AUDIOEYE INC

FORM 10-Q
(Quarterly Report)

Filed 11/14/16 for the Period Ending 09/30/16

Address	5210 E. WILLIAMS CIRCLE SUITE 750 TUCSON, AZ, 85711
Telephone	866-331-5324
CIK	0001362190
Symbol	AEYE
SIC Code	7372 - Services-Prepackaged Software
Industry	IT Services & Consulting
Sector	Technology
Fiscal Year	12/31

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

☐ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from [ ] to [ ]

Commission file number 333-177463

AudioEye, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**20-2939845**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5210 East Williams Circle, Suite 750, Tucson, Arizona	**85711**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **866-331-5324**

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 last 90 days. Yes ☒ No ☐

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

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

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

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

As of November 14, 2016, 107,500,096 shares of the registrant's common stock were issued and outstanding.

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

The financial information set forth below with respect to the financial statements as of September 30, 2016 and 2015 and for the three and nine month periods ended September 30, 2016 and 2015 is unaudited. This financial information, in the opinion of our management, includes all adjustments consisting of normal recurring entries necessary for the fair presentation of such data. The results of operations for the three and nine month periods ended September 30, 2016 are not necessarily indicative of results to be expected for any subsequent period. Our fiscal year end is December 31.

AUDIOEYE, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash	$ 1,494,513	$ 1,687,257
Accounts receivable, net	20,499	22,741
Marketable securities, held in related party	3,600	3,600
Non-marketable securities, held in related party	50,000	50,000
Prepaid expenses and other current assets	57,828	41,388
Total current assets	1,626,440	1,804,986
Intangible assets, net	2,454,162	2,840,856
Goodwill	700,528	700,528
Total assets	$ 4,781,130	$ 5,346,370
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 267,377	$ 213,620
Notes and loans payable, current	24,000	24,000
Related party payables	14,744	153,474
Derivative liabilities	3,648,243	439,361
Deferred revenue	414,082	60,790
Total current liabilities	4,368,446	891,245
Long term liabilities:		
Convertible notes and loans payable, net	5,800	1,923,499
Total liabilities	4,374,246	2,814,744
Stockholders' equity:		
Preferred stock, $0.00001 par value, 10,000,000 shares authorized, 160,000 and 175,000 issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	2	2
Common stock, $0.00001 par value, 250,000,000 shares authorized, 107,458,430 and 81,717,154 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	1,074	817
Treasury stock	(623,000)	(623,000)
Additional paid-in capital	33,997,819	27,393,238
Accumulated deficit	(32,969,011)	(24,239,431)
Total stockholders' equity	406,884	2,531,626
Total liabilities and stockholders' equity	$ 4,781,130	$ 5,346,370

See Notes to Unaudited Consolidated Financial Statements

AUDIOEYE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three months ended September 30, 2016	Three months ended September 30, 2015	Nine months ended September 30, 2016	Nine months ended September 30, 2015
Revenues	$ 282,676	$ 108,685	$ 594,237	$ 314,146
Cost of revenue	311,519	321,755	904,091	1,178,388
Gross Loss	(28,843)	(213,070)	(309,854)	(864,242)
Operating expenses:				
Selling and marketing	192,881	171,594	510,448	747,990
Research and development	85,192	92,857	255,805	293,877
General and administrative	602,041	(27,278)	1,894,964	4,161,269
Amortization and depreciation	150,328	128,381	428,701	396,269
Total operating expenses	1,030,442	365,554	3,089,918	5,599,405
Operating loss	(1,059,285)	(578,624)	(3,399,772)	(6,463,647)
Other income (expense):				
Unrealized gain (loss) on derivative liabilities	351,055	-	(2,990,096)	-
Unrealized gain on marketable securities	900	-	-	-
Loss on settlement of debt	-	-	(1,664,281)	-
Other income	-	-	750	-
Interest income (expense)	266	81	(676,181)	3,345
Total other income (expense)	352,221	81	(5,329,808)	3,345
Net loss	(707,064)	(578,543)	(8,729,580)	(6,460,302)
Preferred stock dividend	(20,000)	-	(60,000)	(594,641)
Net loss available to common stockholders	$ (727,064)	$ (578,543)	$ (8,789,580)	$ (7,054,943)
Net loss per common share-basic and diluted	$ (0.01)	$ (0.01)	$ (0.09)	$ (0.09)
Weighted average common shares outstanding-basic and diluted	107,382,344	81,800,488	95,840,596	80,007,507

See Notes to Unaudited Consolidated Financial Statements

AUDIOEYE, INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2016
(unaudited)

	Common stock		Preferred stock		Additional Paid in Capital	Non-controlling Interest/ Treasury Stock	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount				
Balance, December 31, 2015	81,717,154	$ 817	175,000	$ 2	$ 27,393,238	$ (623,000)	$ (24,239,431)	$ 2,531,626
Common stock issued for services	291,666	3	-	-	47,455	-	-	47,458
Common stock issued in settlement of convertible notes and accrued interest	12,834,800	128	-	-	1,077,995	-	-	1,078,123
Common stock and warrants issued for cash, net of placement costs of $60,918	11,714,285	117	-	-	1,578,965	-	-	1,579,082
Common stock issued upon conversion of preferred stock	900,525	9	(15,000)	-	(9)	-	-	-
Fair value of warrants issued in settlement of convertible debt and accrued interest	-	-	-	-	3,205,959	-	-	3,205,959
Reclassify fair value of liability warrants issued in connection with sale of common stock	-	-	-	-	(218,786)	-	-	(218,786)
Warrants and Options issued for services	-	-	-	-	913,002	-	-	913,002
Net loss	-	-	-	-	-	-	(8,729,580)	(8,729,580)
Balance, September 30, 2016	107,458,430	$ 1,074	160,000	$ 2	$ 33,997,819	$ (623,000)	$ (32,969,011)	$ 406,884

See Notes to Unaudited Consolidated Financial Statements

AUDIOEYE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine months ended September 30, 2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (8,729,580)	$ (6,460,302)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	428,701	396,269
Amortization of debt discounts	600,301	-
Option, warrant and PSU expense	913,002	1,200,459
Stock issued or issuable for services	47,458	679,972
Loss on change in derivative liabilities	2,990,096	-
Loss on settlement of debt	1,664,281	-
Changes in operating assets and liabilities:		
Accounts receivable	2,242	212,662
Related party receivable	-	(44,250)
Other current assets	(16,440)	11,650
Accounts payable and accruals	173,558	(517,743)
Billing in excess of costs	-	(57,012)
Deferred revenue	353,292	-
Related party payables	(138,730)	(226,483)
Net cash (used in) operating activities	(1,711,819)	(4,804,778)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Cash (paid for) intellectual property	(42,007)	(88,156)
Net cash (used in) investing activities	(42,007)	(88,156)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock and warrants for cash	1,579,082	325,000
Collection of stock subscription receivable	-	1,175,000
Issuance of preferred stock for cash	-	1,750,000
Proceeds from exercise of options and warrants	-	43,943
Repayments of notes payable	(18,000)	(22,000)
Net cash provided by financing activities	1,561,082	3,271,943
Net decrease in cash	(192,744)	(1,620,991)
Cash-beginning of period	1,687,257	1,672,901
Cash-end of period	$ 1,494,513	$ 51,910
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Interest paid	$ -	$ 307
Income taxes paid	-	-
Non-cash investing and financing activities:		
Deemed dividend beneficial conversion feature on convertible preferred stock	$ -	$ 594,641
Common stock issued in settlement of convertible notes payable and accrued interest	1,078,123	-
Fair value of warrants issued in settlement of convertible notes payable and accrued interest	3,205,959	-
Reclass fair value of liability warrants from equity to liability upon issuance	218,786	-
Common stock issued upon conversion of preferred stock	9	-

See Notes to Unaudited Consolidated Financial Statements

NOTE 1: ORGANIZATION AND BASIS OF PRESENTATION

The accompanying unaudited interim financial statements of AudioEye, Inc. and its wholly-owned subsidiary (collectively, the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the Securities and Exchange Commission, and should be read in conjunction with the audited financial statements and notes thereto contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2016.

In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of financial position and the results of operations for the interim periods presented have been reflected herein. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year. Notes to the financial statements that would substantially duplicate the disclosures contained in the audited financial statements for the year ended December 31, 2015 as reported in the Company's Annual Report on Form 10-K have been omitted.

Corporate Information and Background

AudioEye, Inc. was formed as a Delaware corporation on May 20, 2005. The Company focuses on providing its customers with the most complete and inclusive web accessibility solution available. The Company's suite of technologies allows its customers to provide their site visitors with an enhanced web experience. When implemented, the Company believes its solutions offer businesses the opportunity to reach more customers, improve brand image, and build additional brand loyalty. In addition, the Company's solutions provide organizations with the ability to comply with internationally accepted web content accessibility guidelines (WCAG) as well as United States, Canadian and United Kingdom accessibility laws.

Reclassification

Certain prior year amounts have been reclassified to conform to the current year presentation.

Revenue Recognition

Revenue is recognized when all applicable recognition criteria have been met, which generally include (a) persuasive evidence of an existing arrangement; (b) fixed or determinable price; (c) delivery has occurred or service has been rendered; and (d) collectability of the sales price is reasonably assured. For software and technology development contracts the Company recognizes revenues on a percentage of completion method based upon several factors including but not limited to (a) estimate of total hours and milestones to complete; (b) total hours completed; (c) delivery of services rendered; (d) change in estimates; and (e) collectability of the contract.

The Company had one major customer including their affiliates which generated approximately 55% of its revenue in the three months ended September 30, 2016.

The Company had four major customers including their affiliates which generated approximately 43% (21%, 16%, 15% and 11%) of its revenue in the nine months ended September 30, 2016.

At September 30, 2016, the Company had three customers representing 24%, 17% and 15% of the outstanding accounts receivable.

Certain Software as a Service (SaaS) and website hosting contracts are prepared and invoiced on an annual basis. Any funds received for hosting services not provided yet are held in deferred revenue, and are recorded as revenue when earned.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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. Significant estimates include the fair value of the Company's stock, stock-based compensation, fair values relating to derivative liabilities, debt discounts and the valuation allowance related to deferred tax assets. Actual results may differ from these estimates.

Stock based compensation

The Company measures the cost of services received in exchange for an award of equity instruments based on the fair value of the award. For employees and directors, the fair value of the award is measured on the grant date and for non-employees, the fair value of the award is generally re-measured on vesting dates and interim financial reporting dates until the service period is complete. The fair value amount is then recognized over the period during which services are required to be provided in exchange for the award, usually the vesting period. Stock-based compensation expense is recorded by the Company in the same expense classifications in the consolidated statements of operations, as if such amounts were paid in cash.

Derivative Instrument Liability

The Company accounts for derivative instruments in accordance with ASC 815, which establishes accounting and reporting standards for derivative instruments and hedging activities, including certain derivative instruments embedded in other financial instruments or contracts and requires recognition of all derivatives on the balance sheet at fair value, regardless of hedging relationship designation. Accounting for changes in fair value of the derivative instruments depends on whether the derivatives qualify as hedge relationships and the types of relationships designated are based on the exposures hedged. At September 30, 2016 and December 31, 2015, the Company did not have any derivative instruments that were designated as hedges.

On October 9, 2015, the Company issued convertible promissory notes representing $2,500,000 in aggregate principal together with warrants exercisable for up to 25,000,000 shares of Common Stock. The warrants have a strike price of $0.10 and term of 5 years. In addition on May 9, 2016, in connection with the sale of the Company's common stock, the Company issued warrants exercisable for up to 1,312,000 shares of Common Stock. The warrants have a strike price of $0.25 and a term of 5 years.

In accordance with ASC 815, these outstanding warrants are deemed to contain embedded derivatives. The value of the derivative instrument will fluctuate with the price of the Company's common stock and is recorded as a current liability on the Company's Consolidated Balance Sheets. The change in the value of the liability is recorded as "unrealized gain (loss) on derivative liability" on the Consolidated Statements of Operations. This is a non-cash income (expense) item and is adjusted in the "operating activities" of the Consolidated Statements of Cash Flow. At September 30, 2016 and December 31, 2015, the derivative liability was stated at $3,648,243 and $439,361, respectively. The change in fair value of $2,990,096 was driven by the increased value of the Company's common stock in the period and recorded as the "Loss on change in derivative liability" in the Consolidated Statements of Operations for the nine months ended September 30, 2016. As the warrants are exercised or expire, the derivative liability will be adjusted on the balance sheet and an adjustment will be reflected in stockholders equity under additional paid-in capital.

Fair Value Measurements

Fair value is an estimate of the exit price, representing the amount that would be received to, sell an asset or paid to transfer a liability in an orderly transaction between market participants (i.e., the exit price at the measurement date). Fair value measurements are not adjusted for transaction cost. Fair value measurement under generally accepted accounting principles provides for use of a fair value hierarchy that prioritizes inputs to valuation techniques used to measure fair value into three levels:

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted market prices that are observable, either directly or indirectly, and reasonably available. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability and are developed based on market data obtained from sources independent of the Company.

Level 3: Unobservable inputs reflect the assumptions that the Company develops based on available information about what market participants would use in valuing the asset or liability.

An asset or liability's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Availability of observable inputs can vary and is affected by a variety of factors. The Company uses judgment in determining fair value of assets and liabilities and Level 3 assets and liabilities involve greater judgment than Level 1 and Level 2 assets or liabilities.

In October and November 2015, the Company issued warrants with an exercise price of $0.10 in connection with a convertible debt instruments. The five year warrants also contain a provision that the warrant exercise price will automatically be adjusted for any common stock equity issuances at less than $0.10 per share. The Company determined that the warrants were not afforded equity classification because the warrants are not considered to be indexed to the Company's own stock due to the anti-dilution provision. Accordingly, the warrants are treated as a derivative liability and are carried at fair value.

The Company estimated the fair value of these derivative warrants at initial issuance and again at each balance sheet date. The changes in fair value are recognized in earnings in the Consolidated Statements of Operations under the caption "unrealized gain/(loss) – derivative liability" until such time as the derivative warrants are exercised or expire. The Company used the Black-Scholes Option Pricing model to estimate the fair value of the dates of issuance, the price of the Company stock ranged $0.031 to $0.058, volatility was estimated to be 102%, the risk free rate ranged 1.14% to 1.75% and the remaining term was 5 years.

In April and May 2016, the Company issued warrants with an exercise price of $0.25 in connection with the sale of Common Stock. The five year warrants also contain a provision that the warrant exercise price will automatically be adjusted for any common stock equity issuances at less than $0.25 per share. The Company determined that the warrants were not afforded equity classification because the warrants are not considered to be indexed to the Company's own stock due to the anti-dilution provision. Accordingly, the warrants are treated as a derivative liability and are carried at fair value.

The Company estimated the fair value of these derivative warrants at initial issuance and again at each balance sheet date. The changes in fair value are recognized in earnings in the Consolidated Statements of Operations under the caption "unrealized gain/(loss) – derivative liability" until such time as the derivative warrants are exercised or expire. The Company used the Black-Scholes Option Pricing model to estimate the fair value of the dates of issuance, the price of the Company stock ranged $0.169 to $0.195, volatility was estimated to be from 169% to 178%, the risk free rate ranged 1.22% to 1.35% and the remaining term was 5 years. The estimated initial fair value of these warrants of $218,786 was reclassified from equity to liability at the date of issuance.

At September 30, 2016, the price of the Company stock was 0.149, volatility was estimated to be 170.52%, the risk free rate of 1.14% and the remaining term ranged from 4.02 to 4.56 years. As of September 30, 2016, the fair value of the warrants was determined to be $3,648,243, resulting in an unrealized gain (loss) on the change in the fair value of this derivative liability of $351,055 and $(2,990,096) for the three and nine months ended September 30, 2016, respectively.

The following are the Company's assets and liabilities, measured at fair value on a recurring basis, as of September 30, 2016 and December 31, 2015:

	Fair Value	Fair Value Hierarchy
Assets		
Marketable securities, September 30, 2016	$ 3,600	Level 1
Marketable securities, December 31, 2015	$ 3,600	Level 1
Liabilities		
Derivative Liability , September 30, 2016	$ 3,648,243	Level 3
Derivative Liability , December 31, 2015	$ 439,361	Level 3

Recent Accounting Pronouncements

There are various updates recently issued, most of which represented technical corrections to the accounting literature or application to specific industries and are not expected to a have a material impact on the Company's financial position, results of operations or cash flows.

NOTE 2: MANAGEMENT LIQUIDITY PLANS

As of September 30, 2016, the Company had cash of $1,494,513 and working capital deficit of $2,742,006, principally due to the inclusion of non-cash derivative liability recorded in current liabilities. Excluding the derivative liability, the Company's working capital would have been $906,237. In addition, the Company used actual net cash in operations of $1,711,819 during the nine months ended September 30, 2016. The Company has incurred net losses since inception. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

In May 2016, the Company sold shares of common stock and warrants for net proceeds, after commissions and other costs, of approximately $1,579,082. It is anticipated that the proceeds from the sale of its common stock and warrants will provide the Company with cash sufficient to fund operations through May 2017.

The Company expects that cash used in operations will decrease significantly over the next several years as the Company executes its business plan. In the event that the Company is not able to fully achieve its plan, the Company may need to raise additional funds through equity or debt financing. If the Company is unsuccessful in raising additional financing, it will need to reduce costs and operations in the future.

Accordingly, the accompanying financial statements have been prepared in conformity with U.S. GAAP, which contemplates continuation of the Company as a going concern and the realization of assets and satisfaction of liabilities in the normal course of business. The carrying amounts of assets and liabilities presented in the financial statements do not necessarily purport to represent realizable or settlement values. The financial statements do not include any adjustment that might result from the outcome of this uncertainty.

NOTE 3: RELATED PARTY TRANSACTIONS

Dr. Carr Bettis, Executive Chairman and Chairman of Board of Directors

As of September 30, 2016 and December 31, 2015, the Company owed Dr. Bettis $5,992 and $72,944 in accrued salary, respectively. In addition, AudioEye sub-leases an office for the Company's CEO Todd Bankofier from Verus Analytics, Inc, a company in which Dr. Bettis has a controlling interest in. The sub-lease amount is $500 per month totaling $1,500 and $4,500 in three and nine months ended September 30, 2016.

Sean Bradley, President, Chief Technology Officer, and Secretary

As of September 30, 2016 and December 31, 2015, the Company owed Sean Bradley $8,752 and $6,250 in accrued salary, respectively.

David Moradi, a Material Shareholder, on a fully diluted basis

As of December 31, 2015 the Company owed David Moradi $70,000 in principal and $4,280 in accrued interest. During the nine months ended September 30, 2016, Mr. Moradi was paid in full. As of September 30, 2016, Mr. Moradi is no longer considered a material shareholder.

In summary, as of September 30, 2016 and December 31, 2015 the total balances of related party payables were $14,744 and $153,474, respectively.

NOTE 4: INTANGIBLE ASSETS

For the nine months ended September 30, 2016 and 2015, the Company invested in Patents in the amounts of $42,007 and $88,156 respectively.

Prior to December 31, 2015, patents, technology and other intangibles with contractual terms were generally amortized over their estimated useful lives of ten years. When certain events or changes in operating conditions occur, an impairment assessment is performed and lives of intangible assets with determinable lives may be adjusted.

Software development costs are amortized over their estimated useful life of three years.

Prior to any impairment adjustment, intangible assets consisted of the following:

	September 30, 2016	December 31, 2015
Patents	$ 3,697,076	$ 3,655,069
Capitalized software development	621,567	621,567
Accumulated amortization	(1,864,481)	(1,435,780)
Intangible assets, net	$ 2,454,162	$ 2,840,856

Amortization expense for patents totaled $94,209 and $281,064 for the three and nine months ended September 30, 2016, respectively; and $87,395 and $268,940 for the three and nine months ended September 30, 2015, respectively. Amortization expense for software development totaled $56,119 and $147,637 for the three and nine months ended September 30, 2016, respectively; and $40,427 and $126,677 for the three and nine months ended September 30, 2015, respectively.

Total amortization expense totaled $428,701 and $395,617 for the nine months ended September 30, 2016 and 2015, respectively.

NOTE 5: NOTES PAYABLE

As of September 30, 2016 and December 31, 2015, the Company has short term and long term notes payable of $24,000 and $5,800, and $24,000 and $1,923,499, respectively as shown in the table below.

Notes and loans payable	September 30, 2016	December 31, 2015
Short Term		
Maryland TEDCO	$ 24,000	$ 24,000
Total	$ 24,000	$ 24,000
Long Term		
Convertible Secured Note (net of unamortized discounts of $600,301 in 2015)	-	1,899,699
Maryland TEDCO	$ 5,800	$ 23,800
Total	$ 5,800	$ 1,923,499

As of December 31, 2012, the Company had an outstanding loan to a third party in the amount of $74,900, which was originally issued during 2006 as part of an Investment Agreement. The loan was unsecured and bore interest at 25% per year for four years. The Company had accrued interest of $74,900, which was included in accounts payable and accrued expenses on the consolidated balance sheets. The note was in default until October 24, 2011, at which time the Company entered into a Termination and Release Agreement (“Release”) with the third party. The terms of the Release, among other things, terminated the Investment Agreement between the parties, and required the Company to issue a Promissory Note to the third-party in the combined amount of principal and accrued interest to date, for a total principal amount of $149,800. The note is interest free, and is payable in monthly installments of $2,000 beginning November 1, 2011. As of September 30, 2016 and December 31, 2015, the principal amount owing was $29,800 and $47,800, respectively, of which $24,000 and $24,000, respectively, has been recorded as the current portion of the note, and $5,800 and $23,800, respectively, as the long-term portion of the note. The Company has paid $18,000 for the nine months ended September 30, 2016.

On October 9, 2015 (the “Initial Closing Date”), AudioEye, Inc. (the “Company”) entered into a Note and Warrant Purchase Agreement (the “Purchase Agreement”) with certain investors (the “Investors”) for the issuance and sale of convertible promissory notes in an aggregate principal amount of up to $3,750,000 (the “Notes”) and warrants (the “Warrants”) to purchase up to an aggregate of 37,500,000 shares of common stock of the Company (the “Common Stock”) (the “Transaction”). Notes representing up to $2,500,000 in aggregate principal, and Warrants exercisable for up to 25,000,000 shares of Common Stock in the aggregate, may be issued and sold at one or more closings during the 30-day period immediately following the Initial Closing Date. The maximum of $2,500,000 in aggregate principal was sold as of November 8, 2015. In addition, upon the election of any Investor within the three-year period immediately following the Initial Closing Date, any Investor may purchase an additional Note in the principal amount equal to 50% of the principal amount of the Notes purchased by such Investor at previous closings (the “Option Principal Amount”) and an additional Warrant with an aggregate exercise price equal to such Investor’s Option Principal Amount.

The Notes mature three years from the date of issuance (the “Maturity Date”) and, until the Notes are repaid or converted into shares of the Company’s equity securities (“Equity Securities”), accrue payable-in-kind interest at the rate of 10% per annum. As described in the Purchase Agreement, as amended (see below), if the Company sold Equity Securities in a single transaction or series of related transactions for cash of at least $1,000,000 (excluding the conversion of the Notes and excluding the shares of Common Stock to be issued upon exercise of the Warrants) on or before the Maturity Date (the “Equity Financing”), all of the unpaid principal on the Notes plus accrued interest shall be automatically converted at the closing of the Equity Financing into a number of shares of the same class or series of Equity Securities as are issued and sold by the Company in such Equity Financing (or a class or series of Equity Securities identical in all respects to and ranking pari passu with the class or series of Equity Securities issued and sold in such Equity Financing) as is determined by dividing (i) the principal and accrued and unpaid interest amount of the Notes by (ii) 60% of the price per share at which such Equity Securities are issued and sold in such Equity Financing. The Notes, if not converted, shall be due and payable in full on the Maturity Date.

The Notes contained customary events of default provisions. In connection with the issuance of the Notes, on October 9, 2015, the Company entered into a Security Agreement with the Investors (the "Security Agreement") pursuant to which the Company granted a security interest in all of its assets to the Investors as collateral for the Company's obligations under the Notes. As noted below, on April 18, 2016, the parties agreed to remove the security interest feature from the form of convertible promissory note that may be issued in the future under the Original Agreement.

The Warrants are exercisable at $0.10 per share and expire 60 months following the date of issuance. The Warrants are subject to anti-dilution protection, subject to certain customary exceptions.

During 2015, the Company issued notes under this offering totaling $2,500,000. The fair value of the warrants issued in connection with the notes was determined to be $627,293 and was recognized as a discount to the debt being amortized to interest expense over the life of the loans. During three and nine months ended September 30, 2016, aggregate amortization (and write-off) of $-0- and $600,301 was recognized against the discount.

In connection with the transaction, the Company also entered into amendments to certain agreements. On April 18, 2016, the Company entered into a First Amendment to Note and Warrant Purchase Agreement (the "Purchase Agreement Amendment") and an Omnibus Amendment to Secured Promissory Notes (the "Note Amendment"), which collectively amend that certain Note and Warrant Purchase Agreement dated as of October 9, 2015 (the "Original Agreement") and the convertible promissory notes previously issued thereunder to, among other things (i) remove the right of Anthion Partners II, LLC (together with its affiliates, "Anthion") to designate a member of the Board of Directors of the Company; (ii) amend the convertible promissory notes issued thereunder to provide that if a change of control of the Company occurs prior to the maturity date or an equity financing (as defined therein), the convertible promissory note shall be repaid in an amount equal to the product of (a) 1.4 and (b) the outstanding principal amount and all accrued and unpaid interest thereunder; (iii) reduce the conversion threshold in the definition of "qualified financing" under the convertible promissory notes from $2,000,000 to $1,000,000; (iv) remove the security interest feature from the form of convertible promissory note that may be issued in the future under the Original Agreement, as amended, and (v) provide for optional conversion into warrants containing "blocker" provisions ("Special Warrants") instead of shares upon an equity financing. The Company also made certain amendments to outstanding warrants to add similar "blocker" provisions.

On April 18, 2016, the Company issued an aggregate of 12,834,800 shares of its common stock to the Note holders other than Anthion, and 18,353,310 warrants to acquire its common stock to Anthion in lieu of common stock. Collectively the common stock and warrants issued were in full settlement of $2,500,000 convertible notes and accrued interest of $119,801. The warrants issued to Anthion are exercisable at $0.001 per share for five years from the date of issuance.

At the date of conversion, the Company determined that the conversion price of $0.84 per share did not exceed the fair value of Common Stock at note inception, therefore there was no beneficial conversion feature upon conversion of $1,025,000 of convertible notes and accrued interest. However, the Company determined that the estimated fair value of the 18,353,310 warrants of $3,205,959 exceeded the settlement of $1,541,678 of convertible notes and accrued interest and accordingly recorded a loss of settlement of debt of $1,664,281 for the nine months ended September 30, 2016. The Company used the Black-Scholes Option Pricing model to estimate the fair value of the warrants at the date of conversion using the following assumptions: the price of the Company stock of $0.175, volatility was estimated to be 178%, the risk free rate of 1.24% and the remaining term was 5 years.

NOTE 6: STOCKHOLDERS' EQUITY

As of September 30, 2016 and December 31, 2015, the Company had 107,458,430 and 81,717,154 shares of common stock issued and outstanding, respectively, and the Company had 160,000 and 175,000 shares of Series A Convertible Preferred Stock, respectively, issued at $10 per share, paying a 5% cumulative annual dividend and convertible at 0.1754 per share of common stock.

In April 2016, the Company issued an aggregate 83,336 shares of its common stock in payment for consulting services at a fair value of $14,292.

In April 2016, the Company issued an aggregate of 12,834,800 shares of its common stock to Note holders in settlement of $1,025,000 in convertible notes and accrued interest (Note 5).

In May 2016, the Company sold an aggregate of 11,714,285 shares of common stock of the Company and 1,312,000 warrants to purchase the Company's common stock to accredited investors for net proceeds of $1,579,082. The warrants have a term of five years, an exercise price of $0.25 per share and are subject to anti-dilution protection, as defined.

In May 2016, the Company issued 900,525 shares of its common stock upon conversion of 15,000 shares of Series A Convertible Preferred Stock and accrued dividends.

In July 2016, the Company issued an aggregate 124,998 shares of its common stock in payment for consulting services at a fair value of $20,666.

In August 2016, the Company issued an aggregate 41,666 shares of its common stock in payment for consulting services at a fair value of $6,208.

In September 2016, the Company issued an aggregate 41,666 shares of its common stock in payment for consulting services at a fair value of $6,292.

Registration rights

Under the purchase agreement, the Company has agreed to use its reasonable best efforts to prepare and file with the SEC registration statement within 60 days of the initial closing date, covering the resale by the investors of any common stock previously issued to the investors, and any common stock into which any convertible promissory notes previously issued to the investors are convertible and any common stock for which the warrants or any warrants previously issued to the investors are exercisable. The Company filed a registration statement on September 30, 2016.

NOTE 7: OPTIONS

As of September 30, 2016 and December 31, 2015, the Company has outstanding options to purchase 25,005,504 and 14,759,914 shares of common stock, respectively.

	Number of Options	Wtd Avg. Exercise Price	Wtd Avg. Remaining Term	Exercisable	Intrinsic Value of Exercisable Options
Outstanding at December 31, 2015	14,759,914	$ 0.30	3.61	8,374,294	$ —
Granted	10,756,090	0.08	4.86		—
Forfeited/Expired	(510,500)	0.78			—
Outstanding at September 30, 2016	25,005,504	$ 0.20	3.52	13,177,211	$ 417,857

On January 15, 2016, the Company granted performance options to acquire shares of the Company's common stock in aggregate of 6,500,000 to key board member and officers at an exercise price of $0.038 per share for five years. Vesting shall only occur if the closing share price of the Company's common stock on each of the 20 trading days before and including the end of any performance period is not less than $0.20 per share (market condition). Of the granted options, 5,500,000 include performance conditions (as defined) with both conditions (market and performance) to be met before vesting. All determinations of whether performance goals have been achieved, the number of vested performance options earned by the grantee, and all other matters related to the award of performance options shall be made by the compensation committee of the Company's board of directors in its sole discretion.

The estimated fair values of the options with performance and market conditions were determined using a Monte Carlo pricing model. Significant assumptions used in the valuation include expected term of 5 years, expected volatility of 162%, risk free interest rate of 1.46%, and expected dividend yield of 0%.

Nonperformance option grants during the nine months ended September 30, 2016 were valued using the Black-Scholes pricing model. Significant assumptions used in the valuation include expected term of 1.5 to 3.5 years, expected volatility of 102.00% to 174.99%, risk free interest rate of 0.87% to 1.73%, and expected dividend yield of 0%.

On April 15, 2016, the Company issued 49,715 options, which vest immediately, have an exercise price of $0.179, and expire on April 15, 2019. The value on the grant date of the options was $6,250.

On May 12, 2016, the Company issued 100,000 options, which vest 50% after one year and 4.17% every month thereafter, have an exercise price of $0.177, and expire on May 12, 2021. The value on the grant date of the options was $16,694.

On May 12, 2016, the Company issued an aggregate of 3,400,000 options, which vest 50% immediately and 50% vesting quarterly over 12 months, have an exercise price of $0.177, and expire on May 12, 2021. The value on the grant date of the options was $559,603.

On July 15, 2016, the Company issued 56,375 options, which vest immediately, have an exercise price of $0.156, and expire on July 15, 2019. The value on the grant date of the options was $6,250.

For the three and nine months ended September 30, 2016 and 2015, total stock compensation expense related to the options totaled $166,111 and $706,230 and $(119,224) and $709,311, respectively.

NOTE 8: WARRANTS

Below is a table summarizing the Company's outstanding warrants as of September 30, 2016 and December 31, 2015:

	Number of Warrants	Wtd Avg. Exercise Price	Wtd Avg. Remaining Term	Exercisable	Intrinsic Value of Exercisable Warrants
Outstanding at December 31, 2015	42,526,609	$ 0.22	4.15	41,297,920	$ 1,167
Exercised	-				
Granted	21,961,513	0.02	4.66		-
Expired	(393,081)	0.42			
Outstanding at September 30, 2016	64,095,041	0.15	3.73	63,907,541	$ 4,059,950

NOTE 8: WARRANTS

The warrant grants during the nine months ended September 30, 2016 were valued using the Black-Scholes pricing model. Significant assumptions used in the valuation include expected term of 1.5 to 2.5 years, expected volatility of 166.74% to 178.98%, risk free interest rate of 0.71% to 1.08%, and expected dividend yield of 0%.

During the nine months ended September 30, 2016, the Company issued an aggregate of 1,575,954 warrants to purchase shares of the Company's common stock with an exercise prices of $0.038 to $0.179 per share vested immediately for services. The fair value on the grant date of the warrants was $150,500.

In April 2016, the Company issued an aggregate of 18,353,310 warrants to acquire its common stock in settlement of $1,541,678 convertible notes and accrued interest. The warrants issued to Anthion are exercisable at $0.001 per share for five years from the date of issuance.

The Company determined that the estimated fair value of the 18,353,311 warrants of $3,205,959 exceeded the settlement of $1,541,678 of convertible notes and accrued interest and accordingly recorded a loss of settlement of debt of $1,664,281 for the nine months ended September 30, 2016. The Company used the Black-Scholes Option Pricing model to estimate the fair value of the warrants at settlement with the following assumptions: the price of the Company stock of $0.175, volatility was estimated to be 178%, the risk free rate of 1.24% and the remaining term was 5 years.

In May 2016, the Company issued 1,312,000 warrants with an exercise price of $0.25 in connection with the sale of Common Stock. The five year warrants also contain a provision that the warrant exercise price will automatically be adjusted for any common stock equity issuances at less than $0.25 per share.

For the three and nine months ended September 30, 2016 and 2015, the Company has incurred warrant-based expense of $58,599 and $206,772 and $20,962 and $491,148, respectively.

NOTE 9: COMMITMENTS AND CONTINGENCIES

Litigation

In April 2015, two shareholder class action lawsuits were filed against the Company and former officers Nathaniel Bradley and Edward O'Donnell in the U.S. District Court for the District of Arizona. The plaintiffs allege various causes of action against the defendants arising from our announcement that our previously issued financial results for the first three quarters of 2014 and the guidance for the fourth quarter of 2014 and the full year of 2014 could no longer be relied upon. The complaints sought among other relief, compensatory damages and plaintiff's counsel's fees and experts' fees. The Court appointed a lead plaintiff and lead counsel, and consolidated the actions. A consolidated amended complaint was filed under the caption *In re AudioEye, Inc. Sec. Litigation.* The Company and individual defendants filed a motion to dismiss.

On July 25, 2016, in connection with a voluntary mediation, the parties reached an agreement in principle to settle the consolidated actions. The settlement agreement is subject to definitive documentation, shareholder notice, and court approval. The terms of the agreement include a settlement payment to the class of $1,525,000 from the Company's insurer, with no admission of liability by any party. In 2015, the Company paid a deductible under its D&O insurance policy in the amount of $100,000 regarding this matter.

On May 16, 2016, a shareholder derivative complaint entitled *LiPoChing, Derivatively and on Behalf of AudioEye, Inc., v. Bradley, et al.* , was filed in the United States District Court for the District of Arizona. As a derivative complaint, the plaintiff-shareholder purports to act on behalf of the Company against certain of the Company's current and former officers and directors (the " ***Named Individuals*** ").

The Company is named as a nominal defendant. The complaint asserts causes of action including breach of fiduciary duty and others, arising from the Company's restatement of its financial results for the first three quarters of 2014. The complaint seeks, among other relief, compensatory damages, restitution and attorneys' fees. No discovery has occurred. In October 2016, the Company and Named Defendants filed a motion to dismiss, which remains pending. While the Company believes that its legal defense costs may be reimbursed by the Company's insurance carrier, no reasonable estimate of the outcome of the litigation, the related legal fees, or the impact on the financial results of the Company can be made as of the date of this statement.

On July 26, 2016, a shareholder derivative complaint entitled *Denese M. Hebert, derivatively on Behalf of Nominal Defendant AudioEye, Inc., v. Bradley, et al.* , was filed in the State of Arizona Superior Court for Pima County. The complaint generally asserts causes of action related to the Company's restatement of its financial statements for the first three fiscal quarters of 2014. As a derivative complaint, the plaintiff-shareholder purports to act on behalf of the Company against certain of the Company's current and former officers and directors (the " *Named Individuals* "). The Company is named as a nominal defendant. The Company understands that the Named Individuals intend to vigorously defend the lawsuit. While the Company believes that its legal defense costs may be reimbursed by the Company's insurance carrier, no reasonable estimate of the outcome of the litigation, the related legal fees, or the impact on the financial results of the Company can be made as of the date of this statement.

We may become involved in various other routine disputes and allegations incidental to our business operations. While it is not possible to determine the ultimate disposition of these matters, our management believes that the resolution of any such matters, should they arise, is not likely to have a material adverse effect on our financial position or results of operations.

NOTE 10: SUBSEQUENT EVENTS

Employee options/warrants

On October 15, 2016, the Company granted 61,599 options to Sean Bradley as compensation for services rendered. The options are exercisable at $0.125 for three years, vesting immediately. The exercise price was determined using the 10-day average closing price beginning with the closing price on October 1, 2016.

Common stock

In October 2015, the Company issued 41,666 shares of its common stock for consulting services rendered valued at $4,292.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations or MD&A, should be read in conjunction with our consolidated financial statements and related notes in Part I, Item 1 of this report.

As used in this quarterly report, the terms "we," "us," "our" and similar references refer to AudioEye, Inc. and our wholly-owned subsidiary, unless otherwise indicated.

Cautionary Note Regarding Forward-Looking Statements

Any statements in this Quarterly Report on Form 10-Q about our expectations, beliefs, plans, objectives, prospects, financial condition, assumptions or future events or performance are not historical facts and are "forward-looking statements" as that term is defined under the federal securities laws. These statements are often, but not always, made through the use of words or phrases such as "believe", "anticipate", "should", "intend", "plan", "will", "expects", "estimates", "projects", "positioned", "strategy", "outlook" and similar words. You should read the statements that contain these types of words carefully. Such forward-looking statements are subject to a number of risks, uncertainties and other factors that could cause actual results to differ materially from what is expressed or implied in such forward-looking statements. There may be events in the future that we are not able to predict accurately or over which we have no control. Potential risks and uncertainties include, but are not limited to, those discussed in "Part I, Item 1A. Risk Factors" in our Annual Report filed on Form 10-K for the year ended December 31, 2015. We urge you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or uncertainties after the date hereof or to reflect the occurrence of unanticipated events.

Overview

AudioEye is a marketplace leader providing web accessibility solutions for our clients' customers through our **Ally Platform Products.** Our technology advances accessibility with patented technology solutions that reduce barriers, expand access for individuals with disabilities, and enhance the user experience for a broader audience of users **.** When implemented, we believe that our solutions offer businesses the opportunity to reach more customers, improve brand image, and build additional brand loyalty. In addition, our solutions help organizations comply with internationally accepted Web Content Accessibility Guidelines (WCAG) as well as US, Canadian, Australian, and United Kingdom accessibility laws.

We generate revenues through the sale of subscriptions of our software as a service (SaaS) technology platform, called the AudioEye Ally Platform, to website owners, publishers, developers, and operators and through the delivery of managed services combined with the implementation of the AudioEye solution. Our solutions have been adopted by some of the largest and most influential companies in the world. Our customers span disparate industries and target market verticals, which encompass (but are not limited to) the following categories: human resources, finance, transportation, media, and education. Government agencies have also integrated our software in their digital platforms.

The AudioEye Solution

AudioEye uses proprietary technology and development tools to offer web accessibility solutions that offer significant savings in time and money relative to traditional solutions. Our compliance solutions focus on rapid remediation of the most important accessibility issues, followed by in-depth analysis identifying and addressing a more comprehensive compliance program. Our technology was built to not only provide users with a cloud-based assistive toolset that gets embedded and made freely available to users within our client websites, but to also improve the code in a way that optimizes the user experience for users of existing third-party assistive technologies, such as screen readers.

Intellectual Property

Our technology development was initiated at the University of Arizona Science & Technology Park in Tucson, Arizona. In 2006, we received technology development venture funding from the Maryland Technology Development Corporation (TEDCO), which contributed to the development of our platform strategy. Beginning in 2009, we engaged in a multi-year technology development program with the Eller College of Management's Department of Management Information Systems at the University of Arizona. In connection with our proprietary technology, our company has been issued a number of U.S. patents in two distinct patent families. Today, an experienced team of in-house engineers, designers, and developers in our Atlanta, GA, and Tucson, AZ, offices develop the Company's technology & software and are actively engaged in the expansion of the AudioEye IP Portfolio.

Our patented technology was a 2013 Edison Gold Award winner for innovation in the category of "Quality of Life."

Our intellectual property is primarily comprised of trade secrets, trademarks, issued and pending patents, copyrights and technological innovation. We have a patent portfolio comprised of six patents issued in the United States, we have received a notice of allowance from the U.S. Patent and Trademark Office for a seventh patent, and we have several additional patents that are either pending or are being prepared for filing in the United States and internationally.

Our current patented invention relates to a server-side method and apparatus that enables users to audibly navigate websites and hear high-quality streaming audio narration and descriptions of websites. This patented invention involves creating an audio-enabled web experience by utilizing voice talent and automated text-to-speech conversion methods to read and describe web content. It involves the creation of audio files for each section within a website, and then assigning a hierarchy and navigation system in line with the website design. To implement the system, a script is installed across the pages of the website and, when loaded, it plays an audible tone upon a user's visit indicating that the website is enhanced with our proprietary technology. Upon hearing the tone, a user presses a key on the keyboard to enter the audible website. Audible narration is played through the user's computer, reading text and describing non-text information, such as images. The narration includes menus for navigating the site which have a hierarchy in line that of the original website. Users navigate the website menus and move from webpage to webpage by making keystrokes or using a mouse.

Our current portfolio has established a foundation for building unique technology solutions that contribute to the way in which we differentiate ourselves from other competitors in the B2B Web Accessibility marketplace. We plan to continue to invest in research and development, and expand our portfolio of proprietary intellectual property.

Our Annual Report filed on Form 10-K for the year ended December 31, 2015 provides additional information about our business and operations.

Results of Operations

Our consolidated audited financial statements are stated in United States Dollars and are prepared in accordance with United States Generally Accepted Accounting Principles ("GAAP"). The discussion of the results of our operations compares the three and nine months ended September 30, 2016 with the three and nine months ended September 30, 2015 and are not necessarily indicative of the results which may be expected for any subsequent period. Our prospects should be considered in light of the risks, expenses and difficulties encountered by companies in similar positions. We may not be successful in addressing these risks and difficulties.

Comparative for the Three Months ended September 30, 2016 and September 30, 2015

Results of Operations

	Three Months Ended September 30,	
	2016	2015
Revenue	282,676	$ 108,685
Cost of sales	311,519	321,755
Gross loss	(28,843)	(213,070)
Operating expenses:		
Selling & marketing	192,881	171,594
Research & development	85,192	92,857
General and administrative expenses	602,041	(27,278)
Amortization & depreciation	150,328	128,381
Total operating expenses	(1,030,442)	(365,554)
Operating loss	(1,059,285)	(578,624)
Unrealized gain on derivative liabilities	351,055	-
Unrealized gain on marketable securities	900	-
Interest income/(expense)	266	81
Net (loss)	(707,064)	(578,543)
Deemed dividend on Series A Convertible preferred stock	(20,000)	(-)
Net loss attributable to common stockholders	$ (727,064)	$ (578,543)
Net loss per common share – basic and diluted	(0.01)	(0.01)
Weighted average common shares outstanding – basic and diluted	107,382,344	81,800,488

Revenue

For the three months ended September 30, 2016 and 2015, revenue was $282,676 and $108,685, respectively, consisting primarily of revenues from various levels of licensing, website design and maintenance. Revenues increased due to a change of marketing focus.

Cost of Sales

For the three months ended September 30, 2016 and 2015, cost of sales was $311,519 and $321,755, respectively, consisting primarily of sub-contracting to outside sources, direct labor and direct technology costs.

Gross Loss

An increase in our implementation costs resulted in a gross loss of $28,843 and $213,070 during the three months ended September 30, 2016 and 2015, respectively. Gross loss decreased as a result of lower implementation costs as compared to the same period in 2015.

Selling and Marketing Expenses

Selling and marketing expenses were $192,881 and $171,594 for the three months ended September 30, 2016 and 2015, respectively. The increase resulted from the higher sales activity in 2016 as compared to 2015.

Research and Development Expenses

Research and development expenses were $85,192 and $92,857 for three months ended September 30, 2016 and 2015, respectively. Research and development expenses decreased from period to period and reflect continued developments of our product.

General and Administrative Expenses

General and administrative expenses were $602,041 and $(27,278) for the three months ended September 30, 2016 and 2015, respectively. In 2015, we recaptured stock option and warrant expense incurred in prior periods due to the forfeitures of unvested awards due to from staff reductions. Stock based compensation for the three months ended September 30, 2016 was $224,710 as compared to $(299,811) for the same period last year.

Amortization and Depreciation

Amortization and depreciation expenses were $150,328 and $128,381 for the three months ended September 30, 2016 and 2015, respectively. The increase in expense was primarily related to added patent costs in later 2015 and 2016.

Gain on change in Fair Value of Derivative Liabilities

In October 2015 and in 2016, we issued warrants with an embedded reset provisions requiring us to fair value the derivatives each reporting period and mark to market as a non-cash adjustment to our current period operations. This resulted in a gain of $351,055 on change in fair value of derivative liabilities for the three months ended September 30, 2016. None were issued as of September 30, 2015.

Interest Income (Expense), net

Interest income (expense), net during the three months ended September 30, 2016 was $266 compared to $81 three months ended September 30, 2015. Both representing interest earning with our interest bearing deposit accounts.

Comparative for the Nine Months ended September 30, 2016 and September 30, 2015

Results of Operations

	Nine Months Ended September 30,	
	2016	**2015**
Revenue	594,237	$ 314,146
Cost of sales	904,091	1,178,388
Gross loss	(309,854)	(864,242)
Operating expenses:		
Selling & marketing	510,448	747,990
Research & development	255,805	293,877
General and administrative expenses	1,894,964	4,161,269
Amortization & depreciation	428,701	396,269
Total operating expenses	(3,089,918)	(5,599,405)
Operating loss	(3,399,772)	(6,463,647)
Unrealized loss on derivative liabilities	(2,990,096)	-
Loss on settlement of debt	(1,664,281)	-
Other income	750	-
Interest income/(expense)	(676,181)	3,345
Net (loss)	(8,729,580)	(6,460,302)
Deemed dividend on Series A Convertible preferred stock	(60,000)	(594,641)
Net loss attributable to common stockholders	$ (8,789,580)	$ (7,054,943)
Net loss per common share – basic and diluted	(0.09)	(0.09)
Weighted average common shares outstanding – basic and diluted	95,840,596	80,007,507

Revenue

For the nine months ended September 30, 2016 and 2015, revenue was $594,237 and $314,146, respectively, consisting primarily of revenues from various levels of licensing, website design and maintenance. Revenues increased due to a change of marketing focus.

Cost of Sales

For the nine months ended September 30, 2016 and 2015, cost of sales was $904,091 and $1,178,388, respectively, consisting primarily of sub-contracting to outside sources, direct labor and direct technology costs.

Gross Loss

An increase in our implementation costs resulted in a gross loss of $309,854 and $864,242 during the nine months ended September 30, 2016 and 2015, respectively. Gross loss decreased as a result of lower implementation costs as compared to the same period in 2015.

Selling and Marketing Expenses

Selling and marketing expenses were $510,448 and $747,990 for the nine months ended September 30, 2016 and 2015, respectively. The decrease resulted from the reduction primarily in staffing levels.

Research and Development Expenses

Research and development expenses were $255,805 and $293,877 for nine months ended September 30, 2016 and 2015, respectively. Research and development expenses declined from period to period and reflect the material completion of our product.

General and Administrative Expenses

General and administrative expenses were $1,894,964 and $4,161,269 for the nine months ended September 30, 2016 and 2015, respectively. General and administrative expenses decreased as a result of employee staff reductions and the associated benefits costs as well as decrease in stock based compensation year over year.

Amortization and Depreciation

Amortization and depreciation expenses were $428,701 and $396,269 for the nine months ended September 30, 2016 and 2015, respectively. The increase in expense was primarily related to added patent costs in later 2015 and 2016.

Loss on change in Fair Value of Derivative Liabilities

In October 2015 and in 2016, we issued warrants with an embedded reset provisions requiring us to fair value the derivatives each reporting period and mark to market as a non-cash adjustment to our current period operations. This resulted in a loss of $2,990,096 on change in fair value of derivative liabilities for the nine months ended September 30, 2016. None were issued as of September 30, 2015.

Loss on settlement of Debt

In April 2016, we issued common stock warrants in settlement of convertible debt and accrued interest. As such, we incurred a non-cash loss on debt settlement between the estimated fair value of the issued warrants and the carrying value of the debt and accrued interest of $1,664,281.

Interest Income (Expense), net

Interest income (expense), net during the nine months ended September 30, 2016 was $(676,181) compared to $3,345 for the nine months ended September 30, 2015. For 2016, Interest expense consists of amortization of debt discounts and interest incurred relating to our issued notes payable, as compared to interest income of $3,264 for the nine months ended September 30, 2016

Contracts in Process/Revenue Recognition

Under current accounting procedures, the Company only recognizes revenue on new contracts for the actual services delivered in the period under the following criteria: i) the contract has been signed and delivered to the Company; ii) the services have been performed or delivered; and iii) the client has been billed for the services delivered. The Company does not record deferred revenues for new contracts until the first payment for services has been received. The Company only records accounts receivable for the amount of revenue recognized as service is rendered, even if the client has been billed for the entire contract value. The table below summarizes the amount of contract value in excess of the revenue recognized of $644,334 and the deferred revenue recognized of $445,082, in the amount of $318,824. This amount is expected to be recognized in future periods. The Company also receives contracts for service hours but whose total contract value is uncertain. These “fee for service contracts” are recorded in the table below only if the services have been delivered and the associated revenue has been recognized.

A summary of our contracts in process is as follows:

	Contracts in Process September 30, 2016				
	Contract Amount	Revenue Recognized prior to 2016	Revenue Recognized 9 Months Ended September 30, 2016	Deferred Revenue September 30, 2016	Contract Amount in Excess of Deferred Revenue and Recognized Revenue
Fixed Contracts	$ 1,330,408	$ 50,097	$ 516,405	$ 445,082	$ 318,824
Fee for Service Contracts	77,832		77,832		
	$ 1,408,240	$ 50,097	$ 594,237	$ 445,082	$ 318,824

Liquidity and Capital Resources

Working Capital

	At September 30, 2016	At December 31, 2015
Current Assets	$ 1,626,440	$ 1,804,986
Current Liabilities	4,368,446	891,245
Working Capital (Deficit)	$ (2,742,006)	$ 913,741

The working capital (deficit)/surplus for the periods ended September 30, 2016 and December 31, 2015 was $(2,742,006) and $913,741 respectively. The decrease in Working Capital was primarily due to an increase in our non-cash derivative liability, accounts payable, deferred revenue and decrease in cash. Adjusting for the non-cash derivative liability, Working Capital would have been $906,237 at September 30, 2016. In addition, the Company used actual net cash in operations of $1,711,819 during the nine months ended September 30, 2016. The Company has incurred net losses since inception. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company expects that cash used in operations will decrease significantly over the next several years as the Company executes its business plan. In the event that the Company is not able to fully achieve its plan, the Company may need to raise additional funds through equity or debt financing. If the Company is unsuccessful in raising additional financing, it will need to reduce costs and operations in the future.

Cash Flows

	For the nine months ended September 30,	
	2016	2015
Net Cash (Used in) Operating Activities	$ (1,711,819)	$ (4,804,778)
Net Cash (Used in) Investing Activities	(42,007)	(88,156)
Net Cash Provided by Financing Activities	1,561,082	3,271,943
Decrease in Cash	$ (192,744)	$ (1,620,991)

We had cash in the amount of $1,494,513 and $1,687,257 as of September 30, 2016 and December 31, 2015, respectively.

On April 18, 2016 (the “Initial Closing Date”), the Company entered into a Common Stock and Warrant Purchase Agreement (the “Purchase Agreement”) with certain investors for the issuance and sale of 11,714,285 shares of common stock of the Company and warrants to purchase up to an aggregate of 1,312,000 shares of Common Stock, representing up to $1,640,000 of proceeds, in one or more closings within 30 days of the Initial Closing Date (the “Transaction”). The warrants are exercisable at $0.25 per share for five years from the date of issuance and subject to anti-dilution protection as defined. As of July 23, 2016, the Company had received proceeds, net of costs, of $1,579,082.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with the accounting principles generally accepted in the United States. Preparing financial statements requires our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by our management’s application of accounting policies. We believe that understanding the basis and nature of the estimates and assumptions involved with the following aspects of our financial statements is critical to an understanding of our financial statements.

Our critical accounting policies, as described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, relate to capitalized legal patent costs, income taxes, goodwill, intangible assets, share-based payments, revenue recognition, and research and other accounting descriptions. There have been no material changes to our critical accounting policies as disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 , as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, to allow for timely decisions regarding required disclosure. Our management carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2016 in accordance with generally accepted accounting principles. Please refer to our Annual Report on Form 10-K for the year ended December 31, 2014 as filed with the SEC on July 10, 2015 for a complete discussion relating to the foregoing evaluation of our controls and procedures.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

In April 2015, two shareholder class action lawsuits were filed against the Company and former officers Nathaniel Bradley and Edward O'Donnell in the U.S. District Court for the District of Arizona. The plaintiffs allege various causes of action against the defendants arising from our announcement that our previously issued financial results for the first three quarters of 2014 and the guidance for the fourth quarter of 2014 and the full year of 2014 could no longer be relied upon. The complaints sought among other relief, compensatory damages and plaintiff's counsel's fees and experts' fees. The Court appointed a lead plaintiff and lead counsel, and consolidated the actions. A consolidated amended complaint was filed under the caption *In re AudioEye, Inc. Sec. Litigation.* The Company and individual defendants filed a motion to dismiss.

On July 25, 2016, in connection with a voluntary mediation, the parties reached an agreement in principle to settle the consolidated actions. The settlement agreement is subject to definitive documentation, shareholder notice, and court approval. The terms of the agreement include a settlement payment to the class of $1,525,000 from the Company's insurer, with no admission of liability by any party. In 2015, the Company paid a deductible under its D&O insurance policy in the amount of $100,000 regarding this matter.

On May 16, 2016, a shareholder derivative complaint entitled *LiPoChing, Derivatively and on Behalf of AudioEye, Inc., v. Bradley, et al.* , was filed in the United States District Court for the District of Arizona. As a derivative complaint, the plaintiff-shareholder purports to act on behalf of the Company against certain of the Company's current and former officers and directors (the " ***Named Individuals*** "). The Company is named as a nominal defendant. The complaint asserts causes of action including breach of fiduciary duty and others, arising from the Company's restatement of its financial results for the first three quarters of 2014. The complaint seeks, among other relief, compensatory damages, restitution and attorneys' fees. No discovery has occurred. In October 2016, the Company and Named Defendants filed a motion to dismiss, which remains pending. While the Company believes that its legal defense costs may be reimbursed by the Company's insurance carrier, no reasonable estimate of the outcome of the litigation, the related legal fees, or the impact on the financial results of the Company can be made as of the date of this statement.

On July 26, 2016, a shareholder derivative complaint entitled *Denese M. Hebert, derivatively on Behalf of Nominal Defendant AudioEye, Inc., v. Bradley, et al.* , was filed in the State of Arizona Superior Court for Pima County. The complaint generally asserts causes of action related to the Company's restatement of its financial statements for the first three fiscal quarters of 2014. As a derivative complaint, the plaintiff-shareholder purports to act on behalf of the Company against certain of the Company's current and former officers and directors (the " *Named Individuals* "). The Company is named as a nominal defendant. The Company understands that the Named Individuals intend to vigorously defend the lawsuit. While the Company believes that its legal defense costs may be reimbursed by the Company's insurance carrier, no reasonable estimate of the outcome of the litigation, the related legal fees, or the impact on the financial results of the Company can be made as of the date of this statement.

We may become involved in various other routine disputes and allegations incidental to our business operations. While it is not possible to determine the ultimate disposition of these matters, our management believes that the resolution of any such matters, should they arise, is not likely to have a material adverse effect on our financial position or results of operations.

Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Item 1.A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2015.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Description
31.1*	Certification of the Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of the Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

SIGNATURES

Pursuant to the requirements 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 on the 14 day of November 2016.

AUDIOEYE, INC.

By: */ s/ Dr. Carr Bettis*
Dr. Carr Bettis
Principal Executive Officer

By: */ s/ Todd Bankofier*
Todd Bankofier
Chief Executive Officer

Exhibit 31.1

CERTIFICATION UNDER SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Carr Bettis, Principal Executive Officer of AudioEye, Inc. (the " Registrant "), certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the period ended September 30, 2016 of AudioEye, Inc. (the " Quarterly Report ");

2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report;

3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Quarterly Report;

4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under my supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this Quarterly Report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Annual Report my conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Quarterly Report based on such evaluation; and

(d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and

5. The Registrant's other certifying officer and I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 14, 2016

By: /s/ Carr Bettis
Name: Carr Bettis
Title: Principal Executive Officer and Principal Financial Officer

Exhibit 32.1

CERTIFICATION UNDER SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the filing by AudioEye, Inc. (the " Registrant ") of its Quarterly Report on Form 10-Q for the period ended September 30, 2016 (the " Quarterly Report ") with the Securities and Exchange Commission, I, Carr Bettis, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(i) The Quarterly Report fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

A signed original of this written statement required by Section 906 has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.

Date: November 14, 2016

By: /s/ Carr Bettis
Name: Carr Bettis
Title: Principal Executive Officer and Principal Financial Officer