket common stock using a valuation of $4.5 million for HipCricket.

4. DISCONTINUED OPERATIONS AND ASSETS AND LIABILITIES HELD FOR SALE - MICRO PAINT REPAIR BUSINESS UNIT

On August 30, 2006, NeoMedia signed a non-binding letter of intent to sell its Micro Paint Repair business unit to Jose Sada, a technology partner of NeoMedia Micro Paint Repair, backed by Global Emerging Markets Group of New York City. The letter of intent calls for completion of the transaction on or before November 24, 2006.

The letter of intent contained the following material terms:

- the letter of intent is subject to completion of due diligence review by the buyers,
- the letter of intent is subject to negotiation of material terms of the transaction,
- the letter of intent is subject to negotiation of a sales price of the business unit,
- the letter of intent is subject to ability of the buyers to obtain funding,
- the letter of intent can be terminated by either party without cause with written notice,
- NeoMedia cannot shop the business unit to other buyers while the letter of intent is in effect, with the exception of specifically named alternate potential buyers.

SFAS 144 governs the accounting over this transaction. NeoMedia has analyzed the pertinent facts of the proposed transaction with respect to the criteria outlined in SFAS 144, and has determined that all of the criteria have been met. Accordingly NeoMedia is reporting the operating results of the MPR business unit as Discontinued Operations, and the assets and liabilities as Held for Sale. The amounts reported as discontinued operations and assets and liabilities held for sale have been appropriately reclassified and reported in the financial statements presented in this filing.

The operating results of the MPR business unit classified as discontinued operations are indicated in the following table.

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net sales	$ 368	$ 244	$ 1,145	$ 960
Cost of sales	605	220	1,592	795
Gross profit	(237)	24	(447)	165
Sales and marketing expenses	207	216	801	1,019
General and administrative expenses	777	68	706	230
Research and development costs	236	121	386	223
Stock-based compensation expense	163	—	485	—
Loss from discontinued operations	$ (1,620)	$ (381)	$ (2,826)	$ (1,307)

The assets and liabilities of the MPR business unit classified as held for sale are as follows.

	September 30, 2006 Unaudited	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 200	$ 587
Trade accounts receivable, net	462	211
Inventories, net of allowance for obsolete & slow-moving inventory of $0	148	421
Prepaid expenses and other current assets	36	30
Total current assets	846	1,249
Leasehold improvements & property and equipment, net	135	126
Goodwill	1,099	1,099
Other intangible assets, net	1,371	1,556
Other long-term assets	—	28
Total assets held for sale	$ 3,451	$ 4,058
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 16	$ 72
Taxes payable	9	—
Accrued expenses	74	6
Deferred revenues and other	651	591
Total liabilities held for sale	$ 750	$ 669

Inventory included in the assets held for sale are as follows.

	September 30, 2006	December 31, 2005
Raw materials	$ 38	$ 33
Work-in-process	—	—
Finished goods	11	388
Total	$ 49	$ 421

There is no tax expense or benefit related to this transaction due to NeoMedia's net operating loss carry forward tax position.

5. FINANCING

Series C Convertible Preferred Stock

The Company entered into a Securities Purchase Agreement, dated February 17, 2006 (the “Agreement”) with Cornell Capital Partners LP, an accredited investor (the “Purchasers”). Pursuant to the Agreement, the Purchasers agreed to purchase 8% cumulative Series C convertible preferred stock to be fully converted three (3) years from the date of issuance in the aggregate amount of $22,000,000. Net consideration from this arrangement amounted to $17,854,000, comprised of cash of $14,066,000, marketable securities with a calculated fair value of $579,000 and a purchase value of $2,000,000, and the extinguishment of $3,209,000 of preexisting indebtedness. In addition, the Purchaser withheld $2,725,000 commitment and structuring fees from the gross proceeds. The Agreement also provided for the issuance to the Purchasers, at no additional cost to the purchasers, warrants to purchase shares of the Company's common stock. The Agreement also called for the purchasers to acquire an additional $5,000,000 of Series C convertible preferred stock on the date a registration statement filed by the Company was declared effective by the U.S. Securities and Exchange Commission. In connection with the Agreement, the Company also entered into a registration rights agreement with the Purchasers that requires the Company to (i) file a registration statement with the SEC registering the resale of the shares of common stock issuable upon conversion of the preferred stock and the exercise of the warrants, (ii) achieve effectiveness by December 1, 2006 and (iii) maintain effectiveness of the registration statement. Failure to meet these requirements will require the Company to incur liquidating damages amounting to 1% of the outstanding amount of Series C preferred stock per month, but in no event shall consideration paid as liquidating damages exceed $1,200,000.

On February 17, 2006, the Company issued the Purchasers $22,000,000 in aggregate amount of such 8% cumulative Series C convertible preferred stock. At any time from the closing date until February 17, 2009, the Purchasers have the right to convert the preferred stock, in whole or in part, into common stock of the Company at the then effective conversion price, which varies relative to the Company's trading stock price, as follows: $0.50 per share, or 97% of the lowest closing bid price (as reported by Bloomberg) of the common stock for the 30 trading days immediately preceding the conversion date. The conversions are limited such that the holder cannot exceed 4.99% ownership, unless the holders waive their right to such limitation. The limitation will terminate under any event of default.

The Series C convertible preferred stock, at the option of the holder, affords the Purchasers anti-dilution protection should, at any time while the Series C preferred stock instruments are outstanding, the Company offer, sell or grant any option to purchase or offer, sell or grant any right to re-price its securities, or otherwise dispose of or issue any common stock or common stock equivalents, entitle any person to acquire shares of common stock at an effective price per share less than the then effective conversion price (excluding employee stock options), as calculated by the formula described above; then, in such instance, the conversion price for the convertible preferred stock shares shall be reduced to the lower price. In case of any such adjustment in the effective conversion price for the convertible preferred shares, this could significantly dilute existing investors.

Under the Agreement, the Purchasers also received “A” warrants, “B” warrants and “C” warrants to purchase an aggregate of up to 75,000,000 shares of common stock. The warrants were exercisable in three separate traunches at a price of $0.50, $0.40 and $0.35 respectively per share, subject to adjustment, included under anti-dilution protection similar to that described above. As an inducement to enter into subsequent financing arrangements related to Cornell Debentures, the warrants were repriced on August 24, 2006 to $0.10, $0.15, and $0.10 respectively subject to all the original terms and conditions of the agreement. The warrants have a five-year contractual life. NeoMedia can force exercise of the warrants if the closing bid price of NeoMedia stock is more than $0.10 greater than the exercise price of any of the warrants for 15 consecutive trading days.

At February 17, 2006, a summary of the allocation of the components of the transaction is as follows:

Instrument:		
Convertible preferred stock[1]	$	1,711,000
Common stock warrants[2]		16,172,000
Embedded conversion feature		1,935,000
Debt extinguishment loss[3]		(1,964,000)
Total gross proceeds	$	17,854,000

(1) The discount to the face value of the 8% cumulative Series C convertible preferred stock that resulted from the allocation along with deferred costs is being accreted through periodic charges to additional paid-in capital using the effective interest method. Accretion of the deferred costs amounted to $604,000 and $0 during the three months ended September 30, 2006 and 2005, respectively, and $1,220,000 and $0 during the nine months ended September 30, 2006 and 2005, respectively.

(2) The Company issued additional warrants to purchase aggregate 75,000,000 shares of common stock in connection with the 8% cumulative Series C convertible preferred stock. The Company also issued 2,000,000 warrants (valued at $447,000) as financing fees.

(3) The financing arrangement settled face value $3,209,000 of preexisting indebtedness. The debt extinguishment loss was calculated as the amount that the fair value of securities issued (using a relative fair value basis) exceeded the Company's carrying value.

The carrying value of the 8% cumulative Series C convertible preferred stock amounted to $2,931,000, net of unaccreted deferred cost of $24,349,000, at September 30, 2006. Face value of Series C convertible preferred stock at September 30, 2006 is $22,000,000. Derivative financial instruments arising from the issuance of Series C convertible preferred stock are initially recorded and continuously carried at fair values. Upon conversion of any derivative financial instrument, the change in fair value from the previous reporting date to the date of conversion is recorded to income (loss), and then the carrying value is recorded to paid-in capital, provided all other criteria for equity classification are met. The following tabular presentation reflects the components of derivative financial instruments on the Company's balance sheet at September 30, 2006:

(Assets) Liabilities:		**September 30, 2006**
Common stock warrants	$	4,625,000
Embedded conversion features		1,515,000
Other warrants[1]		2,126,000
	$	8,266,000

(1) The fair values of certain other derivative financial instruments (warrants) that existed at the time of the issuance of Series C convertible preferred stock were reclassified from stockholders' equity to liabilities when, in connection with the issuance of Series C convertible preferred stock, the Company no longer controlled its ability to share-settle these instruments. These derivative financial instruments had fair values of $13,883,000 and $2,072,000 on February 17, 2006 and September 30, 2006, respectively. The decrease in fair value of these other derivative financial instruments resulted from a decrease in NeoMedia's share price between February 17, 2006 and September 30, 2006. The change in fair value is reported as “Change in fair value from revaluation of warrants and embedded conversion features” in the accompanying condensed consolidated statement of operations. These warrants will be reclassified to stockholders' equity when the Company reacquires the ability to share-settle the

instruments.

The following tabular presentation reflects the number of common shares into which the aforementioned derivative financial instruments are indexed at September 30, 2006:

	Shares of common stock
Common stock warrants	75,000,000
Embedded conversion feature[1]	216,494,845
Other warrants	33,325,000
	324,819,845

(1) The terms of the embedded conversion features (ECF) in the Series C convertible preferred stock provide for variable conversion rates that are indexed to the Company's trading common stock price. As a result, the number of indexed shares is subject to continuous fluctuation. For presentation purposes, the number of shares of common stock into which the ECF was convertible as of September 30, 2006 was calculated as the face value of $22,000,000 plus assumed dividends of $1,220,000 if declared, divided by 97% of the lowest closing bid price for the 30 trading days preceding September 30, 2006 which was $0.111 per share.

26

Derivative income associated with adjustments recorded to reflect the aforementioned derivatives at fair value amounted to $19,934,000 and $0 for the nine months ended September 30, 2006 and 2005, respectively, and $4,161,000 and $0 for the three months ended September 30, 2006 and 2005, respectively. These amounts are reported as "Change in fair value from revaluation of warrants and embedded conversion features" in the accompanying condensed consolidated statement of operations.

Fair value considerations for derivative financial instruments:

Freestanding derivative instruments, consisting of warrants that arose from the financing and those reclassified as described above are valued using the Black-Scholes-Merton valuation methodology because that model embodies all of the relevant assumptions that address the features underlying these instruments. Significant assumptions included in this model as of September 30, 2006 are as follows:

Holder	Cornell Capital Partners	Other
Instrument	Warrants	Warrants
Exercise price	$0.10 - $0.15	$0.01 - $3.45
Term (years)	5.0	1.0 - 5.0
Volatility	59.32%	47.55%-59.32%
Risk-free rate	3.65%	3.65%

Embedded derivative financial instruments, arising from the Series C convertible preferred stock, consist of multiple individual features that were embedded in the instrument. The Company evaluated all significant features of the hybrid instruments and, where required under current accounting standards, bifurcated features for separate report classification. These features were aggregated into one compound derivative financial instrument for financial reporting purposes. The compound embedded derivative instruments are valued using the Flexible Monte Carlo methodology because that model embodies certain relevant assumptions (including, but not limited to, interest rate risk, credit risk, and conversion/redemption privileges) that are necessary to value these complex derivatives.

Assumptions included exercise estimates/behaviors and the following other significant estimates:

Instrument	**Features**
Conversion prices	$0.95 - $1.29
Remaining terms (years)	1 - 5
Equivalent volatility	47.55% - 48.69%
Equivalent interest-risk adjusted rate	8.17% - 8.58%
Equivalent credit-risk adjusted yield rate	14.50%

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

The 8% cumulative Series C convertible preferred stock contains consequences in case of default. Events of default which could subject the Company to penalties, damages, and liabilities as specified in the Agreement include:

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

- Any default in its obligations under a mortgage or debt in excess of $100,000;

- Any cessation in the eligibility of the Company's stock to be quoted on a trading market;
- Failure to timely file the registration statement covering the shares related to the conversion option, or failure to make the registration statement effective timely.
- Any lapse in the effectiveness of the registration statement covering the shares related to the conversion option, the warrants as described and transacted in the securities purchase agreement and accompanying documents;
- Any failure to deliver certificates within the specified time; and
- Any failure, by the Company, to pay in full the amount of cash due pursuant to a buy-in or failure to pay any amounts owed on account on account of an event of default within 10 days of the date due.

Other provisions included in the Agreement include the following:

- The 8% cumulative Series C convertible preferred stock is convertible into common stock, at the option of the Purchaser, at any time after the effective date.
- Conversions can be made in increments and from time to time.
- The 8% cumulative Series C convertible preferred stock has voting rights on an “as converted” basis, meaning the Purchaser is entitled to vote the number of shares of common stock into which the 8% cumulative Series C convertible preferred stock was convertible as of the record date for a meeting of shareholders
- As promptly as practicable after any conversion date, the Company shall cause its transfer agent to deliver a certificate representing the converted shares, free of any legends and trading restrictions for the number of shares converted;
- The Company will reserve and keep available authorized and unissued registered shares available to be issued upon conversion;
- Purchaser will not be responsible for any transfer taxes relative to issuance of shares;
- If the Company offers, sells or grants stock at an effective per share price less than the then Conversion Price, then the Conversion Price shall be reduced to equal the effective conversion, exchange or purchase price for such common stock or common stock equivalents;

NeoMedia filed the registration statement covering the shares related to the conversion option beyond the date stipulated in the investor registration rights agreement. As such, NeoMedia has accrued $161,000 of liquidated damages relating to the Series C convertible stock.

Secured Convertible Debenture

The Company entered into a Securities Purchase Agreement, dated August 24, 2006, (the “Agreement”) with Cornell Capital Partners LP, an accredited investor (the “Purchasers”). Pursuant to the Agreement, the Purchasers agreed to purchase 10% secured convertible debentures maturing two years from the date of issuance in the aggregate amount of $5,000,000. The Agreement also provided for the issuance to the Purchasers, at no additional cost to the purchasers, warrants to purchase shares of the Company's common stock. In connection with the Agreement, the Company also entered into a registration rights agreement with the Purchasers that requires the Company to (i) file a registration statement with the SEC registering the resale of the shares of common stock issuable upon conversion of the convertible debenture and the exercise of the warrants, (ii) achieve effectiveness prior to November 24, 2006 and (iii) maintain effectiveness of the registration statement. Failure to meet these requirements will require the Company to incur liquidating damages amounting to 2% of the principal per month, but in no event shall consideration paid as liquidating damages exceed $1,000,000. The debentures are secured by substantially all of the Company's assets.

On August 24, 2006, the Company issued the Purchasers $5,000,000 in aggregate principal amount of such convertible debentures. At any time from the closing date until August 24, 2008, the Purchasers have the right to convert the convertible debenture into common stock of the Company at the then effective conversion price, which varies relative to the Company's trading stock price, as follows: $0.15 per share, or 90% of the lowest closing bid price (as reported by Bloomberg) of the common stock for the 30 trading days immediately preceding the conversion date. The conversion is limited such that the holder cannot exceed 4.99% ownership, unless the holders waive their right to such limitation. The limitation will terminate under any event of default.

The convertible debenture, at the option of the holder, affords the Purchasers anti-dilution protection should, at any time while the convertible debenture is outstanding, the Company offer, sell or grant any option to purchase or offer, sell or grant any right to re-price its securities, or otherwise dispose of or issue any common stock or common stock equivalents, entitle any person to acquire shares of common stock at an effective price per share less than the then effective conversion price (excluding employee stock options), as calculated by the formula described above; then, in such instance, the conversion price for the convertible debenture shall be reduced to the lower price. In case of any such adjustment in the effective conversion price for the convertible debenture, this could significantly dilute existing investors.

Under the Agreement, the Purchasers also received “A” warrants, “B” warrants, “C” warrants and “D” warrants to purchase 25,000,000, 50,000,000, 50,000,000, and 50,000,000 shares of common stock respectively. The warrants are exercisable in four separate traunches at a price of $0.15, $0.25, $0.20 and $0.05 respectively per share, subject to adjustment, included under anti-dilution protection similar to that described above. The warrants have a five-year contractual life. NeoMedia can force exercise of the warrants if the closing bid price of NeoMedia stock is more than $0.10 greater than the exercise price of any of the warrants for 15 consecutive trading days.

At August 24, 2006, a summary of the allocation of the components of the transaction is as follows:

Instrument:		
Convertible debenture(1)	$	—
Common stock warrants(2)		18,507,000
Embedded conversion feature		970,000
Derivative loss		(14,477,000)
Total gross proceeds	$	5,000,000

(1) There were insufficient proceeds to allocate amounts to the host debentures. Accordingly, for purposes of application of the effective interest method, the company applied the 1% convention which provides for recognition of 1% of the future value as amortization. Amortization of debt discount amounted to $73,000

at September 30, 2006. Unamortized debt discount at September 30, 2006 was $4,927,000.

(2) The Company issued warrants to purchase aggregate 175,000,000 shares of common stock in connection with the convertible debenture, as described above.

The carrying value of the convertible debenture amounted to $73,000 net of unamortized debt discount $4,927,000 at September 30, 2006. The face value of convertible debenture at September 30, 2006 is $5,000,000. The discount recorded at inception of the debenture was equal to the $5,000,000 face value and $1,000,000 of contractual interest at the stated rate of 10% over the term of the debenture was included in the computation of the effective interest rate. Derivative financial instruments arising from the issuance of convertible debenture are initially recorded and continuously carried at fair values. Upon conversion of any derivative financial instrument, the change in fair value from the previous reporting date to the date of conversion is recorded to income (loss), and then the carrying value is recorded to paid-in capital, provided all other criteria for equity classification are met. The following tabular presentation reflects the components of derivative financial instruments related to convertible debentures on the Company's balance sheet at September 30, 2006:

(Assets) Liabilities:		**September 30, 2006**
Common stock warrants	$	17,567,000
Embedded conversion features		864,000
	$	18,431,000

The following tabular presentation reflects the number of common shares into which the aforementioned derivative financial instruments are indexed at September 30, 2006:

	Shares of common stock
Common stock warrants	175,000,000
Embedded conversion feature(1)	50,505,051
	225,505,051

(1) The terms of the embedded conversion features (ECF) in the convertible debenture provide for variable conversion rates that are indexed to the Company's trading common stock price. As a result, the number of indexed shares is subject to continuous fluctuation. For presentation purposes, the number of shares of common stock into which the ECF was convertible as of September 30, 2006 was calculated as the face value of $5,000,000 plus assumed interest of $51,000 due at maturity, divided by 90% of the lowest closing bid price for the 30 trading days preceding September 30, 2006.

Derivative loss for the three and nine months ended September 30, 2006 and 2005 associated with adjustments recorded to reflect the aforementioned derivatives at fair value amounted to $13,431,000 and $0, respectively, and is reported as “Change in fair value from revaluation of warrants and embeddded conversion features” in the accompanying condensed consolidated statement of operations.

<u>Fair value considerations for derivative financial instruments</u>:

Freestanding derivative instruments, consisting of warrants that arose from the financing are valued using the Black-Scholes-Merton valuation methodology because that model embodies all of the relevant assumptions that address the features underlying these instruments. Significant assumptions included in this model as of September 30, 2006 are as follows:

Holder	Cornell Capital Partners
Instrument	Warrants
Exercise price	$0.05 - $0.25
Term (years)	5.0
Volatility	67.62%

Risk-free rate	4.78%

Embedded derivative financial instruments, arising from the convertible debenture, consist of multiple individual features that were embedded in the instrument. The Company evaluated all significant features of the hybrid instruments and, where required under current accounting standards, bifurcated features for separate report classification. These features were aggregated into one compound derivative financial instrument for financial reporting purposes. The compound embedded derivative instruments are valued using the Flexible Monte Carlo methodology because that model embodies certain relevant assumptions (including, but not limited to, interest rate risk, credit risk, and conversion/redemption privileges) that are necessary to value these complex derivatives.

Assumptions included exercise estimates/behaviors and the following other significant estimates:

Instrument:	**Features**
Conversion prices	$0.099
Remaining terms (years)	2
Equivalent volatility	56.03% - 58.00%
Equivalent interest-risk adjusted rate	%
Equivalent credit-risk adjusted yield rate	15.25%

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

The convertible debenture contains consequences in case of default. Events of default which could subject the Company to penalties, liabilities, and foreclosure upon the assets of the Company as specified in the Agreement include:

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

- Any default in its obligations under a mortgage or debt in excess of $100,000;

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

- Any lapse in the effectiveness of the registration statement covering the shares related to the conversion option, the warrants as described and transacted in the securities purchase agreement and accompanying documents;

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

- Any failure, by the Company, to pay in full the amount of cash due pursuant to a buy-in or failure to pay any amounts owed on account on account of an event of default within 3 days of the date due.

Other provisions included in the Agreement include the following:

- The convertible debenture is convertible into common stock, at the option of the Purchaser, at any time after the effective date.

- As promptly as practicable after any conversion date, the Company shall cause its transfer agent to deliver a certificate representing the converted shares, free of any legends and trading restrictions for the number of shares converted;

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

- Purchaser will not be responsible for any transfer taxes relative to issuance of shares;

- If the Company offers, sells or grants stock at an effective per share price less than the then Conversion Price, then the Conversion Price shall be reduced to equal the effective conversion, exchange or purchase price for such common stock or common stock equivalents;

- Pursuant to the terms of the convertible debenture agreement between NeoMedia and Cornell signed in connection with the convertible debenture sale, without Cornell's consent NeoMedia cannot

  — (i) issue or sell any shares of Common Stock or preferred stock without consideration or for consideration per share less than the closing bid price immediately prior to its issuance,

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

  — (iii) enter into any security instrument granting the holder a security interest in any of its assets of, or

  — (iv) file any registration statements on Form S-8.

- In addition, pursuant to a security agreement between NeoMedia and Cornell signed in connection with the convertible debenture, Cornell has a security interest in all of NeoMedia's assets.

Standby Equity Distribution Agreements with Cornell

On October 27, 2003, NeoMedia and Cornell entered into a $20 million Standby Equity Distribution Agreement (the "2003 SEDA"). The agreement provided for a maximum "draw" of $280,000 per week, not to exceed $840,000 in any 30-day period, and Cornell was obligated to purchase up to $20 million of the Company's common stock over a two-year period. The SEDA became effective during January 2004, and expired after a two-year term in January 2006. During the nine months ended September 30, 2006 and 2005, NeoMedia sold 751,880 and 19,337,119 shares of its common stock to Cornell pursuant to the 2003 SEDA. The following table summarizes funding received from Cornell during the nine months ended September 30, 2006 and 2005:

	2006			
	First Quarter	Second Quarter	Third Quarter	Nine Months Ended September 30
Number of shares sold to Cornell	751,880	—	—	751,880
Gross Proceeds from sale of shares	$ 234,000	$ —	$ —	$ 234,000
Less: discounts and fees*	(24,000)	—	—	(24,000)
Net Proceeds from sale of shares	$ 210,000	$ —	$ —	$ 210,000

	2005			
	First Quarter	Second Quarter	Third Quarter	Nine Months Ended September 30
Number of shares sold to Cornell	6,998,931	7,258,094	5,080,094	19,337,119
Gross Proceeds from sale of shares	$ 1,709,000	$ 3,219,000	$ 2,130,000	$ 7,058,000
Less: discounts and fees*	(204,000)	(489,000)	(170,000)	(863,000)
Net Proceeds from sale of shares	$ 1,505,000	$ 2,730,000	$ 1,960,000	$ 6,195,000

* Pursuant to the terms of the 2003 SEDA, stock was valued at 98% of the lowest closing bid price during the week it was sold.

On March 30, 2005, NeoMedia and Cornell entered into a Standby Equity Distribution Agreement (the "2005 SEDA") under which Cornell agreed to purchase up to $100 million of NeoMedia common stock over a two-year period, with the timing and amount of the purchase at NeoMedia's discretion. The maximum amount of each purchase would be $2,000,000 with a minimum of five business days between advances. The shares would be valued at 98% of the lowest closing bid price during the five-day period following the delivery of a notice of purchase by NeoMedia, and NeoMedia would pay 5% of the gross proceeds of each purchase to Cornell. Based on NeoMedia's current market capitalization and other outstanding securities, NeoMedia does not believe that the 2005 SEDA is currently a viable source of financing.

As a commitment fee for Cornell to enter into the 2005 SEDA, NeoMedia issued 50 million warrants to Cornell with an exercise price of $0.20 per share for a term of three (3) years, and also paid a cash commitment fee of $1 million.

During the nine months ended September 30, 2006, Cornell exercised 40 million of the warrants, generating cash proceeds of $8 million to NeoMedia. During August 2006, in connection with the Convertible Debenture, NeoMedia repriced the remaining 2 million warrants to an exercise price of $0.10 per share. NeoMedia also issued 4 million warrants with an exercise price of $0.227 to a consultant as a fee in connection with the 2005 SEDA, which have not been exercised. NeoMedia recorded the $13,256,000 fair value of the warrants to "Deferred equity financing costs" at inception. This amount was written off during the three months ended September 30, 2006 because the Company believes that it can no longer consider the SEDA a viable financing source due to the requirements of the preferred stock financing and the debenture financing.

Promissory Note Payable to Cornell

On March 30, 2005, NeoMedia borrowed from Cornell the principal amount of $10,000,000 before discounts and fees in the form of a secured promissory note. Cornell withheld structuring and escrow fees of $68,000 related to the note. The note was originally scheduled to be repaid at a rate of $1,120,000 per month commencing May 1, 2005, which was subsequently changed to $840,000 per month, continuing until principal and interest were paid in full. The note accrued interest at a rate of 8% per annum on any unpaid principal. In connection with the note, NeoMedia and Cornell entered into a Security Agreement under which the note was secured by all of NeoMedia's assets other than its patents and patent applications. NeoMedia also escrowed 25,000,000 shares of its restricted common stock as security for the note. During the period from March 30, 2005 through January 9, 2006, NeoMedia made payments against the principal totaling $7,210,000. On February 17, 2006, NeoMedia retired the balance of the principal in the amount of $2,790,000, plus accrued interest of $419,000, from the proceeds of the Series C convertible preferred financing arrangement with Cornell. In connection with the payment and issuance of the Series C convertible preferred stock, NeoMedia recognized a loss on extinguishment of debt of $1,964,000 during the nine months ended September 30, 2006.

6. INVESTMENT IN MARKETABLE SECURITIES

On February 25, 2005, NeoMedia invested $250,000 in exchange for 8,333,333 shares of Pickups Plus, Inc ("PUPS") restricted common stock. On February 17, 2006, as a component of net proceeds from the issuance of 8% Series C convertible preferred stock, NeoMedia received marketable securities with a fair value of $579,000, of which, $200,000 represented 20,000,000 shares of PUPS common stock and $379,000 in notes designated as held to maturity. NeoMedia acquired an additional 20,000,000 shares of PUPS common stock for a purchase price equal to $389,000. PUPS is a retail operator and franchiser of retail automotive parts and accessories stores catering to the light truck market, and also provides new vehicle preparation, environmental protection packages, detailing and reconditioning products and services. In accordance with Statements of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the investment in PUPS is being recorded as available-for-sale securities and reported at fair value. Accordingly, unrealized gains and losses on the equity securities are reflected in the condensed consolidated statement of operations and comprehensive income (loss).

The investments in marketable securities are summarized as follows:

	Cost	Unrealized Holding Gain	Unrealized Holding Losses	Fair Value Adjustments	Fair Value
Available-for-sale	$ 639,000	$ -	($384,000)	$ -	$ 255,000
Held to maturity	$ 379,000	$ -	$ -	$ 108,000	$ 487,000

Held to maturity securities consist of four notes receivable from PUPS with a face value of $1,611,000 and a fair value of $487,000. The fair value of $487,000 is recorded in other long-term assets on the consolidated balance sheet as of September 30, 2006, and is based upon a risk adjusted anticipated rate of return. The notes are delinquent and accrue interest at rates between 12 - 24%. NeoMedia has not recorded any interest since the Company is using the cost recovery method.

7. FINANCIAL INSTRUMENTS

The carrying amount of the Company's cash equivalents, accounts receivable, prepaid expenses, other current assets, cash surrender value of life insurance policy, accounts payable and accrued expenses, accrued salaries and benefits, and payable to merchants approximates their estimated fair values due to the short-term maturities of those financial instruments.

Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

It is not practicable to estimate the fair value of the Company's 17% investment in the common stock of i-Point Media Ltd. and its investments of 250,000 shares of preferred stock of Intactis Software, Inc., because of the lack of quoted market prices and the inability to estimate fair value without incurring excessive costs. During the year ended December 31, 2005 NeoMedia took an impairment of the carrying values of its investments in iPoint-media and Intactis of $530,000 and $250,000, respectively. No impairment charge was taken during the nine months ended September 30, 2006. The net carrying value of these investments were $470,000 as of September 30, 2006.

For all available-for-sale investment securities, the carrying values represents fair value of the securities and unrealized gain (losses) that are other than temporary are recognized as other comprehensive income (loss). NeoMedia does not hold these securities for speculative or trading purposes. Also see Note 6.

8. COMPUTATION OF NET INCOME (LOSS) PER SHARE

Basic net loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. During the three and nine month periods ended September 30, 2006 and 2005, the Company reported net loss per share, and as such basic and diluted loss per share were equivalent. The Company has excluded all outstanding stock options and warrants from the calculation of diluted net loss per share because these securities are anti-dilutive for all years presented. The shares excluded from the calculation of diluted net loss per share are detailed in the table below:

	September 30, 2006	**September 30, 2005**
Outstanding Stock Options	117,317,058	77,629,221
Outstanding Warrants	276,325,000	72,775,000

9. STOCK BASED COMPENSATION

Option-based Compensation Expense

At September 30, 2006, NeoMedia has four employee stock option plans (the 1996 Stock Option Plan, the 1998 Stock Option Plan, the 2003 Stock Option Plan, and the 2005 Stock Option Plan) and one employee stock compensation plan (the 2003 Stock Incentive Plan) (collectively, the “Plans”). Prior to January 1, 2006, NeoMedia accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations, as permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation (“Statement 123(R)”). No stock-based employee compensation cost was recognized in the statement of operations for the fiscal years or interim periods ended prior to December 31, 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, NeoMedia adopted the fair value recognition provisions of Statement 123(R), using the modified-prospective-transition method. Under that transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

As a result of adopting Statement 123(R) on January 1, 2006, NeoMedia's net loss for the three and nine months ended September 30, 2006 is $2,483,000 and $5,433,000 higher (including $163,000 and $485,000 relating to discontinued operations) respectively, than if it had continued to account for share-based compensation under Opinion 25. Basic and diluted loss per share, as well as loss per share attributable to common shareholders, are each higher by less than $0.01 per share for the three months ended September 30, 2006 than they would have been if NeoMedia had not adopted Statement 123(R). Basic and diluted loss per share, as well as loss per share attributable to common shareholders, are each higher by $0.01 per share for the nine months ended September 30, 2006 than they would have been if NeoMedia had not adopted Statement 123(R). Estimated income tax benefits recognized during the three and nine months ended September 30, 2006 were offset by a valuation allowance since realization was not reasonably assured.

Prior to the adoption of Statement 123(R), it was NeoMedia's policy to present all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in its statement of cash flows, however, due to NeoMedia's tax loss carryforward, any such benefits were always fully offset by a valuation allowance. Statement 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. NeoMedia will use this presentation if and when it has exhausted its tax loss carryforward.

The following table illustrates the effect on net loss and loss per share if NeoMedia had applied the fair value recognition provisions of Statement 123(R) to options granted under NeoMedia's stock option plans in 2005. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' vesting periods.

	Three Months Ended September 30, 2005	**Nine Months Ended September 30, 2005**
Net Loss, as reported	($1,950)	($5,469)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	—	—
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(1,080)	(2,760)
Pro-forma net loss	($3,030)	($8,229)
Net Loss per share:		
Basic and diluted - as reported	($0.00)	($0.01)
Basic and diluted - pro-forma	($0.01)	($0.02)

Note that the above pro forma disclosures are provided for the three and nine months ended September 30, 2005 because employee stock options were not accounted for using the fair-value method during those periods.

The Plans permit the grant of share options and shares to NeoMedia's employees, board of directors, and outside consultants. NeoMedia believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of NeoMedia's stock at the date of grant; those option awards generally vest over a period of 3 years and have 10-year contractual terms. Shares granted upon the exercise of stock options are newly issued shares. The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model that uses the assumptions noted in the following table. Because the Black-Scholes valuation model incorporates ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based on the expected impact on future stock price of expected future revenue and earnings, historical volatility of NeoMedia's stock, and other factors. NeoMedia uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted represents the period of time that options granted are expected to be outstanding.

	Three and Nine months ended September 30,	
	2006	**2005**
Volatility	56% - 28%	431% - 449%
Expected dividends	—	—
Expected term (in years)	3	3
Risk-free rate	4.35%	4.50%

As of January 1, 2006, NeoMedia reevaluated its volatility calculation to take into consideration the guidance outlined in Statement 123(R). Prior to January 1, 2006, NeoMedia calculated volatility using only historical share price data. Under the provisions of Statement 123(R), from January 1, 2006 onward NeoMedia has considered historical volatility, as well expected future volatility. As a result, NeoMedia's volatility decreased significantly for stock based compensation granted during the nine months ended September 30, 2006 as compared with stock based compensation granted prior to January 1, 2006. NeoMedia will evaluate its volatility on an ongoing basis using the most current information available. NeoMedia expects that, under the guidelines of Statement 123(R), future volatility will more closely resemble 2006 levels than previous years.

A summary of option activity under the Plans as of September 30, 2006, and changes during the nine months then ended is presented below:

	Shares (In thousands)		**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term** (in years)		**Aggregate Intrinsic Value** (In thousands)
Outstanding at January 1, 2006	100,041	$	0.18			
Granted	25,660	$	0.36			
Exercised	(2,568)	$	0.14			
Forfeited	(5,816)	$	0.25			
Outstanding at September 30, 2006	117,317	$	0.22	8.6	$	2,871
Vested or expected to vest at September 30, 2006	72,995	$	0.16	8.2	$	2,842

The weighted-average grant-date fair value of options granted during the nine months ended September 30, 2006 was $0.11. The total intrinsic value of options exercised during the nine months ended September 30, 2006 was $425,000. Total cash received from options exercised was $350,000 and $903,000 for the nine months ended September 30, 2006 and 2005, respectively.

A summary of the status of NeoMedia's nonvested shares as of September 30, 2006, and changes during the nine months ended September 30, 2006, is presented below:

Nonvested Shares	**Shares** (in thousands)		**Weighted Average Grant Date Fair Value**
Nonvested at January 1, 2006	44,215	$	0.18
Granted	15,870	$	0.12
Vested	(11,929)	$	0.20
Forfeited	(3,834)	$	0.21
Nonvested at September 30, 2006	44,322	$	0.24

As of September 30, 2006, there was $7,973,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 1.2 years.

38

Other Stock-based Compensation Expense

On January 10, 2006, NeoMedia issued 52,632 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.309 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $16,000 was expensed during the nine months ended September 30, 2006.

On April 5, 2006, NeoMedia issued 115,681 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.389 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $45,000 was expensed during the nine months ended September 30, 2006.

On May 30, 2006, June 30, 2006, and July 31, 2006, NeoMedia issued 6,977, 6,557, and 36,000 fully vested shares, respectively, to an outside consultant for services rendered. The shares were valued at $0.215, $0.244, and $0.19 per share, respectively, which was the last sale price of NeoMedia common stock on the date of each issuance. The aggregate fair value of $10,000 was expensed during the nine months ended September 30, 2006.

On August 8, 2006, NeoMedia issued 1,098,467 fully vested shares to an outside consultant as prepayment for one year of consulting services. The shares were valued at $0.163 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $179,000 was expensed during the nine months ended September 30, 2006.

On August 29, 2006, NeoMedia issued 161,290 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.124 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $20,000 was expensed during the nine months ended September 30, 2006.

On August 31, 2006, NeoMedia issued 4,975,000 fully vested shares to an employee in exchange for (i) an extension of the employee's service agreement through December 31, 2007, and (ii) a waiver of certain of the employee's rights to receive additional shares under a previous contract. The shares were valued at $0.132 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $657,000 was expensed during the nine months ended September 30, 2006.

On August 31, 2006, NeoMedia issued 5,400,000 fully vested shares to an employee in exchange for (i) an extension of the employee's service agreement through December 31, 2007, and (ii) a waiver of certain of the employee's rights to receive additional shares under a previous contract. The shares were valued at $0.132 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $713,000 was expensed during the nine months ended September 30, 2006.

On September 12, 2006, NeoMedia issued 96,429 fully vested shares to an outside consultant for services rendered. The shares were valued at $0.14 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $14,000 was expensed during the nine months ended September 30, 2006.

Subsequent Events

On October 4, 2006, NeoMedia issued 94,340 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.106 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $10,000 will be expensed during the fourth quarter of 2006.

On October 17, 2006, NeoMedia issued 104,167 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.10 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $10,000 will be expensed during the fourth quarter of 2006.

On October 18, 2006, NeoMedia issued 5,500,000 fully vested shares to an employee in exchange for an extension of the employee's services. The shares were valued at $0.097 per share, which was the last sale price of NeoMedia common stock on the date of issuance. NeoMedia did not recognize any expense relating to this issuance during the three and nine month periods ended September 30, 2006 since the issuance occurred in October. NeoMedia will expense the aggregate fair value of $534,000 during the fourth quarter of 2006.

On October 20, 2006, NeoMedia issued 108,630 fully vested shares to an employee as severance payment. The shares were valued at $0.10 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $10,000 will be expensed during the fourth quarter of 2006.

On October 23, 2006, NeoMedia issued 250,000 fully vested shares to an employee as a sign-on bonus. The shares were valued at $0.10 per share, which was the last sale price of NeoMedia common stock on the date of issuance. The aggregate fair value of $25,000 will be expensed during the fourth quarter of 2006.

10. SEGMENT REPORTING

As of September 30, 2006, NeoMedia was structured and evaluated by its Board of Directors and Management as three distinct business units:

- NeoMedia Mobile (NMM) - encompassing NeoMedia's physical-world-to-internet and mobile marketing technologies branded under qode, 12Snap, Sponge, Gavitec and Mobot

- NeoMedia Micro Paint Repair (NMPR) - encompassing the micro paint and auto aftermarket accessories manufactured and distributed by NeoMedia

- NeoMedia Telecom Services (NTS) - encompassing the billing, clearinghouse and information management services of recently-acquired BSD

NeoMedia's reportable segments are strategic business units that offer different technology and marketing strategies. NMM is headquartered in Ft. Myers, Florida, and operates principally in the United States and in Europe through the recent acquisitions of Sponge (United Kingdom), 12Snap (Germany) and Gavitec (Germany). NMPR is headquartered in Ft. Myers, Florida, and currently sells into Canada, the United States, Australia, New Zealand, Scandinavia, Mexico and China. NTS is headquartered in Calgary, Alberta, Canada and presently primarily operates within Canada.

On August 30, 2006, NeoMedia signed a non-binding letter of intent to sell its NMPR business unit to Jose Sada, a technology partner of NeoMedia Micro Paint Repair, backed by Global Emerging Markets Group of New York City. The letter of intent calls for consummation of the transaction on or before November 24, 2006. As a result of the letter of intent to sell NMPR, results of operations of NMPR are shown under the caption “Net loss from Micro Paint business to be sold” on the accompanying condensed consolidated financial statements, and as such are no longer included in this segment reporting.

Consolidated net sales and net loss from continuing operations for the three and nine month periods ended September 30, 2006 and 2005, and identifiable assets as of September 30, 2006 by geographic area were as follows:

	(in thousands) **Three Months Ended September 30,**		(in thousands) **Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Net Sales: (2)				
United States	$ 298	$ 193	$ 819	$ 762
Germany	1,424	—	3,713	—
United Kingdom	697	—	1,748	—
Canada	547	—	1,089	—
Italy	597	—	1,179	—
Other	28	—	296	—
	$ 3,591	$ 193	$ 8,844	$ 762
Net Loss From Continuing Operations: (2)				
United States	($28,981)	($1,569)	($23,593)	($4,162)
Germany	(150)	—	(759)	—
United Kingdom	(561)	—	(543)	—
Canada	227	—	463	—
Italy	(271)	—	(41)	—
Other	447	—	205	—
	($29,289)	($1,569)	($24,268)	($4,162)
Identifiable Assets (2)				
United States (1)	$ 80,429			
Germany	1,672			
United Kingdom	676			
Canada	1,594			
	$ 84,371			

(1) For segment reporting purposes, goodwill and intangible assets of acquired subsidiaries are assumed to be located at NeoMedia headquarters in the United States.

(2) Segment reporting excludes the NeoMedia Micro Paint Repair business unit discontinued operations and the assets held for sale.

Consolidated net sales, net operating losses for the three and nine month periods ended September 30, 2006 and 2005, and identifiable assets as of September 30, 2006, by business unit were as follows:

	(in thousands) Three Months Ended September 30,		(in thousands) Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Net Sales from Continuing Operations:(4)				
NeoMedia Mobile(1)	$ 3,044	$ 35	$ 7,755	$ 208
NeoMedia Telecom Services(2)	547	—	1,089	—
NeoMedia Consulting & Integration Services(3)	—	158	—	554
	$ 3,591	$ 193	$ 8,844	$ 762
Net Loss from Continuing Operations: (4)				
NeoMedia Mobile(1)	($3,276)	($433)	($8,123)	($1,298)
NeoMedia Telecom Services(2)	214	—	31	—
NeoMedia Consulting & Integration Services(3)	—	(463)	—	(1,388)
Corporate overhead	(3,700)	(673)	(9,443)	(1,476)
Charges related to convertible preferred stock, convertible debenture, and write-off of deferred financing costs	(22,527)	—	(6,733)	—
	($29,289)	($1,569)	($24,268)	($4,162)
Identifiable Assets(4)				
NeoMedia Mobile(1)	$ 76,110			
NeoMedia Telecom Services(2)	3,387			
NeoMedia Consulting & Integration Services(3)	—			
Corporate	4,874			
	$ 84,371			

(1) NeoMedia Mobile consists of NeoMedia's qode® and patent business, Mobot, Sponge, Gavitec, and 12Snap. Mobot operations are included in NeoMedia's consolidated financial results for the period February 18, 2006 through September 30, 2006. Gavitec and Sponge operations are included in NeoMedia's consolidated financial results for the period February 24, 2006 through September 30, 2006. 12Snap operations are included in NeoMedia's consolidated financial results for the period March 1, 2006 through September 30, 2006. Net loss of $8,123,000 for the nine months ended September 30, 2006 includes $1,149,000 of stock based compensation recognized pursuant to SFAS 123.

(2) NeoMedia Telecom Services consists of the operations of BSD Software, Inc., acquired March 21, 2006, and included in NeoMedia's consolidated financial results for the period March 22, 2006 through September 30, 2006. Net income of $31,000 for the nine months ended September 30, 2006 includes $432,000 of stock based compensation recognized pursuant to SFAS 123.

(3) NeoMedia Consulting & Integration Services business unit was wound down during the first quarter of 2006 and combined with the NeoMedia Mobile business unit. Results from operations previously included in this business unit are now included in the NeoMedia Mobile business unit.

(4) Segment reporting excludes the Micro Paint Repair business unit discontinued operations and the assets held for sale.

Operating costs included in one segment may benefit other segments, and therefore these segments are not designed to measure operating income or loss directly related to the products included in each segment.

43

11. INVENTORY

Inventories for continuing operations, consisting of material, material overhead, labor and processing costs, are stated at the lower of cost (first-in, first-out) or market and consist of the following at September 30, 2006:

		September 30, 2006
Raw materials	$	—
Work-in-process		—
Finished goods		53
Total	$	53

12. ACCRUED LIABILITIES

Accrued liabilities for continuing operations consist of the following as of September 30, 2006:

		September 30, 2006
Accruals related to silent partner agreements	$	1,507
Accrued legal and accounting costs		426
Accruals for disputed services		794
Accrued operating expenses		1,441
Payroll related accruals		442
Accrued liquidated damages on Series C convertible preferred stock		161
Total	$	4,771

13. COMMITMENTS AND CONTINGENCIES

NeoMedia is party to various commitments and contingencies, such as:

- NeoMedia and its subsidiaries lease office facilities and certain office and computer equipment under various operating leases
- NeoMedia is party to various payment arrangements with its vendors that call for fixed payments on past due liabilities
- NeoMedia is party to various consulting agreements that carry payment obligations into future years.
- NeoMedia issued Series C convertible preferred shares with face value of $22,000,000 and convertible debentures with a face value of $5 million that are subject to conversion at future dates
- NeoMedia holds notes payable to certain vendors and silent partners of an acquired subsidiary that mature at various dates in the future.
- NeoMedia's subsidiary Sponge has entered into purchase commitments to procure the functionality needed to support a sales agreement with a major customer. The purchase commitments require payments of $1,121,000 in the fourth quarter of 2006, and $2,200,000 in 2007. Revenues related to this program are expected to exceed the purchase commitments over the one-year life of the contract.

The following table sets forth NeoMedia's future minimum payments due under operating leases, vendor and consulting agreements, convertible stock agreements, and debt agreements:

	Operating Leases	Vendor & Consulting Agreements	Notes Payable	Convertible Debentures	Series C Convertible Preferred Stock	Total
2006 (remaining three months)	$ 219	$ 3,040	$ 2,312	$ —	$ —	$ 5,571
2007	743	4,180	27	—	—	4,950
2008	571	—	—	5,000	—	5,571
2009	323	—	—	—	22,000	22,323
2010	206	—	—	—	—	206
Thereafter	198	—	—	—	—	198
Total	$ 2,260	$ 7,220	$ 2,339	$ 5,000	$ 22,000	$ 38,819

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the facts and circumstances involved in each particular agreement. The Company does not record a liability for claims related to indemnification unless the Company concludes that the likelihood of a material claim is probable and estimable. Historically, payments pursuant to these indemnifications have been immaterial. See Item 1 of Part II of this Form 10-Q for discussion of legal proceedings.

In the event that NeoMedia's stock price, at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable, is less than the contractual price (between

$0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees. On September 11, 2006, NeoMedia filed a registration statement on Form S-3 which included the consideration shares issued to acquire Mobot, Sponge, Gavitec, and 12Snap, among others. At current stock prices, NeoMedia does not believe that it will be able to generate enough cash to satisfy the purchase price guarantees if and when they become due, which is expected to occur upon effectiveness of the registration statement. As a result, NeoMedia is attempting to negotiate for payment of the purchase price guarantees in another form, including additional shares of common stock. There is no guarantee that NeoMedia will be successful in negotiating such an agreement with any or all of the parties involved.

14. OTHER

Liabilities related to silent partnership arrangements

12Snap, a wholly-owned subsidiary of NeoMedia, entered into three silent partnership arrangements in 2000 with principal borrowing amounts, totaling EUR 3,500,000 (approximately $4.2 million). Silent partnerships are a common form of investment in Germany. The purpose of a silent partnership is to financially support the Company in its efforts to research, design and develop its product and services, while allowing the lenders not to become a legal owner of the company and thus not become liable for the obligation of the company. The lenders are not involved in the management of 12Snap, but significant business decisions such as changes in the articles of incorporation, mergers and acquisitions or significant contractual matters are subject to their approval.

The partnership agreements regularly terminate on December 31, 2008 and 2009. However, due to the acquisition of all shares of 12Snap by NeoMedia, an early termination has been agreed on for all silent partnership agreements. Those silent partnerships have thus terminated as of February 28, 2006. According to the termination agreements EUR 1,750,000 (approximately $2.1 million) were repaid to the silent partners in March 2006. Another installment amounting to EUR 1,750,000 (approximately $2.1 million) plus interest will be due as of December 31, 2006.

In addition, one of the silent partners initiated arbitration proceedings during 2006 claiming the amount of EUR 353,000 (approximately $443,000) plus interest of 5% per annum since March 1, 2006 arising out of a change in control clause of the silent partnership agreement. The matter has been subject to German arbitration proceedings during the third and fourth quarter 2006, and the parties are currently negotiating a settlement based on the arbitration proceedings.

Debt of NeoMedia Telecom Services

The NeoMedia Telecom Services business unit was formed in March 2006 with the acquisition of BSD Software, Inc. BSD was party to certain debt agreements prior to the acquisition which became obligations of NeoMedia upon completion of the acquisition, as follows:

Wayside Solutions, Inc., a corporation affiliated with BSD, provided financing services to BSD prior to the acquisition. Prior to the acquisition, NeoMedia reached an agreement with Wayside to pay the outstanding debt due to Wayside subsequent to completion of the acquisition. During June 2006, NeoMedia issued 3,721,698 shares of its common stock in satisfaction of the debt and accrued interest. NeoMedia valued the stock at $0.227 per share, which was the last sale price on the date of issuance.

During June 2006, NeoMedia issued 1,512,093 shares of its common stock in satisfaction of the debt and accrued interest due to Guy Fietz, CEO, President and a shareholder of BSD, and now Vice President and General Manager of NeoMedia Telecom Services. NeoMedia valued the stock at $0.24 per share, which was the last sale price on the date of issuance.

NeoMedia also assumed amounts due to former BSD shareholders which bear interest at rates varying from 0%-10% per annum, are unsecured and due on demand and are subject to cash payment plans. Amounts due under such arrangements were $56,000 as of September 30, 2006.

Micro Paint Developments in China

On February 28, 2006, NeoMedia signed a 10-year exclusive supplier agreement with Automart, a Beijing-based joint venture operating under the laws of the People's Republic of China specializing in automobile sales, financing, insurance and repair. Automart is the brand name of Jinche Yingang Auto Technological Services Limited, with which NeoMedia signed a distribution agreement in August 2005. The new agreement expands on the previous agreement, giving Automart the exclusive rights to distribute NeoMedia's micro paint repair products to their own stores and others throughout China, Hong Kong, Macao, and Taiwan, and also guaranteeing that Automart will purchase at least 70% of its non-micro paint products through NeoMedia as its distributor. NeoMedia has signed distribution agreements with DuPont and PPG, and intends to become a distributor of other automotive aftermarket products to Automart.

During the fourth quarter of 2005 and first quarter of 2006, NeoMedia shipped and invoiced $759,000 of Micro Paint Repair products to Automart that has not yet been recognized in revenue as of September 30, 2006. The amount of $573,000 is included in deferred costs as of September 30, 2006.

In the third quarter of 2006, NeoMedia established a reserve for bad debt against the open accounts receivable, and wrote off the deferred revenue and deferred costs, incurring a net charge to income of $653,000. NeoMedia will recognize revenue on these shipments if and when collectibility is reasonably assured.

Pick Ups Plus and Automotive Preservation

On February 25, 2005, NeoMedia invested $250,000 in exchange for 8,333,333 shares of Pickups Plus, Inc. (“PUPS”)(OTCBB:PUPS) restricted common stock. PUPS is a retail operator and franchiser of retail automotive parts and accessories stores catering to the light truck market, and also provides new vehicle preparation, environmental protection packages, detailing and reconditioning products and services. In addition, on February 17, 2006, NeoMedia acquired an additional 20,000,000 shares of PUPS common stock from Cornell Capital Partners acquired from the proceeds of the Series C convertible preferred stock sale. The total of 28,333,333 shares owned represent approximately 19.75% of PUPS outstanding shares (based on 143,482,281 PUPS shares outstanding as of March 15, 2006). Because the investment represents less than 20% of PUPS outstanding shares, and because NeoMedia does not exercise significant influence over PUPS operations or decision making, NeoMedia has recorded the investment as available for sale securities and reported at fair value. As of September 30, 2006, NeoMedia has recorded an unrealized holding loss of $384,000 due to the decrease in the quoted market price of PUPS common stock.

Also on February 25, 2005, NeoMedia signed two non-binding Letters of Intent to acquire up to 100% of Automotive Preservation, Inc. (“AP”), a distributor of automotive paint and accessory products, from AP's parent company, PUPS. The first Letter of Intent calls for NeoMedia to initially acquire 30% of AP for $1,600,000, to be paid $600,000 in cash, $554,000 in shares of NeoMedia restricted common stock, and $446,000 through the assumption of AP debt by NeoMedia. Under the second Letter of Intent, upon completion of the acquisition of the initial 30% of AP by NeoMedia, NeoMedia would have the option to acquire an additional 30% of AP for $1,650,000, payable in shares of NeoMedia restricted common stock. The second Letter of Intent also gives NeoMedia the option to purchase the final 40% of AP for either: (i) $2,200,000, payable in shares of NeoMedia restricted common stock, if NeoMedia exercises this right within 12 months of acquiring the second 30% of AP, or (ii) a price equivalent to AP's previous quarter EBITDA multiplied by 8, payable in shares of NeoMedia restricted common stock. Both Letters of Intent are non-binding and subject to due diligence by NeoMedia and AP. On September 21, 2005, NeoMedia's board of directors approved to change the deal structure for the acquisition of AP, so that the Company would acquire only 30% of AP for a total purchase price of $1.6 million of which $600,000 would be paid in cash and $446,000 would be paid through the assumption of debt, and $554,000 through the issuance of restricted NeoMedia stock. NeoMedia will not acquire the remaining 70% of AP under the new structure.

47

During April 2006, NeoMedia announced its intention to issue a stock dividend with the distribution of common shares of PUPS common stock as a property dividend. NeoMedia intends to distribute 8,333,333 shares of PUPS common stock, which it acquired in February 2005, to NeoMedia shareholders of record as of April 28, 2006. The shares are to be distributed at such time as PUPS files and makes effective a registration statement registering the shares. As of September 30, 2006, PUPS had not filed a registration statement and is not legally obligated to file a registration statement.

Patent Issuance

During April 2006, the Instituto Mexicano de la Propiedad Industrial, the patent office in Mexico, awarded patent No. 233529 to NeoMedia, which corresponds to patents issued to the company by the U.S. Patent Office and the Canadian Intellectual Property Office, for a "Method and System for Accessing Electronic Resources via Machine-Readable Data on Intelligent Documents." Dr. Kevin Hunter, NeoMedia's chief scientist, is the inventor of record. NeoMedia has also filed for patents for the process in Europe, Japan and Brazil. The patent deals with improved methods of storing information placed directly on physical objects as PC-readable data utilizing 2-dimensional bar codes and various data compression techniques.

Change to Composition of Compensation Committee of Board of Directors

On September 20, 2006, the Board of Directors approved a change in the composition of the Compensation Committee. Previously the Compensation Committee was comprised of Charles W. Fritz, Charles T. Jensen, and James J. Keil. Effective September 20, 2006 the Compensation Committee will be comprised of all outside directors, including James J. Keil, A. Hayes Barclay, and William E. Fritz.

15. RESTATEMENT OF PREVIOUSLY REPORTED FINANCIAL INFORMATION

The Company, in reviewing its accounting practices with respect to revenue recognition of its subsidiary NeoMedia Telecom Services, became aware that it incorrectly applied the principles of EITF 99-19, “Reporting Revenue Gross as a Principal vs. Net as an Agent.” As a result, the company had overstated its net sales and its cost of goods sold during the three months and nine months ended September 30, 2006. These amounts are reflected on the statement of operations. The adjustment does not affect net income (loss) during any period. The adjustment does not affect the statement of cash flows or balance sheet.

The NeoMedia Telecom Services business was acquired in March 2006 through the acquisition by the Company of BSD Software. Therefore the adjustment does not affect any results reported during the years ended December 31, 2005 or 2004, or any interim periods during 2005 or 2004.

As a result, the Company has restated certain financial information that was previously reported in its unaudited quarterly reports on Form 10-Q for the three month periods ended March 31, 2006, June 30, 2006, and September 30, 2006. The following tables provide a reconciliation of amounts previously reported by the Company.

	Previously Reported	Restatement Adjustment	Restated Total
Three months ended March 31, 2006			
Net sales	$ 232	($205)	$ 27
Cost of sales	205	(205)	—
Three months ended June 30, 2006			
Net sales	$ 2,937	($2,422)	$ 515

Cost of sales		2,422	(2,422)		—
Six months ended June 30, 2006					
Net sales	$	3,169	($2,627)	$	542
Cost of sales		2,627	(2,627)		—
Three months ended September 30, 2006					
Net sales	$	3,205	($2,658)	$	547
Cost of sales		2,658	(2,658)		—
Nine months ended September 30, 2006					
Net sales	$	6,374	($5,285)	$	1,089
Cost of sales		5,285	(5,285)		—

16. SUBSEQUENT EVENTS

See Note 9.

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

NeoMedia in the Marketplace

During the first quarter of 2006, NeoMedia implemented an aggressive growth strategy aimed at penetrating the rapidly evolving mobile marketing industry, through the acquisition of Mobot, Gavitec, 12Snap, and Sponge. Combining the brand name and innovative power of its new acquisitions with its patent portfolio and proprietary qode® suite of products, NeoMedia's goal is to capture a significant portion of early adopting marketers and drive high volumes of physical-world-to-mobile-internet traffic through the NeoMedia engine.

As with any industry in its relative infancy, there have been bumps along the way. NeoMedia has experienced many of the problems normally associated with developing technologies and markets, such as slower than anticipated marketplace adoption, technical product development issues, the market's unwillingness to find a standard pricing model, and increased competition, among others.

However, NeoMedia management believes that the Company has made significant inroads into this developing market. NeoMedia's family of products and companies has run some of the most innovative and successful mobile marketing campaigns in the marketplace during 2006, such as:

- **qode®** technology will be featured in an interactive textbook published by Prentice Hall, in which students can link to mobile online content through the qode® reader on their mobile phones.

- **12Snap** designs and runs mobile marketing campaigns for a plethora of clients, most notably McDonald's, Coca-Cola, Adidas, Nokia, Lufthansa, MTV, Kraft Foods, and Ferrero. 12snap enables millions of consumers throughout the EMEA (Europe, Middle East & Africa) region to participate in high-quality and entertaining mobile marketing campaigns.

- **Gavitec** has run mobile marketing solutions for clients such as McDonald's Portugal, Amnesty International, Malaysian Railways, World Soccer Games 2006, EMT (Empresa Malagueña de Transportes, a Spanish public transport provider) Ströer, a large media company. Gavitec also ran a mobile couponing campaign for Bitburger beer focusing on World Cup events.

- **Sponge** media successes included increased activity for IPC magazines and News International, as well as television program Big Brother in Sweden and Norway. Sponge has also worked on a number of brand promotions, including: a major specialist motorcycle magazine; on-pack text-to-win mechanics for a major soft drinks brand to coincide with the World Cup as well as other drinks and confectionary brands. Also launched was a pan-European, eight-country trade promotion for TaylorMade®-adidas® Golf.

- **Mobot** expanded its relationship with Hachette Filipacchi Media and delivered a first-of-its-kind nationwide (U.S. & Canada) campaign for Starbucks. Mobot also helped launch an interactive shopping program called *EWish* with ELLE magazine, and provided a direct link campaign for Acura.

NeoMedia Telecom

During March 2006, NeoMedia acquired BSD Software, Inc. and created NeoMedia Telecom Services Business Unit. The acquisition of BSD did not contain the same purchase price guarantee provision as the other acquisitions.

NeoMedia Telecom is currently in the final stages of completing the successful transition of some of its key customers to a new Canadian interchange carrier network, which provides both 1010 dial-around and 900 service nationally. The company is already experiencing a positive impact from this transition in two ways: (1) several customers who were regional are expanding to a national billing strategy, and (2) NeoMedia Telecom has been able to reduce costs by moving from local exchange carriers (LEC's) to the new interchange carrier network, which is a non-tariffed (regulated rates) national network.

Third quarter revenue from NeoMedia Telecom was $547,000, up from second quarter revenue of $515,000 million. The revenue growth is the result of transition to the new IXC, which lowers NeoMedia Telecom's cost basis, as well as expansion of the NeoMedia Telecom's billing solutions to U.S. carriers.

Purchase Price Obligation

From a capitalization perspective, NeoMedia was a relatively small player in the mobile marketing industry prior to its acquisitions of 12Snap, Gavitec, Sponge and Mobot. Many large advertising agencies, software providers, and other larger and better-funded companies were and continue to be in the market for acquisition of these cutting-edge start-ups. In order to induce companies of this caliber to merge with a smaller, unproven entity with fewer resources than competing bidders, NeoMedia agreed to a purchase price guarantee for the stock consideration issued in each transaction, essentially guaranteeing, with cash, that the value of the stock issued to acquire the companies would not decline between the closing of the acquisitions and the time the recipients could sell it. The stock price at the time the acquisitions closed was approximately $0.39 per share. Since the closing of the acquisitions in February and March, NeoMedia's stock price has gradually eroded. The last sale price on October 23, 2006 was $0.10 per share, at which price the purchase price guarantee obligation would be approximately $32.7 million.

NeoMedia has neither sufficient operating capital nor contractually committed capital from outside sources to adequately fund the purchase price guarantee at these levels. As a result, NeoMedia has sought other means to satisfy or eliminate the obligations, including an offer to pay the obligation with shares of its common stock. As of the date of this filing, there have been no formal agreements put in place with respect to alternate payment of any of the obligations. In the event that the obligations are not satisfied through the issuance of common stock or other non-cash means, NeoMedia could be forced to sell or otherwise divest of some of its subsidiaries in the near future, or be subject to potential litigation by the shareholders of the acquired companies.

Additional Cost Reductions

During the third and fourth quarters of 2006, NeoMedia is implementing company wide cost reduction plans aimed at conserving its limited cash resources, including reductions of its workforce, termination of several month-to-month consulting arrangements, and other cost savings measures. NeoMedia will also realize additional cost reductions upon the sale of its Micro Paint Repair business unit, which has operated at a loss since its acquisition in February 2004. NeoMedia will continue to evaluate its cost base and reduce redundant or non-mission critical costs during the remainder of 2006 and into 2007.

Sale of Micro Paint Business Unit

On August 30, 2006, NeoMedia signed a non-binding letter of intent to sell its Micro Paint Repair business unit to Jose Sada, a technology partner of NeoMedia Micro Paint Repair, backed by Global Emerging Markets Group of New

York City. The letter of intent calls for consummation of the transaction on or before November 24, 2006.

As a result of the pending sale, the operations of the NeoMedia Micro Paint Repair business unit have been classified as discontinued operations on the accompanying consolidated statements of operations for the three and nine months ended September 30, 2006 and 2005, and the assets and liabilities of the business unit have been classified as assets held for sale and liabilities held for sale on the accompanying consolidated balance sheets as of September 30, 2006 and December 31, 2005. Loss from these discontinued operations was $1,620,000 and $381,000 for the three months ended September 30, 2006 and 2005, respectively, and $2,826,000 and $1,307,000 for the nine months ended September 30, 2006 and 2005, respectively. The carrying value of assets held for sale was $3,451,000 (unaudited) and $4,058,000 as of September 30, 2006 and December 31, 2005, respectively. The carrying value of liabilities held for sale was $750,000 (unaudited) and $669,000 as of September 30, 2006 and December 31, 2005, respectively. There have been no adjustments to the carrying value subsequent to September 30, 2006 and prior to this filing. NeoMedia will not recognize depreciation and amortization on the assets held for sale subsequent to September 30, 2006 through the date of sale. Depreciation and amortization on assets held for sale would be approximately $77,000 per quarter.

Termination of Hip Cricket Acquisition

On August 24, 2006, NeoMedia terminated a non-binding letter of intent to acquire Hip Cricket, due to an inability of the parties to come to terms on a definitive purchase price. On February 16, 2006, NeoMedia and Hip Cricket signed the letter of intent, under which NeoMedia intended to acquire all of the outstanding shares of Hip Cricket in exchange for $500,000 cash and $4,000,000 of NeoMedia common stock, subject to due diligence and signing of a mutually agreeable definitive purchase agreement by both parties.

In addition to signing the letter of intent, NeoMedia loaned Hip Cricket the principal amount of $500,000 in the form of (a) a promissory note, dated February 16, 2006, in the amount of $250,000 and (b) that certain promissory note, dated March 20, 2006, in the amount of $250,000. The notes accrue interest at a rate of 8% per annum. The notes were to be applied toward the cash portion of the purchase price upon signing of a definitive purchase agreement for the acquisition of all of the outstanding shares of Hip Cricket by NeoMedia, as contemplated in the letter of intent. Due to the termination of the letter of intent, and pursuant to the terms of the notes, the face amount of the notes, plus any and all interest accrued thereon, will become payable and due on November 22, 2006. In the event the Notes are not repaid by November 22, 2006, the notes will convert into shares of Hip Cricket common stock using a valuation of $4.5 million for Hip Cricket.

Consulting & Integration Services Business Unit

As part of the acceleration of global expansion in the Mobile and Micro Paint business units, as well as the creation of the NeoMedia Telecom Services (NTS) business unit through the BSD acquisition, NeoMedia also decided in February 2006 to wind down its legacy NeoMedia Consulting & Integration Services (NCIS) business unit. The NCIS unit consisted of client-server equipment and related software resales. The resale market has been commoditized over the past several years, and NeoMedia believes its resources are better spent on the development and commercialization of its NMM, NMPR and NTS business units. Certain of the proprietary products associated with the NCIS business, such as PDF-417 and Maxicode print encoder software and WISP migration tools, will be retained by NeoMedia and consolidated with the NMM unit. NeoMedia does not intend to pursue additional resales of hardware and software or integration services not directly related to its other business units.

Accounting Treatment of Series C Convertible Preferred Stock and Convertible Debenture

In connection with the accounting treatment of the Series C convertible preferred stock sale (February 17, 2006) and Convertible Debentures (August 24, 2006), NeoMedia recognized a (loss) and gain on derivative financial instruments of $(9,271,000) and $6,503,000 during the three and nine month periods ended September 30, 2006, respectively. The gain and loss is due to the change in fair value of derivative financial instruments resulting from a decrease in NeoMedia's stock price from $0.389 per share on the date of the Series C convertible preferred stock sale (February

17, 2006) to $0.117 per share on September 30, 2006. The fair value of the derivative financial instruments at each measurement date correlates to NeoMedia's stock price at the same date. As a result, NeoMedia's net income varies significantly from its cash flow from operations during the three and six months ended June 30, 2006. In future periods, NeoMedia's earnings could fluctuate dramatically from quarter to quarter if its stock price is significantly different from the stock price at the end of the previous measurement period. Because NeoMedia cannot guarantee that it has enough authorized shares to net share settle the Series C convertible preferred stock, the change in fair value of derivative instruments will be recorded to NeoMedia's statement of operations each reporting period until the Series C convertible preferred stock is fully converted.

Write-off of Deferred Financing Costs

In the third quarter of 2006, NeoMedia incurred a non-cash charge to income in the amount of $13,256,000 to write off deferred equity financing costs related to its $100 million Standby Equity Distribution Agreement. The costs were originally recorded in March 2005 and represent the fair value of warrants issued as financing costs associated with the 2005 SEDA. The Company believes that it can no longer consider the 2005 SEDA a viable financing source due to the utilization of the preferred stock financing and the debenture financing.

Restatement of previously reported financial results

The Company, in reviewing its accounting practices with respect to revenue recognition of its subsidiary NeoMedia Telecom Services, became aware that it incorrectly applied the principles of EITF 99-19, “Reporting Revenue Gross as a Principal vs. Net as an Agent.” As a result, the company had overstated its net sales and its cost of goods sold during the three and nine months ended September 30, 2006. These amounts are reflected on the statement of operations. The adjustment does not affect net income (loss) during any period. The adjustment does not affect the statement of cash flows or balance sheet.

The NeoMedia Telecom Services business was acquired in March 2006 through the acquisition by the Company of BSD Software. Therefore the adjustment does not affect any results reported during the three and nine month periods ended September 30, 2005.

As a result, the Company has restated certain financial information that was previously reported in its unaudited quarterly reports on Form 10-Q for the three and nine month periods ended September 30, 2006. The following tables provide a reconciliation of amounts previously reported by the Company.

	Previously Reported	Restatement Adjustment	Restated Amount
Three months ended September 30, 2006			
Net sales	$ 6,249	($2,658)	$ 3,591
Cost of sales	4,112	(2,658)	1,454
Nine months ended September 30, 2006			
Net sales	$ 14,129	($5,285)	$ 8,844
Cost of sales	8,887	(5,285)	3,602

Critical Accounting Policies

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

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

According to SFAS 144, a long-lived asset should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

- A significant decrease in the market price of the asset
- A significant adverse change in the extent or manner in which the asset is being used, or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of the asset, including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of the asset
- A current expectation that, more likely than not, the asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

NeoMedia follows the two-step process outlined in SFAS 144 for determining if an impairment charge should be taken: (1) the expected undiscounted cashflows from a particular asset or asset group are compared to the carrying value; if the expected undiscounted cashflows are greater than the carrying value, no impairment is taken, but if the expected undiscounted cashflows are less than the carrying value, then (2) an impairment charge is taken for the difference between the carrying value and the expected discounted cashflows. The assumptions used in developing expected cashflow estimates are similar to those used in developing other information used by NeoMedia for budgeting and other forecasting purposes. In instances where a range of potential future cashflows is possible, NeoMedia uses a probability-weighted approach to weigh the likelihood of those possible outcomes. NeoMedia used a rate of 10% for purposes of discounting cashflows in 2006 and 2005.

Financial Instruments and Concentrations of Credit Risk. The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, notes payable, derivative financial instruments, other current liabilities, convertible preferred stock, and convertible debenture financing. Management believes the carrying values of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses, notes payable, and other current liabilities approximate their fair values due to their short-term nature. The fair value of the convertible preferred stock and convertible debenture financing is estimated on September 30, 2006 to be approximately $1,515,000 and $72,692 respectively.

The Company generally does not use derivative financial instruments to hedge exposures to cash-flow risks or market-risks that may affect the fair values of its financial instruments. However, certain other financial instruments, such as warrants and embedded conversion features that are indexed to the Company's common stock, are classified as liabilities when either (a) the holder possesses rights to net-cash settlement or (b) physical or net-share settlement is not within the control of the Company. In such instances, net-cash settlement is assumed for financial accounting and reporting, even when the terms of the underlying contracts do not provide for net-cash settlement. Such financial instruments are initially recorded at fair value and subsequently adjusted to fair value at the close of each reporting period.

The caption “Derivative Financial Instruments” consists of (i) the fair values associated with derivative features embedded in the Series C convertible preferred stock, (ii) the fair values of the detachable warrants that were issued in connection with the preferred stock financing arrangement, and (iii) the fair value of detachable warrants that were outstanding prior to the issuance of the Series C Preferred Shares.

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

Inventory. Inventories are stated at lower of cost (using the first-in, first-out method) or market. NeoMedia continually evaluates the composition of its inventories assessing slow-moving and ongoing products and maintains a reserve for slow-moving and obsolete inventory as well as related disposal costs.

Stock-based Compensation. Beginning January 1, 2006, NeoMedia began to account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment* . Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted. Stock-based compensation expense is calculated using the Black Scholes option pricing model on the date of grant. This option valuation model requires input of highly subjective assumptions. Because NeoMedia's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing model does not necessarily provide a reliable single measure of fair value of its employee stock options.

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

Revenue Recognition.

NeoMedia derives revenues from the following sources: (1) license revenues relating to patents and internally-developed software, (2) hardware, software, and service revenues related to mobile marketing campaign design and implementation, and (3) sale of its proprietary Micro Paint Repair solution.

(1) Technology license fees, including Intellectual Property licenses, represent revenue from the licensing of NeoMedia’s proprietary software tools and applications products. NeoMedia licenses its development tools and application products pursuant to non-exclusive and non-transferable license agreements. The basis for license fee revenue recognition is substantially governed by American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"), as amended, and Statement of Position 98-9, Modification of SOP 97-2, “Software Revenue Recognition, With Respect to Certain Transactions.”. License revenue is recognized if persuasive evidence of an agreement exists, delivery has occurred, pricing is fixed and determinable, and collectibility is probable. The Company defers revenue related to license fees for which amounts have been collected but for which revenue has not been recognized in accordance with the above, and recognizes the revenue over the appropriate period.

(2) Technology service and product revenue, which includes sales of software and technology equipment and service fee is recognized based on guidance provided in SEC Staff Accounting Bulletin (“SAB”) No. 104, "Revenue Recognition in Financial Statements," as amended (SAB 104). Software and technology equipment resale revenue is recognized when persuasive evidence of an arrangement exists, the price to the customer is fixed and determinable, delivery of the service has occurred and collectibility is reasonably assured. Service revenues including maintenance fees for providing system updates for software products, user documentation and technical support are recognized over the life of the contract. The Company’s subsidiaries, Mobot (sold during 2006), and Gavitec follow this policy. The Company defers revenue related to technology

service and product revenue for which amounts have been invoiced and or collected but for which the requisite service has not been provided. Revenue is then recognized over the matching service period.

(3) Technology service also includes mobile marketing services to its customers which mobile marketing projects are recognized after the completion of the project and accepted by the customer. All response and messaging based revenues are recognized at the time such responses are received and processed and the Company recognizes its premium messaging revenues on a net basis based on guidance provided in Emerging Issues Task Force Issues No. 99-19 (EITF 99-19), “Reporting Revenue Gross as Principal or Net as an Agent” and No. 01-09 (EITF 01-09), “Accounting for Consideration Given by a Vendor to a Customer.” Consulting and management revenues and revenues for periodic services are recognized as services are performed. NeoMedia uses stand-alone pricing to determine an element's vendor specific objective evidence (“VSOE”) in order to allocate an arrangement fee amongst various pieces of a multi-element contract. The Company’s subsidiaries 12Snap and Sponge (sold during 2006) follow this policy. Telecom revenues from NeoMedia’s subsidiary BSD are recognized at the time that calls are accepted by the clearinghouse for billing to customers on a net basis, based on guidance in EITF 99-19. The Company defers revenue related to mobile marketing service fees for which amounts have been invoiced and/or collected but for which revenue has not been recognized. Revenue is then recognized over the matching service period.

(4) Revenue for licensing and exclusivity on NeoMedia’s Micro Paint Repair systems is recognized equally over the term of the contract, which is currently one year. A portion of the initial fee paid by the customer is allocated to licensing, training costs and initial products sold with the system. Revenue is recognized upon completion of training and shipment of the products, provided there is VSOE in a multiple element arrangement. Ongoing product and service revenue is recognized as products are shipped and services performed. The Company defers revenue related to micro paint repair licensing for which amounts have been invoiced and/or collected and revenue is then recognized over the estimated contract period, which is currently one year.

Income Tax Valuation Allowance. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be recognized. The Company has recorded a 100% valuation allowance as of September 30, 2006 and 2005.

Foreign Currency Translation. The local currency has been primarily used as the functional currency throughout the world. Translation gains and losses of those operations that use local currency as the functional currency are included in the consolidated balance sheets as “Accumulated other comprehensive income (loss).” Where the U.S. dollar is used as the functional currency, foreign currency gains and losses are reflected in income.

Stock-Based Compensation

NeoMedia adopted Statement of Financial Accounting Standards No. 123 ("SFAS 123R") on January 1, 2006, using the prospective method for stock option grants prior to January 1, 2006 and the modified-prospective transition method for stock option grants and restricted stock issued after January 1, 2006. As a result, the unamortized compensation expense from stock options granted prior to January 1, 2006 is not included in the statement of operations. SFAS 123R requires all share-based payments to employees to be recognized in the income statement based on their fair values. Under the modified-prospective transition method, compensation cost recognized for the three and nine months ended September 30, 2006 includes: (a) compensation cost for all share-based payments granted, but not yet vested as of January 1, 2006 based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Such amounts are reduced by NeoMedia's estimate of forfeitures of all unvested awards.

Prior to January 1, 2006, NeoMedia accounted for its stock-based compensation plans under the intrinsic-value method prescribed in Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees," ("APB 25") and related interpretations as permitted by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation." ("SFAS 123"). Under APB 25, when the exercise price of options granted to employees equals the market price of the common stock on the date of grant, no compensation expense is recorded. When the exercise price of options granted to employees is less than the market price of the common stock on the date of grant, compensation expense is recognized over the vesting period. Had NeoMedia accounted for stock based compensation under the fair value method during the three and nine months ended September 30, 2005, net loss would have been higher by $1.1 million and $2.8 million, respectively, during these periods, causing an increase to the reported net loss per share of $0.01 for each period.

SFAS 123R requires share-based payments to employees to be measured at fair value. However, the valuation of employee stock options is an inherently subjective process, since market values are generally not available for long-term, non-transferable employee stock options. Accordingly, an option pricing model is utilized to derive an estimated fair value. NeoMedia uses the Black-Scholes-Merton pricing model in order to calculate the estimated fair value for its stock options.

Approximately 56% and 37% of the stock-based compensation expense recorded in the three and nine months ended September 30, 2006 respectively, relates to the continued vesting of stock options that were granted prior to January 1, 2006. In accordance with the transition provisions of SFAS 123R, the grant date estimates for these options have not been changed.

As of September 30, 2006, there was $8.0 million of total stock-based compensation expense not yet recognized relating to non-vested awards granted under NeoMedia's option plans and restricted stock agreements as calculated under SFAS 123R. This expense is net of estimated forfeitures and is expected to be recognized over a weighted-average period of approximately 1.2 years. The amount of stock-based compensation expense to be recorded in any future period cannot be exactly predicted due to the uncertainty of future grant levels and actual forfeitures to be recorded. Additionally, changes to the assumptions used in the Black Scholes model could cause a material change in the amount of compensation expense to be recorded in future reporting periods.

One of the key components used in calculating the fair value of stock options is the volatility of the underlying stock. As of January 1, 2006, NeoMedia reevaluated its volatility calculation to take into consideration the guidance outlined in Statement 123(R). Prior to January 1, 2006, NeoMedia calculated volatility using only historical share price data. Under the provisions of Statement 123(R), from January 1, 2006 onward NeoMedia has considered historical volatility, as well expected future volatility. As a result, NeoMedia's volatility decreased significantly for stock based compensation granted during the nine months ended September 30, 2006 as compared with stock based compensation granted prior to January 1, 2006. NeoMedia will evaluate its volatility on an ongoing basis using the most current information available. NeoMedia expects that, under the guidelines of Statement 123(R), future volatility will more closely resemble 2006 levels than previous years.

Effect Of Recently Issued Accounting Pronouncements

A discussion of recent accounting pronouncements is included in Note 2 to the consolidated financial statements included in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

Emerging Issues Task Force issue number 06-03 has been adopted early by NeoMedia in the first quarter of 2006. The implementation of EITF 06-03 had no impact on current or historical financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, “Accounting for Uncertainty in Income Taxes,” that provides guidance on the accounting for uncertainty in income taxes recognized in financial statements. The interpretation will be adopted by the Company on January 1, 2007. The Company is currently evaluating the impact of adopting FIN 48; however, does not expect the adoption of this provision to have a material effect on the financial position, results of operations or cash flows.

In July 2006, the FASB issued FASB Staff Position (FSP) No. FAS 13-2, “Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction,” that provides guidance on how a change or a potential change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction affects the accounting by a lessor for the lease. This staff position will be adopted by the Company on January 1, 2007. The Company is currently evaluating the impact of adopting this FSP; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" ("SFAS 158"). SFAS 158 requires an entity to recognize in its statement of financial position an asset for a defined benefit pension or postretirement plan's overfunded status or a liability for a plan's underfunded status, and to recognize changes in that funded status through other comprehensive income in the year in which the changes occur. SFAS 158 will not change the amount of net periodic benefit expense recognized in an entity's results of operations. SFAS 158 is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the impact of adopting this FSP; however, the Company does not expect the adoption of this provision to have a material effect on its financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin No. 108 (“SAB 108”), *Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.”* SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 provides that once a current year misstatement has been quantified, the guidance in SAB No. 99, *Financial Statements - Materiality* , should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. Under certain circumstances, prior year financial statements will not have to be restated and the effects of initially applying SAB 108 on prior years will be recorded as a cumulative effect adjustment to beginning Retained Earnings on January 1, 2006, with disclosure of the items included in the cumulative effect. We will apply the provisions of SAB 108 with the preparation of our annual financial statements for the calendar year ending December 31, 2006. The Company is currently evaluating, but does not expect the application of the provisions of SAB 108 to have a material impact, if any, on our financial statements for the calendar year ending December 31, 2006.

Results Of Operations For The Three Months Ended September 30, 2006 As Compared To The Three Months Ended September 30, 2005

Net sales. Restated total net sales from continuing operations for the three months ended September 30, 2006 were $3,591,000, which represented a $3,398,000, or 1,761%, increase from $193,000 for the three months ended September 30, 2005. This increase resulted from (i) $3,409,000 net sales from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, offset by a (ii) decrease of $11,000 in net sales from the Company's underlying business represented by qode® and NeoMedia's legacy software products.

Cost of sales. Restated cost of technology services, products and licenses fees were $1,454,000 for the three months ended September 30, 2006 compared to $116,000 for the three months ended September 30, 2006, an increase of $1,338,000, or 1,153%. This increase resulted from (i) $865,000 product and service related cost of sales from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (ii) amortization of $519,000 of intangible assets relating to the acquisitions of Mobot, Sponge, Gavitec, 12Snap and BSD, offset by (iii) a decrease of $46,000 in cost of sales from the Company's underlying business represented by qode® and NeoMedia's legacy software products.

Gross profit. Gross profit was $2,137,000 for the three months ended September 30, 2006, an increase of $2,060,000, or 2,675%, compared with gross profit of $77,000 for the three months ended September 30, 2005. This increase resulted from (i) $2,528,000 operational gross profit from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (ii) increased gross profit of $51,000 from the Company's underlying business represented by qode® and NeoMedia's legacy software products, offset by (iii) amortization of $519,000 of intangible assets relating to the acquisitions.

Sales and marketing. Sales and marketing expenses were $2,795,000 for the three months ended September 30, 2006, compared to $589,000 for the three months ended September 30, 2005, an increase of $2,206,000 or 375%. This increase resulted from (i) sales and marketing expenses of $2,420,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, offset by (ii) lower sales and marketing expense in the Company's underlying business represented by qode® and NeoMedia's legacy software products of $214,000 in 2006.

General and administrative. General and administrative expenses increased by $1,894,000, or 248%, to $2,659,000 for the three months ended September 30, 2006, compared to $765,000 for the three months ended September 30, 2005. The increase resulted from (i) higher accounting, professional, and legal services of $1,215,000 due to Company's implementation of Sarbanes Oxley, higher audit fees and accounting overhead resulting from a more complex reporting structure and transactions, actual and threatened lawsuits, and registration statements, and (ii) general and administrative expenses of $681,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006.

Research and development. During the three months ended September 30, 2006, NeoMedia charged to expense $1,013,000 of research and development costs, an increase of $890,000 or 724% compared to $123,000 for the three months ended September 30, 2005. The increase resulted from (i) research and development expenses of $746,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, and (ii) increased research and development expense related to qode® products of $143,000.

Stock based compensation expense. Stock based compensation was $2,230,000 for the three months ended September 30, 2006, as compared with $93,000 for the three months ended September 30, 2005, an increase of $2,227,000, or 2,395%. The increase was due to the adoption of SFAS 123R (Share Based Payment) on January 1, 2006.

Gain on extinguishment of debt. Gain on extinguishment of debt was $0 for the three months ended September 30, 2006, a decrease of $1,000 or 100%, compared with a gain of $1,000 during the three months ended September 30, 2005. The gain in 2005 resulted from the difference between the cash or market value of stock issued to settle debt and the carrying value of the debt at the time of settlement.

Interest income (expense). Interest income (expense) consists primarily of interest accrued for creditors as part of financed purchases, past due balances, and notes payable, net of interest earned on cash equivalent investments and notes receivable. Interest expense for the three months ended September 30, 2006 was $112,000, as compared to interest expense of $77,000 for the three months ended September 30, 2005, a change of $35,000 or 45%. The change resulted from $123,000 of interest expense during the three months ended September 20, 2005 related to a note payable that was paid off during the first quarter of 2006 and accrued liquidated damages related to the preferred stock of $161,000 in 2006.

Write-off of deferred equity financing costs. During the three months ended September 30, 2006, NeoMedia incurred a charge of $13,256,000 to write off deferred equity financing costs related to the 2005 SEDA. No comparable charges were taken during the three months ended September 30, 2005.

Change in fair value from revaluation of warrants and embedded conversion features. Loss from the change in fair value from revaluation of warrants and embedded conversion features was $9,271,000 for the three months ended September 30, 2006. The gain is on the derivatives and embedded conversion features associated with the preferred stock sale on February 17, 2006 and the convertible debenture financing dated August 24, 2006. Certain derivatives and embedded conversion features were created at the time of each offering and those derivatives are recorded at fair value on the accompanying balance sheet. The gain for the three months ended September 30, 2006 is driven by a reduction in NeoMedia's stock price from June 30, 2006 to September 30, 2006. There was no such gain or loss on derivative financial instruments for the three months ended September 30, 2005.

Loss from discontinued business unit. During the three months ended September 30, 2006, NeoMedia entered into a letter of intent to sell its NMPR business unit. As a result, the Company has classified the operations of the NMPR business unit into this line item. Loss from the discontinued business unit represents direct operations of the NMPR business during the three months ended September 30, 2006. The net loss from the NMPR business unit for the three months ended September 30, 2006 was $1,620,000, an increase of $1,239,000 and 325% from the loss of $381,000 for the three months ended September 30, 2005. The increased loss is due to the fixed overhead costs related to the expansion into the US and China markets and the establishment of a bad debt reserve on the sales to a customer in China.

Net loss. The net loss for the three months ended September 30, 2006 was $30,909,000, which represented a $28,959,000, or 1,485% increase from a $1,950,000 loss for the three months ended September 30, 2005. This increased net loss resulted from (i) $9,271,000 expense from the change in fair value from revaluation of warrants and embedded conversion features associated with the preferred stock and convertible debenture financing, (ii) $13,256,000 charge to write off deferred equity financing costs associated with the 2005 SEDA, (iii) $2,390,000 increase to stock based compensation expense as a result of the adoption of SFAS 123(R) on January 1, 2006, (iv) $1,105,000 loss from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (v) $653,000 bad debt reserve for the Micro Paint customer in China, and (vi) $2,284,000 increased loss from the Company's underlying business represented by qode®, NeoMedia's legacy software products, and corporate administration.

Known trends, demands, commitments, or uncertainties. In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees. On September 11, 2006, NeoMedia filed a registration statement on Form S-3 which included the consideration shares issued to acquire Mobot, Sponge, Gavitec, and 12Snap, among others. At current stock prices, NeoMedia does not believe that it will be able to generate enough cash to satisfy the purchase price guarantees if and when they become due, which is expected to occur upon effectiveness of the registration statement. As a result, NeoMedia is attempting to negotiate for payment of the purchase price guarantees in another form, including additional shares of common stock. There is no guarantee that NeoMedia will be successful in negotiating such an agreement with any or all of the parties involved. In the event that NeoMedia is not able to negotiate another form of payment, NeoMedia could be forced to divest of certain of the acquisitions. In the event that one or more of these subsidiaries is divested (which divestiture would be subject to approval by Cornell Capital Partners), NeoMedia would expect its sales, cost of sales, gross profit, and operating expenses over the next 12 months to decrease materially compared with its 2006 results which reflect operations of all acquisitions.

Results Of Operations For The Nine months Ended September 30, 2006 As Compared To The Nine Months Ended September 30, 2005

Net sales. Restated total net sales for the nine months ended September 30, 2006 were $8,844,000, which represented a $8,082,000, or 1,061%, increase from $762,000 for the nine months ended September 30, 2005. This increase resulted from (i) $8,591,000 net sales from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (ii) an increase of $45,000 in net sales from the Company's underlying business represented by qode® and intellectual property licensing, offset by (iii) a decrease in net sales of $554,000 from NeoMedia's Consulting and Integration Services business unit.

Cost of sales. Restated cost of technology services, products and licenses fees were $3,602,000 for the nine months ended September 30, 2006 compared to $440,000 for the nine months ended September 30, 2005, an increase of $3,162,000, or 719%. This increase resulted from (i) $2,100,000 product and service related cost of sales from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (ii) amortization of $1,241,000 of intangible assets relating to the acquisitions of Mobot, Sponge, Gavitec, 12Snap and BSD, offset by (iii) a decrease of $249,000 in cost of sales from the Company's underlying business represented by qode® and NeoMedia's legacy software products.

Gross profit. Gross profit was $5,242,000 for the nine months ended September 30, 2006, an increase of $4,920,000, or 1,528%, compared with gross profit of $322,000 for the nine months ended September 30, 2005. This increase resulted from (i) $6,491,000 operational gross profit from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, offset by (ii) decreased gross profit of $330,000 from the Company's underlying business represented by qode®, NeoMedia's legacy software products, and NeoMedia's discontinued Consulting and Integration Services business unit, and (iii) amortization of $1,241,000 of intangible assets relating to the acquisitions.

Sales and marketing. Sales and marketing expenses were $6,719,000 for the nine months ended September 30, 2006, compared to $1,332,000 for the nine months ended September 30, 2005, an increase of $5,387,000 or 404%. This increase resulted from (i) sales and marketing expenses of $4,597,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, and (ii) higher sales and marketing expense in the Company's underlying business represented by qode® and NeoMedia's legacy software products of $790,000 in 2006.

General and administrative. General and administrative expenses increased by $4,609,000, or 215%, to $6,752,000 for the nine months ended September 30, 2006, compared to $2,143,000 for the nine months ended September 30, 2005. The increase resulted from (i) higher accounting, professional, and legal services of $2,482,000 due to Company's implementation of Sarbanes Oxley, higher audit fees resulting from a more complex reporting structure and transactions, actual and threatened lawsuits, and registration statements, and (ii) general and administrative expenses of $2,128,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006.

Research and development. During the nine months ended September 30, 2006, NeoMedia charged to expense $2,309,000 of research and development costs, an increase of $1,944,000 or 533% compared to $365,000 for the three months ended September 30, 2005. The increase resulted from (i) research and development expenses of $1,481,000 from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, and (ii) increased research and development expense related to qode® products of $462,000.

Stock based compensation expense. Stock based compensation was $4,948,000 for the nine months ended September 30, 2006, as compared with $593,000 for the nine months ended September 30, 2005, an increase of $4,355,000, or 743%. The increase was due to the adoption of SFAS 123R (Share Based Payment) on January 1, 2006.

Gain (loss) on extinguishment of debt. NeoMedia incurred a loss on extinguishment of debt of $1,858,000 for the nine months ended September 30, 2006, primarily resulting from debt retired in connection with the Series C preferred stock issued and sold to Cornell on February 17, 2006. A loss was incurred on the surrender of a certain promissory note to Cornell dated March 30, 2005 in connection with the preferred stock sale. During the nine months ended September 30, 2005, NeoMedia recognized a gain on extinguishment of debt of $172,000, resulting from the payment of debt at a discount to its book value.

Interest income (expense). Interest income (expense) consists primarily of interest accrued for creditors as part of financed purchases, past due balances, and notes payable, net of interest earned on cash equivalent investments. Interest expense decreased by $32,000, or 14%, to $191,000 for the nine months ended September 30, 2006 from $223,000 for the nine months ended September 30, 2005. The change resulted from $319,000 of interest expense during the nine months ended September 30, 2005 related to a note payable that was paid off during the first quarter of 2006, offset by interest earned on notes receivable in 2006, and the accrual of $161,000 of liquidated damages related to the preferred stock in 2006.

Write-off of deferred equity financing costs. During the nine months ended September 30, 2006, NeoMedia incurred a charge of $13,256,000 to write off deferred equity financing costs related to the 2005 SEDA. No comparable charges were taken during the nine months ended September 30, 2005.

Change in fair value from revaluation of warrants and embedded conversion features. Gain from the change in fair value from the revaluation of warrants and embedded conversion features was $6,523,000 for the nine months ended September 30, 2006. The gain is on the derivatives and embedded conversion features associated with the preferred stock sale on February 17, 2006 and the convertible debenture financing dated August 24, 2006. Certain derivatives and embedded conversion features were created at the time of each offering and those derivatives are recorded at fair value on the accompanying balance sheet . The gain for the nine months ended September 30, 2006 is the reduction in value of the derivatives and embedded conversion features from the inception of each financing to September 30, 2006 and is due almost entirely to a reduction in NeoMedia's stock price from the inception of each financing to September 30, 2006. There was no such gain or loss on derivative financial instruments for the nine months ended September 30, 2005.

Loss from discontinued business unit. During the nine months ended September 30, 2006, NeoMedia entered into a letter of intent to sell its NMPR business unit. As a result, the Company has classified the operations of the NMPR business unit into this line item. Loss from the discontinued business unit represent direct operations of the NMPR business during the nine months ended September 30, 2006. The net loss from the NMPR business unit for the nine months ended September 30, 2006 was $2,826,000, an increase of $1,519,000 and 116% from the loss of $1,307,000 for the nine months ended September 30, 2005. The increased loss is due to the fixed overhead costs related to the expansion into the US and China markets and the establishment of a bad debt reserve on the amount owed by a customer in China.

Net loss. The net loss for the nine months ended September 30, 2006 was $27,094,000, which represented a $21,625,000, or 395% increase from a $5,469,000 loss for the nine months ended September 30, 2005. This increased net loss resulted from (i) $4,499,000 increase to stock based compensation expense as a result of the adoption of SFAS 123(R) on January 1, 2006, (ii) $1,715,000 loss from subsidiaries Mobot, Sponge, Gavitec, 12Snap and BSD, all of which were acquired during the first quarter of 2006, (iii) $13,256,000 charge to write off deferred equity financing costs associated with the 2005 SEDA, (iv) $1,858,000 loss on the extinguishment of debt, (v) $1,034,000 increased losses from the expansion of the Micro Paint business unit held for sale, and (vi) $5,786,000 increased loss from the Company's underlying business represented by qode®, NeoMedia's legacy software products, and corporate administration including audit and legal fees, offset by (vii) $6,523,000 gain from the change in fair value from revaluation of warrants and embedded conversion features associated with the preferred stock and convertible debenture financing.

Known trends, demands, commitments, or uncertainties. In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees. On September 11, 2006, NeoMedia filed a registration statement on Form S-3 which included the consideration shares issued to acquire Mobot, Sponge, Gavitec, and 12Snap, among others. At current stock prices, NeoMedia does not believe that it will be able to generate enough cash to satisfy the purchase price guarantees if and when they become due, which is expected to occur upon effectiveness of the registration statement. As a result, NeoMedia is attempting to negotiate for payment of the purchase price guarantees in another form, including additional shares of common stock. There is no guarantee that NeoMedia will be successful in negotiating such an agreement with any or all of the parties involved. In the event that NeoMedia is not able to negotiate another form of payment, NeoMedia could be forced to divest of certain of the acquisitions. In the event that one or more of these subsidiaries is divested (which divestiture would be subject to approval by Cornell Capital Partners), NeoMedia would expect its sales, cost of sales, gross profit, and operating expenses over the next 12 months to decrease materially compared with its 2006 results which reflect operations of all acquisitions.

Liquidity and Capital Resources

Current Period Activity

Net cash from operations. Net cash used in continuing operating activities (net of cash used from operations of discontinued business unit) was $8,381,000 for the nine months ended September 30, 2006, compared with $4,323,000 for the nine months ended September 30, 2005. NeoMedia's net cash used in continuing operating activities increased substantially during the nine months ended September 30, 2006. The increase was driven by the following factors (1) additional sales, marketing, research and development resources employed to complete the technical requirements for a 2006 qode® launch in the U.S. and Europe; (2) increased general and administrative costs associated with supporting the new acquisitions and other administrative initiatives such as Sarbanes Oxley; and (3) negative operational cashflow during the nine months ended September 30, 2006 from newly-acquired subsidiaries Mobot, Gavitec, Sponge, and 12Snap.

Net used in investing. NeoMedia's net cash flow used in investing activities (net of cash used in investing of discontinued business unit) for the nine months ended September 30, 2006 and 2005 was $14,687,000 and $4,117,000, respectively. The increase resulted from the investment of $11,891,000 in the acquisitions of Mobot, Sponge, Gavitec and 12Snap. NeoMedia also advanced $500,000 to Hip Cricket in the form of promissory notes, and increased capital expenditures on equipment and software required for the qode® launch.

Net cash provided by financing activities. Net cash provided by financing activities for the nine months ended September 30, 2006 and 2005 was $25,165,000 and $10,292,000, respectively. NeoMedia received $14,066,000 from the sale of Series C convertible stock during February 2006, and an additional $5,000,000 from the sale of convertible debentures during August 2006. NeoMedia also received $8,419,000 from the exercise of warrants and employee stock options during the nine months ended September 30, 2006.

Net cash used in discontinued operations. Net cash used in the Company's discontinued Micro Paint Repair operations for the nine months ended September 30, 2006 was $2,020,000, of which $1,980,000 was used in operations, $56,000 was used in investing activities, and $16,000 was generated as a result of the effect of exchange rates on cash. Net cash used in the Company's discontinued Micro Paint Repair operations for the nine months ended September 30, 2005 was $1,737,000, of which $1,628,000 was used in operations, $133,000 was used in investing activities, and $24,000 was generated as a result of the effect of exchange rates on cash. The negative cashflow from operations of the discontinued Micro Paint Repair business will cease upon the pending sale of the business unit, which will reduce NeoMedia's consolidated cash used in operations.

As of September 30, 2006, NeoMedia has a working capital deficiency of $30,222,000, of which $26,667,000 relates to the fair value of derivative financial instruments. NeoMedia intends to fund its working capital deficiency as described in “Sources of Cash and Projected Cash Requirements”.

Significant Liquidity Events

In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees. On September 11, 2006, NeoMedia filed a registration statement on Form S-3 which included the consideration shares issued to acquire Mobot, Sponge, Gavitec, and 12Snap, among others. At current stock prices, NeoMedia does not believe that it will be able to generate enough cash to satisfy the purchase price guarantees if and when they become due, which is expected to occur upon effectiveness of the registration statement. As a result, NeoMedia is attempting to negotiate for payment of the purchase price guarantees in another form, including additional shares of common stock. There is no guarantee that NeoMedia will be successful in negotiating such an agreement with any or all of the parties involved.

During the nine months ended September 30, 2006, NeoMedia made cash payments totaling $2.1 million to silent partners of 12Snap, as partial payment under silent partner agreements put in place prior to the acquisition of 12Snap by NeoMedia. The agreements call for additional cash payments of approximately $2.3million on or before December 31, 2006.

During the fourth quarter of 2005 and first quarter of 2006, NeoMedia shipped and invoiced $757,000 of Micro Paint Repair products to Automart for which payment has not been received. The accounts receivable related to this transaction have been fully reserved. Recognition of revenue on this transaction has been deferred since this is a new customer in a new territory. If and when payment is made, NeoMedia expects to recognize revenue for these shipments, and would also receive a material cash infusion. In the absence of payment, NeoMedia would not recognize revenue related to these products and would not recoup its cost of goods sold which have already been paid. These assets could be sold in connection with the proposed sale of the NMPR business unit.

Sources of Cash and Projected Cash Requirements

NeoMedia intends to fund its growth and working capital deficiencies from the following sources during the remainder of 2006 and beyond:

Exercise of options and warrants. In connection with the convertible debenture financing, NeoMedia issued 175,000,000 warrants to purchase shares of common stock at exercise prices between $0.05 - $0.25 per share. NeoMedia also repriced 85,000,000 previously issued warrants to prices between $0.10 - $0.15. NeoMedia can force conversion of the warrants if its stock price is more than $0.10 higher than the exercise price of the warrants once the shares underlying the warrants are registered. If all of these warrants were exercised, NeoMedia would receive $38.5 million proceeds. Based on its current stock price, NeoMedia would not realize any proceeds from these warrants. In addition, the warrants contain a provision that, if at the time of exercise, the shares underlying the warrant are not subject to an effective registration statement or if NeoMedia is in default of the warrant agreement, the holder can perform a “cashless” exercise of the warrants and in lieu of making payment of the exercise price in cash, elect instead withhold shares as consideration for the exercise price. In the event of such a “cashless” exercise, NeoMedia would not receive any cash proceeds upon the exercise of such warrants.

In addition, certain outstanding employee stock options are in-the-money and could be exercised at the holders' discretion from time to time. As of September 30, 2006, NeoMedia had 117 million outstanding employee stock options, of which 42 million were in-the-money based on the closing price on September 30, 2006 of $0.117 per share. Total potential proceeds from exercise of all in-the-money options is $2.1 million.

Sale of Micro Paint Repair business unit. During August 2006, NeoMedia announced its intent to sell its Micro Paint Repair business unit. Any cash proceeds realized from the sale of the Micro Paint Repair business will be used to fund the operations of the NeoMedia Mobile and NeoMedia Telecom Services businesses.

$100 Million SEDA. On March 30, 2005, NeoMedia and Cornell Capital Partners entered into a Standby Equity Distribution Agreement under which Cornell Capital Partners agreed to purchase up to $100 million of NeoMedia's common stock over a two-year period, with the timing and amount of the purchase at NeoMedia's discretion. The maximum amount of each purchase would be $2,000,000 with a minimum of five business days between advances. Based on NeoMedia's current market capitalization and other outstanding securities, NeoMedia does not believe that the 2005 SEDA is currently a viable source of financing.

NeoMedia's reliance on Cornell Capital Partners as its primary financing source has certain ramifications that could affect future liquidity and business operations. For example, pursuant to the terms of the convertible debenture agreement between NeoMedia and Cornell signed in connection with the convertible debenture sale, without Cornell's consent NeoMedia cannot (i) issue or sell any shares of Common Stock or preferred stock without consideration or for consideration per share less than the closing bid price immediately prior to its issuance, (ii) issue or sell any preferred stock, warrant, option, right, contract, call, or other security or instrument granting the holder thereof the right to acquire common stock for consideration per share less than the closing bid price immediately prior to its issuance, (iii) enter into any security instrument granting the holder a security interest in any of its assets of, or (iv) file any registration statements on Form S-8. In addition, pursuant to a security agreement between NeoMedia and Cornell signed in connection with the convertible debenture, Cornell has a security interest in all of NeoMedia's assets. Such covenants could severely harm NeoMedia's ability to raise additional funds from sources other than Cornell, and would likely result in a higher cost of capital in the event funding were secured.

Additionally, pursuant to the terms of the investment agreement between NeoMedia and Cornell signed in connection with the Series C convertible preferred stock sale, NeoMedia cannot (i) enter into any debt arrangements in which it is the borrower, (ii) grant any security interest in any of its assets, or (iii) grant any security below market price.

In addition, NeoMedia has incurred both cash and non-cash costs associated with the financing arrangements with Cornell Capital Partners, as follows:

- In connection with the convertible debenture, NeoMedia issued 175 million warrants to Cornell with exercise prices between $0.05 and $0.25, repriced 75 million warrants that had been issued in connection with the Series C convertible preferred stock sale, and repriced an additional 10 million warrants that had been issued in connection with the 2005 SEDA.

- In connection with the $27 million Series C convertible preferred stock sale, NeoMedia incurred the following costs: (i) Cornell held back a $2.7 million cash fee from the proceeds of the sale, (ii) NeoMedia issued 75 million warrants to Cornell with exercise prices between $0.35 and $0.50, which were subsequently repriced in connection with the convertible debenture, and (iii) NeoMedia issued 2 million warrants with an exercise price of $0.328 to another party for structuring and consulting fees associated with the sale.

- In connection with the 2005 SEDA, NeoMedia incurred the following costs: (i) NeoMedia issued 75 million warrants to Cornell with an exercise price of $0.20, 10 million of which were subsequently repriced in connection with the convertible debenture, and (ii) NeoMedia issued 4 million warrants with an exercise price of $0.227 to another party for structuring and consulting fees associated with the 2005 SEDA. The fair value of these warrants in the amount of $13,256,000 was written off during the three months ended September 30, 2006.

NeoMedia's cash flow used in operations was $8.4 million (net of cash used in operations of discontinued Micro Paint Repair business unit of $2.0 million) for the nine months ended September 30, 2006. In the event that NeoMedia's stock price does not increase to levels where NeoMedia can force exercise of enough of its outstanding warrants to generate material operating capital, or if the market for NeoMedia's stock will not support the sale of shares underlying such warrants or other funding sources, or NeoMedia does not realize a material increase in revenue during the next 12 months, NeoMedia will have to seek additional cash sources. There can be no assurances that such funding sources will be available. If necessary funds are not available, NeoMedia's business and operations would be materially adversely affected and in such event, NeoMedia would attempt to reduce costs and adjust its business plan, and could be forced to sell certain of its assets, including its subsidiaries.

Contractual Obligations

NeoMedia is party to various commitments and contingencies, such as:

- NeoMedia and its subsidiaries lease office facilities and certain office and computer equipment under various operating leases

- NeoMedia is party to various payment arrangements with its vendors that call for fixed payments on past due liabilities

- NeoMedia is party to various consulting agreements that carry payment obligations into future years.

- NeoMedia issued Series C convertible preferred shares with face value of $22,000,000 and convertible debentures with a face value of $5 million that are subject to conversion at future dates

- NeoMedia holds notes payable to certain vendors and silent partners of an acquired subsidiary that mature at various dates in the future.

- NeoMedia's subsidiary Sponge has entered into purchase commitments to procure the functionality needed to support a sales agreement with a major customer. The purchase commitments require payments of $1,121,000 in the fourth quarter of 2006, and $2,200,000 in 2007. Revenues related to this program are expected to exceed the purchase commitments over the one-year life of the contract.

65

The following table sets forth NeoMedia's future minimum payments due under operating leases, vendor and consulting agreements, convertible stock agreements, and debt agreements:

	Operating Leases	Vendor & Consulting Agreements	Notes Payable	Convertible Debentures	Series C Convertible Preferred Stock	Total
2006 (remaining three months)	$ 219	$ 3,040	$ 2,312	$ —	$ —	$ 5,571
2007	743	4,180	27	—	—	4,950
2008	571	—	—	5,000	—	5,571
2009	323	—	—	—	22,000	22,323
2010	206	—	—	—	—	206
Thereafter	198	—	—	—	—	198
Total	$ 2,260	$ 7,220	$ 2,339	$ 5,000	$ 22,000	$ 38,819

In addition to contractually obligated amounts above, NeoMedia has also guaranteed the value of stock consideration issued in connection with certain acquisitions, the amount of which will not be determinable until the shares issued for such acquisitions are registered. In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees.

Going Concern

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. Net loss for the nine months ended September 30, 2006, was $27,094,000, which includes a net gain on derivative financial instruments of $6,523,000 and a charge to write off deferred equity financing costs related to the 2005 SEDA of $13,256,000. NeoMedia also reported net losses of $9,147,000 and $7,230,000 for the years ended December 31, 2005 and 2004, respectively, and has an accumulated deficit of $119,618,000 and a working capital deficit of $30,222,000 as of September 30, 2006.

In addition, NeoMedia has material liquidity events that could adversely affect its ability to continue as a going concern, primarily:

- In the event that NeoMedia's stock price at the time the consideration shares issued in connection with the acquisitions of Mobot, Sponge, Gavitec, and 12Snap become saleable is less than the contractual price (between $0.3839 and $0.3956), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the relevant contractual price. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million relating to the guarantees.

- During the nine months ended September 30, 2006, NeoMedia made cash payments totaling $2.1 million to silent partners of 12Snap, as partial payment under silent partner agreements in place prior to the acquisition of 12Snap by NeoMedia. The agreements call for additional cash payments of $2.1million plus accrued interest and penalties totaling $0.4 million on or before

December 31, 2006.

NeoMedia had cash balances of $3,133,000 as of September 30, 2006. As disclosed above under the caption “Sources of Cash and Projected Cash Requirements,” NeoMedia could receive cash at future dates as follows: (1) from the exercise of stock options, to the extent that the exercise price of such stock options is less than the market price of NeoMedia's common stock, (2) from the exercise of stock warrants, to the extent that the warrants become registered for resale and the exercise price of such stock warrants is less than the market price of NeoMedia's common stock at the time of exercise, and to the extent that the holder of such warrants does not elect to perform a “cashless” exercise, in which case NeoMedia would not receive any cash proceeds from the exercise, and (3) from the sale of its Micro Paint Repair business unit.

However, none of these events is contractually obligated as of the date of this filing. Based on cash currently available, and in the absence of any additional funding, NeoMedia expects to be able to sustain operations through December 31, 2006. In order to maintain operations for a 12-month period, and in the absence of a material increase in revenues, NeoMedia estimates that it would need to raise at least an additional $7-10 million to sustain operations. NeoMedia expects that, while not contractually committed, it could receive cash from one or more of the sources outlined above. The most likely source of cash in the short term is from the sale of the Micro Paint business unit. To the extent that funds are not available from these sources, NeoMedia will seek alternate financing in another form, or attempt to sell its assets to meet its obligations.

During the third quarter of 2006, NeoMedia was using capital at a rate of approximately $2 million per quarter from its continuing operations. During the third quarter and continuing into the fourth quarter, NeoMedia has instituted cost-cutting measures, including the sale of the Micro Paint business unit, which operated at a loss an a quarter-over-quarter basis, and the reduction of its remaining workforce and overhead expenses.

NeoMedia plans to address its working capital deficiency by completing the sale of the Micro Paint Repair business unit and continuing to reduce its workforce and overhead expenses in non-critical areas. In addition, NeoMedia will attempt to generate additional revenue and profit from the launch of its qode® products, the commercialization of its patent portfolio, and from increased revenue and profit from its 12Snap, Gavitec, and NeoMedia Telecom businesses.

In the event that these financing sources do not materialize, or that NeoMedia is unsuccessful in increasing its revenues and profits, NeoMedia will be forced to further reduce its costs, may be unable to repay its debt obligations as they become due, or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations. Additionally, if these funding sources or increased revenues and profits do not materialize, and NeoMedia is unable to secure additional financing, NeoMedia could be forced to reduce or curtail its business operations unless it is able to engage in a merger or other corporate finance transaction with a better capitalized entity.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

NeoMedia previously filed its periodic reports as a small business issuer through the period ended December 31, 2005. The information required by Item 305 of Regulation S-K was not required under the disclosure requirements for small business issuers. Pursuant to Item 305 of Regulation S-K, disclosure of quantitative and qualitative information about market risk is required in the first annual report. Information relating to interim financial statements is not required until after the first fiscal year end in which Item 305 is applicable. Accordingly, NeoMedia anticipates providing a quantitative and qualitative analysis regarding market risk in its Form 10-K for the year ending December 31, 2006.

ITEM 4. CONTROLS AND PROCEDURES

There were no policy reviews, improvements of documentation or general improvement in the state of internal controls that led to any change during the fiscal quarter, or subsequent to the end of the fiscal quarter through the date of this Form 10-Q, that materially affected or were reasonably likely to materially affect, internal controls over financial reporting.

Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. The Company's disclosure controls and procedures are designed to provide a reasonable level of assurance of achieving the Company's disclosure control objectives. The Company's Principal Executive Officer and Principal Financial Officer have concluded that the Company's disclosure controls and procedures are, in fact, effective at this reasonable assurance level as of the end of period covered. In addition, the Company reviewed its internal controls and there have been no significant changes in its internal controls or in other factors that could significantly affect those controls subsequent to the date of their last evaluation or from the end of the reporting period to the date of this Form 10-Q.

Changes in Internal Controls. In connection with the evaluation of the Company's internal controls during the Company's nine months ended September 30, 2006, the Company's Principal Executive Officer and Principal Financial Officer have determined that there were no changes to the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially effect, the Company's internal controls over financial reporting during the nine months ended September 30, 2006, or subsequent to the date of their last evaluation, or from the end of the reporting period to the date of this Form 10-Q.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is involved in various legal actions arising in the normal course of business, both as claimant and defendant. While it is not possible to determine with certainty the outcome of these matters, it is the opinion of management that the eventual resolution of the following legal actions could have a material adverse effect on the Company's financial position or operating results. The following outlined legal proceedings for which the potential outcome could be in excess of $50,000.

Scanbuy, Inc.

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

On April 20, 2004, NeoMedia re-filed its suit against Scanbuy in the Southern District of New York alleging patent infringement. Scanbuy filed its answer on June 2, 2004. NeoMedia filed its answer and affirmative defenses on July 23, 2004. On February 13, 2006, Scanbuy filed an amended answer to the complaint. NeoMedia filed its reply to Scanbuy's amended answer on March 6, 2006. Discovery is ongoing.

Former Mobot Shareholders

On June 8, 2006, Mark Freitas (“Plaintiff”), a former Mobot shareholder, filed a complaint in Massachusetts state court against NeoMedia alleging that NeoMedia breached the merger agreement between NeoMedia and Mobot by failing to file a registration statement with the SEC that included his shares by May 9, 2006. Plaintiff's complaint requested that the Court issue a preliminary injunction prohibiting NeoMedia from: (1) causing its charter to be amended so as to increase the number of shares of authorized common stock in excess of one billion shares; (2) entering into any contract, agreement, or other undertaking in which NeoMedia shares are used as payment; (3) issuing a warrant or option to acquire NeoMedia common stock with an exercise price of less than $0.3839; and (4) filing a registration statement with the SEC that does not include the Mobot shareholder's shares. Plaintiff also seeks costs and attorney's fees in his complaint.

A hearing on the request for preliminary injunctive relief was held on June 21, 2006. During the hearing, Plaintiff changed his request for relief by asking that the Court enjoin NeoMedia from amending the Registration Statement it filed on June 21, 2006 to add any additional shares or from filing any further registration statements until the one filed on June 21, 2006 becomes effective. On June 26, 2006, the Court issued a Memorandum of Decision and Order on Plaintiff's Request for Preliminary Injunction and denied Plaintiff's request for a preliminary injunction.

NeoMedia plans to file a motion to dismiss the complaint, but the parties have agreed to extend the deadline for the submission of those papers to the Court. NeoMedia may also join Plaintiff's request that the action be transferred to the Business Litigation Session of the Suffolk Superior Court. NeoMedia intends to defend the lawsuit vigorously.

12Snap Silent Partners

On April 18, 2006, 12Snap AG, a wholly-owned subsidiary of NeoMedia acquired on February 28, 2006, received a letter of Technologie Beteiligungsfonds Bayern GmbH & Co. KG, Munich, to initiate arbitration proceedings. Technologie Beteiligungsfonds claims for a final payment in the amount of EUR 353,000 (approximately $443,000) plus interest of 5% per annum since March 1, 2006 arising out of a silent partnership agreement with 12Snap. The matter was subject to a German arbitration proceeding during the third and fourth quarter 2006, and the parties are currently negotiating a settlement based on the arbitration proceedings.

12 Snap Rent Dispute

NeoMedia's subsidiary 12Snap is involved in a dispute with its landlord regarding rent due for office space previously used by 12Snap in Italy. The dispute was heard in court on May 23, 2006, whereby the judge ruled for the parties to reach a settlement. The parties were unable to reach a settlement, and the case is being sent back to the courts. The opposing party is seeking approximately $140,000. The Company believes the actual settlement will be less than the amount sought.

Threatened Litigation

On March 15, 2006, NeoMedia received a letter from an unrelated third party alleging that the party performed independent consulting services leading up to the closing of the merger between NeoMedia and Mobot on February 17, 2006. The letter contends that NeoMedia and Mobot breached a consulting agreement whereby the party was to be paid $300,000, equal to 3% of the merger consideration paid by NeoMedia to Mobot. NeoMedia believes the claim is without merit and intends to vigorously defend.

ITEM 1A. RISK FACTORS

Risks Related to NeoMedia's Business

NeoMedia Has Historically Lost Money And Losses May Continue

NeoMedia has incurred substantial operating losses since inception, and anticipates continuing to incur substantial losses for the foreseeable future. Net loss for the nine months ended September 30, 2006, was $27,094,000 (unaudited), which includes a $6,523,000 (unaudited) gain from the change in fair value from revaluation of warrants and embedded conversion features associated with the preferred stock and convertible debenture financing and a $13,256,000 (unaudited) charge to write off deferred equity financing costs associated with the 2005 SEDA. NeoMedia also reported net losses of $9,147,000 and $7,230,000 for the years ended December 31, 2005 and 2004, respectively. NeoMedia's accumulated losses were approximately $119,618,000 (unaudited) and $92,524,000 as of September 30, 2006 and December 31, 2005, respectively. As of September 30, 2006 NeoMedia had a working capital deficit of approximately $30,222,000 (unaudited). NeoMedia had stockholders' equity of $40,854,000 (unaudited), $4,227,000 and $4,392,000 as of September 30, 2006 and December 31, 2005 and 2004, respectively. NeoMedia generated revenues of $14,129,000 (unaudited) and $762,000 (unaudited) for the nine months ended September 30, 2006 and 2005, respectively. In addition, during the nine months ended September 30, 2006 and 2005 NeoMedia recorded negative cash flows from continuing operations of $8,381,000 (unaudited) and $4,323,000 (unaudited), respectively. To succeed, NeoMedia must develop new client and customer relationships and substantially increase its revenue derived from improved products and additional value-added services. NeoMedia has expended, and to the extent it has available financing, NeoMedia intends to continue to expend, substantial resources to develop and improve its products, increase its value-added services and to market its products and services. These development and marketing expenses must be incurred well in advance of the recognition of revenue. As a result, NeoMedia may not be able to achieve or sustain profitability.

NeoMedia's Independent Registered Public Accounting Firm Have Added Going Concern Language To Their Report On NeoMedia's Consolidated Financial Statements, Which Means That NeoMedia May Not Be Able To Continue Operations

The report of Stonefield Josephson, Inc., NeoMedia's independent registered public accounting firm, with respect to NeoMedia's consolidated financial statements and the related notes for the years ended December 31, 2005 and 2004, indicates that, at the date of their report, NeoMedia had suffered significant recurring losses from operations and its working capital deficit raised substantial doubt about its ability to continue as a going concern. NeoMedia's consolidated financial statements do not include any adjustments that might result from this uncertainty.

NeoMedia Has Guaranteed The Value Of Stock Issued In Connection With Recent Mergers Through The Registration Of The Shares, Which Could Result In A Material Cash Liability

Pursuant to the terms of the merger agreements with Mobot, Sponge, Gavitec, and 12Snap, in the event that NeoMedia's stock price at the time the consideration shares issued in connection with each acquisition are saleable is less than the price at which they were valued for purposes of the merger agreement (between $0.3839 and $0.3956 per share), NeoMedia is obligated to compensate the sellers in cash for the difference between the price at the time the shares become saleable and the price the shares were valued for purposes of the merger agreement. Subsequent to the closing of the acquisitions and through October 23, 2006, NeoMedia's stock has closed as low as $0.07 per share. Assuming a stock price at the time the shares become saleable of $0.10, which was the last sale price on October 23, 2006, NeoMedia would have a cash liability of $32.7 million resulting from these clauses. As a result, NeoMedia is attempting to negotiate for payment of the purchase price guarantees in another non-cash form, including additional shares of common stock. There is no guarantee that NeoMedia will be successful in negotiating such an agreement with any or all of the parties involved.

NeoMedia Has Contractual Commitments To Pay Silent Partners

Resulting from the acquisition of 12 Snap, NeoMedia has a commitment to pay approximately $2.1 million plus accrued interest and penalties of approximately $0.4 million, at the end of 2006 to the Silent Partners of 12Snap. If NeoMedia's financial resources are insufficient, NeoMedia may require additional financing in order to meet this obligation. There is no guarantee that NeoMedia will be able to obtain the necessary additional capital to meet this obligation on a timely basis, on acceptable terms, or at all. In any of these events, NeoMedia may be unable to repay this obligation when it becomes due.

NeoMedia Could Identify Material Internal Control Weaknesses As Part Of Its Sarbanes-Oxley Internal Control Review For Its Fiscal Year Ended December 31, 2006,

The regulations implementing Section 404 of the Sarbanes-Oxley Act of 2002 require an assessment of the effectiveness of the Company's internal controls over financial reporting beginning with our Annual Report on Form 10-K for the fiscal year ending December 31, 2006. The Company's independent auditors will be required to confirm in writing whether management's assessment of the effectiveness of the internal controls over financial reporting is fairly stated in all material respects, and separately report on whether they believe management maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006. As part of the assessment of our internal controls in connection with the process required by Section 404 of the Sarbanes-Oxley Act of 2002, management intends to continue to review, evaluate and strengthen our controls and processes. Management cannot state that material weaknesses in internal controls will not be determined. Management also cannot state that the process of evaluation and the auditor's attestation will be completed on time. If a material weakness is discovered, corrective action may be time consuming, costly and further divert the attention of management. The disclosure of a material weakness, even if quickly remedied, could reduce the market's confidence in the Company's financial statements and harm the Company's stock price, especially if a restatement of financial statements for past periods is required.

There Is Limited Information Upon Which Investors Can Evaluate NeoMedia's Business Because The Physical-World-To-Internet Market Has Existed For Only A Short Period Of Time

The physical-world-to-Internet market in which NeoMedia operates is a recently developed market. Further, NeoMedia has conducted operations in this market only since March 1996. Consequently, NeoMedia has a relatively limited operating history upon which an investor may base an evaluation of NeoMedia's primary business and determine NeoMedia's prospects for achieving its intended business objectives. To date, NeoMedia has sold its physical-world-to-Internet products to only 12 companies. NeoMedia is prone to all of the risks inherent to the establishment of any new business venture, including unforeseen changes in its business plan. An investor should consider the likelihood of NeoMedia's future success to be highly speculative in light of its limited operating history in its primary market, as well as the limited resources, problems, expenses, risks, and complications frequently encountered by similarly situated companies in new and rapidly evolving markets, such as the physical-world-to-Internet space. To address these risks, NeoMedia must, among other things:

- maintain and increase its client base;
- implement and successfully execute its business and marketing strategy;
- continue to develop and upgrade its products;
- continually update and improve service offerings and features;

- respond to industry and competitive developments; and

- attract, retain, and motivate qualified personnel.

NeoMedia may not be successful in addressing these risks. If NeoMedia is unable to do so, its business, prospects, financial condition, and results of operations would be materially and adversely affected.

NeoMedia's Future Success Depends On The Timely Introduction Of New Products And The Acceptance Of These New Products In The Marketplace.

Rapid technological change and frequent new product introductions are typical for the markets NeoMedia serves. NeoMedia's future success will depend in large part on continuous, timely development and introduction of new products that address evolving market requirements. To the extent that NeoMedia fails to introduce new and innovative products, it may lose market share to its competitors, which may be difficult to regain. Any inability, for technological or other reasons, to successfully develop and introduce new products could materially and adversely affect NeoMedia's business.

NeoMedia's Common Stock Is Deemed To Be "Penny Stock," Which May Make It More Difficult For Investors To Sell Their Shares Due To Suitability Requirements

NeoMedia's common stock is deemed to be "penny stock" as that term is defined in Rule 3a51-1 promulgated under the Securities Exchange Act of 1934, as amended. These requirements may reduce the potential market for NeoMedia's common stock by reducing the number of potential investors. This may make it more difficult for investors in NeoMedia's common stock to sell shares to third parties or to otherwise dispose of them. This could cause NeoMedia's stock price to decline. Penny stocks are stock:

- with a price of less than $5.00 per share;
- that are not traded on a "recognized" national exchange;
- whose prices are not quoted on the NASDAQ automated quotation system (NASDAQ listed stock must still have a price of not less than $5.00 per share); or
- in issuers with net tangible assets less than $2 million (if the issuer has been in continuous operation for at least three years) or $10 million (if in continuous operation for less than three years), or with average revenues of less than $6 million for the last three years.

Broker-dealers dealing in penny stocks are required to provide potential investors with a document disclosing the risks of penny stocks. Moreover, broker-dealers are required to determine whether an investment in a penny stock is a suitable investment for a prospective investor.

Existing Shareholders Will Experience Significant Dilution When Certain Investors Convert Their Preferred Stock to Common Stock, Convert Outstanding Convertible Debentures, Or When the Investors Exercise Their Warrants and Receive Common Stock Shares Under The Investment Agreement With The Investors

The issuance of shares of common stock pursuant to the conversion of Series C convertible preferred stock or the conversion of convertible debentures pursuant to our transactions with Cornell Capital Partners will have a dilutive impact on our stockholders. As a result, our net income or loss per share could decrease in future periods, and the market price of our common stock could decline. In addition, the lower our stock price is, the more shares of common stock we will have to issue pursuant to the conversion of our preferred stock or the convertible debentures. If our stock price is lower, then our existing stockholders would experience greater dilution.

Due To The Accounting Treatment Of Certain Convertible Preferred Stock And Convertible Debenture Instruments Issued By NeoMedia, A Fluctuation In NeoMedia's Stock Price Could Have A Material Impact On NeoMedia's Results Of Operations

During the three months ended March 31, 2006, June 30, 2006, and September 30, 2006, NeoMedia recognized income (expense) in the amount of $4,768,000, $11,026,000, and ($9,271,000), respectively, from adjustments recorded to reflect the change in fair value from revaluation of warrants and embedded conversion features in connection with its Series C convertible preferred shares and its convertible debenture. NeoMedia will adjust the carrying value of its derivative instruments to market at each balance sheet date. As a result, NeoMedia could experience significant fluctuations in its net income (loss) in future periods from such charges based on corresponding movement in NeoMedia's share price.

73

NeoMedia Is Uncertain Of The Success Of Its NeoMedia Mobile Business Unit And The Failure Of This Unit Would Negatively Affect The Price Of NeoMedia's Stock

NeoMedia provides products and services that provide a link from physical objects, including printed material, to the mobile Internet. NeoMedia can provide no assurance that:

- its NeoMedia Mobile business unit will ever achieve profitability;
- its current product offerings will not be adversely affected by the focusing of its resources on the physical-world-to-Internet space; or
- the products NeoMedia develops will obtain market acceptance.

In the event that the NeoMedia Mobile business unit should never achieve profitability, that NeoMedia's current product offerings should so suffer, or that NeoMedia's products fail to obtain market acceptance, NeoMedia's business, prospects, financial condition, and results of operations would be materially adversely affected.

A Large Percentage Of NeoMedia's Assets Are Intangible Assets, Which Will Have Little Or No Value If NeoMedia's Operations Are Unsuccessful

At September 30, 2006 and December 31, 2005 and 2004, approximately 81%, 48% and 49%, respectively, of NeoMedia's total assets were intangible assets, consisting primarily of rights related to NeoMedia's patents, other intellectual property, and excess of purchase price over fair market value paid for Mobot, Sponge, Gavitec, 12Snap, BSD, and CSI International, Inc. If NeoMedia's operations are unsuccessful, these assets will have little or no value, which would materially adversely affect the value of NeoMedia's stock and the ability of NeoMedia's stockholders to recoup their investments in NeoMedia's capital stock.

NeoMedia reviews its amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. NeoMedia may be required to record a significant charge to earnings in its financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, resulting in an impact on results of operations.

Certain Of NeoMedia's Emerging Products And Services Have Limited History And May Not Result In Success

To date, NeoMedia has conducted limited marketing efforts directly relating to its emerging technology products, consisting primarily of the Qode suite of products, and certain products of recent acquisitions Mobot and Gavitec. Many of NeoMedia's marketing efforts with respect to these emerging technologies have been largely untested in the marketplace, and may not result in materially increased sales of these emerging products and services. To penetrate the emerging markets in which it competes, NeoMedia expects that it will have to exert significant efforts to create awareness of, and demand for, its emerging products and services. NeoMedia intends to continue to expand its sales and marketing resources as the market continues to mature. NeoMedia's failure to further develop its sales and marketing capabilities and successfully market its emerging products and services would have a material adverse effect on its business, prospects, financial condition, and results of operations.

NeoMedia's Internally Developed Systems Are Inefficient And May Put NeoMedia At A Competitive Disadvantage

NeoMedia uses internally developed technologies for a portion of its systems integration services, as well as the technologies required to interconnect its clients' and customers' physical-world-to-Internet systems and hardware with its own. As NeoMedia develops these systems in order to integrate disparate systems and hardware on a case-by-case basis, these systems are inefficient and require a significant amount of customization. Such client and customer-specific customization is time consuming and costly and may place NeoMedia at a competitive disadvantage when compared to competitors with more efficient systems.

NeoMedia Could Fail To Attract Or Retain Key Personnel

NeoMedia's future success will depend in large part on its ability to attract, train, and retain additional highly skilled executive level management, creative, technical, and sales personnel. Competition is intense for these types of personnel from other technology companies and more established organizations, many of which have significantly larger operations and greater financial, marketing, human, and other resources than NeoMedia has. NeoMedia may not be successful in attracting and retaining qualified personnel on a timely basis, on competitive terms, or at all. NeoMedia's failure to attract and retain qualified personnel could have a material adverse effect on its business, prospects, financial condition, and results of operations.

NeoMedia Depends Upon Its Senior Management And Their Loss Or Unavailability Could Put NeoMedia At A Competitive Disadvantage

NeoMedia's success depends largely on the skills of certain key management and technical personnel, including Charles T. Jensen, NeoMedia's President and Chief Executive Officer, Charles W. Fritz, NeoMedia's founder and Chairman of the Board of Directors, Martin N. Copus, NeoMedia's Chief Operating Officer and head of the NMM business unit, and David A. Dodge, NeoMedia's Chief Financial Officer. The loss of the services of Messrs. Jensen, Fritz, Copus, or Dodge could materially harm NeoMedia's business because of the cost and time necessary to replace and train a replacement. Such a loss would also divert management attention away from operational issues. NeoMedia does not presently maintain a key-man life insurance policy on Messrs. Jensen, Fritz, Copus, or Dodge.

NeoMedia May Be Unsuccessful In Integrating Its Recently Completed and Pending Acquisitions With Its Current Business

The success of the acquisitions of Mobot, 12Snap, Sponge, Gavitec, and BSD could depend on the ability of NeoMedia's executive management to integrate the business plan of each company with NeoMedia's overall business plan. Failure to properly integrate the business could have a material adverse effect on the expected revenue and operations of the acquisitions, as well as the expected return on investment for NeoMedia.

NeoMedia May Be Unable To Protect Its Intellectual Property Rights And May Be Liable For Infringing The Intellectual Property Rights Of Others

NeoMedia's success in the physical-world-to-Internet market is dependent upon its proprietary technology, including patents and other intellectual property, and on the ability to protect proprietary technology and other intellectual property rights. In addition, NeoMedia must conduct its operations without infringing on the proprietary rights of third parties. NeoMedia also intends to rely upon unpatented trade secrets and the know-how and expertise of its employees, as well as its patents. To protect its proprietary technology and other intellectual property, NeoMedia relies primarily on a combination of the protections provided by applicable patent, copyright, trademark, and trade secret laws as well as on confidentiality procedures and licensing arrangements. Although NeoMedia believes that it has taken appropriate steps to protect its unpatented proprietary rights, including requiring that its employees and third parties who are granted access to NeoMedia's proprietary technology enter into confidentiality agreements, NeoMedia can provide no assurance that these measures will be sufficient to protect its rights against third parties. Others may independently develop or otherwise acquire patented or unpatented technologies or products similar or superior to NeoMedia's.

NeoMedia licenses from third parties certain software tools that are included in NeoMedia's services and products. If any of these licenses were terminated, NeoMedia could be required to seek licenses for similar software from other third parties or develop these tools internally. NeoMedia may not be able to obtain such licenses or develop such tools in a timely fashion, on acceptable terms, or at all. Companies participating in the software and Internet technology industries are frequently involved in disputes relating to intellectual property. NeoMedia may in the future be required to defend its intellectual property rights against infringement, duplication, discovery, and misappropriation by third parties or to defend against third party claims of infringement. Likewise, disputes may arise in the future with respect to ownership of technology developed by employees who were previously employed by other companies. Any such litigation or disputes could result in substantial costs to, and a diversion of effort by, NeoMedia. An adverse determination could subject NeoMedia to significant liabilities to third parties, require NeoMedia to seek licenses from, or pay royalties to, third parties, or require NeoMedia to develop appropriate alternative technology. Some or all of these licenses may not be available to NeoMedia on acceptable terms or at all, and NeoMedia may be unable to develop alternate technology at an acceptable price or at all. Any of these events could have a material adverse effect on NeoMedia's business, prospects, financial condition, and results of operations.

NeoMedia Is Exposed To Product Liability Claims And An Uninsured Claim Could Have A Material Adverse Effect On NeoMedia's Business, Prospects, Financial Condition, And Results Of Operations, As Well As The Value Of NeoMedia's Stock

Many of NeoMedia's projects are critical to the operations of its clients' businesses. Any failure in a client's information system could result in a claim for substantial damages against NeoMedia, regardless of NeoMedia's responsibility for such failure. NeoMedia could, therefore, be subject to claims in connection with the products and services that it sells. NeoMedia currently maintains product liability insurance. There can be no assurance that:

- NeoMedia has contractually limited its liability for such claims adequately or at all; or

- NeoMedia would have sufficient resources to satisfy any liability resulting from any such claim.

The successful assertion of one or more large claims against NeoMedia could have a material adverse effect on its business, prospects, financial condition, and results of operations.

NeoMedia Will Not Pay Cash Dividends And Investors May Have To Sell Their Shares In Order To Realize Their Investment

NeoMedia has not paid any cash dividends on its common stock and does not intend to pay cash dividends in the foreseeable future. NeoMedia intends to retain future earnings, if any, for reinvestment in the development and marketing of NeoMedia's products and services. As a result, investors may have to sell their shares of common stock to realize their investment.

Some Provisions Of NeoMedia's Certificate of Incorporation And bylaws May Deter Takeover Attempts, Which May Limit The Opportunity Of NeoMedia's Stockholders To Sell Their Shares At A Premium To The Then-Current Market Price

Some of the provisions of NeoMedia's Certificate of Incorporation and bylaws could make it more difficult for a third party to acquire NeoMedia, even if doing so might be beneficial to NeoMedia's stockholders by providing them with the opportunity to sell their shares at a premium to the then-current market price. On December 10, 1999, NeoMedia's Board of Directors adopted a stockholders rights plan and declared a non-taxable dividend of one right to acquire Series A Preferred Stock of NeoMedia, par value $0.01 per share, on each outstanding share of NeoMedia's common stock to stockholders of record on December 10, 1999 and each share of common stock issued thereafter until a pre-defined hostile takeover date. The stockholder rights plan was adopted as an anti-takeover measure, commonly referred to as a “poison pill.” The stockholder rights plan was designed to enable all stockholders not engaged in a hostile takeover attempt to receive fair and equal treatment in any proposed takeover of NeoMedia and to guard against partial or two-tiered tender offers, open market accumulations, and other hostile tactics to gain control of NeoMedia. The stockholders rights plan was not adopted in response to any effort to acquire control of NeoMedia at the time of adoption. This stockholders rights plan may have the effect of rendering more difficult, delaying, discouraging, preventing, or rendering more costly an acquisition of NeoMedia or a change in control of NeoMedia. Certain of NeoMedia's directors, officers and principal stockholders, Charles W. Fritz, William E. Fritz and The Fritz Family Limited Partnership and their holdings were exempted from the triggering provisions of NeoMedia's “poison pill” plan, as a result of the fact that, as of the plan's adoption, their holdings might have otherwise triggered the “poison pill”.

In addition, NeoMedia's Certificate of Incorporation authorizes the Board of Directors to designate and issue preferred stock, in one or more series, the terms of which may be determined at the time of issuance by the Board of Directors, without further action by stockholders, and may include voting rights, including the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion, redemption rights, and sinking fund provisions.

NeoMedia is authorized to issue a total of 25,000,000 shares of Preferred Stock, par value $0.01 per share. The issuance of any preferred stock could have a material adverse effect on the rights of holders of NeoMedia's common stock, and, therefore, could reduce the value of shares of NeoMedia's common stock. In addition, specific rights granted to future holders of preferred stock could be used to restrict NeoMedia's ability to merge with, or sell NeoMedia's assets to, a third party. The ability of the Board of Directors to issue preferred stock could have the effect of rendering more difficult, delaying, discouraging, preventing, or rendering more costly an acquisition of NeoMedia or a change in NeoMedia's control thereby preserving control by the current stockholders.

All Of The Company's Assets Are Pledged To Secure Certain Debt Obligations, Which The Company Could Fail To Repay

Pursuant to secured convertible debentures, dated as of August 24, 2006 in the principal amount of $5,000,000 issued to Cornell Capital Partners, LP, the Company was required to secure such secured convertible debentures' repayment with substantially all of its assets. In the event the Company is unable to repay the secured convertible debentures, it could lose all of its assets and be forced to cease its operations. If the Company is found to be in default under the debentures, the full principal amount of the debentures, together with interest and other amounts owing, may become immediately due and payable.

Risks Relating To NeoMedia's Industry

The Security Of The Internet Poses Risks To The Success Of NeoMedia's Entire Business

Concerns over the security of the Internet and other electronic transactions, and the privacy of consumers and merchants, may inhibit the growth of the Internet and other online services generally, especially as a means of conducting commercial transactions, which may have a material adverse effect on NeoMedia's physical-world-to-Internet business.

NeoMedia Will Only Be Able To Execute Its Physical-World-To-Internet Business Plan If Internet Usage and Electronic Commerce Continue To Grow

NeoMedia's future revenues and any future profits are substantially dependent upon the widespread acceptance and use of the Internet and camera devices on mobile telephones. If use of the Internet and camera devices on mobile telephones does not continue to grow or grows more slowly than expected, or if the infrastructure for the Internet and camera devices on mobile telephones does not effectively support the growth that may occur, or does not become a viable commercial marketplace, NeoMedia's physical-world-to-Internet business, and therefore NeoMedia's business, prospects, financial condition, and results of operations, could be materially adversely affected. Rapid growth in the use of, and interest in, the Internet and camera devices on mobile telephones is a recent phenomenon, and may not continue on a lasting basis. In addition, customers may not adopt, and continue to use mobile telephones as a medium of information retrieval or commerce. Demand and market acceptance for recently introduced services and products over the mobile Internet are subject to a high level of uncertainty, and few services and products have generated profits. For NeoMedia to be successful, consumers and businesses must be willing to accept and use novel and cost efficient ways of conducting business and exchanging information.

In addition, the public in general may not accept the use of the Internet and camera devices on mobile telephones as a viable commercial or information marketplace for a number of reasons, including potentially inadequate development of the necessary network infrastructure or delayed development of enabling technologies and performance improvements. To the extent that mobile phone Internet usage continues to experience significant growth in the number of users, their frequency of use, or in their bandwidth requirements, the infrastructure for the mobile Internet may be unable to support the demands placed upon them. In addition, the mobile Internet and mobile interactivity could lose its viability due to delays in the development or adoption of new standards and protocols required to handle increased levels of mobile Internet activity, or due to increased governmental regulation. Significant issues concerning the commercial and informational use of the mobile Internet, and online networks technologies, including security, reliability, cost, ease of use, and quality of service, remain unresolved and may inhibit the growth of Internet business solutions that utilize these technologies. Changes in, or insufficient availability of, telecommunications services to support the Internet, the Web or other online services also could result in slower response times and adversely affect usage of the Internet, the Web and other online networks generally and NeoMedia's physical-world-to-Internet product and networks in particular.

NeoMedia May Not Be Able To Adapt As The Internet, Physical-World-To-Internet, And Customer Demands Continue To Evolve

NeoMedia may not be able to adapt as the mobile Internet and physical-world-to-Internet markets and consumer demands continue to evolve. NeoMedia's failure to respond in a timely manner to changing market conditions or client requirements would have a material adverse effect on its business, prospects, financial condition, and results of operations. The mobile Internet and physical-world-to-Internet markets are characterized by:

- rapid technological change;

78

- changes in user and customer requirements and preferences;
- frequent new product and service introductions embodying new technologies; and
- the emergence of new industry standards and practices that could render proprietary technology and hardware and software infrastructure obsolete.

NeoMedia's success will depend, in part, on its ability to:

- enhance and improve the responsiveness and functionality of its products and services;
- license or develop technologies useful in its business on a timely basis;
- enhance its existing services, and develop new services and technologies that address the increasingly sophisticated and varied needs of NeoMedia's prospective or current customers; and
- respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis.

NeoMedia May Not Be Able To Compete Effectively In Markets Where Its Competitors Have More Resources

While the market for physical-world-to-Internet technology is relatively new, it is already highly competitive and characterized by an increasing number of entrants that have introduced or developed products and services similar to those offered by NeoMedia. NeoMedia believes that competition will intensify and increase in the near future. NeoMedia's target market is rapidly evolving and is subject to continuous technological change. As a result, NeoMedia's competitors may be better positioned to address these developments or may react more favorably to these changes, which could have a material adverse effect on NeoMedia's business, prospects, financial condition, and results of operations.

Some of NeoMedia's competitors have longer operating histories, larger customer bases, longer relationships with clients, and significantly greater financial, technical, marketing, and public relations resources than NeoMedia. NeoMedia may not successfully compete in any market in which it conducts or may conduct operations. NeoMedia may not be able to penetrate markets or market its products as effectively as NeoMedia's better-funded more-established competitors.

In The Future There Could Be Government Regulations And Legal Uncertainties Which Could Harm NeoMedia's Business

Any new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to NeoMedia's business, or the application of existing laws and regulations to the Internet and other online services, could have a material adverse effect on NeoMedia's business, prospects, financial condition, and results of operations. Due to the increasing popularity and use of the Internet, the Web and other online services, federal, state, and local governments may adopt laws and regulations, or amend existing laws and regulations, with respect to the Internet or other online services covering issues such as taxation, user privacy, pricing, content, copyrights, distribution, and characteristics and quality of products and services. The growth and development of the market for electronic commerce may prompt calls for more stringent consumer protection laws to impose additional burdens on companies conducting business online. The adoption of any additional laws or regulations may decrease the growth of the Internet, the Web or other online services, which could, in turn, decrease the demand for NeoMedia's services and increase NeoMedia's cost of doing business, or otherwise have a material adverse effect on NeoMedia's business, prospects, financial condition, and results of operations. Moreover, the relevant governmental authorities have not resolved the applicability to the Internet, the Web and other online services of existing laws in various jurisdictions governing issues such as property ownership and personal privacy and it may take time to resolve these issues definitively.

Certain of NeoMedia's proprietary technology allows for the storage of demographic data from NeoMedia's users. In 2000, the European Union adopted a directive addressing data privacy that may limit the collection and use of certain information regarding Internet users. This directive may limit NeoMedia's ability to collect and use information collected by NeoMedia's technology in certain European countries. In addition, the Federal Trade Commission and several state governments have investigated the use by certain Internet companies of personal information. NeoMedia could incur significant additional expenses if new regulations regarding the use of personal information are introduced or if NeoMedia's privacy practices are investigated.

Certain of NeoMedia's micro paint solutions could be subject to environmental regulations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (a), (b), (c) and (d)

None.

Item 3. Default upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and reports on form 8-K

(a) Exhibits:

Exhibit No.	**Description**	**Location**
31.1	Certification by Chief Executive Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Provided herewith
31.2	Certification by Chief Financial Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Provided herewith
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Provided herewith
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Provided herewith

(b) Reports on Form 8-K:

NeoMedia filed a report on Form 8-K on July 27, 2006, with respect to Item 1.01, reporting that it had signed a an operating agreement with Shang Fang Wei Ye Technology Development Limited Company (“Shang Fang”), a subsidiary of Beijing Sino-U.S. Jinche Yingyang Auto Technological Services Ltd., to introduce and market NeoMedia's patented qode direct-to-Web technology in key markets in Asia.

NeoMedia filed a report on Form 8-K on August 30, 2006, with respect to Item 1.01 and Item 3.02, reporting that it had sold a $5 million secured convertible debenture.

NeoMedia filed a report on Form 8-K on August 30, 2006, with respect to Item 8.01, reporting that it had terminated a non-binding letter of intent to acquire Hip Cricket, Inc.

NeoMedia filed a report on Form 8-K on August 31, 2006, with respect to Item 8.01, reporting that it had signed a non-binding letter of intent to sell its Micro Paint Repair business unit.

SIGNATURES

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

NEOMEDIA TECHNOLOGIES, INC.

Registrant

Date: May 1, 2007

By: /s/ *Charles W. Fritz*

Charles W. Fritz, Interim Chief Executive Officer, and Chairman of the Board

Date: May 1, 2007

By: /s/ *David A. Dodge*

David A. Dodge, Vice President,
Chief Financial Officer and Principal Accounting Officer