

NOCOPI TECHNOLOGIES INC/MD/  
Form 10-Q  
August 14, 2009

**United States  
Securities and Exchange Commission  
Washington, D.C. 20549  
Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

**For the quarterly period ended June 30, 2009.**

or

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 000-20333  
NOCOPI TECHNOLOGIES, INC.**

(Exact name of registrant as specified in its charter)

MARYLAND

87-0406496

(State or other jurisdiction  
of incorporation or organization)

(I.R.S. Employer Identification No.)

9C Portland Road, West Conshohocken, PA

19428

(Address of principal executive offices)

(Zip Code)

(610) 834-9600

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 53,551,462 shares of common stock, par value \$.01, as of August 1, 2009.

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

*Nocopi Technologies, Inc.*  
*Statements of Operations\**  
*(unaudited)*

	<b>Three Months ended June 30</b>		<b>Six Months ended June 30</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Revenues</b>				
<b>Licenses, royalties and fees</b>	\$ 95,300	\$ 109,900	\$ 165,800	\$ 304,100
<b>Product and other sales</b>	92,200	127,600	135,300	205,200
	187,500	237,500	301,100	509,300
<b>Cost of revenues</b>				
<b>Licenses, royalties and fees</b>	23,300	24,000	43,300	46,900
<b>Product and other sales</b>	66,200	76,000	113,400	138,200
	89,500	100,000	156,700	185,100
<b>Gross profit</b>	98,000	137,500	144,400	324,200
<b>Operating expenses</b>				
<b>Research and development</b>	40,900	39,800	83,100	82,100
<b>Sales and marketing</b>	95,700	65,600	169,600	133,500
<b>General and administrative</b>	88,300	112,600	197,900	248,900
	224,900	218,000	450,600	464,500
<b>Net loss from operations</b>	(126,900)	(80,500)	(306,200)	(140,300)
<b>Other income (expenses)</b>				
<b>Reversal of accounts payable and accrued expenses</b>	69,100	37,500	69,100	37,500
<b>Interest income</b>		900		2,300
<b>Interest expense and bank charges</b>	(800)	(500)	(1,000)	(1,100)
	68,300	37,900	68,100	38,700
<b>Net loss before income taxes</b>	(58,600)	(42,600)	(238,100)	(101,600)
<b>Income taxes</b>		900		900
<b>Net loss</b>	\$ (58,600)	\$ (43,500)	\$ (238,100)	\$ (102,500)
<b>Basic and diluted net loss per common share</b>	\$ (.00)	\$ (.00)	\$ (.00)	\$ (.00)
	52,541,045	52,284,170	52,413,441	52,280,004

**Basic and diluted weighted average  
common shares outstanding**

\* See  
accompanying  
notes to these  
financial  
statements.

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*Nocopi Technologies, Inc.*  
*Balance Sheets\**

	<b>June 30 2009 (unaudited)</b>	<b>December 31 2008 (audited)</b>
<i>Assets</i>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 54,400	\$ 87,200
Accounts receivable less \$5,000 allowance for doubtful accounts	115,500	167,100
Inventory	81,500	97,200
Prepaid and other	22,100	35,900
<b>Total current assets</b>	<b>273,500</b>	<b>387,400</b>
<b>Fixed assets</b>		
Leasehold improvements	72,500	72,500
Furniture, fixtures and equipment	184,900	184,900
	257,400	257,400
<b>Less: accumulated depreciation and amortization</b>	<b>237,700</b>	<b>233,100</b>
	19,700	24,300
<b>Total assets</b>	<b>\$ 293,200</b>	<b>\$ 411,700</b>
<i>Liabilities and Stockholders Equity (Deficiency)</i>		
<b>Current liabilities</b>		
Line of credit	\$ 75,000	
Accounts payable	263,200	\$ 272,200
Accrued expenses	114,600	117,100
Deferred revenue	17,200	10,000
<b>Total current liabilities</b>	<b>470,000</b>	<b>399,300</b>
<b>Stockholders' equity (deficiency)</b>		
Common stock, \$.01 par value		
Authorized 75,000,000 shares		
Issued and outstanding		
2009 52,926,462 shares; 2008 52,285,837 shares	529,300	522,900
Paid-in capital	12,174,800	12,132,300
Accumulated deficit	(12,880,900)	(12,642,800)
<b>Total stockholders' equity (deficiency)</b>	<b>(176,800)</b>	<b>12,400</b>
<b>Total liabilities and stockholders' equity (deficiency)</b>	<b>\$ 293,200</b>	<b>\$ 411,700</b>

\* **See  
accompanying  
notes to these  
financial  
statements.**

*Nocopi Technologies, Inc.*  
**Statements of Cash Flows\***  
*(unaudited)*

	<b>Six Months ended June 30</b>	
	<b>2009</b>	<b>2008</b>
<b>Operating Activities</b>		
Net loss	\$ (238,100)	\$ (102,500)
<b>Adjustments to reconcile net loss to cash used in operating activities</b>		
Depreciation and amortization	4,600	6,600
Reversal of accounts payable and accrued expenses	(69,100)	(37,500)
Compensation expense stock option grants	7,900	30,500
	(294,700)	(102,900)
<b>(Increase) decrease in assets</b>		
Accounts receivable	51,600	78,800
Inventory	15,700	(1,400)
Prepaid and other	13,800	19,600
<b>Increase (decrease) in liabilities</b>		
Accounts payable and accrued expenses	57,600	(41,600)
Accrued income taxes		(800)
Deferred revenue	7,200	
	145,900	54,600
<b>Net cash used in operating activities</b>	<b>(148,800)</b>	<b>(48,300)</b>
<b>Investing Activities</b>		
Additions to fixed assets		(1,200)
<b>Net cash used in investing activities</b>		<b>(1,200)</b>
<b>Financing Activities</b>		
Net borrowings under line of credit	75,000	
Issuance of common stock	41,000	
Exercise of warrants		2,200
<b>Net cash provided by financing activities</b>	<b>116,000</b>	<b>2,200</b>
<b>Decrease in cash and cash equivalents</b>	<b>(32,800)</b>	<b>(47,300)</b>
Cash and cash equivalents at beginning of year	87,200	263,600
<b>Cash and cash equivalents at end of period</b>	<b>\$ 54,400</b>	<b>\$ 216,300</b>



**Supplemental disclosure of cash flow information**

<b>Cash paid for interest</b>	\$	400	\$	2,700
<b>Cash paid for income taxes</b>			\$	1,600

\* See  
accompanying  
notes to these  
financial  
statements.

**NOCOPI TECHNOLOGIES, INC.**

**NOTES TO FINANCIAL STATEMENTS  
(UNAUDITED)**

**Note 1. Financial Statements**

The accompanying unaudited condensed financial statements have been prepared by Nocopi Technologies, Inc. (the Company). These statements include all adjustments (consisting only of normal recurring adjustments) which management believes necessary for a fair presentation of the statements and have been prepared on a consistent basis using the accounting policies described in the summary of Accounting Policies included in the Company's 2008 Annual Report on Form 10-K. Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the accompanying disclosures are adequate to make the information presented not misleading. The Notes to Financial Statements included in the 2008 Annual Report on Form 10-K should be read in conjunction with the accompanying interim financial statements. The interim operating results for the three and six months ended June 30, 2009 may not be necessarily indicative of the operating results expected for the full year.

**Note 2. Going Concern**

Since its inception, the Company has incurred significant losses and, as of June 30, 2009, had accumulated losses of \$12,880,900. For the six months ended June 30, 2009, the Company had a net loss from operations of \$306,200 and negative cash flow from operations of \$148,800. At June 30, 2009, the Company had negative working capital of \$196,500 and a stockholders' deficiency of \$176,800. For the year ended December 31, 2008, the Company's net loss from operations was \$362,300. Due in part to the recession that has and is continuing to negatively impact the country's economy, the Company, which is substantially dependent on its licensees to generate licensing revenues, may incur further operating losses and experience negative cash flow in the future. Achieving profitability and positive cash flow depends on the Company's ability to generate and sustain significant increases in revenues and gross profits from its traditional business and its newly formed Loss Prevention Division. There can be no assurances that the Company will be able to generate sufficient revenues and gross profits to return to and sustain profitability and positive cash flow in the future.

During 2008, the Company negotiated a \$100,000 revolving line of credit with a bank as an additional potential source of capital. During the second quarter of 2009, the Company borrowed \$75,000 under the line of credit to fund its operating activities. There can be no assurances that the bank will continue to make the line of credit available in the future. During the second quarter of 2009, the Company raised \$41,000 in a private placement whereby 640,625 shares of the Company's common stock were sold to two non-affiliated individual investors. Management of the Company is continuing to seek potential investors to fund investments needed to increase its operating revenues to levels that will sustain its operations, to fund the start-up of a new business line and to fund operating deficits that it anticipates will continue until revenues from traditional product lines increase and revenues from new product lines can be realized. There can be no assurances that the Company will be successful in obtaining sufficient additional capital,

or if it does, that the additional capital will enable the Company to impact its revenues so as to have a material positive effect on the Company's operations and cash flow. The Company believes that without additional capital, whether in the form of debt, equity or both, it may be forced to cease operations in the near future.

**Note 3. Stock Based Compensation**

The Company follows SFAS 123(R), Share-Based Payment and uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award.

In February 2009, the Board of Directors of the Company, under the Company's 1999 Stock Option Plan, granted options to acquire 200,000 shares of its common stock to five employees of the Company, options to acquire 75,000 shares of its common stock to two consultants and options to acquire 50,000 shares of its common stock to an officer of the Company at \$.12 per share. The options vest after one year and expire after five years. In accordance with the fair value method as described in accounting requirements of SFAS No. 123(R), compensation expense of approximately \$22,900 is being recognized over the vesting period of the options through February 2010 to account for the cost of services received by the Company in exchange for the grant of stock options. During the three months and six months ended June 30, 2009, compensation expense of approximately \$6,000 and \$7,900, respectively, was recognized. As of June 30, 2009, the unrecognized portion of compensation expense was approximately \$15,000.

On April 30, 2008, under the Company's directors' option plan (the Plan), options to acquire 100,000 shares of the Company's common stock were granted to each of the five members of the Board of Directors of the Company, including one member who is also an executive officer of the Company, at \$.45 per share. Under the terms of the Plan, the options (i) vested on January 1, 2009 and (ii) will expire five years from the date of grant. In accordance with the fair value method as described in accounting requirements of SFAS No. 123(R), compensation expense of approximately \$121,700 was recognized during 2008 to account for the cost of employee and director services received by the Company in exchange for the grant of stock options. During the three and six months ended June 30, 2008, compensation expense of approximately \$30,500 was recognized.

The Company's 1999 Stock Option Plan terminated in February 2009 and no further stock options can be granted under the plan; however, options granted before the termination date may be exercised through their expiration date.

The following table summarizes all stock option activity of the Company since December 31, 2008:

	Number of Shares	Exercise Price	Weighted Average Exercise Price
Outstanding options - December 31, 2008	2,250,000	\$ .10 to \$.45	\$ .23
Issued	325,000	\$ .12	\$ .12
Canceled	950,000	\$ .17	\$ .17
Outstanding options - June 30, 2009	1,625,000	\$ .10 to \$.45	\$ .24
Weighted average remaining contractual life (years)	2.79		
Exercisable options - June 30, 2009	1,300,000	\$ .10 to \$.45	\$ .27
Weighted average remaining contractual life (years)	2.32		

**Note 4. Line of Credit**

In August 2008, the Company negotiated a \$100,000 revolving line of credit with a bank to provide a source of working capital. The line of credit is secured by all the assets of the Company and bears interest at the bank's prime rate plus .5%. At June 30, 2009, the interest rate applicable to the Company's line of credit was 3.75%. The line of credit is subject to an annual review and quiet period. The Company presently is required to pay interest only on borrowings under the line of credit. During the three months ended June 30, 2009, the Company borrowed \$75,000 of the \$100,000 available under the line of credit.

**Note 5. Stockholders' Equity (Deficiency)**

During the second quarter of 2009, the Company sold 640,625 shares of its common stock to two non-affiliated individuals for a total of \$41,000 pursuant to a private placement. During the second quarter of 2008, a non-affiliated warrant holder exercised warrants to acquire 10,000 shares of common stock of the Company at \$.22 per share.

**Note 6. Other Income (Expenses)**

Other income (expenses) includes, for the three months and six months ended June 30, 2009, the reversal of \$69,100 of accounts payable related to invoices received from 2001 through 2003 from a business for consulting services that the Company, with legal counsel, has determined to be no longer statutorily payable as the statute of limitations to bring a claim has expired. Other

income (expenses) included, for the three months and six months ended June 30, 2008, the reversal of \$37,500 of accounts payable and accrued expenses that the Company, with legal counsel, determined to be no longer statutorily payable as the statute of limitations to bring a claim had expired.

**Note 7. Income Taxes**

There is no income tax benefit for the three months and six months ended June 30, 2009 and June 30, 2008 because the Company has determined that the realization of the net deferred tax asset is not assured. The Company has created a valuation allowance for the entire amount of such benefits. The Company recorded an income tax expense of \$900 in the three months and six months ended June 30, 2008 for certain state income taxes due for 2007 in excess of the tax liability recorded in that year.

There was no change in unrecognized tax benefits during the period ended June 30, 2009 and there was no accrual for uncertain tax positions as of June 30, 2009.

Tax years from 2005 through 2008 remain subject to examination by U.S. federal and state jurisdictions.

**Note 8. Loss per Share**

In accordance with SFAS No. 128, *Earnings per Share*, basic earnings (loss) per common share is computed using net earnings divided by the weighted average number of common shares outstanding for the periods presented. Diluted earnings per common share assumes that outstanding common shares were increased by shares issuable upon exercise of those stock options and warrants for which the market price exceeds the exercise price, less shares that could have been purchased by the Company with related proceeds. Because the Company reported a net loss for the three months and six months ended June 30, 2009 and June 30, 2008, common stock equivalents, consisting of stock options and warrants, were anti-dilutive.

**Note 9. Major Customer and Geographic Information**

The Company's revenues, expressed as a percentage of total revenues, from non-affiliated customers that equaled 10% or more of the Company's total revenues were:

	Three Months ended		Six Months ended	
	June 30		June 30	
	2009	2008	2009	2008
Customer A	34%	34%	36%	47%
Customer B	30%	31%	25%	22%
Customer C	17%	19%	18%	17%
Customer D	8%	6%	10%	6%

The Company's non-affiliate customers whose individual balances amounted to more than 10% of the Company's net accounts receivable, expressed as a percentage of net accounts receivable, were:

	June 30 2009	December 31 2008
Customer A	55%	65%
Customer B	24%	
Customer C	17%	28%
Customer D		3%

The Company performs ongoing credit evaluations of its customers and generally does not require collateral. The Company also maintains allowances for potential credit losses.

The Company's revenues by geographic region are as follows:

	Three Months ended June 30		Six Months ended June 30	
	2009	2008	2009	2008
North America	\$ 131,800	\$ 163,300	\$ 226,700	\$ 395,300
Other	55,700	74,200	74,400	114,000
	\$ 187,500	\$ 237,500	\$ 301,100	\$ 509,300

**Note 10. Subsequent Events**

The Company continues negotiations for employment agreements with three individuals, one of whom is a current employee of the Company, related to the Company's formation of a new sales and marketing division that focuses on sales of products to prevent and fight retail receipt and document fraud.

In July 2009, the Company sold 625,000 shares of its common stock to a non-affiliated investor for a total of \$35,000 pursuant to a private placement.

**Item 2.**

**NOCOPI TECHNOLOGIES, INC.**  
**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operation**

**Forward-Looking Information**

*This Form 10-Q contains 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, regarding, among other things, anticipated improvements in operations, the Company's plans, earnings, cash flow and expense estimates, strategies and prospects, both business and financial. All statements other than statements of current or historical fact contained in this report are forward-looking statements. The words believe, expect, anticipate, should, plan, will, may, intend, estimate, potential, continue and similar expressions, as they relate to the Company, are intended to identify forward-looking statements.*

The Company has based these forward-looking statements largely on its current expectations and projections about future events, financial trends, market opportunities, competition, and the adequacy of the Company's available cash resources, which the Company believes may affect its financial condition, results of operations, business strategy and financial needs. This Form 10-Q also contains forward-looking statements attributed to third parties. All such statements can be affected by inaccurate assumptions, including, without limitation, with respect to risks, uncertainties, anticipated operating efficiencies, new business prospects and the rate of expense increases. In light of these risks, uncertainties and assumptions, the forward-looking statements in this report may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. For these reasons, and because of the uncertainty relating to the current financial crisis in today's economic environment and the potential reduction in demand for the Company's products, you should not consider this information to be a guarantee by the Company or any other person that its objectives and plans will be achieved. When you consider these forward-looking statements, you should keep in mind the Risk Factors and other cautionary statements set forth in this Item 2 and elsewhere in this Form 10-Q. The Company's forward-looking statements speak only as of the date made. The Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Condensed Financial Statements and related notes included elsewhere in this report as well as with the Company's audited Financial Statements and Notes thereto for the year ended December 31, 2008 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2009, and keeping in mind this entire cautionary statement regarding forward-looking information.

## Results of Operations

The Company's revenues are derived from (i) royalties paid by licensees of the Company's technologies, (ii) fees for the provision of technical services to licensees and (iii) the direct sale of (a) products incorporating the Company's technologies, such as inks, security paper and pressure sensitive labels, and (b) equipment used to support the application of the Company's technologies, such as ink-jet printing systems. Royalties consist of guaranteed minimum royalties payable by the Company's licensees and/or additional royalties, which typically vary with the licensee's sales or production of products incorporating the licensed technology. Technical services, in the form of on-site or telephone consultations by members of the Company's technical staff, may be offered to licensees of the Company's technologies. The consulting fees are billed at agreed upon per diem or hourly rates at the time the services are rendered. Service fees and sales revenues vary directly with the number of units of service or product provided.

The Company recognizes revenue on its lines of business as follows:

a) License fees and royalties are recognized when the license term begins. Upon inception of the license term, revenue is recognized in a manner consistent with the nature of the transaction and the earnings process, which generally is ratably over the license term;

b) Product sales are recognized (i) upon shipment of products; (ii) when the price is fixed or determinable and (iii) when collectability is reasonably assured; and

c) Fees for technical services are recognized when (i) the service has been rendered; (ii) an arrangement exists; (iii) the price is fixed or determinable based upon a per diem or hourly rate; and (iv) collectability is reasonably assured.

The Company believes that, as fixed cost reductions beyond those it has achieved in recent years may not be achievable, its operating results are substantially dependent on revenue levels. Because revenues derived from licenses and royalties carry a much higher gross profit margin than other revenues, operating results are also substantially affected by changes in revenue mix.

Both the absolute amounts of the Company's revenues and the mix among the various sources of revenue are subject to substantial fluctuation. The Company has a relatively small number of substantial customers rather than a large number of small customers. Accordingly, changes in the revenue received from a significant customer can have a substantial effect on the Company's total revenue and on its revenue mix and overall financial performance. Such changes may result from a customer's product development delays, engineering changes, changes in product marketing strategies and the like. In addition, certain customers have, from time to time, sought to renegotiate certain provisions of their license agreements and, when the Company agrees to revise terms, revenues from the customer may be affected. The addition of a substantial new customer or the loss of a substantial existing customer may also have a substantial effect on the Company's total revenue, revenue mix and operating results.

Revenues for the second quarter of 2009 were \$187,500 compared to \$237,500 in the second quarter of 2008, a decrease of \$50,000, or approximately 21%. Licenses, royalties and fees decreased by \$14,600, or approximately 13%, to \$95,300 in the second quarter of 2009 from \$109,900 in the second quarter of 2008. The decrease in licenses, royalties and fees is due primarily to lower licensing revenues derived from three licensees in the entertainment and toy



products business and lower royalties from a licensee in the retail receipt and document fraud market resulting from the conversion of an exclusive license to a non-exclusive license at a lower royalty rate at the beginning of 2009 offset in part by revenues from two licenses signed in late 2008 and early 2009. The conversion to a non-exclusive license with this licensee in the retail receipt and document fraud market enables the Company to enter this market to sell its security products directly to loss prevention departments within retail businesses and chains and to license other printers who serve this market segment. Product and other sales decreased by \$35,400, or approximately 28%, to \$92,200 in the second quarter of 2009 from \$127,600 in the second quarter of 2008. Sales of both ink and security paper declined in the second quarter of 2009 compared to the second quarter of 2008. The lower level of ink sales in the second quarter of 2009 compared to the second quarter of 2008 is due primarily to lower ink requirements of the third party printers of the Company's major licensee in the entertainment and toy products business due to the licensee's decline in sales during the current period of economic decline. The Company derived revenues of approximately \$121,100 from licensees and their printers in the entertainment and toy products market in the second quarter of 2009 compared to approximately \$155,700 in the second quarter of 2008. Sales of security paper also declined in the second quarter of 2009 compared to the second quarter of 2008.

For the first six months of 2009, revenues were \$301,100, \$208,200, or approximately 41%, lower than revenues of \$509,300 in the first six months of 2008. Licenses, royalties and fees of \$165,800 in the first half of 2009 were \$138,300, or approximately 45%, lower than \$304,100 in the first half of 2008, due primarily to the same factors that caused the revenue decline in the second quarter of 2009 compared to the second quarter of 2008. Product and other sales declined by \$69,900, or approximately 34%, to \$135,300 in the first half of 2009 from \$205,200 in the first half of 2008. The lower level of ink sales in the first half of 2009 compared to the first half of 2008 is due primarily to lower ink requirements of the third party printers of the Company's major licensee in the entertainment and toy products business related to the licensee's declines in sales during the current period of economic decline. The Company derived revenues of approximately \$185,600 from licensees and their printers in the entertainment and toy products market in the first half of 2009 compared to approximately \$353,500 in the first half of 2008. Additionally, ink sales to the Company's licensee in the retail receipt and document fraud market declined in the first half of 2009 compared to the first half of 2008. The Company also experienced a decline in sales of its security papers in the first half of 2009 compared to the first half of 2008.

The Company's gross profit decreased to \$98,000 in the second quarter of 2009 or approximately 52% of revenues from \$137,500 or approximately 58% of revenues in the second quarter of 2008. Licenses, royalties and fees have historically carried a higher gross profit than product and other sales, which generally consist of supplies or other manufactured products which incorporate the Company's technologies or equipment used to support the application of its technologies. These items (except for inks which are manufactured by the Company) are generally purchased from third-party vendors and resold to the end-user or licensee and carry a lower gross profit than licenses, royalties and fees. The lower gross profit in the second quarter of 2009 compared to the second quarter of 2008 results primarily from lower gross revenues from licenses, royalties and fees and product and other sales in the second quarter of 2009 compared to the second quarter of 2008.

For the first six months of 2009, the gross profit was \$144,400, or approximately 48% of revenues, compared to \$324,200, or approximately 64% of revenues, in the first six months of

2008. The decrease in the gross profit in absolute dollars and as a percentage of revenues in the first half of 2009 compared to the first half of 2008 resulted from lower gross revenues of both licenses, royalties and fees and product and other sales in the first half of 2009 compared to the first half of 2008.

As the variable component of cost of revenues related to licenses, royalties and fees is a low percentage of these revenues and the fixed component is not substantial, period to period changes in revenues from licenses, royalties and fees can significantly affect both the gross profit from licenses, royalties and fees as well as the overall gross profit. Primarily due to the decrease in revenues from licenses, royalties and fees in the second quarter of 2009 compared to the second quarter of 2008, the gross profit from licenses, royalties and fees decreased to approximately 76% of revenues from licenses, royalties and fees in the second quarter of 2009 from approximately 78% in the second quarter of 2008 and to approximately 74% of revenues from licenses, royalties and fees in the first half of 2009 from approximately 85% in the first half of 2008.

The gross profit, expressed as a percentage of revenues, of product and other sales is dependent on both the overall sales volumes of product and other sales and on the mix of the specific goods produced and/or sold. As a result of lower sales of both inks and security paper products in the second quarter of 2009 compared to the second quarter of 2008, the gross profit from product and other sales declined to approximately 28% of revenues in the second quarter of 2009 compared to approximately 40% of revenues from product and other sales in the second quarter of 2008 and to approximately 16% of revenues from product and other sales in the first half of 2009 compared to approximately 33% of revenues from product and other sales in the first half of 2008.

Research and development expenses of \$40,900 and \$83,100 in the second quarter and first six months of 2009 were comparable to \$39,800 and \$82,100 in the second quarter and first six months of 2008.

Sales and marketing expenses increased to \$95,700 in the second quarter of 2009 from \$65,600 in the second quarter of 2008 and to \$169,600 in the first six months of 2009 from \$133,500 in the first six months of 2008. The increase in both the second quarter and first six months of 2009 compared to the second quarter and first six months of 2008 reflects fees paid to two sales consultants involved in the start up of the Company's new Loss Prevention Division, participation in three Loss Prevention trade shows in the second quarter of 2009 and related travel expenses offset in part by lower commission expense on the lower level of sales and lower costs associated with the Company's web site in the second quarter and first six months of 2009 compared to the second quarter and first six months of 2008.

General and administrative expenses decreased to \$88,300 in the second quarter of 2009 from \$112,600 in the second quarter of 2008. The decrease in the second quarter of 2009 compared to the second quarter of 2008 is due primarily to: a) \$6,000 in expenses recorded in the second quarter of 2009 in connection with the issuance of 325,000 options to purchase shares of the Company's common stock in February 2009 to employees, an officer and others compared to \$30,500 in expenses recorded in the second quarter of 2008 in connection with the issuance of 500,000 options to purchase shares of the Company's common stock to members of the Company's Board of Directors in April 2008; b) no patent acquisition and maintenance expenses in the second quarter of 2009; c) lower insurance expense in the second quarter of 2009

compared to the second quarter of 2008 related to favorable policy renewals and d) lower legal expenses due to lower requirements in the second quarter of 2009 compared to the second quarter of 2008 offset in part by higher compensation expense due to the inception in June 2008 of an employment agreement with the Company's Chief Executive Officer.

For the first six months of 2009, general and administrative expenses decreased to \$197,900 from \$248,900 in the first six months of 2008 due primarily to: a) the non-recurrence of the Company's one-time contribution in the first half of 2008 of \$40,000 to a licensee of the Company under an agreement whereby the licensee acquired an interest in a patent held by a third party and the Company received, among other things, certain assurances regarding its continuing ability to manufacture and sell products to this licensee; b) \$7,900 in expenses recorded in the first half of 2009 in connection with the issuance of 325,000 options to purchase shares of the Company's common stock in February 2009 to employees, an officer and others compared to \$30,500 in expenses recorded in the first half of 2008 in connection with the issuance of 500,000 options to purchase shares of the Company's common stock to members of the Company's Board of Directors in April 2008; c) no patent acquisition and maintenance expenses in the first half of 2009; and d) lower insurance expense in the first half of 2009 compared to the first half of 2008 related to favorable policy renewals offset in part by higher compensation expense due to the inception in June 2008 of an employment agreement with the Company's Chief Executive Officer.

Other income (expenses) includes, for the three months and six months ended June 30, 2009, the reversal of \$69,100 of accounts payable related to invoices received from 2001 through 2003 from a business for consulting services that the Company, with legal counsel, has determined to be no longer statutorily payable as the statute of limitations to bring a claim has expired. Other income (expenses) included, for the three months and six months ended June 30, 2008, the reversal of \$37,500 of accounts payable and accrued expenses that the Company, with legal counsel, determined to be no longer statutorily payable as the statute of limitations to bring a claim had expired.

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