

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
FINANCIAL STATEMENTS
FOR THE YEARS ENDED
DECEMBER 31, 2013 AND 2012
AND FOR THE PERIOD FROM
MARCH 17, 2005 (DATE OF INCEPTION)
TO DECEMBER 31, 2013

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
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December 31, 2013 and 2012

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders of
AirXpanders, Inc.
Palo Alto, California



Report on the Financial Statements

We have audited the accompanying balance sheets of AirXpanders, Inc. (a development stage enterprise) (the "Company") as of December 31, 2013 and 2012, and the related statements of operations, stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

To the Board of Directors and Stockholders of
AirXpanders, Inc.
Independent Auditor's Report
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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The financial statements of the Company for the period from March 17, 2005 (date of inception) to December 31, 2011, were audited by other auditors whose report dated February 22, 2013 expressed an unmodified opinion on those statements.

A handwritten signature in black ink that reads "SingerLewak LLP". The signature is written in a cursive, flowing style.

SingerLewak LLP

San Jose, California
June 27, 2014

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
BALANCE SHEETS
December 31, 2013 and 2012

ASSETS		
	<u>2013</u>	<u>2012</u>
Current assets		
Cash and cash equivalents	\$ 5,224,848	\$ 3,025,329
Prepaid expenses and other current assets	<u>53,491</u>	<u>75,148</u>
Total current assets	5,278,339	3,100,477
Property and equipment, net	96,283	78,523
Other assets	<u>53,720</u>	<u>57,294</u>
Total assets	<u>\$ 5,428,342</u>	<u>\$ 3,236,294</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
	<u>2013</u>	<u>2012</u>
Current liabilities		
Accounts payable	\$ 428,514	\$ 372,407
Accrued expenses	146,504	95,436
Current portion of long-term debt	<u>1,068,548</u>	<u>1,019,956</u>
Total current liabilities	1,643,566	1,487,799
Warrant liabilities	81,744	19,200
Long-term debt	<u>-</u>	<u>790,862</u>
Total liabilities	<u>\$ 1,725,310</u>	<u>\$ 2,297,861</u>

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
BALANCE SHEETS
December 31, 2013 and 2012

LIABILITIES AND STOCKHOLDERS' EQUITY (Continued)

	2013	2012
Stockholders' equity		
Series E, 8% convertible noncumulative preferred stock, par value \$0.001; 45,200,000 share authorized, 44,499,028 shares issued and outstanding (liquidation preference of \$8,899,806)	\$ 44,499	\$ -
Series D, 8% convertible noncumulative preferred stock, par value \$0.001; 42,176,625 and 44,028,477 shares authorized respectively; 42,176,625 shares issued and outstanding (liquidation preference of \$11,387,689)	42,177	42,177
Series C, 8% convertible noncumulative preferred stock, par value \$0.001; 22,725,718 and 24,000,000 shares authorized respectively; 22,245,718 shares issued and outstanding (liquidation preference of \$5,561,430)	22,246	22,246
Series B-1, 8% convertible noncumulative preferred stock, par value \$0.001; 9,554,375 shares authorized, 9,554,375 shares issued and outstanding (liquidation preference of \$4,549,793)	9,554	9,554
Series B, 8% convertible noncumulative preferred stock, par value \$0.001; 3,375,954 shares authorized, 3,125,954 shares issued and outstanding (liquidation preference of \$1,488,579)	3,126	3,126
Series A, 8% convertible noncumulative preferred stock, par value \$0.001; 4,323,958 shares authorized, 3,908,168 shares issued and outstanding (liquidation preference of \$1,861,070)	3,908	3,908
Common stock; par value \$0.001, 232,983,187 and 103,287,736 shares authorized 4,508,329 and 4,472,859 shares issued and outstanding	4,508	4,473
Additional paid-in capital	32,339,315	23,553,346
Deficit accumulated during the development stage	(28,766,301)	(22,700,397)
Total stockholders' equity	3,703,032	938,433
Total liabilities and stockholders' equity	\$ 5,428,342	\$ 3,236,294

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2013 and 2012 and
For the Period from March 17, 2005 (Date of Inception) to December 31, 2013

	For the Year Ended December 31, 2013	For the Year Ended December 31, 2012	For the Period from March 17, 2005 (Date of Inception) to December 31, 2013
Operating expenses			
Research and development	\$ 789,022	\$ 1,060,005	\$ 9,465,540
Clinical trials	3,121,687	3,600,748	9,474,747
Selling, general and administrative	<u>2,011,785</u>	<u>1,913,724</u>	<u>8,881,623</u>
Total operating expenses	<u>5,922,494</u>	<u>6,574,477</u>	<u>27,821,910</u>
Operating loss	(5,922,494)	(6,574,477)	(27,821,910)
Interest expense	190,196	222,963	1,325,757
Other (income) expense, net	<u>(46,786)</u>	<u>(161,442)</u>	<u>(381,366)</u>
Net loss	<u>\$ (6,065,904)</u>	<u>\$ (6,635,998)</u>	<u>\$ (28,766,301)</u>

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
For the Period from March 17, 2005 (Date of Inception) to December 31, 2013

	Convertible Preferred Stock		Common Stock		Additional Paid-In Capital		Deficit	
	Issued and Outstanding Shares	Amount	Issued and Outstanding Shares	Amount	Common Stock	Preferred Stock	Accumulated During the Development	Total Stockholders' Equity (Deficit)
Balance - March 17, 2005 (date of inception)								
Issuance of common stock for cash	-	\$ -	-	\$ -	-	\$ -	-	\$ -
Stock-based compensation	-	-	1,221,333	1,221	-	-	-	1,221
Exercise of stock options granted to employees and officers	-	-	-	-	320	-	-	320
Net loss for the period ended December 31, 2005	-	-	1,180,000	1,180	-	-	-	1,180
	-	-	-	-	-	-	(350,055)	(350,055)
Balance - December 31, 2005								
Issuance of common stock for cash	-	-	2,401,333	2,401	320	-	(350,055)	(347,334)
Exercise of stock options granted to employees and officers	-	-	855,026	855	-	-	-	855
Accrued dividends	-	-	-	-	-	-	-	-
Stock-based compensation	-	-	1,150,000	1,150	(1,980)	1,980	-	1,150
Issuance of Series A preferred stock for cash (net of issuance costs of \$13,323)	-	-	-	-	2,793	-	-	2,793
Issuance of Series A preferred stock in exchange for outstanding convertible notes	8,399,832	8,400	-	-	-	3,978,277	-	3,986,677
Net loss	955,474	955	-	-	-	454,045	(222,653)	455,000
	-	-	-	-	-	-	(222,653)	(222,653)
Balance - December 31, 2006								
Exercise of stock options granted to employees and officers	9,355,306	9,355	4,406,359	4,406	1,133	4,434,302	(572,708)	3,876,488
Accrued dividends	-	-	44,000	44	2,156	-	-	2,200
Issuance of Series A preferred stock for cash (net of issuance costs of \$36,055)	-	-	-	-	(389,413)	389,413	-	-
Stock-based compensation	861,794	862	-	-	-	373,469	-	374,331
Net loss	-	-	-	-	56,873	-	(1,338,194)	56,873
	-	-	-	-	-	-	(1,338,194)	(1,338,194)
Balance - December 31, 2007								
	10,217,100	10,217	4,450,359	4,450	(329,251)	5,197,184	(1,910,902)	2,971,698

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

AIRXPANDERS, INC.

(A DEVELOPMENT STAGE ENTERPRISE)

STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

For the Period from March 17, 2005 (Date of Inception) to December 31, 2013

	Convertible Preferred Stock		Common Stock		Additional Paid-In Capital		Deficit	
	Issued and Outstanding Shares	Amount	Issued and Outstanding Shares	Amount	Common Stock	Preferred Stock	Accumulated During the Development	Total Stockholders' Equity (Deficit)
Accrued dividends	-	\$ -	-	\$ -	(509,135)	\$ 509,135	\$ -	\$ -
Exercise of stock options granted to employees and officers	-	-	2,500	3	122	-	-	125
Issuance of Series A preferred stock for cash (net of issuance costs of \$5,469)	1,564,467	1,564	-	-	-	737,967	-	739,531
Stock-based compensation	-	-	-	-	64,578	-	-	64,578
Net loss	-	-	-	-	-	-	(3,895,664)	(3,895,664)
Balance - December 31, 2008	11,781,567	11,781	4,452,859	4,453	(773,686)	6,444,286	(5,806,566)	(119,732)
Accrued dividends	-	-	-	-	(495,287)	495,287	-	-
Issuance of Series A preferred stock in exchange for Series A accumulated dividends	1,680,976	1,681	-	-	-	(1,681)	-	-
Issuance of Series B preferred stock for cash (net of issuance costs of \$165,445)	3,125,954	3,126	-	-	-	1,320,008	-	1,323,134
Issuance of Series B-1 preferred stock in exchange for Series A preferred stock	9,554,375	9,554	-	-	-	-	-	9,554
Exchange of Series A preferred stock for Series B-1	(9,554,375)	(9,554)	-	-	-	-	-	(9,554)
Recordation of value of embedded derivatives	-	-	-	-	-	(2,320,124)	-	(2,320,124)
Stock-based compensation	-	-	-	-	68,764	-	-	68,764
Net loss	-	-	-	-	-	-	(1,925,494)	(1,925,494)
Balance - December 31, 2009	16,588,497	16,588	4,452,859	4,453	(1,200,209)	5,937,776	(7,732,060)	(2,973,452)
Accrued dividends	-	-	-	-	(190,473)	190,473	-	-
Issuance of Series C preferred stock for cash (net of issuance costs of \$82,743)	20,000,000	20,000	-	-	-	4,897,257	-	4,917,257
Issuance of Series C preferred stock in exchange for outstanding convertible notes	2,245,718	2,246	-	-	-	446,898	-	449,144
Stock-based compensation	-	-	-	-	31,990	-	-	31,990
Recordation of the removal of the embedded derivative	-	-	-	-	-	2,126,682	-	2,126,682
Net loss	-	-	-	-	-	-	(3,138,810)	(3,138,810)
Balance - December 31, 2010	38,834,215	\$ 38,834	4,452,859	\$ 4,453	\$ (1,358,692)	\$ 13,599,086	\$ (10,870,870)	\$ 1,412,811

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
For the Period from March 17, 2005 (Date of Inception) to December 31, 2013

	Convertible Preferred Stock	Common Stock		Additional Paid-In Capital		Deficit	Total
	Issued and Outstanding Shares	Amount	Issued and Outstanding Shares	Amount	Common Stock	Accumulated During the Development	Stockholders' Equity (Deficit)
Exercise of stock options granted to employees and officers	-	\$ -	20,000	\$ 20	\$ 980	\$ -	\$ 1,000
Stock-based compensation	-	-	-	-	39,965	-	39,965
Net loss	-	-	-	-	-	(5,193,529)	(5,193,529)
Balance - December 31, 2011	38,834,215	38,834	4,472,859	4,473	(1,317,747)	13,599,086	(3,739,753)
Issuance of Series D preferred stock for cash (net of issuance costs of \$116,626)	34,983,515	34,984	-	-	-	9,293,939	9,328,923
Issuance of Series D preferred stock upon conversion of convertible notes	7,193,110	7,193	-	-	-	1,934,947	1,942,140
Stock-based compensation	-	-	-	-	43,121	-	43,121
Net loss	-	-	-	-	-	(6,635,998)	(6,635,998)
Balance, December 31, 2012	81,010,840	\$ 81,011	4,472,859	\$ 4,473	\$ (1,274,626)	\$ 24,827,972	\$ 938,433
Issuance of Series E preferred stock for cash (net of issuance costs of \$155,051)	44,499,028	44,499	-	-	-	8,700,256	8,744,755
Exercise of Stock Options	-	-	35,470	35	2,093	-	2,128
Stock-based compensation	-	-	-	-	83,620	-	83,620
Net loss	-	-	-	-	-	(6,065,904)	(6,065,904)
Balance, December 31, 2013	125,509,868	\$ 125,510	4,508,329	\$ 4,508	\$ (1,188,913)	\$ 33,528,228	\$ 3,703,032

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2013 and 2012 and
For the Period from March 17, 2005 (Date of Inception) to December 31, 2013

	For the Year Ended December 31, 2013	For the Year Ended December 31, 2012	For the Period from March 17, 2005 (Date of Inception) to December 31, 2013
Cash flows from operating activities			
Net loss	\$ (6,065,904)	\$ (6,635,998)	\$ (28,766,301)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization	50,443	77,243	474,907
Amortization of debt discount	21,899	21,899	126,905
Loss from fixed asset disposal	-	-	4,663
Change in fair value of warrant liabilities	62,544	(160,785)	(59,761)
Change in fair value of embedded derivative	-	-	(193,442)
Stock-based compensation	83,620	43,121	392,024
Changes in assets and liabilities			
Prepaid expenses and other assets	25,231	(79,343)	(107,211)
Accounts payable	56,107	150,021	428,514
Accrued expenses	51,068	(54,493)	139,218
Interest expense accrued but not paid	-	-	56,787
Net cash used in operating activities	<u>(5,714,992)</u>	<u>(6,638,335)</u>	<u>(27,503,697)</u>
Cash flows from investing activities			
Purchase of property and equipment	(68,203)	(35,813)	(576,963)
Proceeds from sale of property and equipment	-	-	1,111
Cash used in investing activities	<u>(68,203)</u>	<u>(35,813)</u>	<u>(575,852)</u>
Cash flows from financing activities			
Proceeds from borrowings on notes payable	-	-	7,133,694
Principal payments on notes payable	(764,169)	(943,920)	(3,253,764)
Principal from exercise of stock options	-	-	5,655
Proceeds from issuance of preferred stock, net of issuance costs	8,744,755	9,328,923	29,414,609
Proceeds from exercise of stock options	2,128	-	4,204
Net cash provided by financing activities	<u>7,982,714</u>	<u>8,385,003</u>	<u>33,304,398</u>
Increase in cash and cash equivalents	2,199,519	1,710,855	5,224,849
Cash and cash equivalents - beginning of year	<u>3,025,329</u>	<u>1,314,474</u>	<u>-</u>
Cash and cash equivalents - end of year	<u>\$ 5,224,848</u>	<u>\$ 3,025,329</u>	<u>\$ 5,224,849</u>
Supplemental schedule of noncash investing and financing activities			
Stocks dividends declared	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,586,288</u>
Issuance of warrants in connections with borrowings	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 14,505</u>
Preferred stock issued in satisfaction of accrued interest	<u>\$ -</u>	<u>\$ 23,815</u>	<u>\$ 37,959</u>
Preferred stock issued upon conversion of convertible notes payable	<u>\$ -</u>	<u>\$ 1,918,325</u>	<u>\$ 2,808,325</u>
Preferred stock issued in satisfaction of accrued dividends	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 800,490</u>

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

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 1 – DESCRIPTION OF BUSINESS

AirXpanders, Inc. ("AirXpanders" or the "Company") is a Delaware corporation formed on March 17, 2005, and is headquartered in Palo Alto, California. Through December 31, 2013, the Company has been primarily engaged in developing initial product technology, recruiting personnel and raising capital.

As a medical device company, AirXpanders is focusing in the field of tissue expansion after mastectomy, with an emphasis on breast reconstruction. The Company is a development stage entity that is designing the novel AeroForm patient controlled tissue expander. The AeroForm system consists of a self-contained expander (which is implanted in a similar manner to traditional saline expanders following a mastectomy), and a small hand-held wireless remote control unit. The lipstick-sized carbon dioxide (CO₂) reservoir in the expander gradually releases a predetermined amount of CO₂ through a small internal valve, eliminating the need for frequent saline injections at doctors' offices typically associated with current on-market expanders.

NOTE 2 – DEVELOPMENT STAGE

The Company is in the development stage as of December 31, 2013. The Company is a development stage entity as there has been no revenue generated from its planned principal operations, and accordingly, its financial statements have been presented in accordance with Accounting Standards Codification Topic No. 915 *Development Stage Entities*. The Company is subject to risks common to companies in the development stage, including, but not limited to, development of new products, development of markets and distribution channels, dependence on key personnel, obtaining adequate supplier relationships, building its customer base, successfully executing its business and marketing strategy and the ability to obtain additional capital as needed to fund its product plans. The Company has a limited operating history and has yet to generate any revenues from customers. To date, the Company has been funded by equity and debt financings. The Company's ultimate success is dependent upon its ability to raise additional capital, to obtain necessary regulatory approvals for its products, and to successfully develop and market its products.

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP).

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of assets, liabilities, equity instruments, and expenses during the reporting period. Actual results could differ materially from those estimates.

Certain Significant Risks and Uncertainties

The Company operates in a dynamic, highly competitive industry and believes that changes in any of the following areas could have a material adverse effect on the Company's future financial position, results of operations, or cash flows; ability to obtain future financing; advances and trends in new technologies and industry standards; regulatory approval and market acceptance of the Company's products; development of sales channels; certain strategic relationships; litigation or claims against the Company based on intellectual property, patent, product, regulatory, or other factors; and the Company's ability to attract and retain employees necessary to support its growth.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of cash and cash equivalents. The Company maintains all of its U.S. cash balances at one financial institution, which at times may exceed the Federal Deposit Insurance Corporation (FDIC) limits of \$250,000 for interest-bearing accounts. Beginning January 1, 2013, deposits held in non-interest-bearing accounts will be aggregated with any interest-bearing deposits the owner may hold in the same ownership category, and the combined total insured up to \$250,000. At December 31, 2013, the Company had cash balances of approximately \$4,999,848 that were in excess of the FDIC limits.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. Restricted cash of \$25,000 at December 31, 2013, which serves as collateral for corporate credit cards, is included in other assets in the balance sheet.

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three to five years. Leasehold improvements and property and equipment under capital leases are depreciated over the shorter of estimated useful lives of the assets or the lease terms.

Expenditures for repairs and maintenance are charged to expense as incurred. Upon disposition of an asset, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in the statement of operations.

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment of Long-Lived Assets

The Company's long-lived assets and other assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Recoverability of an asset to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such asset is considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value. Through December 31, 2013, the Company had not experienced impairment losses on its long-lived assets.

Fair Value of Financial Instruments

The Company follows Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic No. 820, *Fair Value Measurement* ("ASC 820"), which clarifies fair value as an exit price, establishes a hierarchical disclosure framework for measuring fair value, and requires extended disclosures about fair value measurements. The provisions of ASC 820 apply to all financial assets and liabilities measured at fair value.

As defined in ASC 820, fair value represents the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As a result, fair value is a market-based approach that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering these assumptions, ASC 820 defines a three-tier value hierarchy that prioritizes the inputs used in the valuation methodologies in measuring fair value.

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value of Financial Instruments (Continued)

The following table sets forth by level, within the fair value hierarchy, the Company's assets and liabilities measured at fair value in the balance sheet as of December 31, 2013:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 5,224,848	\$ -	\$ -	\$ 5,224,848
Total assets at fair value	\$ 5,224,848	\$ -	\$ -	\$ 5,224,848
Warrant liabilities	\$ -	\$ -	\$ 81,744	\$ 81,744
Total liabilities at fair value	\$ -	\$ -	\$ 81,744	\$ 81,744

The following table sets forth by level, within the fair value hierarchy, the Company's assets and liabilities measured at fair value in the balance sheet as of December 31, 2012:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 3,025,329	\$ -	\$ -	\$ 3,025,329
Total assets at fair value	\$ 3,025,329	\$ -	\$ -	\$ 3,025,329
Warrant liabilities	\$ -	\$ -	\$ 19,200	\$ 19,200
Total liabilities at fair value	\$ -	\$ -	\$ 19,200	\$ 19,200

See Note 11 for discussion of the valuation methodology and inputs for the warrant liabilities.

At December 31, 2013 and 2012, the Company had the following financial instruments for which disclosure only of fair value is required:

Long-term debt – Valued at carrying value which is considered to be representative of its fair value based on current market rates available to the Company for comparable borrowing facilities.

AIRXPANDERS, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock-Based Compensation

Stock-based compensation is measured at the grant date based on the fair value of the award. The fair value of the award that is ultimately expected to vest is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. The expense recognized for the portion of the award that is expected to vest has been reduced by an estimated forfeiture rate. The forfeiture rate is determined at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option-pricing model (the "Black-Scholes model") as the method for determining the estimated fair value of stock options.

Expected Term

The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding and is determined using the simplified method.

Expected Volatility

Expected volatility is estimated using comparable public companies volatility for similar terms.

Expected Dividend

The Black-Scholes model calls for a single expected dividend yield as an input. The Company has never paid dividends and has no plans to pay dividends on its common stock.

Risk-Free Interest Rate

The risk-free interest rate used in the Black-Scholes model is based on the U.S. Treasury zero coupon issues in effect at the time of grant for periods corresponding with the expected term of option.

The Company recognizes fair value of stock options granted to nonemployees as stock-based compensation expense over the period in which the related services are received.

Research and Development

Costs incurred in research and development activities are expensed as incurred. Research and development costs include, but are not limited to, payroll and personnel expenses, laboratory supplies, consulting costs, travel, parts and materials, equipment expenses, and equipment depreciation.

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NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under this method, deferred income tax assets and liabilities are recorded based on the estimated future tax effects of differences between the financial statement and income tax basis of assets and liabilities. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating loss and credit carryovers. Deferred tax assets and liabilities are measured using the enacted tax rates applied to taxable income. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided against the Company's deferred income tax assets when it is more likely than not that the asset will not be realized.

Significant judgment is required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, the Company considers all available evidence, including past operating results, estimates of future taxable income and the feasibility of tax planning strategies. In the event that the Company changes its determination as to the amount of deferred tax assets that are more likely than not to be realized, the Company will adjust its valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

The Company follows authoritative guidance regarding uncertain tax positions. This guidance requires that realization of an uncertain income tax position must be more likely than not (i.e. greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements. The guidance further prescribes the benefit to be realized assumes a review by tax authorities having all relevant information and applying current conventions. The interpretation also clarifies the financial statement classification of tax related penalties and interest and sets forth disclosures regarding unrecognized tax benefits. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as income tax expense.

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NOTE 4 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following at December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Machinery and equipment	\$ 376,070	\$ 318,182
Furniture and fixtures	66,526	64,796
Computer equipment	52,808	52,808
Leasehold improvements	26,055	17,470
Software licenses	19,061	19,061
Office equipment	<u>1,878</u>	<u>1,878</u>
Property and equipment, gross	542,398	474,195
Accumulated depreciation and amortization	<u>(446,115)</u>	<u>(395,672)</u>
Property and equipment, net	<u>\$ 96,283</u>	<u>\$ 78,523</u>

Depreciation and amortization expense amounted to \$50,443, \$77,243 and \$474,907 for the years ended December 31, 2013 and 2012 and for the period from March 17, 2005 (date of inception) to December 31, 2013, respectively.

NOTE 5 – ACCRUED EXPENSES

Accrued expenses consisted of the following at December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Accrued payroll and related expenses	\$ 95,755	\$ 80,675
Accrued rent payable	1,900	5,761
Accrued other	<u>48,849</u>	<u>9,000</u>
Total accrued expenses	<u>\$ 146,504</u>	<u>\$ 95,436</u>

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NOTE 6 – DEBT FINANCING

In March 2011, the Company borrowed \$3,000,000 under a loan and security agreement with a financial institution which expires in September 2014. Interest is paid monthly on the principal amount at 9.01%. Under the terms of the agreement, interest-only payments were made monthly through September 2011, with principal payments commencing in October 2011, due in 36 equal monthly installments. A fee of \$165,000 is due at maturity, which is being accrued over the term of the loan. The Company can prepay the entire loan amount by providing a written ten day notice prior to such prepayment and pay all outstanding principal, interest and prepayment fee plus any default fees and all other sums that shall have become due and payable. The loan is secured by substantially all of the Company's assets, excluding intellectual property.

In January 2013, the Company entered into a loan modification agreement related to the loan and security agreement, to make monthly repayments of interest only from February 1, 2013 to June 1, 2013. The Company paid a modification fee of \$15,000. In conjunction with the modification, the Company issued 148,148 warrants for Series D Preferred Stock at an exercise price of \$0.27. As a result of the Series E round of financing during the year, the holder of the warrant had the election under their existing warrant agreement to convert their warrants into warrants for 200,000 shares of Series E at an exercise price of \$0.20. The fair value of the warrants totaled \$21,525 and was recorded to interest expense at 12/31/13.

The Company recorded \$168,931, \$212,607 and \$582,649 of interest expense on the loan for the years ended December 31, 2013 and 2012 and for the period from March 17, 2005 (date of inception) to December 31, 2013, respectively. At December 31, 2013 and 2012, \$1,083,148 and \$1,847,318, respectively, was outstanding under this loan agreement.

In connection with the loan agreement, the Company granted a warrant to the financial institution to purchase 480,000 shares of Series C convertible preferred stock ("Series C") at \$0.25 per share. The warrant is exercisable at the option of the holder at any time through February 28, 2021. The fair value of the warrant of \$76,647 on the date of issuance was recorded as a debt discount (see Note 11 for further details on the warrant accounting). The debt discount is being amortized over the expected term of the loan as a component of interest expense. The Company recorded \$21,899 and \$21,899 to interest expense related to amortization of debt discount for the years ended December 31, 2013 and 2012, respectively. As of December 31, 2013, the unamortized discount on the debt is \$14,600. Future amortization of the unamortized discount amounted to \$14,600, which is expected to be fully amortized in 2014.

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NOTE 6 – DEBT FINANCING (Continued)

At December 31, 2013, future scheduled principal payments are as follows:

Total scheduled future payments in 2014	\$ 1,083,148
Unamortized discount	<u>(14,599)</u>
Total debt	1,068,549
Less current portion	<u>1,068,549</u>
Total noncurrent portion of debt	<u>\$ -</u>

NOTE 7 – CONVERTIBLE BRIDGE NOTES PAYABLE

In November 2011, the Company issued \$1,918,325 in convertible bridge notes payable at an interest rate of 10% per annum. Interest would be paid in-kind upon conversion of the notes. The notes accrued monthly interest at 10% per annum, and matured on December 1, 2012. On January 18, 2012 the notes were amended to include an automatic conversion feature, allowing the noteholders to convert all principal and accrued interest due under the notes into Series D preferred stock.

The notes and accrued interest totaling \$1,942,140 were converted into Series D preferred stock on January 18, 2012. See Note 10 for details.

NOTE 8 – COMMITMENTS

Lease Obligations

The Company leases its office space under a non-cancelable operating lease. Monthly base rent payments range from \$6,460 to \$13,306. The Company amended the lease to extend the term of the lease from August 2013 through July 2016. The Company recognizes rent expense on a straight-line basis over the term of the lease. Rent expense (including common area maintenance) related to the Company's operating leases was \$167,717 and \$141,746 for the year ended December 31, 2013 and 2012, respectively, and for the period from March 17, 2005 (date of inception) to December 31, 2012 rent expense was \$798,690.

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NOTE 8 – COMMITMENTS (Continued)

Lease Obligations (Continued)

The future rental commitments due under the lease are:

For the Years Ending December 31,	
2014	152,392
2015	156,963
2016	<u>93,145</u>
Total	<u>\$ 402,500</u>

Indemnifications

The Company has agreed to indemnify its officers and directors for certain events or occurrences arising as a result of the officers or directors serving in such capacity. The Company has a directors and officers liability insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid resulting from the indemnification of its officers and directors. In addition, the Company enters into indemnification agreements with other parties in the ordinary course of business. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. The Company's management believes the estimated fair value of these indemnification agreements is minimal and has not recorded a liability for these agreements as of December 31, 2013 and 2012.

NOTE 9 – COMMON STOCK

The Company's Articles of Incorporation, as amended, authorize the Company to issue 232,983,187 shares of \$0.001 par value common stock. Common stockholders are entitled to dividends when and if declared by the Board of Directors and after any convertible preferred shares dividends are fully paid. The holder of each share of common stock is entitled to one vote. At December 31, 2013, no dividends had been declared for common stock.

At December 31, 2013 and 2012, common stock that the Company had reserved for issuance was as follows:

	<u>2013</u>	<u>2012</u>
Conversion of convertible preferred stock	\$145,833,112	\$ 81,010,840
Warrants for common and convertible preferred shares	45,989,818	1,145,790
Stock option plan	<u>30,850,799</u>	<u>12,729,352</u>
Total	<u>\$222,673,729</u>	<u>\$ 94,885,982</u>

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NOTE 10 – CONVERTIBLE PREFERRED STOCK

The Company issued Series A, B, B-1, C, D and E convertible preferred stock during the period from 2005 through 2013, raising a total of \$29,414,608 in cash, net of issuance costs of \$574,512. In March 2009, the Company issued Series B and B-1 convertible preferred stock with new terms that included embedded derivative features with contingent conversion options, premium redemption and conversion options and recognized the fair value of an embedded derivative liability of \$2,320,124. In April 2010, the Company issued Series C convertible preferred stock with amended terms that terminated the previous embedded derivative features.

The fair value of the embedded derivative liability of \$2,126,682 was written off. As of December 31, 2013 and 2012, there is no embedded derivative liability balance.

In January 2012, the Company issued 38,176,625 shares of Series D Preferred Stock (Series D) at \$0.27 per share, for total cash consideration of \$8,365,550, less issuance costs of \$116,626, plus conversion of all outstanding convertible notes and accrued interest totaling \$1,942,140 (aforementioned in Note 7). In May 2012, the Company closed the second tranche of Series D by issuing an additional 4,000,000 shares for total cash consideration of \$1,080,000.

In May 2013, the Company's stockholders approved the following:

- (i) the increase in the authorized number of shares of preferred stock from 85,282,764 to 127,356,630,
- (ii) the creation and authorization of 45,200,000 shares of Series E Preferred Stock,
- (iii) the waiving of certain right to anti-dilution adjustments in connection with the sale and issuance of Series E Preferred Stock and warrants to purchase common stock (rights to anti-dilution adjustments were waived by all preferred shareholders), and
- (iv) the special mandatory the conversion of all shares of Preferred Stock held by any investor in the initial closing of the Series E financing that does not fulfill its obligations to participate in the second closing of the Series E financing (no shareholders converted preferred to common stock during the year), and
- (v) the adjustment of the conversion prices of Series C and Series D Preferred Stock to be equal to the conversion price of the Series E Preferred Stock.

In 2013, the Company issued 44,499,028 shares of Series E Preferred Stock (Series E) at \$0.20 per share, for total cash consideration of \$8,744,755, less issuance costs of \$155,051.

AIRXPANDERS, INC.
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NOTE 10 – CONVERTIBLE PREFERRED STOCK (Continued)

A summary of the authorized and outstanding preferred stock as of December 31, 2013, is as follows:

	Shares Authorized	Shares Outstanding	Issuance Value per Share	Total Liquidation Preference
Series A	4,323,958	3,908,168	\$ 0.4762	\$ 1,861,070
Series B	3,375,954	3,125,954	0.4762	1,488,579
Series B-1	9,554,375	9,554,375	0.4762	4,549,793
Series C	22,725,718	22,245,718	0.2500	5,561,430
Series D	42,176,625	42,176,625	0.2700	11,387,689
Series E	45,200,000	44,499,028	0.2000	8,899,806

The holders of preferred stock have various rights and preferences as follow:

Ranking

Generally, preferred stock issued on a later date ranks senior to any shares of preferred stock issued on an earlier date. All preferred stock ranks senior to the Company's common stock.

Voting Rights

Holder of each share of preferred stock has the right to a number of votes equal to the number of shares of common stock issuable upon conversion of the preferred stock. The preferred stockholders are entitled to vote with the common stockholders on all matters except as specifically provided or as otherwise required by law. Set forth in the certificate of incorporation, there are separate voting rights of directors and protective provisions requiring approval of 60% of the holders of preferred stock, and a few items requiring a separate vote of Series A preferred stock. In the Series D financing, the Company amended the language and eliminated the separate Series A protective provisions. Before then, the certificate of incorporation included a separate vote of Series A if the Series A rights were affected adversely or if the number of Series A were increased or decreased.

Dividends

Prior to April 21, 2010, preferred stockholders were entitled to receive dividends at the rate of 8% per annum. On April 21, 2010, the articles of incorporation was amended and preferred stockholders became entitled to receive noncumulative dividends at the rate of 8% of the original purchase price per share per annum upon declaration by the board of directors. Preferred stockholders are entitled to receive such dividends in preference to the Company's common stockholders. From the period from inception to December 31, 2013, total stock dividends declared was \$1,586,288.

AIRXPANDERS, INC.
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NOTE 10 – CONVERTIBLE PREFERRED STOCK (Continued)

Liquidation Preference

In the event of any liquidation or winding up of the Company, whether voluntary or involuntary, or in the event of a transfer of the Company's capital stock in which the transferee will hold the majority of the Company's outstanding voting stock after closing, Series E preferred stockholders are entitled to receive an amount equal to the original purchase price, plus all declared but unpaid dividends, in preference to the Series D, C, B, B-1 and A preferred stockholders and common stockholders. If, upon the occurrence of such event, the assets and funds thus distributed among the holders is insufficient to permit the full payment of preferential amounts, the entire assets and funds of the Company legally available for distribution shall be distributed ratably on a pari passu basis. Then the Series D and Series C preferred stockholders are entitled to receive an amount equal to the original purchase price, plus all declared but unpaid dividends, in preference to the Series B, B-1 and A preferred stockholders and common stockholders. Then the Series B and B-1 preferred stockholders are entitled to receive an amount equal to their respective original purchase price, plus certain accrued dividends and all other declared but unpaid dividends, in preference to the Series A preferred stockholders and common stockholders. Then the Series A preferred stockholders are entitled to receive their original purchase price, plus certain accrued dividends and all other declared but unpaid dividends. Thereafter, the preferred and common stockholders share in all remaining assets of the Company on an as-converted basis. In each case, "original purchase price" is as adjusted for anti-dilution adjustments and at December 31, 2013 equals the "issuance value per share" listed above.

Conversion Rights

Series E, B, B-1 and A preferred stockholder have the right to convert shares of preferred shares at any time, at the option of the holder, into shares of common stock at a conversion rate of 1:1; while Series D and C preferred stockholders at conversion rate of 1:1.35 and 1:25, respectively, subject to anti-dilution adjustments. Preferred shares are automatically converted upon a qualified initial public offering or upon election of at least 55% of preferred stock.

Redemption Rights

The preferred stock is not redeemable at the option of the holder.

NOTE 11 – STOCK WARRANTS

The Company accounts for warrants in accordance with FASB Accounting Standards Codification Topic 480, *Distinguishing Liabilities from Equity* ("ASC 480"). Under ASC Topic 480, warrants containing certain features, such as put rights and anti-dilution protection, are required to be accounted for as liabilities and recorded at fair value, with changes in fair value being recorded in the statement of operations. The Company's preferred stock warrants contain such features, requiring liability accounting.

AIRXPANDERS, INC.
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NOTE 11 – STOCK WARRANTS (Continued)

The Company is required to reserve authorized but unissued shares of its common and preferred stock in an amount equal to the number of warrant shares purchasable under the arrangements described below.

The Company's warrant liabilities account consists of:

<u>Date Issued</u>	<u>December 31, 2013</u>	<u>December 31, 2012</u>	<u>Initial Recognition</u>
2007	\$ 43	\$ 281	\$ 30,281
2008	14	90	8,983
2009	36,015	1,085	25,624
2011	24,407	17,744	76,647
2013	21,265	-	21,265
	<u>\$ 81,744</u>	<u>\$ 19,200</u>	<u>\$ 132,519</u>

The warrant liabilities are revalued at the end of each reporting period with the changes in fair value recorded in other income and expense in the statements of operations. The changes in fair value of these warrants recorded as other income (expense) are as follows:

<u>Date Issued</u>	<u>For the Year Ended December 31, 2013</u>	<u>For the Year Ended December 31, 2012</u>	<u>For the Period From March 17, 2005 (Date of Inception) to December 31, 2013</u>
2007	\$ 238	\$ 46,643	\$ 30,238
2008	76	14,925	8,983
2009	(34,930)	42,868	(10,391)
2011	(6,663)	56,350	52,240
2013	<u>(21,265)</u>	<u>-</u>	<u>(21,265)</u>
	<u>\$ (62,544)</u>	<u>\$ 160,786</u>	<u>\$ 59,805</u>

AIRXPANDERS, INC.
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NOTE 11 – STOCK WARRANTS (Continued)

The fair value of the warrant liabilities was estimated using Black-Scholes model using the following assumptions:

	For the Year Ended December 31, 2013	For the Year Ended December 31, 2012
Stock price	\$0.13 - \$0.206	\$0.10 - \$0.12
Expected term (years)	2.00 – 9.08 years	3.00 – 8.16 years
Volatility	34.26 – 43.20%	42.39 – 43.70%
Risk-free interest rate	0.31 – 2.35%	0.31 – 1.41%
Dividend yield	- %	- %

In August 2007, in connection with a loan and security agreement, the Company issued a warrant to a financial institution to purchase 314,992 Series A convertible preferred shares at \$0.48 per share. The warrant is exercisable at any time at the option of the holder and expires in 2015. This warrant is classified as a liability.

In March 2008, in connection with a loan and security agreement, the Company issued a warrant to a financial institution to purchase 100,798 Series A convertible preferred shares at \$0.48 per share. The warrant is exercisable at any time at the option of the holder and expires in 2015. This warrant is classified as a liability.

In March 2009, in connection with a loan and security agreement, the Company issued a warrant to a financial institution to purchase 250,000 Series B convertible preferred shares at \$0.48 per share. The warrant is exercisable at any time at the option of the holder and expires in 2016. This warrant is classified as a liability.

In February 2011, in connection with the loan and security agreement, the Company issued a warrant to a financial institution to purchase 480,000 Series C convertible preferred shares at \$0.25 per share (See Note 6). This warrant is classified as a liability.

In June 2013, the Company issued 44,499,028 warrants in connection with the issuance of Series E Preferred Stock. This warrant is classified as equity (Note 10).

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NOTE 12 – STOCK-BASED COMPENSATION PLAN

In March 2005, the Company adopted the 2005 Equity Incentive Plan (the "Plan"). The Plan provides for the granting of stock options to employees and consultants of the Company. Options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to Company employees and consultants. The Company reserved 12,729,352 shares of common stock for issuance under the Plan as of December 31, 2012.

In May 2013, the 2005 Equity Incentive Plan (the "Plan") was amended to increase the number of shares reserved for issuance under the Plan from 12,729,352 to 30,850,799 shares of common stock.

Options under the Plan may be granted for periods of up to 10 years and at prices no less than 100% of the estimated fair value of the shares on the date of grant. In the case of an Incentive Stock Option granted to a holder who, at the time the Option is granted, owns stock representing more than 10% of the voting power of all classes of stock of the Company or any Parent or Subsidiary, the term of the Option shall be up to 5 years from the date of grant and at no less than 110% of the estimated fair value of the shares on the date of grant. Options granted generally vest 1/4 on the 12-month anniversary of the vesting commencement date and 1/48 on each monthly anniversary thereafter.

Activity under the Plan is set forth below:

	Options Available for Grant	Number of Options Outstanding	Exercise Price per Share	Weighted Average Remaining Contractual Life in Years
Balance – March 17, 2005 (date of inception)	-	-	-	-
Shares reserved at plan inception	1,278,667	-	-	-
Options granted (weighted-average fair value of \$0.0003 per share)	(1,180,000)	1,180,000	\$ 0.001	-
Options exercised	1,180,000	(1,180,000)	\$ 0.001	-
Balance – December 31, 2005	1,278,667	-	\$ 0.001	-

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AIRXPANDERS, INC.
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NOTE 12 – STOCK-BASED COMPENSATION PLAN (Continued)

	Options Available for Grant	Number of Options Outstanding	Exercise Price per Share	Weighted Average Remaining Contractual Life in Years
<i>Continued from previous page</i>				
Additional shares reserved	3,039,298	-	\$ -	-
Options granted (weighted-average fair value of \$0.003 per share)	(1,170,323)	1,170,323	\$ 0.001	-
Options exercised	<u>1,150,000</u>	<u>(1,150,000)</u>	\$ 0.001	-
Balance – December 31, 2006	4,297,642	20,323	\$ 0.001	4.99
Options granted (weighted-average fair value of \$0.0148 per share)	(1,279,000)	1,279,000	\$ 0.05	-
Options exercised	44,000	(44,000)	\$ 0.05	-
Options forfeited	<u>70,000</u>	<u>(70,000)</u>	\$ 0.05	-
Balance – December 31, 2007	3,132,642	1,185,323	\$ 0.05	4.26
Options granted (weighted-average fair value of \$0.0129 per share)	(511,000)	511,000	\$ 0.05	-
Options exercised	2,500	(2,500)	\$ 0.05	-
Options forfeited	<u>18,000</u>	<u>(18,000)</u>	\$ 0.05	-
Balance – December 31, 2008	2,642,142	1,675,823	\$ 0.05	3.50
Options granted (weighted-average fair value of \$0.00000000004 per share)	(162,000)	162,000	\$ 0.05	-
Options forfeited	<u>170,000</u>	<u>(170,000)</u>	\$ -	-
Balance – December 31, 2009	2,650,142	1,667,823	\$ 0.05	2.69
<i>Continued on following page</i>				

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NOTE 12 – STOCK-BASED COMPENSATION PLAN (Continued)

	Options Available for Grant	Number of Options Outstanding	Exercise Price per Share	Weighted Average Remaining Contractual Life in Years
<i>Continued from previous page</i>				
Additional shares reserved	5,211,387	-	\$ -	-
Options granted	-	-	\$ -	-
Options exercised	-	-	\$ -	-
Options forfeited	-	-	\$ -	-
Balance – December 31, 2010	7,861,529	1,667,823	\$ 0.05	1.69
Options granted (weighted-average fair value of \$0.0193 per share)	(3,216,815)	3,216,815	\$ 0.05	-
Options exercised	20,000	(20,000)	\$ 0.05	-
Options forfeited	80,000	(80,000)	\$ -	-
Balance – December 31, 2011	4,744,714	4,784,638	\$ 0.05	2.89
Additional shares reserved	3,200,000	-	\$ -	-
Options granted	(3,942,092)	3,942,092	\$ 0.06	-
Options exercised	-	-	\$ -	-
Options forfeited	-	-	\$ -	-
Balance – December 31, 2012	4,002,622	8,726,730	\$ 0.05	7.97
Additional shares reserved	18,121,447	-	\$ -	-
Options granted	(10,548,540)	10,548,540	\$ 0.06	-
Options exercised	-	(35,470)	\$ 0.03	-
Options forfeited	186,722	(186,722)	\$ -	-
Balance – December 31, 2013	7,759,629	19,053,078	\$ 0.057	8.29

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NOTE 12 – STOCK-BASED COMPENSATION PLAN (Continued)

At December 31, 2013, 18,647,526 options were vested and expected to vest with a weighted-average exercise price of \$0.057 and weighted average remaining contractual life of 8.29 years. The weighted average grant date fair value per share of options granted was \$0.27 during 2013 and \$0.26 during 2012. The fair value of shares vested during 2013 and 2012 was \$63,977 and \$18,367. The intrinsic value of options exercised during 2013 was zero.

In connection with the grant of stock options to employees and non-employees, the Company recorded stock compensation expense to general and administrative expenses in the amounts of \$83,620, \$43,121 and \$392,024 for the years ended December 31, 2013 and 2012 and for the period from March 17, 2005 (date of inception) to December 31, 2013, respectively. As of December 31, 2013, unrecognized compensation expense related to employees totaled \$294,599 and will be recognized over approximately 3.08 years.

The fair value of each option granted to employees was estimated at the date of grant using the following assumptions:

	<u>For the Year Ended December 31, 2013</u>	<u>For the Year Ended December 31, 2012</u>
Expected term (years)	5.16 – 6.08 years	5.87 – 6.08 years
Volatility	45.21 – 46.56%	45.14 – 45.45%
Risk-free interest rate	0.91 – 1.67%	0.81 – 1.15%
Dividend yield	- %	- %

NOTE 13 – INCOME TAXES

The significant components of the net deferred tax asset are as follows at December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Gross deferred income tax assets		
Property and equipment (depreciation) and other	\$ 21,240	\$ 19,051
Net operating loss and R&D credit carryforwards	<u>12,051,395</u>	<u>9,540,329</u>
	12,072,635	9,559,380
Valuation allowance	<u>(12,072,635)</u>	<u>(9,559,380)</u>
Total	<u>\$ -</u>	<u>\$ -</u>

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NOTES TO FINANCIAL STATEMENTS
December 31, 2013 and 2012

NOTE 13 – INCOME TAXES (Continued)

A valuation allowance has been recorded for the entire amount of the Company's deferred tax assets as a result of uncertainties regarding the realization of the assets, including the Company's history of losses. The change in the valuation allowance totaled \$2,513,255 and \$2,711,642 during 2013 and 2012, principally due to increases in the allowance associated with increased net operating losses.

As of December 31, 2013, the Company had net operating loss carryforwards for federal and state income tax reporting purposes of approximately \$28,562,780 and \$28,507,152, in 2013 respectively. The net operating losses will begin to expire in 2025 for federal purposes and in 2015 for California purposes. U.S. tax laws limit the use of net operating loss carryforwards in certain situations where the ownership of a corporation changes during a prescribed time period. Any ownership changes which fall under these rules may significantly restrict the Company's ability to offset its loss carryforwards against future income. The Company also had Federal and California research and development tax credit carryforwards of approximately \$329,828 and \$347,000, respectively, as of December 31, 2013. The Federal net operating loss and tax credit carryforwards will expire at various dates beginning in 2025 through 2033. The California research and development tax credit carryforwards have no expiration date.

Utilization of the NOL and tax credit carryforwards may be subject to a substantial annual limitation due to ownership change limitations that may have occurred or that could occur in the future, as required by the Internal Revenue Code (the "Code"), as well as similar state provisions. In general, an "ownership change" as defined by the Code results from a transaction or series of transactions over a three-year period resulting in an ownership change of more than 50 percentage points of the outstanding stock of a company by certain stockholders or public groups.

Since the Company's formation, the Company has raised capital through the issuance of capital stock on several occasions which, combined with the purchasing stockholders' subsequent disposition of those shares, may have resulted in such an ownership change, or could result in an ownership change in the future upon subsequent disposition. The annual limitation may result in the expiration of NOL and tax credit carryforwards before utilization.

The Company has not completed a study to assess whether an ownership change has occurred or whether there have been multiple ownership changes since the Company's formation due to the complexity and cost associated with such a study, and the fact that there may be additional such ownership changes in the future. If the Company has experienced an ownership change at any time since its formation, utilization of the NOL or tax credit carryforwards to offset future taxable income and taxes, respectively, would be subject to an annual limitation under the Code, which is determined by first multiplying the value of the Company's stock at the time of the ownership change by the applicable long-term, tax-exempt rate, and then could be subject to additional adjustments, as required. Any limitation may result in expiration of all or a portion of the NOL or tax credit carryforwards before utilization.

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NOTE 13 – INCOME TAXES (Continued)

The Company maintains a full valuation allowance for other deferred tax assets due to its historical losses and uncertainties surrounding its ability to generate future taxable income to realize these assets. Due to the existence of the valuation allowance, future changes in the Company's unrecognized tax benefits and recognizable deferred tax benefits after the completion of an ownership change analysis is not expected to impact its effective tax rate.

The Company does not expect that the total amounts of unrecognized tax benefits will increase or decrease within twelve months of the reporting date. In accordance with ASC 740, the Company will recognize interest and penalties accrued on any material unrecognized tax benefits as a component of the provision for income taxes. As of December 31, 2013 and 2012, the Company has not accrued interest or penalties related to uncertain tax positions.

A number of the Company's tax returns remain subject to examination by taxing authorities: these include U.S. federal and state tax returns from 2005 forward.

NOTE 14 – RETIREMENT PLAN

The Company has a salary deferral plan under Section 401(k) of the Internal Revenue Code. The plan allows eligible employees to defer a portion of their compensation ranging from 1% to the maximum allowable dollar limit which is set by law. Such deferrals accumulate on a tax deferred basis until the employee withdraws the funds. The Company, at its option, may match a portion of the employees' contribution. At this time, the Company does not make any matching contributions.

NOTE 15 – MANAGEMENT INCENTIVE PLAN

On May 30, 2013, the Company adopted a management incentive plan that establishes a bonus pool with the objective of retaining its key employees and service providers through a potential Corporate Transaction, as defined in the plan. The plan provides for up to 7% of the total proceeds in a Corporate Transaction to be paid to key employees covered under the Plan.

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NOTE 16 – SUBSEQUENT EVENTS

In January 2014, the Company obtained a loan with a principal amount of \$7,000,000 from a financial institution and paid off its existing loan. The loan is to be disbursed in two equal installments with the first disbursement to the Company totaling \$3,500,000 which was received in January 2014 and the second \$3,500,000 installment of the loan to be drawn down under conditional requirements by the end of 2014. As of May 2014, the Company is on track to meet those conditional requirements.

The Company evaluated subsequent events through June 27, 2014, the date which the financial statements were available to be issued, and determined that there were no additional subsequent events that required disclosure.