TREATY OAK BANCORP INC
Form 10KSB
December 31, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-KSB

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended September 30, 2007

Commission File Number: 000-52911

Treaty Oak Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Texas (State or other jurisdiction of incorporation or organization)	**20-0413144** (I.R.S. Employer Identification Number)
101 Westlake Drive, Austin, Texas (Address of Principal Executive Offices)	**78746** (Zip Code)

(512) 617-3600
(Registrant s telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act: **None.**

Securities registered under Section 12(g) of the Exchange Act: **Common stock**

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x **No o**

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Yes o **No x**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o **No x**

The issuer s revenues for its most recent fiscal year were approximately $7,849,000.

The aggregate market value of the common stock held by non-affiliates, based upon the last reported sales price at which the common stock was sold as of December 1, 2007, was $24,589,880.

The number of shares outstanding of common stock, par value $0.01 per share, as of the close of business on December 1, 2007 was 2,975,734.

Selected portions of the registrant s definitive proxy statement for the 2008 annual meeting of shareholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (Check One): Yes o; No x

ANNUAL REPORT ON FORM 10-KSB

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007

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This Form 10-KSB contains forward-looking statements consisting of estimates with respect to the financial condition, results of operations and other business of Treaty Oak Bancorp, Inc., that are subject to various factors, which could cause actual results to differ materially from those estimates. Factors that could influence the estimates include changes in the national, regional and local market conditions, legislative and regulatory conditions, and an adverse interest rate environment.

Part I

Item 1. ***Description of Business***

Overview

Holding Company

Treaty Oak Bancorp, Inc. (the Company, we, us, or our hereafter) was incorporated under the laws of the State of Texas on November 18, 2003. Our primary business is to own and manage our wholly-owned banking subsidiary, Treaty Oak Bank, which is a Texas state-chartered banking association (the Bank). On November 15, 2006, we acquired Treaty Oak Holdings, Inc., one of our original organizing shareholders, by merging Treaty Oak Holdings, Inc. with and into us. As a result of the merger transaction, we now control all of the property where our offices and the headquarters of the Bank are located.

We chose a holding company structure because we believe this structure provides flexibility in accommodating our business objectives. For example, we may assist the Bank in maintaining its required capital ratios, or increasing its legal lending limits, by borrowing money and contributing the proceeds to the Bank as primary capital. Additionally, under provisions of the Gramm-Leach-Bliley Act, if we elect to be a financial holding company, we may engage in activities that are financial in nature or incidental or complementary to a financial activity, including merchant banking activities, in which the Bank would be prohibited from engaging. Although we do not presently intend to engage in these financial activities, we would be able to do so without notice to or a filing with the Federal Reserve if we believed that there is a need for these services in our market area, that we can be successful in these activities, and that these activities would be profitable.

On November 15, 2007, we announced plans to terminate the registration of our common stock under the Securities Exchange Act of 1934 and, therefore, terminate our obligations to file reports with the Securities and Exchange Commission. This going private transaction would be accomplished through an amendment (the Amendment) to our Articles of Incorporation, which would (i) authorize 2,500,000 shares of a new Series A Preferred Stock and (ii) effect a reclassification of all shares of our common stock held by record shareholders owning less than 2,500 shares of our common stock into shares of our Series A Preferred Stock on a one-for-one basis (the Reclassification). Those shareholders receiving shares of our Series A Preferred Stock in the Reclassification would have the option to sell those shares to us at any time during the 30 day period following the Reclassification at a cash price equal to $11.00 per share. The Amendment must be approved by holders of at least two-thirds of the outstanding shares of our common stock. If the Amendment is approved by the requisite vote of our shareholders and, after the Reclassification, we have fewer than 300 shareholders of record, we intend to terminate the registration of our common stock under the Securities Exchange Act of 1934 and become a non-reporting company. If that occurs, we will no longer file periodic reports with the Securities and Exchange Commission, including annual reports on Form 10-KSB and quarterly reports on Form 10-QSB, and we will no longer be subject to the SEC s proxy rules.

Bank

The primary focus of our Austin branch is on medium and small commercial businesses (including professionals such as doctors, dentists and lawyers) and real estate lending (including interim construction and commercial real estate loans), while our Texline branch has continued to focus primarily on agricultural lending. As of September 30, 2007, the Bank had total assets of approximately $110,554,000 and total deposits of approximately $99,730,000.

When we opened the Austin offices of the Bank, our goal was to return a high level of personal service and personal contact to our banking relationships. Our management has accomplished this by:

- demonstrating that banking can be built on interpersonal relationships and still be profitable, by capitalizing on our relationships in the community to build our loan and deposit base;

- creating a bank driven by client needs and expectations by training our staff and establishing policies and reward systems that are driven by client feedback;

- using technology to enhance the relationship between the Bank and its clients instead of replacing that relationship with technology solutions to banking, as well as maintaining a strong commitment to personal service and a personal banking relationship with our private bankers;

- empowering clients through education by providing both programs and printed information designed to increase our clients awareness both of banking opportunities and of general financial matters; and

- facilitating an open dialogue between clients and our staff by creating both a physical and emotional atmosphere conducive to communication between staff and clients.

We attempt to differentiate ourselves from other banks in our market area by delivering a high degree of personal service combined with a suite of products and capabilities comparable to that offered by much larger banks, all within a neighborhood community bank. We empower our employees with both the authority and the responsibility to ensure that each client s needs are addressed in a timely and satisfactory manner. We measure our success in the relationships we have developed with our clients by their referrals to us and by their feedback about their experiences with us and with our staff.

On June 28, 2005, the Bank acquired a 50% ownership interest in Treaty Oak Mortgage, LLC (Treaty Oak Mortgage), which offices in the same building as the Company and the Bank. Treaty Oak Mortgage is a mortgage broker focused primarily on a wide range of residential lending products that complement our own products and provide a greater degree of residential mortgage flexibility. We do not have a controlling financial interest in Treaty Oak Mortgage, and it is, therefore, not included in our consolidated results of operations.

On June 29, 2006, the Bank acquired a 50% ownership interest in Treaty Oak Commercial Group, LLC (TOCG). TOCG is a commercial real estate mortgage brokerage firm providing medium and long term mortgages on commercial real estate. TOCG works with life insurance and pension companies to fund these mortgages. TOCG offices in the same building as the Company and the Bank, and also maintains an office in Houston, Texas. Aside from its initial investment, the Company has no risk associated with operating expenditures or other liabilities of TOCG. The transaction was approved by the Texas Department of Banking on June 19, 2006.

We believe the operations of Treaty Oak Mortgage and TOCG are not significant when compared to the operations of the Bank.

Primary Clients and Markets

In the Austin area, the Bank concentrates on small and middle market businesses and individual clients with net worth in excess of $1,000,000. The Bank s Texline branch in the Texas panhandle continues to concentrate its efforts primarily in agricultural lending. We believe that the diverse nature of customers in the target markets provides a varied client base and allows the Bank to spread lending risk over different industries. We plan to open additional branches through internal growth and capital expansion, but do not compete on a retail basis with the large national banks that have branches located in and around Austin. Our branch in Marble Falls, Texas opened in July 2007 and we anticipate that our new branch in Barton Creek, in southwest Austin, will open in January 2008. In October 2007, we opened a small one-person office in a retirement community known as Querencia that is located near the Barton Creek branch.

Banking Operations

Our core services include traditional banking activities, such as personal and commercial deposit accounts and loans, as well as finance, consulting, and treasury services. Ancillary services include notary services, safe deposit boxes, cashiers checks and money orders, traveler s checks, wire transfers, and other services.

The Bank is an active business lender, with approximately 35% of its total loans as commercial loans, 52% as residential, commercial and construction real estate loans, and the balance in agricultural and personal lending. The Bank s primary targeted businesses are those requiring aggregate loans in the $100,000 to $10,000,000 range. The Bank offers business-oriented banking products and services, including the following:

- commercial loans for businesses to finance internal growth, acquisitions, and working capital needs;
- real estate and construction loans;
- cash management services, including on-line banking; and
- remote deposit opportunities and other business services.

The Bank also offers consumer-oriented banking services, which include consumer loans, checking accounts with debit cards and overdraft protection available, credit card services, traditional savings accounts and certificates of deposit, and 24-hour telephone and Internet banking.

Business Strategies

Our primary objective is to take advantage of expansion opportunities while maintaining efficiency and individualized client service, supplemented with technological advances and strategic branch expansion in key market areas, using the following strategies:

- Developing middle market commercial and private client banking.
- Developing mutual referral relationships with organizations offering complementary services.
- Increasing loan volume and diversifying loan portfolio.
- Expanding operations.

We continue to develop systems and train personnel to deliver the level of banking experience that is the cornerstone of our business. We market through a series of established relationships, including current clients, investors, friends, and business partners of our advisors and directors. By working with community and business leaders, we are developing a bank that is an integral part of the community. We endeavor to create professional relationships with individuals and businesses that complement our client base.

Part of our growth will come from the opening of new offices. Our branch in the Marble Falls/Horseshoe Bay area in the Texas Hill Country 45 miles northwest of Austin opened in July 2007, while our Barton Creek branch in West Austin is expected to open in January 2008. Given the number of banks and bank branches in the Austin, Texas market, the success of electronic banking services, courier services and other remote banking alternatives that we provide our clients, and our desire to maintain our levels of service, we carefully review both the location of proposed branches and the timing of their opening when planning for expansion.

Services

Deposit Services

The Bank offers a traditional mix of deposit accounts. Rates and terms are set by the Bank s senior management team with input and guidance from our Asset/Liability Committee (ALCO), and are continually updated based on market conditions. The team strives to create a stable, low-cost base of deposits through personalized offerings and high levels of client service.

The Bank also offers a variety of other types of accounts, including:

- goal-oriented savings accounts;
- accumulation certificates of deposit (CDs);

- standard CDs;
- children s savings accounts;
- medical savings accounts;
- IRA accounts; and
- educational accounts.

In order to maximize our ability to serve our clients in a cost-effective manner, we provide automated and electronic account management tools free of charge to all clients.

Lending Services

Our lending practices are structured to meet the credit needs of medium and small-sized businesses. These loans include lines of credit, term loans, home equity products, construction loans and commercial real estate loans for owner-occupants. Our loan portfolio relies on the commercial and consumer credit experience of the loan committee and primary servicing officers.

The Bank s credit standards include consideration of the following:

- historical and projected financial information;
- strength of management, including the experience and character of the principals;
- acceptable collateral and associated advance rates;

- market conditions; and

- trends in the borrower s industry.

As a state chartered bank, total loans and extensions of credit to a person or entity at one time may not exceed an amount equal to 25% of the lesser of the Bank s capital and certified surplus or the Bank s total equity capital according to Texas law.

The Bank is primarily a secured lender with 90% or more of all loans collateralized. Further, a maximum loan to value ratio of 80% is generally targeted for purchase money loans or loans based upon an acceptable appraisal.

We analyze prospective loans based on industry concentrations in the Bank s loan portfolio to prevent an unacceptable concentration of loans in any particular industry. The Bank strives to diversify its loan portfolio by spreading loans over multiple industries and reviewing concentration of loans to related industries. The Bank focuses on middle market commercial and high net worth individual clients. The Bank endeavors to ensure loans that are appropriately collateralized according to its credit standards. We strive to tailor credit policies and underwriting guidelines to address the unique risks of each industry in the portfolio. We seek a reasonable mix of industries and loan types with up to 40% of the Bank s portfolio over time comprised of commercial loans to businesses, and up to 55% of the portfolio concentrated in real estate loans, including interim construction loans secured by real estate owned by owner/operators.

Interest rates of the Bank s variable rate loans fluctuate with a predetermined indicator, such as the United States prime rate or the London Inter-Bank Offered Rate. Variable rates help to protect the Bank from risks associated with interest rate fluctuations since the rates of interest earned by the Bank automatically reflect those fluctuations. Our expectation is to retain a loan portfolio consisting of at least 90% variable rate loans.

Internet Services

Our service strategy is enhanced through the Internet. We believe the Bank s Internet client demographics parallel those of the general Internet population. Our website, TreatyOakBank.com, provides a complete line of deposit services. Customers are able to view multiple accounts, transfer funds between related accounts, view statements, send and receive messages, pay bills and other traditional online services.

Additionally, we offer remote deposit services via internet integrated devices that reside at our commercial clients offices, thereby reducing the need for customers to drive to a branch location for deposit services.

We have contracted with third party vendors to provide both basic computer systems and advanced security measures. All banking transactions are encrypted and routed behind the security system. Clients are able to access the Bank s services through any Internet service provider by means of a secure Web browser.

Mortgage Services

Treaty Oak Mortgage is a full service residential mortgage brokerage offering an array of residential mortgage products, while Treaty Oak Commercial Group is a commercial mortgage brokerage sourcing various long-term fixed rate commercial mortgage loans. Under the conditions to acquire granted by the TDB, Treaty Oak Mortgage and TOCG are managed on a day-to-day basis by its officers, but all decisions are ultimately under the control of the Bank to ensure that the mortgage operation does not inadvertently engage in a service or activity inconsistent with state banking regulations. Neither mortgage brokerage originates or holds loans for its own account.

Other Services

We provide other incentives and benefits to our customers, including the following:

- Rebates of ATM fees paid at most ATM machines throughout the United States;
- Correspondent relationships, which allow customers to use the correspondent s locations to make deposits;
- The ability to link multiple accounts of different but related Bank clients for the calculation of overall relationship profitability; and

- Extended banking hours.

Market Analysis

Competition

Competition within the banking business in our primary market area of Austin and Central Texas continues to increase. We compete with some of the largest banking organizations in the state and the country. In addition, we face competition from other financial institutions, such as federally and state-chartered savings and loan institutions, and other lenders engaged in the business of extending credit or taking investment monies, such as consumer finance companies and mutual funds. Our competitors also include well-capitalized local banks, branches of large regional or national banks, and state-regulated entities offering bank-like services and products. In addition, there are also quasi-banking institutions, such as credit unions and brokerage houses that may compete with us. These types of competitors have the ability to make loans, issue credit cards, cash checks, conduct wire transfers, and mimic most other banking functions.

Many of our larger competitors have broader geographic markets and higher lending limits than us and have greater access to capital and other resources. They are also able to provide more services and make greater use of media advertising. Although we will compete directly with these larger institutions from time to time, we will likely compete more directly with regional and mid-sized banks that have offices in our target markets. These community banks and others in surrounding areas have a direct competitive advantage as borrowers tend to shop the terms of their loans and deposits. In addition, the quasi-banking institutions and non-bank competitors do not fall under the tight regulatory environment applicable to banks. This lack of regulatory oversight gives these competitors advantages over us in providing some services and may enable them to offer more favorable financing alternatives.

Despite the competition in our target markets, we believe that we have certain competitive advantages that distinguish us from our competition. We believe the Bank competes effectively with other financial institutions by emphasizing client service, technology, and responsive decision-making, and by building long-term client relationships based on products and services designed to address clients specific needs. We offer customers modern banking services without forsaking community values such as prompt, personal service and friendliness. We offer personalized services and attract customers by being responsive and sensitive to their individualized needs. One of our principal competitive advantages is our local decision-making process as opposed to electronic, remote, or out-of-market decisions. We believe our approach to business builds goodwill among our customers, shareholders, and the communities we serve that will result in referrals from shareholders and satisfied customers.

Marketing

The majority of our new business opportunity is derived from referrals from our shareholders, existing customers, officers and directors, and others close to the Bank. In addition to the referral activity, we market in our primary markets through sponsorships and the active involvement and leadership of our employees in community and civic events. By using our limited marketing budget in this manner, we have developed an image as the community bank in our primary markets.

Employees

We have a total of 38 full time employees. Of those, 27 are employed at the Austin headquarters; five are employed in Texline, Texas, five in Marble Falls, Texas, and one at our Barton Creek branch in Austin, Texas.

Supervision and Regulation

The following is a summary description of the relevant laws, rules and regulations governing banks and bank holding companies. The descriptions of, and references to, the statutes and regulations below are brief summaries and do not purport to be complete. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

Banking is a complex, highly regulated industry. Consequently, our growth and earnings performance and those of the Bank can be affected not only by management decisions and general and local economic conditions, but also by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. These authorities include, but are not limited to, the Board of Governors of the Federal Reserve System (Federal System), the FDIC, the Texas Department of Banking, the Internal Revenue Service, and state taxing authorities. The effect of these statutes, regulations, and policies and any changes to any of them can be significant and cannot be predicted.

The primary goals of the bank regulatory system are to maintain a safe and sound banking system and to facilitate the conduct of sound monetary policy. In furtherance of these goals, Congress has created several largely autonomous regulatory agencies and enacted numerous laws that govern banks, bank holding companies, and the banking industry. The system of supervision and regulation applicable to us and our banking subsidiary establishes a comprehensive framework for their respective operations and is intended primarily for the protection of the FDIC s deposit insurance funds, the bank s depositors, and the public, rather than the shareholders and creditors. The following is an attempt to summarize some of the relevant laws, rules, and regulations governing banks and bank holding companies, but does not purport to be a complete summary of all applicable laws, rules, and regulations governing banks and bank holding companies. The descriptions are qualified in their entirety by reference to the specific statutes and regulations discussed.

Treaty Oak Bancorp, Inc.

We are a bank holding company registered with, and subject to regulation by, the Federal Reserve under the Bank Holding Company Act of 1956 (the Bank Holding Company Act). The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

In accordance with Federal Reserve policy, we are expected to act as a source of financial strength to the Bank and commit resources to support the Bank. This support may be required under circumstances when we might not be inclined to do so absent this Federal Reserve policy. As discussed below, we could be required to guarantee the capital plan of the Bank if it becomes undercapitalized for purposes of banking regulations.

Certain acquisitions. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve before (1) acquiring more than 5% of the voting stock of any bank or other bank holding company, (2) acquiring all or substantially all of the assets of any bank or bank holding company, or (3) merging or consolidating with any other bank holding company.

Additionally, the Bank Holding Company Act provides that the Federal Reserve may not approve any of these transactions if it would result in or tend to create a monopoly or substantially lessen competition or otherwise function as a restraint of trade, unless the anti-competitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the community to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the community to be served. The Federal Reserve s consideration of financial resources generally focuses on capital adequacy, which is discussed below. As a result of the USA PATRIOT Act, which is discussed below, the Federal Reserve is also required to consider the record of a bank holding company and its subsidiary bank(s) in combating money laundering activities in its evaluation of bank holding company merger or acquisition transactions. The Federal Reserve is also required to consider the record of a bank holding company in meeting the needs of its community under the Community Reinvestment Act, which is discussed below.

Under the Bank Holding Company Act, any bank holding company located in Texas, if adequately capitalized and adequately managed, may purchase a bank located outside of Texas, subject to certain restrictions. See further discussion on branch banking under -The Bank-Branch Banking below. Conversely, an adequately capitalized and adequately managed bank holding company located outside of Texas may purchase a bank located inside Texas. In each case, however, restrictions currently exist on the acquisition of a bank that has only been in existence for a limited amount of time or will result in specified concentrations of deposits.

Change in Bank control. Subject to various exceptions, the Bank Holding Company Act and the Change in Bank Control Act of 1978, together with related regulations, require Federal Reserve approval prior to any person or company acquiring control of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the bank holding company. With respect to our Company, control is presumed to exist if a person or company acquires 10% or more, but less than 25%, of any class of voting securities.

Permitted activities. Generally, bank holding companies are prohibited under the Bank Holding Company Act from engaging in or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in any activity other than (1) banking or managing or controlling banks or (2) an activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking.

Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

- factoring accounts receivable;
- making, acquiring, brokering, or servicing loans and usual related activities;
- leasing personal or real property;
- operating a non-bank depository institution, such as a savings association;
- trust company functions;
- financial and investment advisory activities;
- conducting discount securities brokerage activities;
- underwriting and dealing in government obligations and money market instruments;
- providing specified management consulting and counseling activities;
- performing selected data processing services and support services;
- acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and
- performing selected insurance underwriting activities.

Despite prior approval, the Federal Reserve has the authority to require a bank holding company to terminate an activity or terminate control of or liquidate or divest certain subsidiaries or affiliates when the Federal Reserve Board believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness, or stability of any of its banking subsidiaries. A bank holding company that qualifies and elects to become a financial holding company is permitted to engage in additional activities that are financial in nature or incidental or complementary to financial activity. The Bank Holding Company Act expressly lists the following activities as financial in nature:

- lending, exchanging, transferring, investing for others, or safeguarding money or securities;
- insuring, guaranteeing, or indemnifying against loss or harm, or providing and issuing annuities, and acting as principal, agent, or broker for these purposes, in any state;
- providing financial, investment, or advisory services;
- issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
- underwriting, dealing in, or making a market in securities;
- other activities that the Federal Reserve may determine to be so closely related to banking or managing or controlling banks as to be a proper incident to managing or controlling banks;
- foreign activities permitted outside of the United States if the Federal Reserve has determined them to be usual in connection with banking operations abroad;
- merchant banking through securities or insurance affiliates; and
- insurance company portfolio investments.

To qualify to become a financial holding company, the Bank and any other depository institution subsidiary that we may own at the time must be well capitalized and well managed and must have a Community Reinvestment Act rating of at least satisfactory. Additionally, we must file an election with the Federal Reserve to become a financial holding company and must provide the Federal Reserve with 30 days written notice prior to engaging in a permitted financial activity. A bank holding company that falls out of compliance with these requirements may be required to cease engaging in some of its activities. The Federal Reserve serves as the primary umbrella regulator of financial holding companies, with supervisory authority over each parent company and limited authority over its subsidiaries. Expanded financial activities of financial holding companies generally will be regulated according to the type of such financial activity: banking activities by banking regulators, securities activities by securities regulators, and insurance activities by insurance regulators.

Sound Banking practice. Bank holding companies are not permitted to engage in unsound banking practices. For example, the Federal Reserve Board s Regulation Y requires a holding company to give the Federal Reserve prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases in the preceding year, is equal to 10% or more of the company s consolidated net worth. The Federal Reserve may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. As another example, a holding company could not impair its subsidiary bank s soundness by causing it to make funds available to non-banking subsidiaries or their customers if the Federal Reserve believed it not prudent to do so.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 expanded the Federal Reserve s authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations. The Financial Institutions Reform, Recovery and Enforcement Act increased the amount of civil money penalties which the Federal Reserve can assess for activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1,000,000 for each day the activity continues. The Financial Institutions Reform, Recovery and Enforcement Act also expanded the scope of individuals and entities against which such penalties may be assessed.

Anti-tying restrictions. Bank holding companies and affiliates are prohibited from tying the provision of services, such as extensions of credit, to other services offered by a holding company or its affiliates.

Dividends. Consistent with its policy that bank holding companies should serve as a source of financial strength for their subsidiary banks, the Federal Reserve has stated that, as a matter of prudent banking, a bank holding company generally should not maintain a rate of distributions to shareholders unless its available net income has been sufficient to fully fund the distributions, and the prospective rate of earnings retention appears consistent with the bank holding company s capital needs, asset quality, and overall financial condition. In addition, we are subject to certain restrictions on the making of distributions as a result of the requirement that the Bank maintain an adequate level of capital as described below. As a Texas corporation, we are restricted under the Texas Business Corporation Act from paying dividends under certain conditions. Under Texas law, we cannot pay dividends to shareholders if the dividends exceed our surplus or if after giving effect to the dividends, we would be insolvent.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (the SOX Act) represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. Among other requirements, the SOX Act, along with related SEC rules and regulations, established: (i) new requirements for audit committees of public companies, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the chief executive officers and chief financial officers of reporting companies; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for reporting companies regarding various matters relating to corporate governance; (v) new and increased civil and criminal penalties for violation of the securities laws; and (vi) the issuance of management s assessments and auditors reports on reporting companies internal controls.

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The Bank

The Bank is subject to various requirements and restrictions under the laws of the United States and the State of Texas, and to regulation, supervision, and regular examination by the Texas Department of Banking and the Federal Deposit Insurance Corporation. The Texas Department of Banking and the Federal Deposit Insurance Corporation have the power to enforce compliance with applicable banking statutes and regulations. These requirements and restrictions include requirements to maintain reserves, restrictions on the nature and amount of loans that may be made and the interest that may be charged thereon, and restrictions relating to investments and other activities of the Bank.

Regulation of lending activities. Loans made by the Bank are subject to numerous federal and state laws and regulations, including the Truth-In-Lending Act, the Texas Finance Code, the Texas Consumer Credit Code, the Texas Consumer Protection Code, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and adjustable rate mortgage disclosure requirements. Remedies to the borrower or consumer and penalties to the Bank are provided if the Bank fails to comply with these laws and regulations. The scope and requirements of these laws and regulations have expanded significantly in recent years.

Dividends. All dividends paid by the Bank are paid to us, as the sole shareholder of the Bank. The general dividend policy of the Bank is to pay dividends at levels consistent with maintaining its liquidity and preserving applicable capital ratios and servicing obligations. The dividend policy of the Bank is subject to the discretion of the Board of Directors of the Bank and will depend upon such factors as future earnings, financial conditions, cash needs, capital adequacy, compliance with applicable statutory and regulatory requirements, and general business conditions.

The ability of the Bank, as a Texas banking association, to pay dividends is restricted under applicable law and regulations. Except in certain circumstances, the Bank generally may not pay a dividend reducing its capital and surplus without the prior approval of the Texas Banking Commissioner. All dividends must be paid out of net profits then on hand, after deducting expenses, including losses and provisions for loan losses. The Federal Deposit Insurance Corporation has the right to prohibit the payment of dividends by the Bank where the payment is deemed to be an unsafe and unsound banking practice. The Bank is also subject to certain restrictions on the payment of dividends as a result of the requirements that it maintain an adequate level of capital in accordance with guidelines promulgated from time to time by the Federal Deposit Insurance Corporation.

The exact amount of future dividends on the stock of the Bank will be a function of the profitability of the Bank in general, applicable tax rates in effect from year to year, and the discretion of the Board of Directors of the Bank. The Bank s ability to pay dividends in the future will directly depend on the Bank s future profitability, which cannot be accurately estimated or assured.

Capital adequacy. Federal banking regulators have adopted capital adequacy regulations to which all national and state banks, such as the Bank, are subject. At September 30, 2007, Treaty Oak Bank was well-capitalized (as defined below) and had a total risk-based capital ratio of 10.61%, a Tier I risk-based capital ratio of 9.76%, and a leverage capital ratio of 8.78%.

Prompt Corrective Action. Banks are subject to restrictions on their activities depending on their level of capital. The Federal Deposit Insurance Corporation s prompt corrective action regulations divide banks into five different categories, depending on their level of capital. Under these regulations, a bank is deemed to be well capitalized if it has a total risk-based capital ratio of 10% or more, a core capital ratio of 6% or more, and a leverage ratio of 5% or more, and if the bank is not subject to an order or capital directive to meet and maintain a certain capital level. Under these regulations, a bank is deemed to be adequately capitalized if it has a total risk-based capital ratio of 8% or more, a core capital ratio of 4% or more, and a leverage ratio of 4% or more (unless it receives the highest composite rating at its most recent examination and is not experiencing or anticipating significant growth, in which instance it must maintain a leverage ratio of 3% or more). Under these regulations, a bank is deemed to be undercapitalized if it has a total risk-based capital ratio of less than 8%, a core capital ratio of less than 4%, or a leverage ratio of less than 4%. Under these regulations, a bank is deemed to be significantly undercapitalized if it has a risk-based capital ratio of less than 6%, a core capital ratio of less than 3%, and a leverage ratio of less than 3%. Under such regulations, a bank is deemed to be critically undercapitalized if it has a leverage ratio of less than or equal to

2%. In addition, the Federal Deposit Insurance Corporation has the ability to downgrade a bank s classification (but not to critically undercapitalized) based on other considerations even if the bank meets the capital guidelines. Based on the foregoing classifications, the Bank was well-capitalized at September 30, 2007.

If a state nonmember bank, such as the Bank, is classified as undercapitalized, the bank is required to submit a capital restoration plan to the Federal Deposit Insurance Corporation. An undercapitalized bank is prohibited from increasing its assets, engaging in a new line of business, acquiring any interest in any company or insured depository institution, or opening or acquiring a new branch office, except under certain circumstances, including the acceptance by the Federal Deposit Insurance Corporation of a capital restoration plan for the bank.

If a state nonmember bank is classified as undercapitalized, the Federal Deposit Insurance Corporation may take certain actions to correct the capital position of the bank. If a bank is classified as significantly undercapitalized, the Federal Deposit Insurance Corporation would be required to take one or more prompt corrective actions. These actions would include, among other things, requiring sales of new securities to bolster capital, improvements in management, limits on interest rates paid, prohibitions on transactions with affiliates, termination of certain risky activities, and restrictions on compensation paid to executive officers. If a bank is classified as critically undercapitalized, the bank must be placed into conservatorship or receivership within 90 days, unless the Federal Deposit Insurance Corporation determines otherwise.

The capital classification of a bank affects the frequency of examinations of the bank and impacts the ability of the bank to engage in certain activities, and affects the deposit insurance premiums paid by the bank. The Federal Deposit Insurance Corporation is required to conduct a full-scope, on-site examination of every bank at least once every 18 months.

Banks also may be restricted in their ability to accept brokered deposits, depending on their capital classification. Well capitalized banks are permitted to accept brokered deposits, but all banks that are not well capitalized are not permitted to accept such deposits without prior written regulatory approval. The Federal Deposit Insurance Corporation may permit, on a case-by-case basis, banks that are adequately capitalized to accept brokered deposits if the Federal Deposit Insurance Corporation determines that acceptance of such deposits would not constitute an unsafe or unsound banking practice with respect to the bank.

Community Reinvestment Act. Under the Community Reinvestment Act, the Bank has a continuing and affirmative obligation consistent with safe and sound banking practices to help meet the needs of its entire community, including low- and moderate-income neighborhoods served by the Bank. The Community Reinvestment Act does not establish specific lending requirements or programs for financial institutions nor does it limit the Bank s discretion to develop the types of products and services that it believes are best suited to its particular community. On a periodic basis, the Federal Deposit Insurance Corporation is charged with preparing a written evaluation of the Bank s record of meeting the credit needs of the entire community and assigning a rating. The bank regulatory agencies will take that record into account in their evaluation of any application made by the Bank or the Company for, among other things, approval of the acquisition or establishment of a branch or other deposit facility, an office relocation, a merger or the acquisition of shares of capital stock of another financial institution. An unsatisfactory Community Reinvestment Act rating may be used as the basis to deny an application. In addition, as discussed above, a bank holding company may not become a financial holding company unless each of its subsidiary banks has a Community Reinvestment Act rating of at least satisfactory . Treaty Oak Bank was last examined for compliance with the Community Reinvestment Act on May 3, 2005, and received a rating of satisfactory.

Deposit Insurance. The Bank s deposits are insured up to $100,000 per depositor per insured bank by the Bank Insurance Fund and certain retirement accounts are insured up to $250,000 per depositor per insured bank. As insurer, the Federal Deposit Insurance Corporation imposes deposit premiums and is authorized to conduct examinations of and to require reporting by the Bank. The Federal Deposit Insurance Corporation assesses insurance premiums on a bank s deposits at a variable rate depending on the probability that the deposit insurance fund will incur a loss with respect to the bank. The Federal Deposit Insurance Corporation determines the deposit insurance assessment rates on the basis of the Bank s capital classification and supervisory evaluations. The Bank s deposits insurance assessments may increase or decrease depending upon the risk assessment classification to which the Bank is assigned by the Federal Deposit Insurance Corporation. Any increase in insurance assessments could have an adverse effect on the Bank s earnings.

USA PATRIOT Act. On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 in response to the terrorist events of September 11, 2001. Also known as the USA PATRIOT Act, the law enhances the powers of the federal government and law enforcement organizations to combat terrorism, organized crime, and money laundering. The USA PATRIOT Act significantly amends and expands the application of the Bank Secrecy Act, including enhanced measures regarding customer identity, new suspicious activity reporting rules, and enhanced anti-money laundering programs. Under the Act, each financial institution is required to establish and maintain anti-money laundering compliance and due diligence programs, which include, at a minimum, the development of internal policies, procedures, and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. In addition, the Act requires the bank regulatory agencies to consider the record of a bank or bank holding company in combating money laundering activities in their evaluation of bank and bank holding company merger or acquisition transactions. On April 24, 2002, the Treasury Department issued regulations under the USA PATRIOT Act.

The Bank amended its Bank Secrecy Act Policy to include the provisions of the USA PATRIOT Act, including specific steps employed to properly identify individual customers and an enhanced due diligence program to identify suspicious activity of individual customers. Separate files are maintained to segregate identification records from other banking information. In addition, the Bank uses ancillary products to its core processing system that permit the identity of new customers to be immediately verified at account opening, as well as compare the new customer s information against lists of known terrorist or money laundering individuals and organizations. The policy also includes procedures to be followed should a match occur in comparing customers with lists of known terrorist organizations or individuals. The funding of transactions is prohibited unless certain procedures for identification have been fulfilled. The policy also includes provisions for training and periodic audit.

Transactions with affiliates. Transactions between the Bank and any of its affiliates (including Treaty Oak Bancorp) are governed by Sections 23A and 23B of the Federal Reserve Act. An affiliate of a bank is any company or entity that controls, is controlled by, or is under common control with the bank. A subsidiary of a bank that is not also a depository institution is not treated as an affiliate of a bank for purposes of Sections 23A and 23B unless it engages in activities not permissible for a national bank to engage in directly. Generally, Sections 23A and 23B (1) limit the extent to which a bank or its subsidiaries may engage in covered transactions with any one affiliate to an amount equal to 10% of such institution s capital stock and surplus, and limit such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus, and (2) require that all such transactions be on terms that are consistent with safe and sound banking practices. The term covered transaction includes the making of loans to an affiliate, the purchase of or investment in securities issued by an affiliate, the purchase of assets from an affiliate, the issuance of a guarantee for the benefit of an affiliate, and similar transactions. Most loans by a bank to any of its affiliates must be secured by collateral in amounts ranging from 100 to 130 percent of the loan amount, depending on the nature of the collateral. In addition, any covered transaction by a bank with an affiliate and any sale of assets or provision of services to an affiliate must be on terms that are substantially the same, or at least as favorable, to the bank as those prevailing at the time for comparable transactions with nonaffiliated companies. The Bank is also restricted in the loans that it may make to its executive officers and directors, the executive officers and directors of the Company, any owner of 10% or more of its stock or the stock of the Company, and certain entities affiliated with any such person.

On October 31, 2002, the Federal Reserve issued a new regulation, Regulation W, effective April 1, 2003, that comprehensively implements sections 23A and 23B of the Federal Reserve Act, which are intended to protect insured depository institutions from suffering losses arising from transactions with affiliates. The regulation unifies and updates staff interpretations issued over the years, incorporates several new interpretative proposals (such as to clarify when transactions with an unrelated third party will be attributed to an affiliate), and addresses new issues arising as a result of the expanded scope of non-banking activities engaged in by bank and bank holding companies in recent years and authorized for financial holding companies under the Gramm-Leach-Bliley Act.

Branch Banking. Pursuant to the Texas Finance Code, all banks located in Texas are authorized to branch statewide. Accordingly, a bank located anywhere in Texas has the ability, subject to regulatory approval, to establish branch facilities near any of our facilities and within our market area. If other banks were to establish branch facilities near our facilities, it is uncertain whether these branch facilities would have a material adverse effect on the business of the Bank.

In 1994 Congress adopted the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. That statute provides for nationwide interstate banking and branching, subject to certain aging and deposit concentration limits that may be imposed under applicable state laws. Texas law permits interstate branching in two manners, with certain exceptions. First, a financial institution with its main office outside of Texas may establish a branch in the State of Texas by acquiring a financial institution located in Texas that is at least five years old, so long as the resulting institution and its affiliates would not hold more than 20% of the total deposits in the state after the acquisition. In addition, a financial institution with its main office outside of Texas generally may establish a branch in the State of Texas on a *de novo* basis if the financial institution s main office is located in a state that would permit Texas institutions to establish a branch on a *de novo* basis in that state.

The Federal Deposit Insurance Corporation has adopted regulations under the Riegle-Neal Act to prohibit an out-of-state bank from using the interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to insure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to meet the credit needs of the communities served by the out-of-state bank.

Enforcement authority. The federal banking laws also contain civil and criminal penalties available for use by the appropriate regulatory agency against a bank or certain institution-affiliated parties primarily including management, employees, and agents of a financial institution, as well as independent contractors such as attorneys, accountants, and others who participate in the conduct of the financial institution s affairs and who caused or are likely to cause more than minimum financial loss to or a significant adverse affect on the institution, who knowingly or recklessly violate a law or regulation, breach a fiduciary duty, or engage in unsafe or unsound practices. These practices can include the failure of an institution to timely file required reports or the submission of inaccurate reports. These laws authorize the appropriate banking agency to issue cease and desist orders that may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnification, or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, or take other action as determined by the ordering agency to be appropriate.

Governmental monetary policies. The commercial banking business is affected not only by general economic conditions but also by the monetary policies of the Federal Reserve. Changes in the discount rate on member bank borrowings, control of borrowings, open market operations, the imposition of and changes in reserve requirements against member banks, deposits and assets of foreign branches, the imposition of and changes in reserve requirements against certain borrowings by banks and their affiliates, and the placing of limits on interest rates which member Banks may pay on time and savings deposits are some of the instruments of monetary policy available to the Federal Reserve. Those monetary policies influence to a significant extent the overall growth of all bank loans, investments and deposits and the interest rates charged on loans or paid on time and savings deposits. The nature of future monetary policies and the effect of such policies on the future business and earnings of the Company, therefore, cannot be predicted accurately.

All of the above laws and regulations add to the cost of our operations and thus have a negative impact on profitability. You should note that there has been a tremendous expansion experienced in recent years by financial service providers that are not subject to the same rules and regulations as are applicable to the Company and the Bank. These institutions, because they are not so highly regulated, have a competitive advantage over us and may continue to draw large amounts of funds away from traditional banking institutions, with a continuing adverse effect on the banking industry in general.

Risk Factors

If any of the following risks actually occurs, our business, financial condition, or operating results could be materially adversely affected.

We face intense competition from a variety of competitors.

The banking business in our markets and the surrounding areas has become increasingly competitive over the past several years, and the level of competition continues to increase. In our primary operating area of West Lake Hills, Texas, a suburb of Austin, Texas, there are 21 different banks operating from 16 different locations. The profitability of the Bank (and thus our profitability) depends in large part on the Bank s ability to compete effectively in our banking markets.

Many non-bank competitors are not subject to the same degree of regulation as we are, have advantages over us in providing some services, and may be able to offer more favorable financing alternatives than the Bank. Many competitors are larger than we are and have greater access to capital and other resources. The Bank also competes with companies located outside of our banking markets that provide financial services to persons within our banking markets.

If this competition forces us to offer aggressive loan and deposit rates, the Bank s net interest margin will be diminished. This may decrease net interest income and adversely affect our financial performance and results of operations. Many of our competitors have established customer bases and offer services, such as extensive and established branch networks and trust services.

Though we believe that our approach to providing services allows us to be a successful competitor in the area s financial services market, there is no assurance that we will be able to compete successfully with other financial service providers serving our banking markets. Our inability to compete effectively could have a material adverse effect on our growth and profitability.

We could be affected adversely by lending activities.

The Bank s loan portfolio and investments in marketable securities could subject us to a concentration of credit risk. Inherent risks in lending include the inability to compete with other lenders, lack of control over fluctuations in interest rates, and economic downturns. We use high credit standards to reduce the risk of uncollectible loans and variable interest loans to offset the risk of interest rate fluctuations, have developed attractive loan products, and take other measures to reduce inherent lending risks. During its initial years of operations, the Bank s legally mandated lending limits has been lower than those of many of our competitors because we have had less capital than many of our competitors. Our lower lending limits may discourage potential borrowers who have lending needs that exceed our limits, which may restrict our ability to establish relationships with larger businesses in our area. We plan to serve the needs of these borrowers by selling loan participations to other institutions where appropriate and acceptable to the clients. The Bank maintains reserves against loan losses and periodically reevaluates its credit standards, but its lending activities may have an adverse impact on our profitability.

Interest rate fluctuations may affect us negatively.

The Bank s operations could be affected adversely due to interest rate movement. The Bank s profitability (and, therefore, our profitability) depends, in part, on its net interest income, which is the difference between the income that the Bank earns on its interest-earning assets, such as loans, and the expenses that the Bank incurs in connection with its interest-bearing liabilities, such as checking or savings deposits or certificates of deposit.

Changes in the general level of interest rates and other economic factors can affect the Bank s net interest income by affecting the spread between interest-earning assets and interest-bearing liabilities. Interest rate risk arises in part from mismatches between the dollar amount of repricing or maturing assets and liabilities. More assets than liabilities repricing or maturing over a given time frame is considered asset-sensitive, and more liabilities than assets repricing or maturing over a given time frame is considered liability-sensitive. A liability-sensitive position will generally enhance earnings in a falling interest rate environment and reduce earnings in a rising interest rate environment, while an asset-sensitive position will generally enhance earnings in a rising interest rate environment and will reduce earnings in a falling interest rate environment.

Changes in the general level of interest rates also affect, among other things, the Bank s ability to make new loans, the value of interest-earning assets and the Bank s ability to realize gains from the sale of such assets, the average life of interest-earning assets, and the Bank s ability to obtain deposits in competition with other available investment alternatives. Interest rates are highly sensitive to many factors beyond the Bank s control, including government monetary policies and domestic and international conditions, both economic and political.

We believe that the Bank is no more or less interest rate sensitive than other commercial banks, generally. We will attempt to maintain a favorable match between maturities or repricing dates of our interest earning assets and interest bearing liabilities. However, we cannot assure you that the Bank will achieve positive net interest income.

An economic downturn, especially one affecting our primary service area, may have an adverse effect on our financial performance.

As a holding company for a community bank, our success depends on the general economic condition of the regions in which we operate, which we cannot forecast with certainty. Unlike many of our larger competitors, the majority of our borrowers and depositors are individuals and small-to medium-sized businesses located or doing business in our local banking markets. As a result, our operations and profitability may be more adversely affected by a local economic downturn than those of our larger, more geographically diverse competitors. Factors that adversely affect the economy in our local banking markets could reduce our deposit base and the demand for our products and services, which may decrease our earnings.

Our growth plans and strategies associated with strategic alliances may lead to inefficiencies.

We may enter into strategic alliances with third parties. Risks common to these alliances include:

- difficulty in assimilation of the operations, technology, and personnel of the combined companies;
- disruption of ongoing business;
- inability to retain key personnel;
- inability to integrate acquired businesses successfully;
- additional expenses associated with the impairment of goodwill and the amortization of purchased intangible assets;

- additional operating losses and expenses associated with the acquired businesses;
- maintenance of uniform standards, controls, and policies; and
- possible impairment of relationships with existing employees and customers.

In addition, increases in our client base produce increased demands on sales, marketing, administrative, and client service resources. Our inability to generate satisfactory revenues from expanded services and products to offset the cost of developing and implementing them could have a material adverse effect on our business, prospects, financial condition, and results of operations.

Monetary policy and other economic factors could affect our profitability adversely.

The following factors will affect the demand for loans and the ability of the Bank and other banks to attract deposits:

- changes in governmental economic and monetary policies;
- the Internal Revenue Code and banking and credit regulations;
- national, state, and local economic growth rates;
- employment rates; and
- population trends.

The success of the Bank depends in significant part upon its ability to maintain a sufficiently large interest margin between the rates of interest it receives on loans and other investments and the rates it pays out on deposits and other liabilities. The monetary and economic factors listed above, and the need to pay rates sufficient to attract deposits, may adversely affect the ability of the Bank to maintain an interest margin sufficient to result in operating profits. Please refer to Part I, Item 1 Supervision and Regulation above for additional information.

We are subject to extensive regulatory oversight, which could restrain our growth and profitability.

Federal and state regulation of the banking industry, along with tax and accounting laws, regulations, rules, and standards, may limit our operations significantly and control the methods by which we conduct business, as they do those of other banking organizations. Many of these regulations are intended to protect depositors, the public, or the FDIC insurance funds, not shareholders. Regulatory requirements affect our lending practices, capital structure, investment practices, dividend policy and many other aspects of our business. These requirements may constrain our operations, and the adoption of new laws and changes to or repeal of existing laws may have a further impact on our business, results of operations, and financial condition. Also, the burden imposed by those federal and state regulations may place banks in general, and Treaty Oak Bank in particular, at a competitive disadvantage compared to less regulated competitors. Any failure to comply with these laws, regulations, rules, and standards could lead to termination or suspension of licenses, rights of rescission for borrowers, class action lawsuits, and administrative enforcement actions, any of which could have a material adverse impact on the our financial condition and results of operations. Please refer to Part I, Item 1 Supervision and Regulation above for additional information concerning the regulation of the banking industry applicable to our business.

We are also subject to requirements with respect to the confidentiality of information obtained from clients concerning their identity, business and personal financial information, employment, and other matters. The Bank s personnel are required to keep all such information confidential. Failure to comply with confidentiality requirements could result in material liability to us and adversely affect our business.

We may be required to provide capital resources support to the Bank.

The Board of Governors of the Federal Reserve System requires a bank holding company to act as a source of financial and managerial strength to its subsidiary bank. The Federal Reserve Board may require a bank holding company to make capital injections into a troubled subsidiary bank and may charge the bank holding company with engaging in unsafe and unsound practices for failure to do so. We used a portion of the proceeds of our initial public offering to, among other things, make capital injections into the Bank and fund business operations in Austin. We may be required in the future to make further capital injections into the Bank under this policy.

Departures of our key personnel or directors may impair our operations.

Our performance depends on the services and performance of senior management and other key personnel, and our ability to attract and retain highly qualified senior management experienced in banking and financial services will influence our success. Competition for employees is intense, and the process of locating key personnel with the combination of skills and attributes required to execute our business plan may be lengthy.

In particular, we believe Jeffrey L. Nash, Coralie S. Pledger, and Charles T. Meeks are important to our success. Jeff Nash has been instrumental in our organization and is our chief executive officer. Coralie Pledger is our chief financial officer and is responsible for all accounting and financial performance measurement tracking activities. Charles Meeks has over 40 years of banking experience and serves as our and the Bank s chairman of the board of directors. If any of these individuals leaves his or her respective position, our financial condition and results of operations may suffer.

Additionally, if the services of any of our other key personnel should become unavailable for any reason, we would be required to employ other persons to help manage and operate our business, and we cannot assure you that we would be able to employ qualified persons on terms acceptable to us. Additionally, our directors and senior management s community involvement, diverse backgrounds, and extensive local business relationships are important to our success. If the composition of our management team changes materially, our business may suffer.

Goodwill from the Texline State Bank acquisition.

We accounted for our acquisition of Texline State Bank as a purchase transaction in accordance with GAAP. Under this accounting treatment, and in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations, the purchase price was assigned to the fair value of the net tangible and intangible assets acquired, and the amount in excess thereof ($1,161,000) was assigned to goodwill. In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, qualifying intangibles, such as core deposit intangibles, are to be amortized by charges to future earnings over their expected useful lives. Amortization of core deposit intangibles is non-deductible for tax purposes. The remaining goodwill was capitalized and will be evaluated for impairment (diminished value) on an annual basis or if circumstances arise in which it is more likely than not that the fair market value of the related reporting unit has been reduced. If such goodwill were to be deemed impaired, that impairment would be measured, and any such amount would be charged against current earnings.

Our ability to pay dividends is limited.

Our ability to pay dividends to our shareholders depends in large part on the Bank s ability to pay dividends to us. The board of directors of the Bank intends to retain earnings to promote growth, build capital, and recover any losses incurred in prior periods. Accordingly, we do not expect to receive dividends from the Bank in the foreseeable future. In addition, banks and bank holding companies are both subject to certain regulatory restrictions on the payment of cash dividends. Please refer to Part I, Item 1 Supervision and Regulation above for additional information.

Provisions in our charter documents limit your ability to approve or deny matters affecting our operations and could delay or prevent a change in corporate control.

Under our charter documents, our Board of Directors and officers have broad powers to make most of the decisions affecting our operation without further shareholder approval. Those powers include the authority to issue preferred stock in one or more series, to fix the rights, designations, preferences, privileges, qualifications, and restrictions of the preferred stock, and, to the extent hereafter permitted by law, to amend our articles of incorporation to fix the voting rights of any unissued or treasury shares of any class of preferred stock. Additionally, our Board of Directors, without shareholder approval, may issue shares of preferred stock with conversion, voting, and other rights that could affect the rights of our common shareholders adversely. These provisions have the effect of limiting your ability as a shareholder to approve or deny matters affecting our operations.

In addition, certain provisions of our amended and restated articles of incorporation and bylaws may be deemed to have anti-takeover effects and may delay, prevent, or make more difficult unsolicited tender offers or takeover attempts that a shareholder may consider to be in his or her best interest, including those attempts that might result in a premium over the market price for the shares held by shareholders. These provisions may also have the effect of making it more difficult for third parties to cause the replacement of current management. These provisions include the classification of our Board of Directors and certain provisions regarding shareholders ability to bring matters before a meeting of shareholders and to attempt to obtain control of our company.

There is limited trading in our common stock.

Our shares of common stock are traded on the Over-the Counter Bulletin Board. In the event you want to dispose of your common stock, you may not be able to find a buyer willing to pay the price that you paid per share or within an anticipated timeframe.

If we are not profitable, you may lose part or all of your investment.

Our profitability depends in large part on the Bank s profitability. We can give no assurance whether the Bank will continue to operate profitably. If the Bank is ultimately unsuccessful, you may lose part or all of your investment in our common stock. Your investment is not insured by the FDIC.

We may not be able to raise additional capital on terms favorable to us.

In the future, if we need additional capital to support our business, expand our operations, or maintain our minimum capital requirements, we may not be able to raise additional funds through the issuance of additional shares of common stock or other securities. Even if we are able to obtain capital through the issuance of additional shares of common stock or other securities, the sale of these additional shares could significantly dilute your ownership interest.

Your shares are not an insured deposit.

Your investment in our common stock is not a bank deposit and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Your investment is subject to investment risk.

Forward Looking Statements

This report contains various Forward-Looking Statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements about us and our subsidiaries are subject to risks and uncertainties. These statements include discussions of our business strategy, future financial performance, projected plans, and objectives. Information about markets for our products and services and trends in sales, as well as statements preceded by, followed by, or that otherwise include the words anticipates, believes, estimates, expects, intends, plans, may increase, may fluctuate, and similar expressions of future or conditiona as will, should, would, and could are generally forward-looking in nature and not historical facts. You are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this report. You should understand that the following important factors, in addition to those discussed elsewhere in this report and our other filings with the Securities and Exchange Commission, could affect our future results and could cause results to differ materially from those expected in the forward-looking statements:

- effects of economic conditions and interest rates on a local, state, or national basis;

- performance of the Bank;

- competitive pressures in the financial services industry;

- financial resources of, and products available to, competitors;

- changes in the interest rate environment;

- changes in laws and regulations to which Treaty Oak Bancorp, the Bank, our customers, competitors, and potential competitors are subject, including those related to banking, tax, securities, insurance, and labor; and

- the loss of senior management or operating personnel and the potential inability to hire qualified personnel at reasonable compensation levels.

The forward-looking statements involve risks and uncertainties in addition to the risk factors described above. We cannot foresee or identify all of these factors. Except for any ongoing obligations to disclose material information under federal or state securities laws, we do not undertake any obligations to update any forward-looking statement, or to disclose any facts, events, or circumstances after the date of this report that may affect the accuracy of any forward-looking statement.

Available Information

We file annual, quarterly, and current reports, proxy statements, and other documents with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (the Exchange Act). You may read and copy any materials that we file with the SEC at the SEC s public reference room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the public reference room by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains a website that contains these SEC filings. You can obtain these filings at the SEC s website at http://www.sec.gov.

We also make available free of charge on or through our website (http://www.treatyoakbank.com) our Annual Report on Form 10-KSB, Quarterly Reports on Form 10-QSB, Current Reports on Form 8-K, and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Item 2. ***Description of Property***

Our principal offices and the main location of the Bank are located at 101 Westlake Drive, Austin, Texas 78746 in a building of 15,851 square feet. Approximately 3,000 square feet of the building is leased to an unrelated association. The property is subject to a mortgage secured under a deed of trust with Prudential Mortgage Capital Company, LLC in the principal amount of $2.6 million.

The Bank s Texline branch, Texline State Bank, is located at 111 N. 2nd Street, Texline, Texas 79087. The Bank owns the 2,817 square foot building in which our Texline branch is located. The Bank leases its facilities in Marble Falls and at Barton Creek, which leases expire in November 2017 and January 2023, respectively.

We believe our properties are suitable for their purposes and adequate for our business as currently conducted.

Item 3. ***Legal Proceedings***

NONE.

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

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2007.

Part II

Item 5. ***Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities***

General

Our common stock is traded on the OTC Bulletin Board, under the symbol TOAK. The shares have been traded since October 1, 2004, though to date trading activity has been limited with the most recent transaction selling at $10.00 per share on December 17, 2007. The initial public offering of our stock that closed September 30, 2004, priced our common stock at that time at $8.33 per share. The following table sets forth, for the periods indicated, the high and low sales prices for the common stock since October 1, 2005:

	High	Low
2006		
First Quarter ended December 31, 2005	$ 8.50	$ 8.50
Second Quarter ended March 31, 2006	$ 8.50	$ 8.35
Third Quarter ended June 30, 2006	$ 8.70	$ 8.35
Fourth Quarter ended September 30, 2006	$ 9.00	$ 8.50
2007		
First Quarter ended December 31, 2006	$ 9.00	$ 8.00
Second Quarter ended March 31, 2007	$ 12.00	$ 8.50
Third Quarter ended June 30, 2007	$ 11.50	$ 10.00
Fourth Quarter ended September 30, 2007	$ 10.50	$ 10.00
2008		
First Quarter ending December 31, 2007 (1)	$ 10.50	$ 9.75

(1) Through December 17, 2007

The quotations reflect inter-dealer prices without retail markups, markdowns or commissions and do not necessarily represent actual transactions. The quotations were derived from the Electronic Quotation and Trading System for OTC Securities; the OTC Bulletin Board.

On December 17, 2007, the last reported sales price for the common stock on the OTC Bulletin Board was $10.00 per share. As of December 17, 2007, we had 593 holders of record of our common stock.

The Company s registrar and transfer agent is Continental Stock Transfer & Trust Company, 17 Battery Place, New York, New York 10004.

Dividends

We have never declared or paid any dividends on our capital stock. We expect to retain future earnings, if any, for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. Any determination to pay dividends in the future will be at the discretion of our Board of Directors and will depend upon regulatory requirements, and our results of operations, financial condition, and capital requirements, among other factors. We expect initially to have no material source of income other than dividends that we receive from the Bank. Therefore, our ability to pay dividends to our shareholders will depend on the Bank s ability to pay dividends to us. The Board of Directors of the Bank intends to retain earnings to promote growth and build capital and recover any losses incurred in prior periods. Accordingly, we do not expect to receive dividends from the Bank in the foreseeable future. In addition, banks and bank holding companies are both subject to certain regulatory restrictions on the payment of cash dividends, and the Bank is currently restricted from paying dividends for at least three years from the date of acquisition of Texline State Bank, which was completed on November 2003, as a condition of our regulatory approval.

Use of Proceeds from Sales of Registered Securities

On May 7, 2004, the Securities and Exchange Commission declared our Registration Statement on Form SB-2 (File No. 333-112325) related to our initial public offering effective. In addition, on October 22, 2004, we filed a Form SB-2MEF under Rule 462 registering additional shares of our common stock, of which 324,000 shares are issuable under registered common stock warrants. We accepted subscriptions for 1,582,987 shares of our common stock under the offering and have received net offering proceeds (after deducting offering expenses) of approximately $11.9 million.

From the offering proceeds, we paid our organizing shareholder and affiliate, Treaty Oak Holdings, for reimbursement of expenses and advances on our behalf in connection with our offering and repayment of the amount due under a convertible promissory note. Treaty Oak Holdings owned approximately 39% of our common stock, but was acquired by us in a transaction that closed on November 15, 2006. We contributed to the capital of the Bank and paid operating expenses including repayment of certain costs previously paid by Treaty Oak Holdings. We also repaid principal and interest under unsecured promissory notes issued in connection with the purchase price of the Bank, and have paid ongoing operating expenses. These payments are summarized in the table below:

		As of September 30, 2007
Gross proceeds from sale of shares	$	13,276,271
Amounts receivable as of December 31, 2004		
Repayment of offering and start-up costs under Expense Reimbursement Agreement to Treaty Oak Holdings, Inc., including offering costs of $500,000 and pre-opening expenses of $275,000		(775,000)
Repayment of note payable to Treaty Oak Holdings, Inc., including accrued interest of approximately $7,000		(507,302)
Repayment of notes payable for the acquisition of Texline State Bank including accrued interest of approximately $29,000		(1,015,332)
Contribution to the capital of the Bank		(7,500,000)
Payments to directors and officers (bonuses and directors fees)		(207,368)
Payments to officers (salary and benefits)		(348,108)
Other payments to affiliates for services		(149,057)
Limited partnership investment in affiliated limited partnership		(1,030,000)
Loan to affiliated company		(46,037)
Repurchase of shares issued		(50,005)
Payment of additional operating expenses (estimated)		(1,030,900)
Remaining net proceeds	$	617,162

Equity Compensation Plan

On January 19, 2004, the 2004 Stock Incentive Plan (the Plan) was adopted by our Board of Directors for the purpose of providing eligible persons in our service with the opportunity to acquire or increase their proprietary interest in us as an incentive for them to remain in such service. The Plan initially set aside 500,000 shares of our common stock. The number of shares of common stock available for issuance under the Plan automatically increases on the first business day of January each calendar year during the term of the Plan by an amount equal to two percent (2%) of the total number of shares of Common Stock outstanding on the last business day in December of the immediately preceding calendar year, but in no event shall any such annual increase exceed 100,000 shares. At September 30, 2007 there were a total of 433,300 options outstanding, 49,507 restricted stock shares issued and outstanding, 659,376 total shares issuable under the Plan and 176,569 shares available for issuance.

EQUITY COMPENSATION PLAN INFORMATION

The Plan, and all amendments thereto, had been approved by our shareholders. The following table sets forth certain information as of September 30, 2007 about our equity compensation plans:

Plan Category	(a) Number of shares of our common stock to be issued upon exercise of outstanding options, warrants and rights		(b) Weighted-average exercise price of outstanding options, warrants and rights	`	(c) Number of shares of our common stock remaining available for future issuance under equity compensation plans (exceeding securities reflected in column (a))
2004 Amended and Restated Stock Incentive Plan	482,807	$	8.74		176,569
Other equity compensation plans approved by our security holders	N/A		N/A		N/A

Equity compensation plans not approved by our security holders	N/A	N/A	N/A

Recent Sales of Unregistered Securities

Pursuant to the Agreement and Plan of Merger, dated as of October 3, 2006, between us and Treaty Oak Holdings, Inc., we issued 1,094,163 shares of our common stock in exchange for 1,110,082 shares of Treaty Oak Holdings, Inc. common stock, which represented all of the issued and outstanding shares of Treaty Oak Holdings, Inc. We also issued warrants to acquire a total of 450,000 shares of our common stock to existing warrantholders of Treaty Oak Holdings, Inc., which warrants have an exercise price equal to the greater of (i) $6.67 per share or (ii) the book value per share of common stock and which are exercisable until November 15, 2011. We issued the shares and warrants in a private transaction without registration in reliance upon an exemption from registration provided by Section 4(2) of the Securities Act. No broker was involved and no commissions were paid on the transaction.

Item 6. ***Management s Discussion and Analysis or Plan of Operation***

Introduction

We are a bank holding company headquartered in Austin, Texas. We own all of the outstanding shares of Treaty Oak Bank (the Bank), which was acquired on March 9, 2004. Treaty Oak Bancorp, Inc. acquired a Class D limited partnership interest in PGI Equity Partners, LP on December 30, 2004. For comparative purposes, for the year ended September 30, 2005, results of operations include activity for PGI Equity Partners, LP for the period beginning December 31, 2004 and ending September 30, 2005. The Bank acquired a 50% membership interest in Treaty Oak Mortgage, LLC on June 27, 2005, which is accounted for on the equity method of accounting. The Bank acquired a 50% interest in Treaty Oak Commercial Group, LLC (TOCG) on June 29, 2006 for a purchase price of $100,000, which is accounted for on the equity method of accounting. Aside from its initial investment, the Company has no risk associated with operating expenditures or other liabilities of TOCG.

Recent Developments

On November 13, 2007 our Board of Directors appointed Marvin Bendele as a Class I director of our Board of Directors. Mr. Bendele was appointed to fill the vacancy created after the passing of William T. Willis on September 29, 2007. Mr. Bendele was also appointed as a member of our Audit Committee.

Also on November 13, 2007, our Board of Directors approved a plan to deregister our common stock under the Securities Exchange Act of 1934 and, therefore, terminate our obligations to file reports with the Securities and Exchange Commission. This going private transaction would be accomplished through an amendment (the Amendment) to our Articles of Incorporation, which would (1) authorize 2,500,000 shares of a new Series A Preferred Stock and (2) effect a reclassification of all shares of our common stock held by record shareholders owning less than 2,500 shares of our common stock into shares of our Series A Preferred Stock on a one-for-one basis (the Reclassification). Shares of common stock held by record shareholders owning 2,500 or more shares will remain outstanding and will be unaffected by the Reclassification.

The Amendment and Reclassification are subject to approval by the holders of two-thirds (2/3) of the outstanding shares of our common stock. Shareholders will be asked to approve the Amendment and Reclassification at our 2008 annual shareholders meeting.

If the Amendment is approved by our shareholders and, after completion of the Reclassification, we have fewer than 300 shareholders of record of our common stock, we intend to terminate the registration of our common stock under the Securities Exchange Act of 1934 and become a non-reporting company. If that occurs, we will no longer file periodic reports with the Securities and Exchange Commission, including annual reports on Form 10-KSB and quarterly reports on Form 10-QSB.

Those shareholders receiving shares of our Series A Preferred Stock in the Reclassification will have the option to sell those shares to us at any time during the 30 day period following the Reclassification at a cash price equal to $11.00 per share (the Put Price).

Our Board of Directors received a fairness opinion from our financial advisor, Fowler Valuation Services, LC, that the Put Price to be paid following the Reclassification is fair, from a financial perspective, to all of our shareholders.

Plan of Operation

General

In Austin, given its greater growth potential, we are focusing the majority of our efforts on growing a community-oriented bank out of our headquarters in the 15,851 square foot facility that we occupy at 101 Westlake Drive (at Bee Cave Road), Austin, Texas 78746. Our locations serve two disparate markets. In Texline, Texas the majority of business is agricultural and agriculturally related. The primary focus of our operations is in Central Texas, including our new branches in Marble Falls and the Barton Creek community, however, we continue to service the Texline community and anticipate that activity in Texline will remain relatively constant. We have a total of 38 full time employees. Of those, 27 are employed at the Austin headquarters; five are employed in Texline, Texas, five in Marble Falls, Texas, and one in Barton Creek, Texas.

Where required in the preparation of our financial statements in accordance with generally accepted accounting principles, estimates are made by management to present fairly our financial condition. The notes to our Consolidated Financial Statements, included herein, describe our significant accounting policies including the use of estimates by noting that the preparation of our financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect certain reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the period. Accordingly, actual results could differ from those estimates.

Estimates made in preparation of the financial statements included herein are the estimates of management including management of the Bank. We use estimates to record items such as prepaid expenses, accrued expenses, accrued taxes and similar items. Although we believe that the estimates used lead to the fair presentation, in all material respects, of the financial statements for the Company, accounting estimates could have a material effect on our financial results.

Our critical estimates are centered in three areas: the treatment of certain loans, the allowance for loan losses, and goodwill and other intangibles. Each of these estimates generally relates to the operations of the Bank.

Estimates as they relate to loans

When a loan is considered to be impaired, management has concluded that based upon current information and events, we will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Management s conclusions regarding the status of a loan are estimates. Management then chooses the method by which this loan will be accounted for from one of three methods: (1) The loan is accounted for at the net present value of expected future cash flows, discounted at the loan s effective interest rate, (2) the observable market price of the loan or (3) at the fair value of the collateral if the loan is collateral dependent. The impact of such method and the underlying estimate of classification varies, dependent upon which of these approaches is deemed to be appropriate for the loan. Each of these methods essentially revalues the underlying loan and the difference between the carrying value and the calculated loan value is included in the Allowance for Loan Losses. Depending upon the number of loans subject to revaluing and the amount charged-off, this could create a material additional charge to the Provision for Loan Loss expense. In each case, management uses its best efforts to evaluate problem loans and provide adequately for their collectibility based on all the facts available. However, the under or over valuing of loans could materially affect our performance and financial condition. The actual results of collection efforts, regardless of the method selected, could vary significantly, thereby impacting reported earnings, reserves and asset values.

Estimates as they relate to the allowance for loan losses

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. The allowance is an amount that management, in its best estimate, believes will be adequate to absorb estimated losses inherent in the loan portfolio. There are generally two components utilized to determine the allowance for loan losses. The first is a specific allocation determined in the evaluation of criticized loans identified by management and deemed to be impaired or troubled. The second component is a general allocation based upon the perceived risk associated with the individual loan, changes in economic conditions, collateral valuations, or other factors that could impact a borrower s ability to repay, or the underlying value of collateral securing loans, might result in actual losses that could be greater or less than the allowance for losses established by management, in turn resulting in additional charges against earnings or a recovery that would positively impact earnings.

Failure of management to adequately reserve against future losses could materially affect the Bank s financial condition and performance and, therefore, our financial condition and performance. Likewise, an excessive reserve could also materially affect our performance and condition.

Estimates as they relate to goodwill

In addition to the two critical estimates discussed above, we also used estimates in evaluating certain intangible assets including goodwill. Management periodically reviews goodwill (and other similar intangibles) to determine whether a decline in value exists which requires a charge to earnings and a reduction to the net goodwill reflected on the statement of financial condition. Under SFAS 142, goodwill is tested for impairment at least annually and more frequently if circumstances indicate that the asset could be impaired. To test for impairment, the fair value of the asset is compared to its carrying amount and if the fair value is less than its carrying value, we will recognize an impairment loss. If the fair value exceeds the carrying amount, no increase in the carrying amount is recorded. In addition, if following the recognition of impairment loss, the fair value increases back to or in excess of the carrying amount prior to the recognition of the loss, no reversal of the impairment is recorded.

A two-step impairment test is normally used to identify potential goodwill impairment. The first step compares the fair value of the acquired net assets with its carrying amount, including goodwill. If the fair value of the acquired net assets exceeds its carrying amount, goodwill is considered not impaired, thus the second step of the impairment test is unnecessary. The fair value of the acquired net assets refers to the amount at which the net assets as a whole could be bought or sold in a current transaction between willing parties.

We completed our annual impairment test in September 2007 and management has determined that no impairment to goodwill has occurred as of September 30, 2007.

Results of Operations

General

The following discussion analyzes the results of our operations for the years ended September 30, 2007, and September 30, 2006. For the fiscal years ended September 30, 2007 and 2006, results of operations includes the accounts of the Company, the Bank and PGI Equity Partners, LP. For the fiscal year ended September 30, 2007, results of operations additionally include the accounts of wholly-owned subsidiaries PGI Capital, Inc. and Treaty Oak Financial Holdings, Inc., entities which were acquired by us in connection with our merger with Treaty Oak Holdings, Inc. on November 15, 2006.

Net Income General

Our fiscal year ends on September 30. Net income for the year ended September 30, 2007, was $265,000, compared to $195,000 for the fiscal year ended September 30, 2006. This improvement is due to earnings generated at the Austin and Texline branches as a result of growth experienced at the Austin branch net of start-up branch costs for the new Marble Falls branch which opened in July 2007.

Our profitability depends primarily on net interest income, which is defined as the difference between total interest earned on interest earning assets (investments and loans) and total interest paid on interest bearing liabilities (deposits, borrowed funds). Our net income is affected by our provision for loan losses, as well as other income and other expenses. The provision for loan losses reflects the amount considered to be adequate to cover probable credit losses in the loan portfolio. Non-interest income or other income consists of service charges on deposits, gain on sale of loans, and other operating income. Other expenses include salaries and employee benefits, occupancy expenses, data processing expenses, marketing, supplies, and other operating expenses.

Net interest income is affected by changes in the volume and mix of interest earning assets, the level of interest rates earned on those assets, the volume and mix of interest bearing liabilities, and the level of interest rates paid on those interest bearing liabilities. The provision for loan losses is dependent upon changes in the loan portfolio and management s assessment of the collectibility of the loan portfolio, as well as economic and market conditions. Other income and other expenses are impacted by growth of operations and growth in the number of accounts through both acquisitions and core banking business growth. Growth in operations affects other expenses as a result of additional employees, branch facilities, and promotional marketing expense. Growth in the number of accounts affects other income including service fees, as well as other expenses such as computer services, supplies, postage, telecommunications, and other miscellaneous expenses.

Net Interest Income

For the fiscal year ended September 30, 2007, our net interest income was $4,815,000 compared to $3,508,000 for the fiscal year ended September 30, 2006. Net interest income for the fiscal years ended September 30, 2007 and 2006 was impacted by the amortization of direct loan origination costs of approximately $56,000 and $55,000, respectively.

For the comparative years ended September 30, 2006, and September 30, 2007, the average rate on interest-bearing liabilities increased 112 basis points, from 3.42% to 4.54%, while the average rate on interest bearing assets increased 83 basis points from 7.69% to 8.52% during the same period. The decrease in the net interest spread of 29 basis points, from 4.27% for the fiscal year ended September 30, 2006 to 3.98% for the fiscal year ended September 30, 2007 and the decrease in net interest margin of 24 basis points from 5.73% for the fiscal year ended September 30, 2006, to 5.49% for the fiscal year ended September 30, 2007, is primarily a result of the increased competition for deposits to fund growing loan demand and the increase in interest-bearing deposit accounts relative to non-interest bearing deposit accounts. The average loan portfolio increased from $48,804,000 for the fiscal year ended September 30, 2006 to $73,165,000 for the fiscal year ended September 30, 2007, or an increase of 49.9%. For the same period, our average non-interest bearing demand deposits increased from $23,135,000 to $24,859,000, or an increase of 7.5%.

The following table presents, for the periods indicated, the total dollar amount of interest income from average interest earning assets, and the resultant yields, as well as the interest expense on average interest bearing liabilities, and the resultant costs, expressed both in dollars and rates. The averages are computed using the daily averages for each item noted. Yields are reflected on an annualized basis.

	Fiscal Year September 30, 2007			Fiscal Year September 30, 2006			Fiscal Year September 30, 2005		
	Average Balance	Interest (2)	Yield/ Rate	Average Balance	Interest (2)	Yield/ Rate	Average Balance	Interest (2)	Yield/ Rate
Interest Earning Assets:									
Loans (1)	$ 73,165,000	6,757,000	9.24%	48,804,000	4,184,000	8.57%	18,281,000	1,700,000	9.30%
Taxable investment securities	1,511,000	67,000	4.43%	3,045,000	93,000	3.05%	3,797,000	131,000	3.45%
Federal funds sold	12,642,000	647,000	5.12%	7,186,000	340,000	4.73%	7,997,000	160,000	2.00%
Interest bearing deposits with other Banks	5,000		0.00%	1,898,000	86,000	4.53%	2,659,000	63,000	2.37%
Federal Home Loan Bank Stock	326,000		0.00%	323,000	7,000	2.17%	212,000	7,000	3.30%
Total interest earning assets	87,649,000								

The condensed consolidated balance sheet as of June 30, 2013 included certain errors in connection with our consolidation of NeoMedia Europe GmbH. As a result of the errors, accounts payable and accrued expenses were understated by $163,000 and $38,000, respectively, as of June 30, 2013. Additionally, the accumulated other comprehensive income (loss) reported within shareholders' deficit reflected income of $99,000 but should have reflected a loss of $102,000. The condensed consolidated statements of comprehensive income (loss) for the three and six months ended June 30, 2013 reflected other comprehensive losses of $223,000 and $334,000, respectively, but should have reflected other comprehensive gains of $22,000 and $133,000, respectively. The revised comprehensive losses for the three and six months ended June 30, 2013 were $30,350,000 and $21,202,000, respectively. The revised comprehensive loss for the six months ended June 30, 2013 includes the impact of the correction to the general and administrative expenses noted in the above paragraph.

The condensed consolidated statements of cash flows for the three months ended March 31, 2013 overstated net cash used in operating activities and effect of exchange rate changes on cash by approximately $113,000. The revised net cash used in operating activities was approximately $547,000 and the effect of exchange rate changes on cash was negative $2,000. The condensed consolidated statements of cash flows for the six months ended June 30, 2013 overstated net cash used in operating activities and effect of exchange rate changes on cash by approximately $334,000. The revised net cash used in operating activities was approximately $541,000 and the effect of exchange rate changes on cash was $0.

Basic and Diluted Net Income (Loss) Per Common Share The components of basic and diluted income (loss) per share attributable to NeoMedia Technologies, Inc. common stock shareholders were as follows (in thousands, except share and per share data):

	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Numerator:				
Net income (loss) available to common shareholders	$ (26,245)	$ 19,470	$ (48,276)	$ (21,945)
Effect of dilutive securities				
Change in fair value of derivative liability Series C and D preferred stock and debentures	-	1,036	-	-
Change in fair value of derivative liability - warrants	-	4,897	-	-
Change in fair value of hybrid financial instruments	-	6,353	-	-
Interest expense on convertible debt	-	(10)	-	-
Numerator for diluted income (loss) per common share	$ (26,245)	$ 31,746	$ (48,276)	$ (21,945)
Denominator				
Weighted average shares used to compute basic income (loss) per common share	4,984,827,279	1,510,797,881	3,823,483,604	1,075,605,167
Effect of dilutive securities:				
Derivative warrants	-	1,091,953,786	-	-
Convertible debentures	-	5,129,818,595	-	-
Convertible preferred stock	-	742,807,130	-	-
Denominator for diluted Income (loss) per common share	4,984,827,279	8,475,377,392	3,823,483,604	1,075,605,167
Basic income (loss) per common share	$ (0.005)	$ 0.013	$ (0.013)	$ (0.020)
Diluted income (loss) per common share	$ (0.005)	$ 0.004	$ (0.013)	$ (0.020)

We excluded 513,342,555 dilutive securities from the calculation of diluted income (loss) per common share for the three months and nine months ended September 30, 2013 because inclusion of these securities would be antidilutive.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-02, *Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income*. The update improves the reporting of reclassifications out of accumulated other comprehensive income for certain transactions and is applied prospectively for periods beginning January 1, 2013. We do not anticipate that the accounting pronouncement will have a material impact on our consolidated financial statements in future periods.

In March 2013, the FASB issued ASU No. 2013-05, *Liabilities (Topic 830): Parent's Accounting for Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity.* The ASU is effective beginning after December 15, 2013 and requires the release of any cumulative translation adjustment into net income upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in foreign entity. We do not anticipate that the accounting pronouncement will have a material impact on our consolidated financial statements in future periods.

In July 2013, the FASB issued ASU No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.* The ASU is effective for periods beginning after December 15, 2013 and standardizes the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. We do not anticipate that the accounting pronouncement will have a material impact on our consolidated financial statements in future periods.

From time to time, various other new accounting pronouncements are issued that we adopt as of the specified effective date. We believe that the impact of any other recently issued standards that are not yet effective will not have a material impact on our results of operations and financial position.

Note 3 Accrued Liabilities

Accrued liabilities consist of the following as of September 30, 2013 and December 31, 2012:

	September 30, 2013 (in thousands)		December 31, 2012	
Accrued operating expenses	$	223	$	347
Accrued payroll related expenses		51		6
Accrued interest		-		19
Accrued legal fees		260		27
Total	$	534	$	399

Note 4 Financing

At September 30, 2013, financial instruments arising from our financing transactions with YA Global Investments, L.P. ("YA Global"), an accredited investor, included shares of our Series C preferred stock issued in February 2006, Series D preferred stock issued in January 2010, a series of six consolidated secured convertible debentures (the "Consolidated Debentures") issued July 1, 2013 and various warrants to purchase shares of our common stock. All of our assets are pledged to secure our obligations under the debt securities. At various times, YA Global has assigned or distributed portions of its holdings of these securities to other holders, including persons who are officers of YA Global and its related entities, as well as to other holders who are investors in YA Global's funds.

Secured Debentures We had originally entered into financing transactions with YA Global, which included a series of twenty-seven secured convertible debentures issued between August 2006 and July 2012. Effective July 1, 2013, the terms of the debentures held by YA Global were modified to consolidate the principal and interest amounts outstanding under all of the outstanding secured convertible debentures previously issued by us to YA Global, such that, upon the issuance of the Consolidated Debentures and cancellation of the prior debentures, the amount of outstanding debentures issued to YA Global decreased from twenty-seven to six debentures. The maturity dates of these secured convertible debentures were also extended from August 1, 2014 to August 1, 2015.

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The underlying agreements for each of the Consolidated Debentures are very similar in form. The Consolidated Debentures are convertible into our common stock, at the option of the holder, at the lower of a fixed conversion price per share or a percentage of the lowest volume-weighted average price ("VWAP") for a specified number of days prior to the conversion (the "look-back period"). The conversion is limited such that the holder cannot exceed 9.99% ownership of the outstanding common stock, unless the holder waives their right to such limitation. All of the debentures are secured according to the terms of a Security Pledge Agreement dated August 23, 2006, which was entered into in connection with the first convertible debenture issued to YA Global and which provides YA Global with a security interest in substantially all of our assets. The debentures are also secured by a Patent Security Agreement dated July 29, 2008. On August 13, 2010, our wholly owned subsidiary, NeoMedia Europe GmbH, became a guarantor of all outstanding financing transactions between us and YA Global, through pledges of their intellectual property and other movable assets. As security for our obligations to YA Global, all of our Pledged Property, Patent Collateral and other collateral is affirmed through the several successive Ratification Agreements executed in connection with each of the 2010, 2011 and 2012 financings. The 2013 modification and consolidation of the outstanding secured convertible debentures as well as the execution of an Amended and Restated Patent Security Agreement in October 2013 reaffirmed the Pledged Property, Patent Collateral and other collateral pledged as security for our obligations to YA Global.

We evaluated the financing transactions in accordance with ASC 815, *Derivatives and Hedging*, and determined that the conversion features of the Series C and Series D preferred stock and the Consolidated Debentures were not afforded the exemption for conventional convertible instruments due to their variable conversion rates. The contracts have no explicit limit on the number of shares issuable, so they did not meet the conditions set forth in current accounting standards for equity classification. Accordingly, either the embedded derivative instruments, including the conversion option, must be bifurcated and accounted for as derivative instrument liabilities or, as permitted by ASC 815-15-25-4, *Recognition of Embedded Derivatives*, the instruments may be carried in their entirety at fair value.

At inception, we elected to bifurcate the embedded derivatives related to the Series C and Series D preferred stock, while electing the fair value option for the Consolidated Debentures. ASC 825, *Financial Instruments*, allows us to elect the fair value option for recording financial instruments when they are initially recognized or if there is an event that requires re-measurement of the instruments at fair value, such as a significant modification of the debt.

The terms of the debentures held by YA Global prior to the consolidation were modified on May 25, 2012 to extend the stated maturity dates to August 1, 2013 and reduce the interest rates to 9.5% per year, with interest being payable on the maturity date in cash or, provided certain equity conditions are satisfied, in shares of our common stock at the applicable conversion price. Because the effect of the modifications exceeded a significance threshold relative to cash flows prescribed by ASC 470-50, *Debt Modifications and Extinguishments*, the modifications of the amounts due under these arrangements were accounted for as extinguishments, whereby the existing debentures are considered to be retired and new debentures issued. The existing instruments were first adjusted to fair value as of May 25, 2012 using the interest rate and maturity date prior to the amendment. The fair value of the new instruments was then calculated using the modified interest rate and maturity date to determine the fair value of the instrument subsequent to the amendment. The differences in the fair values before and after the amendment were recorded as an extinguishment loss of approximately $27.5 million in the accompanying statements of operations for the nine months ended September 30, 2012.

On February 4, 2013, we entered into a Debenture Extension Agreement with YA Global to extend the maturity dates of the secured convertible debentures to August 1, 2014. Because the effect of the extension did not exceed a significance threshold relative to cash flows prescribed by ASC 470-50, *Debt Modifications and Extinguishments*, extinguishment accounting was not applicable. On July 1, 2013, in addition to consolidating the secured debentures into six Consolidated Debentures, the maturity date was extended to August 1, 2015. Four of the Consolidated Debentures are non-interest bearing while the remaining two Consolidated Debentures accrue interest at 9.5% as outlined in further detail below. We evaluated the impact of the modification on the accounting for the Consolidated

Debentures in accordance with ASC 470-50-40-6 through 12 to determine whether extinguishment accounting was appropriate. Because the effect of the extension did not exceed a significance threshold relative to cash flows prescribed by ASC 470-50, *Debt Modifications and Extinguishments*, extinguishment accounting was not applicable.

Debentures assigned to other investors by YA Global were also modified effective July 1, 2013 to extend the maturity date to August 1, 2015 and revise the conversion price to the lower of $2.00 or 90% of the lowest volume-weighted average price for 125 days prior to the conversion.

The follwoing table summarizes the significant terms of each of the debentures for which the entire hybrid instrument is recorded at fair value as of September 30, 2013:

Debenture Issuance Year	Face Amount (in thousands)	Interest Rate	Fixed Price	Conversion Price Lower of Fixed Price or Percentage of VWAP for Look-back period Anti-Dilution Adjusted Price	%	Look-back Period
2006	$ 2,263	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2007	1,150	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2008	1,216	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2009	172	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2011	864	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2012	612	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2013	22,344	9.5 %	$2.00	$ 0.00018	90 %	125 Days
2013	12,299	-	$2.00	$ 0.00019	95 %	125 Days
Total	$ 40,920					

We continue to bifurcate the compound embedded derivatives related to the Series C and Series D preferred stock and carry these financial instruments as liabilities in the accompanying balance sheet. Election to carry the instruments at fair value in their entirety is not available since their terms have not been modified. Significant components of the compound embedded derivative include (i) the embedded conversion feature, (ii) down-round anti-dilution protection features and (iii) default, non-delivery and buy-in puts, all of which were combined into one compound instrument that is carried at fair value as a derivative liability. Changes in the fair value of the compound derivative liability are charged or credited to income each period.

Conversions and Repayments Our preferred stock and convertible debentures are convertible into shares of our common stock. Upon conversion of any of the convertible financial instruments in which the compound embedded derivative is bifurcated, the carrying amount of the debt, including any unamortized premium or discount, and the related derivative instrument liability are credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized. For instruments that are recorded in their entirety at the fair value of the hybrid instrument, the fair value of the hybrid instrument converted is credited to the capital accounts upon conversion to reflect the stock issued and no gain or loss is recognized. Beginning in April 2013, the trading market price of our common stock (and the conversion price) was less than its par value. We are limited to issuing shares of common stock at no less than the par value, and all shares of our common stock issued in those conversions were issued at par value. However, the methodology used to estimate the number of shares of convertible debentures and preferred stock converted during this time are based upon the value received for the shares issued, with the difference between that value and the par value recorded as a deemed dividend.

The following table provides a summary of the preferred stock conversions that have occurred since inception and the number of common shares issued upon conversion.

	Preferred shares issued	Preferred shares converted	Preferred shares remaining	Common shares issued
	(in thousands)			

Series C Preferred Stock	22	17	5	314,619
Series D Preferred Stock	25	22	3	245,162

The outstanding principal and accrued interest for the debentures as of September 30, 2013 is reflected in the following table in addition to the principal and interest converted since inception and the number of common shares issued upon conversion.

	Outstanding principal and accrued interest at September 30, 2013 (in thousands)	Principal and accrued interest converted since inception	Common Shares issued
Debentures	$ 43,665	$ 11,747	4,403,415

As of September 30, 2013, we do not have sufficient authorized shares of common stock available for issuance to satisfy the conversion rights under certain outstanding convertible debenture and series of preferred stock. If the holders of such debentures and preferred stock request the conversion of such holdings to common stock, we would be unable to respond to the request which would request in an event of default under such instruments. Although we will pursue other options to increase the number of shares authorized for issuance in order to honor the conversion rights of the debentures and preferred stock, we can provide no assurance that we will be successful with these efforts.

Warrants YA Global holds warrants to purchase shares of our common stock that were issued in connection with the convertible debentures and the Series C and Series D preferred stock. The warrants are exercisable at a fixed exercise price which, from time to time, has been reduced due to anti-dilution provisions when we have entered into subsequent financing arrangements with a lower price. The exercise prices may be reset again in the future if we subsequently issue stock or enter into a financing arrangement with a lower price. In addition, upon each adjustment in the exercise price, the number of warrant shares issuable is adjusted to the number of shares determined by multiplying the warrant exercise price in effect prior to the adjustment by the number of warrant shares issuable prior to the adjustment divided by the warrant exercise price resulting from the adjustment.

The warrants issued to YA Global do not meet all of the established criteria for equity classification in ASC 815-40, *Derivatives and Hedging Contracts in Entity's Own Equity,* and accordingly, are recorded as derivative liabilities at fair value. Changes in the fair value of the warrants are charged or credited to income each period.

Effective February 1, 2013, 1.4 billion of the 1.9 billion warrants held by YA Global were cancelled and the remaining 500 million had their exercise price reduced to $0.0001 per share. These changes resulted in a decrease in fair value of the warrants of approximately $1.6 million during the first quarter of 2013 as reflected in the gain (loss) from change in fair value of derivative liabilities-warrants.

Fair value disclosures for Series C and D Bifurcated Embedded Derivative Instruments For financings in which the embedded derivative instruments are bifurcated and recorded separately, the compound embedded derivative instruments are valued using a Monte Carlo Simulation 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.

The conversion price in each of the convertible debentures is subject to adjustment for down-round, anti-dilution protection. Accordingly, if we sell common stock or common share indexed financial instruments below the stated or variable conversion price of the debenture, the conversion price adjusts to that lower amount.

The assumptions included in the calculations are highly subjective and subject to interpretation. Assumptions used as of September 30, 2013 included exercise estimates/behaviors and the following other significant estimates: (i) Preferred Stock: remaining term of 1.84 years, equivalent volatility of 165%, equivalent interest rate of 8%, equivalent credit-risk adjusted rate of 6.31% and conversion price of $0.000194. Equivalent amounts reflect the net results of multiple modeling simulations that the Monte Carlo Simulation methodology applies to underlying assumptions.

Due to the variability of the conversion prices, fluctuations in the trading market price of our common stock may result in significant variations to the calculated conversion price. For each debenture, we analyze the ratio of the conversion price (as calculated based on the percentage of VWAP for the appropriate look-back period) to the trading market price for a period of time equal to the term of the debenture to determine the average ratio for the term of the note. Each quarter, the ratio in effect on the date of the valuation is compared with the average ratio over the term of the debenture to determine if the calculated conversion price is representative of past trends or if it is considered unrepresentative due to a large fluctuation in the common stock price over a short period of time. If the calculated conversion price results in a ratio that deviates significantly from the average ratio over the term of the agreement, the average ratio of the conversion price to the trading market price is then multiplied by the current trading market price to determine the variable conversion price for use in the fair value calculations. This variable conversion price is then compared with the fixed conversion price and, as required by the terms of the debentures, the lower of the two amounts is used as the conversion price in the Monte Carlo Simulation model used for valuation purposes. On September 30, 2013, the fixed conversion price for each of the debentures was equal to or higher than the calculated variable conversion price. Accordingly, the variable conversion price was used in the Monte Carlo Simulation model. This analysis is performed each quarter to determine if the calculated conversion price is reasonable for purposes of determining the fair value of the embedded conversion features (for instruments recorded under ASC 815-15-25-1) or the fair value of the hybrid instrument (for instruments recorded under ASC 815-15-25-4).

The following table reflects the face value of the instruments, their amortized carrying value and the fair value of the separately-recognized compound embedded derivative, as well the number of common shares into which the instruments are convertible as of September 30, 2013 and December 31, 2012.

September 30, 2013

	Face Value (in thousands)	Carrying Value	Embedded Conversion Feature	Common Stock Shares
Series C Preferred Stock	$ 4,816	$ 4,816	$ 6,440	24,823,015
Series D Preferred Stock	348	348	465	1,794,330
Total	$ 5,164	$ 5,164	$ 6,905	26,617,345

December 31, 2012

	Face Value (in thousands)	Carrying Value	Accrued Interest	Embedded Conversion Feature	Common Stock Shares
Series C Preferred Stock	$ 4,840	$ 4,840	$ -	$ 1,988	923,953
Series D Preferred Stock	348	348	-	143	66,457
Total	$ 5,188	$ 5,188	$ -	$ 2,131	990,410
Debentures:					
2006	$ 53	$ 53	$ 7	16	11,871

The terms of the embedded conversion features in the convertible instruments presented above provide for variable conversion rates that are indexed to our quoted 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 embedded conversion feature of the Series C and Series D preferred stock was convertible as of September 30, 2013 and December 31, 2012 was calculated as face value plus assumed dividends (if declared), divided by the lesser of the fixed rate or the calculated variable conversion price using the 125 day look-back period.

Changes in the fair value of derivative instrument liabilities related to the bifurcated embedded derivative features of convertible instruments not carried at fair value are reported as Gain (loss) from change in fair value of derivative liability Series C and Series D preferred stock and debentures in the accompanying consolidated statements of operations.

Gain (loss) from change in fair value of derivative liability Series C and D Preferred Stock and debentures

	Three months ended September 30, 2013 (in thousands)	2012	Nine months ended September 30, 2013 (in thousands)	2012
Series C Preferred Stock	$ (2,473)	$ 918	$ (4,462)	$ (2,284)
Series D Preferred Stock	(178)	44	(322)	(1,302)
Debentures:				
2006	31	74	15	(2,996)
2008	-	-	-	(1,350)
2009	-	-	-	(486)
2010	-	-	-	(34)
2011	-	-	-	(4,825)
2012	-	-	-	15
Gain (loss) from change in fair value of derivative liability	$ (2,620)	$ 1,036	$ (4,769)	$ (13,262)

Hybrid Financial Instruments Carried at Fair Value At inception, the March 2007, August 2007, April 2008, May 2008 and April 2012 convertible debentures were recorded in their entirety at fair value as hybrid instruments in accordance with ASC 815-15-25-4 with subsequent changes in fair value charged or credited to income each period. As of May 25, 2012, we elected the fair value option for all other convertible debentures held by YA Global upon a re-measurement date that was triggered by significant modifications of the financial instruments. The convertible debentures continued to be recorded in their entirety at fair value upon their consolidation into six Consolidated Debentures effective July 1, 2013.

Because these debentures are carried in their entirety at fair value, the value of the embedded conversion feature is embodied in those fair values. We estimate the fair value of the hybrid instrument as the present value of the cash flows of the instrument, using a risk-adjusted interest rate, enhanced by the value of the conversion option, valued using a Monte Carlo model. This method was considered by our management to be the most appropriate method of encompassing the credit risk and exercise behavior that a market participant would consider when valuing the hybrid financial instrument. Inputs used to value the hybrid instruments as of September 30, 2013 included: (i) present value of future cash flows for the debentures using a risk adjusted interest rate of 9.50% or zero if the instrument is non-interest bearing, (ii) remaining term of 1.84 years, (iii) equivalent volatility of 165%, equivalent interest rate of 9.5% or zero for non-interest bearing debt, equivalent credit-risk adjusted rate of 6.31% and anti-dilution adjusted conversion prices ranging from $0.00018 - $0.00019.

The following table reflects the face value of the financial instruments, the fair value of the hybrid financial instrument and the number of common shares into which the instruments are convertible as of September 30, 2013 and December 31, 2012.

September 30, 2013	Face Value (in thousands)	Fair Value	Common Stock Shares
Debentures:			
2006	$ 2,263	$ 7,858	17,386,106
2007	1,150	3,001	6,707,442
2008	1,216	5,234	11,511,771

2009	172	876	1,919,461
2011	864	2,557	5,687,898
2012	612	1,786	3,974,950
2013	34,643	85,706	191,799,671
Total	$ 40,920	$ 107,018	238,987,299

December 31, 2012	Face Value (in thousands)	Fair Value	Common Stock Shares
Debentures:			
2006	$ 6,180	$ 14,758	5,196,283
2007	6,856	17,172	6,098,480
2008	6,468	15,492	5,487,497
2009	1,644	3,565	1,243,390
2010	3,806	7,178	2,512,724
2011	1,954	3,080	1,084,237
2012	1,979	3,047	1,073,527
Total	$ 28,887	$ 64,292	22,696,138

Changes in the fair value of convertible instruments that are carried in their entirety at fair value are reported as Gain (loss) from change in fair value of hybrid financial instruments in the accompanying consolidated statements of operations. The changes in fair value of these hybrid financial instruments were as follows:

Gain (loss) from change in fair value of hybrid financial instruments

	Three months ended September 30,		Nine months ended September 30,	
	2013 (in thousands)	2012	2013 (in thousands)	2012
2006	$ 11,069	$ 902	$ 5,754	$ 2,637
2007	19,420	1,994	13,929	1,005
2008	16,569	1,914	9,930	5,465
2009	2,672	477	1,391	912
2010	9,693	799	7,178	1,695
2011	635	155	42	666
2012	1,483	427	523	740
2013	(85,706)	-	(85,706)	-
	(24,165)	6,668	(46,959)	13,120
Less: Day-one loss from debenture financings	-	(315)	-	(1,162)
Gain (loss) from changes in fair value of hybrid instruments	$ (24,165)	$ 6,353	$ (46,959)	$ 11,958

Warrants The following table summarizes the warrants outstanding, their fair value and their exercise price after adjustment for anti-dilution provisions:

	September 30, 2013			December 31, 2012		
Expiration Year	Anti-Dilution Adjusted Exercise Price	Warrants	Fair Value	Anti-Dilution Adjusted Exercise Price	Warrants	Fair Value
	(in thousands)				(in thousands)	

Warrants issued with preferred stock:									
Series D Preferred Stock	2017	0.000100	87,368	$	33	0.00684	328,947	$	709
Warrants issued with debentures:									
2008	2015	0.000100	238,079		86	0.00684	896,382		1,691
2010	2015	0.000100	81,350		30	0.00684	306,287		571
2011	2016	0.000100	58,246		23	0.00684	219,298		453
2012	2017	0.000100	34,947		12	0.00684	131,579		263
Total			499,990	$	184		1,882,493	$	3,687

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The warrants are valued using a binomial lattice option valuation methodology because that model embodies all of the significant relevant assumptions that address the features underlying these instruments. Significant assumptions used in this model as of September 30, 2013 included an expected life equal to the remaining term of the warrants, an expected dividend yield of zero, estimated volatility ranging from 175% to 188%, and risk-free rates of return ranging from 0.02% to 0.63%. For the risk-free rates of return, we use the published yields on zero-coupon Treasury Securities with maturities consistent with the remaining term of the warrants and volatility is based upon our expected common stock price volatility over the remaining term of the warrants. As a result of the repricing on February 1, 2013, the exercise price of the warrants is currently $.0001. The anti-dilution provisions are still applicable so in the future the fixed exercise price of the warrants may be reset to equal to the lowest price of any subsequently issued common share indexed instruments with a conversion price below the current exercise price of the warrant.

Changes in the fair value of the warrants are reported as (Gain) loss from change in fair value of derivative liability - warrants in the accompanying consolidated statement of operations. The changes in the fair value of the warrants were as follows:

Gain (loss) from change in fair value of derivative liability- warrants

	Three months ended September 30, 2013 (in thousands)		2012		Nine months ended September 30, 2013 (in thousands)		2012	
Warrants issued with preferred stock:								
Series D Preferred Stock	$	16	$	847	$	675	$	795
Warrants issued with debentures:								
2007		-		492		-		1,511
2008		44		2,107		1,605		2,657
2010		15		718		543		901
2011		11		565		431		566
2012		6		168		249		(612)
Total	$	92	$	4,897	$	3,503	$	5,818

Reconciliation of changes in fair value Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to their fair value measurement. Our derivative financial instruments that are measured at fair value on a recurring basis are all measured at fair value using Level 3 inputs. Level 3 inputs are 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 following represents a reconciliation of the changes in fair value of financial instruments measured at fair value using Level 3 inputs and changes in the fair value of hybrid instruments carried at fair value during the nine months ended September 30, 2013:

	Compound Embedded Derivatives	Warrant Derivatives	Hybrid Instruments	Total
Beginning balance, December 31, 2012:	$ 2,147	$ 3,687	$ 64,292	$ 70,126
Fair value adjustments:				
Compound embedded derivatives	4,768	-	-	4,768
Warrant derivatives	-	(3,503)	-	(3,503)
Hybrid instruments	-	-	46,959	46,959
Conversions:				
Series C Preferred Stock	(10)	-	-	(10)
August 24, 2006 financing	-	-	(644)	(644)
December 29, 2006 financing	-	-	(503)	(503)
March 27, 2007 financing	-	-	(242)	(242)
April 11, 2008 financing	-	-	(71)	(71)
July 29, 2008 financing	-	-	(234)	(234)
October 18, 2008 financing	-	-	(23)	(23)
July 15, 2009 financing	-	-	(823)	(823)
August 14, 2009 financing	-	-	(475)	(475)
February 8, 2011 financing	-	-	(28)	(28)
April 13, 2011 financing	-	-	(199)	(199)
October 25, 2011 financing	-	-	(37)	(37)
December 8, 2011 financing	-	-	(217)	(217)
February 6, 2012 financing	-	-	(29)	(29)
March 26, 2012 financing	-	-	(141)	(141)
June 1, 2012 financing	-	-	(567)	(567)
Ending balance, September 30, 2013	$ 6,905	$ 184	$ 107,018	$ 114,107

Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and external market factors. In addition, valuation techniques are sensitive to changes in the trading market price of our common stock, which has a high estimated historical volatility. Because derivative financial instruments are initially and subsequently carried at fair values, our income will reflect the volatility in these estimate and assumption changes.

Note 5 Contingencies

From time to time, we are involved in various legal actions arising in the normal course of business, both as claimant and defendant. Although it is not possible to determine with certainty the outcome of these matters, we believe the eventual resolution of any ongoing legal actions is unlikely to have a material effect on our financial position or operating results.

Note 6 Stock-Based Compensation

Total stock-based compensation expense recorded in the statement of operations was $206 and $1,000 for the three months ended September 30, 2013 and 2012, respectively, and $992 and $15,000 for the nine months ended September 30, 2013 and 2012, respectively.

A summary of the transactions and status of our granted, vested and exercisable options during the nine months ended September 30, 2013 follows:

	Shares (in thousands)	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted-Average Contractual Life Remaining in Years
Outstanding at December 31, 2012	1,340	$ 0.017	$ -	
Granted	-	-	-	
Exercised	-	-	-	
Forfeited	(167)	-	-	
Outstanding at September 30, 2013	1,173	$ 0.017	$ -	7.9
Exercisable at September 30, 2013	903	$ 0.018	$ -	7.8

The following table summarizes information about our stock options outstanding at September 30, 2013:

Options Outstanding				Options Exercisable	
Exercise Prices	Number of Shares (in thousands)	Weighted-Average Remaining Life (in years)	Weighted-Average Exercise Price	Number of Shares (in thousands)	Weighted-Average Exercise Price
$0.008	200	9.0	$ 0.008	40	$ 0.008
$0.014 - $0.017	884	7.8	0.015	774	0.016
$0.050	89	7.4	0.047	89	0.047
	1,173	7.9	0.017	903	0.018

Note 7 Geographic Information

Revenue, classified by geographic location from which the revenue was originated, was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
United States	$ 1,602	$ 598	$ 3,806	$ 1,759
Germany	-	82	65	108
Total revenue	$ 1,602	$ 680	$ 3,871	$ 1,867

Approximately $78,000 and $137,000 of total assets were located in Germany as of September 30, 2013 and December 31, 2012, respectively. All other assets were located in the U.S.

Note 8 Subsequent Events

On October 11, 2013, we entered into a Debenture Redemption Agreement with YA Global. Under the agreement, we have the option to redeem outstanding amounts under the six secured convertible debentures issued by us and currently held by YA Global at a purchase price equal to 75% of the value of the amount being redeemed. The agreement may be terminated by either party upon 90 days' written notice.

On October 25, 2013, we entered into an Amended and Restated Patent Security Agreement with YA Global. Under the agreement, a security interest in our IP Collateral as defined in the agreement was granted to YA Global in connection with our obligations to YA Global.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

We are a pioneer in 2D mobile barcode technology and infrastructure solutions that enable the mobile barcode ecosystem world-wide. We believe that our extensive intellectual property portfolio differentiates us from the competition. We strive to harness the power of mobile devices in innovative ways with state-of-the-art mobile barcode technology. With this technology, mobile devices with cameras become barcode scanners and this enables a range of practical applications including mobile marketing and advertising as well as mobile couponing. We offer barcode management and infrastructure solutions, barcode reader solutions and IP licensing.

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We are focused in two key areas: the first is the maximization of our patent portfolio through IP licensing and enforcement, and the second is our two tiered sales approach on partnering with brands and agencies directly as well as partnering with key mobile marketing organizations to maximize the reach of our barcode management and infrastructure solutions. We are focusing our sales and marketing activities primarily in the United States and Europe and pursue other regions opportunistically.

NeoMedia has been active in, and strived to be an innovator in, the mobile barcode field since the mid-1990s, and during that time has spearheaded the development of a robust IP portfolio. In September 2011, we announced an agreement with Global IP Law Group to help further monetize our patent portfolio and lead the licensing of our IP, focusing on the US market but covering all markets in which we have patent coverage. In early 2013, we won an appeal for a key patent in our portfolio in the EU and believe this European Patent Office ("EPO") win is key to the growth of our patent licensing business in Europe. We currently have IP agreements with over thirty companies. We are hopeful that our IP licensing activities will continue to generate new licensees through the remainder of 2013 and through 2014. We intend to continue to vigorously pursue or defend, as applicable, claims affecting the business interests and intellectual property of the Company including litigation activities, where appropriate. In addition, through our licensing program, several companies, including technology companies and brands, have agreed to cease and desist in their mobile barcode activities.

Our barcode management and infrastructure solution includes our barcode reader (NeoReader®), our enterprise grade code platform (NeoSphere) and our self-service code creation platform (QodeScan). Mobile barcodes continue to be an increasingly important engagement tool for brands and marketers and we continue to see interest from prospective customers from across the globe.

We continue to be faced with downward price pressure in the market given the fragmented competitive environment for mobile barcode solutions as well as the 'battle' between free and fee based solutions. We believe that NeoMedia will continue to differentiate itself on the basis of its high quality product and service offerings, customizable and full service solutions and our robust intellectual property portfolio. The sales process for mobile barcodes is a consultative sales process and our research suggests that in most cases, organizations are seeking an end-to-end solution, including mobile websites, rich media, etc. Accordingly, NeoMedia has extended its partner relationships to offer its customers a full service solution. Given the consultative sale process, the sales cycles tend to be longer and more resource intensive. We are hopeful that QodeScan will help reduce the effort required to support small or low cost sales opportunities, freeing staff to focus on larger opportunities.

NeoMedia continues to promote an open and interoperable approach to the market to empower the mobile ecosystem - and deploys an indirect methodology for our customers. Our research suggests we are one of the few providers in the global ecosystem to offer Aztec, Code 39 and PDF417 code support, in addition to QR, Data matrix and a variety of 1D symbologies.

NeoReader has also experienced continued growth in the third quarter of 2013 compared to the prior year. With pre-install agreements with Sony Mobile and Samsung Electronics Italy, as well as being downloadable from the key "app stores" including Google Play , Apple App Store , Blackberry App World, Windows Marketplace, Nokia Store, Facebook and Amazon as well as via our own website, http://get.neoreader.com, our reader now has 40+ million installations. NeoReader is offered to consumers free of charge and we anticipate the growth in consumer utilization will continue and help encourage brand adoption of mobile barcodes. We added mobile advertising support to our NeoReader product as well as the opportunity to disable mobile ads, at an additional fee. NeoMedia also offers NeoReader SDK for enterprise opportunities and we have seen a significant increase in demand for NeoReader SDK, primarily from Asia and Europe. We believe we have the best decoding algorithms (speed and performance) in the industry, which differentiate our reader from the majority of solutions in the market.

As a result of our successes in our operating business, including our increasing revenues and stabilized costs, we have not had to take any additional outside funding since the Summer of 2012 and expect this to continue. In the third quarter of 2013, we generated, for the second consecutive quarter, what we deem to be meaningful operating income.

Results of Operations

We continue to focus on growing our patent licensing and barcode management and infrastructure business. During the nine months ended September 30, 2013 our operating income was $0.6 million as compared to an operating loss during the nine months ended September 30, 2012 of $2.3 million. The improvement in our operating results is due to an increase in 2D core and IP licensing revenue as well as a decline in cost of revenues as a percentage of revenue and lower operating expenses. Our net loss was $47.5 million and $21.9 million for the nine months ended September 30, 2013 and 2012, respectively. Our net loss includes gains and losses from the change in fair value of our hybrid financial instruments, warrants and debentures. We incur these gains and losses principally as a result of changes in the market value of our common stock as well as changes in the terms of the related securities, such as the maturity dates and nature of the look-back features. During the nine months ended September 30, 2013 and 2012, we reported total net losses on our hybrid financial instruments, warrants and debentures of $48.2 million and $23.0 million, respectively. Changes in the fair value of our derivative liabilities caused significant variability in our overall net losses during the periods presented. Operationally, we focus on our income (loss) from operations in assessing our overall performance.

Income (Loss) from Operations

The following table sets forth financial information for our income (loss) from operations for each of the periods presented:

	Three months ended September 30,						Nine months ended September 30,					
	2013		2012		% Change		2013		2012		% Change	
	(dollars in thousands)											
Revenue	$	1,602	$	680	136	%	$	3,871	$	1,867	107	%
Cost of revenues		(300)		(639)	(53)	%		(600)		(667)	(10)	%
Gross profit		1,302		41	NM			3,271		1,200	173	%
Sales and marketing		(16)		(112)	(86)	%		(124)		(532)	(77)	%
General and administrative		(723)		(313)	131	%		(2,245)		(2,226)	1	%
Research and development		(123)		(195)	(37)	%		(507)		(788)	(36)	%
Other operating		-		-	NM			227		-	NM	
Operating income (loss)	$	440	$	(579)	NM		$	622	$	(2,346)	NM	

NM Information is not meaningful.

Revenue. Revenues for the three months ended September 30, 2013 and 2012 were $1,602,000 and $680,000, respectively, an increase of $922,000, or 136%. Revenues for the nine months ended September 30, 2013 and 2012 were $3,871,000 and $1,867,000, respectively, an increase of $2,004,000, or 107%. The increases in revenue are primarily attributable to new IP licensing revenue as well as an increase in revenue from our NeoReader SDK sales.

Cost of Revenues. Cost of revenues was $300,000 for the three months ended September 30, 2013 compared with $639,000 for the three months ended September 30, 2012, a decrease of $339,000, or 53%. Cost of revenues was $600,000 for the nine months ended September 30, 2013 compared with $667,000 for the nine months ended September 30, 2012, a decrease of $67,000 or 10%. Cost of revenues primarily relates to third party professional fees incurred in connection with the sale of our IP licenses. Cost of revenues typically varies in a manner consistent with changes in our IP licenses revenue. Cost of revenues in the prior year's periods relative to revenue was unusually high due to the expensing of certain professional fees associated with revenue that was initially recorded as deferred.

Sales and Marketing. Sales and marketing expenses were $16,000 and $112,000 for the three months ended September 30, 2013 and 2012, respectively, a decrease of $96,000, or 86%. Sales and marketing expenses were $124,000 and $532,000 for the nine months ended September 30, 2013 and 2012, respectively, a decrease of $408,000 or 77%. The decrease in sales and marketing expenses is due to cost containment efforts. We expect sales and marketing expenses will increase in future periods as we continue to develop and execute on our business goals.

General and Administrative. General and administrative expenses were $723,000 and $313,000 for the three months ended September 30, 2013 and 2012, respectively, an increase of $410,000, or 131%. General and administrative expenses were $2,245,000 and $2,226,000 for the nine months ended September 30, 2013 and 2012, respectively, an increase of $19,000 or 1%. The prior year's quarter general and administrative expenses were unusually low due to certain cost reduction activities during the period. General and administrative expenses also increased during the third quarter of 2013 due to higher public company costs incurred in connection with our annual shareholder meeting as well as higher legal fees associated with certain arbitration activities.

Research and Development. Research and development expenses were $123,000 and $195,000 for the three months ended September 30, 2013 and 2012, respectively, a decrease of $72,000, or 37%. Research and development expenses were $507,000 and $788,000 for the nine months ended September 30, 2013 and 2012, respectively, a decrease of $281,000 or 36%. Research and development expenses decreased as we focused our development efforts in our 2D Core services and subsequently launched our QodeScan self-service barcode management platform, resulting in a reduced requirement for ongoing development services.

Other Operating Losses (Gains). The $227,000 of other gains realized during the nine months ended September 30, 2013 related to an arbitration proceeding and settlement in our favor, which concluded during the three month period ended June 30, 2013. There was no similar activity in the other periods presented.

Other Income (Expenses)

The following table sets forth financial information for our other income (expenses) for each of the periods presented:

	Three months ended September 30, 2013	2012	% Change	Nine months ended September 30, 2013	2012	% Change
	(dollars in thousands)					
Impairment loss on cash surrender value of life insurance policy	$ -	$ (527)	NM	$ -	$ (527)	NM
Gain on derecognition of accrued expenses and purchase price guarantee	-	8,300	NM	-	8,300	NM
Gain (loss) on extinguishment of debt	53	-	NM	53	(27,479)	NM
Gain (loss) from change in fair value of hybrid financial instruments	(24,165)	6,353	NM	(46,959)	11,958	NM
Gain (loss) from change in fair value of derivative liability - warrants	92	4,897	(98) %	3,503	5,818	(40) %
Gain (loss) from change in fair value of derivative liability - Series C and D preferred stock and debentures	(2,620)	1,036	NM	(4,769)	(13,262)	64 %
Interest (expense) / income	-	(10)	NM	16	(4,407)	NM
Total other income (expense)	$ (26,640)	$ 20,049	NM	$ (48,156)	$ (19,599)	(146) %

NM Information is not meaningful.

Impairment Loss On Cash Surrender Value of Life Insurance Policy. During the third quarter of 2012, we determined that we would be unable to collect the cash surrender value of a life insurance policy due to a dispute with the insurance company. Accordingly, we recorded a loss of $527,000 to impair the value of the policy as reflected in the results for the three and nine months ended September 30, 2012. There was no similar activity in the other periods presented.

Gain on Derecognition of Accrued Expenses and Purchase Price Guarantee. We determined during the third quarter of 2012 that certain accrued purchase price obligations and disputed expenses associated with a 2006 acquisition were no longer legally enforceable due to the expiration of the statutes of limitations. As a result, we de-recognized the liabilities, which resulted in a $8.3 million gain as reflected in the results for the three and nine month periods ended September 30, 2012. There was no similar activity in the other periods presented.

Gain (Loss) on Extinguishment of Debt. During the third quarter of 2013, we modified and consolidated our outstanding debentures resulting in a $53,000 gain on extinguishment. During the second quarter of 2012, we modified our debt causing the existing debentures to be effectively retired and new debentures issued. The differences in the fair values of the debt before and after the modification resulted in an extinguishment loss of approximately $27.5 million as reflected in the nine months ended September 30, 2012.

Gain (Loss) from Change in Fair Value of Hybrid Financial Instruments. We carry certain of our debentures at fair value in accordance with the applicable accounting codification and do not separately account for the embedded conversion feature. The change in the fair value of these liabilities includes changes in the value of the accrued interest due under these instruments, as well as changes in the fair value of the common stock underlying the instruments. For the three months ended September 30, 2013 and 2012, the liability related to these hybrid instruments fluctuated, resulting in a loss of $24.2 million and a gain of $6.4 million, respectively. For the nine months ended September 30, 2013 and 2012, the liability related to these hybrid instruments fluctuated, resulting in a loss of $47.0 million and a gain of $12.0 million, respectively.

Gain (Loss) from Change in Fair Value of Derivative Liabilities Warrants. We account for our outstanding common stock warrants that were issued in connection with our preferred stock and our debentures, at fair value. For the three months ended September 30, 2013 and 2012, the liability related to these instruments fluctuated, resulting in gains of $92,000 and $4.9 million, respectively. For the nine months ended September 30, 2013 and 2012, the liability related to warrants fluctuated resulting in gains of $3.5 million and $5.8 million, respectively.

Gain (Loss) from Change in Fair Value of Derivative Liabilities Series C and D Preferred Stock and Debentures. For our Series C and D Preferred Stock, and certain of our debentures, we account for the embedded conversion feature separately as a derivative financial instrument. We carry these derivative financial instruments at fair value. For the three months ended September 30, 2013 and 2012, the liability related to these hybrid instruments fluctuated, resulting in a loss of $2.6 million and a gain of $1.0 million, respectively. For the nine months ended September 30, 2013 and 2012, the liability related to the derivative instruments embedded in the Series C and D Preferred Stock and these debentures fluctuated, resulting in losses of $4.8 million and $13.3 million, respectively.

The changes in the fair values of our hybrid financial instruments and our derivative liabilities were primarily the result of fluctuations in the value of our common stock during the period as well as changes in the terms of the related security agreements. Because our common stock price has been volatile and because many of our derivative financial instruments include relatively low fixed conversion or exercise prices, it is possible that further fluctuations in the market price of our common stock could cause the fair value of these instruments to increase or decrease significantly in future periods. The fair values of these instruments are subject to volatility so long as the preferred stock, debentures and warrants are outstanding. These instruments will no longer be volatile upon their conversion or exercise into common stock.

Interest Expense Related to Convertible Debt. Following the May 25, 2012 modification of the debentures, which extended the due date, the debentures were no longer carried at amortized cost but are carried as hybrid financial instruments at fair value. As a result, the interest on these debentures subsequent to May 25, 2012 is reported as part of the Gain (Loss) from Change in Fair Value of Hybrid Financial Instruments and is no longer separately reported as interest expense.

Other Comprehensive Income (Loss). For the three months ended September 30, 2013 and 2012, other comprehensive losses were $0 and $3,000, respectively. For the nine months ended September 30, 2013, other comprehensive gains were $133,000 as compared to other comprehensive losses of $18,000 for the nine months ended September 30, 2012. The other comprehensive gains and losses were due to the impact of fluctuations in currency exchange rates associated with our translation of the NeoMedia Europe GmbH subsidiary financial statements from its local currency, the Euro, to U.S. dollars. As discussed above, we determined during the third quarter of 2013 that the functional currency of the foreign subsidiary changed to the U.S. dollar and as a result of the change in functional currency, translation gains and losses associated with the conversion of the NeoMedia Europe GmbH financial statements are recorded in our results from operations rather than through other comprehensive income (loss) effective July 1, 2013.

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Liquidity and Capital Resources

As of September 30, 2013, we had $157,000 in cash and cash equivalents, a decrease of $454,000, compared with $611,000 as of December 31, 2012.

Cash used in operating activities was $536,000 for the nine months ended September 30, 2013 representing a significant improvement as compared to $1,377,000 for the nine months ended September 30, 2012. The improvement is primarily due to increased revenue from IP licensing and NeoReader SDK sales and from decreased operational expenses.

There was no cash provided by or used in investing activities during the nine months ended September 30, 2013 as compared to $5,000 of cash used during the same prior period.

Net cash provided by financing activities during the nine months ended September 30, 2013 was $83,000 and reflects borrowings and repayments on a short-term notes payable in order to pay certain annual insurance premiums. Cash provided by financing activities during the nine months ended September 30, 2012 was $2.6 million, reflecting gross proceeds of $2,650,000 from six secured debentures issued to YA Global, net of $150,000 in structuring and due diligence fees as well as $110,000 associated with two bridge loans.

Going Concern We have historically incurred operating losses, and we may continue to generate negative cash flows as we implement our business plan. There can be no assurance that our continuing efforts to execute our business plan will be successful and that we will be able to continue as a going concern. The accompanying consolidated financial statements have been prepared in conformity with US GAAP, which contemplates our continuation as a going concern. Our net loss for the nine months ended September 30, 2013 and 2012 was $47.5 million and $21.9 million, respectively, including $48.2 million and $23.0 million, respectively, of net losses related to our financing instruments. Our operating income was $0.6 million for the nine months ended September 30, 2013, and our operating loss was $2.3 million for the nine months ended September 30, 2012.

Net cash used by operations during the nine months ended September 30, 2013 and 2012 was $0.5 million and $1.4 million, respectively. As of September 30, 2013, we have an accumulated deficit of $312.9 million. We also have a working capital deficit of $117.4 million, including $114.1 million in current liabilities for our derivative and debenture financing instruments.

As of September 30, 2013, we do not have sufficient authorized shares of common stock available for issuance to satisfy the conversion rights under certain outstanding convertible debenture and series of preferred stock. If the holders of such debentures and preferred stock request the conversion of such holdings to common stock, we would be unable to respond to the request which would result in an event of default under such instruments. Although we are making best efforts to pursue options to be able to honor the conversion rights of the debenture holders and preferred stock, we can provide no assurance that we will be successful with these efforts.

The items discussed above raise doubt about our ability to continue as a going concern.

We currently do not have sufficient cash or commitments for financing to sustain our operations for the next twelve months if we are unable to generate sufficient cash flows from operations. Our plan is to develop new client and customer relationships and substantially increase our revenue derived from our products/services and IP licensing. If our revenues do not reach the level anticipated in our plan, we may require additional financing in order to execute our operating plan; however, we believe that our revenues will reach such level and such additional financing will not be necessary. If additional financing is required, we cannot predict whether this additional financing will be in the form of equity, debt, or another form, and we may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In the event that financing sources are not available, or that we are unsuccessful in increasing our revenues and profits, we may be unable to implement our current plans for expansion, repay our debt obligations or respond to competitive pressures, any of which would have a material adverse effect on our business, prospects, financial condition and results of operations.

The convertible debentures and preferred stock used to finance the Company, which may be converted into common stock at the sole option of the holders, have a highly dilutive impact when they are converted, greatly increasing the number of common shares outstanding. During the three and nine months ended September 30, 2013, there were 75 million and 2,879 million shares of common stock issued for these conversions, respectively. We cannot predict if or when each holder may or may not elect to convert into common shares.

Our financial statements do not include any adjustments relating to the recoverability and reclassification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should we be unable to continue as a going concern.

Sources of Cash and Projected Cash Requirements As of September 30, 2013, our cash balance was $157,000. NeoMedia's past financing agreements with YA Global have certain ramifications that could affect future liquidity and business operations. For example, pursuant to the terms of the debenture agreements between us and YA Global, without YA Global's consent we cannot (i) issue or sell any shares of our common stock or our 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 our 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 our assets or (iv) file any registration statements on Form S-8. In addition, pursuant to security agreements between us and YA Global, YA Global has a security interest in all of our assets. Such covenants could severely harm our ability to raise additional funds from sources other than YA Global, and would likely result in a higher cost of capital in the event we secured funding. Additionally, pursuant to the terms of the Investment Agreement between us and YA Global in connection with our Series C Preferred Stock, we cannot (i) enter into any debt arrangements in which we are the borrower, (ii) grant any security interest in any of our assets or (iii) grant any security below market price.

Critical Accounting Policies and Estimates

The significant accounting policies set forth in Note 2 to our audited consolidated financial statements included in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2012, as updated by Note 2 to the Unaudited Condensed Consolidated Financial Statements included herein, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2012, appropriately represent, in all material respects, the current status of our critical accounting policies and estimates, the disclosure with respect to which is incorporated herein by reference.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

We are a "smaller reporting company" as defined by Rule 12b-2 of the Exchange Act and are not required to provide information under this item.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on management's evaluation, with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as of the end of the period covered by this report, our CEO and CFO have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), are not effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

In connection with the quarterly reporting for the three and nine months ended September 30, 2013 and the evaluation of the disclosure controls and procedures, management concluded we have a material weakness related to our internal control over financial reporting and specifically, a lack of sufficient internal control procedures over our external reporting sufficient to prevent the revisions to the 2013 interim reporting described in Note 2 Summary of Significant

Accounting Policies herein. We assessed the impact of the errors and concluded that the errors did not result in a material misstatement. To correct the errors, we revised the nine months ended September 30, 2013 reporting.

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A material weakness is a deficiency, or combination of deficiencies, that result in a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis. While the identified material weakness did not result in a material misstatement to our condensed consolidated financial statements, these deficiencies could, if not remediated, result in a material misstatement of future reported financial statements.

Changes in Internal Control over Financial Reporting

During the second quarter of 2013, management established certain accounting policies and procedures to provide proper oversight for financial reporting, which included detailed reviews of the condensed consolidated balance sheets and statements of operations. Management also established more formalized accounting policies and procedures to allow for the review of financial performance on a monthly basis and establish procedures to ensure proper treatment for recording financial transactions. Management also established review procedures to ensure recurring and non-recurring journal entries were properly reviewed and approved prior to preparation of the financial statements.

The material weakness noted above related to the revisions to the 2013 interim reporting was identified subsequent to the quarter ended September 30, 2013. In order to remediate the weakness, management has implemented additional controls and procedures subsequent to September 30, 2013 over the external reporting. The additional review procedures include, but are not limited to, processes to ensure new and complex transactions are properly researched and accounted for under the SEC and ASC reporting requirements.

The remediation plan has been implemented; however, the material weakness will not be considered remediated until the additional review procedures have been operating effectively for an adequate period of time. Management will consider the status of this remedial effort when assessing the effectiveness of the internal controls over financial reporting and other disclosure controls and procedures as of December 31, 2013. While management believes that the remedial efforts will resolve the identified material weakness, there is no assurance that management's remedial efforts conducted to date will be sufficient or that additional remedial actions will not be necessary.

Inherent Limitations on Effectiveness of Controls

Our management, including our CEO and CFO, do not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system’s objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been detected. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of the effectiveness of controls to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, we are involved in various legal actions arising in the normal course of business, both as claimant and defendant. Although it is not possible to determine with certainty the outcome of these matters, we believe the eventual resolution of any ongoing legal actions is unlikely to have a material impact on our financial position or operating results.

ITEM 1A. Risk Factors

We are a smaller reporting company as defined by Rule 12b-2 of the Securities Exchange Act of 1934 and are not required to provide information under this item.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

ITEM 3. Defaults upon Senior Securities

None

ITEM 4. Mine Safety Disclosures

Not Applicable

ITEM 5. Other Information

None

ITEM 6. Exhibits

Exhibit No.	Description	Filed Herewith	Form	Exhibit	Filing Date
3.1	Articles of Incorporation of Dev-Tech Associates, Inc. and amendment thereto		SB-2	3.1	11/25/1996
3.2	By-laws of the Company		8-K	3.2	12/21/2010
3.3	Restated Certificate of Incorporation of DevSys, Inc.		SB-2	3.3	11/25/1996
3.4	Articles of Merger and Agreement and Plan of Merger of DevSys, Inc. and Dev-Tech Associates, Inc.		SB-2	3.5	11/25/1996
3.5	Certificate of Merger of Dev-Tech Associates, Inc. into DevSys, Inc.		SB-2	3.6	11/25/1996
3.6	Articles of Incorporation of Dev-Tech Migration, Inc. and amendment thereto		SB-2	3.7	11/25/1996
3.7	Restated Certificate of Incorporation of DevSys Migration, Inc.		SB-2	3.9	11/25/1996
3.8	Form of Agreement and Plan of Merger of Dev-Tech Migration, Inc. into DevSys Migration, Inc.		SB-2	3.11	11/25/1996
3.9	Form of Certificate of Merger of Dev-Tech Migration, Inc. into DevSys Migration, Inc.		SB-2	3.12	11/25/1996
3.10	Certificate of Amendment to Certificate of Incorporation of DevSys, Inc. changing our name to NeoMedia Technologies, Inc.		SB-2	3.13	11/25/1996
3.11	Form of Certificate of Amendment to Certificate of Incorporation of the Company authorizing a reverse stock split		SB-2	3.14	11/25/1996
3.12	Form of Certificate of Amendment to Restated Certificate of Incorporation of the Company increasing authorized capital and creating preferred stock		SB-2	3.15	11/25/1996
3.13			8-K	10.9	2/21/2006

	Certificate of Designation of the Series C Convertible Preferred Stock dated February 17, 2006			
3.14	Certificate of Amendment to the Certificate of Designation of the Series C Convertible Preferred Stock dated January 5, 2010	8-K	3.1	1/11/2010
3.15	Certificate of Designation of the Series D Convertible Preferred Stock dated January 5, 2010	8-K	10.1	1/8/2010
3.16	Certificate of Amendment to the Certificate of Designation of the Series D Convertible Preferred Stock dated January 7, 2010	8-K	3.3	1/11/2010
3.17	Certificate of Amendment to the Certificate of Designation of the Series D Convertible Preferred Stock dated March 5, 2010	8-K	3.1	3/11/2010

3.18	Preferability Letter dated August 1, 2013 from the Company's Auditors, Stark Schenkein LLP regarding a change in the Company's accounting policies related to revenue recognition		10-Q	18.1	8/5/2013
3.19*	Employment Agreement by and between the Company and Laura Marriott dated August 30, 2013		8-K	10.1	8/30/2013
10.1	Reaffirmation and Ratification Agreement by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.2	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-42, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.3	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-43, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.4	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-44, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.5	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-45, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.6	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-46, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.7	Amended, Restated and Consolidated Secured Convertible Debenture, No. NEOM-47, by and between the Company and YA Global Investments, L.P. dated September 16, 2013	X			
10.8	Debenture Redemption Agreement, by and between the Company and YA Global Investments, L.P. dated October 11, 2013	X			
10.9	Amended and Restated Patent Security Agreement, by and between the Company and YA Global Investments, L.P. dated October 25, 2013	X			
31.1	Certification by Principal Executive Officer pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X			
31.2	Certification by Principal Financial and Principal Accounting Officer pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X			
32.1	Certification by Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X			
32.2	Certification by Principal Financial and Principal Accounting Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X			
101	Interactive data. The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Cash Flows and (iv) related notes.	X			

* Denotes management contract or compensatory plan or arrangement.

SIGNATURE

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)

Dated: October 28, 2013

/s/ Colonel Barry S. Baer
Colonel (Ret.) Barry S. Baer, Chief Financial Officer and Principal Financial and Accounting Officer