

CLEARSIGN COMBUSTION CORP
Form 10-Q
August 12, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from _____ to _____

Commission File Number 001-35521

CLEARSIGN COMBUSTION CORPORATION

(Exact name of registrant as specified in its charter)

WASHINGTON

26-2056298

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

12870 Interurban Avenue South

Seattle, Washington 98168

(Address of principal executive offices)

(Zip Code)

(206) 673-4848

(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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 August 12, 2014 the issuer has 9,658,824 shares of common stock, par value \$.0001, issued and outstanding.

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

| | June 30, 2014 | December 31, 2013 |
|--|------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$4,731,000 | \$2,688,000 |
| Prepaid expenses | 212,000 | 118,000 |
| Total current assets | 4,943,000 | 2,806,000 |
| Fixed assets, net | 371,000 | 427,000 |
| Patents and other intangible assets | 2,030,000 | 1,459,000 |
| Other assets | 10,000 | 10,000 |
| Total Assets | \$7,354,000 | \$4,702,000 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$216,000 | \$297,000 |
| Accrued compensation and taxes | 516,000 | 586,000 |
| Total current liabilities | 732,000 | 883,000 |
| Deferred rent | 38,000 | 31,000 |
| Total liabilities | 770,000 | 914,000 |
| Commitments and Contingencies | | |
| Stockholders' Equity: | | |
| Preferred stock, \$0.0001 par value, zero shares issued and outstanding | - | - |
| Common stock, \$0.0001 par value, 9,637,320 and 8,810,674 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively | 1,000 | 1,000 |
| Additional paid-in capital | 23,820,000 | 17,751,000 |
| Accumulated deficit | (17,237,000) | (13,964,000) |

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| | | |
|--|-------------|-------------|
| Total stockholders' equity | 6,584,000 | 3,788,000 |
| Total Liabilities and Stockholders' Equity | \$7,354,000 | \$4,702,000 |

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

ClearSign Combustion Corporation**Condensed Statements of Operations****(Unaudited)**

| | For the Three Months Ended | | For the Six Months Ended | |
|---|----------------------------|-----------------|--------------------------|-----------------|
| | June 30, | 2013 | June 30, | 2013 |
| | 2014 | | 2014 | |
| Operating expenses: | | | | |
| Research and development | \$ 556,000 | \$ 537,000 | \$ 1,163,000 | \$ 995,000 |
| General and administrative | 1,072,000 | 871,000 | 2,113,000 | 1,774,000 |
| Total operating expenses | 1,628,000 | 1,408,000 | 3,276,000 | 2,769,000 |
| Loss from operations | (1,628,000) | (1,408,000) | (3,276,000) | (2,769,000) |
| Other income: | | | | |
| Interest income | 2,000 | 3,000 | 3,000 | 7,000 |
| Net Loss | \$ (1,626,000) | \$ (1,405,000) | \$ (3,273,000) | \$ (2,762,000) |
| Net Loss per share - basic and fully diluted | \$ (0.17) | \$ (0.16) | \$ (0.35) | \$ (0.31) |
| Weighted average number of shares outstanding - basic and fully diluted | 9,631,972 | 8,789,433 | 9,347,647 | 8,785,413 |

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

ClearSign Combustion Corporation**Condensed Statement of Stockholders' Equity****(Unaudited)****For the Six Months Ended June 30, 2014**

| | Common Stock | | Additional | Accumulated | Total |
|---|--------------|----------|-----------------|----------------|-------------------------|
| | Shares | Amount | Paid-In Capital | Deficit | Stockholders' Equity |
| Balances at December 31, 2013 | 8,810,674 | \$ 1,000 | \$ 17,751,000 | \$(13,964,000) | \$ 3,788,000 |
| Shares issued in registered direct offering (\$8.00 per share) | 812,500 | - | 6,500,000 | - | 6,500,000 |
| Issuance costs of registered direct offering | - | - | (812,000) | - | (812,000) |
| Share based payments of warrants | - | - | 92,000 | - | 92,000 |
| Shares issued for services (\$10.26 per share) | 10,811 | - | 111,000 | - | 111,000 |
| Shares issued upon exercise of options (\$4.88 per share) | 3,335 | - | 16,000 | - | 16,000 |
| Share based compensation | - | - | 162,000 | - | 162,000 |
| Net loss | - | - | - | (3,273,000) | (3,273,000) |
| Balances at June 30, 2014 | 9,637,320 | \$ 1,000 | \$ 23,820,000 | \$(17,237,000) | \$ 6,584,000 |

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

ClearSign Combustion Corporation**Condensed Statements of Cash Flows****(Unaudited)**

| | For the Six Months Ended June 30, | |
|---|-----------------------------------|-----------------|
| | 2014 | 2013 |
| Cash flows from operating activities: | | |
| Net loss | \$ (3,273,000) | \$ (2,762,000) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Common stock issued for services | 111,000 | 109,000 |
| Share based payments | 162,000 | 75,000 |
| Depreciation | 119,000 | 102,000 |
| Abandonment of capitalized patents | 8,000 | - |
| Deferred rent | 7,000 | (2,000) |
| Change in operating assets and liabilities: | | |
| Prepaid expenses | (94,000) | (117,000) |
| Accounts payable | (81,000) | (106,000) |
| Accrued compensation | (70,000) | 315,000 |
| Net cash used in operating activities | (3,111,000) | (2,386,000) |
| Cash flows from investing activities: | | |
| Acquisition of fixed assets | (63,000) | (131,000) |
| Disbursements for patents and other intangible assets | (579,000) | (346,000) |
| Net cash used in investing activities | (642,000) | (477,000) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock for cash, net of offering costs | 5,796,000 | - |
| Net cash provided by financing activities | 5,796,000 | - |
| Net increase (decrease) in cash and cash equivalents | 2,043,000 | (2,863,000) |
| Cash and cash equivalents, beginning of period | 2,688,000 | 8,027,000 |
| Cash and cash equivalents, end of period | \$ 4,731,000 | \$ 5,164,000 |

Supplemental disclosure of non-cash investing and financing activities:*During the six months ended June 30, 2014, the Company:*

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

During the six months ended June 30, 2013, the Company:

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

issued 11,250 shares of common stock valued at \$102,000 to a consultant for services performed from April to December 2013,

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

ClearSign Combustion Corporation

Notes to Unaudited Condensed Financial Statements

Note 1 – Organization and Description of Business

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

The Company has generated limited revenues from operations to date to meet its operating expenses, and has historically financed its operations primarily through issuances of equity securities. The Company has incurred losses since its inception totaling \$17,237,000 and expects to experience operating losses and negative cash flow for the foreseeable future. Management believes that the successful growth and operation of the Company's business is dependent upon its ability to obtain adequate sources of funding through co-development agreements, strategic partnering agreements, or equity or debt financing to adequately support research and development efforts, protect intellectual property, form relationships with strategic partners, and provide for working capital and general corporate purposes. There can be no assurance that the Company will be successful in achieving its long-term plans as set forth above, or that such plans, if consummated, will enable the Company to obtain profitable operations or continue in the long-term as a going concern.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission for Form 10-Q. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The condensed balance sheet at December 31, 2013 has been derived from the Company's audited financial statements.

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

Use of Estimates

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

Revenue Recognition

The Company recognizes revenue on co-development agreements using the percentage of completion method. Under this method, the completion percentage is determined by dividing costs incurred to date by total estimated project costs. Since these projects will require technological development to complete, which by its nature is difficult to predict, the actual cost required to complete contracted work may vary from estimates. Estimated project costs are revised regularly which can alter the reported level of project profitability. Any estimated project losses are recognized in the current reporting period. Customer billings are recorded when cash receipts are probable and in accordance with the underlying co-development contract. If billings exceed recognized revenue, the difference is recorded as a current liability, while any recognized revenues exceeding billings are recorded as a current asset. Recognized revenues are subject to revisions as the contract progresses to completion and actual revenue and cost become certain. Revisions in revenue estimates are reflected in the period in which the facts that give rise to the revision become known. There were no revenues for the three and six months ended June 30, 2014 and 2013.

Cost of Revenue

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

Cash and Cash Equivalents

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

Fixed Assets

Fixed assets are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are depreciated over the life of the lease or their useful life,

whichever is shorter. All other fixed assets are depreciated over two to four years. Maintenance and repairs are expensed as incurred.

Patents and Trademarks

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

Impairment of Long-Lived Assets

The Company tests long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through the estimated undiscounted cash flows expected to result from the use and eventual disposition of the assets. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair values are reduced for the cost of disposal. During the three and six months ended June 30, 2014, the Company recorded an impairment loss of \$0 and \$8,000, respectively, from abandonment of capitalized patents.

Fair Value of Financial Instruments

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

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

Research and Development

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

Deferred Rent

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

Income Taxes

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

Stock-Based Compensation

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

Net Loss per Common Share

Basic loss per share is computed by dividing loss available to common stockholders by the weighted-average number of common shares outstanding. Diluted loss per share is computed similar to basic loss per share except that the denominator is increased to include additional common shares available upon exercise of stock options and warrants using the treasury stock method, except for periods for which no common share equivalents are included because their effect would be anti-dilutive. At June 30, 2014 and 2013, potentially dilutive shares outstanding amounted to 1,249,582 and 1,124,733, respectively.

Recently Issued Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 2014-10 which eliminated in its entirety the differential reporting requirements applicable to development stage entities under ASC 915, *Development Stage Entities*. Thus, the distinction between development stage entities and other types of reporting entities will no longer exist, and all differential reporting requirements applicable to development stage entities were removed from United States generally accepted accounting principles. Specifically, the amendments eliminated the requirements for development stage entities to (1) present inception-to-date information in the income statement, cash flows statement, and statement of stockholders' equity, (2) identify the financial statements as those of a development stage entity, (3) provide a description of the development stage activities in which the entity is engaged, and (4) disclose in the first year in which the entity becomes an operating company that it had previously been in the development stage. Adoption of ASC 2014-10 is required for annual reporting periods beginning after December 15, 2014 with early application permitted. The Company has elected early application of this standard.

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

Emerging Growth Company

The Company is an emerging growth company as defined under the Jumpstart Our Business Startups Act of 2012 (JOBS Act). An emerging growth company may delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. The Company will remain an emerging growth company until December 31, 2017, although it will lose that status sooner if its revenues exceed \$1 billion, if it issues more than \$1 billion in non-convertible debt in a three year period, or if the market value of its common stock that is held by non-affiliates exceeds \$700 million as of any June 30. At June 30, 2014, the market value of the Company's common stock that is held by non-affiliates totaled \$71 million.

Note 3 – Fixed Assets

Fixed assets are summarized as follows:

| | June 30, 2014 | December 31, 2013 |
|--------------------------------|------------------|----------------------|
| Machinery and equipment | \$637,000 | \$ 633,000 |
| Office furniture and equipment | 98,000 | 95,000 |
| Leasehold improvements | 115,000 | 62,000 |
| Accumulated depreciation | (485,000) | (366,000) |
| | 365,000 | 424,000 |
| Construction in progress | 6,000 | 3,000 |
| | \$371,000 | \$ 427,000 |

Note 4 – Stockholders' EquityCommon Stock and Preferred Stock

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

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

Equity Incentive Plan

The Company has an Equity Incentive Plan (the Plan) which provides for the granting of options to purchase shares of common stock, stock awards to purchase shares at no less than 85% of the value of the shares, and stock bonuses to officers, employees, board members, consultants, and advisors. The Compensation Committee of the Board of Directors is authorized to administer the Plan and establish the grant terms, including the grant price, vesting period and exercise date. As of June 30, 2014, the number of shares reserved for issuance under the Plan totaled 1,075,046 shares. The Plan provides for quarterly increases in the available number of authorized shares equal to the lesser of 10% of any new shares issued by the Company during the quarter immediately prior to the adjustment date or such lesser amount as the Board of Directors shall determine.

In February 2014, the Company granted 122,880 stock options under the Equity Incentive Plan to certain employees. The stock options have an exercise price of \$9.90 per share, the grant date fair value, a contractual life of 10 years, and vest over four years. The fair value of stock options granted in February 2014 estimated on the date of grant using the Black-Scholes option valuation model was \$721,000. The recognized compensation expense associated with these grants for the three and six months ended June 30, 2014 was \$45,000 and \$90,000, respectively. The following weighted-average assumptions were utilized in the calculation of the fair value of the stock options:

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

In February 2014, the Company granted 14,625 shares of common stock under the Equity Incentive Plan to its three independent directors in accordance with board agreements for service in 2014 and subject to completion of service each quarter. The fair value of the stock at the time of grant was \$10.26 per share for a total value of \$150,000 which the Company will recognize in general and administrative expense on a pro-rated quarterly basis in 2014, including \$37,000 and \$75,000 for the three and six months ended June 30, 2014.

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

Outstanding stock option grants at June 30, 2014 and December 31, 2013 totaled 685,310 and 565,765 with 387,893 and 317,354 being vested and exercisable at June 30, 2014 and December 31, 2013, respectively. Stock grants made to date through June 30, 2014 and December 31, 2013 totaled 183,110 shares and 175,799 shares, respectively. Of these amounts, 36,000 and 44,000 at June 30, 2014 and December 31, 2013, respectively, are subject to declining

repurchase rights by the Company at \$0.0001 per share through September 30, 2016. The recognized compensation expense associated with these grants for the three and six months ended June 30, 2014 and 2013 totaled \$81,000, \$162,000, \$36,000, and \$75,000, respectively. At June 30, 2014, the number of shares reserved under the Plan but unissued totaled 206,626. At June 30, 2014, there was \$925,000 of total unrecognized compensation cost related to non-vested share based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted average period of 3.1 years.

Consultant Stock Plan

On May 2, 2013, the stockholders approved the 2013 Consultant Stock Plan (the Consultant Plan) which provides for the granting of shares of common stock to consultants who provide services related to capital raising, investor relations, and making a market in or promoting the Company's securities. The Company's officers, employees, and board members are not entitled to receive grants from the Consultant Plan. The Compensation Committee of the Board of Directors is authorized to administer the Consultant Plan and establish the grant terms. The number of shares reserved for issuance under the Consultant Plan on June 30, 2014 and December 31, 2013 totaled 83,662, and 75,287 shares, respectively. The Consultant Plan provides for quarterly increases in the available number of authorized shares equal to the lesser of 1% of any new shares issued by the Company during the quarter immediately prior to the adjustment date or such lesser amount as the Board of Directors shall determine. In May 2013, the Company granted 11,250 shares from the Consultant Plan to a consultant for 2013 services. The fair value of the stock at the time of grant was \$9.12 per share for a total value of \$102,000 which the Company recognized in general and administrative expense on a quarterly basis over the remainder of 2013. In February 2014, the Company granted 7,000 shares of common stock under the Consultant Stock Plan to a consultant for service in 2014 and subject to completion of service each quarter. The fair value of the stock at the time of grant was \$10.26 per share for a total value of \$72,000 which the Company will recognize in general and administrative expense on a pro-rated quarterly basis in 2014. The Consultant Plan expense for the three and six months ended June 30, 2014 and 2013 was \$18,000, \$36,000, \$34,000 and \$34,000, respectively.

Warrants

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

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

The Company has the following warrants outstanding at June 30, 2014:

| Exercise Price | Total Outstanding Warrants | | |
|----------------|----------------------------|---------------------------------|-----------------|
| | Warrants | Weighted Average Exercise Price | Life (in years) |
| \$ 1.80 | 80,000 | \$ 1.80 | 6.64 |
| \$ 2.20 | 118,959 | \$ 2.20 | 1.86 |
| \$ 5.00 | 345,000 | \$ 5.00 | 2.82 |
| \$ 10.00 | 20,313 | \$ 10.00 | 4.68 |
| | 564,272 | \$ 4.14 | |

Note 5 – Related Party Transactions

For the three and six months ended June 30, 2013, the Company incurred consulting fees of \$30,000 and \$60,000, respectively, to the Alternative Energy Resource Alliance, a non-profit organization whose executive director is David Goodson. In exchange, Mr. Goodson provided scientific consulting services to the Company. Mr. Goodson is a director and co-founder of the Company and, through an irrevocable trust, a significant beneficial owner of the Company's common stock at June 30, 2014.

Note 6 – Commitments and Contingencies

The Company has a triple net lease for office and laboratory space for the period November 2011 to February 2017. Under the terms of the lease, the Company paid no rent for the period November 2011 to February 2012 and for February 2014. Rent escalates annually by 3%. The Company records monthly rent expense equal to the total of the payments over the lease term divided by the number of months of the lease term. Therefore, rent expense of \$7,000 was accrued for the six months ended June 30, 2014 and for the six months ended June 30, 2013 the deferred rent was reduced by \$1,000. Under the terms of the lease, the Company also pays triple net operating costs which currently approximate \$3,000 per month. Minimum future payments under the lease at June 30, 2014 are as follows:

| | |
|------|-----------|
| 2014 | \$67,000 |
| 2015 | 137,000 |
| 2016 | 141,000 |
| 2017 | 24,000 |
| | \$369,000 |

For the three and six months ended June 30, 2014 and 2013, rent expense amounted to \$41,000, \$79,000, \$33,000, and \$67,000, respectively.

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

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

Note 7 – Subsequent Event

Subsequent to June 30, 2014, the Company entered into a Field Test Agreement with a Southern California-based company to demonstrate and test the Duplex technology in a once through steam generator (OTSG) used to facilitate the production of heavy oil in California's San Joaquin Valley. Under the terms of the agreement, the Company will retrofit an OTSG unit in order to achieve certain performance criteria. Assuming successful completion of the demonstration and testing, the agreement also includes time-sensitive pricing, delivery and installation terms, if elected, that will apply to future purchases of this Duplex application.

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

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

- our limited cash and our history of losses;
- our ability to achieve profitability;
- our limited operating history;
- emerging competition and rapidly advancing technology in our industry that may outpace our technology;
- our ability to develop commercially viable products based upon our technology;
- customer demand for the products and services we develop;
- the impact of competitive or alternative products, technologies and pricing;
- our ability to manufacture any products we develop;
- general economic conditions and events and the impact they may have on us and our potential customers;
- our ability to obtain adequate financing in the future;
- our ability to continue as a going concern;
- our success at managing the risks involved in the foregoing items; and
- other factors discussed in this report.

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

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

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

OVERVIEW

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

Plan of Operation

We are pursuing development of our technology to enable future sales. These activities entail laboratory research, where we have successfully demonstrated our proprietary technology operating in our research facility with thermal output of 5 million BTUs per hour, and business development and marketing activities with established manufacturers and other entities that use boilers, solid fuel burners, refinery heaters, and other combustion systems. We intend to enter into collaborative arrangements which would enable us to work closely with established companies in specific industries to apply developed solutions in laboratory and field settings. Subsequent to June 30, 2014, we entered into a Field Test Agreement with a Southern California-based company to demonstrate and test the Duplex technology in a once through steam generator (OTSG) used to facilitate the production of heavy oil in California's San Joaquin Valley. Under the terms of the agreement, we will retrofit an OTSG unit in order to achieve certain performance criteria. Assuming successful completion of the demonstration and testing, the agreement also includes time-sensitive pricing, delivery and installation terms, if elected, that will apply to future purchases of this Duplex application. Further, we currently are pursuing a broad development program with the cooperation of three companies involved in solid fuel combustion. Further, we are seeking other solid fuel dependent companies to participate in this project. Through June 30, 2014, we have received \$93,000 in co-development revenue from Covanta Energy Corporation, a waste-to-energy service company and subsidiary of Covanta Holding Corporation, and a commercial wood pellet boiler unit from Grandeg, a privately-owned original equipment manufacturer based in Riga, Latvia. However, there is no assurance

that additional revenues will be realized, terms will be reached, or a final agreement executed between us and any of these companies.

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

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

Our anticipated costs include employee salaries and benefits, compensation paid to consultants, capital costs for research and other equipment, costs associated with development activities including travel and administration, legal expenses, sales and marketing costs, general and administrative expenses, and other costs associated with an early stage, publicly-traded technology company. We currently have 14 full-time employees and 2 part-time employees. We anticipate continuing to increase the number of employees required to support our activities in the areas of research and development, sales and marketing, and general and administrative functions. We expect to incur consulting expenses related to technology development commensurate with our current levels and we expect to incur increasing expenses to protect our intellectual property. We expect capital expenditures to be approximately \$0.5 million annually, but these are highly dependent on the nature of the operations where co-development activities are ongoing.

The amount that we spend for any specific purpose may vary significantly, and could depend on a number of factors including, but not limited to, the pace of progress of our commercialization and development efforts, actual needs with respect to product testing, development and research, market conditions, and changes in or revisions to our marketing strategies.

Research and development of new technologies is, by its nature, unpredictable. Although we will undertake development efforts with commercially reasonable diligence, there can be no assurance that the net proceeds from our securities offerings will be sufficient to enable us to develop our technology to the extent needed to create future sales to sustain operations. If the net proceeds from these offerings are insufficient for this purpose, we will consider other options to continue our path to commercialization, including, but not limited to: additional financing through follow-on equity offerings, debt financing, co-development agreements, sale or licensing of developed intellectual or other property, or other alternatives.

If management is unable to implement its proposed business plan or employ alternative financing strategies, it does not presently have any alternative proposals. In that case, we may be required to scale back our development plans by reducing expenditures for employees, consultants, business development and marketing efforts, and other envisioned expenditures or curtail or even suspend our operations.

We cannot assure that our technology will be accepted, that we will ever earn revenues sufficient to support our operations, or that we will ever be profitable. Furthermore, we have no committed source of financing and we cannot assure that we will be able to raise money as and when we need it to continue our operations. If we cannot raise funds as and when we need them, we may be required to severely curtail, or even to cease, our operations.

CRITICAL ACCOUNTING POLICIES

The following discussion and analysis of financial condition and results of operations is based upon our financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Certain accounting policies and estimates are particularly important to the understanding of our financial position and results of operations and require the application of significant judgment by our management or can be materially affected by changes from period to period in economic factors or conditions that are outside of our control. As a result, they are subject to an inherent degree of uncertainty. In applying these policies, our management uses their judgment to determine the appropriate assumptions to be used in the determination of certain estimates. Those estimates are based on our historical operations, our future business plans and projected financial results, the terms of existing contracts, our observance of trends in the industry, information provided by our customers and information available from other outside sources, as appropriate. See Note 2 to our unaudited condensed financial statements for a more complete description of our significant accounting policies.

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

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

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

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

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

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

RESULTS OF OPERATIONS

Comparison of the Three and Six Months Ending June 30, 2014 and 2013

Operating Expenses. Operating expenses, consisting of research and development (R&D) and general and administrative (G&A) expenses, increased by approximately \$220,000 to \$1,628,000 for the three months ended June

30, 2014, referred to herein as Q2 2014, compared to the same period in 2013 (Q2 2013). The Company increased its R&D expenses by \$19,000 to \$556,000 for Q2 2014. R&D expenses rose primarily due to increased compensation of \$81,000 related to increased personnel levels offset by decreased consumables and testing materials cost of \$49,000. G&A expenses increased by \$201,000 to \$1,072,000 in Q2 2014 resulting primarily from \$201,000 of increased business development and marketing costs.

Operating expenses increased by \$507,000 to \$3,276,000 for the six months ended June 30, 2014 compared to the same period in 2013. The Company increased its R&D expenses by \$168,000 to \$1,163,000 for the six months ended June 30, 2014. R&D expenses rose primarily due to increased compensation of \$169,000 related to increased personnel levels. G&A expenses increased by \$339,000 to \$2,113,000 for the six months ended June 30, 2014 resulting primarily from \$320,000 of increased business development and marketing costs.

Loss from Operations. Due to the increase in operating expenses, our loss from operations increased during Q2 2014 by \$220,000 to \$1,628,000 and increased for the six months ended June 30, 2014 by \$507,000 to \$3,276,000.

Net Loss. Primarily as a result of the increase in operating expenses, our net loss for Q2 2014 was \$1,626,000 as compared to a net loss of \$1,405,000 for Q2 2013, resulting in an increased net loss of \$221,000, and our net loss for the six months ended June 30, 2014 was \$3,273,000 as compared to a net loss of \$2,762,000 for Q2 2013, resulting in an increased net loss of \$511,000.

Liquidity and Capital Resources

At June 30, 2014, our cash and cash equivalent balance totaled \$4,731,000 compared to \$2,688,000 at December 31, 2013. This increase resulted primarily from our registered direct offering of common stock in March 2014 which resulted in net proceeds of approximately \$5.8 million. This was offset by the operating costs for the six months ended June 30, 2014 supporting our ongoing research and development of our technology to enable future sales. We expect this sum to be sufficient to fund our activities at least through January 2015. Although we are pursuing co-development agreements, there is no assurance that they, together with the funds we have raised through sales of our common stock, will be adequate to fund our operations and to commercialize our technology. To the extent our funds are insufficient to support our operations and commercialize our technology, we may undertake additional offerings of our securities, debt financing, selling or licensing our developed intellectual or other property, or other alternatives. In that regard, the Company filed a Form S-3 shelf registration statement with the Securities and Exchange Commission on May 6, 2013 that was declared effective on May 30, 2013. The registration statement allowed the Company to offer up to an aggregate of \$30 million of common stock, preferred stock or warrants from time to time as market conditions permit. Thus far, as described in this report, we have sold common stock having a gross value of \$6.5 million. We may continue to offer securities included in this registration statement until the earlier of the third anniversary of the effective date of the registration statement or until we sell, in delayed or continuous offerings, an additional \$23.5 million in securities. We expect to use the proceeds from any further offerings to enable further investment in our technology and product development and to maintain a strong balance sheet as we pursue strategic joint development and marketing relationships and prepare to pursue significant opportunities in various segments of the market. This information does not constitute an offer of any securities for sale.

At June 30, 2014, our current assets were in excess of current liabilities resulting in working capital of \$4,211,000 compared to \$1,923,000 at December 31, 2013.

Operating activities for the six months ended June 30, 2014 resulted in cash outflows of \$3,111,000 which were due primarily to the loss for the period of \$3,273,000 and net changes in working capital, exclusive of cash, which reduced cash flow by \$245,000. These were offset by services paid with common stock and stock options of \$273,000, and other non-cash expenses of \$134,000. Operating activities for the six months ended June 30, 2013 resulted in cash outflows of \$2,386,000 which were due primarily to the loss for the period of \$2,762,000, offset by net changes in working capital, exclusive of cash, of \$92,000 related primarily to an increase in accrued compensation, services paid with common stock and stock options of \$184,000, and other non-cash expenses of \$100,000.

Investing activities for the six months ended June 30, 2014 resulted in cash outflows of \$579,000 for development of patents and other intangible assets and \$63,000 for acquisition of fixed assets. This reflects an increasing cost to protect our intellectual property as our patent applications proceed through the grant process in various jurisdictions. Investing activities for the six months ended June 30, 2013 resulted in cash outflows of \$346,000 for development of patents and other intangible assets and \$131,000 for acquisition of fixed assets.

Financing activities for the six months ended June 30, 2014 resulted in \$5,796,000 of cash inflows, which came primarily from the issuance of 812,500 shares of common stock at \$8.00 per share resulting in gross proceeds of \$6,500,000 and net cash proceeds of \$5,780,000. Additionally, we raised \$16,000 through an exercise of stock options. There were no financing activities for the six months ended June 30, 2013.

Off-Balance Sheet Transactions

We do not have any off-balance sheet transactions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a smaller reporting company we are not required to provide this information.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the "Act") is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, has concluded that, as of June 30, 2014, our disclosure controls and procedures are effective.

There have been no material changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II-OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable.

ITEM 1A. RISK FACTORS

We incorporate herein by reference the risk factors included under Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013 which we filed with the Securities and Exchange Commission on March 11, 2014.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In November 2011 we filed a registration statement, number 333-177946, with the Securities and Exchange Commission to register an offering of 3 million shares of our common stock, with an option granted to the underwriter to sell an additional 450,000 shares of our common stock (the “overallotment”). The registration statement was declared effective on April 24, 2012. The offering closed on April 30, 2012 and the offering of the overallotment closed on May 15, 2012. The common stock was offered at a price of \$4.00 per share. All of the shares of common stock, including the overallotment, were sold. We raised a total of \$13,800,000 in gross proceeds in the offering and received approximately \$11,600,000 in net cash. The net proceeds from the offering were used through April 2014 as follows: approximately \$8,987,000 for operations, \$1,667,000 for patents and trademarks, \$579,000 for capital expenditures primarily related to research and development machinery and equipment, \$238,000 for the payment of accrued compensation, and \$129,000 for the repayment of short term indebtedness. None of the proceeds were used for construction of plant, building and facilities, the purchase of real estate, or the acquisition of any business.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

| Exhibit Number | Document |
|-----------------------|--|
| 3.1 | Articles of Incorporation of ClearSign Combustion Corporation, amended on February 2, 2011 (1) |
| 3.1.1 | Articles of Amendment to Articles of Incorporation of ClearSign Combustion Corporation filed on December 22, 2011 (1) |
| 3.2 | Bylaws (1) |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer* |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer* |
| 32.1 | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer* |
| 101 | The following financial statements from the registrant's Quarterly Report on Form 10-Q for the six months ended June 30, 2014, formatted in XBRL: (i) Condensed Balance Sheets (Unaudited); (ii) Condensed Statements of Operations (Unaudited); (iii) Condensed Statement of Stockholders' Equity (Unaudited); (iv) Condensed Statements of Cash Flows (Unaudited); (v) Notes to Unaudited Condensed Financial Statements.* |

*Filed herewith

(1) Incorporated by reference from the registrant's registration statement on Form S-1, as amended, file number 333-177946, originally filed with the Securities and Exchange Commission on November 14, 2011.

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**CLEARSIGN
COMBUSTION
CORPORATION**
(Registrant)

Date: August 12, 2014 By: /s/ Richard F. Rutkowski
Richard F. Rutkowski
Chief Executive Officer

By: /s/ James N. Harmon
James N. Harmon
Chief Financial Officer