NETLIST INC
Form 10-Q
August 13, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 29, 2013

or

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

For the transition period from to

Commission file number 001-33170

NETLIST, INC.

(Exact name of registrant as specified in its charter)

Delaware	**95-4812784**
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)

51 Discovery, Suite 150

Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant s telephone number, including area code)

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

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 (section 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 x No o

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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check One):

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

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

The number of shares outstanding of the registrant s common stock as of the latest practicable date:

Common Stock, par value $0.001 per share

31,582,417 shares outstanding at July 31, 2013

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED JUNE 29, 2013

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NETLIST, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(in thousands, except par value)

	(unaudited) June 29, 2013	(audited) December 29, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,817	$ 7,755
Investments in marketable securities		415
Accounts receivable, net	2,064	3,434
Inventories	5,305	7,380
Prepaid expenses and other current assets	472	723
Total current assets	14,658	19,707
Property and equipment, net	1,804	2,560
Other assets	126	130
Total assets	$ 16,588	$ 22,397
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,438	$ 3,367
Accrued payroll and related liabilities	710	784
Accrued expenses and other current liabilities	435	497
Accrued engineering charges	450	450
Current portion of long term debt	111	3,493
Total current liabilities	5,144	8,591
Long term debt, net of current portion	2,800	
Other liabilities	105	94
Total liabilities	8,049	8,685
Commitments and contingencies		
Stockholders equity:		
Common stock, $0.001 par value - 90,000 shares authorized; 30,460 (2013) and 30,348 (2012) shares issued and outstanding	30	30
Additional paid-in capital	101,263	100,403
Accumulated deficit	(92,754)	(86,721)
Total stockholders equity	8,539	13,712
Total liabilities and stockholders equity	$ 16,588	$ 22,397

See accompanying notes

3

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 29, 2013	June 30, 2012	June 29, 2013	June 30, 2012
Net sales	$ 5,065	$ 10,552	$ 11,029	$ 24,519
Cost of sales(1)	4,818	7,814	10,216	16,345
Gross profit	247	2,738	813	8,174
Operating expenses:				
Research and development(1)	1,457	3,770	3,299	7,612
Selling, general and administrative(1)	1,571	2,871	3,327	5,480
Total operating expenses	3,028	6,641	6,626	13,092
Operating loss	(2,781)	(3,903)	(5,813)	(4,918)
Other income (expense):				
Interest expense, net	(88)	(79)	(218)	(150)
Other income, net	7	3	1	8
Total other expense, net	(81)	(76)	(217)	(142)
Loss before provision for income taxes	(2,862)	(3,979)	(6,030)	(5,060)
Provision for income taxes	1	1	3	1
Net loss	$ (2,863)	$ (3,980)	$ (6,033)	$ (5,061)
Net loss per common share:				
Basic and diluted	$ (0.09)	$ (0.14)	$ (0.20)	$ (0.18)
Weighted-average common shares outstanding:				
Basic and diluted	30,320	28,111	30,263	27,420

(1) Amounts include stock-based compensation expense as follows:

Cost of sales	$ 11	$ 42	$ 23	$ 77
Research and development	118	153	278	345
Selling, general and administrative	240	287	502	583

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Comprehensive Loss

(in thousands)

	Three Months Ended		Six Months Ended	
	June 29, 2013	June 30, 2012	June 29, 2013	June 30, 2012
Net loss	$ (2,863)	$ (3,980)	$ (6,033)	$ (5,061)
Other comprehensive gain (loss):				
Net unrealized gain (loss) on investments in marketable securities, net of tax		(6)		1
Total comprehensive loss	$ (2,863)	$ (3,986)	$ (6,033)	$ (5,060)

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended June 29, 2013	Six Months Ended June 30, 2012
Cash flows from operating activities:		
Net loss	$ (6,033)	$ (5,061)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	813	1,070
Gain on disposal of property and equipment	1	
Stock-based compensation	803	1,005
Changes in operating assets and liabilities:		
Accounts receivable	1,370	3,305
Inventories	2,075	(3,586)
Prepaid expenses and other current assets	491	354
Other assets	4	31
Accounts payable	71	662
Accrued payroll and related liabilities	(74)	(508)
Accrued expenses and other current liabilities	(51)	19
Accrued engineering charges		40
Net cash used in operating activities	(530)	(2,669)
Cash flows from investing activities:		
Acquisition of property and equipment	(52)	(1,089)
Proceeds from sale of property and equipment	2	
Proceeds from maturities and sales of investments in marketable securities	415	
Net cash provided by (used in) investing activities	365	(1,089)
Cash flows from financing activities:		
Proceeds of bank term loan, net of issuance costs		1,320
Payments on debt	(830)	(1,045)
Proceeds from public offering, net	28	3,618
Proceeds from exercise of equity awards, net of taxes remitted for restricted stock	29	629
Net cash (used in) provided by financing activities	(773)	4,522
(Decrease) increase in cash and cash equivalents	(938)	764
Cash and cash equivalents at beginning of period	7,755	10,535
Cash and cash equivalents at end of period	$ 6,817	$ 11,299

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 29, 2013

Note 1 Description of Business

Netlist, Inc. (the Company or Netlist) designs and manufactures a wide variety of high performance, logic-based memory subsystems for the global datacenter and high-performance computing and communications markets. The Company s memory subsystems consist of combinations of dynamic random access memory integrated circuits (DRAM ICs or DRAM), NAND flash memory (NAND), application-specific integrated circuits (ASICs) and other components assembled on printed circuit boards (PCBs). Netlist primarily markets and sells its products to leading original equipment manufacturer (OEM) customers. The Company s solutions are targeted at applications where memory plays a key role in meeting system performance requirements. The Company leverages a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high memory density, small form factor, high signal integrity, attractive thermal characteristics, reduced power consumption and low cost per bit. Our NVvault product is the first to offer both DRAM and NAND in a standard form factor memory subsystem as a persistent DIMM in mission critical applications.

Netlist was incorporated in June 2000 and is headquartered in Irvine, California. In 2007, the Company established a manufacturing facility in the People s Republic of China (the PRC), which became operational in July 2007 upon the successful qualification of certain key customers.

Liquidity

The Company incurred net losses of approximately $6.0 million and $5.1 million for the six months ended June 29, 2013 and June 30, 2012, respectively, and has an accumulated deficit of approximately $92.8 million as of June 29, 2013. As a result of these continuing losses, the Company was out of compliance with the tangible net worth debt covenant contained in its credit agreement with Silicon Valley Bank (the SVB Credit Agreement) during the fourth quarter of 2012 and the first and second quarters of 2013.

On July 18, 2013, the Company obtained debt financing of up to $10 million in term loans and up to $5 million in revolving loans from DBD Credit Funding, LLC, a Delaware limited liability company, an affiliate of Fortress Investment Group, LLC (see Note 12). The first tranche ($6 million) of the debt was drawn immediately and used to pay down all the Silicon Valley Bank term debt and related obligations of approximately $3 million. The tangible net worth covenant in connection with the credit agreement entered into with Silicon Valley Bank was relaxed as part of the SVB amendment agreement (see Note 12), which also waived certain events of default related to the noncompliance. The new financing with DBD Credit Funding, LLC does not have fixed charge ratio or tangible net worth covenants, and the loan is interest only for the first 18 months of the 36 month term.

Concurrent with the debt financing, the Company raised additional net proceeds of approximately $960,000 in a registered public offering of its securities (see Note 12) from an institutional investor for the sale of 1,098,902 shares of common stock and a seven-year warrant to purchase

1,098,902 shares of common stock at an exercise price of $1.00 per share.

The Company raised net proceeds of approximately $3.9 million in the year ended December 29, 2012 and approximately $1.9 million in the year ended December 31, 2011 under a sales agreement with Ascendiant Capital Markets LLC (Ascendiant). The Company may raise additional funds through the Company s agreement with Ascendiant but may be limited in its ability to benefit from the agreement with Ascendiant if the volume of its shares traded in the market or the market price of its shares remains low.

Table of Contents

If adequate working capital is not available when needed, the Company may be required to significantly modify its business model and operations to reduce spending to a sustainable level. Insufficient working capital could cause the Company to be unable to execute its business plan, take advantage of future opportunities, or respond to competitive pressures or customer requirements. It may also cause the Company to delay, scale back or eliminate some or all of its research and development programs, or to reduce or cease operations. While there is no assurance that the Company can meet its revenue forecasts, management anticipates that it can successfully execute its plans and continue operations for at least the next twelve months.

Note 2 Summary of Significant Accounting Policies

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (the U.S.) for interim financial information and with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 8 of SEC Regulation S-X. These condensed consolidated financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. Therefore, these unaudited condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 29, 2012, included in the Company s Annual Report on Form 10-K filed with the SEC on March 29, 2013.

The condensed consolidated financial statements included herein as of June 29, 2013 are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company s management, are necessary to present fairly the condensed consolidated financial position of the Company and its wholly-owned subsidiaries as of June 29, 2013, the condensed consolidated statements of its operations and comprehensive loss for the three and six months ended June 29, 2013 and June 30, 2012, and the condensed consolidated statements of cash flows for the six months ended June 29, 2013 and June 30, 2012. The results of operations for the six months ended June 29, 2013 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Netlist, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Fiscal Year

The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2013, the Company s fiscal year is scheduled to end on December 28, 2013 and will consist of 52 weeks. Each of the Company s first three quarters in a fiscal year is comprised of 13 weeks.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires 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 condensed consolidated financial statements, and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. Significant estimates made by management include, among others, provisions for uncollectible receivables and sales returns, warranty liabilities, valuation of inventories, fair value of financial instruments, recoverability of long-lived assets, stock-based compensation expense and realization of deferred tax assets. The Company bases its estimates on historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. The Company reviews its estimates on an on-going basis. The actual results experienced by the Company may differ materially and adversely from its estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

Table of Contents

Revenue Recognition

The Company s revenues primarily consist of product sales of high-performance memory subsystems to OEMs. Revenues also include sales of excess component inventories to distributors and other users of memory integrated circuits (ICs). Such sales amounted to less than $0.1 million for each of the three and six month periods ended June 29, 2013 and June 30, 2012.

The Company recognizes revenues in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 605. Accordingly, the Company recognizes revenues when there is persuasive evidence of an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

The Company generally uses customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. The Company assesses whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess component inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. The Company offers a standard product warranty to its customers and has no other post-shipment obligations. The Company assesses collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer s payment history.

All amounts billed to customers related to shipping and handling are classified as revenues, while all costs incurred by the Company for shipping and handling are classified as cost of sales.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less, other than short-term investments in securities that lack an active market.

Investments in Marketable Securities

The Company accounts for its investments in marketable securities in accordance with ASC Topic 320. The Company determines the appropriate classification of its investments at the time of purchase and reevaluates such designation at each balance sheet date. The Company s investments in marketable securities have been classified and accounted for as available-for-sale based on management s investment intentions relating to these securities. Available-for-sale securities are stated at fair value, generally based on market quotes, to the extent they are available. Unrealized gains and losses, net of applicable deferred taxes, are recorded as a component of other comprehensive income (loss). Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in other income, net in the consolidated statements of operations.

The Company generally invests its excess cash in domestic bank-issued certificates of deposit which carry federal deposit insurance, money market funds and highly liquid debt instruments of U.S. municipalities, corporations and the U.S. government and its agencies. All highly liquid investments with stated maturities of three months or less from the date of purchase are classified as cash equivalents; all investments with stated maturities of greater than three months are classified as investments in marketable securities.

Fair Value of Financial Instruments

The Company s financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of the Company s cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. The Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Table of Contents

Allowance for Doubtful Accounts

The Company evaluates the collectibility of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer s ability to meet its financial obligations subsequent to the original sale, the Company will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company records allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and its historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, investments in marketable securities, and accounts receivable.

The Company invests its cash equivalents primarily in money market mutual funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. The Company had $0.8 million of Federal Deposit Insurance Corporation and Securities Investor Protection Corporation insured cash and cash equivalents at June 29, 2013. Investments in marketable securities are generally in high-credit quality debt instruments. Such investments are made only in instruments issued or enhanced by high-quality institutions. The Company has not incurred any credit losses related to these investments.

The Company s trade accounts receivable are primarily derived from sales to OEMs in the computer industry. The Company performs credit evaluations of its customers financial condition and limits the amount of credit extended when deemed necessary, but generally requires no collateral. The Company believes that the concentration of credit risk in its trade receivables is moderated by its credit evaluation process, relatively short collection terms, the high level of credit worthiness of its customers (see Note 3), foreign credit insurance and letters of credit issued on the Company s behalf. Reserves are maintained for potential credit losses, and such losses historically have not been significant and have been within management s expectations.

Inventories

Inventories are valued at the lower of actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, the Company evaluates its ending inventory quantities on hand and on order and records a provision for excess quantities and obsolescence. Among other factors, the Company considers historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. In addition, the Company considers changes in the market value of components in determining the net realizable value of its inventory. Once established, lower of cost or market write-downs are considered permanent adjustments to the cost basis of the excess or obsolete inventories. Provisions are made to reduce excess or obsolete inventories to their estimated net realizable values.

Property and Equipment

Property and equipment are recorded at cost and depreciated on a straight-line basis over their estimated useful lives, which generally range from three to seven years. Leasehold improvements are recorded at cost and amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term.

Impairment of Long-Lived Assets

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows. The Company s management believes there is no impairment of long-lived assets as of June 29, 2013.

Table of Contents

There can be no assurance, however, that market conditions will not change or demand for the Company s products will continue, which could result in future impairment of long-lived assets.

Warranties

The Company offers warranties generally ranging from one to three years, depending on the product and negotiated terms of the purchase agreements with customers. Such warranties require the Company to repair or replace defective product returned to the Company during the warranty period at no cost to the customer. Warranties are not offered on sales of excess component inventory. The Company records an estimate for warranty-related costs at the time of sale based on its historical and estimated product return rates and expected repair or replacement costs (see Note 3). Such costs have historically been consistent between periods and within management s expectations and the provisions established.

Stock-Based Compensation

The Company accounts for equity issuances to non-employees in accordance with ASC Topic 505. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company s estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of the Company s common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. The expected volatility is based on the historical volatility of the Company s common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividend assumption is based on the Company s history and management s expectation regarding dividend payouts. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award, provided that the accumulated cost recognized as of any date at least equals the value of the vested portion of the award.

The Company recognizes the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

Income Taxes

Under ASC Topic 270, the Company is required to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. The Company is also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects, calculated at currently effective tax rates, of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements. A valuation allowance related to a net deferred tax asset is recorded when it is more likely than not that some portion of the deferred tax asset will not be realized.

Table of Contents

ASC Topic 740 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under ASC Topic 740 the Company may only recognize or continue to recognize tax positions that meet a more likely than not threshold.

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Collaboration Agreements

In 2011, the Company entered into two memory technology Collaboration Agreements. The first agreement is a HyperCloud® Technology Collaboration Agreement (the IBM Agreement) with International Business Machines (IBM). Under the IBM Agreement, IBM and the Company have agreed to cooperate with respect to the qualification of HyperCloud® technology for use with IBM servers and to engage in certain joint marketing efforts if qualification is achieved. IBM and the Company have agreed to commit resources and funds in support of these activities. The IBM Agreement is non-exclusive.

The second agreement is a Collaboration Agreement (the HP Agreement) with Hewlett-Packard Company (HP). Under the HP Agreement, HP and the Company agreed to cooperate and commit resources in furtherance of qualifying of HyperCloud® technology for use with HP servers and to engage in certain joint marketing efforts if qualification is achieved. HP and the Company agreed to commit resources and funds in support of these activities. The HP Agreement is exclusive for a period of time. HP and the Company agreed to collaborate on the future use of HyperCloud® load reduction and rank multiplication technologies for next generation server memory for HP.

In total, the Company reimbursed IBM and HP $0.2 million and $1 million, respectively, for the cost of certain qualification activities. In addition, the Company made $0.8 million of payments to IBM for joint HyperCloud® marketing activities, all of which have been amortized based on actual unit shipments compared with estimated total shipments over the term of the Collaboration Agreement. The Company s net sales were determined after deduction of such customer allowances, in accordance with ASC 605-50. There can be no assurance that the efforts undertaken under either of the IBM or HP collaboration agreements will result in revenues for the Company that are sufficient to cover the cost of qualification activities, including payments made to HP and IBM under the collaboration agreements.

Risks and Uncertainties

The Company is subject to certain risks and uncertainties including their ability to obtain profitable operations due to the history of losses and accumulated deficits, the Company s dependence on a few customers for a significant portion of revenues, risks related to intellectual property matters, market development of and demand for the Company s products, and the length of the sales cycle. Such risks could have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

The Company has invested and expects to continue to invest a significant portion of its research and development budget into the design of ASIC devices, including the HyperCloud® memory subsystem. This new design and the products it is incorporated into are subject to increased risks as compared to the Company s existing products. The Company may be unable to achieve customer or market acceptance of the HyperCloud® memory subsystem or other new products, or achieve such acceptance in a timely manner. The Company has experienced a longer qualification cycle than anticipated with its HyperCloud® memory subsystems, and as of June 29, 2013, the product has not generated significant revenue relative to the Company s investment in the product. The Company has entered into collaborative agreements with both HP and IBM pursuant to which these OEMs have cooperated with the Company to qualify HyperCloud® for use in their respective products. The qualifying OEMs have engaged and continue to engage with the Company in joint marketing and further product development efforts. The Company and each of the OEMs have committed financial and other resources toward the collaboration. There can be no assurance that the efforts undertaken pursuant to either of the collaborative agreements will result in any new revenues for the Company. Further delays or any failure in placing or qualifying this product with HP, IBM or other potential customers would adversely impact the Company s consolidated results of operations.

Table of Contents

The Company s operations in the PRC are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in the PRC. These include, but are not limited to, (i) potential changes in economic conditions in the region, (ii) managing a local workforce that may subject the Company to uncertainties or certain regulatory policies, (iii) changes in other policies of the Chinese governmental and regulatory agencies, and (iv) changes in the laws and policies of the U.S. government regarding the conduct of business in foreign countries, generally, or in the PRC, in particular. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi (RMB), is converted into other currencies and by which dividends may be declared or capital distributed for the purpose of repatriation of earnings and investments. If restrictions in the conversion of RMB or in the repatriation of earnings and investments through dividend and capital distribution restrictions are instituted, the Company s operations and operating results may be negatively impacted. The liabilities of the Company s subsidiaries in the PRC exceeded its assets as of June 29, 2013 and December 29, 2012.

Foreign Currency Remeasurement

The functional currency of the Company s foreign subsidiary is the U.S. dollar. Local currency financial statements are remeasured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. All remeasurement gains and losses are included in determining net loss. Transaction gains and losses were not significant in the three and six months ended June 29, 2013 or June 30, 2012.

Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period, excluding unvested shares issued pursuant to restricted share awards under the Company s share-based compensation plans. Diluted net loss per share is calculated by dividing the net loss by the weighted-average shares and dilutive potential common shares outstanding during the period. Dilutive potential shares consist of dilutive shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively, computed using the treasury stock method. In periods of losses, basic and diluted loss per share are the same, as the effect of stock options and unvested restricted share awards on loss per share is anti-dilutive.

Note 3 Supplemental Financial Information

Inventories

Inventories consist of the following (in thousands):

	June 29, 2013	December 29, 2012
Raw materials	$ 3,516	$ 4,544

Work in process		283		70
Finished goods		1,506		2,766
	$	5,305	$	7,380

Warranty Liabilities

The following table summarizes the activity related to the warranty liabilities (in thousands):

	Six Months Ended			
	June 29, 2013		June 30, 2012	
Beginning balance	$	235	$	189
Estimated cost of warranty claims charged to cost of sales		62		100
Cost of actual warranty claims		(38)		(68)
Ending balance		259		221
Less current portion		(154)		(133)
Long-term warranty obligations	$	105	$	88

Table of Contents

The allowance for warranty liabilities expected to be incurred within one year is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets. The allowance for warranty liabilities expected to be incurred after one year is included as a component of other liabilities in the accompanying condensed consolidated balance sheets.

Computation of Net Loss Per Share

The following table sets forth the computation of net loss per share, including the reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 29, 2013	**June 30, 2012**	**June 29, 2013**	**June 30, 2012**
Basic and diluted net loss per share:				
Numerator: Net loss	$ (2,863)	$ (3,980)	$ (6,033)	$ (5,061)
Denominator: Weighted-average common shares outstanding, basic and diluted	30,320	28,111	30,263	27,420
Basic and diluted net loss per share	$ (0.09)	$ (0.14)	$ (0.20)	$ (0.18)

The following table sets forth potentially dilutive common share equivalents, consisting of shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively computed using the treasury stock method. These potential common shares have been excluded from the diluted net loss per share calculations above as their effect would be anti-dilutive for the periods then ended (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2013	**June 30, 2012**	**June 29, 2013**	**June 30, 2012**
Common share equivalents	193	694	215	973

The above common share equivalents would have been included in the calculation of diluted earnings per share had the Company reported net income for the periods then ended.

Major Customers

The Company s product sales have historically been concentrated in a small number of customers. The following table sets forth sales to customers comprising 10% or more of the Company s net sales as follows:

	Three Months Ended		Six Months Ended	
	June 29, 2013	June 30, 2012	June 29, 2013	June 30, 2012
Customer:				
Customer A	48%	60%	35%	74%
Customer B	17%	18%	18%	*%

The Company s accounts receivable as of June 29, 2013 were concentrated with two customers, representing approximately 53% and 14% of aggregate gross receivables. At December 29, 2012, two customers represented approximately 41% and 24% of aggregate gross receivables. A significant reduction in sales to, or the inability to collect receivables from, a significant customer could have a material adverse impact on the Company. The Company mitigates risk with foreign receivables by purchasing comprehensive foreign credit insurance.

Table of Contents

Cash Flow Information

The following table sets forth supplemental disclosures of cash flow information and non-cash investing and financing activities (in thousands):

	Six Months Ended			
	June 29, 2013		June 30, 2012	
Supplemental disclosure of non-cash investing and financing activities:				
Purchase of equipment not paid for at the end of the period	$		$	500
Debt financed acquisition of fixed assets	$	240	$	180
Change in unrealized loss from investments in marketable securities	$		$	(1)
Contractual marketing funds due to collaboration partners	$		$	800

Note 4 Fair Value Measurements

The following tables detail the fair value measurements within the fair value hierarchy of the Company s assets (in thousands):

			Fair Value Measurements at June 29, 2013 Using					
	Fair Value at June 29, 2013		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
Money market mutual funds	$	2,812	$	2,812	$		$	
Total	$	2,812	$	2,812	$		$	

			Fair Value Measurements at December 29, 2012 Using					
	Fair Value at December 29, 2012		Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)	
Money market mutual funds	$	2,338	$	2,338	$		$	
Auction and variable floating rate notes		415						415
Total	$	2,753	$	2,338	$		$	415

The following tables summarize the Company s assets measured at fair value on a recurring basis as presented in the Company s condensed consolidated balance sheets at June 29, 2013 and December 29, 2012:

		Fair Value Measurements at June 29, 2013 Using		
	Fair Value at June 29, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	$ 2,812	$ 2,812	$	$
	$ 2,812	$ 2,812	$	$

		Fair Value Measurements at December 29, 2012 Using		
	Fair Value at December 29, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	$ 2,338	$ 2,338	$	$
Long-term marketable securities	415			415
Total assets measured at fair value	$ 2,753	$ 2,338	$	$ 415

Table of Contents

Fair value measurements using Level 3 inputs in the table above relate to the Company s investments in auction rate securities. Level 3 inputs are unobservable inputs used to estimate the fair value of assets or liabilities and are utilized to the extent that observable inputs are not available (see Note 5).

The following table provides a reconciliation of the beginning and ending balances for the Company s assets measured at fair value using Level 3 inputs (in thousands):

	Six Months Ended			
	June 29, 2013		June 30, 2012	
Beginning balance	$	415	$	444
Proceeds from sales of available-for-sale marketable securities		(415)		
Unrealized loss transferred from other comprehensive loss to earnings				1
Ending balance	$		$	445

Note 5 Investments in Marketable Securities

Investments in marketable securities consist of the following (in thousands):

	December 29, 2012					
	Amortized Cost		Net Unrealized Loss		Fair Value	
Auction and variable floating rate notes	$	415	$		$	415

At December 29, 2012, the Level 3 fair value of the Company s auction rate security consists of the par value of $500,000 adjusted for a realized loss of $85,000, recorded as other expense as of December 31, 2012.

Realized gains and losses on the sale of investments in marketable securities are determined using the specific identification method. Other than the sale of Company s auction rate security, described below, there were no sales of available-for-sale securities prior to maturity in 2012 or 2011.

Table of Contents

The following table provides the breakdown of investments in marketable securities with unrealized losses (in thousands):

	December 29, 2012 Continuous Unrealized Loss			
	Less than 12 months		12 months or greater	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Auction and variable floating rate notes	$ 415	$	$	$

Auction Rate Securities

As of December 29, 2012, the Company held one investment in a Baa1 rated auction rate debt security of a municipality with a total purchase cost of $0.5 million and recorded a permanent impairment of this asset for a realized loss of $85,000. During the first quarter of 2013, the Company sold this auction rate security for $415,000.

Note 6 Silicon Valley Bank Credit Agreement

On October 31, 2009, the Company entered into a credit agreement with Silicon Valley Bank (SVB), which was most recently amended on July 18, 2013 (as amended, the SVB Credit Agreement). Currently, the SVB Credit Agreement provides that the Company can borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) $5.0 million.

Pursuant to the September 2010 amendment to the SVB Credit Agreement, SVB extended a $1.5 million term loan, bearing interest at a rate of prime plus 2.00%. The Company was required to make monthly principal payments of $41,666 over the 36 month term of the loan, or $0.5 million annually. In May 2011, SVB extended an additional $3.0 million term loan, bearing interest at a rate of prime plus 2.75%. The Company was required to make monthly principal payments of $125,000 over the 24 month term of the loan, or $1.5 million annually. In May 2012, SVB consolidated both term loans and extended additional credit, resulting in a combined balance of $3.5 million as of May 2012 (the Consolidated Term Loan). The Consolidated Term Loan was payable in 36 installments of $97,222, beginning December 2012, with interest at a rate of prime plus 2.50%. Interest was payable monthly from the date of funding through final payoff of the loan. On July 18, 2013, as part an amendment to the SVB Credit Agreement entered into with SVB and following the Company s receipt of additional loan financing from DBD Credit Funding, LLC, the Consolidated Term Loan and outstanding interest was paid in full. The Company reclassified the long-term portion of the Consolidated Term Loan to current portion of debt in the accompanying consolidated balance sheet as of December 29, 2012. In accordance with the terms of the financing obtained through DBD Credit Funding, LLC, the Company recorded all amounts due under the Consolidated Term Loan as long-term portion of debt in the accompanying consolidated balance sheet as of June 29, 2013 (see note 12).

Prior to the May 2012 amendment, the SVB Credit Agreement contained an overall sublimit of $10.0 million to collateralize the Company s contingent obligations under letters of credit and other financial services. Amounts outstanding under the overall sublimit reduced the amount available pursuant to the SVB Credit Agreement. As a result of the May 2012 amendment, letters of credit and other financial services were no longer subject to borrowing base sublimits and did not reduce the amount that could be borrowed under the revolving line of credit. The July 18, 2013 amendment (see Note 12) requires letters of credit to be secured by cash. At June 29, 2013, letters of credit in the amount of $1.0 million were outstanding.

The following table presents details of interest expense related to borrowings on the line of credit with SVB, along with certain other applicable information (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2013	**June 30, 2012**	**June 29, 2013**	**June 30, 2012**
Interest expense	$ 28	$ 25	$ 95	$ 48

Table of Contents

The following table presents details of the Company s outstanding borrowings and availability under our line of credit with SVB:

	June 29, 2013		December 29, 2012	
Availability under the revolving line of credit	$	1,616	$	1,486
Outstanding borrowings on the revolving line of credit				
Amounts reserved under credit sublimits				
Unutilized borrowing availability under the revolving line of credit	$	1,616	$	1,486

All obligations under the SVB Credit Agreement are secured by a first priority lien on the Company s tangible and intangible assets, other than its intellectual property, which is subject to a first priority lien held by DBD Credit Funding, LLC. The SVB Credit Agreement subjects the Company to certain affirmative and negative covenants, including financial covenants with respect to the Company s liquidity and tangible net worth and restrictions on the payment of dividends. As of June 29, 2013 and December 29, 2012, the Company was in violation of the tangible net worth covenant but remained in compliance with the quick ratio covenant. Subsequent to quarter end, in connection the repayment of the Consolidated Term Loan and an amendment to the SVB Credit Agreement dated July 18, 2013, the Company has obtained a waiver of such non-compliance and amended the tangible net worth covenant which resulted in the Company s compliance with all financial covenants as of July 18, 2013.

On January 23, 2013, the Company entered into a Forbearance Agreement with Silicon Valley Bank (the Forbearance Agreement), pursuant to which Silicon Valley Bank agreed to forbear from filing any legal action or instituting or enforcing any rights and remedies it may have against the Company as a result of its violation of the financial covenants until February 28. 2013. On March 27, 2013, the effectiveness of the Forbearance Agreement was extended until April 30, 2013. As a result of the Company s non-compliance with a loan covenant at December 29, 2012, and in accordance with relevant accounting guidance, the Company reclassified the long-term portion of the Consolidated Term Loan to current portion of debt in the accompanying consolidated balance sheet as of December 29, 2012. Subsequent to June 29, 2013, the Company has obtained a waiver of such non-compliance, in connection with an amendment to the SVB Credit Agreement dated July 18, 2013. In accordance with the terms of the financing obtained through DBD Credit Funding, LLC, the Company recorded all amounts due under the Consolidated Term Loan as long-term portion of debt in the accompanying consolidated balance sheet as of June 29, 2013 (see Note 12).

Pursuant to the Forbearance Agreement in effect as of June 29, 2013, any principal amount outstanding under the revolving line would accrue interest at a per annum rate equal to the following (i) at all times that a Streamline Period (as defined) is in effect, 1.75% above the Prime Rate; and (ii) at all times that a Streamline Period is not in effect, 2.75% above the Prime Rate, which interest would be payable monthly. In addition, the reserve on the revolving line increased to $2 million. The SVB Credit Agreement requires payment of an unused line fee, as well as anniversary and early termination fees, as applicable. On July 18, 2013, as part of the Loan Amendment, the Streamline Period interest was eliminated and any principal amount outstanding under the Revolving Line will accrue interest at 2.75% above the Prime Rate. The Loan Amendment also eliminated the reserve on the revolving line of $2 million, thereby increasing the borrowing availability.

Note 7 Debt

Debt consists of the following (in thousands):

	June 29,	December 29,

		2013		2012
Consolidated Term Loan, net of issuance cost of $20 (2013) and $28 (2012)	$	2,800	$	3,375
Obligations under capital leases		30		118
Note payable to others		81		
		2,911		3,493
Less current portion		(111)		(3,493)
	$	2,800	$	

Table of Contents

Interest expense related to debt is presented in the following table (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2013	June 30, 2012	June 29, 2013	June 30, 2012
Interest expense	$ 61	$ 57	$ 125	$ 108

See note 12 for additional information regarding the Company s indebtedness.

Note 8 Income Taxes

The following table sets forth the Company s provision for income taxes, along with the corresponding effective tax rates (in thousands, except percentages):

	Three Months Ended		Six Months Ended	
	June 29, 2013	June 30, 2012	June 29, 2013	June 30, 2012
Provision for income taxes	$ 1	$ 1	$ 3	$ 1
Effective tax rate	(0.0)%	(0.0)%	(0.0)%	(0.0)%

The Company evaluates whether a valuation allowance should be established against its deferred tax assets based on the consideration of all available evidence using a more likely than not standard. Due to uncertainty of future utilization, the Company has provided a full valuation allowance as of June 29, 2013 and December 29, 2012. Accordingly, no benefit has been recognized for net deferred tax assets.

The Company does not have any unrecognized tax benefits at June 29, 2013 and December 29, 2012.

Note 9 Commitments and Contingencies

Litigation and Patent Reexaminations

The Company owns numerous patents and continues to enlarge and strengthen its patent portfolios, which cover different aspects of the Company s technology innovations with various claim scopes. The Company has plans to generate revenue by selling or licensing its technology, and intends to vigorously enforce its patent rights against infringers of such rights. The Company dedicates substantial resources in protecting its intellectual property, including its efforts to defend its patents against challenges made by way of reexamination proceedings at the United States Patent and Trademark Office (USPTO). These activities are likely to continue for the foreseeable future, without any guarantee that any ongoing or future patent protection and litigation activities will be successful. The Company is also subject to litigation claims that it has infringed on the intellectual property of others, against which the Company intends to defend vigorously.

Litigation, whether or not eventually decided in the Company s favor or settled, is costly and time-consuming and could divert management s attention and resources. Because of the nature and inherent uncertainties of litigation, should the outcome of any of such actions be unfavorable, the Company s business, financial condition, results of operations or cash flows could be materially and adversely affected. Additionally, the outcome of pending litigation, and the related patent reexaminations, as well as any delay in their resolution, could affect the Company s ability to license its intellectual property in the future or to protect against competition in the current and expected markets for its products.

Table of Contents

Google Litigation

In May 2008, the Company initiated discussions with Google, Inc. (Google) based on information and belief that Google had infringed on a U.S. patent owned by the Company, U.S. Patent No. 7,289,386 (the 386 patent), which relates generally to technologies to implement rank multiplication in memory modules. Preemptively, Google filed a declaratory judgment lawsuit against the Company in the U.S. District Court for the Northern District of California (the Northern District Court), seeking a declaration that Google did not infringe the 386 patent and that the 386 patent was invalid. The Company filed a counterclaim for infringement of the 386 patent by Google. Claim construction proceedings were held in November 2009, and the Company prevailed on every disputed claim construction issue. In June 2010, the Company filed motions for summary judgment of patent infringement and dismissal of Google s affirmative defenses. In May 2010, Google requested and was later granted an *Inter Partes* Reexamination of the 386 patent by the USPTO. The reexamination proceedings are described below. The Northern District Court granted Google s request to stay the litigation pending result of the reexamination, and therefore has not ruled on the Company s motions for summary judgment.

In December 2009, the Company filed a patent infringement lawsuit against Google in the Northern District Court, seeking damages and injunctive relief based on Google s infringement of U.S. Patent No. 7,619,912 (the 912 patent), which is related to the 386 patent and relates generally to technologies to implement rank multiplication. In February 2010, Google answered the Company s complaint and asserted counterclaims against the Company seeking a declaration that the patent is invalid and not infringed, and claiming that the Company committed fraud, negligent misrepresentation and breach of contract based on the Company s activities in the JEDEC standard-setting organization. The counterclaim seeks unspecified compensatory damages. Accruals have not been recorded for loss contingencies related to Google s counterclaim because it is not probable that a loss has been incurred and the amount of any such loss cannot be reasonably estimated. In October 2010, Google requested and was later granted an *Inter Partes* Reexamination of the 912 patent by the USPTO. The reexamination proceedings are described below. In connection with the reexamination request, the Northern District Court granted the Company and Google s joint request to stay the 912 patent infringement lawsuit against Google until the completion of the reexamination proceedings.

Inphi Litigation

In September 2009, the Company filed a patent infringement lawsuit against Inphi Corporation (Inphi) in the U.S. District Court for the Central District of California (the Central District Court). The complaint, as amended, alleges that Inphi is contributorily infringing and actively inducing the infringement of U.S. patents owned by the Company, including the 912 patent, U.S. Patent No. 7,532,537 (the 537 patent), which relates generally to memory modules with load isolation and memory domain translation capabilities, and U.S. Patent No. 7,636,274 (the 274 patent), which is related to the 537 patent and relates generally to load isolation and memory domain translation technologies. The Company is seeking damages and injunctive relief based on Inphi s use of the Company s patented technology. Inphi denied infringement and claimed that the three patents are invalid. In April 2010, Inphi requested but was later denied *Inter Partes* Reexaminations of the 912, 537 and 274 patents by the USPTO. In June 2010, Inphi submitted new requests and was later granted *Inter Partes* Reexaminations of the 912, 537 and 274 patents by the USPTO. The reexamination proceedings are described below. In connection with the reexamination requests, Inphi filed a motion to stay the patent infringement lawsuit with the Central District Court, which was granted. The Central District Court has requested that the Company notify it within one week of any action taken by the USPTO in connection with the reexamination proceedings, at which time the Central District Court may decide to maintain or lift the stay.

Smart Modular Litigations

In September 2012, Smart Modular, Inc. (SMOD) filed a patent infringement lawsuit against the Company in the U.S. District Court for the Eastern District of California (the Eastern District Court). The complaint alleges that the Company willfully infringes and actively induces the infringement of six claims of a U.S. patent newly issued to SMOD, U.S. Patent No. 8,250,295 (the 295 patent), and seeks damages and injunctive relief. SMOD also filed a motion for preliminary injunction and a memorandum in support of the motion on the same day of the complaint. The Company promptly filed a request for reexamination of the 295 patent with the USPTO setting forth six different combinations of prior art that would render the six asserted claims of the 295 patent unpatentable. The Company also filed an answer to SMOD s complaint with the Eastern District Court in October 2012 to deny infringement of the 295 patent, assert that the 295 patent is invalid and unenforceable, and bring a set of counterclaims against SMOD. SMOD filed various motions on the pleadings on November 1, 2012, which were opposed by the Company in its briefs filed in late November 2012.

In December 2012, the USPTO granted the Company s request for the reexamination of the 295 patent, and issued an Office Action rejecting all of the six asserted claims over the six different combinations of prior art set forth by the Company in its request. The Company promptly moved to stay litigation pending result of reexamination. On February 19, 2013, a few days after SMOD filed replies in support of its motions, the Eastern District Court issued a Minute Order, in which the court on its own motion took the preliminary injunction; the motion to dismiss and the motion to stay under submission without oral argument and vacated the hearing dates.

Table of Contents

On February 7, 2013, SMOD filed a response to the Office Action in the reexamination of the 295 patent. Thereafter, the Company and SMOD made various filings to address certain apparent defects contained in SMOD s response. On March 13, 2013, the USPTO issued a Notice of Defective Paper, in which the USPTO found SMOD s responses, both the initial filing and a supplemental filing, to be improper, and both responses were expunged from the record. The USPTO gave SMOD 15 days to submit another response, which SMOD submitted on March 26, 2013. The Company timely filed its comments on SMOD s corrected response on April 25, 2013.

On May 30, 2013, the Eastern District Court issued an order granting Netlist s motion to stay pending results of the reexamination of the 295 patent and denied SMOD s motion for preliminary injunction.

386 Patent Reexamination

As noted above, in May 2010, Google requested and was later granted an *Inter Partes* Reexamination of the 386 patent by the USPTO. In October 2010, SMOD requested and was later granted an *Inter Partes* Reexamination of the 386 patent. The reexaminations requested by Google and SMOD were merged by the USPTO into a single proceeding. In April 2011, a Non-Final Action was issued by the USPTO, rejecting all claims in the patent. In July 2011, the Company responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims in view of cited references. Both Google and SMOD filed their comments to the Company s response in October 2011. In October 2012, the USPTO issued an Action Closing Prosecution (ACP) rejecting all 60 claims. The Company filed a response to the ACP on December 3, 2012. On June 21, 2013, the USPTO issued a Right of Appeal Notice (RAN) in which the USPTO examiner maintained his rejection of the claims. Netlist filed a notice of appeal on July 19, 2013. Google and SMOD filed a cross-appeal on August 2, 2013. Thus, the reexamination of the 386 patent remains pending and will continue in accordance with established procedures for merged reexamination proceedings.

912 Patent Reexamination

As noted above, in April 2010, Inphi requested but was later denied an *Inter Partes* Reexamination of the 912 patent by the USPTO. In June 2010, Inphi submitted a new request and was later granted an *Inter Partes* Reexamination of the 912 patent by the USPTO. In September 2010, the USPTO confirmed the patentability of all fifty-one claims of the 912 patent. In October 2010, Google and SMOD each filed and were later granted requests for reexamination of the 912 patent. In February 2011, the USPTO merged the Inphi, Google and SMOD 912 reexaminations into a single proceeding. In an April 2011 Non-Final Action in the merged reexamination proceeding, the USPTO rejected claims 1-20 and 22-51 and confirmed the patentability of claim 21 of the 912 patent. In July 2011, the Company responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims. Inphi, Google, and SMOD filed their comments on the Company s response in August 2011. In October 2011, the USPTO mailed a second Non-Final Action confirming the patentability of twenty claims of the 912 patent, including claims that were added in the reexamination process. In January 2012, the Company responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims. Google, Inphi and SMOD filed their comments to the Company s response in February 2012. The USPTO determined that SMOD s comments were defective, and issued a notice to SMOD to rectify and resubmit its comments. SMOD filed corrected comments and a petition for the USPTO to withdraw the notice in March 2012. The USPTO issued a non-final Office Action on November 13, 2012 maintaining the patentability of many key claims while rejecting some claims that were previously determined to be patentable. The Company filed a response to the Office Action on January 14, 2013. The requesters filed their comments on February 13, 2013. The reexamination of the 912 patent remains pending and will continue in accordance with established procedures for merged reexamination proceedings.

627 Patent Reexamination

In September 2011, SMOD filed a request for reexamination of U.S. Patent No. 7,864,627 (the 627 patent) issued to the Company on January 4, 2011. The 627 patent is related to the 912 patent. In November 2011, the USPTO granted SMOD s request for reexamination of the 627 patent and concurrently issued a Non-Final Action confirming the patentability of three claims. In February 2012, the Company responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims. SMOD filed its comments to the Company s response in March 2012. The USPTO determined that SMOD s comments were defective and issued a notice in April 2012 to SMOD to rectify and resubmit its comments. SMOD filed corrected comments and a petition for the USPTO to withdraw the notice in April 2012. The USPTO posted an Office Action on December 19, 2012, confirming one claim and rejecting the rest of the claims in the 627 patent. The Company filed a response to the Office Action on March 19, 2013. The reexamination of the 627 patent remains pending and will continue in accordance with established *Inter Partes* Reexamination procedures.

Table of Contents

537 Patent Reexamination

As noted above, in April 2010, Inphi requested and was later denied an *Inter Partes* Reexamination of the 537 patent by the USPTO. In June 2010, Inphi submitted a new request and was later granted an *Inter Partes* Reexamination of the 537 patent by the USPTO. In September 2010, the USPTO issued a Non-Final Action confirming the patentability of four claims. In October 2010, the Company responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims. Inphi filed its comments on the Company s response in January 2011. In June 2011, the USPTO issued an ACP, which reconfirmed the patentability of the four claims. In August 2010, the Company responded by amending some of the claims and making arguments as to the validity of the rejected claims. Inphi filed its comments to the Company s response in September 2011. The USPTO issued a Right of Appeal Notice (RAN) in February 2012, in which the claim rejections were withdrawn, thus confirming the patentability of all sixty (60) claims in view of all the previously submitted comments by both Inphi and the Company. Inphi filed a notice of appeal in March 2012 followed by an appeal brief in May 2012. In response, the USPTO issued a Notice of Defective Appeal Brief. Inphi filed a corrective appeal brief in late May 2012, and the Company filed its reply brief to the corrected Inphi appeal brief in early July 2012. The examiner responded to Inphi s corrected appeal brief as well as the Company s reply brief by Examiner s Answer on April 16, 2013, in which he maintained his position confirming all sixty (60) claims. The Company and the examiner will jointly defend the 537 patent in a hearing with the USPTO, in accordance with established procedures for *Inter Partes* Reexamination.

274 Patent Reexamination

As noted above, in April 2010, Inphi requested and was later denied an *Inter Partes* Reexamination of the 274 patent by the USPTO. In June 2010, Inphi submitted a new request and was later granted an *Inter Partes* Reexamination of the 274 patent by the USPTO. In September 2011, the USPTO issued a Non-Final Action, confirming the patentability of six claims. The Company has responded by amending or canceling some of the claims, adding new claims, and making arguments as to the validity of the rejected claims. Inphi filed its comments on the Company s response in November 2011. The USPTO issued an ACP in March 2012, which confirmed the patentability of one hundred and four (104) claims in view of all the previously submitted comments by both Inphi and the Company. The USPTO subsequently issued a RAN in June 2012. This RAN triggered Inphi s right as the losing party to file a notice of appeal and corresponding appeal brief, which Inphi filed when due. The Company responded to Inphi s appeal brief by filing a reply brief in October 2012. The examiner responded to Inphi s appeal brief and the reply brief by Examiner s Answer on April 16, 2013, in which he maintained his position confirming the one hundred and four (104) claims. The Company and the USPTO examiner will jointly defend the 274 patent in a hearing with the USPTO, in accordance with established procedures for *Inter Partes* Reexamination.

Other Contingent Obligations

During its normal course of business, the Company has made certain indemnities, commitments and guarantees pursuant to which it may be required to make payments in relation to certain transactions. These include: (i) intellectual property indemnities to the Company s customers and licensees in connection with the use, sales and/or license of Company products; (ii) indemnities to vendors and service providers pertaining to claims based on the Company s negligence or willful misconduct; (iii) indemnities involving the accuracy of representations and warranties in certain contracts; (iv) indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware; and (v) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company s use of the applicable premises. The duration of these indemnities, commitments and guarantees varies and, in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets.

Note 10 Stockholders Equity

Serial Preferred Stock

The Company s authorized capital includes 10,000,000 shares of Serial Preferred Stock, with a par value of $0.001 per share. No shares were outstanding at June 29, 2013 or December 29, 2012.

Table of Contents

Common Stock

In November 2011, the Company entered into a sales agreement with Ascendiant Capital Markets LLC (Ascendiant), whereby shares with a total value of up to $10.0 million may be released for sale to the public at the discretion of management at a price equal to the current market price in an at-the-market offering as defined in Rule 415 under the Securities Act of 1933. During 2012 and 2011, the Company received net proceeds of approximately $3.9 million and $1.9 million, respectively, raised through the sale of 1,312,669 and 697,470 shares of common stock, respectively. The sales agreement with Ascendiant expires in November 2014. During the six months ended June 29, 2013, the Company received net proceeds of approximately $28,200, raised through the sale of 24,288 shares of common stock.

On December 20, 2012, the Company raised gross proceeds of $1.5 million in a registered public offering (Offering) of its securities. The Offering closed on December 26, 2012, and the Company received net proceeds of $1.3 million after deducting commissions and offering costs. The Offering resulted in the issuance of 1,685,394 shares of common stock and warrants to purchase up to an aggregate of 2,275,282 shares of the Company s common stock, which represents 135% of the number of shares issued and sold in the Offering. Each warrant grants the holder the right to purchase one share of the Company s common stock at an exercise price of $0.89 per share and expires in June 2018. These warrants become exercisable 181 days following the December 26, 2012 issuance date.

On July 17, 2013, the Company entered into a definitive securities purchase agreement for the sale of common stock and warrants in a registered public offering (Offering) of its securities for gross proceeds of $1.0 million. The Offering closed on July 19, 2013, and the Company received estimated net proceeds of $960,000 after deducting commissions and offering costs. The Offering resulted in the issuance 1,098,902 shares of the Company s common stock and a warrant to purchase up to an aggregate of 1,098,902 shares of the Company s common stock. The warrant is exercisable as of the date of its issuance, has a term of seven years, and an exercise price of $1.00 per share. The exercise price and the number of warrant shares issuable upon exercise of warrant is subject to adjustment in the event of, among other things, certain transactions affecting the Company s common stock (including without limitation stock splits and stock dividends), and certain fundamental transactions (including without limitation a merger or other sale-of-company transaction).

In addition, on July 18, 2013, concurrent with the execution of the Loan Agreement, the Company issued to an affiliate of DBD Credit Funding, LLC, a seven-year warrant (the Warrant) to purchase an aggregate of 1,648,351 shares of the Company s common stock at a per share price of $1.00, of which 989,011 shares are exercisable immediately on a cash or cashless basis in whole or in part. Pursuant to the terms of the stock purchase warrant agreement, (i) 329,670 shares will become exercisable upon the achievement of the IP Monetization Milestones and (ii) the remaining 329,670 shares will become exercisable upon the Company s receipt of an IP Milestone Term Loan. The Warrant was issued in a private placement transaction that was exempt from registration under Section 4(2) of the Securities Act of 1933 (the Securities Act).

During the six months ended June 29, 2013 and the year ended December 29, 2012, the Company cancelled 11,386 and 23,631 shares of common stock, respectively, valued at approximately $7,500 and $64,000, respectively, in connection with its obligation to holders of restricted stock to withhold the number of shares required to satisfy the holders tax liabilities in connection with the vesting of such shares.

The Company is incorporated in the state of Delaware, and as such, is subject to various state laws which may restrict the payment of dividends or purchase of treasury shares.

Stock-Based Compensation

The Company has stock-based compensation awards outstanding pursuant to the Amended and Restated 2000 Equity Incentive Plan (the 2000 Plan) and the Amended and Restated 2006 Equity Incentive Plan (the 2006 Plan), under which a variety of option and direct stock-based awards may be granted to employees and nonemployees of the Company. Further grants under the 2000 Plan were suspended upon the adoption of the 2006 Plan. In addition to awards made pursuant to the 2006 Plan, the Company periodically issues inducement grants outside the 2006 Plan to certain new hires.

Subject to certain adjustments, as of June 29, 2013, the Company was authorized to issue a maximum of 6,605,566 shares of common stock pursuant to awards under the 2006 Plan. That maximum number will automatically increase on the first day of each subsequent calendar year by the lesser of (i) 5.0% of the number of shares of common stock that are issued and outstanding as of the first day of the calendar year, and (ii) 1,200,000 shares of common stock, subject to adjustment for certain corporate actions. At June 29, 2013, the Company had 1,148,512 shares available for grant under the 2006 Plan. Options granted under the 2000 Plan, the 2006 Plan and outside the equity incentive plans primarily vest at a rate of at least 25% per year over four years and expire 10 years from the date of grant. Restricted stock awards vest in eight equal increments at intervals of approximately six months from the date of grant.

Table of Contents

A summary of the Company s common stock option activity for the six months ended June 29, 2013 is presented below (shares in thousands):

	Options Outstanding	
	Number of Shares	Weighted-Average Exercise Price
Options outstanding at December 29, 2012	4,752	$ 3.22
Options granted	1,510	0.73
Options exercised	(107)	0.33
Options cancelled	(682)	2.20
Options outstanding at June 29, 2013	5,473	$ 2.73

The intrinsic value of options exercised in the six months ended June 29, 2013 was $41,392.

A summary of the Company s restricted stock awards as of and for the six months ended June 29, 2013 is presented below (shares in thousands):

	Restricted Stock Outstanding	
	Number of Shares	Weighted-Average Grant-Date Fair Value per Share
Balance outstanding at December 29, 2012	158	$ 3.32
Restricted stock forfeited	(9)	3.49
Restricted stock vested	(49)	3.40
Balance outstanding at June 29, 2013	100	$ 3.27

The following table presents details of the assumptions used to calculate the weighted-average grant date fair value of common stock options granted by the Company:

	Six Months Ended	
	June 29, 2013	June 30, 2012
Expected term (in years)	6.1	6.1
Expected volatility	121%	126%
Risk-free interest rate	1.26%	1.12%
Expected dividends		
Weighted-average grant date fair value per share	$ 0.65	$ 3.10

The fair value per share of restricted stock grants is calculated based on the fair value of the Company s common stock on the respective grant dates. The grant date fair value of restricted stock vested was $0.03 million and $0.20 million in the six months ended June 29, 2013 and June 30, 2012, respectively.

At June 29, 2013, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2013 through fiscal 2016 related to unvested common stock options and restricted stock awards is approximately $3.1 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2.4 years. If there are any modifications or cancellations of the underlying unvested awards, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense.

Table of Contents

Note 11 Segment and Geographic Information

The Company operates in one reportable segment: the design and manufacture of high-performance memory subsystems for the server, high-performance computing and communications markets. The Company evaluates financial performance on a Company-wide basis.

At June 29, 2013 and December 29, 2012, approximately $1.0 and $1.5 million, respectively, of the Company s long-lived assets, net of depreciation and amortization, respectively, were located in the PRC. Substantially all other long-lived assets were located in the U.S.

Note 12 Subsequent Events

Loan and Security Agreement and Related Agreements

On July 18, 2013, the Company, entered into a Loan Agreement with DBD Credit Funding, LLC, a Delaware limited liability company (the Lender), an affiliate of Fortress Investment Group LLC, providing for up to $10 million in term loans and up to $5 million in revolving loans. The term loans are available in an initial $6 million tranche (the Initial Term Loan) with a second tranche in the amount of $4 million becoming available upon achievement of certain performance milestones relating to intellectual property matters (the IP Monetization Milestones and such second tranche loan, IP Milestone Term Loan). The $5 million in revolving loans are available at the Lender s discretion and subject to customary conditions precedent. The $6 million Initial Term Loan was fully drawn at closing on July 18, 2013. Proceeds from the Initial Term Loan were used in part to repay the Company s existing Consolidated Term Loan with Silicon Valley Bank. The remainder of such funds will be used to fund the Company s ongoing working capital needs.

The loans bear interest at a stated fixed rate of 11.0% per annum. During the first eighteen (18) months following the closing date, the payments on the term loans are interest-only at a cash rate of 7.0% per annum and a payment-in-kind deferred cash interest rate of 4.0%, which payment-in-kind interest is capitalized semi-annually, beginning with December 31, 2013. Following the eighteen (18) month interest-only period, the term loans are amortized with 65% of the principal amount due in equal monthly installments over the following eighteen (18) months with a balloon payment equal to 35% of the remaining principal amount of the term loans, plus accrued interest, being payable on July 18, 2016.

The Company s obligations under the Loan Agreement are secured by a first-priority security interest in the Company s intellectual property assets (other than certain patents and related assets relating to the NVvault product line) pursuant to an intellectual property security agreement with the Lender (the IP Security Agreement) and a second-priority security interest in substantially all of the Company s other assets.

In connection with the Loan Agreement, the Company paid certain facility, due diligence and legal fees of the Lender on the closing date and is obligated to pay a conditional facility fee upon satisfaction of the IP Monetization Milestones. If the Company repays or prepays all or a portion of the term loans prior to maturity, the Company is obligated to pay the Lender a prepayment fee based on a percentage of the then outstanding principal balance being prepaid, equal to 4.0% if the prepayment occurs on or prior to July 18, 2014 (or 2.0% if such prepayment is made in connection with the early repayment option premium discussed in the preceding sentence), 2.0% if the prepayment occurs between July 18, 2014 and July 18, 2015, or 0.0% if the prepayment occurs after July 18, 2015.

The Loan Agreement contains customary representations, warranties and indemnification provisions. The Loan Agreement also contains affirmative and negative covenants that, among other things restrict the ability of the Company to:

- incur additional indebtedness or guarantees;
- incur liens;
- make investments, loans and acquisitions;
- consolidate or merge;
- sell or exclusively license assets, including capital stock of subsidiaries;
- alter the business of the Company;
- engage in transactions with affiliates; and
- pay dividends or make distributions.

Table of Contents

The Loan Agreement also includes events of default, including, among other things, payment defaults, breaches of representations, warranties or covenants, certain bankruptcy events, the failure to maintain its listing on a nationally recognized securities exchange or alternatively for its shares to be qualified for trading on the OTC Bulletin Board and certain material adverse changes, including an impairment of the perfection or priority of the Lender s lien. Upon the occurrence of an event of default and following any applicable cure periods, a default interest rate of an additional 5.0% per annum may be applied to the outstanding loan balances, and the Lender may declare all outstanding obligations immediately due and payable and take such other actions as set forth in the Loan Agreement.

Concurrently with the execution of the Loan Agreement, the Company and an affiliate of the Lender entered into a Patent Monetization Side Letter Agreement (the Letter Agreement). The Letter Agreement provides, among other things, that the Lender may be entitled to share in certain monetization revenues that the Company may derive in the future related to its patent portfolio (the Patent Portfolio). The Patent Portfolio does not include certain patents relating to the NVvaultTM product line. Monetization revenues subject to this arrangement include revenues recognized during the seven year term of the Letter Agreement from amounts (whether characterized as settlement payments, license fees, royalties, damages, or otherwise) actually paid to the Company or its subsidiaries in connection with any assertion of, agreement not to assert, or license of, the Patent Portfolio (in whole or in part) either (A) in consideration of the grant of a license or covenant not sue, or other immunity with respect to the Patent Portfolio, or (B) as a damages award with respect to such assertion of the Patent Portfolio, less (i) actual legal fees and expenses (including fees payable on a contingency basis) and actual court costs paid or payable by the Company or its subsidiaries in connection with any such assertion and/or grant of a license or covenant not to sue, or other immunity with respect to the Patent Portfolio, provided that such legal fees and expenses shall be capped at forty percent (40%) of such gross, aggregate amounts paid to the Company, (ii) all reasonable and actual legal fees, filing fees, maintenance fees, annuities, and other reasonable and actual costs and expenses paid or required to be paid by the Company or its subsidiaries after the effective date in connection with the prosecution, maintenance, and defense of any patents or patent applications within the Patent Portfolio, (iii) reasonable and actual legal fees and reasonable and actual other costs and expenses paid or required to be paid by the Company or its subsidiaries in connection with the enforcement of any agreement, undertaking, commitment or court order that would generate monetization revenues and the collection thereof, and (iv) reasonable and actual costs of acquisition of patents and patent applications included in the Patent Portfolio that are acquired by or licensed to the Company or its subsidiaries after the effective date. Monetization revenues also include the value attributable to the Patent Portfolio in any sale of the Company during the seven year term, subject to a maximum amount payable to the Lender. The Letter Agreement also requires that the Company use commercially reasonable efforts to pursue opportunities to monetize the Patent Portfolio during the term of the Letter Agreement, provided that the Company is under no obligation to pursue any such opportunities that Company does not deem to be in the Company s best interest in the Company s reasonable business judgment. Notwithstanding the foregoing, there can be no assurance that the Company will be successful in these efforts, and the Company may expend resources in pursuit of monetization revenues that may not result in any benefit to the Company.

Concurrently with the execution of the Loan Agreement, the Company issued to an affiliate of DBD Credit Funding, LLC a seven-year warrant (the Warrant) to purchase an aggregate of 1,648,351 shares of the Company s common stock at an exercise price of $1.00 per share, of which 989,011 shares are exercisable immediately on a cash or cashless basis in whole or in part. Pursuant to the stock purchase warrant agreement, (i) 329,670 shares will become exercisable upon the achievement of the IP Monetization Milestones and (ii) the remaining 329,670 shares will become exercisable upon the Company s receipt of an IP Milestone Term Loan. The Warrant was issued in a private placement transaction that was exempt from registration under Section 4(2) of the Securities Act of 1933 (the Securities Act).

Also in connection with the Loan Agreement, the Company agreed to pay to a consultant a consulting fee equal to (i) $300,000 to the consultant in connection with the Company s receipt of the Initial Term Loan and (ii) 5% of any additional principal amount loaned to the Company as an IP Milestone Term Loan.

Amendment to Credit Agreement with Silicon Valley Bank; Payoff of Consolidated Term Loan

Concurrently with the execution of the Loan Agreement and the funding of the Initial Term Loan, on July 18, 2013, the Company repaid in full all amounts owed under the Company s Consolidated Term Loan with SVB, consisting of a lump sum payment of approximately $2,732,000. In addition, on July 18, 2013, the Company and SVB entered into a loan amendment (the SVB Amendment) to the Company s loan and security agreement with SVB. Pursuant to the SVB Loan Amendment, the SVB Credit Agreement now allows for the financing and security interests contemplated under the Loan Agreement entered into with Lender and releases certain patents and related assets relating to the NVvault product line

Table of Contents

from the collateral subject to SVB s security interest under the SVB Credit Agreement. Additionally, pursuant to the SVB Loan Amendment, advances under the revolving line now accrue interest at a rate equal to SVB s most recently announced prime rate plus 2.75%. The SVB Loan Amendment also relaxed the Company s tangible net worth covenant under the SVB Credit Agreement and waived certain events of default in connection therewith. Certain reporting requirements under the SVB Credit Agreement were modified while certain reserves with respect to the borrowing base and the availability of revolving loans were removed pursuant to the SVB Loan Amendment. Under the terms of the SVB Credit Agreement, the Company may draw revolving advances in an aggregate outstanding principal amount of up to the lesser of $5 million and the available borrowing base, subject to reserve amounts. The Company s borrowing base under the SVB Credit Agreement is subject to certain adjustments and up to the lesser of 80% of eligible accounts receivable.

Sale of Common Stock and Warrants Pursuant to Securities Purchase Agreement

On July 17, 2013, the Company entered into a Securities Purchase Agreement (the Purchase Agreement) with an institutional investor (the Purchaser), pursuant to which the Company sold to the Purchaser in a registered public offering (the Offering) an aggregate of 1,098,902 shares of the Company s common stock at $0.91 per share and a warrant (Purchaser Warrant) to purchase up to an aggregate of 1,098,902 shares of the Company s common stock at a purchase price of $1.00 per share, for aggregate gross proceeds of approximately $1.0 million and expected net proceeds, after deducting offering costs, of approximately $960,000. The Purchaser Warrant is exercisable as of the date of its issuance, has a term of seven years, and has an exercise price of $1.00 per share. The exercise price and the number of warrant shares issuable upon exercise are subject to adjustment in the event of, among other things, certain transactions affecting the Company s common stock (including without limitation stock splits and stock dividends), and certain fundamental transactions (including without limitation a merger or other sale-of-company transaction). The Offering closed on July 19, 2013. The Company intends to use the net proceeds from the Offering for general corporate purposes.

Facility Lease

On July 26, 2013, the Company entered into an amendment for a three year lease with the Irvine Company. The amendment terminates the existing lease of the 51 Discovery, Suite 150, Irvine, California, 92618 premise in exchange for 8,203 square feet of office space located at 175 Technology Drive, Suite 150, Irvine, California, 92618 USA. The initial lease payment is $9,269 per month, increasing to $10,090 per month over the term of the lease. This lease is valid through July 31, 2016. The annual payment for this space equates to approximately $111,000 per year.

Table of Contents

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

Cautionary Statement

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the fiscal year ended December 29, 2012 and subsequent reports on Form 10-Q and 8-K, which discuss our business in greater detail.

This report contains forward-looking statements regarding future events and our future performance. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those expected or projected. These risks and uncertainties include, but are not limited to risks associated with: the uncertainty of our future capital requirements and the likelihood that we need to raise additional funds; the amount and terms of our indebtedness; the launch and commercial success of our products, programs and technologies; the success of product partnerships; continuing development, qualification and volume production of EXPRESSvault , NVvault , HyperCloud and VLP Planar-X RDIMM; the timing and magnitude of anticipated additional decreases in sales to our key customer; our ability to leverage our NVvault technology in a more diverse customer base; the rapidly-changing nature of technology; risks associated with intellectual property, including the costs and unpredictability of litigation and reexamination proceedings before the USPTO; volatility in the pricing of DRAM ICs and NAND; changes in and uncertainty of customer acceptance of, and demand for, our existing products and products under development, including uncertainty of and/or delays in product orders and product qualifications; delays in our and our customers product releases and development; introductions of new products by competitors; changes in end-user demand for technology solutions; our ability to attract and retain skilled personnel; our reliance on suppliers of critical components and vendors in the supply chain; fluctuations in the market price of critical components; evolving industry standards; and the political and regulatory environment in the PRC. Other risks and uncertainties are described under the heading Risk Factors in Part II, Item IA of this Quarterly Report on Form 10-Q, and similar discussions in our other SEC filings. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

We design, manufacture and sell high-performance, intelligent memory subsystems for datacenter server and high-performance computing and communications markets. Our memory subsystems consist of combinations of dynamic random access memory integrated circuits (DRAM ICs or DRAM), NAND flash memory (NAND), application-specific integrated circuits (ASICs) and other components assembled on printed circuit boards (PCBs). We primarily market and sell our products to leading original equipment manufacturer (OEM) customers. Our solutions are targeted at applications where memory plays a key role in meeting system performance requirements. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high memory density, small form factor, high signal integrity, attractive thermal characteristics and low cost per bit.

Our Products

HyperCloud®

In November 2009, we introduced our 16GB HyperCloud® DDR3 memory technology. HyperCloud® utilizes HyperCloud® technology that incorporates the Company patented rank multiplication technology that increases memory capacity and load reduction technology that increases memory bandwidth. We expect that these patented technologies will make possible improved levels of performance for memory intensive datacenter applications and workloads, including enterprise virtualization, cloud computing infrastructure, business intelligence real-time data analytics, and high performance computing. HyperCloud® memory has been qualified by two of our OEM customers for use in their server products. HyperCloud® is interoperable with JEDEC standard DDR3 memory modules. Our HyperCloud® products are designed to allow for installation in servers without the need for a BIOS change. As such, their anticipated sales launch is not dependent on the design plans or product cycle of our OEM customers. However, we have experienced longer qualification cycles than anticipated. There can be no assurances that sales of our HyperCloud® products will be significant or that we will derive favorable margins from any sales of such products. We have invested and expect to continue to invest a significant portion of our research and development budget into the design of HyperCloud® technology.

Table of Contents

In November 2011, we introduced a 32GB two-virtual rank HyperCloud® HCDIMM enabling up to 768GB of DRAM memory in next generation two-processor servers. Also in November 2011, we announced collaborative agreements with each of Hewlett-Packard Company (HP) and International Business Machines (IBM), pursuant to which these OEMs have cooperated with us in efforts to qualify HyperCloud® memory products for use with their respective products. In February 2012 and May 2012, we achieved memory qualification of our 16GB HyperCloud® product at IBM and HP, respectively. In September 2012 and July 2013, we achieved memory qualification of our 32GB HyperCloud® product at IBM and HP, respectively. We and each of the OEMs have committed financial and other resources toward the collaboration. However, the efforts undertaken with each of these collaborative agreements have not resulted in significant product margins for us to date relative to our investment in developing and marketing these products and there is no assurance that we will achieve sufficient revenues or margins from our HyperCloud® products under these arrangements.

NVvault

Our NVvault product line consists primarily of battery-free and battery-powered flash backed cache memory subsystem targeting Redundant Array of Independent Disks, (RAID) storage applications. NVvault battery-free provides server and storage OEMs a solution for enhanced datacenter fault recovery. The NVvault products have historically been sold primarily to Dell, for incorporation in its PERC 7 server products. Following Intel s launch of its Romley platform in the first quarter of 2012, we have experienced a rapid decline in NVvault sales to Dell. Sales of NVvault products to Dell totaled $555,300 and $912,200 for the three and six months ended June 29, 2013, respectively, compared to $4.7 million and $15.1 million for the three and six months ended June 30, 2012, respectively. We expect that we will continue to see declining demand from Dell through 2013, after which sales of NVvault products for incorporation into PERC 7 servers will be minimal. In order to leverage our NVvault technology into a more diverse customer base, we continue to pursue additional qualifications of NVvault with other customers. We introduced EXPRESSvault in March 2011, and continue to pursue qualifications of next generation DDR3 NVvault with customers. However, our efforts may not result in significant revenues from the sale of NVvault products.

Specialty Memory Modules and Flash-Based Products

The remainder of our net sales is primarily from OEM sales of specialty memory modules and flash-based products, the majority of which were utilized in data center and industrial applications. When developing custom modules for an equipment product launch, we engage our OEM customers from the earliest stages of new product definition, providing us unique insight into their full range of system architecture and performance requirements. This close collaboration has also allowed us to develop a significant level of systems expertise. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high speed, capacity and signal integrity, small form factor, attractive thermal characteristics and low cost per bit. Revenues from our specialty modules and flash-based products are subject to fluctuation as a result of the life cycles of the products into which our modules are incorporated. Our ability to continue to produce revenues from specialty memory modules and flash-based products is dependent on our ability to qualify our products on new platforms as current platforms reach the end of their lifecycles, and on the state of the global economy.

Consistent with the concentrated nature of the OEM customer base in our target markets, a small number of large customers have historically accounted for a significant portion of our net sales. Two customers represented approximately 35% and 18% of our net sales for the six months ended June 29, 2013 and one customer represented approximately 74% of our net sales for the six months ended June 30, 2012.

Technology

We have a portfolio of proprietary technologies and design techniques and have assembled an engineering team with expertise in semiconductors, printed circuit boards, memory subsystem and system design. Our technology competencies include:

IC Design Expertise. We have designed special algorithms that can be implemented in stand-alone integrated circuits or integrated into other functional blocks in ASICs. We utilize these algorithms in the HyperCloud® chipset to incorporate rank multiplication and load reduction functionality. We also incorporate these algorithms in our NVvaultTM product line of RDIMMS.

Very Low Profile Designs. We were the first company to create memory subsystems in a form factor of less than one inch in height. We believe our proprietary board design technology is particularly useful in the blade server market, where efficient use of motherboard space is critical. Our technology has allowed us to decrease the system board space required for memory, and improve thermal performance and operating speeds, by enabling our customers to use alternative methods of component layout.

Table of Contents

Proprietary PCB Designs. We utilize advanced, proprietary techniques to optimize electronic signal strength and integrity within a PCB. These techniques include the use of 8- or 10-layer boards, matching conductive trace lengths, a minimized number of conductive connectors, or vias, and precise load balancing to, among other things, help reduce noise and crosstalk between adjacent traces. In addition, our proprietary designs for the precise placement of intra-substrate components allow us to assemble memory subsystems with significantly smaller physical size, enabling OEMs to develop products with smaller footprints for their customers.

Planar-X Designs. Our patented Planar-X circuit design provides additional board space for a large number of DRAM components. This enables us to produce higher capacity RDIMM modules, such as our 32GB two-virtual rank HyperCloud® RDIMM, at a lower cost by allowing us to use standard, currently available 4GB DRAM technology.

Thermal Management Designs. We design our memory subsystems to ensure effective heat dissipation. We use thermal cameras to obtain thermal profiles of the memory subsystem during the design phase, allowing us to rearrange components to enhance thermal characteristics and, if necessary, replace components that do not meet specifications. We use thermal simulation and modeling software to create comprehensive heat transfer models of our memory subsystems, which enables our engineers to quickly develop accurate solutions for potential thermal issues. We also develop and use proprietary heat spreaders to enhance the thermal management characteristics of our memory subsystems.

NVvault . We were the first to develop and market memory subsystems that incorporate both DRAM and NAND in a single NVvault persistent DIMM solution for backup of volatile data to non-volatile NAND. NVvault is desirable for mission critical backups during power interruption in RAID and main memory for Cloud, Big Data, on-line banking and other real time applications. NVvault is incorporated in our EXPRESSvault PCIe solution for both acceleration and backup in storage applications.

Key Business Metrics

The following describes certain line items in our condensed consolidated statements of operations that are important to management s assessment of our financial performance:

Net Sales. Net sales consist primarily of sales of our high performance memory subsystems, net of a provision for estimated returns under our right of return policies, which generally range up to 30 days. We generally do not have long-term sales agreements with our customers. Although OEM customers typically provide us with non-binding forecasts of future product demand over specific periods of time, they generally place orders with us approximately two weeks in advance of scheduled delivery. Selling prices are typically negotiated monthly, based on competitive market conditions and the current price of DRAM ICs and NAND. Purchase orders generally have no cancellation or rescheduling penalty provisions. We often ship our products to our customers international manufacturing sites. All of our sales to date, however, are denominated in U.S. dollars. We also sell excess component inventory of DRAM ICs and NAND to distributors and other users of memory ICs. Component inventory sales are a relatively small percentage of net sales as a result of our efforts to diversify both our customer and product line bases. This diversification effort has also allowed us to use components in a wider range of memory subsystems. We expect that component inventory sales will continue to represent a minimal portion of our net sales in future periods.

Cost of Sales. Our cost of sales includes the cost of materials, manufacturing costs, depreciation and amortization of equipment, inventory valuation provisions, stock-based compensation, and occupancy costs and other allocated fixed costs. The DRAM ICs and NAND incorporated into our products constitute a significant portion of our cost of sales, and thus our cost of sales will fluctuate based on the current price of DRAM ICs and NAND. We attempt to pass through such DRAM IC and NAND flash memory cost fluctuations to our customers by frequently renegotiating pricing prior to the placement of their purchase orders. However, the sales prices of our memory subsystems can also fluctuate due to competitive situations unrelated to the pricing of DRAM ICs and NAND, which affects gross margins. The gross margin on our sales of excess component DRAM IC and NAND inventory is much lower than the gross margin on our sales of our memory subsystems. As a result, fluctuations in DRAM IC and NAND inventory sales as a percentage of our overall sales could impact our overall gross margin. We assess the valuation of our inventories on a quarterly basis and record a provision to cost of sales as necessary to reduce inventories to the lower of cost or net realizable value.

Table of Contents

Research and Development. Research and development expense consists primarily of employee and independent contractor compensation and related costs, stock-based compensation, non-recurring engineering fees, computer-aided design software licenses, reference design development costs, patent filing and protection legal fees, depreciation or rental of evaluation equipment, and occupancy and other allocated overhead costs. Also included in research and development expense are the costs of material and overhead related to the production of engineering samples of new products under development or products used solely in the research and development process. Our customers typically do not separately compensate us for design and engineering work involved in developing application-specific products for them. All research and development costs are expensed as incurred. In order to conserve capital resources in light of the significant year over year revenue decline, we have materially reduced our research and development expenditures by reducing headcount and professional and outside service costs. However, we anticipate that research and development expenditures will increase in future periods as we seek to expand new product opportunities, increase our activities related to new and emerging markets and continue to develop additional proprietary technologies.

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of employee salaries and related costs, stock-based compensation, independent sales representative commissions, professional services, promotional and other selling and marketing expenses, and occupancy and other allocated overhead costs. A significant portion of our selling effort is directed at building relationships with OEMs and other customers and working through the product approval and qualification process with them. Therefore, the cost of material and overhead related to products manufactured for qualification is included in selling expenses. In order to conserve capital resources in light of the significant year over year revenue decline, we have materially reduced our selling, general and administrative expenditures by reducing headcount and other expenses.

Recent Developments

On July 18, 2013, we entered into a loan and security agreement (the Loan Agreement) with DBD Credit Funding, LLC (the Lender), an affiliate of Fortress Investment Group, LLC, providing for up to $10 million in terms loans and up to $5 million in revolving loans. The term loans are available in an initial $6 million tranche (the Initial Term Loan) with a second tranche in the amount of $4 million becoming available upon achievement of certain performance milestones relating to intellectual property matters (the IP Monetization Milestones and such second tranche loan, IP Milestone Term Loan). The $5 million in revolving loans are available in the Lender s discretion and subject to customary conditions precedent. The $6 million Initial Term Loan was fully drawn at closing on July 18, 2013. Proceeds from the Initial Term Loan used in part to repay our existing consolidated term loan with Silicon Valley Bank. The remainder of such funds will be used to fund our ongoing working capital needs.

The loans bear interest at a stated fixed rate of 11.0% per annum. During the first eighteen (18) months following the closing date, the payments on the term loans are interest-only at a cash rate of 7.0% per annum and a payment-in-kind interest rate of 4.0%, which payment-in-kind interest is capitalized semi-annually, beginning with December 31, 2013. Following such eighteen (18) month interest-only period, the term loans are amortized with 65% of the principal amount thereof being due in equal monthly installments over the following eighteen (18) months with a balloon payment equal to 35% of the remaining principal amount of the term loans, plus accrued interest, being payable on July 18, 2016 (the Maturity Date).

Our obligations under the Loan Agreement are secured by a first-priority security interest in our intellectual property assets (other than certain patents and related assets relating to the NVvaultTM product line) and a second-priority security interest in substantially all of our other assets.

In connection with the Loan Agreement, we paid certain facility, due diligence and legal fees of the Lender on the closing date and are obligated to pay a conditional facility fee upon satisfaction of the IP Monetization Milestones. In addition, if we repay or prepay all or a portion of the term loans prior to maturity, we are obligated to pay the Lender a prepayment fee based on a percentage of the then outstanding principal balance being prepaid, equal to 4.0% if the prepayment occurs on or prior to July 18, 2014 (or 2.0% if such prepayment is made in connection with the early repayment option premium discussed in the preceding sentence), 2.0% if the prepayment occurs between July 18, 2014 and July 18, 2015, or 0.0% if the prepayment occurs after July 18, 2015.

The Loan Agreement contains customary representations, warranties and indemnification provisions. The Loan Agreement also contains affirmative and negative covenants that, among other things restrict our ability to:

- incur additional indebtedness or guarantees;
- incur liens;
- make investments, loans and acquisitions;
- consolidate or merge;
- sell or exclusively license assets, including capital stock of subsidiaries;
- alter our business;
- engage in transactions with affiliates; and
- pay dividends or make distributions.

Table of Contents

The Loan Agreement also includes events of default, including, among other things, payment defaults, breaches of representations, warranties or covenants, certain bankruptcy events, the failure to maintain its listing on a nationally recognized securities exchange or alternatively for its shares to be qualified for trading on the OTC Bulletin Board and certain material adverse changes, including an impairment of the perfection or priority of the Lender s lien. Upon the occurrence of an event of default and following any applicable cure periods, a default interest rate of an additional 5.0% per annum may be applied to the outstanding loan balances, and the Lender may declare all outstanding obligations immediately due and payable and take such other actions as set forth in the Loan Agreement.

Concurrently with the execution of the Loan Agreement, we entered into a Patent Monetization Side Letter Agreement with an affiliate of the Lender (the Letter Agreement). The Letter Agreement provides, among other things, that the Lender may be entitled to share in certain monetization revenues that we may derive in the future related to our patent portfolio (the Patent Portfolio). The Patent Portfolio does not include certain patents relating to the NVvaultTM product line. Monetization revenues subject to this arrangement include revenues recognized during the seven year term of the Letter Agreement from amounts (whether characterized as settlement payments, license fees, royalties, damages, or otherwise) actually paid to us in connection with any assertion of, agreement not to assert, or license of, the Patent Portfolio (in whole or in part) either (A) in consideration of the grant of a license or covenant not sue, or other immunity with respect to the Patent Portfolio, or (B) as a damages award with respect to such assertion of the Patent Portfolio, less (i) actual legal fees and expenses (including fees payable on a contingency basis) and actual court costs paid or payable by us in connection with any such assertion and/or grant of a license or covenant not to sue, or other immunity with respect to the Patent Portfolio, provided that such legal fees and expenses shall be capped at forty percent (40%) of such gross, aggregate amounts paid to us, (ii) all reasonable and actual legal fees, filing fees, maintenance fees, annuities, and other reasonable and actual costs and expenses paid or required to be paid by us after the effective date in connection with the prosecution, maintenance, and defense of any patents or patent applications within the Patent Portfolio, (iii) reasonable and actual legal fees and reasonable and actual other costs and expenses paid or required to be paid by us in connection with the enforcement of any agreement, undertaking, commitment or court order that would generate monetization revenues and the collection thereof, and (iv) reasonable and actual costs of acquisition of patents and patent applications included in the Patent Portfolio that are acquired by or licensed to us after the effective date. Monetization revenues also include the value attributable to the Patent Portfolio in any sale of Netlist during the seven year term, subject to a maximum amount payable to the Lender. The Letter Agreement also requires that we use commercially reasonable efforts to pursue opportunities to monetize the Patent Portfolio during the term of the Letter Agreement, provided that we are under no obligation to pursue any such opportunities that we do not deem to be in our best interest in our reasonable business judgment. Notwithstanding the foregoing, there can be no assurance that we will be successful in these efforts, and we may expend resources in pursuit of monetization revenues that may not result in any benefit to us.

Concurrently with the execution of the Loan Agreement, we issued to an affiliate of the Lender seven-year warrants (the Lender Warrants) to purchase an aggregate of 1,648,351 shares of our common stock at a per share price of $1.00, of which 989,011 shares are exercisable immediately on a cash or cashless basis in whole or in part. Pursuant to the Lender Warrants, (i) 329,670 shares subject to the Lender Warrants will become exercisable upon the achievement of the IP Monetization Milestones and (ii) the remaining 329,670 shares subject to the Lender Warrants will become exercisable upon our receipt of an IP Milestone Term Loan.

Also in connection with the Loan Agreement, we agreed to pay to a consultant a consulting fee equal to (i) $300,000 in connection with our receipt of the Initial Term Loan and (ii) 5% of any additional principal amount loaned to us as an IP Milestone Term Loan.

Amendment to Credit Agreement with Silicon Valley Bank; Payoff of Consolidated Term Loan

Concurrently with the execution of the Loan Agreement and the funding of the Initial Term Loan, on July 18, 2013, we repaid in full all amounts owed under our consolidated term loan with Silicon Valley Bank (SVB), consisting of a lump sum payment of approximately $2.73 million. In addition, on July 18, 2013, we entered into an amendment (the SVB Amendment) with SVB to our loan and security agreement with SVB, dated as of October 31, 2009 and as most recently amended on May 14, 2012 (as amended, the SVB Credit Agreement). Pursuant to the SVB Amendment, the SVB Credit Agreement now allows for the financing and security interests contemplated under the Loan Agreement entered into with Lender and releases certain patents and related assets relating to the NVvaultTM product line from the collateral subject to

Table of Contents

SVB s security interest under the SVB Credit Agreement. Additionally, pursuant to the SVB Amendment, advances under the revolving line now accrue interest at a rate equal to SVB s most recently announced prime rate plus 2.75%. The SVB Amendment also relaxed our tangible net worth covenant under the SVB Credit Agreement and waived certain events of default in connection therewith. Certain reporting requirements under the SVB Credit Agreement were modified while certain reserves with respect to the borrowing base and the availability of revolving loans were removed pursuant to the SVB Amendment. Under the terms of the SVB Credit Agreement, we may draw revolving advances in an aggregate outstanding principal amount of up to the lesser of $5 million and the available borrowing base, subject to reserve amounts. Our borrowing base under the SVB Credit Agreement is, subject to certain adjustments and up to the lessor of 80% of eligible accounts receivable or $5.0 million.

Equity Financing

On July 18, 2013, we entered into a Securities Purchase Agreement (the Purchase Agreement) with an institutional investor (the Purchaser), pursuant to which we sold in a registered public offering (the Offering) an aggregate of 1,098,902 shares (the Shares) of our common stock and warrants to purchase up to an aggregate of 1,098,902 shares of our common stock (the Purchaser Warrants, and the shares issuable upon exercise of the Purchaser Warrants, the Purchaser Warrant Shares) at a purchase price of $0.91 per share and accompanying warrant, for aggregate gross proceeds of approximately $1.0 million and expected net proceeds, after deducting offering costs, of approximately $960,000. The Purchaser Warrant is exercisable as of the date of its issuance, will have a term of seven years, and will have an exercise price of $1.00 per share. The exercise price and the number of Purchaser Warrant Shares issuable upon exercise of the Purchaser Warrant are subject to adjustment in the event of, among other things, certain transactions affecting the Company s common stock (including without limitation stock splits and stock dividends), and certain fundamental transactions (including without limitation a merger or other sale-of-company transaction). The Offering closed on July 19, 2013. The Company intends to use the net proceeds from the Offering for general corporate purposes.

Critical Accounting Policies

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. We base our estimates on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. We review our estimates on an on-going basis. Actual results may differ from these estimates, which may result in material adverse effects on our operating results and financial position. We believe the following critical accounting policies involve our more significant assumptions and estimates used in the preparation of our condensed consolidated financial statements:

Revenue Recognition. We recognize revenues in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 605. Accordingly, we recognize revenues when there is persuasive evidence that an arrangement exists, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

We generally use customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess component inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. We offer a standard product warranty to our customers and have no other post-shipment obligations. We assess collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer s payment history.

All amounts billed to customers related to shipping and handling are classified as net sales, while all costs incurred by us for shipping and handling are classified as cost of sales.

Fair Value of Financial Instruments. Our financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities, the fair value of our cash equivalents and investments in marketable

Table of Contents

securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. The fair value of our auction rate securities is determined based on Level 3 inputs. We recognize transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. We believe that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Allowance for Doubtful Accounts. We perform credit evaluations of our customers financial condition and limit the amount of credit extended to our customers as deemed necessary, but generally require no collateral. We evaluate the collectibility of accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer s ability to meet its financial obligations subsequent to the original sale, we will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount that we reasonably believe will be collected. For all other customers, we record allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and our historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted. Generally, our credit losses have been within our expectations and the provisions established. However, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past.

Our accounts receivable are highly concentrated among a small number of customers, and a significant change in the liquidity or financial position of one of these customers could have a material adverse effect on the collectibility of our accounts receivable, our liquidity and our future operating results.

Inventories. We value our inventories at the lower of the actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, we evaluate ending inventory quantities on hand and record a provision for excess quantities and obsolescence. Among other factors, we consider historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. In addition, we consider changes in the market value of DRAM ICs and NAND in determining the net realizable value of our raw material inventory. Once established, any write downs are considered permanent adjustments to the cost basis of our excess or obsolete inventories.

A significant decrease in demand for our products could result in an increase in the amount of excess inventory quantities on hand. In addition, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventories are determined to be overvalued, we would be required to recognize additional expense in our cost of sales at the time of such determination. Likewise, if our inventories are determined to be undervalued, we may have over-reported our costs of sales in previous periods and would be required to recognize additional gross profit at the time such inventories are sold. In addition, should the market value of DRAM ICs or NAND decrease significantly, we may be required to lower our selling prices to reflect the lower current cost of our raw materials. If such price decreases reduce the net realizable value of our inventories to less than our cost, we would be required to recognize additional expense in our cost of sales in the same period. Although we make every reasonable effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand, technological developments or the market value of DRAM ICs or NAND could have a material effect on the value of our inventories and our reported operating results.

Impairment of Long-Lived Assets. We evaluate the recoverability of the carrying value of long-lived assets held and used in our operations for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, we compare the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. These projected future cash flows may vary significantly over time as a result of increased competition, changes in technology, fluctuations in demand, consolidation of our customers and reductions in average selling prices. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows.

Warranty Reserve. We offer product warranties generally ranging from one to three years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during the warranty period at no cost to the customer. Warranties are not offered on sales of excess inventory. Our estimates for warranty-related costs are recorded at the time of sale based on historical and estimated future product return rates and expected repair or replacement costs. While such costs have historically been consistent between periods and within our expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on us, requiring additional warranty reserves, and adversely affecting our gross profit and gross margins.

Table of Contents

Stock-Based Compensation. We account for equity issuances to non-employees in accordance with ASC Topic 505. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of our common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. The expected volatility is based on the historical volatility of our common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividends assumption is based on our history and our expectations regarding dividend payouts. We evaluate the assumptions used to value our common stock option awards on a quarterly basis. If factors change and we employ different assumptions, stock- based compensation expense may differ significantly from what we have recorded in prior periods. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award, provided that the accumulated cost recognized as of any date at least equals the value of the vested portion of the award.

We recognize the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

If there are any modifications or cancellations of the underlying vested or unvested stock-based awards, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense, or record additional expense for vested stock-based awards. Future stock-based compensation expense and unearned stock- based compensation may increase to the extent that we grant additional common stock options or other stock-based awards.

Income Taxes. Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements, calculated at enacted tax rates for expected periods of realization. We regularly review our deferred tax assets for recoverability and establish a valuation allowance, when determined necessary, based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. Because we have operated at a loss for an extended period of time, we did not recognize deferred tax assets related to losses incurred in 2012 or 2011. In the future, if we realize a deferred tax asset that currently carries a valuation allowance, we may record an income tax benefit or a reduction to income tax expense in the period of such realization.

ASC Topic 740 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under ASC Topic 740 we may only recognize or continue to recognize tax positions that meet a more likely than not threshold.

Table of Contents

The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are subject to change as a result of changes in fiscal policy, changes in legislation, the evolution of regulations and court rulings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially reverse previously recorded tax liabilities.

Results of Operations

The following table sets forth certain condensed consolidated statements of operations data as a percentage of net sales for the periods indicated:

	Three Months Ended		Six Months Ended	
	June 29, 2013	**June 30, 2012**	**June 29, 2013**	**June 30, 2012**
Net sales	100%	100%	100%	100%
Cost of sales	95	74	93	67
Gross profit	5	26	7	33
Operating expenses:				
Research and development	29	35	30	31
Selling, general and administrative	31	27	30	22
Total operating expenses	60	63	61	53
Operating loss	(55)	(37)	(54)	(20)
Other income (expense):				
Interest expense, net	(2)	(1)	(2)	(1)
Other expense, net				
Total other expense, net	(2)	(1)	(2)	(1)
Loss before provision for income taxes	(57)	(38)	(56)	(21)
Provision for income taxes				
Net loss	(57)%	(38)%	(56)%	(21)%

Three and Six Months Ended June 29 2013 Compared to Three and Six Months Ended June 30, 2012

Net Sales, Cost of Sales and Gross Profit

The following table presents net sales, cost of sales and gross profit for the three and six months ended June 29, 2013 and June 30, 2012 (in thousands, except percentages):

	Three Months Ended			
	June 29, 2013	**June 30, 2012**	**Change**	**% Change**
Net sales	$ 5,065	$ 10,552	$ (5,487)	(52)%

Cost of sales		4,818		7,814		(2,996)	(38)%
Gross profit	$	247	$	2,738	$	(2,491)	(91)%
Gross margin		5%		26%		(21)%	

	Six Months Ended						
		June 29, 2013		June 30, 2012		Change	% Change
Net sales	$	11,029	$	24,519	$	(13,490)	(55)%