

Net Element, Inc.  
Form 10-Q  
November 14, 2017

**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, 2017

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: **001-34887**

**Net Element, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware** **90-1025599**  
(State or other jurisdiction of incorporation (I.R.S. Employer  
or organization) Identification No.)

**3363 NE 163rd Street, Suite 705**  
**North Miami Beach, Florida 33160**  
(Address of principal executive offices) (Zip Code)

**(305) 507-8808**

(Registrant's telephone number, including area code)

**Not applicable**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period 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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Emerging growth company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. "

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

The number of outstanding shares of common stock, \$.0001 par value, of the registrant as of November 11, 2017 was 2,454,457 after giving effect to the registrant's one-for-ten reverse stock split effected October 5, 2017.

## Defined Terms

Net Element, Inc. is a corporation organized under the laws of the State of Delaware. As used in this Quarterly Report on Form 10-Q (this “Report”), unless the context otherwise requires, the terms “Company,” “we,” “us” and “our” refer to Net Element, Inc. and, as applicable, its majority-owned and consolidated subsidiaries. References in this Report to “PayOnline” refer, collectively, to PayOnline System LLC, Innovative Payment Technologies LLC, Polimore Capital Limited and Brosword Holding.

## Forward-Looking Statements

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended. Any statements contained in this Report that are not statements of historical fact may be deemed forward-looking statements.

Forward-looking statements generally are identified by the words “expects,” “anticipates,” “believes,” “intends,” “estimates,” “aims,” “plans,” “may,” “will,” “continue,” “seeks,” “should,” “believe,” “potential” or the negative of such terms and similar expressions. Forward-looking statements are based on current plans, estimates and projections, and therefore you should not place too much reliance on them. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement in light of new information or future events, except as expressly required by law. Forward-looking statements involve inherent risks and uncertainties, most of which are difficult to predict and are generally beyond the Company’s control. The Company cautions you that a number of important factors could cause actual results or outcomes to differ materially from those expressed in, or implied by, the forward-looking statements. These factors include, among other factors:

- the impact of any new or changed laws, regulations, card network rules or other industry standards affecting our business including the U.S. government decision to impose sanctions or other legal restrictions that may restrict our ability to do business in Russia;
- the impact of any significant chargeback liability and liability for merchant or customer fraud, which we may not be able to accurately anticipate and/or collect;
- our ability to secure or successfully migrate merchant portfolios to new bank sponsors if current sponsorships are terminated;
- our and our bank sponsors’ ability to adhere to the standards of the Visa®, Discover®, American Express® and MasterCard® payment card associations;
- our reliance on third-party processors and service providers;
- our dependence on independent sales groups (“ISGs”) that do not serve us exclusively to introduce us to new merchant accounts;
- our ability to pass along increases in interchange costs and other costs to our merchants;
- our ability to protect against unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise;
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- the effect of the loss of key personnel on our relationships with ISGs, card associations, bank sponsors and our other service providers;
- the effects of increased competition, which could adversely impact our financial performance;
- the impact of any increase in attrition due to an increase in closed merchant accounts and/or a decrease in merchant charge volume that we cannot anticipate or offset with new accounts;
- the effect of adverse business conditions on our merchants;
- our ability to adopt technology to meet changing industry and customer needs or trends;
- the impact of any decline in the use of credit cards as a payment mechanism for consumers or adverse developments with respect to the credit card industry in general;
- the impact of any adverse conditions in industries in which we obtain a substantial amount of our bankcard processing volume;
- the impact of seasonality on our operating results;
- the impact of any failure in our systems due to factors beyond our control;
- the impact of any material breaches in the security of third-party processing systems we use;
- the impact of any new and potential governmental regulations designed to protect or limit access to consumer information;
- the impact on our profitability if we are required to pay federal, state or local taxes on transaction processing or VAT on content;
- the impact on our growth and profitability if the markets for the services that we offer fail to expand or if such markets contract;
- our ability (or inability) to continue as a going concern;

- foreign laws and regulations, which are subject to change and uncertain interpretation;
- the Company's ability (or inability) to obtain additional financing in sufficient amounts or on acceptable terms when needed;
- the impact on our operating results as a result of impairment of our goodwill and intangible assets;
- our material weaknesses in internal control over financial reporting and our ability to maintain effective controls over financial reporting in the future; and
- the other factors described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 and in Part II, Item 1A of this Report and our subsequent filings with the U.S. Securities and Exchange Commission (the "Commission").

If these or other risks and uncertainties (including those described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 and in Part II, Item 1A of this Report and the Company's subsequent filings with the Commission) materialize, or if the assumptions underlying any of these statements prove incorrect, the Company's actual results may be materially different from those expressed or implied by such statements. We undertake no obligation to publicly revise any forward-looking statement to reflect circumstances or events after the date of this Report to reflect the occurrence of unanticipated events. You should, however, review the factors and risks described in the reports we file from time-to-time with the Commission after the date of this Report.

World Wide Web addresses contained in this Report are for explanatory purposes only and they (and the content contained therein) do not form a part of and are not incorporated by reference into this Report.

**Net Element, Inc.**

**Form 10-Q**

**For the Three Months Ended September 30, 2017**

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**PART I — FINANCIAL INFORMATION****NET ELEMENT, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

	September 30, 2017	December 31, 2016
<b>ASSETS</b>		
Current assets:		
Cash	\$922,102	\$621,635
Accounts receivable, net	4,446,358	7,126,429
Prepaid expenses and other assets	1,658,200	1,467,897
Total current assets, net	7,026,660	9,215,961
Fixed assets, net	64,381	117,295
Intangible assets, net	3,242,889	3,589,850
Goodwill	9,643,752	9,643,752
Other long term assets	456,948	603,209
Total assets	20,434,630	23,170,067
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	6,067,319	7,510,113
Accrued expenses	3,419,879	5,518,823
Deferred revenue	1,196,743	1,355,972
Notes payable (current portion)	503,041	808,976
Due to related parties	376,593	299,004
Total current liabilities	11,563,575	15,492,888
Notes payable (net of current portion)	6,887,382	3,615,782
Total liabilities	18,450,957	19,108,670
<b>STOCKHOLDERS' EQUITY</b>		
Series A Convertible Preferred stock (\$.0001 par value, 1,000,000 shares authorized, no shares issued and outstanding at September 30, 2017 and December 31, 2016)	-	-
Common stock (\$.0001 par value, 100,000,000 shares authorized and 2,141,208 and 1,535,349 shares issued and outstanding at September 30, 2017 and December 31, 2016)	2,142	1,535
Paid in capital	167,805,711	163,918,685
Accumulated other comprehensive loss	(2,528,424 )	(2,486,616 )
Accumulated deficit	(163,272,959)	(157,442,585)
Noncontrolling interest	(22,797 )	70,378
Total stockholders' equity	1,983,673	4,061,397

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Total liabilities and stockholders' equity	\$20,434,630	\$23,170,067
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See accompanying notes to unaudited condensed consolidated financial statements.

## NET ELEMENT, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	Three Months Ended September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Net revenues				
Service fees	\$ 14,901,131	\$ 12,874,386	\$ 43,263,217	\$ 34,355,912
Branded content	-	1,135,266	1,340,896	4,607,647
Total Revenues	14,901,131	14,009,652	44,604,113	38,963,559
Costs and expenses:				
Cost of service fees	12,756,627	10,683,897	36,232,170	28,285,984
Cost of branded content	-	1,011,271	1,302,841	4,279,218
General and administrative	2,357,729	2,284,737	7,788,068	6,372,361
Non-cash compensation	111,277	732,701	836,218	3,108,274
Bad debt expense	319,690	301,170	1,465,311	678,150
Depreciation and amortization	630,020	764,886	1,860,401	2,497,538
Total costs and operating expenses	16,175,343	15,778,662	49,485,009	45,221,525
Loss from operations	(1,274,212 )	(1,769,010 )	(4,880,896 )	(6,257,966 )
Interest expense, net	(302,813 )	(608,716 )	(894,553 )	(1,186,207 )
Loss from stock value guarantee	-	(1,559,281 )	-	(3,722,142 )
Other income (expense)	(92,904 )	433,784	(148,099 )	392,257
Net loss before income taxes	(1,669,929 )	(3,503,223 )	(5,923,548 )	(10,774,058 )
Income taxes	-	-	-	-
Net loss	(1,669,929 )	(3,503,223 )	(5,923,548 )	(10,774,058 )
Net (income) loss attributable to the noncontrolling interest	(32,607 )	33,683	93,175	110,350
Net loss attributable to Net Element, Inc. stockholders	(1,702,536 )	(3,469,540 )	(5,830,373 )	(10,663,708 )
Foreign currency translation gain (loss)	92,191	(96,786 )	(41,809 )	(622,568 )
Comprehensive loss attributable to common stockholders	\$ (1,610,345 )	\$ (3,566,326 )	\$ (5,872,182 )	\$ (11,286,276 )
Loss per share - basic and diluted	\$ (0.90 )	\$ (2.47 )	\$ (3.29 )	\$ (8.65 )
Weighted average number of common shares outstanding - basic and diluted	1,891,023	1,403,020	1,770,947	1,232,593

See accompanying notes to unaudited condensed consolidated financial statements.



## NET ELEMENT, INC.

## UNAUDITED CONSOLIDATED STATEMENT OF CASH FLOWS

	Nine Months Ended September 30,	
	2017	2016
Cash flows from operating activities		
Net loss	\$ (5,830,373 )	\$ (10,663,708 )
Adjustments to reconcile net loss to net cash (used in) provided by operating activities		
Non controlling interest	(93,175 )	(110,350 )
Share based compensation	836,218	3,108,274
Deferred revenue	(159,228 )	135,003
Depreciation and amortization	1,860,401	2,497,538
Non cash interest	98,774	741,857
Changes in assets and liabilities		
Accounts receivable	3,421,265	(610,384 )
Prepaid expenses and other assets	(352,551 )	(331,498 )
Accounts payable and accrued expenses	(2,390,495 )	4,165,778
Net cash used in operating activities	(2,609,164 )	(1,067,490 )
Cash flows from investing activities		
Client acquisition costs	(1,380,661 )	(1,346,718 )
Receipt of excess reserves and ( purchase) of fixed and other assets	77,430	-
Net cash used in investing activities	(1,303,231 )	(1,346,718 )
Proceeds from common stock	1,150,098	-
Proceeds from indebtedness	3,239,033	2,668,500
Repayment of indebtedness	(273,360 )	(110,434 )
Related party advances	77,587	117,779
Net cash provided by financing activities	4,193,358	2,675,845
Effect of exchange rate changes on cash	19,504	97,902
Net (decrease) increase in cash	300,467	359,539
Cash at beginning of period	621,635	1,025,747
Cash at end of period	\$ 922,102	\$ 1,385,286
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$ 795,779	\$ 461,673
Taxes	\$ 86,942	\$ 94,718
Share issuance for settlement of unpaid compensation	\$ -	\$ 1,042,509
Shares issued for redemption of indebtedness	\$ 363,986	\$ 2,328,351

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Shares issued in settlement of advances from from board member	\$ -	\$ 909,285
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See accompanying notes to unaudited condensed consolidated financial statements.

**NET ELEMENT, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization**

Net Element, Inc. (“we”, “us”, “our” or the “Company”) is a global financial technology and value-added solutions group specializing in mobile payments and other transactional services in emerging countries and in the United States. We have three reportable segments: (i) North American Transaction Solutions for electronic commerce, (ii) Mobile Solutions which primarily serves the Russian Federation and Eurasia and (iii) Online Solutions, comprehensive online payment acceptance solution, with access to 100+ payment methods in 50 countries and 120+ currencies. We are differentiated by our proprietary technology which enables us to provide a broad suite of payment products, end-to-end transaction processing services and superior client support. We are able to deliver these services across multiple points of access, or “multi-channel,” including brick and mortar locations, software integration, e-commerce, mobile operator billing, mobile and tablet-based solutions. In the United States, via our U.S. based subsidiaries, we generate revenues from transactional services and other payment technologies for small and medium-sized businesses (“SMBs”). Through Digital Provider, LLC (“Digital Provider”) and PayOnline, we have mobile operator relationships and contracts allowing us to facilitate transactional services, mobile payment transactions, online payment transactions and other payment technologies in emerging countries in the Russian Federation, Europe and Asia.

**Business**

Our transactional services business enables merchants to accept credit cards as well as other forms of payment, including debit cards, checks, gift cards, loyalty programs and alternative payment methods in traditional card-present or swipe transactions, as well as card-not-present transactions, such as those conducted over the phone or through the Internet or a mobile device. We market and sell our services through both independent sales groups (“ISGs”), which are non-employee, external sales organizations and other third-party resellers of our products and services, and directly to merchants through electronic media, telemarketing and other programs, including utilizing partnerships with other companies that market products and services to local and international merchants. We have agreements with several banks that sponsor us for membership in the Visa®, MasterCard®, American Express® and Discover® card associations and settle card transactions for our merchants. These sponsoring banks include Merrick Bank, N.A., Esquire Bank, N.A. and Wells Fargo Bank, N.A. From time to time, we may enter into agreements with additional banks. We perform core functions for merchants such as application processing, underwriting, account set-up, risk

management, fraud detection, merchant assistance and support, equipment deployment and chargeback services.

Our Mobile Solutions business, Digital Provider, provides relationships and contracts with mobile operators that give us the ability to offer our clients in-app, premium SMS (short message services, which is a text messaging service), Wireless Application Protocol (WAP)-click, one click and other carrier billing services. We also market our own branded content as a separate line of business for our mobile commerce business from offices in Russia and Kazakhstan. In August 2017, we substantially reorganized this business, and consolidated its operations into PayOnline and TOT Group Russia. We currently are not generating revenues from new mobile content and we continue to explore partnership opportunities that can monetize our relationships and contracts with mobile operators.

PayOnline provides flexible high-tech payment solutions to companies doing business on the Internet or in the mobile environment. PayOnline specializes in integration and customization of payment solutions for websites and mobile apps. In particular, PayOnline arranges payment on the website of any commercial organization, which increases the convenience of using the website and helps maximize the number of successful transactions. In addition, PayOnline is focused on providing online and mobile payment acceptance services to the travel industry through direct integration with leading Global Distribution Systems (“GDS”), which include Amadeus® and Sabre®. Key geographic regions that PayOnline serves include Eastern Europe, Central Asia, Western Europe, North American and Asia major sub regions. PayOnline offices are located in Russia, Kazakhstan and in the Republic of Cyprus.

Also part of our transactional services business, Aptito is a proprietary, cloud-based payments platform for the hospitality industry, which creates an online consumer experience in offline commerce environments via tablet, mobile and all other cloud-connected devices. Aptito’s easy to use point-of-sale (“POS”) system makes things easier by providing a comprehensive solution to the hospitality industry to help streamline management and operations. Orders placed tableside by customers directly speed up the ordering process and improve overall efficiency. Aptito's mobile POS system provides portability to the staff while performing all the same functions as a traditional POS system, and more.



## Company Overview

Net Element is a global financial technology and value-added solutions group that supports companies in accepting electronic payments in an omni-channel environment that spans across point-of-sale (“POS”), e-commerce and mobile devices. The Company operates in three segments as a provider of North America Transaction Solutions, Mobile Solutions and Online Solutions.

We enable merchants of all sizes to accept and process over 100 different payment options in more than 120 currencies, including credit, debit and prepaid payments. We also provide merchants with value-added services and technologies including integrated payment technologies, POS solutions, security solutions, fraud management, information solutions and analytical tools.

We provide a range of solutions to our clients across the value chain of commerce-enabling services and technologies. We create our value-added solutions from a suite of proprietary technology products which includes cloud-based applications, processing services, security offerings, and customer support programs that we configure to meet our clients’ individual needs.

We provide additional services including:

Payment processing POS solutions and value-added services throughout the United States provided by TOT Payments doing business as *Unified Payments*;

Proprietary cloud-based POS platform for the hospitality industry and SMB merchants through *Aptito* and *Restoactive*;

Proprietary integrated, global e-commerce and mobile payments processing platform and fraud management system through *PayOnline*;

Integrated payment processing solutions to the travel industry, which includes integrations with various GDS, such as Amadeus®, Galileo® and Sabre®, and additional geo filters and passenger name record (PNR) through Pay-Travel service offered by *PayOnline*;

PayNet Solutions – universal payment platform provided by *PayOnline* (software-as-a-service (“SaaS”) and White Label models) provides an opportunity for top clients of *PayOnline* to develop their own independent business solutions; and

We have operations and offices located within the United States (“U.S.”) (domestic) and outside of the U.S. (international) where sales, customer service and/or administrative personnel are based. Through U.S. based subsidiaries, we generate revenues from transactional services, valued-added payment services and technologies for SMBs. Through wholly owned subsidiaries, we operate internationally with a focus on transactional services, mobile payment transactions, online payment transactions, value-added payment services and technologies in selected international markets.

Our business is characterized by transaction related fees, multi-year contracts, and a diverse client base which allows us to grow alongside our clients. Our multi-year contracts allow us to achieve a high level of recurring revenues. While the contracts typically do not specify fixed revenues to be realized thereunder, they do provide a framework for revenues to be generated based on volume of services provided during the contract’s term.

## **Basis of Presentation**

## **Use of Estimates**

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of expenses for the period presented. Actual results could differ from those estimates.

Significant estimates include (i) the valuation of acquired merchant portfolios, (ii) collectability of accounts receivable, (iii) the recoverability of long lived and indeterminate-lived assets, (iv) the remaining useful lives of tangible long-lived assets, and (v) the sufficiency of merchant, aggregator, legal, and other reserves. On an ongoing basis, we evaluate the sufficiency and accuracy of our estimates. Actual results could differ from those estimates.

## **Reclassifications**

Certain reclassifications have been made to the comparative period amounts to conform to our current period presentation. These reclassifications had no impact on previously presented financial condition or results of operations.



### **Cash and Cash Equivalents**

We maintain our U.S. dollar-denominated cash in several non-interest bearing bank deposit accounts. All U.S. non-interest bearing transaction accounts are insured up to a maximum of \$250,000, at all FDIC insured institutions. The bank balances did not exceed FDIC limits at September 30, 2017 and December 31, 2016.