

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 **March 31, 2017**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: **000-33155**



**COATES INTERNATIONAL, LTD.**

(Exact name of registrant as specified in its charter)

**Delaware**

**22-2925432**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

**2100 Highway 34, Wall Township, New Jersey 07719**  
(Address of principal executive offices) (Zip Code)

**(732) 449-7717**

(Registrant's telephone number, including area code)

N/A

(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, 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

Non-accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

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

As of May 9, 2017, the Registrant had 4,146,575,076 shares of its common stock, par value \$0.0001 per share issued and outstanding, 720,222 shares of Series A Preferred Stock, par value \$0.001, issued and outstanding, and 20,668,975 shares of Series B Preferred Stock, par value \$0.001, issued and outstanding.

**COATES INTERNATIONAL, LTD.**  
**QUARTERLY REPORT ON FORM 10-Q**

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**MARCH 31, 2017**

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Coates International, Ltd.  
Balance Sheets

	March 31, 2017 (Unaudited)	December 31, 2016
Assets		
Current Assets		
Cash	\$ 2,555	\$ 9,163
Inventory, net	191,482	191,482
Deferred offering costs and other assets	1,000	47,028
Total Current Assets	<u>195,037</u>	<u>247,673</u>
Property, plant and equipment, net	2,065,218	2,076,396
Deferred licensing costs, net	37,095	38,166
Total Assets	<u>\$ 2,297,350</u>	<u>\$ 2,362,235</u>
Liabilities and Stockholders' Deficiency		
Current Liabilities		
Accounts payable and accrued liabilities	\$ 2,650,876	\$ 2,461,175
Promissory notes to related parties	1,449,673	1,454,699
Deferred compensation payable	1,394,127	1,272,317
Derivative liability related to convertible promissory notes	204,749	153,472
Deposits on orders	150,595	150,595
Convertible promissory notes, net of unamortized discount	87,564	45,801
Mortgage loan payable	60,000	60,000
Current portion of sublicense deposits	55,925	60,725
Promissory note	25,000	-
Total Current Liabilities	<u>6,078,509</u>	<u>5,658,784</u>
Non-current portion of mortgage loan payable	1,258,158	1,273,158
Non-current portion of sublicense deposits	627,175	627,175
Total Liabilities	<u>7,963,842</u>	<u>7,559,117</u>
Commitments and Contingencies	-	-
Stockholders' Deficiency		
Preferred stock, \$0.001 par value, 100,000,000 shares authorized:		
Series A Preferred Stock, 1,000,000 shares designated, 720,722 and 50,000 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively	720	50
Series B Convertible Preferred Stock, 75,000,000 shares designated, 16,981,089 and 16,252,584 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively	16,981	16,253
Common Stock, \$0.0001 par value, 12,000,000,000 shares authorized, 3,177,788,855 and 3,002,730,366 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively	317,779	300,273
Additional paid-in capital	60,172,286	59,813,632
Accumulated deficit	(66,174,258)	(65,327,090)
Total Stockholders' Deficiency	<u>(5,666,492)</u>	<u>(5,196,882)</u>
Total Liabilities and Stockholders' Deficiency	<u>\$ 2,297,350</u>	<u>\$ 2,362,235</u>

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

**Coates International, Ltd.**  
**Statements of Operations**  
**For the Three Months Ended March 31,**  
**(Unaudited)**

	<u>2017</u>	<u>2016</u>
Sublicensing fee revenue	\$ 4,800	\$ 4,800
Total Revenues	<u>4,800</u>	<u>4,800</u>
Expenses:		
Research and development costs	138,387	91,561
Stock-based compensation expense	191,325	1,761,905
Compensation and benefits	131,747	69,912
General and administrative expenses	118,839	77,078
Depreciation and amortization	12,249	12,749
Total Operating Expenses	<u>592,547</u>	<u>2,013,205</u>
Loss from Operations	<u>(587,747)</u>	<u>(2,008,405)</u>
Other Income (Expense):		
(Increase) decrease in estimated fair value of embedded derivative liabilities	(51,277)	121,078
Loss on conversion of convertible notes	(11,629)	(26,380)
Interest expense, net	<u>(196,515)</u>	<u>(243,960)</u>
Total other income (expense)	<u>(259,421)</u>	<u>(149,262)</u>
Loss Before Income Taxes	(847,168)	(2,157,667)
Provision for income taxes	-	-
Net Loss	<u>\$ (847,168)</u>	<u>\$ (2,157,667)</u>
Basic net loss per share	<u>\$ (0.00)</u>	<u>\$ (0.00)</u>
Basic weighted average shares outstanding	<u>3,100,963,595</u>	<u>1,144,882,150</u>
Diluted net loss per share	<u>\$ (0.00)</u>	<u>\$ (0.00)</u>
Diluted weighted average shares outstanding	<u>3,100,963,595</u>	<u>1,144,882,150</u>

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

**Coates International Ltd.**  
**Condensed Statements of Cash Flows**  
**For the Three Months Ended March 31,**  
**(Unaudited)**

	<u>2017</u>	<u>2016</u>
Net Cash Used in Operating Activities	\$ (144,527)	\$ (151,530)
<b>Cash Used in Investing Activities:</b>		
Acquisition of property, plant and equipment	-	(11,492)
Total Cash Used in Investing Activities	<u>-</u>	<u>(11,492)</u>
<b>Cash Flows Provided (Used in) by Financing Activities:</b>		
Issuance of convertible promissory notes	90,000	85,000
Issuance of common stock under equity purchase agreements	42,944	100,000
Issuance of promissory note	25,000	-
Issuance of promissory notes to related parties	4,740	-
Issuance of common stock and warrants	-	25,000
Repayment of mortgage loan	(15,000)	(15,000)
Repayment of promissory notes to related parties	(9,765)	(10,000)
Finance lease obligation payments	-	(8,625)
Net Cash Provided by Financing Activities	<u>137,919</u>	<u>176,375</u>
Net (Decrease) Increase in Cash	(6,608)	13,353
Cash, beginning of period	9,163	29,207
Cash, end of period	<u>\$ 2,555</u>	<u>\$ 42,560</u>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid during the period for interest	\$ 26,566	\$ 26,925
<b>Supplemental Disclosure of Non-cash Financing Activities:</b>		
Conversion of convertible promissory notes	<u>\$ 56,372</u>	<u>\$ 294,679</u>

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

**Coates International, Ltd.**  
**Notes to Financial Statements**  
**March 31, 2017**  
**(All amounts rounded to thousands of dollars)**  
**(Unaudited)**

**1. THE COMPANY AND BASIS OF PRESENTATION**

*Nature of Organization*

Coates International, Ltd. (the “Company” or “CIL”) has acquired the exclusive licensing rights to the patented Coates spherical rotary valve (“CSRV<sup>®</sup>”) system technology in North America, Central America and South America (the “CSRV<sup>®</sup> License”). The CSRV<sup>®</sup> system technology has been developed over a period of more than 20 years by the Company’s founder George J. Coates, President and Chief Executive Officer, and his son Gregory G. Coates. The CSRV<sup>®</sup> system technology is adaptable for use in piston-driven internal combustion engines of many types and has been patented in the United States and numerous countries throughout the world. The Company is endeavoring to raise working capital to commence production of hydrogen gas and natural gas powered CSRV<sup>®</sup> industrial electric power generator sets (“Gen Sets”) and is also seeking to enter into sublicense agreements with third party, original equipment manufacturers (“OEM’s”) which provide for licensing fees. The Company is also continuing with research and development of a hydrogen reactor to harvest Hydroxy-Gas from water with the intent to power the Company’s products, including large industrial Gen Sets. George J. Coates, owner of the hydrogen reactor technology, has committed to license this technology to the Company once the related patent protection is in place.

Management believes that the CSRV<sup>®</sup> engines provide the following advantages as compared to conventional internal combustion engines designed with “poppet valves”:

- Improved fuel efficiency
- Lower levels of harmful emissions
- Adaptability to numerous types of engine fuels
- Longer engine life
- Longer intervals between engine servicing

The CSRV<sup>®</sup> system technology is designed to replace the intake and exhaust conventional “poppet valves” currently used in almost all piston-driven, automotive, truck, motorcycle, marine and electric power generator engines, among others. Unlike conventional valves which protrude into the engine combustion chamber, the CSRV<sup>®</sup> system technology utilizes spherical valves that rotate in a cavity formed between a two-piece cylinder head. The CSRV<sup>®</sup> system technology utilizes significantly fewer moving parts than conventional poppet valve assemblies. As a result of these design improvements, management believes that engines incorporating the CSRV<sup>®</sup> system technology (“Coates Engines”) will last significantly longer and will require less lubrication over the life of the engine, as compared to conventional engines. In addition, CSRV<sup>®</sup> Engines can be designed with larger openings into the engine cylinder than with conventional valves so that more fuel and air can be inducted into, and expelled from, the cylinder in a shorter period of time. Larger valve openings permit higher revolutions-per-minute (RPM’s) and permit higher compression ratios with lower combustion chamber temperatures, allowing the Coates Engine<sup>®</sup> to produce more power than equivalent conventional engines. The extent to which, higher RPM’s, greater volumetric efficiency and thermal efficiency can be achieved with the CSRV<sup>®</sup> system technology, is a function of the engine design and application.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

*Basis of Presentation*

The accompanying condensed financial statements include the accounts of the Company. In the opinion of the Company's management, the condensed consolidated financial statements reflect all adjustments, which are normal and recurring in nature, necessary for fair financial statement presentation. The preparation of these condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the amounts reported in these condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. Certain prior period amounts in the condensed financial statements have been reclassified to conform to the current period's presentation.

These condensed financial statements and accompanying notes should be read in conjunction with the Company's annual financial statements and the notes thereto included in its Annual Report on Form 10-K for the year ended December 31, 2016 and the Company's quarterly financial statements and the notes thereto included in its Quarterly Reports.

Since the Company's inception, the Company has been responsible for the development costs of the CSRV<sup>®</sup> technology in order to optimize the value of the licensing rights and has incurred related operational costs, the bulk of which have been funded primarily through cash generated from licensing fees, sales of stock, short term convertible promissory notes, capital contributions, loans made by George J. Coates, Bernadette Coates, his spouse, Gregory G. Coates and certain directors, fees received from research and development of prototype models and a small number of CSRV<sup>®</sup> engine generator sales. The Company has incurred substantial cumulative losses from operations since its inception. Losses from operations are expected to continue until the Coates Engines<sup>®</sup> are successfully introduced into and accepted in the marketplace enabling the Company to generate substantial sales and/or receive substantial licensing revenues. These losses from operations were primarily related to research and development of the Company's intellectual property rights, patent filing and maintenance costs and general and administrative expenses. The Company has also incurred substantial non-cash expenses for stock-based compensation and remeasurement of the estimated fair value of embedded derivative liabilities related to convertible promissory notes issued and interest expense and losses on conversion of convertible promissory notes.

As shown in the accompanying financial statements, the Company has incurred recurring losses from operations and, as of March 31, 2017, had a stockholders' deficiency of (\$5,666,000). In addition, the recent trading price range of the Company's common stock at a fraction of a penny has introduced additional difficulty to the Company's challenge to secure needed additional working capital. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management has instituted a cost control program intended to restrict variable costs to only those expenses that are necessary to complete its activities related to entering the production phase of operations, develop additional commercially feasible applications of the CSRV<sup>®</sup> system technology, seek additional sources of working capital and cover general and administrative costs in support of such activities. The Company has been actively undertaking efforts to secure new sources of working capital. At March 31, 2017, the Company had negative working capital of (\$5,858,000) compared with negative working capital of (\$5,411,000) at the end of 2016.

The Company continues to actively seek out new sources of working capital; however, there can be no assurance that it will be successful in these efforts. The accompanying financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

*Inventory*

Inventory consists of raw materials and work-in-process, including overhead. Effective January 2017, the Company adopted the accounting guidance of Accounting Standards Update No. 2015-11, "Inventory – Simplifying the Measurement of Inventory (Topic 330), on a prospective basis. Pursuant to this update, inventory is stated at the lower of cost or net realizable value. Prior thereto, inventory was stated at the lower of cost or market. This change in 2017 did not have a material effect on the reported inventory values. Inventory is accounted for on the first-in, first-out method.

*Use of Estimates*

The preparation of the Company's financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These significant estimates include determining the fair value of convertible promissory notes containing embedded derivatives and variable conversion rates, determining a value for shares of Series A Preferred Stock and Series B Convertible Preferred Stock issued, assigning useful lives to the Company's property, plant and equipment, determining an appropriate amount to reserve for obsolete and slow moving inventory, estimating a valuation allowance for deferred tax assets, assigning expected lives to, and estimating the rate of forfeitures of, stock options granted and selecting a trading price volatility factor for the Company's common stock in order to estimate the fair value of the Company's stock options on the date of grant or other appropriate measurement date. Actual results could differ from those estimates.

**2. CONCENTRATIONS OF CREDIT AND BUSINESS RISK**

The Company maintains cash balances with one financial institution. Monies on deposit are fully insured by the Federal Deposit Insurance Corporation.

The Company's operations are devoted to the development, application and marketing of the CSRV<sup>®</sup> system technology which was invented by George J. Coates, the Company's founder, Chairman, Chief Executive Officer, President and controlling stockholder. Development efforts have been conducted continuously during this time. From July 1982 through May 1993, seven U.S. patents as well as a number of foreign patents were issued with respect to the CSRV<sup>®</sup> system technology. Since inception of the Company in 1988, all aspects of the business have been completely dependent upon the activities of George J. Coates. The loss of George J. Coates' availability or service due to death, incapacity or otherwise would have a material adverse effect on the Company's business and operations. The Company does not presently have any key-man life insurance in force for Mr. Coates.

**3. FAIR VALUE OF FINANCIAL INSTRUMENTS**

*Cash, Other Assets, Accounts Payable and Accrued Liabilities and Other Liabilities*

With the exception of convertible promissory notes, the carrying amount of these items approximates their fair value because of the short term maturity of these instruments. The convertible promissory notes are reported at their estimated fair value, determined as described in more detail in Note 15.

*Limitations*

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.



**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

**4. LICENSING AGREEMENT AND DEFERRED LICENSING COSTS**

The Company holds a manufacturing, use, lease and sale license from George J. Coates and Gregory G. Coates for the CSRV<sup>®</sup> system technology in the territory defined as the Western Hemisphere (the "License Agreement"). Under the License Agreement, George J. Coates and Gregory G. Coates granted to the Company an exclusive, perpetual, royalty-free, fully paid-up license to the patented intellectual property that specifically relates to an internal combustion engine that incorporates the CSRV<sup>®</sup> system technology (the "CSRV<sup>®</sup> Engine") and that is currently owned or controlled by them (the "CSRV<sup>®</sup> Intellectual Property"), plus any CSRV<sup>®</sup> Intellectual Property that is developed by them during their employment with the Company. In the event of insolvency or bankruptcy of the Company, the licensed rights would terminate and ownership would revert back to George J. Coates and Gregory G. Coates.

Under the License Agreement, George J. Coates and Gregory G. Coates agreed that they will not grant any Western Hemisphere licenses to any other party with respect to the CSRV<sup>®</sup> Intellectual Property.

At March 31, 2017, and December 31, 2016, deferred licensing costs, comprised of expenditures for patent costs incurred pursuant to the CSRV<sup>®</sup> licensing agreement, net of accumulated amortization, amounted to \$37,000 and \$38,000, respectively. Amortization expense for the three months ended March 31, 2017 and 2016 amounted to \$1,000 and \$1,000, respectively.

**5. AGREEMENT ASSIGNED TO ALMONT ENERGY, INC.**

In 2010, Almont Energy Inc. ("Almont"), a privately held, independent third-party entity based in Alberta, Canada became the assignee of a sublicense which covers the use of the CSRV<sup>®</sup> system technology in the territory of Canada in the oil and gas industry (the "Canadian License"). This sublicense is currently inactive because the parties have not fulfilled their obligations thereunder due to the Company's delay in starting up production and delivery of CSRV<sup>®</sup> products to Almont. The parties mutually agreed to consider the basis on which the license could be reactivated at such time that the Company is successful in starting up its manufacturing operations.

In prior years, the Company received a non-refundable \$300,000 deposit on the Canadian License. As the Company continues to be desirous of commencing shipments of its CSRV<sup>®</sup> products to Almont under the sublicense at such time that it is able to start up production operations, it has continued to amortize this deposit into income over the period until expiration of the last CSRV<sup>®</sup> system technology patent in force. At March 31, 2017, the unamortized balance was \$185,000. Amortization of this amount is as follows:

<u>Year Ending</u>	<u>Amount</u>
2017	\$ 15,000
2018	19,000
2019	19,000
2020	19,000
2021	19,000
Thereafter	94,000
	<u>\$ 185,000</u>

**6. NON-EXCLUSIVE DISTRIBUTION SUBLICENSE WITH RENOWN POWER DEVELOPMENT, LTD.**

In February 2015, the Company granted a non-exclusive distribution sublicense to Renown Power Development, Ltd., a China-based sales and distribution company ("Renown") covering the territory defined as the Western Hemisphere. Under this sublicense, Renown will be permitted to sell, lease and distribute CSRV<sup>®</sup> products. The Company received an initial non-refundable deposit of \$500,000 through March 31, 2017. In addition, after Renown receives aggregate cash flow of \$10,000,000, it is required to pay the Company 25% of all funds it receives from any and all sources, until it fully pays the contractual licensing fee.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

In addition, Coates Power, Ltd., a China-based manufacturing company (“Coates Power”) intends to produce CSRV<sup>®</sup> products in China. At this time, as the Company’s intellectual property rights cover the territory of North America, it does not have any rights to enter into a manufacturing and sale license agreement with Coates Power. These rights are currently held by George J. Coates, Gregory G. Coates and The Coates Trust. Coates Power and Renown are controlled and managed by Mr. James Pang, the Company’s liaison agent in China.

The Company received a \$131,000 cash deposit with an order from Coates Power for two completed Gen Sets. This amount is included in Deposits in the accompanying balance sheets at March 31, 2017 and December 31, 2016.

**7. INVENTORY**

Inventory consisted of the following:

	March 31, 2017	December 31, 2016
Raw materials	\$ 178,000	\$ 178,000
Work-in-process	13,000	13,000
Total	\$ 191,000	\$ 191,000

**8. LICENSE DEPOSITS**

License deposits consist of monies received as deposits on sublicense agreements, primarily comprised of deposits from Renown in the amount of \$498,000 and from Almont in the amount of \$300,000. These deposits are being recognized as income on a straight-line basis over the remaining period until expiration of the last remaining CSRV<sup>®</sup> patent in force in 2027. Through March 31, 2017, the Company has recognized a total of \$115,000 of the Almont deposit as revenue. The Company expects that sublicense-related activities by Renown may commence within the next twelve months and that it will begin recognizing revenue at that time. Recognition of revenue from the Almont license is included in the statements of operations for the three months ended March 31, 2017 and 2016. The current portion of the license deposits represents the portion of the license deposits expected to be recognized as revenue within one year from the balance sheet date. The balance of the license deposits is included in non-current license deposits.

In December 2016, the Company executed an exclusive license with Secure Supplies Mexico LLC and Secure Supplies USA LLC (collectively “Secure Supplies”) of Coates CSRV<sup>®</sup> electric power hydrogen generator sets and engines for distribution, use, sale and lease in the territory of North America. Secure Supplies employs a combination of solar generated power and hydrogen cell technology to generate hydrogen gas. It intends to integrate its technology with the Coates CSRV<sup>®</sup> system technology to power Engine Generator Sets to be utilized in establishing power generation plants throughout North America. Secure Supplies has indicated it intends to procure CSRV<sup>®</sup> Engine Generators adapted to run on hydrogen fuel (“Hydrogen Gen Sets”), capable of producing up to 1MW of electrical power output.

Upon execution of this agreement, Secure Supplies was to pay a one-time licensing fee of \$1,000,000 to the Company. In addition, a royalty fee of \$50 per engine or gen set sold to Secure Supplies, is to be paid to The Coates Trust, a private trust controlled by George J. Coates, regardless of the size or type of CSRV<sup>®</sup> engine. A 50% down payment on all CSRV<sup>®</sup> products shall be paid to the Company with each order presented. The balance due on each order shall be paid at the time the order has been staged for delivery from the Company’s manufacturing plant.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

As of the date of this filing, the Company had not received a \$1,000,000, one-time upfront license fee as required by the agreement and cannot determine when, and if, the fee will be collected. Accordingly, the Company has not recorded a \$1,000,000 receivable for the past due upfront license fee or recognized any unpaid amount as revenue related to this license agreement.

Sublicensing fee revenue for the three months ended March 31, 2017 and 2016 amounted to \$5,000 and \$5,000, respectively.

**9. PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment at cost, less accumulated depreciation, consist of the following:

	March 31, 2017	December 31, 2016
Land	\$ 1,235,000	\$ 1,235,000
Building	964,000	964,000
Building improvements	83,000	83,000
Machinery and equipment	689,000	689,000
Furniture and fixtures	57,000	57,000
	3,028,000	3,028,000
Less: Accumulated depreciation	(940,000)	(952,000)
Total	\$ 2,065,000	\$ 2,076,000

Depreciation expense amounted to \$11,000 and \$12,000 for the three months ended March 31, 2017 and 2016, respectively.

**10. MORTGAGE LOAN PAYABLE**

The Company has a mortgage loan on the land and building that serves as its headquarters and research and development facility which bears interest at the rate of 7.5% per annum and matures in July 2018. Interest expense for the three months ended March 31, 2017 and 2016 amounted to \$33,000 and \$26,000, respectively. The loan requires monthly payments of interest, plus \$5,000 which is being applied to the principal balance. The remaining principal balance at March 31, 2017 and December 31, 2016 was \$1,318,000 and \$1,333,000, respectively. The mortgage loan may be prepaid in whole, or, in part, at any time without penalty.

The loan is collateralized by a security interest in all of the Company's assets, the pledge of five million shares of common stock of the Company owned by George J. Coates, which were deposited into escrow for the benefit of the lender and the personal guarantee of George J. Coates. The Company is not permitted to create or permit any secondary mortgage or similar liens on the property or improvements thereon without prior consent of the lender.

**11. FINANCE LEASE OBLIGATION**

In August 2013, the Company entered into a sale/leaseback financing arrangement pursuant to which it sold its research and development and manufacturing equipment in consideration for net cash proceeds of \$133,000. This lease terminated in February 2016, upon which the Company reacquired title to the equipment. The effective interest rate on this lease was 36.6%.

In accordance with GAAP, this sale/leaseback was required to be accounted for as a financing lease. Under this accounting method, the equipment and accumulated depreciation remained on the Company's books and records as if the Company still owned the equipment.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

For the three months ended March 31, 2017 and 2016, interest expense amounted to \$-0- and \$2,000, respectively. These amounts are included in interest expense in the accompanying statements of operations.

**12. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities are as follows:

	March 31, 2017	December 31, 2016
Legal and professional fees	\$ 1,475,000	\$ 1,452,000
Accrued interest expense	533,000	502,000
General and administrative expenses	528,000	392,000
Research and development costs	115,000	115,000
Total	<u>\$ 2,651,000</u>	<u>\$ 2,461,000</u>

**13. PROMISSORY NOTES TO RELATED PARTIES**

*Promissory Notes Issued to George J. Coates*

During the three months ended March 31, 2017 and 2016, the Company issued, in a series of transactions, promissory notes to George J. Coates and received cash proceeds of \$4,000 and \$-0-, respectively, repaid promissory notes to George J. Coates in the aggregate principal amount of \$4,000 and \$10,000, respectively. Interest expense for the three months ended March 31, 2017 and 2016 amounted to \$13,000 and \$13,000, respectively.

The promissory notes are payable on demand and provide for interest at the rate of 17% per annum, compounded monthly. At March 31, 2017, the outstanding balance was \$328,000, including accrued interest thereon.

*Promissory Note Issued to Gregory G. Coates*

The Company has a non-interest bearing promissory note due to Gregory G. Coates which is payable on demand. Interest is being imputed on this promissory note at the rate of 10% per annum. Interest expense for the three months ended March 31, 2017 and 2016, amounted to \$35,000 and \$36,000, respectively. At March 31, 2017, the outstanding principal balance was \$1,438,000.

*Promissory Notes Issued to Bernadette Coates*

During the three months ended March 31, 2017 and 2016, the Company issued a promissory note to Bernadette Coates, spouse of George J. Coates and received cash proceeds of \$1,000 and \$-0-, respectively. The Company repaid promissory notes to Bernadette Coates in the principal amount of \$6,000 and \$-0-, respectively. The promissory notes are payable on demand and provide for interest at the rate of 17% per annum, compounded monthly. Interest expense for the three months ended March 31, 2017 and 2016 amounted to \$3,000 and \$3,000, respectively. At March 31, 2017, the outstanding balance amounted to \$82,000, including accrued interest thereon.

Unpaid accrued interest on these promissory notes amounting to \$410,000 is included in accounts payable and accrued liabilities in the accompanying balance sheet at March 31, 2017.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

**14. PROMISSORY NOTE**

In March 2017, the Company issued a \$25,000 promissory note which matures May 13, 2017. Interest is payable upon maturity in the form of 10,000,000 shares of unregistered, restricted shares of the Company's common stock. The note provides for late payment fees of 750,000 additional shares of unregistered, restricted shares of the Company's common stock for each month after maturity that payment is late until repaid. In addition, the Company agreed to extend warrants held by the lender to purchase 10,839,752 shares of common stock that were scheduled to expire in 2017 for an additional five years and modify the exercise price to \$0.0015.

**15. CONVERTIBLE PROMISSORY NOTES AND EMBEDDED DERIVATIVE LIABILITY**

From time to time, the Company issues convertible promissory notes, the proceeds of which are used for general working capital purposes. At March 31, 2017, there was \$140,000 principal amount of convertible promissory notes outstanding. During the three months ended March 31, 2017 and 2016, \$93,000 and \$91,000 of convertible promissory notes were issued, respectively. Outstanding notes may be converted into unregistered shares of the Company's common stock at a discount ranging from 30% to 39% of the defined trading price of the common stock on the date of conversion. The defined trading prices are based on the trading price of the stock during a defined period ranging from fifteen to twenty-five trading days immediately preceding the date of conversion. The conversion rate discount establishes a beneficial conversion feature ("BCF") or unamortized discount, which is required to be valued and accreted to interest expense over the six-month period until the conversion of the notes into restricted shares of common stock is permitted. In addition, the conversion formula meets the conditions that require accounting for convertible notes as derivative liability instruments. The effective interest rate on the outstanding convertible notes at March 31, 2017 was 147%. The unamortized discount on the outstanding convertible notes at March 31, 2017 and December 31, 2016 amounted to \$52,000 and \$53,000, respectively.

The convertible notes generally become convertible, in whole, or in part, beginning on the six month anniversary of the issuance date and may be prepaid at the option of the Company, generally with a prepayment penalty equal to 50% of the principal amount of the convertible note at any time prior to becoming eligible for conversion.

One convertible promissory note with a balance of \$23,000 is convertible in monthly installments in an amount determined by the noteholder of up to \$23,000, plus accrued interest. The Company may elect, at its option to repay each monthly installment in whole, or in part, in cash, without penalty. The amount of each installment not paid in cash is converted into shares of the Company's common stock. This convertible note also requires that the conversion price be re-measured 23 trading days after the conversion shares are originally delivered. If the re-measured conversion price is lower, then the Company is required to issue additional conversion shares to the noteholder.

In accordance with GAAP, the estimated fair value of the embedded derivative liability related to the convertible notes is required to be remeasured at each balance sheet date. The fair value measurement accounting standard establishes a valuation hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used, when available. Observable inputs are inputs market participants would use in valuing the asset or liability developed based on independent market data sources. Unobservable inputs are inputs that reflect the Company's assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available. The valuation hierarchy is composed of three categories, which are as follows:

- Level 1 – Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

- Level 3 – Inputs to the fair value measurement are unobservable inputs or valuation techniques.

The estimated fair value of the embedded derivative liabilities related to promissory notes outstanding was measured as the aggregate estimated fair value, based on Level 2 inputs, which included the average of the quoted daily yield curve rates on six-month and one-year treasury securities and, because the actual volatility rate on the Company's common stock is not available, a conservative estimated volatility rate of 200%.

The embedded derivative liability arises because, based on historical trading patterns of the Company's stock, the formula for determining the Conversion Rate is expected to result in a different Conversion Rate than the closing price of the stock on the actual date of conversion (hereinafter referred to as the "Variable Conversion Rate Differential"). The estimated fair values of the derivative liabilities have been calculated based on a Black-Scholes option pricing model.

The following table presents the Company's fair value hierarchy of financial assets and liabilities measured at fair value at:

	March 31, 2017	December 31, 2016
Level 1 Inputs	\$ -	\$ -
Level 2 Inputs	205,000	153,000
Level 3 Inputs	-	-
Total	<u>\$ 205,000</u>	<u>\$ 153,000</u>

In a series of transactions, during the three months ended March 31, 2017, convertible promissory notes with an aggregate principal balance of \$56,000, including accrued interest thereon were converted into 170,872,980 unregistered shares of common stock. The Company incurred a loss on these conversions amounting to \$12,000 for the three months ended March 31, 2017.

In a series of transactions, during the three months ended March 31, 2016, convertible promissory notes with an aggregate principal balance of \$295,000, including accrued interest thereon were converted into 234,920,926 unregistered shares of common stock. The Company incurred a loss on these conversions amounting to \$26,000 for the three months ended March 31, 2016.

At March 31, 2017, the Company had reserved 2,112,854,710 shares of its unissued common stock for conversion of convertible promissory notes.

The Company made the private placement of these securities in reliance upon Section 4(2) of the Securities Act of 1933, as amended (the "Act"), Rule 506 of Regulation D, and the rules and regulations promulgated thereunder, and/or upon any other exemption from the registration requirements of the Act, as applicable.

**16. CAPITAL STOCK**

*Common Stock*

The Company's common stock is traded on OTC Pink Sheets. Investors can find stock quotes and market information for the Company at [www.otcm Markets.com](http://www.otcm Markets.com) market system under the ticker symbol COTE. Effective June 17, 2016, the Company amended its Certificate of Incorporation to increase the number of authorized shares of common stock, par value, \$0.0001 per share (the "Common Stock") to 12,000,000,000.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

The following common stock transactions occurred during the three months ended March 31, 2017:

- In a series of transactions during the three months ended March 31, 2017, convertible promissory notes with an aggregate principal balance of \$56,000, including accrued interest thereon were converted into 170,872,980 unregistered shares of common stock.
- During the three months ended March 31, 2017, Barry C. Kaye converted 1,372 shares of Series B into 1,372,000 unregistered, restricted shares of the Company's common stock.

The following common stock transactions occurred during the three months ended March 31, 2016:

- In a series of transactions during the three months ended March 31, 2016, convertible promissory notes with an aggregate principal balance of \$295,000, including accrued interest thereon were converted into 234,920,926 unregistered shares of common stock.
- In a series of transactions during the three months ended March 31, 2016, the Company issued 37,234,002 registered shares of its common stock to Southridge Partners II LP ("Southridge") under the 2015 EP Agreement, as discussed in Note 20, in consideration for \$100,000. The proceeds were used for general working capital.
- In March 2016, the Company made a private sale, pursuant to a stock purchase agreement of 25,000,000 unregistered shares of its common stock and 25,000,000 common stock warrants to purchase one unregistered share of its common stock at an exercise price of \$0.001 per share in consideration for \$25,000.

At March 31, 2017, on a pro forma basis, the approximate number of shares of common stock that would have been issued if all of the Company's outstanding convertible notes eligible for conversion had been converted was 340,780,432. None of the outstanding stock options and warrants were assumed to be exercised since the trading price of the stock on March 31, 2017 was below the exercise price of such instruments.

*Preferred Stock and anti-dilution rights*

The Company is authorized to issue 100,000,000 shares of preferred stock, par value, \$0.001 per share (the "Preferred Stock"). The Company may issue any class of the Preferred Stock in any series. The board is authorized to establish and designate series, and to fix the number of shares included in each such series and the relative rights, preferences and limitations as between series, provided that, if the stated dividends and amounts payable on liquidation are not paid in full, the shares of all series of the same class shall share ratably in the payment of dividends including accumulations, if any, in accordance with the sums which would be payable on such shares if all dividends were declared and paid in full and in any distribution of assets other than by way of dividends in accordance with the sums which would be payable on such distribution if all sums payable were discharged in full. Shares of each such series when issued, shall be designated to distinguish the shares of each series from shares of all other series.

There are two series of Preferred Stock that have been designated to date from the total 100,000,000 authorized shares of Preferred Stock. These are as follows:

- Series A Preferred Stock, par value \$0.001 per share ("Series A"), 1,000,000 shares designated, 770,222 and 50,000 shares issued and outstanding as of March 31, 2017 and December 31, 2016, respectively. Shares of Series A entitle the holder to 10,000 votes per share on all matters brought before the shareholders for a vote. These shares are not entitled to receive dividends or share in distributions of capital and have no liquidation preference. All outstanding shares of Series A are owned by George J. Coates.

For the three months ended March 31, 2017, the Company issued 670,219 shares of Series A Preferred Stock to George J. Coates representing anti-dilution shares to restore Mr. Coates' percentage of eligible votes to 85.7%. This percentage increased during the year ended December 31, 2016 as a result of Mr. Coates' acquisition of 211,318,358 shares of common stock upon conversion of promissory notes from the Company which he held with a principal amount of \$157,000 and 115,006,000 shares of common stock upon conversion of 115,006 shares of Series B Convertible Preferred Stock.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

- Series B Convertible Preferred Stock, par value \$0.001 per share, 75,000,000 shares designated, 16,981,089 and 16,252,584 shares issued and outstanding as of March 31, 2017 and December 31, 2016, respectively. Shares of Series B do not earn any dividends and may be converted at the option of the holder at any time beginning on the second annual anniversary date after the date of issuance into 1,000 unregistered shares of the Company's common stock. Holders of Series B are entitled to one thousand votes per share held, on all matters brought before the shareholders for a vote.

In the event that either (i) the Company enters into an underwriting agreement for a secondary public offering of securities, or (ii) a change in control of the Company is consummated representing 50% more of the then outstanding shares of Company's common stock, plus the number of shares of common stock into which any convertible preferred stock is convertible, regardless of whether or not such shares are otherwise eligible for conversion, then the Series B may be immediately converted at the option of the holder into restricted shares of the Company's common stock.

The Company provides anti-dilution protection for certain of its key employees. For each new share of common stock issued by the Company to non-Coates family members in the future, additional shares of Series B will be issued to maintain their fixed ownership percentage of the Company. The fixed ownership percentage is adjusted for acquisitions and dispositions of common stock, not related to conversions of Series B Convertible Preferred Stock, by these key employees. At March 31, 2017, the fixed ownership percentages were as follows:

- George J. Coates – 80.63%
- Gregory G. Coates – 6.10%
- Barry C. Kaye – 0.048%

These anti-dilution provisions do not apply to new shares of common stock issued in connection with exercises of employee stock options, a secondary public offering of the Company's securities or a merger or acquisition.

The following presents by year, the number of shares of Series B held and the year that they become eligible for conversion into shares of common stock, as of March 31, 2017.

	Total	2017	2018	2019
George J. Coates	15,674,047	3,135,357	11,766,624	772,066
Gregory G. Coates	1,216,320	224,975	872,014	119,331
Barry C. Kaye	90,722	13,063	68,266	9,393
Total	<u>16,981,089</u>	<u>3,373,395</u>	<u>12,706,904</u>	<u>900,790</u>

For the three months ended March 31, 2017, 772,066, 119,315 and 9,393 shares of Series B were issued to George J. Coates, Gregory G. Coates and Barry C. Kaye, respectively, having an estimated fair value of \$132,000, \$39,000 and \$3,000, respectively. These amounts were included in stock-based compensation expense in the accompanying statement of operations for the three months ended March 31, 2017.

For the three months ended March 31, 2016, 1,263,978, 86,048 and 6,736 shares of Series B were issued to George J. Coates, Gregory G. Coates and Barry C. Kaye, respectively, having an estimated fair value of \$1,641,000, \$112,000 and \$9,000, respectively. These amounts were included in stock-based compensation expense in the accompanying statement of operations for the three months ended March 31, 2016.



**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

During the three months ended March 31, 2017, Barry C. Kaye converted 1,372 shares of Series B into 1,372,000 unregistered, restricted shares of the Company's common stock.

In the event that all of the 16,981,089 shares of Series B outstanding at March 31, 2017 were converted, once the conversion restrictions lapse, an additional 16,981,089,000 new restricted shares of common stock would be issued. On a pro forma basis, based on the number of shares of common stock outstanding at March 31, 2017, this would dilute the ownership percentage of non-affiliated stockholders from 81.0% to 12.8%.

To the extent that additional shares of Series B are issued under the anti-dilution plan, the non-affiliated stockholders' percentage ownership of the Company would be further diluted.

**17. UNEARNED REVENUE**

Unearned revenue at March 31, 2017, consisted of the following:

- A deposit received with an order for two CSRV® Gen Sets from Coates Power, Ltd., a China-based unaffiliated manufacturing company in the amount of \$131,000.
- A \$19,000 non-refundable deposit from Almont in connection with its order for a natural gas fueled electric power CSRV® engine generator.

**18. SUBLICENSING FEE REVENUE**

Sublicensing fee revenue for the three months ended March 31, 2017 and 2016 amounted to \$5,000 and \$5,000, respectively. The Company is recognizing the license deposit of \$300,000 on the Canadian License as revenue on a straight-line basis over the approximate remaining life until 2027 of the last CSRV® technology patent in force.

**19. LOSS PER SHARE**

At March 31, 2017, there were stock warrants outstanding to purchase 150,344,911 shares of common stock at exercise prices ranging from \$0.0005 to \$0.675 per share and vested stock options outstanding to acquire 12,470,000 shares of common stock at exercise prices ranging from \$0.028 to \$0.44 per share and \$72,000 of convertible promissory notes eligible for conversion, which on a pro forma basis, assuming they would have been converted on March 31, 2017, would have been convertible into 340,780,432 shares of common stock.

At March 31, 2016, there were stock warrants outstanding to purchase 60,344,911 shares of common stock at exercise prices ranging from \$0.001 to \$0.12 per share and vested stock options outstanding to acquire 12,470,000 shares of common stock at exercise prices ranging from \$0.028 to \$0.44 per share and \$252,000 of convertible promissory notes eligible for conversion, which on a pro forma basis, assuming they would have been converted on March 31, 2016, would have been convertible into 244,775,045 shares of common stock.

For the three months ended March 31, 2017 and 2016, none of the potentially issuable shares of common stock were assumed to be converted because the Company incurred a net loss in those periods and the effect of including them in the calculation of earnings per share would have been anti-dilutive.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

**20. STOCK OPTIONS**

The Company's 2006 Stock Option and Incentive Plan (the "Stock Plan") was adopted by the Company's board in October 2006. In September 2007, the Stock Plan, by consent of George J. Coates, majority shareholder, was adopted by our shareholders. The Stock Plan provides for the grant of stock-based awards to employees, officers and directors of, and consultants or advisors to, the Company and its subsidiaries, if any. Under the Stock Plan, the Company may grant options that are intended to qualify as incentive stock options within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended ("ISO's"), options not intended to qualify as incentive stock options ("non-statutory options"), restricted stock and other stock-based awards. ISO's may be granted only to employees of the Company. All of the shares of common stock authorized under the Stock Plan have been granted and no further grants may be awarded thereunder.

The Company established a 2014 Stock Option and Incentive Plan (the "2014 Stock Plan") which was adopted by the Company's board on May 30, 2014. On March 2, 2015, the 2014 Stock Plan, by consent of George J. Coates, majority shareholder, was adopted by our shareholders. The 2014 Stock Plan provides for the grant of stock-based awards to employees, officers and directors of, and consultants or advisors to, the Company and its subsidiaries, if any. Under the 2014 Stock Plan, the Company may grant ISO's, non-statutory options, restricted stock and other stock-based awards. ISO's may be granted only to employees of the Company. A total of 50,000,000 shares of common stock may be issued upon the exercise of options or other awards granted under the 2014 Stock Plan. The maximum number of shares with respect to which awards may be granted during any one year to any employee under the 2014 Stock Plan shall not exceed 25% of the 50,000,000 shares of common stock covered by the 2014 Stock Plan. At March 31, 2017, none of the shares of common stock authorized under the 2014 Stock Plan had been granted as stock options or awards.

The Stock Plan and the 2014 Stock Plan (the "Stock Plans") are administered by the board and the Compensation Committee. Subject to the provisions of the Stock Plans, the board and the Compensation Committee each has the authority to select the persons to whom awards are granted and determine the terms of each award, including the number of shares of common stock subject to the award. Payment of the exercise price of an award may be made in cash, in a "cashless exercise" through a broker, or if the applicable stock option agreement permits, shares of common stock, or by any other method approved by the board or Compensation Committee. Unless otherwise permitted by the Company, awards are not assignable or transferable except by will or the laws of descent and distribution.

Upon the consummation of an acquisition of the business of the Company, by merger or otherwise, the board shall, as to outstanding awards (on the same basis or on different bases as the board shall specify), make appropriate provision for the continuation of such awards by the Company or the assumption of such awards by the surviving or acquiring entity and by substituting on an equitable basis for the shares then subject to such awards either (a) the consideration payable with respect to the outstanding shares of common stock in connection with the acquisition, (b) shares of stock of the surviving or acquiring corporation, or (c) such other securities or other consideration as the board deems appropriate, the fair market value of which (as determined by the board in its sole discretion) shall not materially differ from the fair market value of the shares of common stock subject to such awards immediately preceding the acquisition. In addition to, or in lieu of the foregoing, with respect to outstanding stock options, the board may, on the same basis or on different bases as the board shall specify, upon written notice to the affected optionees, provide that one or more options then outstanding must be exercised, in whole or in part, within a specified number of days of the date of such notice, at the end of which period such options shall terminate, or provide that one or more options then outstanding, in whole or in part, shall be terminated in exchange for a cash payment equal to the excess of the fair market value (as determined by the board in its sole discretion) for the shares subject to such stock options over the exercise price thereof. Unless otherwise determined by the board (on the same basis or on different bases as the board shall specify), any repurchase rights or other rights of the Company that relate to a stock option or other award shall continue to apply to consideration, including cash, that has been substituted, assumed or amended for a stock option or other award pursuant to these provisions. The Company may hold in escrow all or any portion of any such consideration in order to effectuate any continuing restrictions.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

The board may at any time provide that any stock options shall become immediately exercisable in full or in part, that any restricted stock awards shall be free of some or all restrictions, or that any other stock-based awards may become exercisable in full or in part or free of some or all restrictions or conditions, or otherwise realizable in full or in part, as the case may be.

The board or Compensation Committee may, in its sole discretion, amend, modify or terminate any award granted or made under the Stock Plan, so long as such amendment, modification or termination would not materially and adversely affect the participant.

During the three months ended March 31, 2017 and 2016, no stock options were granted. There were no unvested stock options outstanding at March 31, 2017.

During the three months ended March 31, 2017 and 2016, the Company did not incur any stock-based compensation expense related to employee stock options. At March 31, 2017, all stock-based compensation expense related to outstanding stock options had been fully recognized.

Details of the stock options outstanding under the Company's Stock Option Plans are as follows:

	Exercise Price Per Share	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable	Weighted Average Exercise Price	Weighted Average Fair Value Per Stock Option at Date of Grant
Balance, 3/31/17	\$0.028 – \$0.44	12,470,000	10	12,470,000	\$ 0.182	\$ 0.169

No stock options were exercised, forfeited or expired during the three months ended March 31, 2017 and 2016.

The weighted average fair value of the Company's stock options was estimated using the Black-Scholes option pricing model which requires highly subjective assumptions including the expected stock price volatility. These assumptions were as follows:

● Historical stock price volatility	139% - 325%
● Risk-free interest rate	0.21% - 4.64%
● Expected life (in years)	4
● Dividend yield	0.00

The valuation assumptions were determined as follows:

- Historical stock price volatility: The Company utilized the volatility in the trading of its common stock computed for the 12 months of trading immediately preceding the date of grant.
- Risk-free interest rate: The Company bases the risk-free interest rate on the interest rate payable on U.S. Treasury securities in effect at the time of the grant for a period that is commensurate with the assumed expected option life.
- Expected life: The expected life of the options represents the period of time options are expected to be outstanding. The Company has very limited historical data on which to base this estimate. Accordingly, the Company estimated the expected life based on its assumption that the executives will be subject to frequent blackout periods during the time that the stock options will be exercisable and based on the Company's expectation that it will complete its research and development phase and commence its initial production phase. The vesting period of these options was also considered in the determination of the expected life of each stock option grant.
- No expected dividends.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

**21. EQUITY PURCHASE AND REGISTRATION RIGHTS AGREEMENTS**

In July 2015, the Company entered into an equity purchase agreement (the "EP Agreement") with Southridge Partners II LP, a Delaware limited partnership ("Southridge"). Pursuant to the terms of the EP Agreement, Southridge committed to purchase up to 205,000,000 shares of the Company's common stock at 94% of the lowest closing price of the common stock during the ten trading days that comprise the defined pricing period. In December 2016, the EP Agreement automatically terminated because Southridge had purchased all 205,000,000 registered shares of common stock under the EP Agreement.

The Company filed a registration statement with the SEC covering 205,000,000 shares of common stock underlying the EP Agreement, which was declared effective in August 2015.

During the three months ended March 31, 2016, the Company sold 37,234,042 registered shares of common stock to Southridge and received proceeds of \$100,000 under the EP Agreement.

**22. INCOME TAXES**

Deferred income taxes are determined using the liability method for the temporary differences between the financial reporting basis and income tax basis of the Company's assets and liabilities. Deferred income taxes are measured based on the tax rates expected to be in effect when the temporary differences are included in the Company's tax return. Deferred tax assets and liabilities are recognized based on anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases.

Deferred tax assets increased by \$209,000 and \$833,000 for the three months ended March 31, 2017 and 2016, respectively. These amounts were fully offset by a corresponding increase in the tax valuation allowance resulting in no net change in deferred tax assets, respectively, during these periods.

No liability for unrecognized tax benefits was required to be reported at March 31, 2017 and December 31, 2016. Based on the Company's evaluation, it has concluded that there are no significant uncertain tax positions requiring recognition in the Company's financial statements. The Company's evaluation was performed for tax years ended 2013 through 2015, the only periods subject to examination. The Company believes that its income tax positions and deductions will be sustained on audit and does not anticipate that adjustments, if any, will result in a material change to its financial position. For the three months ended March 31, 2017 and 2016, there were no penalties or interest related to the Company's income tax returns.

At March 31, 2017, the Company had available, \$20,793,000 of net operating loss carryforwards which may be used to reduce future federal taxable income, expiring between 2018 and 2037 and \$10,969,000 of net operating loss carryforwards which may be used to reduce future state taxable income, expiring between 2029 and 2037.

**23. RELATED PARTY TRANSACTIONS**

*Issuances and Repayments of Promissory Notes to Related Parties*

Issuances and repayments of promissory notes to related parties during the three months ended March 31, 2017 and 2016, are discussed in detail in Note 13.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

*Issuances of Preferred Stock*

Shares of Series A Preferred Stock awarded to George J. Coates and Shares of Series B Convertible Preferred Stock awarded to George J. Coates, Gregory G. Coates and Barry C. Kaye during the three months ended March 31, 2017 and 2016 are discussed in detail in Note 16.

*Personal Guaranty and Stock Pledge*

In connection with the Company's mortgage loan, George J. Coates has pledged certain of his shares of common stock of the Company to the extent required by the lender and provided a personal guaranty as additional collateral for a mortgage loan on the Company's headquarters facility.

*Compensation and Benefits Paid*

The approximate amount of compensation and benefits, all of which were approved by the board, paid to George J. Coates, Gregory G. Coates and Bernadette Coates, exclusive of stock-based compensation for unregistered, restricted shares of Preferred Stock awarded to George J. Coates and Gregory G. Coates is summarized as follows:

	For the three months ended March 31,	
	2017	2016
George J. Coates (a) (b) (c)	\$ 14,000	\$ 3,000
Gregory G. Coates (d) (e)	3,000	40,000
Bernadette Coates (f)	1,000	1,000

- (a) For the three months ended March 31, 2017 and 2016, George J. Coates earned additional base compensation of \$53,000 and \$63,000, respectively, payment of which is being deferred until the Company has sufficient working capital. These amounts are included in deferred compensation in the accompanying balance sheets at March 31, 2017 and December 31, 2016.
- (b) During the three months ended March 31, 2017 and 2016, George J. Coates was awarded 772,066 and 1,263,978 shares of Series B Convertible Preferred Stock, respectively, with an estimated fair value of \$132,000 and \$1,641,000, respectively, for anti-dilution.
- (c) During the three months ended March 31, 2017, George J. Coates was awarded 670,222 shares of Series A Preferred Stock with an estimated fair value of \$17,000, for anti-dilution.
- (d) For the three months ended March 31, 2017 and 2016, Gregory G. Coates earned additional base compensation of \$38,000 and \$-0-, respectively, payment of which is being deferred until the Company has sufficient working capital. These amounts are included in deferred compensation in the accompanying balance sheets at March 31, 2017 and December 31, 2016.
- (e) During the three months ended March 31, 2017 and 2016, Gregory G. Coates was awarded 119,331 and 86,048 shares of Series B Convertible Preferred Stock, respectively, with an estimated fair value of \$39,000 and \$112,000, respectively, for anti-dilution.
- (f) For the three months ended March 31, 2017 and 2016, Bernadette Coates earned additional base compensation of \$17,000 and \$17,000, respectively, payment of which is being deferred until the Company has sufficient working capital. These amounts are included in deferred compensation in the accompanying balance sheets at March 31, 2017 and December 31, 2016.

During the three months ended March 31, 2017 and 2016, Barry C. Kaye, Treasurer and Chief Financial Officer was paid compensation of \$10,000 and \$-0-, respectively. For the three months ended March 31, 2017 and 2016, Mr. Kaye earned compensation of \$32,000 and \$23,000, respectively, which was not paid and is being deferred until the Company has sufficient working capital to remit payment to him. Starting in September 2016, the Company agreed to pay Mr. Kaye interest on the balance of his deferred compensation retroactive to when it began being deferred in May 2012. Interest continues to be accrued on the unpaid balance. During the three months ended March 31, 2017, interest accrued on Mr. Kaye's deferred compensation amounted to \$11,000. At March 31, 2017, the total amount of Mr. Kaye's unpaid, deferred compensation, including accrued interest thereon, was \$343,000. This amount is included in accounts payable and accrued liabilities in the accompanying balance sheet at March 31, 2017. During the three months ended March 31, 2017 and 2016, Barry C. Kaye was awarded 9,393 and 6,736 shares of Series B Convertible Preferred Stock, respectively, with an estimated fair value of \$3,000 and \$9,000, respectively, for anti-dilution.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

**24. CONTRACTUAL OBLIGATIONS AND COMMITMENTS**

The following table summarizes the Company's contractual obligations and commitments at March 31, 2017:

	<u>Total</u>	<u>2017</u>	<u>2018</u>
Promissory notes to related parties	\$ 1,450,000	\$ 1,450,000	\$ -
Mortgage loan payable	1,318,000	60,000	1,258,000
Deferred compensation	1,394,000	1,394,000	-
Convertible promissory notes	140,000	117,000	23,000
Promissory note	25,000	25,000	-
Total	<u>\$ 4,327,000</u>	<u>\$ 3,046,000</u>	<u>\$ 1,281,000</u>

**25. LITIGATION AND CONTINGENCIES**

The Company is not a party to any litigation that is material to its business.

**26. RECENTLY ISSUED ACCOUNTING STANDARDS**

*Revenue Recognition*

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled to when products are transferred to customers. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) – Deferral of the Effective Date, which defers the effective date of ASU 2014-09 for one year and permits early adoption. Accordingly, the Company may adopt the standard in either its first quarter of 2018 or 2019.

In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606) – Identifying Performance Obligations and Licensing ("ASU 2016-10"), which amends the guidance in ASU 2014-09 related to identifying performance obligations and accounting for licenses of intellectual property. The Company will adopt ASU 2016-10 with ASU 2014-09. The Company is currently evaluating the impact of adopting the new revenue recognition standard, as amended, but does not expect it to have a material impact on its financial statements.

*Stock Compensation*

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718), which simplified certain aspects of the accounting for share-based payment transactions, including income taxes, classification of awards and classification in the statement of cash flows. ASU 2016-09 will be effective for the Company beginning in its first quarter of 2018. The Company is currently evaluating the impact of adopting the new stock compensation standard, but does not expect it to have a material impact on its financial statements.

**Coates International, Ltd.**  
**Notes to Financial Statements - (Continued)**

*Financial Instruments*

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10) (“ASU 2016-01”), which updates certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 will be effective for the Company beginning in its first quarter of 2019. The Company does not believe the adoption of the new financial instruments standard will have a material impact on its financial statements.

**27. SUBSEQUENT EVENTS**

*Issuance of Convertible Promissory Notes*

During the period from April 1 to May 9, 2017, the Company issued three new convertible promissory notes and received net proceeds of \$109,000, after transaction costs. The holders may convert the convertible note at any time beginning six months after funding, into shares of the Company's common stock at a conversion price ranging from 61% to 65% of the trading price, as defined, of the Company's common stock over a specified trading period prior to the date of conversion. In addition, the Company and certain noteholders mutually agreed to fund additional back-end, collateralized convertible notes that were executed in 2016. The principal amount of the back-end notes funded was \$304,000 after transaction costs. These notes were immediately eligible for conversion upon funding. The conversion price of the back-end notes ranged from 62% to 70% of the trading price, as defined, of the Company's common stock over a specified trading period prior to the date of conversion.

*Conversion of Convertible Promissory Notes*

During the period from April 1 to May 9, 2017, \$226,000 principal amount of convertible promissory notes, including accrued interest, was converted into 960,097,696 unregistered, restricted shares of the Company's common stock.

*Issuance of Anti-dilution shares*

During the period from April 1 to May 9, 2017, the Company issued 3,409,590, 258,091 and 20,205 shares of Series B Convertible Preferred Stock to George J. Coates, Gregory G. Coates and Barry C. Kaye, respectively, representing anti-dilution shares related to newly issued shares of common stock. The estimated fair value of these shares was \$1,125,000, \$85,000 and \$7,000, respectively.

*Issuances of Promissory Notes to Related Parties*

During the period from April 1 to May 9, 2017, the Company issued promissory notes to George J. Coates and received cash proceeds of \$16,000 and repaid promissory notes to George J. Coates amounting to \$25,000, including interest of \$6,000. The promissory notes are payable on demand and provide for interest at the rate of 17% per annum, compounded monthly.

During the period from April 1 to May 9, 2017, the Company issued promissory notes to Bernadette Coates and received cash proceeds of \$23,000 and repaid promissory notes to Bernadette Coates amounting to \$10,000. The promissory notes are payable on demand and provide for interest at the rate of 17% per annum, compounded monthly.

*Deferred Compensation*

As of May 9, 2017, George J. Coates, Gregory G. Coates, Barry C. Kaye and Bernadette Coates agreed to additional deferral of their compensation amounting to \$28,000, \$17,000, \$14,000 and \$8,000, respectively. During this period, Mr. Kaye was also paid \$15,000. At May 9, 2017 the total balance of their deferred compensation was \$1,061,000, \$87,000, \$224,000 and \$283,000, respectively.

*Promissory Note*

On April 13, 2017, the Company issued a promissory note for \$5,000 providing for interest thereon at the rate of 25% per annum. On April 25, 2017, this promissory note, including accrued interest thereon was repaid.

On May 5, 2017, the Company repaid the \$25,000 promissory note and issued 8,688,525 unregistered, restricted shares of the Company's common stock to the holder in payment of interest on the note.

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

### Cautionary Notice Regarding Forward-Looking Statements

THE FOLLOWING DISCUSSION OF OUR PLAN OF OPERATION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH THE FINANCIAL STATEMENTS AND RELATED NOTES TO THE FINANCIAL STATEMENTS INCLUDED ELSEWHERE IN THIS REPORT. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT RELATE TO FUTURE EVENTS OR OUR FUTURE FINANCIAL PERFORMANCE. THESE STATEMENTS INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY CAUSE OUR ACTUAL RESULTS, LEVELS OF ACTIVITY, PERFORMANCE OR ACHIEVEMENTS TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, LEVELS OF ACTIVITY, PERFORMANCE OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY THESE FORWARD-LOOKING STATEMENTS. THESE RISKS AND OTHER FACTORS INCLUDE, AMONG OTHERS, THOSE LISTED UNDER "FORWARD-LOOKING STATEMENTS" AND "RISK FACTORS" INCLUDED IN THE COMPANY'S ANNUAL REPORT ON FORM 10-K FILED WITH THE SECURITIES AND EXCHANGE COMMISSION FOR THE YEAR ENDED DECEMBER 31, 2016.

### **Background**

We have completed development of the Coates spherical rotary valve engine ("CSRV<sup>®</sup>") system technology. This technology has been successfully applied to natural gas fueled industrial electric power CSRV<sup>®</sup> generator engines ("Gen Sets"), automobile engines, residential generators and high performance racing car engines. We have also designed and retrofitted the CSRV<sup>®</sup> system technology into a diesel engine which is suitable for and can be applied to heavy trucks. As explained in more detail below, we intend to devote a substantial amount of resources during the remainder of 2017 to develop Hydrogen Gen Sets, capable producing up to 1MW of electrical power output in connection with a newly granted sublicense agreement with Secure Supplies.

In December 2016, we executed an exclusive license with Secure Supplies covering Hydrogen Gen Sets in the territory of North America. Secure Supplies employs a combination of solar generated power and hydrogen cell technology to generate hydrogen gas. It expects to procure 400 Hydrogen Gen Sets for Phase I of its project to install power generation plants throughout North America. The Company intends to sell each such Generator Set for \$1 million. Development of the first production Generator Set is anticipated to commence during or shortly after the second quarter of 2017.

In February 2015, we granted a \$100 million non-exclusive distribution sublicense to a China-based sales and distribution company that covers distribution in the territory of the Western Hemisphere. We also undertook to procure parts and components to commence limited production of our Gen Sets. We have complete production of an initial next generation 855 cubic inch industrial Gen Set. We intend to perform quality control on these Gen Sets, after which we will begin ramping up production for sales and distribution to end users.

Independent testing on internal combustion engines incorporating the CSRV<sup>®</sup> system technology indicated the following advantages would be derived from this technology:

- Better fuel efficiency
- Reduced harmful emissions



Based on more than ten years of operating a Mercedes 300 with an SE 280 engine retrofitted with the CSRV® system technology, the following advantages were demonstrated:

- Longer intervals between engine servicing, and
- Longer engine life than conventional internal combustion engines.

We continue to be engaged in new research and development activities from time-to-time in connection with applying this technology to other commercially feasible internal combustion engine applications and intend to manufacture engines and/or license the CSRV® system technology to third party Original Equipment Manufacturers (“OEM’s”) for multiple other applications and uses.

#### *Hydrogen Reactor Technology Owned by George J. Coates*

George J. Coates has developed a hydrogen reactor which rearranges H<sub>2</sub>O water molecules into HOH molecules also known as Hydroxy-Gas. Hydroxy-Gas has a different molecular structure than hydrogen gas which will power the Gen Sets for Secure Supplies. It consists of two hydrogen atoms. The Hydroxy-Gas produced by the hydrogen reactor can then be harvested for use as a type of fuel. While Mr. Coates intends to continue with development of this technology to enable the harvested Hydroxy-Gas to be utilized as the fuel source to power our patented CSRV® engines, development is being intentionally postponed in order to focus on the new sublicense agreement with Secure Supplies. The next phase of this research and development will focus on powering larger, industrial engines. If successful, this application will only require a ready supply of water and would be suitable for stationary engines and generators. Conventional internal combustion engines employing poppet valve assemblies require lubrication and would experience excessive heat and friction if powered with Hydroxy-Gas. This, in turn, would cause the engines to burn out in a rather short period of time. The materials and components of the CSRV® engines do not require such lubrication and because of their design, are able to operate relatively trouble-free on Hydroxy-Gas as the engine fuel. There can be no assurance that this technology can be developed successfully, or that if developed, it will be feasible to penetrate the internal combustion engine market with this technology.

We previously agreed to collaborate on the development of this technology with WTF Asia International Ltd. (“WTF Asia”), a Hong Kong-based entity to enable it to be applied to large industrial gen set engines. We have designed and integrated the switchgears, controls, load bank and emissions equipment into the hydrogen reactor/gen set (“Coates Assembled Components”). We recently recommended that Secure Supplies and WTF Asia directly coordinate this development as a joint effort due to their inherent synergies in developing hydrogen powered generation of electric power. WTF Asia would be responsible for building additional components based on technology already developed that will enable the hydrogen reactor to adequately power larger CSRV® commercial and industrial engines.

Applications for patent protection of this technology would be filed upon completion of the research and development. Although at this time no arrangements have been made between us and George J. Coates, owner of the technology, regarding licensing of the hydrogen reactor, Mr. Coates has provided his commitment to license this technology to us once the related patent protection is in place. Accordingly, we do not currently have any rights to manufacture, use, sell and distribute the hydrogen reactor technology, should it become commercially feasible to manufacture and distribute products powered by the Hydroxy-Gas fuel. We have been responsible for all costs incurred to date related to the development of this technology.

#### **Plan of Operation**

##### *Manufacturing, Sales and Distribution*

We have completed development of the CSRV® system technology-based generator engine and during 2016 completed retrofitting a next generation Cummins industrial engine with our CSRV® engine technology. This unit is being used to attract new licensing transactions and other manufacturing activities. We will need to raise sufficient new working capital to ramp up our own manufacturing and distribution operations.

As discussed above, we plan to devote substantial resources for the remainder of 2017 to development of the substantially more powerful Hydrogen Gen Set for Secure Supplies.

We intend to take advantage of the fact that essentially all the parts and components of the CSRV<sup>®</sup> generator engine may be readily sourced and acquired from U.S. based suppliers and subcontractors, and, accordingly, expect to manufacture Gen Sets by developing assembly lines within owned manufacturing facilities. The initial limited production will enable us to prove our concept for the CSRV<sup>®</sup> system technology and we expect this will dovetail with the existing demand in the marketplace. We plan to address this demand by establishing large scale manufacturing operations in the United States. Transitioning to large scale manufacturing is expected to require a substantial increase in our work force, securing additional manufacturing capacity and substantial capital expenditures.

Our ability to establish such manufacturing operations, recruit plant workers, finance initial manufacturing inventories and fund capital expenditures is highly dependent on our ability to successfully raise substantial new working capital in an amount and at a pace which matches our business plans. Potential sources of such new working capital include (i) licensing fees from new sublicensing agreement, (ii) positive working capital generated from sales of our CSRV<sup>®</sup> products and (iii) issuance of promissory notes to related parties and issuance of convertible notes. Although we have been successful in raising sufficient working capital to continue our ongoing operations, we have encountered very challenging credit and equity investment markets, and have not been able to raise sufficient new working capital to enable us to commence production of our Gen Sets. There can be no assurance that we will be successful in raising adequate new working capital or even any new working capital to carry out our business plans. The recent trading price range of our common stock at a fraction of a penny has introduced additional risk and difficulty to our challenge to secure needed additional working capital.

#### *Sublicensing*

We plan to sublicense the CSRV<sup>®</sup> system technology to multiple OEM's in order to take advantage of third party manufacturers' existing production capacity and resources by signing OEM agreements.

Sublicensing agreements with Secure Supplies and Renown which are already in place are discussed under "*Item 1: Business, Operational Plan, Sublicensing.*"

#### **Significant Estimates**

The preparation of our financial statements in conformity with generally accepted accounting principles in the United States ("GAAP") requires our management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. These significant estimates include determining the fair value of convertible promissory notes containing embedded derivatives as a result of variable conversion rate provisions, determining a value for Series A Preferred Stock and Series B Convertible Preferred Stock issued in connection with anti-dilution provisions in place, assigning useful lives to our property, plant and equipment, determining an appropriate amount to reserve for obsolete and slow moving inventory, providing a valuation allowance for deferred tax assets, assigning expected lives to and estimating the rate of forfeitures of stock options granted and selecting a volatility factor for the Company's stock options in order to estimate the fair value of the Company's stock options on the date of grant. Actual results could differ from those estimates.

## Results of Operations for the Three Months Ended March 31, 2017 and 2016

Our principal business activities and efforts during the three months ended March 31, 2017 and 2016 were devoted to (i) applying the CSRV<sup>®</sup> system technology to optimally fuel industrial engines with hydrogen gas, in 2017, in connection with the sublicense with Secure Supplies, (ii) undertaking efforts to raise additional working capital in order to fund ongoing operations and (iii) research and development of the hydrogen reactor technology in 2016.

Although we incurred substantial net losses for the three months ended March 31, 2017 and 2016 of (\$847,168) and (\$2,157,667), respectively, it is important to consider that a substantial portion of these losses resulted from non-cash expenses required to be recorded for financial reporting purposes in accordance with GAAP. These net losses should be considered in view of the fact that actual cash used in operating activities amounting to (\$144,527) and (\$151,530) in 2017 and 2016, respectively, was significantly less than these reported net losses. The differences between the reported net losses incurred in 2017 and 2016 are described in detail in the section "Liquidity and Capital Resources".

### Revenue

There were no sales for the three months ended March 31, 2017 and 2016.

Sublicensing fee revenue for the three months ended March 31, 2017 and 2016 amounted to \$4,800 and \$4,800, respectively. Sublicensing fees are being recognized by amortizing the license deposit of \$300,000 on the Canadian License over the approximate remaining life of the last CSRV<sup>®</sup> technology patent in force.

### Expenses

#### *Research and Development Expenses*

Research and development activities for the three months ended March 31, 2017 and 2016 were primarily related to applying the CSRV<sup>®</sup> system technology to optimally fuel industrial engines with hydrogen gas in 2017 in connection with the sublicense with Secure Supplies and research and development of the hydrogen reactor technology in 2016. Research and development expenses increased by \$46,826 to \$138,387 in 2017 from \$91,561 in 2016.

#### *Stock-based Compensation Expense*

Stock-based compensation expense decreased by (\$1,570,580) to \$191,325 for the three months ended March 31, 2017 from \$1,761,905 for the three months ended March 31, 2016. This decrease was primarily due to a decrease in issuances of Series B Convertible Preferred Stock to George J. Coates, Gregory G. Coates and Barry C. Kaye, for anti-dilution, partially offset by an issuance of Series A Preferred Stock with an estimated fair value of \$17,219 to George J. Coates for anti-dilution.

#### *Compensation and Benefits*

Compensation and benefits increased by \$61,835 to \$131,747 for the three months ended March 31, 2017 from \$69,912 for the three months ended March 31, 2016. This increase was primarily due to an increase in the amount of compensation allocated to research and development costs in the 2017 period.

#### *General and Administrative Expenses*

General and administrative expenses increased by \$41,761 to \$118,839 for the three months ended March 31, 2017 from \$77,078 for the three months ended March 31, 2016. This net increase in 2017 resulted from increases in professional fees of \$39,525, miscellaneous expense of \$15,756, utilities of \$5,025 and financing costs of \$1,580, partially offset by decreases in investors relations costs of (\$11,369), patent maintenance costs of (\$8,483) and all other expenses, net of (\$273).

### *Depreciation and Amortization*

Depreciation and amortization expense decreased to \$12,249 for the three months ended March 31, 2017 from \$12,749 for the three months ended March 31, 2016.

### **Loss from Operations**

A loss from operations of (\$587,747) was incurred for the three months ended March 31, 2017 compared with a loss from operations of (\$2,008,405) for the three months ended March 31, 2016. The decrease in the amount of the loss from operations was primarily attributable to the decrease in non-cash, stock-based compensation expense of (\$1,570,580), as discussed above, offset by the increase in the change in embedded liabilities of \$172,355 as discussed hereinafter.

### **Other Income (Expense)**

#### *Increase (decrease) in Estimated Fair Value of Embedded Liabilities*

The estimated fair value of embedded liabilities, which relates to outstanding convertible promissory notes, is remeasured at each balance sheet date. For the three months ended March 31, 2017 and 2016, other (expense) income was recorded to reflect the (increase) decrease in the fair value of embedded liabilities of (\$51,277) and \$121,078, respectively.

#### *Loss on conversion of convertible notes*

For the three months ended March 31, 2017 and 2016, the Company realized a loss on conversion of convertible notes of (\$11,629) and (\$26,380), respectively.

#### *Interest Expense*

Interest expense decreased to (\$196,515) for the three months ended March 31, 2017 from (\$243,960) in 2016. Interest expense in 2017 consisted of non-cash interest related to convertible promissory notes of \$90,070, interest on promissory notes and deferred compensation to related parties of \$64,462, mortgage loan interest of \$33,475 and net other interest of \$8,508.

Interest expense in 2016 consisted of non-cash interest related to convertible promissory notes of \$160,427, interest on promissory notes to related parties of \$51,654, mortgage loan interest of \$26,234, interest expense related to the sale/leaseback of equipment of \$1,618 and net other interest of \$4,027.

### **Deferred Taxes**

For the three months ended March 31, 2017 and 2016, the change in deferred taxes was fully offset by a valuation allowance, resulting in a \$-0- net income tax provision.

### **Net Loss**

For the three months ended March 31, 2017, we incurred a net loss of (\$847,168) or (\$0.00) basic net loss per share, as compared with net loss of (\$2,157,667) or (\$0.00) basic net loss per share for three months ended March 31, 2016. The increase in the amount of the net loss was primarily attributable to the decrease in non-cash, stock-based compensation expense of (\$1,570,580), offset by the increase in the change in embedded liabilities of \$172,355 as discussed above.

## Liquidity and Capital Resources

Our cash position at March 31, 2017 was \$2,555, a decrease of (\$6,608) from the cash position of \$9,163 at December 31, 2016. We had negative working capital of (\$5,883,472) at March 31, 2017 which represents a decrease in our working capital of (\$447,361) compared to the (\$5,411,111) of negative working capital at December 31, 2016. Our current liabilities of \$6,078,509 at March 31, 2017, increased by \$419,725 from \$5,658,784 at December 31, 2016. This net decrease resulted from (i) a \$189,701 increase in accounts payable and accrued liabilities, (ii) a \$121,810 increase in deferred compensation payable, (iii) a \$51,277 net increase in the derivative liability related to convertible promissory notes, (iv) a \$41,763 increase in the carrying amount of convertible promissory notes, net of unamortized discount and (v) issuance of a \$25,000 promissory note, offset by a (\$9,826) net decrease in other current liabilities.

Operating activities utilized cash of (\$144,527) for the three months ended March 31, 2017, an improvement of \$7,003 from the cash utilized for operating activities of (\$151,530) for the three months ended March 31, 2016. Cash utilized by operating activities in the three months ended March 31, 2017 resulted primarily from (i) a cash basis net loss of (\$415,939), after adding back (deducting) non-cash stock-based compensation expense of \$191,325, interest accrued, but not paid of \$169,949, an increase in embedded derivative liabilities related to convertible notes of \$51,277, depreciation and amortization of \$12,249, a non-cash loss on conversion of convertible notes of \$11,629 and non-cash licensing revenues of (\$4,800) and (ii) changes in current assets and liabilities, including an increase in deferred offering costs and other assets of (\$3,083), an increase of \$152,285 in accounts payable and accrued liabilities and an increase in deferred compensation payable of \$121,810.

No cash was used in investing activities for the three months ended March 31, 2017.

Cash provided by financing activities for the three months ended March 31, 2017, amounted to \$137,919, a decrease of \$38,456 from the cash provided by financing activities of \$176,375 for the three months ended March 31, 2016. This was comprised of proceeds from issuances of convertible promissory notes aggregating \$90,000, issuances of common stock under an equity purchase agreement of \$42,944, proceeds from issuance of a \$25,000 promissory note and issuances of promissory notes to related parties of \$4,740, partially offset by principal repayments of (\$15,000) on a mortgage loan payable and repayments of promissory notes held by related parties of (\$9,765).

## Going Concern

We have incurred net recurring losses since inception, amounting to (\$66,174,258) as of March 31, 2017 and had a stockholders' deficiency of (\$5,666,492). We will need to obtain additional working capital in order to continue to cover our ongoing cash expenses.

These factors raise substantial doubt about our ability to continue as a going concern. In addition, the recent trading price range of our common stock at a fraction of a penny has introduced additional difficulty to our challenge to secure needed additional working capital. Our Independent Registered Public Accountants have stated in their Auditor's Report dated April 14, 2017, with respect to our financial statements as of and for the year ended December 31, 2016, that these circumstances raise substantial doubt about our ability to continue as a going concern.

During 2017, we restricted variable costs to only those expenses that are necessary to perform activities related to efforts to negotiate sublicenses for distribution of our CSRV<sup>®</sup> products, raising working capital to enable us to commence limited production of our CSRV<sup>®</sup> system technology products, research and development and general administrative costs in support of such activities.

Our financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

Sources of working capital and new funding being pursued by us include (i) deposits for orders from Secure Supplies for Hydrogen Gen Sets, (ii) issuances of promissory notes and convertible promissory notes, (iii) proceeds from sales of CSRV<sup>®</sup> Gen Sets, (iv) new equity investment, (v) new borrowing arrangements and (vi) up front licensing fees from prospective new sublicensees. There can be no assurance that we will be successful in securing any of these sources of additional funding. In this event, we may be required to substantially or completely curtail our operations, which could have a material adverse effect on our operations and financial condition.

During the period from April 1, 2017 to May 9, 2017, the Company raised a total \$532,300 of new working capital, which included \$488,700 from issuances of convertible promissory notes, \$38,600 from issuances of promissory notes to related parties and \$5,000 from issuance of a promissory note.

At March 31, 2017, current liabilities amounted to \$6,078,509, comprised of legal and professional fees of \$1,474,903, promissory notes due to related parties aggregating \$1,449,673, deferred compensation of \$1,394,127, accrued interest expense of \$532,667, accrued general and administrative expenses of \$528,447, a derivative liability related to convertible promissory notes of \$204,749, deposits of \$150,595, accrued research and development expenses of \$114,859, convertible promissory notes, net of unamortized discount of \$87,564, the current portion of a mortgage loan amounting to \$60,000 and the current portion of license deposits of \$55,925.

### Contractual Obligations and Commitments

The following table summarizes our contractual obligations and commitments at September 30, 2016:

	<u>Total</u>	<u>2017</u>	<u>2018</u>
Promissory notes to related parties	\$ 1,449,673	\$ 1,449,673	\$ -
Mortgage loan payable	1,318,158	60,000	1,258,158
Deferred compensation	1,394,127	1,394,127	-
Convertible promissory notes	139,614	117,000	22,614
Promissory Note	25,000	25,000	-
Total	<u>\$ 4,326,572</u>	<u>\$ 3,045,800</u>	<u>\$ 1,280,772</u>

### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

### Critical Accounting Policies

The Company's significant accounting policies are presented in the Company's notes to financial statements for the period ended March 31, 2017, which are contained in this filing and notes to financial statements for the year ended December 31, 2016 which are contained in the Company's 2016 Annual Report on Form 10-K. The significant accounting policies that are most critical and aid in fully understanding and evaluating the reported financial results include the following:

The Company prepares its financial statements in conformity with GAAP. These principals require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management believes that these estimates are reasonable and have been discussed with the Board of Directors; however, actual results could differ from those estimates.

Long-lived assets such as property, equipment and identifiable intangibles are reviewed for impairment whenever facts and circumstances indicate that the carrying value may not be recoverable. When required, impairment losses on assets to be held and used are recognized based on the fair value of the asset. The fair value is determined based on estimates of future cash flows, market value of similar assets, if available, or independent appraisals, if required. If the carrying amount of the long-lived asset is not recoverable from its undiscounted cash flows, an impairment loss is recognized for the difference between the carrying amount and fair value of the asset. When fair values are not available, the Company estimates fair value using the expected future cash flows discounted at a rate commensurate with the risk associated with the recovery of the assets. We did not recognize any impairment losses for any periods presented.

Other significant estimates include determining the fair value of convertible promissory notes containing embedded derivatives and variable conversion rates, determining a value for Series A Preferred Stock and Series B Convertible Preferred Stock issued, assigning useful lives to the Company's property, plant and equipment, determining an appropriate amount to reserve for obsolete and slow moving inventory, estimating a valuation allowance for deferred tax assets, assigning expected lives to, and estimating the rate of forfeitures of, stock options granted and selecting a trading price volatility factor for the Company's common stock in order to estimate the fair value of the Company's stock options on the date of grant or other appropriate measurement date. Actual results could differ from those estimates.

## **New Accounting Pronouncements**

### *Revenue Recognition*

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled to when products are transferred to customers. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) – Deferral of the Effective Date, which defers the effective date of ASU 2014-09 for one year and permits early adoption as early as the original effective date. Accordingly, the Company may adopt the standard in either its first quarter of 2018 or 2019.

In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606) – Identifying Performance Obligations and Licensing ("ASU 2016-10"), which amends the guidance in ASU 2014-09 related to identifying performance obligations and accounting for licenses of intellectual property. The Company will adopt ASU 2016-10 with ASU 2014-09. The Company is currently evaluating the impact of adopting the new revenue recognition standard, as amended, but does not expect it to have a material impact on its financial statements.

### *Stock Compensation*

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718) ("ASU 2016-09"), which simplified certain aspects of the accounting for share-based payment transactions, including income taxes, classification of awards and classification in the statement of cash flows. ASU 2016-09 will be effective for the Company beginning in its first quarter of 2018. The Company is currently evaluating the impact of adopting the new stock compensation standard, but does not expect it to have a material impact on its financial statements.

### *Financial Instruments*

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10) ("ASU 2016-01"), which updates certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 will be effective for the Company beginning in its first quarter of 2019. The Company does not believe the adoption of the new financial instruments standard will have a material impact on its financial statements.

### *Inventory Measurement*

In July 2015, the FASB issued ASU No. 2015-11, "Inventory – Simplifying the Measurement of Inventory (Topic 330)". This update requires that inventory value be measured at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. Currently, generally accepted accounting principles require that inventory be valued at the lower of cost or market price to replace the inventory. This update is to become effective for annual and interim financial statements for fiscal years ending after December 15, 2016. Earlier application is permitted. This update is required to be applied prospectively. The Company is currently evaluating the impact of this update; however, at this time it does not expect it will have a material impact on its financial statements.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are not required to provide the information under this item as we are a smaller reporting company.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls**

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the “Exchange Act”), we carried out an evaluation, with the participation of our management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) (our principal financial and accounting officer), of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act 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 CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

#### **Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during the last fiscal quarter 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

We are currently not involved in any litigation that we believe could have a materially adverse effect on our financial condition or results of operations. There is no action, suit, proceeding, inquiry or investigation before or by any court, public board, government agency, self-regulatory organization or body pending or, to the knowledge of the executive officers of our company or any of our subsidiaries, threatened against or affecting our company, our common stock, any of our subsidiaries or of our company's or our company's subsidiaries' officers or directors in their capacities as such, in which an adverse decision could have a material adverse effect.

### Item 1A. Risk Factors

We believe there are no changes that constitute material changes from the risk factors previously disclosed in the Company's 2016 Annual Report on Form 10-K filed April 14, 2017.

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

*The following issuances of securities during the three months ended March 31, 2017 were exempt from registration pursuant to Section 4(2), and Regulation D promulgated under the Securities Act. We made this determination based on the representations of the Investors which included, in pertinent part, that such Investors were "accredited investors" within the meaning of Rule 501 of Regulation D promulgated under the Securities Act, and that such Investors were acquiring our common stock for investment purposes for their own respective accounts and not as nominees or agents, and not with a view to the resale or distribution thereof, and that the Investors understood that the shares of our common stock may not be sold or otherwise disposed of without registration under the Securities Act or an applicable exemption therefrom.*

In a series of transactions, during the three months ended March 31, 2017, an aggregate of \$56,372 principal amount of convertible promissory notes, including accrued interest was converted by the holders into 170,872,980 unregistered shares of our common stock.

In a series of transactions, during the three months ended March 31, 2017, 772,066, 119,315 and 9,393 shares of Series B were issued to George J. Coates, Gregory G. Coates and Barry C. Kaye, respectively, having an estimated fair value of \$199,000, \$39,000 and \$3,000, respectively.

During the three months ended March 31, 2017, Barry C. Kaye converted 1,372 shares of Series B into 1,372,000 unregistered restricted shares of the Company's common stock.

Net proceeds from the above transactions were used for general working capital purposes.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not Applicable.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
31.1*	<a href="#">Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
31.2*	<a href="#">Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</a>
32.1*	<a href="#">Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
32.2*	<a href="#">Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Schema
101.CAL*	XBRL Taxonomy Calculation Linkbase
101.DEF*	XBRL Taxonomy Definition Linkbase
101.LAB*	XBRL Taxonomy Label Linkbase
101.PRE*	XBRL Taxonomy Presentation Linkbase
101.DE*	XBRL Taxonomy Extension Definition Linkbase Document

\* Furnished 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.

**COATES INTERNATIONAL, LTD.**

Date: May 11, 2017

/s/ George J. Coates

George J. Coates  
Duly Authorized Officer,  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 11, 2017

/s/ Barry C. Kaye

Barry C. Kaye  
Duly Authorized Officer,  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, George J. Coates, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Coates International, Ltd. (the “registrant”);
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant’s other certifying officer(s) 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 our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our 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 report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this 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(s) and I have disclosed, based on our 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: May 11, 2017

/s/ George J. Coates

George J. Coates  
President and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Barry C. Kaye, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Coates International, Ltd. (the “registrant”);
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant’s other certifying officer(s) 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 our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our 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 report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this 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(s) and I have disclosed, based on our 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: May 11, 2017

/s/ Barry C. Kaye

Barry C. Kaye  
Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Coates International, Ltd. (the "Company") on Form 10-Q for the period ended March 31, 2017 (the "Report"), I, George J. Coates, Chief Executive Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 11, 2017

*/s/ George J. Coates*

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George J. Coates  
President and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Coates International, Ltd. (the "Company") on Form 10-Q for the period ended March 31, 2017 (the "Report"), I, Barry C. Kaye, Chief Financial Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 11, 2017

*/s/ Barry C. Kaye*

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Barry C. Kaye  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)