SERVOTRONICS INC /DE/
Form 10-Q
May 13, 2011
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
Form 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2011

or

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

Commission File No. 1-07109
SERVOTRONICS, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 16-0837866 |
| (State or other jurisdiction of incorporation or organization) | (I. R. S. Employer Identification No.) |

1110 Maple Street
Elma, New York 14059
(Address of principal executive offices) (zip code)
(716) 655-5990
(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 x No o

Indicate by checkmark 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) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

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 oAccelerated filer oNon-accelerated filer oSmaller reporting company 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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

| Class | Outstanding at April 30, 2011 |
| --- | --- |
| Common Stock, $.20 par value | 2,237,371 |

INDEX

SERVOTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
($000's omitted except share and per share data)

| | March 31, 2011 (Unaudited) | December 31, 2010 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $4,170 | $4,447 |
| Accounts receivable, net | 5,978 | 5,427 |
| Inventories, net | 11,158 | 11,032 |
| Prepaid income taxes | 56 | 226 |
| Deferred income taxes | 567 | 567 |
| Other assets | 679 | 352 |
| Total current assets | 22,608 | 22,051 |
| Property, plant and equipment, net | 6,094 | 6,159 |
| Other non-current assets | 302 | 296 |
| Total Assets | $29,004 | $28,506 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | $297 | $323 |
| Current portion of capital lease related party | 81 | 81 |
| Accounts payable | 1,203 | 1,247 |
| Accrued employee compensation and benefit costs | 1,564 | 1,332 |
| Other accrued liabilities | 180 | 230 |
| Total current liabilities | 3,325 | 3,213 |
| Long-term debt | 3,046 | 3,058 |
| Long-term portion of capital lease related party | 394 | 414 |
| Deferred income taxes | 509 | 509 |
| Shareholders' equity: | | |
| Common stock, par value $.20; authorized 4,000,000 shares; issued 2,614,506 shares; outstanding 1,981,877 (1,981,877 – 2010) shares | 523 | 523 |
| Capital in excess of par value | 13,491 | 13,491 |
| Retained earnings | 11,885 | 11,467 |
| Accumulated other comprehensive loss | (78) | (78) |
| | 25,821 | 25,403 |
| Employee stock ownership trust commitment | (1,367) | (1,367) |
| Treasury stock, at cost 377,135 (377,135 – 2010) shares | (2,724) | (2,724) |
| Total shareholders' equity | 21,730 | 21,312 |
| Total Liabilities and Shareholders' Equity | $29,004 | $28,506 |

See notes to consolidated financial statements

SERVOTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
($000's omitted except per share data)
(Unaudited)

| | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Revenue | $8,275 | $7,884 |
| Costs, expenses and other income: | | |
| Cost of goods sold, exclusive of depreciation and amortization | 6,209 | 5,490 |
| Selling, general and administrative | 1,297 | 1,297 |
| Interest expense | 15 | 17 |
| Depreciation and amortization | 167 | 163 |
| Other income, net | (10) | (15) |
| | 7,678 | 6,952 |
| Income before income tax provision | 597 | 932 |
| Income tax provision | 179 | 310 |
| Net income | $418 | $622 |
| | | |
| Income per share: | | |
| Basic | | |
| Net income per share | $0.21 | $0.32 |
| Diluted | | |
| Net income per share | $0.19 | $0.29 |

See notes to consolidated financial statements

SERVOTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
($000's omitted)
(Unaudited)

| | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Cash flows related to operating activities: | | |
| Net income | $418 | $622 |
| Adjustments to reconcile net income to net Cash used in operating activities - | | |
| Depreciation and amortization | 167 | 163 |
| Change in assets and liabilities - | | |
| Accounts receivable | (551) | (1,462) |
| Inventories | (126) | 240 |
| Prepaid income taxes | 170 | 205 |
| Other assets | (327) | (155) |
| Other non-current assets | (6) | (107) |
| Accounts payable | (44) | (173) |
| Accrued employee compensation and benefit costs | 231 | 380 |
| Other accrued liabilities | (50) | (393) |
| Accrued income taxes | - | 95 |
| Net cash used in operating activities | (118) | (585) |
| Cash flows related to investing activities: | | |
| Capital expenditures - property, plant and equipment | (101) | (77) |
| Net cash used in investing activities | (101) | (77) |
| Cash flows related to financing activities: | | |
| Principal payments on long-term debt | (38) | (38) |
| Principal payments on capital lease related party | (20) | (22) |
| Cash dividend | - | (336) |
| Net cash used in financing activities | (58) | (396) |
| Net decrease in cash and cash equivalents | (277) | (1,058) |
| Cash and cash equivalents at beginning of period | 4,447 | 3,825 |
| Cash and cash equivalents at end of period | $4,170 | $2,767 |

See notes to consolidated financial statements

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by United States generally accepted accounting principles for complete financial statements.

The accompanying consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature. Operating results for the three months ending March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The consolidated financial statements should be read in conjunction with the 2010 annual report and the notes thereto.

2. Business Description and Summary of Significant Accounting Policies

Business Description

Servotronics, Inc. and its subsidiaries design, manufacture and market advanced technology products consisting primarily of control components and consumer products consisting of knives and various types of cutlery and other edged products.

Principles of Consolidation

The consolidated financial statements include the accounts of Servotronics, Inc. and its wholly-owned subsidiaries (the "Company"). All intercompany balances and transactions have been eliminated upon consolidation.

Cash and Cash Equivalents

The Company considers cash and cash equivalents to include all cash accounts and short-term investments purchased with an original maturity of three months or less. Cash equivalents consist primarily of short-term certificates of deposits.

Accounts Receivable

The Company grants credit to substantially all of its customers and carries its accounts receivable at original invoice amount less an allowance for doubtful accounts. On a periodic basis, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts based on history of past write-offs, collections, and current credit conditions. The allowance for doubtful accounts amounted to approximately $113,000 at March 31, 2011 and $117,000 at December 31, 2010.

Revenue Recognition

Revenues are recognized as services are rendered or as units are shipped and at the designated FOB point consistent with the transfer of title, risks and rewards of ownership. Such purchase orders generally include specific terms relative to quantity, item description, specifications, price, customer responsibility for in-process costs, delivery schedule, shipping point, payment and other standard terms and conditions of purchase.

Inventories

Inventories are stated at the lower of standard cost or net realizable value. Cost includes all costs incurred to bring each product to its present location and condition, which approximates actual cost (first-in, first-out). Market provisions in respect of net realizable value and inventory expected to be used in greater than one year are applied to the gross value of the inventory through a reserve of approximately $647,000 and $651,000 at March 31, 2011 and December 31, 2010, respectively. Pre-production and start-up costs are expensed as incurred.

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The purchase of suppliers' minimum economic quantities of material such as steel, etc. may result in a purchase of quantities exceeding one year of customer requirements. Also, in order to maintain a reasonable and/or agreed to lead time, certain larger quantities of other product support items may have to be purchased and may result in over one year's supply.

Shipping and Handling Costs

Shipping and handling costs are classified as a component of cost of goods sold.

Property, Plant and Equipment

Property, plant and equipment is carried at cost; expenditures for new facilities and equipment and expenditures which substantially increase the useful lives of existing plant and equipment are capitalized; expenditures for maintenance and repairs are expensed as incurred. Upon disposal of properties, the related cost and accumulated depreciation are removed from the respective accounts and any profit or loss on disposition is included in income.

Depreciation is provided on the basis of estimated useful lives of depreciable properties, primarily by the straight-line method for financial statement purposes and by accelerated methods for tax purposes. Depreciation expense includes the amortization of capital lease assets. The estimated useful lives of depreciable properties are generally as follows:

| | |
|---|---|
| Buildings and improvements | 5-39 years |
| Machinery and equipment | 5-15 years |
| Tooling | 3-5 years |

Income Taxes

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of operating loss and credit carryforwards and temporary differences between the carrying amounts and the tax basis of assets and liabilities. The Company and its subsidiaries file a consolidated federal income tax return, a consolidated New York State income tax return and separate Pennsylvania and Arkansas state income tax returns.

The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company did not have any accrued interest or penalties included in its consolidated balance sheets at March 31, 2011 or December 31, 2010, and did not recognize any interest and/or penalties in its consolidated statements of income during the three months ended March 31, 2011 and 2010.

Supplemental cash flow information

Income taxes paid during the three months ended March 31, 2011 and 2010 amounted to approximately $22,000 and $20,000, respectively. Interest paid during the three months ended March 31, 2011 and 2010 amounted to approximately $15,000 and $17,000, respectively.

Employee Stock Ownership Plan

Contributions to the employee stock ownership plan are determined annually by the Company according to plan formula.

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable based on undiscounted future operating cash flow analyses. If an impairment is determined to exist, any related impairment loss is calculated based on fair value. Impairment losses on assets to be disposed of, if any, are based on the estimated proceeds to be received, less costs of disposal. The Company has determined no circumstances that would require testing of impairment of long lived assets existed at March 31, 2011 and December 31, 2010.

Use of Estimates

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

Reclassifications

Certain balances as previously reported were reclassified to conform with classifications adopted in the current period.

Research and Development Costs

Research and development costs are expensed as incurred.

Concentration of Credit Risks

Financial instruments that potentially subject the Company to concentration of credit risks principally consist of cash accounts in financial institutions. Although the accounts exceed the federally insured deposit amount, management does not anticipate nonperformance by the financial institutions. Refer to Note 12, Business Segments, for disclosures related to customer concentrations.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, accounts receivable, inventories, accounts payable and accrued expenses are reasonable estimates of their fair value due to their short maturity. Based on variable interest rates and the borrowing rates currently available to the Company for loans similar to its long-term debt, the fair value approximates its carrying amount.

3. Inventories

March 31,

| | 2011 | December 31, 2010 |
|---|---|---|
| | ($000's omitted) | |
| Raw materials and common parts, net of reserve | $5,425 | $5,491 |
| Work-in-process | 3,934 | 3,358 |
| Finished goods | 1,799 | 2,183 |
| Total inventories, net of reserve | $11,158 | $11,032 |

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Property, Plant and Equipment

| | March 31, 2011 | December 31, 2010 |
|---|---|---|
| | ($000's omitted) | |
| Land | $ 25 | $ 25 |
| Buildings | 7,080 | 7,060 |
| Machinery, equipment and tooling (including capital lease) | 12,524 | 12,444 |
| | 19,629 | 19,529 |
| Less accumulated depreciation and amortization | (13,535) | (13,370) |
| Total property, plant and equipment | $ 6,094 | $ 6,159 |

Property, plant and equipment includes land and building in Elma, New York, under a $5,000,000 capital lease which can be purchased for a nominal amount at the end of the lease term. As of March 31, 2011 and December 31, 2010, accumulated amortization on the building amounted to approximately $2,325,000 and $2,293,000, respectively. Amortization expense amounted to $32,000 and $35,000 for the three month periods ended March 31, 2011 and 2010, respectively. The associated current and long-term liabilities are discussed in Note 5, Long-Term Debt, of the accompanying consolidated financial statements. Property, plant and equipment also includes machinery and equipment under a $588,000 capital lease with related party. As of March 31, 2011 and December 31, 2010, accumulated amortization on the machinery and equipment amounted to approximately $119,000 and $98,000, respectively. Amortization expense amounted to $21,000 for the three month periods ended March 31, 2011 and 2010, respectively. The associated current and long-term liabilities are discussed in Note 6, Capital Lease – Related Party, of the accompanying consolidated financial statements. Depreciation expense amounted to $112,000 and $107,000 for the three month periods ended March 31, 2011 and 2010, respectively. The combined depreciation and amortization expense were $167,000 and $163,000 for the three month periods ended March 31, 2011 and 2010, respectively. The Company believes that it maintains property and casualty insurance in amounts adequate for the risk and nature of its assets and operations and which are generally customary in its industry.

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Long-Term Debt

| | March 31, 2011 | December 31, 2010 |
|---|---|---|
| | ($000's omitted) | |
| Industrial Development Revenue Bonds; secured by an equivalent letter of credit from a bank with interest payable monthly at a floating rate (0.45% at March 31, 2011) (A) | $ 3,130 | $ 3,130 |
| Term loan payable to a financial institution; interest at LIBOR plus 2%, (2.26% at March 31, 2011); quarterly principal payments of $26,786 through the fourth quarter of 2011 | 80 | 107 |
| Secured term loan payable to a government agency; monthly payments of $1,950 including interest fixed at 3% payable through fourth quarter of 2015 | 102 | 107 |
| Secured term loan payable to a government agency; monthly principal payments of approximately $2,000 with interest waived payable through second quarter of 2012 | 31 | 37 |
| | 3,343 | 3,381 |
| Less current portion | (297 ) | (323 ) |
| | $ 3,046 | $ 3,058 |

(A) The Industrial Development Revenue Bonds were issued by a government agency to finance the construction of the Company's headquarters/advanced technology facility. Annual sinking fund payments of $170,000 commenced December 1, 2000 and continue through 2013, with a final payment of $2,620,000 due December 1, 2014. The Company has agreed to reimburse the issuer of the letter of credit if there are draws on that letter of credit. The Company pays the letter of credit bank an annual fee of 1% of the amount secured thereby and pays the remarketing agent for the bonds an annual fee of 1/4% of the principal amount outstanding. The Company's interest under the facility capital lease has been pledged to secure its obligations to the government agency, the bank and the bondholders.

The Company also has an unsecured $1,000,000 line of credit on which there was no balance outstanding at March 31, 2011 and December 31, 2010.

Certain lenders require the Company to comply with debt covenants as described in the specific loan documents, including a debt service ratio. At March 31, 2011 and December 31, 2010, the Company was in compliance with its debt covenants.

6. Capital Lease – Related Party

On November 3, 2009, the Company entered into a capital lease with a related party of the Company for certain equipment to be used in the expansion of the Company's capabilities and product lines. See Note 10, Related Party Transactions, of the accompanying consolidated financial statements for information on the related party transaction. Monthly payments of $7,500, which include an imputed fixed interest rate of 2.00%, commenced November 3, 2009 and will continue through the fourth quarter of 2016. At March 31, 2011, the present value of the minimal lease payment is approximately $475,000 (after subtracting approximately $27,000 of imputed interest).

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. Income Taxes

The Company did not have any material uncertain tax positions or unrecognized tax benefits or obligations as of March 31, 2011 and December 31, 2010.

The Company and/or its subsidiaries file income tax returns in the United States federal jurisdiction and in the states of New York, Pennsylvania and Arkansas. During the third quarter of 2009, the New York State Department of Taxation and Finance (NYS) commenced an examination of the Company's New York State franchise tax returns for the years 2005 through 2007. In the third quarter of 2010, the examination was completed and resulted in no change to the Company's originally filed returns. Also, during the third quarter of 2010, the Internal Revenue Service commenced an examination of the Company's Federal Income tax returns for years 2008 and 2009. In the first quarter of 2011, the examination was completed and resulted in no material adjustments to the originally filed returns. The 2007 and 2010 federal and 2008 through 2010 state tax returns remain open for potential examination by taxing authorities.

8. Shareholders' Equity

($000's omitted except for share data)

| | Common stock Number of shares issued | Amount | Capital in excess of par value | Retained earnings | ESOP | Treasury stock | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|---|---|---|---|---|---|---|---|---|
| Balance December 31, 2010 | 2,614,506 | $523 | $13,491 | $11,467 | $(1,367 ) | $(2,724 ) | $ (78 ) | $ 21,312 |
| Net income | - | - | - | 418 | - | - | - | 418 |
| Balance March 31, 2011 | 2,614,506 | $523 | $13,491 | $11,885 | $(1,367 ) | $(2,724 ) | $ (78 ) | $ 21,730 |

In January of 2006, the Company's Board of Directors authorized the purchase by the Company of up to 250,000 shares of its common stock in the open market or in privately negotiated transactions. On October 31, 2008, the Company announced that its Board of Directors authorized the purchase of an additional 200,000 shares of the Company's common stock under the Company's current purchase program. As of March 31, 2011, the Company has purchased 238,088 shares and there remain 211,912 shares available to purchase under this program. There were no shares purchased by the Company during the three month periods ended March 31, 2011 and 2010.

On April 4, 2011, the Company announced that its Board of Directors declared a $0.15 per share cash dividend. The dividend will be paid on May 20, 2011 to shareholders of record on April 29, 2011 and will be approximately $336,000 in the aggregate. This fourth consecutive annual dividend does not represent that the Company will pay dividends on a regular or scheduled basis.

Earnings Per Share

Basic earnings per share is computed by dividing net earnings by the weighted average number of shares outstanding during the period. Diluted earnings per share is computed by dividing net earnings by the weighted average number of shares outstanding during the period plus the number of shares of common stock that would be issued assuming all contingently issuable shares having a dilutive effect on the earnings per share that were outstanding for the period. Incremental shares from assumed conversions are calculated as the number of shares that would be issued, net of the number of shares that could be purchased in the marketplace with the cash received upon stock option exercise.

SERVOTRONICS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| | ($000's omitted except per share data) | |
| Net income | $ 418 | $ 622 |
| Weighted average common shares outstanding (basic) | 1,982 | 1,961 |
| Incremental shares from assumed conversions of stock options | 171 | 173 |
| Weighted average common shares outstanding (diluted) | 2,153 | 2,134 |
| Basic | | |
| Net income per share | $ 0.21 | $ 0.32 |
| Diluted | | |
| Net income per share | $ 0.19 | $ 0.29 |

9. Commitments

The Company leases certain equipment and real property pursuant to operating lease arrangements. Total rental expense in the three month periods ended March 31, 2011 and 2010 and future minimum payments under such leases are not material to consolidated financial statements. The Company also leases certain personal property being accounted for under a style="DISPLAY: block; MARGIN-LEFT: 0pt; TEXT-INDENT: 0pt; MARGIN-RIGHT: 0pt" align="justify">
The category of "Audit-related fees" includes employee benefit plan audits, internal control reviews and accounting consultation.

The category of "Tax fees" includes consultation related to corporate development activities.

All above audit services, audit-related services and tax services were pre-approved by the Board of Directors, which concluded that the provision of such services by Moquist Thorvilson Kaufmann Kennedy & Pieper LLC was compatible with the maintenance of that firm's independence in the conduct of its auditing functions.

31

Table of Contents

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

| Exhibit Number | Description |
|---|---|
| 3.1 | Certificate of Incorporation of Axis Technologies Group, Inc.(1) |
| 3.1(a) | Certificate of Amendment of Certificate of Incorporation, dated September 19, 2006(2) |
| 3.2 | Bylaws of Axis Technologies Group, Inc. (1) |
| 4.1 | Securities Purchase Agreement dated April 25, 2008 with Gemini Master Fund, Ltd. (1) |
| 4.2 | 10% Senior Secured Convertible Note dated April 25, 2008 with Gemini Master Fund, Ltd. (1) |
| 4.3 | Common Stock Purchase Warrant dated April 25, 2008 with Gemini Master Fund, Ltd. (1) |
| 10.1 | Security Agreement dated April 25, 2008 with Gemini Master Fund, Ltd. (1) |
| 10.2 | Intellectual Property Security Agreement dated April 25, 2008 by and between Axis Technologies, Inc. and Gemini Master Fund, Ltd. (1) |
| 10.3 | Guarantee Agreement dated April 25, 2008 by Axis Technologies, Inc., as Guarantor, in favor of Gemini Master Fund, Ltd. (1) |
| 10.4 | Co-Exclusive License Agreement for Simplified Daylight Harvesting Technology dated January 1, 2008 with The Regents of the University of California, a California Corporation(1) |
| 10.5 | Manufacturing Agreement with Shanghai Lighting and Gold, Inc. dated August 22, 2003 (1) |
| 10.6 | United States Patent (No. U.S. 6,969,955) for a "Method and Apparatus for Dimming Control of Electronic Ballasts" dated November 29, 2005(1) |
| 10.7 | United States Trademark (Reg No. 3,001,445) for "The Future of Fluorescent Lighting" dated September 27, 2005(1) |
| 10.8 | Form of Lock-Up Agreement(1) |
| 10.9 | Fluorescent Lamp Ballast: First Quarter 2006(2) |
| 10.10 | Letter of Understanding with Merritt Media, Inc., dated March 16, 2005(2) |
| 10.11 | Promissory Note, dated May 20, 2009 with MidAmerica Funding Co., Inc. (3) |
| 10.12 | Amendment Agreement, dated December 30, 2009 with Gemini Master Fund, Ltd. (3) |
| 10.13 | Amended and Restated 10% Senior Secured Convertible Note, dated December 30, 2009 with Gemini Master Fund, Ltd. (3) |
| 10.14 | Axis Joint Venture Agreement, dated April 22, 2010. (4) |
| 10.15 | Promissory Note from DHAB, LLC, dated April 22, 2010. (4) |
| 10.16 | Stock Pledge and Security Agreement by DHAB, LLC in favor of the Company, dated April 22, 2010. (4) |
| 10.17 | Security Agreement by the Company in favor of IRC – Interstate Realty Corporation, dated April 22, 2010. (4) |
| 10.18 | Amendment Agreement with Gemini Strategies, LLC and Gemini Master Fund, Ltd., dated April 22, 2010. (5) |
| 21 | List of Subsidiaries (1) |
| 31.1 | Certification of Chief Executive Officer of Axis Technologies Group, Inc. required by Rule 13a-14(1) or Rule 15d - 14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. * |
| 31.2 | Certification of Principal Financial Officer of Axis Technologies Group, Inc. required by Rule 13a-14(1) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.* |
| 32.1 | Certification of Chief Executive Officer of Axis Technologies Group, Inc. pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and Section 1350 of 18 U.S.C. 63.* |
| 32.2 | Certification of Principal Financial Officer of Axis Technologies Group, Inc. pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and Section 1350 of 18 U.S.C. 63.* |

(1) Previously filed with our Registration Statement on Form 10, dated July 24, 2008

(2) Previously filed with our Registration Statement on Form 10, dated October 9, 2008
(3) Previously filed with our Form 10-Q, dated April 30, 2010.
(4) Previously filed with our Form 8-K, dated May 3, 2010.
(5) Previously filed with our Form 8-K/A, dated June 21, 2010.
* Filed herewith

32

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AXIS TECHNOLOGIES GROUP, INC.

By /s/ Kipton Hirschbach Date: June 21, 2010
Kipton Hirschbach
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Kipton Hirschbach Date: June 21, 2010
Kipton Hirschbach
Chief Executive Officer and Director

By: /s/ James Erickson Date: June 21, 2010
James Erickson
Chief Accounting Officer,
Principal Financial Officer and Director

Table of Contents

REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Stockholders of Axis Technologies Group, Inc.

We have audited the accompanying consolidated balance sheets of Axis Technologies Group, Inc. (the "Company") as of December 31, 2009 and 2008 and the related consolidated statements of operations, stockholders' deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States of America). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Axis Technologies Group, Inc. as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered losses from operations and its total liabilities exceed its total assets. These factors raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Moquist Thorvilson Kaufmann Kennedy & Pieper LLC

Edina, Minnesota
June 21, 2010

Table of Contents

Axis Technologies Group, Inc.
Consolidated Balance Sheets
December 31, 2009 and 2008

| | 2009 | 2008 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash | $11,488 | $12,205 |
| Accounts receivable, net of returns allowance of $36,660 and $0, respectively | 32,136 | 150,609 |
| Inventory | 226,412 | 337,566 |
| Inventory deposits | 89,878 | 58,497 |
| Prepaid expenses | 2,973 | 3,412 |
| Total Current Assets | 362,887 | 562,289 |
| PROPERTY AND EQUIPMENT | | |
| Property and equipment | 18,667 | 18,188 |
| Less: accumulated depreciation | (15,191) | (12,899) |
| Net Property and Equipment | 3,476 | 5,289 |
| OTHER ASSETS | | |
| Patents, net of accumulated amortization of $3,479 and $2,627, respectively | 13,558 | 14,410 |
| Deferred financing costs, net | 31,481 | 180,300 |
| Total Other Assets | 45,039 | 194,710 |
| TOTAL ASSETS | $411,402 | $762,288 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $162,209 | $145,108 |
| Accrued expenses | 120,915 | 92,053 |
| Short-term note payable | 107,167 | - |
| Convertible note payable, net of discounts $137,638 and $788,288, respectively | 1,746,459 | 600,601 |
| Accrued salary - officers/stockholders | 685,542 | 485,637 |
| Total Current Liabilities | 2,822,292 | 1,323,399 |
| STOCKHOLDERS' DEFICIT | | |
| Common stock, $0.001 par value, 500,000,000 shares authorized, 64,446,779 and 62,267,767 shares issued and outstanding, respectively | 64,447 | 62,268 |
| Additional paid-in capital | 3,622,542 | 3,202,261 |
| Stock issuable | 66,600 | 66,600 |
| Accumulated deficit | (6,164,479) | (3,892,240) |
| Total Stockholders' Deficit | (2,410,890) | (561,111) |
| TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT | $411,402 | $762,288 |

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

Table of Contents

Axis Technologies Group, Inc.
Consolidated Statements of Operations
For the Years Ended December 31, 2009 and 2008

| | 2009 | 2008 |
|---|---|---|
| Sales, net | $ 429,243 | $ 686,528 |
| Cost of goods sold | 329,730 | 566,694 |
| Gross profit | 99,513 | 119,834 |
| Operating expenses | 797,359 | 924,608 |
| Loss from operations | (697,846) | (804,774) |
| Other income (expense): | | |
| Interest income | 28 | 4,021 |
| Interest expense | (1,574,421) | (843,543) |
| Total other income (expense) | (1,574,393) | (839,522) |
| Net loss before income taxes | (2,272,239) | (1,644,296) |
| Income tax provision | - | - |
| Net loss | $ (2,272,239) | $ (1,644,296) |
| Net loss per common share (basic and diluted) | $ (0.036) | $ (0.026) |
| Weighted average shares outstanding: | | |
| Basic and diluted | 63,573,800 | 62,226,178 |

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

Table of Contents

Axis Technologies Group, Inc.
Consolidated Statements of Changes in Stockholders' Deficit
For the Years Ended December 31, 2009 and 2008

| | Common Stock Shares Issued and Outstanding | Amount | Additional Paid-in Capital | Shares Issuable | Accumulated Deficit | Total Stockholders' Deficit |
|---|---|---|---|---|---|---|
| Balance, December 31, 2007 | 62,037,767 | $ 62,038 | $ 1,908,239 | $ - | $ (2,247,944) | $ (277,667) |
| Restricted common stock awards - no immediate vesting | 60,000 | 60 | (60) | - | - | - |
| Compensation related to vesting of restricted common stock awards | | - | 10,152 | - | - | 10,152 |
| Issuance of common stock for compensation related to equity raised in 2007 | 60,000 | 60 | (60) | - | - | - |
| Issuance of common stock for contractor compensation | 60,000 | 60 | 18,540 | - | - | 18,600 |
| Issuance of common stock for placement costs related to convertible note payable | 50,000 | 50 | 15,450 | - | - | 15,500 |
| Issuance of detachable stock warrant related to convertible note payable | | - | 861,778 | - | - | 861,778 |
| Beneficial conversion cost related to convertible note payable | | - | 388,222 | - | - | 388,222 |
| Common shares issuable (180,000) as placement costs in connection with convertible note payable | | - | - | 66,600 | - | 66,600 |
| Net loss | - | - | - | - | (1,644,296) | (1,644,296) |
| Balance, December 31, 2008 | 62,267,767 | 62,268 | 3,202,261 | 66,600 | (3,892,240) | (561,111) |
| Compensation related to vesting of restricted common stock awards | | - | 8,448 | - | - | 8,448 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Issuance of common stock for contractor compensation | 250,000 | 250 | 47,250 | - | - | 47,500 |
| Conversion of $231,482 of principle and accrued interest on convertible notes payable into common stock, including additional beneficial conversion charges for variable conversion price totaling $135,031 | 1,929,012 | 1,929 | 364,583 | - | - | 366,512 |
| Net loss | | - | - | - | (2,272,239) | (2,272,239) |
| Balance, December 31, 2009 | 64,446,779 | $ 64,447 | $ 3,622,542 | $ 66,600 | $ (6,164,479) | $ (2,410,890) |

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

37

Axis Technologies Group, Inc.
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2009 and 2008

| | 2009 | 2008 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $ (2,272,239) | $ (1,644,296) |
| | | |
| Adjustments to reconcile net loss to net cash (used in) operations: | | |
| Depreciation | 2,292 | 2,966 |
| Amortization of patent costs | 852 | 852 |
| Share-based compensation | 8,448 | 10,152 |
| Issuance of common stock for services | 47,500 | 18,600 |
| Amortization of original issue discount | 65,065 | 60,060 |
| Amortization of debt issuance costs | 148,819 | 137,372 |
| Non-cash interest expense related to issuances of warrants and beneficial conversion features | 720,615 | 540,541 |
| Loan default interest charges added to notes payable | 384,723 | - |
| Provision for sales returns | 36,660 | - |
| | | |
| Changes in operating assets and liabilities: | | |
| Decrease (increase) in accounts receivable | 81,813 | (111,293) |
| Decrease in inventory and inventory deposits | 79,773 | 5,496 |
| Decrease (increase) in prepaid expenses | 439 | (783) |
| Increase in accounts payable | 17,101 | 96,105 |
| Increase in accrued salary - officers/stockholders | 199,905 | 41,931 |
| Increase in accrued expenses | 220,829 | 21,715 |
| Net cash used in operating activities | (257,405) | (820,582) |
| | | |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (479) | (1,095) |
| Net cash used in investing activities | (479) | (1,095) |
| | | |
| Cash flows from financing activities: | | |
| Cash proceeds from convertible notes payable, net of original issue discount of $138,889 and transaction fees of $32,000 in 2008 | - | 1,218,000 |
| Debt issuance costs | - | (203,572) |
| Payments on short-term notes payable | (42,833) | (195,074) |
| Proceeds from issuance of notes payable | 300,000 | - |
| Net cash provided by financing activities | 257,167 | 819,354 |
| | | |
| Net decrease in cash and cash equivalents | (717) | (2,323) |
| | | |
| Cash and cash equivalents at beginning of period | 12,205 | 14,528 |
| | | |
| Cash and cash equivalents at end of period | $ 11,488 | $ 12,205 |
| | | |
| Supplemental cash and non-cash flow information | | |

| | | | | |
|---|---|---|---|---|
| Cash paid for interest | $ | 82,814 | $ | 71,603 |
| Deferred financing costs paid with the issuance of common stock | $ | - | $ | 82,100 |
| Convertible debt discount recorded for warrant and beneficial conversion feature | $ | - | $ | 1,250,000 |
| Conversion of note payable to common stock | $ | 231,482 | $ | - |
| Accrued interest added to convertible note payable | $ | 191,967 | $ | - |

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

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

NOTE 1:
NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization: Riverside Entertainment, Inc. ("Riverside") was incorporated in the State of Delaware. On September 18, 2006, Riverside entered into a Share Exchange and Acquisition Agreement whereby it agreed to issue 45,000,000 shares of its common stock to acquire all of the outstanding shares of Axis Technologies, Inc. ("ATI"), a private corporation incorporated in 2003 in the State of Delaware. At the time of the share exchange transaction, Riverside was a non-reporting public company and had no current operations. ATI has developed and sells a daylight harvesting fluorescent lighting ballast that uses natural lighting to reduce electricity consumption. The Company's market for advertising and selling the product currently lies within North America.

Upon completion of the transaction on October 25, 2006, ATI became a wholly-owned subsidiary of Riverside and Riverside changed its name to Axis Technologies Group, Inc. (the "Company"). Since this transaction resulted in the existing shareholders of ATI acquiring control of Riverside, the share exchange transaction has been accounted for as an additional capitalization of Riverside (a reverse acquisition, with ATI being treated as the accounting acquirer for financial statement purposes).

The operations of ATI are the only continuing operations of the Company. In accounting for this transaction, ATI was deemed to be the purchaser and parent company for financial reporting purposes. Accordingly, its net assets were included in the consolidated balance sheet at their historical value.

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Axis Technology, Inc. All inter-company transactions and balances have been eliminated in the consolidation.

Management Estimates: The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the 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 income and expenses during the period. Actual results could differ from those estimates.

Cash and Cash Equivalents: For purposes of reporting cash flows, the Company considers all cash accounts which are not subject to withdrawal restrictions or penalties, and certificates of deposit with original maturities of 90 days or less to be cash or cash equivalents.

The Company has concentrated its credit risk for cash by maintaining deposits in financial institutions within the geographic region of Lincoln, Nebraska, which may at times exceed amounts covered by insurance provided by the U.S. Federal Deposit Insurance Corporation (FDIC). The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk to cash.

Customer Concentrations and Accounts Receivable: The accounts receivable arise in the normal course of business in selling products to customers. Concentrations of credit risk with respect to accounts receivable arise because the Company grants unsecured credit in the form of trade accounts receivable to its customers.

39

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

At December 31, 2009, one customer accounted for 41% of sales and two customers accounted for 62% of gross outstanding accounts receivable. At December 31, 2008, one customer accounted for 48% of sales and 45% of outstanding accounts receivable.

Accounts are written-off as they are deemed uncollectible based upon a periodic review of the accounts. As of December 31, 2009 and 2008, management has estimated that accounts receivable is fully collectible, and thus, has not established an allowance for doubtful accounts.

The Company has established a reserve for sales returns of $36,660 at December 31, 2009. The reserve is based on returns expected in 2010 for sales in 2009. There was no reserve at December 31, 2008.

Supplier Concentrations and Inventory: The Company maintains its inventory on a perpetual basis utilizing the first-in first-out (FIFO) method. Inventories have been valued at the lower of cost or market. Management has not recorded an obsolescence reserve for inventory at December 31, 2009 and 2008. All inventory is considered usable and market value is above cost.

The Company purchases 100% of its inventory from a supplier based in California with manufacturing facilities in China.

Property and Equipment: Property and equipment is reported at cost less accumulated depreciation. Maintenance and repairs are charged to expense as incurred. The cost of property and equipment is depreciated over the following estimated useful lives of the related assets using the straight-line basis:

| | |
|---|---|
| Office Equipment and Vehicle | 5 years |
| Computer Equipment | 3 years |

Intangible Assets: Intangible assets subject to amortization include patent costs, which are being amortized over twenty years. Amortization expense is estimated to be $850 for each of the next five years.

Long-Lived Assets: The Company periodically evaluates the carrying value of long-lived assets to be held and used, including but not limited to, capital assets and intangible assets, when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flow from such asset is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on long-lived assets to be disposed of are determined in a similar manner, except that fair values are reduced for the cost to dispose. The Company has reviewed long-lived assets and certain intangible assets with estimable useful lives and determined that the carrying value as of December 31, 2009, are recoverable in future periods.

Revenue Recognition: The Company recognizes revenue when persuasive evidence of an arrangement exists, transfer of title has occurred, the selling price is fixed or determinable, collectability is reasonably assured and delivery has occurred per the contract terms.

Warranty and return costs are estimated and accrued based on historical rates. For the years ended December 31, 2009 and 2008, total warranty and return costs were $7,114 and $13,347, respectively. The warranty reserve balances at December 31, 2009 and 2008 were $7,000 and $10,349, respectively.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

Deferred Financing Costs: Costs related to the convertible note payable issued by the Company on April 25, 2008, are being amortized using the effective interest method over the term (24 months) of the debt instrument to April 2010 (see Note 6).

Segment Reporting: The Company operates and manages the business under one reporting segment.

Advertising Costs: The Company expenses advertising costs in the period incurred. Advertising costs were $1,520 and $3,090 for the years ended December 31, 2009 and 2008, respectively.

Fair Value of Financial Instruments: The respective carrying value of certain on-balance sheet financial instruments approximates their fair values. These financial instruments include cash, accounts receivable, prepaid expenses, accounts payable and accrued liabilities, indebtedness to related parties and notes payable. Fair values were assumed to approximate cost or carrying values as most of the debt was incurred recently and the assets were acquired within one year. Management is of the opinion that the Company is not exposed to significant interest, credit or currency risks arising from these financial instruments.

Income Taxes: The Company accounts for deferred tax assets and liabilities under the liability method. Deferred tax liabilities are recognized for temporary differences that will result in taxable amounts in future years. Deferred tax assets are recognized for deductible temporary differences and tax operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled. The Company assesses the likelihood that deferred tax assets will be recovered from future taxable income and records a valuation allowance to reduce deferred tax assets to the amounts believed to be realizable. The Company concluded that a full valuation allowance against its U.S. deferred tax assets was appropriate as of December 31, 2009 and 2008.

The Company accounts for income taxes pursuant to Financial Accounting Standards Board (“FASB”) guidance which prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than not to be sustained upon examination by taxing authorities. The Company believes its income tax filing positions and deductions will be sustained upon examination and, accordingly, no reserves, or related accruals for interest and penalties has been recorded at December 31, 2009 and 2008. In accordance with the guidance, the Company has adopted a policy under which, if required to be recognized in the future, interest related to the underpayment of income taxes will be classified as a component of interest expense and any related penalties will be classified in operating expenses in the statements of operations. The Company’s remaining open tax years subject to examination by the Internal Revenue Service include the years ended December 31, 2006 through 2009.

Stock-Based Compensation

The Company accounts for stock-based payments to employees and non-employee directors, including grants of stock options and shares of non-vested stock, to be recognized in the financial statements based on the estimated fair value of the equity award issued.

Comprehensive Income (Loss): Comprehensive income (loss) includes net income (loss) and items defined as other comprehensive income (loss). Items defined as other comprehensive income (loss) include items such as foreign currency translation adjustments and unrealized gains and losses on certain marketable securities. For the years ended December 31, 2009 and 2008, there were no adjustments to net loss to arrive at comprehensive loss.

Net Loss per Common Share: Basic net loss per common share is computed by dividing net loss applicable to common shareholders by the weighted average number of common shares outstanding during the periods presented. Diluted net loss per common share is determined using the weighted average number of common shares outstanding during the periods presented, adjusted for the dilutive effect of any common stock equivalents, consisting of shares that might be issued upon exercise of options, warrants, and conversion of convertible debt.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

Recent Accounting Developments:

Effective September 15, 2009, the Company adopted a new accounting standard that establishes the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") as the exclusive reference to be applied in the preparation of financial statements in conformity with GAAP. Accordingly, all references to legacy guidance issued under previously recognized authoritative literature have been removed in the third quarter of fiscal 2009. The Company's adoption of this authoritative guidance changed how it references GAAP in its disclosures.

In June 2009, the FASB issued authoritative guidance that eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity and requires on-going qualitative reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. This guidance is effective for fiscal years beginning after November 15, 2009. The adoption of this guidance is not anticipated to have a material impact on the Company's consolidated financial statements.

In October 2009, the FASB issued guidance on the accounting for multiple-deliverable revenue arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable; eliminates the residual method of allocation and requires arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method; and requires a vendor to determine its best estimate of selling price in a manner consistent with that used to determine the selling price of the deliverable on a stand-alone basis. This guidance also expands the required disclosures related to a vendor's multiple-deliverable revenue arrangements. The guidance is effective beginning February 1, 2011 with early adoption permitted. The Company does not believe the adoption of this standard will have a material impact on our consolidated results of operations, financial condition, cash flows, or disclosures.

NOTE 2:
LIQUIDITY/GOING CONCERN

The Company has incurred significant operating losses during its periods of operation. At December 31, 2009, the Company reports a negative working capital position of $2,459,405, an accumulated deficit of $6,164,479, and a stockholders' deficit of $2,410,890. It is management's opinion that these facts raise substantial doubt about the Company's ability to continue as a going concern without additional debt or equity financing or the ability of the Company to increase revenues.

On April 22, 2010, the Company entered into a joint venture agreement with another Company to temporarily provide financing to facilitate the purchase of inventory. This same Company has committed to an equity placement of $6,000,000 (see Note 12 for additional information). As of June 21, 2010, the Company has not received any payment related to this equity transaction. However, the Company is uncertain such financing will be available to the Company if at all.

NOTE 3:
INVENTORIES

Inventories at December 31, 2009 and 2008 consist entirely of finished goods, totaling $226,412 and $337,566, respectively.

Deposits on purchases of inventory not received as of year-end totaled $89,878 and $58,497, at December 31, 2009 and 2008, respectively.

NOTE 4:
ACCRUED SALARY - OFFICERS/STOCKHOLDERS

Certain officers/stockholders of the Company have elected to forego a certain portion of their salary due to having limited operating funds in the past and for the foreseeable future. These amounts are due and mostly payable to these officers/stockholders as excess operating cash flows become available in the future. The total balance owed as of December 31, 2009 and 2008 is $685,542 and $485,637, respectively. Subsequent to year end, the Company issued stock for the balance due (see Note 12).

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

NOTE 5:
NOTES PAYABLE

On March 25, 2009, the Company entered into a debt instrument security agreement with Gemini Master Fund, Ltd. (“Gemini”), pursuant to which the Company issued a 10% Senior Secured Note in the principal amount of $150,000 (the “Note”) for working capital funds. The note has a mandatory default amount where the principal of the obligation increases 25% and the stated interest rate increases to 24% if the note is in default. The note was deemed in default in July 2009 and an interest charge of $37,500 was recorded and the note balance increased to $187,500. The note was refinanced on December 30, 2009 by adding the obligation plus accrued interest of $21,250 with the convertible note payable as discussed in Note 6.

On May 20, 2009, the Company issued a promissory note with Mid-America Funding Company generating net cash proceeds of $150,000 for working capital purposes. In connection with the note payable, the Company issued 1,000,000 shares of its common stock to be held in escrow as collateral for the loan. Additionally, the Company assigned a customer purchase order totaling $247,500 to the issuer as additional collateral on the note. The note bears interest at a monthly rate of 2% of the outstanding balance. The note is past due and demand can be made for payment in full. The note has a balance of $107,167 at December 31, 2009.

NOTE 6:
CONVERTIBLE NOTE PAYABLE

On April 25, 2008, the Company entered into a debt instrument security agreement with Gemini Master Fund LTD (“Gemini”), pursuant to which Gemini was issued a 10% Senior Secured Convertible Promissory Note in the principal amount of $1,388,889 (the “Note”). The face amount of the Note of $1,388,889 was reduced by an original issue discount of $138,889 and other issuance costs of $32,000 to arrive at net proceeds of $1,218,000.

In connection with the Note, the Company also incurred additional financing costs of $203,572 which were paid out of the net proceeds to third-party agents and issued 50,000 shares of common stock valued at $0.31 per share to these same agents. The Company is obligated to issue to the placement agents for this transaction an additional 180,000 shares valued at $0.37 per share totaling $66,600. The share price of which was based on the five day average closing price of the Company’s common stock prior to the closing date of the Note. These shares were ultimately issued to the agents on April 22, 2010.

The Note has a maturity date of April 25, 2010, and is secured by all assets of the Company. The Note accrues interest at a rate of 10% per annum, and such interest is payable on a quarterly basis commencing July 26, 2008, with the principal balance of the Note, together with any accrued and unpaid interest thereon, due in twelve monthly installments beginning May 1, 2009. The Company has the option to make the installment payments in cash or in common stock shares at a conversion price equal to the lesser of $0.26 or 80% of the lowest closing bid price occurring 10 trading days immediately preceding the date at which the price is determined. The May and June 2009 installment payments were made through issuance of common stock. This resulted in an additional beneficial conversion feature valued at $135,030 being charged as non-cash interest expense for the three-month period ended June 30, 2009 due to the variable conversion price.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

The Note has a mandatory default amount where the principal of the obligation increases by 30% and the stated interest rate increases to 24% if the note payments are in default. The note was deemed in default in July 2009. Therefore, the principal balance of the note was increased by $347,223 due to this default.

The Note is convertible at the option of the holder at any time into shares of the Company's common stock at an initial conversion price of $0.26 per share. The conversion price is subject to a weighted-average anti-dilution adjustment in the event the Company issues equity or equity-linked securities at a price below the then-applicable conversion price. The Note can be converted into a maximum of 4.9% of the Company’s outstanding common stock on the date of conversion.

Effective December 30, 2009, the Company entered into an Amendment Agreement and an Amended and Restated 10% Senior Secured Convertible Note with Gemini; thereby the Convertible Note Payable and related Note Payable to Gemini were amended. The Note Payable, as discussed in Note 5, accrued interest to date, and the increase in principal for the default terms were consolidated into this agreement. This resulted in the stated value of the combined loans to be $1,884,097 on December 30, 2009. In addition, the new agreement fixed the conversion share price of the debt to equity at a price of $0.10 per share and is now convertible on or after February 1, 2010. Previously, the Note had a variable conversion rate. All other terms remained the same. Additionally, in connection with the financing agreement that the Company entered into on April 22, 2010 (see Note 12 Subsequent Events), the Gemini consolidated loan was further extended to a maturity date of July 1, 2010.

The terms of the Securities Purchase Agreement issued in connection with the Note provides that until such time as Gemini no longer holds any of the securities or underlying securities purchased, the Company cannot issue shares of common stock, securities convertible into common stock, or debt obligations involving a variable rate transaction (meaning there is a conversion, exercise or exchange price that is contingent on trading prices or other factors) or a transaction where a purchaser of securities is granted the right to receive additional securities in the future on terms better than those presently being granted to the purchaser. Further, until such time as Gemini no longer holds any of the securities or underlying securities purchased, if the Company issues common stock or securities convertible into common stock on terms that Gemini deems to be more favorable than the terms received by Gemini, Gemini may require the Company to amend the Securities Purchase Agreement and related documents to give Gemini the benefit of the more favorable terms.

Under the terms of the original Note and as additional consideration for the loan, the Company issued Gemini a five-year warrant to purchase up to 5,341,880 shares of its common stock at an exercise price of $0.26 per share (the “Warrant”) which was deemed to have a fair value of $861,778. The Company used the Black-Scholes-Merton pricing model as a method for determining the estimated fair value of the Warrant issued. The following assumptions were used to estimate the fair value of the Warrant:

§ risk free interest rate of 3.2%;
§ expected life of 2 years;
§ no expected dividends;
§ and volatility of 147%.

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

The expected life of the Warrant was determined to be the full-term of the warrant. The risk-free interest rate is based on the Federal Reserve Board's constant maturities of U.S. Treasury bond obligations with terms comparable to the expected life of the Warrant valued. The Company's volatility is based on the historical volatility of the Company's stock.

The fair value of the Warrant was recorded as a discount to the original Note and amortized to interest expense over the term of the Note using the effective interest method. In the event the Company does not have an effective Form 10 registration statement by February 25, 2009, the Warrant provides for a cashless exercise in which the holder will be entitled to the number of shares equal to the difference between the volume weighted average price, as defined in the Note agreement, and the exercise price of the Warrant multiplied by the number of shares issuable upon exercise of the Warrant divided by the volume weighted average price. The Warrant also provides for a weighted-average anti-dilution adjustment to the exercise price in the event the Company issues equity or equity-linked securities at a price below the then-applicable exercise price. As of February 25, 2009, the Company did not have an effective registration statement; therefore the cashless exercise feature will apply.

The Company may be obligated to issue an additional five-year Warrant at an exercise price of $0.26 per share to a placement agent if all or a portion of the underlying Warrant attached to the Note are converted by the holder. For every 100 warrants exercised by the holder, the placement agent will receive 7 warrants up to a maximum of 373,932 warrants. The fair value for the conditional Warrant will be recorded by the Company if and when the original Warrant is exercised by the holder.

The proceeds of the original loan were allocated based on the relative fair value of the loan and warrant as of the commitment date. Then the Company calculated the intrinsic value of the beneficial conversion feature embedded in the Note. As the amount of the beneficial conversion feature exceeded the fair value allocated to the loan, the amount of the beneficial conversion feature to be recorded was limited to the proceeds allocated to the loan. Accordingly, the beneficial conversion feature was calculated to be $388,222 and was recorded as an additional discount on the Note and will be recognized over the term of the Note using the effective interest method.

The following summarizes the convertible note balance as of December 31, 2009:

| | |
|---|---|
| Original gross proceeds received in 2008 | $ 1,388,889 |
| Less: original issue discount at time of issuance of notes | (138,889) |
| Net proceeds prior to paying transaction costs | 1,250,000 |
| Less: value assigned to beneficial conversion feature and warrants | (1,250,000) |
| Add: amortization of original issue discount, beneficial conversion feature and warrants | 1,251,251 |
| Add: mandatory default charge | 347,223 |
| Add: short-term note payable (see Note 5) | 208,750 |
| Add: accrued interest added to note | 170,717 |
| Less: principal payments converted to common stock | (231,482) |
| Balance at December 31, 2009 ($1,884,097 face value) | $ 1,746,459 |

The effective interest rate of the Note was 82% as of December 31, 2009.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

NOTE 7:
STOCKHOLDERS' EQUITY (DEFICIT)

On June 1, 2009, the Company issued 964,506 shares of common stock at a fair value of $0.12 per share valued in total at $115,741 as a principal payment for the convertible debt obligation (see Note 6).

On May 1, 2009, the Company issued 964,506 shares of common stock at a fair value of $0.12 per share valued in total at $115,741 as a principal payment for the convertible debt obligation (see Note 6).

On May 1, 2009, the Company issued 250,000 shares of common stock at a fair value of $0.19 per share valued in total at $47,500 as compensation for marketing services performed in 2009. The fair value of these shares was determined based upon the quoted market price as of the date the shares were declared.

On March 7, 2008, the Company issued 60,000 shares of common stock at an estimated fair value of $0.31 per share valued in total at $18,600 as compensation for public and investor relations for the period from April 1, 2007 to March 31, 2008. The fair value of these shares was determined based upon the quoted market price of the stock as of the date of the shares were declared reduced by a lack of marketability discount.

On March 7, 2008, the Company issued 50,000 shares of common stock at an estimated fair value of $0.31 per share valued in total at $15,500 as advance compensation for services being rendered in connection with the convertible debt issuance on April 25, 2008 (see Note 6). The fair value of these shares was determined based upon the quoted market price of the stock as of the date of the shares were declared reduced by a lack of marketability discount.

Stock Issuable:

In connection with the convertible note payable (Note 6), the Company is obligated to issue to the placement agents for this transaction an additional 180,000 shares of common stock valued at $0.37 per share for a total cost of $66,600. These shares were issued April 22, 2010 (Note 12).

Restricted Stock:

During the year ended December 31, 2008, the Company awarded 60,000 shares of time-based restricted stock (non-vested) shares to certain employees of the Company. As a condition of the award, the employees must be employed with the Company in order to continue to vest in their shares over an 18-month period. The fair value of the non-vested shares ($0.31) was determined based upon the quoted market price of the stock as of the award date of grant reduced by a lack of marketability discount and will be amortized ratably over the vesting period.

The Company recorded $8,448 and $10,152 of compensation expense in the consolidated statements of operations related to vested shares (restricted stock) for the years ended December 31, 2009 and 2008, respectively.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

A summary of the status of non-vested restricted shares and changes and remaining unearned compensation as of December 31, 2009 is set forth below:

| Period | Restricted Shares | Weighted Average Fair Value | Unrecognized Compensation | Weighted Average Remaining Recognition (Months) |
|---|---|---|---|---|
| Outstanding, December 31, 2007 | - | | $ - | |
| Granted | 60,000 | $ 0.31 | 18,600 | |
| Vested | (32,739) | 0.31 | (10,152) | |
| | | | | |
| Outstanding, December 31, 2008 | 27,261 | 0.31 | 8,448 | 8.2 |
| Vested | (27,261) | 0.31 | (8,448) | |
| Outstanding, December 31, 2009 | - | $ - | $ - | - |

NOTE 8:
BASIC AND DILUTED EARNINGS PER SHARE

The Company computes earnings per share under two different methods, basic and diluted, and presents per share data for all periods in which statements of operations are presented. Basic earnings per share are computed by dividing net income by the weighted average number of shares of common stock outstanding. Diluted earnings per share are computed by dividing net income by the weighted average number of common stock and common stock equivalents outstanding.

The following provides a reconciliation of the numerators and denominators used in calculating basic and diluted earnings per share for the years ended December 31, 2009 and 2008.

| | 2009 | 2008 |
|---|---|---|
| Basic earnings per share calculation: | | |
| Net loss to common shareholders | $ (2,273,239) | $ (1,644,296) |
| Weighted average of common shares outstanding | 63,573,800 | 62,226,178 |
| Basic net loss per share | $ (0.036) | $ (0.026) |
| | | |
| Diluted earnings per share calculation: | | |
| Net loss to common shareholders | $ (2,273,239) | $ (1,644,296) |
| | | |
| Weighted average of common shares outstanding | 63,573,800 | 62,226,178 |
| Stock warrants, and convertible debt (1) | - | - |
| Diluted weighted average common shares outstanding | 63,573,800 | 62,226,178 |
| Diluted net loss per share | $ (0.036) | $ (0.026) |

(1) The computation of diluted net loss per share as of December 31, 2009 and 2008, respectively, does not differ from the basic computation because potentially dilutive issuable securities of warrants of 5,341,000. and conversion shares related to the convertible debt promissory note of 18,840,970 and 5,341,000 as of December 31, 2009 and

2008, respectively would be anti-dilutive.

47

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

NOTE 9:
INCOME TAXES

The provision for income taxes for the years ended December 31, 2009 and 2008 are as follows:

| | 2009 | 2008 |
|---|---|---|
| Current: | | |
| Federal | $ - | $ - |
| State | - | - |
| | | |
| Deferred | (739,400) | (570,500) |
| | (739,400) | (570,500) |
| Increase in deferred tax valuation allowance | 739,400 | 570,500 |
| | | |
| Total income tax provision | $ - | $ - |

The provision for income taxes varies from the income tax rates applied to the total loss for the years ended December 31 as follows:

| | 2009 | 2008 |
|---|---|---|
| Federal income tax benefit at an average rate (33%) | $ (749,800) | $ (542,600) |
| State tax benefit, net of federal | (136,400) | (98,900) |
| Non-deductible expenses | 146,800 | 71,000 |
| Current valuation allowance | 739,400 | 570,500 |
| Total income tax provision | $ - | $ - |

Significant components of the Company's deferred tax assets and liabilities were as follows at December 31:

| | 2009 | 2008 |
|---|---|---|
| Deferred tax assets: | | |
| Net operating loss carry forwards | $ 1,208,000 | $ 718,800 |
| Reserves and accruals | 307,700 | 215,400 |
| Warrants | 302,800 | 145,300 |
| | 1,818,500 | 1,079,500 |
| Deferred tax liabilities: | | |
| Depreciation | - | (100) |
| Amortization | (5,300) | (5,600) |
| | (5,300) | (5,700) |
| | | |
| Net deferred tax assets | 1,813,200 | 1,073,800 |
| | | |
| Valuation allowance | (1,813,200) | (1,073,800) |

| | | | | |
|---|---|---|---|---|
| | $ | - | $ | - |

48

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

The Company has net operating loss carryforwards aggregating approximately $4,179,000 as of December 31, 2009, which begin to expire in 2026. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences will become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. The Company has recorded a full valuation allowance against its net deferred tax assets because it is not currently able to conclude that it is more likely than not that these assets will be realized. The amount of deferred tax assets considered to be realizable could be increased in the near term if estimates of future taxable income during the carryforward period are increased.

Under Internal Revenue Code Section 382, certain stock transactions which significantly change ownership, including the sale of stock to new investors, the exercise of options to purchase stock, or other transactions between shareholders could limit the amount of net operating loss carryforwards that may be utilized on an annual basis to offset taxable income in future periods. With the equity transaction that was initiated on April 22, 2010, the Company would most likely meet the criteria for a Section 382 limitation on their NOL carryforwards.

Based on the Company's evaluation, the Company has concluded that there are no significant unrecognized tax benefits. The Company's evaluation was performed for the tax years ended December 31, 2006, 2007, 2008 and 2009, the tax years that remains subject to examination by major tax jurisdictions as of December 31, 2009. The Company does not believe there will be any material changes in its unrecognized tax positions over the next 12 months.

The Company may, from time to time, be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. The Company has adopted a policy to classify interest and penalties as a component of income tax expense.

NOTE 10:
OPERATING LEASE

The Company leases office and warehouse space on a month-to-month basis at a current rate of $1,302 per month. Rental expense was $15,627 for the years ended December 31, 2009 and 2008.

NOTE 11:
LITIGATION

The Company periodically is subject to claims and lawsuits that arise in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Company.

Table of Contents

Axis Technologies Group, Inc.
Notes to Consolidated Financial Statements
December 31, 2009 and 2008

NOTE 12:
SUBSEQUENT EVENTS

IRC Financing Agreement

On April 22, 2010, the Company, IRC - Interstate Realty Corporation ("IRC"), and DHAB, LLC ("DHAB") entered into an Axis Joint Venture Agreement (the "JV Agreement"), thereby forming a joint venture partnership between the Company and IRC. The primary purpose of the Joint Venture is to facilitate and make funds available to the Company on a temporary basis until the contemplated equity transaction, as further described below, is completed in its entirety. This joint venture structure is being set up only to secure IRC's interest for their willingness to advance funds to the Company to purchase inventory and to provide a letter of credit to a specific customer/distributor of the Company. Specifically, IRC will advance funds up to $310,000 for the purchase of new inventory and IRC will put up a $468,000 letter of credit to a Company customer in order for the distributor to feel confident to purchase $468,000 of inventory from the Company. If for some reason the Axis customer is not able to sell all of this inventory purchased over the next twelve months, the customer could draw against this letter of credit for each unit of inventory not sold by them. As of June 21, 2010, the Company has received $70,000 in advances for new inventory purchases and the $468,000 letter of credit is in place but has not been drawn against. IRC will receive a fee of $50,000 as consideration for providing for and arranging these financial agreements.

In connection with the JV Agreement, the Company issued DHAB an aggregate of 163,192,720 shares of its common stock in return for a Promissory Note from DHAB in the principal amount of $6,000,000. The issued DHAB shares are being held by the Company until payment on the obligation is received. The Promissory Note bears no interest and is due on July 1, 2010. If an event of default occurs under the Promissory Note, the Company's sole remedy is to cancel the shares. As DHAB pays such obligation to the Company, the Company will release the equivalent number of shares of the DHAB stock on a prorated basis as is represented by the sums so paid on a $0.04 per share basis. DHAB will not have any voting rights pertaining to the DHAB stock, other than to shares that the Company has released as security. The JV Agreement provides that the Company will not issue or agree to issue any additional shares of its common stock prior to July 20, 2010. Any proceeds received on the promissory note, must be used to repay the note payable to Gemini (see notes 5 and 6) in full, prior to any other use. As of June 21, 2010, the Company has not received any payments against the Promissory Note.

Issuance of Common Stock

On April 22, 2010, the Company issued 179,068,002 shares of common stock. This total includes 163,192,720 shares of common stock held by the Company relating to the IRC Financing Agreement discussed above. The Company issued 5,341,880 shares of common stock still held by the Company relating to the potential exercise of stock warrants from Gemini discussed in Note 6. These shares have not been released as of June 21, 2010.

The Company issued 9,723,089 shares valued at $777,847 ($0.08 per share) to current and past employees for deferred compensation owed through March 31, 2010. The remaining shares totaling 810,313 were issued for past services performed by independent contractors. The fair value of these issuances was determined based upon the quoted market price of the stock as of the date the shares were declared.

50