CLEARSIGN COMBUSTION CORP
Form 10-Q
August 11, 2016

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 June 30, 2016

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**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer 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)

No change

(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 x 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 x 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 ¨ (Do not check if a smaller reporting company)	Smaller 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 ¨ No x

As of August 11, 2016 the issuer has 12,956,882 shares of common stock, par value $.0001, issued and outstanding.

PART I-FINANCIAL INFORMATION

ITEM 1. CONDENSED FINANCIAL STATEMENTS

ClearSign Combustion Corporation

Condensed Balance Sheets

(Unaudited)

	June 30, 2016	December 31, 2015
ASSETS		
Current Assets:		
Cash and cash equivalents	$5,373,000	$10,985,000
Prepaid expenses	535,000	203,000
Total current assets	5,908,000	11,188,000
Fixed assets, net	117,000	123,000
Patents and other intangible assets, net	3,276,000	2,881,000
Other assets	10,000	10,000
Total Assets	$9,311,000	$14,202,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	$598,000	$495,000
Accrued compensation and taxes	719,000	1,109,000
Deferred rent	11,000	20,000
Total current liabilities	1,328,000	1,624,000
Commitments		
Stockholders' Equity:		
Preferred stock, $0.0001 par value, zero shares issued and outstanding	-	-
Common stock, $0.0001 par value, 12,956,882 and 12,868,943 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	1,000	1,000
Additional paid-in capital	42,160,000	41,735,000
Accumulated deficit	(34,178,000)	(29,158,000)
Total stockholders' equity	7,983,000	12,578,000

Total Liabilities and Stockholders' Equity	$9,311,000	$14,202,000

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

ClearSign Combustion Corporation

Condensed Statements of Operations

(Unaudited)

	For the Three Months Ended June 30, 2016	2015	For the Six Months Ended June 30, 2016	2015
Operating expenses:				
Research and development	$1,216,000	$714,000	$2,541,000	$1,287,000
General and administrative	1,226,000	1,096,000	2,502,000	2,115,000
Total operating expenses	2,442,000	1,810,000	5,043,000	3,402,000
Loss from operations	(2,442,000)	(1,810,000)	(5,043,000)	(3,402,000)
Other income:				
Interest income	11,000	14,000	23,000	23,000
Net Loss	$(2,431,000)	$(1,796,000)	$(5,020,000)	$(3,379,000)
Net Loss per share - basic and fully diluted	$(0.19)	$(0.14)	$(0.39)	$(0.28)
Weighted average number of shares outstanding - basic and fully diluted	12,917,410	12,799,666	12,893,251	12,085,478

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

ClearSign Combustion Corporation

Condensed Statement of Stockholders' Equity

(Unaudited)

For the Six Months Ended June 30, 2016

	Common Stock		Additional	Accumulated	Total Stockholders'
	Shares	Amount	Paid-In Capital	Deficit	Equity
Balances at December 31, 2015	12,868,943	$ 1,000	$ 41,735,000	$ (29,158,000)	$ 12,578,000
Shares issued for services ($3.40 per share)	22,056	-	75,000	-	75,000
Shares issued for services ($3.96 per share)	5,000	-	20,000	-	20,000
Shares issued upon exercise of warrants ($2.20 per share)	60,883	-	-	-	-
Share based compensation	-	-	330,000	-	330,000
Net loss	-	-	-	(5,020,000)	(5,020,000)
Balances at June 30, 2016	12,956,882	$ 1,000	$ 42,160,000	$ (34,178,000)	$ 7,983,000

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

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ClearSign Combustion Corporation

Condensed Statements of Cash Flows

(Unaudited)

	For the Six Months Ended June 30,	
	2016	2015
Cash flows from operating activities:		
Net loss	$ (5,020,000)	$ (3,379,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Common stock issued for services	95,000	62,000
Share based payments	330,000	355,000
Depreciation and amortization	90,000	112,000
Abandonment of capitalized patents pending	232,000	5,000
Deferred rent	(9,000)	(6,000)
Change in operating assets and liabilities:		
Prepaid expenses	(332,000)	(145,000)
Accounts payable	103,000	174,000
Accrued compensation	(390,000)	(340,000)
Net cash used in operating activities	(4,901,000)	(3,162,000)
Cash flows from investing activities:		
Acquisition of fixed assets	(60,000)	(30,000)
Disbursements for patents and other intangible assets	(651,000)	(611,000)
Net cash used in investing activities	(711,000)	(641,000)
Cash flows from financing activities:		
Proceeds from issuance of common stock for cash, net of offering costs	-	16,279,000
Proceeds from exercise of stock options	-	285,000
Net cash provided by financing activities	-	16,564,000
Net increase (decrease) in cash and cash equivalents	(5,612,000)	12,761,000
Cash and cash equivalents, beginning of period	10,985,000	1,845,000
Cash and cash equivalents, end of period	$ 5,373,000	$ 14,606,000

Supplemental disclosure of non-cash operating and financing activities:

During the six months ended June 30, 2016, the Company issued 60,883 shares of common stock through net settlement cashless exercises of warrants to purchase 118,959 shares at $2.20 per share when the closing prices on the date of exercises were a weighted average of $4.51 per share.

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

ClearSign Combustion Corporation

Notes to Unaudited Condensed Financial Statements

Note 1 – Organization and Description of Business

ClearSign Combustion Corporation (ClearSign or the Company) designs and develops technologies for the purpose of improving key performance characteristics of combustion systems, including emission and operational performance, energy efficiency and overall cost-effectiveness. The Company's primary technologies include its Duplex™ technology, which achieves very low emissions without the need of external flue gas recirculation, selective catalytic reduction, or higher excess air operation, and 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. The Company is headquartered in Seattle, Washington and was incorporated in the state of Washington in 2008.

The Company's Duplex technology is currently in field development and has generated de minimis revenues from operations to date to meet operating expenses. In order to generate meaningful revenues, the technologies must be fully developed, gain market recognition and acceptance, and develop a critical level of successful sales and product installations. The Company has historically financed its operations primarily through issuances of equity securities. The Company has incurred losses since its inception totaling $34,178,000 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

<u>Basis of Presentation</u>

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, 2015 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, 2015. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year or any other future periods.

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 and Cost of Revenue

Revenues from design and installation of the Company's products are recognized on the completed contract method. Revenues from contracts and related costs of goods sold are recognized once the contract is completed or substantially completed. Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, and depreciation costs. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined.

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.

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. Fair value is determined based on the present value of estimated expected cash flows using a discount rate commensurate with the risks involved, quoted market prices, or appraised values depending upon the nature of the 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.

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 attributable to the short term 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 used in laboratory and field testing.

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 sheets.

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 June 30, 2016 and 2015, potentially dilutive shares outstanding amounted to 1,333,363 and 1,392,352, respectively.

Recently Issued Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-02 regarding leases. The new standard requires lessee recognition on the balance sheet of a right-of-use asset and a lease liability, initially measured at the present value of the lease payments. It further requires recognition in the income statement of a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis. Finally, it requires classification of all cash payments within operating activities in the statement of cash flows. It is effective for fiscal years commencing after December 15, 2018 and early adoption is permitted. Management does not believe that this standard or any other 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, 2016, the market value of the Company's common stock held by non-affiliates totaled $62 million.

Note 3 – Fixed Assets

Fixed assets are summarized as follows:

	June 30, 2016 (unaudited)	December 31, 2015
Machinery and equipment	$ 639,000	$ 639,000
Office furniture and equipment	133,000	115,000
Leasehold improvements	130,000	130,000
Accumulated depreciation and amortization	(827,000)	(761,000)
	75,000	123,000
Construction in progress	42,000	-
	$ 117,000	$ 123,000

Note 4 – Patents and Other Intangible Assets

Patents and other intangible assets are summarized as follows:

	June 30, 2016 (unaudited)	December 31, 2015
Patents		
Patents pending	$ 2,927,000	$ 2,730,000

Issued patents	337,000	115,000
	3,264,000	2,845,000
Trademarks		
Trademarks pending	18,000	18,000
Registered trademarks	23,000	23,000
	41,000	41,000
Other	8,000	8,000
	3,313,000	2,894,000
Accumulated amortization	(37,000)	(13,000)
	$3,276,000	$ 2,881,000

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Future amortization expense associated with issued patents and registered trademarks as of June 30, 2016 is estimated as follows:

2016	$31,000
2017	62,000
2018	63,000
2019	63,000
2020	60,000
Thereafter	44,000
	$323,000

During the three and six months ended June 30, 2016 and 2015, the Company recorded an impairment loss of $167,000, $232,000, $5,000 and $5,000, respectively, from abandonment of capitalized patents.

Note 5 – Termination of Employment Agreement

The Company and its former Chief Executive Officer, Richard F. Rutkowski, entered into an agreement in December 2014 terminating a prior employment agreement. Under this agreement, Mr. Rutkowski will be paid his annual salary of $359,000 through December 31, 2016, was paid a bonus of $60,000 in 2015, has received employee benefits through December 2015, and received accelerated vesting on 15,625 stock options with an exercise price of $4.88 per share and 14,219 stock options with an exercise price of $9.90 per share. The options were not exercised prior to March 2015, therefore, pursuant to the terms of the option agreements and the ClearSign Combustion Company 2011 Equity Incentive Plan, the right to exercise the options terminated.

The liability incurred under this agreement totaled $943,000 which was recognized in general and administrative expense in 2014 and included a fair value of $50,000 attributable to the stock option provisions. At June 30, 2016, the remaining liability totaled $182,000 and is due through December 2016.

Note 6 – Stockholders' Equity

<u>Common Stock and Preferred Stock</u>

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 February 2015, the Company completed an underwritten public offering of common stock whereby 2,990,000 shares were issued at $5.85 per share. Gross proceeds from the offering totaled $17.5 million and net cash proceeds approximated $16.3 million. Expenses of the offering approximated $1.2 million, including underwriting fees of $1,049,000, underwriter legal fees and other costs of $55,000, and other costs of $108,000.

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 June 30, 2016, the number of shares reserved for issuance under the Plan totaled 1,398,476 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 the three months ended June 30, 2016, the Company granted 169,900 stock options under the Plan to employees. The stock options have exercise prices at the grant date fair value of $4.21 per share, contractual lives of 10 years, and vest over 4 years. The fair value of stock options granted estimated on the date of grant using the Black-Scholes option valuation model was $414,000. The recognized compensation expense associated with these grants for the three months ended June 30, 2016 was $26,000. 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	73	%
Forfeiture rate	12	%
Weighted average risk-free interest rate	1.56	%
Expected dividend rate	0	%

In March 2016, the Company authorized 44,112 shares of common stock to be issued under the Plan to its three independent directors in accordance with board agreements and which will be earned quarterly for service in 2016. The fair value of the stock at the time of grant was $3.40 per share for a total value of $150,000. The Company recognized $38,000 and $75,000 in general and administrative expense for the three and six months ended June 30, 2016 and will recognize the remaining $75,000 in the remainder of 2016.

In accordance with the Plan, options for the purchase of 7,504 shares of common stock were exercised in 2014 prior to vesting and the shares of common stock purchased were issued with a declining repurchase right in favor of the Company at the exercise price of $4.88 per share. The Company may repurchase shares if, prior to December 31, 2016, the employee terminates employment or certain other designated events occur. At June 30, 2016, 2,502 shares remained subject to this repurchase right.

Outstanding stock option grants at June 30, 2016 and December 31, 2015 totaled 888,050 shares and 723,400 shares with the right to purchase 495,974 s