

CLEARSIGN COMBUSTION CORP
Form 10-Q
May 08, 2014

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 March 31, 2014

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 001-35521

CLEARSIGN COMBUSTION CORPORATION

(Exact name of registrant as specified in its charter)

WASHINGTON

26-2056298

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(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

12870 Interurban Avenue South

Seattle, Washington 98168

(Address of principal executive offices)

(Zip Code)

(206) 673-4848

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 than 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, or a non-accelerated filer. See definition of "accelerated filer," and "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of May 8, 2014 the issuer has 9,631,913 shares of common stock, par value \$.0001, issued and outstanding.

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PART I-FINANCIAL INFORMATION**ITEM 1****ClearSign Combustion Corporation****(a Development Stage Company)****Condensed Balance Sheets****(Unaudited)**

	March 31, 2014	December 31, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	\$6,503,000	\$2,688,000
Prepaid expenses	42,000	118,000
Total current assets	6,545,000	2,806,000
Fixed assets, net		
Patents and other intangible assets	1,779,000	1,459,000
Other assets	10,000	10,000
Total Assets	\$8,720,000	\$4,702,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$284,000	\$297,000
Accrued compensation and taxes	322,000	586,000
Total current liabilities	606,000	883,000
Deferred rent	40,000	31,000
Total liabilities	646,000	914,000

Commitments and Contingencies

Stockholders' Equity:

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Preferred stock, \$0.0001 par value, zero shares issued and outstanding	-	-
Common stock, \$0.0001 par value, 9,631,913 and 8,810,674 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	1,000	1,000
Additional paid-in capital	23,683,000	17,751,000
Deficit accumulated in the development stage	(15,610,000)	(13,964,000)
Total stockholders' equity	8,074,000	3,788,000
Total Liabilities and Stockholders' Equity	\$8,720,000	\$4,702,000

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

ClearSign Combustion Corporation**(a Development Stage Company)****Condensed Statements of Operations****(Unaudited)**

	For the Three Months Ended March 31,		For the Period from Inception (January 23, 2008) to March 31, 2014
	2014	2013	
Co-development revenue	\$-	\$-	\$93,000
Cost of co-development revenue	-	-	88,000
Gross profit	-	-	5,000
Operating expenses:			
Research and development	607,000	458,000	4,165,000
General and administrative	1,040,000	903,000	11,487,000
Total operating expenses	1,647,000	1,361,000	15,652,000
Loss from operations	(1,647,000)	(1,361,000)	(15,647,000)
Other income (expense):			
Interest income	1,000	4,000	38,000
Interest expense	-	-	(1,000)
Total other income (expense)	1,000	4,000	37,000
Net Loss	\$(1,646,000)	\$(1,357,000)	\$(15,610,000)
Net Loss per share - basic and fully diluted	\$(0.18)	\$(0.15)	\$(3.26)
Weighted average number of shares outstanding - basic and fully diluted	9,060,163	8,781,348	4,795,460

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

ClearSign Combustion Corporation**(a Development Stage Company)****Condensed Statement of Stockholders' Equity****(Unaudited)****For the period from Inception (January 23, 2008) to March 31, 2014**

	Common Stock		Common Stock		Additional Paid-In Capital	Deficit Accumulated in the Development Stage	Total Stockholders' Equity
	Shares	Amount	Class B Shares	Amount			
Shares issued to founders, at no cost	1,065,000	\$-	476,000	\$ -	\$33,000	\$-	\$ 33,000
Shares issued for services (\$0.02 per share)	125,000	-	-	-	2,000	-	2,000
Shares issued for cash (\$0.02 per share)	-	-	384,000	-	10,000	-	10,000
Shares issued for cash (\$1.80 per share)	467,310	-	-	-	841,000	-	841,000
Shares issued for cash (\$2.20 per share)	1,363,364	-	-	-	2,999,000	-	2,999,000
Issuance costs	-	-	-	-	(813,000)	-	(813,000)
Shares issued in initial public offering (\$4.00 per share)	3,450,000	1,000	-	-	13,799,000	-	13,800,000
Issuance costs of initial public offering	-	-	-	-	(2,727,000)	-	(2,727,000)
Share based payments of warrants	-	-	-	-	240,000	-	240,000
Shares issued for services (\$1.80 per share)	146,644	-	-	-	264,000	-	264,000
Shares issued for services (\$2.20 per share)	733,523	-	-	-	1,614,000	-	1,614,000
Shares issued for services (\$4.00 per share)	18,000	-	-	-	72,000	-	72,000
Shares issued for services (\$4.94 per share)	20,799	-	-	-	103,000	-	103,000
Shares issued for services (\$5.00 per share)	30,000	-	-	-	150,000	-	150,000
Shares issued for services (\$9.12 per share)	11,250	-	-	-	102,000	-	102,000

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Shares issued upon exercise of warrant (\$2.20 per share)	17,409	-	-	-	39,000	-	39,000
Shares issued to retire payable (\$4.00 per share)	110,000	-	-	-	440,000	-	440,000
Conversion of shares	1,075,000	-	(860,000)	-	-	-	-
Share based compensation	177,375	-	-	-	583,000	-	583,000
Net loss	-	-	-	-	-	(13,964,000)	(13,964,000)
Balances at December 31, 2013	8,810,674	1,000	-	-	17,751,000	(13,964,000)	3,788,000
Shares issued in registered direct offering (\$8.00 per share)	812,500	-	-	-	6,500,000	-	6,500,000
Issuance costs of registered direct offering	-	-	-	-	(812,000)	-	(812,000)
Share based payments of warrants	-	-	-	-	92,000	-	92,000
Shares issued for services (\$10.26 per share)	5,404	-	-	-	55,000	-	55,000
Shares issued upon exercise of options (\$4.88 per share)	3,335	-	-	-	16,000	-	16,000
Share based compensation	-	-	-	-	81,000	-	81,000
Net loss	-	-	-	-	-	(1,646,000)	(1,646,000)
Balances at March 31, 2014	9,631,913	\$ 1,000	-	\$ -	\$ 23,683,000	\$(15,610,000)	\$ 8,074,000

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

ClearSign Combustion Corporation**(a Development Stage Company)****Condensed Statements of Cash Flows****(Unaudited)**

	For the Three Months Ended March 31,		For the Period from Inception (January 23, 2008) to March 31, 2014
	2014	2013	
Cash flows from operating activities:			
Net loss	\$(1,646,000)	\$(1,357,000)	\$(15,610,000)
Adjustments to reconcile net loss to net cash used in operating activities:			
Common stock issued or issuable for services	55,000	37,000	1,836,000
Share based payments	81,000	39,000	549,000
Depreciation	58,000	52,000	424,000
Abandonment of capitalized patents	8,000	-	12,000
Deferred rent	9,000	(1,000)	40,000
Change in operating assets and liabilities:			
Prepaid expenses	76,000	15,000	(42,000)
Other assets	-	-	(10,000)
Accounts payable	(13,000)	49,000	778,000
Accrued compensation	(264,000)	97,000	437,000
Net cash used in operating activities	(1,636,000)	(1,069,000)	(11,586,000)
Cash flows from investing activities:			
Acquisition of fixed assets	(17,000)	(141,000)	(789,000)
Disbursements for patents and other intangible assets	(328,000)	(162,000)	(1,791,000)
Net cash used in investing activities	(345,000)	(303,000)	(2,580,000)
Cash flows from financing activities:			
Proceeds from issuance of common stock for cash, net of offering costs	5,796,000	-	20,717,000
Proceeds from issuance of short term promissory note	-	-	98,000
Principal payments on promissory notes	-	-	(146,000)
Net cash provided by financing activities	5,796,000	-	20,669,000

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Net increase (decrease) in cash and cash equivalents	3,815,000	(1,372,000)	6,503,000
Cash and cash equivalents, beginning of period	2,688,000	8,027,000	-
Cash and cash equivalents, end of period	\$6,503,000	\$6,655,000	\$6,503,000

Supplemental disclosure of cash flow information:

Cash paid during the period for interest	\$-	\$-	\$1,000
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Supplemental disclosure of non-cash investing and financing activities:

-

During the three months ended March 31, 2014, the Company:

issued warrants to purchase 20,313 shares of common stock valued at \$92,000 as part of a placement agent fee related to the March 2014 registered direct offering of common stock.

During the three months ended March 31, 2013, the Company:

issued 30,000 shares of common stock valued at \$150,000 to directors for services performed in 2013.

During the period from inception (January 23, 2008) to March 31, 2014, exclusive of the above, the Company:

issued 11,250 shares of common stock valued at \$102,000 to a consultant for services performed from April to December 2013,
 issued warrants to purchase 345,000 shares of common stock valued at \$128,000 as part of an underwriting fee related to the initial public offering,
 issued 110,000 shares of common stock valued at \$440,000 in partial satisfaction of an account payable,
 issued 20,799 shares of common stock valued at \$103,000 to directors for services performed from April to December 2012,
 issued 18,000 shares of common stock valued at \$72,000 to a consultant for services performed in 2012,
 issued 263,637 shares of common stock valued at \$580,000 and warrants to purchase 136,368 shares of common stock valued at \$64,000 for issuance costs related to a common stock offering,
 issued 454,547 shares of common stock valued at \$1,000,000 to MDB Capital Group LLC for consulting services in 2011,
 issued 52,375 shares of common stock valued at \$115,000 to certain employees to partially satisfy compensation accrued at December 31, 2010,
 issued 68,091 shares of common stock valued at \$126,000 in order to discharge \$99,000 of common stock to be issued at December 31, 2010 and pay rent for the eight months ended August 31, 2011,
 issued 49,728 shares of common stock valued at \$90,000 in order to discharge the common stock to be issued at December 31, 2010,
 canceled 5,825 shares valued at \$10,000 in order to partially discharge common stock to be issued at December 31, 2010,
 made stock grants of 50,000 and 75,000 shares to an employee valued at \$275,000 which is to be earned from July 2011 to September 2016,
 swapped 860,000 shares of Class B common stock held by its founding shareholders for 1,075,000 shares of common stock,
 converted a \$46,000 account payable to a vendor and acquired a fixed asset valued at \$2,000 through a \$48,000 interest-bearing promissory note retired in 2012,

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- issued 3,555 shares of common stock valued at \$8,000 in partial satisfaction of an account payable,
- issued 10,834 shares of common stock valued at \$20,000 in exchange for equipment, and
- issued 2,000 shares of common stock valued at \$4,000 to a consultant for services performed in 2011.

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

ClearSign Combustion Corporation

(a Development Stage Company)

Notes to Unaudited Condensed Financial Statements

Note 1 – Organization and Description of Business

ClearSign Combustion Corporation (ClearSign or the Company) is a development stage company located in Seattle, Washington and incorporated in the state of Washington on January 23, 2008. The Company was formed to design, develop and market technologies that improve both the energy efficiency and emission control characteristics of combustion systems. The Company's primary technologies include its Electrodynamic Combustion Control™ or ECC™ technology, which introduces a computer-controlled electric field into the combustion region which may better control gas-phase chemical reactions and improve system performance and cost-effectiveness, and its Duplex™ technology, which achieves very low emissions without the need of external flue gas recirculation, selective catalytic reduction, or higher excess air operation.

As a development stage company, the Company has generated limited revenues from operations to date to meet its operating expenses, and has historically financed its operations primarily through issuances of equity securities. The Company has incurred losses since its inception totaling \$15,610,000 and expects to experience operating losses and negative cash flow for the foreseeable future. Management believes that the successful growth and operation of the Company's business is dependent upon its ability to obtain adequate sources of funding through co-development agreements, strategic partnering agreements, or equity or debt financing to adequately support research and development efforts, protect intellectual property, form relationships with strategic partners, and provide for working capital and general corporate purposes. There can be no assurance that the Company will be successful in achieving its long-term plans as set forth above, or that such plans, if consummated, will enable the Company to obtain profitable operations or continue in the long-term as a going concern.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission for Form 10-Q. Accordingly, certain 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. The condensed balance sheet at December 31, 2013 has been derived from the Company's audited financial statements.

In the opinion of management, these financial statements reflect all normal recurring and other adjustments necessary for a fair presentation. These financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year or any other future periods.

Development Stage Enterprise

The Company is a development stage company as defined in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 915, *Development Stage Entities*. The Company is devoting substantially all of its present efforts to design and develop new technologies in combustion systems and its planned principal operations have not yet commenced. The Company has not generated any significant revenues from operations and has no assurance of any future revenues. All losses accumulated since January 23, 2008 have been considered as part of the Company's development stage activities.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition

The Company recognizes revenue on co-development agreements using the percentage of completion method. Under this method, the completion percentage is determined by dividing costs incurred to date by total estimated project costs. Since these projects will require technological development to complete, which by its nature is difficult to predict, the actual cost required to complete contracted work may vary from estimates. Estimated project costs are revised regularly which can alter the reported level of project profitability. Any estimated project losses are recognized in the current reporting period. Customer billings are recorded when cash receipts are probable and in accordance with the underlying co-development contract. If billings exceed recognized revenue, the difference is recorded as a current liability, while any recognized revenues exceeding billings are recorded as a current asset. Recognized revenues are subject to revisions as the contract progresses to completion and actual revenue and cost become certain. Revisions in revenue estimates are reflected in the period in which the facts that give rise to the revision become known.

Cost of Revenue

Cost of co-development revenue includes both direct and allocated indirect costs of completing the scope of work of co-development agreements. Direct costs include labor, materials and other costs incurred directly in fulfilling co-development agreements. Indirect costs include labor, rent, depreciation and other costs associated with operating the Company. Due to the nature of the work involved, the cost of co-development projects may fluctuate substantially from period to period.

Cash and Cash Equivalents

Highly liquid investments purchased with an original maturity of three months or less are considered cash equivalents. Cash is maintained with a commercial bank where accounts are generally guaranteed by the Federal Deposit Insurance Corporation up to \$250,000. The Company's deposits may at times exceed this limit. The Company has not

experienced losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents.

Fixed Assets

Fixed assets are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are depreciated over the life of the lease or their useful life, whichever is shorter. All other fixed assets are depreciated over two to four years. Maintenance and repairs are expensed as incurred.

Patents and Trademarks

Patents and trademarks are recorded at cost. Amortization is computed using the straight-line method over the estimated useful lives of the assets once they are awarded, which has not yet occurred.

Impairment of Long-Lived Assets

The Company tests long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through the estimated undiscounted cash flows expected to result from the use and eventual disposition of the assets. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair values are reduced for the cost of disposal. During the three months ended March 31, 2014, the Company recorded an impairment loss of \$8,000 from abandonment of capitalized patents. As of March 31, 2014, the Company had recorded impairment losses since its inception of \$12,000 from abandonment of capitalized patents.

Fair Value of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Assets and liabilities measured at fair value are categorized based on whether or not the inputs are observable in the market and the degree that the inputs are observable. The categorization of financial assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The Company's financial instruments primarily consist of cash and cash equivalents, accounts payable and accrued expenses. As of the balance sheet dates, the estimated fair values of the financial instruments were not materially different from their carrying values as presented on the balance sheets. This is primarily attributed to the short maturities of these instruments. The Company did not identify any other non-recurring assets and liabilities that are required to be presented in the balance sheets at fair value.

Research and Development

The cost of research and development is expensed as incurred. Research and development costs consist of salaries, benefits, share based compensation, consulting fees, rent, utilities, depreciation, and consumables.

Deferred Rent

Operating lease agreements which contain provisions for future rent increases or periods in which rent payments are reduced or abated are recorded in monthly rent expense in the amount of the total payments over the lease term divided by the number of months of the lease term. The difference between rent expense recorded and the amount paid is credited or charged to deferred rent which is reflected on the accompanying balance sheet.

Income Taxes

The Company accounts for income taxes using an asset and liability approach which allows for the recognition and measurement of deferred tax assets based upon the likelihood of realization of tax benefits in future years. Under the asset and liability approach, deferred taxes are provided for the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before the Company is able to realize their benefits, or that future deductibility is uncertain. Tax benefits from an uncertain tax position are recognized only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate resolution.

Stock-Based Compensation

The costs of all employee stock options, as well as other equity-based compensation arrangements, are reflected in the financial statements based on the estimated fair value of the awards on the grant date. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. Stock compensation for stock granted to non-employees is determined as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

Net Loss per Common Share

Basic loss per share is computed by dividing loss available to common stockholders by the weighted-average number of common shares outstanding. Diluted loss per share is computed similar to basic loss per share except that the denominator is increased to include additional common shares available upon exercise of stock options and warrants using the treasury stock method, except for periods for which no common share equivalents are included because their effect would be anti-dilutive. At March 31, 2014 and 2013, potentially dilutive shares outstanding amounted to 1,249,582 and 1,124,733, respectively.

Recently Issued Accounting Pronouncements

Management does not believe that any recently issued, but not yet effective standards, if adopted, will have a material effect on the financial statements.

Emerging Growth Company

The Company is an emerging growth company as defined under the Jumpstart Our Business Startups Act of 2012 (JOBS Act). An emerging growth company may delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. The Company will remain an emerging growth company until December 31, 2017, although it will lose that status sooner if its revenues exceed \$1 billion, if it issues more than \$1 billion in non-convertible debt in a three year period, or if the market value of its common stock that is held by non-affiliates exceeds \$700 million as of any June 30. At June 30, 2013, the market value of the Company's common stock that is held by non-affiliates totaled \$60 million.

Note 3 – Fixed Assets

Fixed assets are summarized as follows:

March 31, December
 31,

	2014	2013
Machinery and equipment	\$635,000	\$633,000
Office furniture and equipment	98,000	95,000
Leasehold improvements	62,000	62,000
Accumulated depreciation	(425,000)	(366,000)
	370,000	424,000
Construction in progress	16,000	3,000
	\$386,000	\$427,000

Note 4 – Stockholders’ Equity

Common Stock and Preferred Stock

The Company is authorized to issue 62,500,000 shares of common stock and 2,000,000 shares of preferred stock. Preferences, limitations, voting powers and relative rights of any preferred stock to be issued may be determined by the Company’s Board of Directors. The Company has not issued any shares of preferred stock.

In March 2014, the Company completed a registered direct offering of common stock whereby 812,500 shares were issued at \$8.00 per share. Gross proceeds from the offering totaled \$6.5 million and net cash proceeds approximated \$5.8 million. Expenses of the offering approximated \$0.8 million. Cash expenses included placement agent fees of \$488,000, placement agent legal and other fees of \$75,000, issuer legal fees of \$113,000, and other costs of \$44,000. Non-cash expenses consisted of a placement agent warrant to purchase 20,313 shares of the Company’s common stock at \$10.00 per share exercisable until March 2019 valued at \$92,000.

Equity Incentive Plan

The Company has an Equity Incentive Plan (the Plan) which provides for the granting of options to purchase shares of common stock, stock awards to purchase shares at no less than 85% of the value of the shares, and stock bonuses to officers, employees, board members, consultants, and advisors. The Compensation Committee of the Board of Directors is authorized to administer the Plan and establish the grant terms, including the grant price, vesting period and exercise date. As of March 31, 2014, the number of shares reserved for issuance under the Plan totaled 991,300 shares. The Plan provides for quarterly increases in the available number of authorized shares equal to the lesser of 10% of any new shares issued by the Company during the quarter immediately prior to the adjustment date or such lesser amount as the Board of Directors shall determine.

In February 2014, the Company granted 122,880 stock options under the Equity Incentive Plan to certain employees. The stock options have an exercise price of \$9.90 per share, the grant date fair value, a contractual life of 10 years, and vest over four years. The fair value of stock options granted in February 2014 estimated on the date of grant using the Black-Scholes option valuation model was \$721,000. The recognized compensation expense associated with these grants for the three months ended March 31, 2014 was \$45,000. The following weighted-average assumptions were utilized in the calculation of the fair value of the stock options:

Expected life	6.25	years
Weighted average volatility	75	%
Forfeiture rate	12	%
Weighted average risk-free interest rate	1.92	%
Expected dividend rate	-	

In February 2014, the Company granted 14,625 shares of common stock under the Equity Incentive Plan to its three independent directors in accordance with board agreements for service in 2014 and subject to completion of service each quarter. The fair value of the stock at the time of grant was \$10.26 per share for a total value of \$150,000 which the Company will recognize in general and administrative expense on a pro-rated quarterly basis in 2014, including \$37,000 for the three months ended March 31, 2014.

In January 2014, an employee exercised 3,335 stock options with a strike price of \$4.88 per share whereby the Company received \$16,000 in proceeds.

Outstanding stock option grants at March 31, 2014 and December 31, 2013 totaled 685,310 and 565,765 with 356,409 and 317,354 being vested and exercisable at March 31, 2014 and December 31, 2013, respectively. Stock grants made to date through March 31, 2014 and December 31, 2013 totaled 179,456 shares and 175,799 shares, respectively. Of

these amounts, 40,000 and 44,000 at March 31, 2014 and December 31, 2013, respectively, are subject to declining repurchase rights by the Company at \$0.0001 per share through September 30, 2016. The recognized compensation expense associated with these grants for the three months ended March 31, 2014 and 2013 and for the period from inception (January 23, 2008) to March 31, 2014 totaled \$81,000, \$39,000, and \$549,000, respectively. At March 31, 2014, the number of shares reserved under the Plan but unissued totaled 126,537. At March 31, 2014, there was \$1,006,000 of total unrecognized compensation cost related to non-vested share based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted average period of 3.3 years.

Consultant Stock Plan

On May 2, 2013, the shareholders approved the 2013 Consultant Stock Plan (the Consultant Plan) which provides for the granting of shares of common stock to consultants who provide services related to capital raising, investor relations, and making a market in or promoting the Company's securities. The Company's officers, employees, and board members are not entitled to receive grants from the Consultant Plan. The Compensation Committee of the Board of Directors is authorized to administer the Consultant Plan and establish the grant terms. The number of shares reserved for issuance under the Consultant Plan on the date of adoption of May 2, 2013, December 31, 2013, and March 31, 2014 totaled 75,000, 75,287, and 75,287 shares, respectively. The Consultant Plan provides for quarterly increases in the available number of authorized shares equal to the lesser of 1% of any new shares issued by the Company during the quarter immediately prior to the adjustment date or such lesser amount as the Board of Directors shall determine. In May 2013, the Company granted 11,250 shares from the Consultant Plan to a consultant for 2013 services. The fair value of the stock at the time of grant was \$9.12 per share for a total value of \$102,000 which the Company recognized in general and administrative expense on a quarterly basis over the remainder of 2013. In February 2014, the Company granted 7,000 shares of common stock under the Consultant Stock Plan to a consultant for service in 2014 and subject to completion of service each quarter. The fair value of the stock at the time of grant was \$10.26 per share for a total value of \$72,000 which the Company will recognize in general and administrative expense on a pro-rated quarterly basis in 2014. The Consultant Plan expense for the three months ended March 31, 2014 and 2013 was \$18,000 and \$0, respectively.

Warrants

In conjunction with the March 2014 registered direct offering of common stock, the Company granted a warrant to the placement agent to purchase 20,313 common stock shares at \$10.00 per share exercisable until March 2019. The fair value of these warrants was estimated to be \$92,000 on the date of the grant using the Black-Scholes option-pricing model. Expected volatility was determined based upon the historical prices of the Company's common stock. The risk-free rate for periods within the contractual life of the warrants is based on the U.S. Treasury yield in effect at the time of grant. The Company has never declared or paid dividends and has no plans to do so in the foreseeable future. The following weighted-average assumptions were utilized for the calculations:

Expected life (in years)	5
Weighted average volatility	74 %
Weighted average risk-free interest rate	1.49 %
Expected dividend rate	-

The Company has the following warrants outstanding at March 31, 2014:

Exercise Price	Total Outstanding Warrants		Life (in years)
	Warrants	Weighted Average Exercise Price	
\$1.80	80,000	\$1.80	6.89
\$2.20	118,959	\$2.20	2.11
\$5.00	345,000	\$5.00	3.07
\$10.00	20,313	\$10.00	4.93
	564,272	\$4.14	

Note 5 – Related Party Transactions

For the three months ended March 31, 2014 and 2013 and for the period from inception (January 23, 2008) to March 31, 2014, the Company incurred consulting fees of \$0, \$30,000, and \$365,000, respectively, to the Alternative Energy Resource Alliance, a non-profit organization whose executive director is David Goodson. In exchange, Mr. Goodson provides scientific consulting services to the Company. Mr. Goodson is a director and co-founder of the Company and, through an irrevocable trust, a significant beneficial owner of the Company's common stock at March 31, 2014.

Note 6 – Commitments and Contingencies

The Company has a triple net lease for office and laboratory space for the period November 2011 to February 2017. Under the terms of the lease, the Company paid no rent for the period November 2011 to February 2012 and for February 2014. Rent escalates annually by 3%. The Company records monthly rent expense equal to the total of the payments over the lease term divided by the number of months of the lease term. Therefore, rent expense of \$9,000 was accrued for the three months ended March 31, 2014 and for the three months ended March 31, 2013 the deferred rent was reduced by \$1,000. Under the terms of the lease, the Company also pays triple net operating costs which currently approximate \$3,000 per month. Minimum future payments under the lease at March 31, 2014 are as follows:

2014	\$ 100,000
2015	137,000
2016	141,000
2017	24,000
	\$402,000

For the three months ended March 31, 2014 and 2013 and for the period from inception (January 23, 2008) to March 31, 2014, rent expense amounted to \$39,000, \$34,000, and \$467,000, respectively.

The Company and its Chief Executive Officer, Richard F. Rutkowski, are parties to an employment agreement (the Agreement) which terminates on January 1, 2017, unless earlier terminated. Compensation under the Agreement includes an annual salary of \$359,000 with annual cost-of-living adjustments, annual cash and equity bonuses based on performance standards established by the Compensation Committee of the Board of Directors, medical and dental benefits for Mr. Rutkowski and his family, disability insurance, and term life insurance for the benefit of his dependents. The Agreement may be terminated by the Company without cause under certain circumstances, as defined in the Agreement whereby a severance payment would be due in the amount of compensation that would have been due had employment not been terminated or one year of the current annual compensation, whichever is greater.

The Company has agreements with its three independent directors to compensate them annually after the Company's common stock commenced trading publicly. The obligation totals \$300,000 per year of which \$150,000 is to be paid with the Company's common stock at fair value. Directors are elected for annual terms which expire in May 2015.

The Company's former legal advisors, Perkins Coie LLP, contacted management in March 2012 that they believe TWB Investment Partnership II, L.P., a party related to Perkins Coie LLP, has the right to acquire 25,250 shares of the Company's common stock at \$0.02 per share pursuant to an engagement letter dated December 4, 2007. The claim was denied since, among other defenses, management believes it entered into a full settlement of all amounts owed to

Perkins Coie LLP in November 2011. There has been no further communication with Perkins Coie LLP regarding the matter since March 2012.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND OTHER INFORMATION
CONTAINED IN THIS REPORT**

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and the provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements give our current expectations or forecasts of future events. You can identify these statements by the fact that they do not relate strictly to historical or current facts. You can find many (but not all) of these statements by looking for words such as “approximates,” “believes,” “hopes,” “expects,” “anticipates,” “estimates,” “projects,” “intends,” “plans,” “would,” “should,” “could,” “may,” or other similar expressions in the report. In particular, these include statements relating to future actions, prospective products, applications, customers, technologies, future performance or results of anticipated products, expenses, and financial results. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our historical experience and our present expectations or projections. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to:

- our limited cash and our history of losses;
- our ability to achieve profitability;
- our limited operating history;
- emerging competition and rapidly advancing technology in our industry that may outpace our technology;
- our ability to develop commercially viable products based upon our technology;
- customer demand for the products and services we develop;
- the impact of competitive or alternative products, technologies and pricing;
- our ability to manufacture any products we develop;
- general economic conditions and events and the impact they may have on us and our potential customers;
- our ability to obtain adequate financing in the future;

- our ability to continue as a going concern;
- our success at managing the risks involved in the foregoing items; and
- other factors discussed in this report.

The forward-looking statements are based upon management's beliefs and assumptions and are made as of the date of this report. We undertake no obligation to publicly update or revise any forward-looking statements included in this report. You should not place undue reliance on these forward-looking statements.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the unaudited condensed financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q as well as our audited financial statements and related notes included in our Annual Report on Form 10-K. In addition to historical information, this discussion and analysis here and throughout this Form 10-Q contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements.

OVERVIEW

We are a development stage company located in Seattle, Washington that designs and develops technologies that aim to improve both the energy efficiency and emission control characteristics of combustion systems. Our core technologies include our Electrodynamic Combustion Control™ (ECC™) and Duplex™ technologies. Our ECC technology introduces a computer-controlled electric field into a combustion system in order to better control gas-phase chemical reactions and improve system performance and cost-effectiveness. Our Duplex technology uses a unique refractory tile to homogenize the flame temperature and achieve very low emissions without the need of external flue gas recirculation, selective catalytic reduction, or higher excess air operation. To date, our operations have been funded primarily through sales of our common stock. We have earned no significant revenue since inception on January 23, 2008.

Plan of Operation

We are pursuing development of our technology to enable future sales. These activities entail laboratory research, where we have successfully demonstrated our proprietary technology operating in our research facility with thermal output of 1,000,000 BTUs per hour, and business development and marketing activities with established manufacturers and other entities that use boilers, solid fuel burners, refinery heaters, and other combustion systems. We intend to enter into collaborative arrangements which would enable us to work closely with established companies in specific industries to apply developed solutions in laboratory and field settings. We currently are pursuing a broad development program with the cooperation of two companies involved in solid fuel combustion. Further, we are seeking other solid fuel dependent companies to participate in this project. Through March 31, 2014, we have received \$93,000 in co-development revenue from Covanta Energy Corporation, a waste-to-energy service company and subsidiary of Covanta Holding Corporation, and a commercial wood pellet boiler unit from Grandeg, a privately-owned original equipment manufacturer based in Riga, Latvia. However, there is no assurance that additional revenues will be realized, terms will be reached, or a final agreement executed between us and either of these companies.

In April and May 2012, we completed an initial public offering (IPO) of our common stock whereby we sold 3,450,000 shares of common stock at \$4.00 per share, which included the exercise of the underwriter's overallotment option, resulting in gross proceeds of \$13.8 million and, after deducting certain costs paid with common stock, net proceeds of \$11.6 million.

In March 2014, we completed a registered direct offering of our common stock whereby we sold 812,500 shares of common stock at \$8.00 per share resulting in gross proceeds of \$6.5 million and net proceeds of approximately \$5.8 million. We currently intend to use the net proceeds from this offering as follows: approximately \$2 million for research and development including capital expenditures, approximately \$1 million for protection of intellectual property, approximately \$1 million for business development and marketing, and the balance for working capital and general corporate purposes. We expect the net proceeds from the offering to be sufficient to fund our activities at least through January 2015.

Our anticipated costs include employee salaries and benefits, compensation paid to consultants, capital costs for research and other equipment, costs associated with development activities including travel and administration, legal expenses, sales and marketing costs, general and administrative expenses, and other costs associated with an early stage, publicly-traded technology company. We currently have 13 full-time employees and 2 part-time employees. We anticipate continuing to increase the number of employees required to support our activities in the areas of research and development, sales and marketing, and general and administrative functions. We expect to incur consulting expenses related to technology development commensurate with our current levels and we expect to incur increasing expenses to protect our intellectual property. We expect capital expenditures to be approximately \$0.5 million annually, but these are highly dependent on the nature of the operations where co-development activities are ongoing.