

NETLIST INC
Form 10-Q
November 12, 2013
[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 28, 2013

or

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

For the transition period from _____ to _____

Commission file number 001-33170

NETLIST, INC.

(Exact name of registrant as specified in its charter)

Delaware

State or other jurisdiction of incorporation or organization

95-4812784

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

175 Technology Drive, 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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (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 No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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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

31,573,978 shares outstanding at October 31, 2013

Table of Contents

NETLIST, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 28, 2013

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets at September 28, 2013 (unaudited) and December 29, 2012 (audited)</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 28, 2013 and September 29, 2012</u>	4
<u>Unaudited Condensed Consolidated Statements of Comprehensive Loss for the Three and Nine Months Ended September 28, 2013 and September 29, 2012</u>	5
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 28, 2013 and September 29, 2012</u>	6
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29
<u>Item 4. Controls and Procedures</u>	43
<u>PART II. OTHER INFORMATION</u>	43
<u>Item 1. Legal Proceedings</u>	43
<u>Item 1A. Risk Factors</u>	43
<u>Item 6. Exhibits</u>	62

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) September 28, 2013	(audited) December 29, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,029	\$ 7,755
Restricted cash	1,000	
Investments in marketable securities		415
Accounts receivable, net	2,110	3,434
Inventories	4,269	7,380
Prepaid expenses and other current assets	493	723
Total current assets	14,901	19,707
Property and equipment, net	1,449	2,560
Debt issuance costs	731	
Other assets	124	130
Total assets	\$ 17,205	\$ 22,397
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,410	\$ 3,367
Accrued payroll and related liabilities	767	784
Accrued expenses and other current liabilities	525	497
Accrued engineering charges	500	450
Current portion of long term debt	5	3,493
Total current liabilities	4,207	8,591
Long term debt, net of current portion and debt discount of \$1,133	4,867	
Other liabilities	103	94
Total liabilities	9,177	8,685
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value - 90,000 shares authorized; 31,574 (2013) and 30,348 (2012) shares issued and outstanding	31	30
Additional paid-in capital	103,892	100,403
Accumulated deficit	(95,895)	(86,721)
Total stockholders' equity	8,028	13,712
Total liabilities and stockholders' equity	\$ 17,205	\$ 22,397

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Net sales	\$ 4,289	\$ 6,391	\$ 15,318	\$ 30,910
Cost of sales(1)	3,896	6,003	14,112	22,348
Gross profit	393	388	1,206	8,562
Operating expenses:				
Research and development(1)	1,641	2,615	4,941	10,227
Selling, general and administrative(1)	1,554	2,497	4,880	7,977
Total operating expenses	3,195	5,112	9,821	18,204
Operating loss	(2,802)	(4,724)	(8,615)	(9,642)
Other income (expense):				
Interest expense, net	(324)	(98)	(542)	(248)
Other income (expense), net	(8)	4	(8)	12
Total other expense, net	(332)	(94)	(550)	(236)
Loss before provision for income taxes	(3,134)	(4,818)	(9,165)	(9,878)
Provision for income taxes	7	4	9	5
Net loss	\$ (3,141)	\$ (4,822)	\$ (9,174)	\$ (9,883)
Net loss per common share:				
Basic and diluted	\$ (0.10)	\$ (0.17)	\$ (0.30)	\$ (0.36)
Weighted-average common shares outstanding:				
Basic and diluted	31,268	28,199	30,599	27,680

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

Cost of sales	\$ 13	\$ 28	\$ 37	\$ 105
Research and development	162	193	440	538
Selling, general and administrative	266	294	768	877

See accompanying notes.

Table of Contents**NETLIST, INC. AND SUBSIDIARIES****Unaudited Condensed Consolidated Statements of Comprehensive Loss****(in thousands)**

	Three Months Ended		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Net loss	\$ (3,141)	\$ (4,822)	\$ (9,174)	\$ (9,883)
Other comprehensive loss:				
Net unrealized loss on investments in marketable securities, net of tax		(2)		(1)
Total comprehensive loss	\$ (3,141)	\$ (4,824)	\$ (9,174)	\$ (9,884)

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended	
	September 28, 2013	September 29, 2012
Cash flows from operating activities:		
Net loss	\$ (9,174)	\$ (9,883)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,166	1,541
Amortization of debt discount and debt issuance costs	164	
Gain on disposal of property and equipment	(5)	
Stock-based compensation	1,245	1,520
Changes in operating assets and liabilities:		
Restricted cash	(1,000)	
Accounts receivable	1,324	7,764
Inventories	3,111	(3,918)
Prepaid expenses and other current assets	470	(165)
Other assets	6	32
Accounts payable	(957)	(2,257)
Accrued payroll and related liabilities	(17)	(742)
Accrued expenses and other current liabilities	37	458
Accrued engineering charges	50	
Net cash used in operating activities	(3,580)	(5,650)
Cash flows from investing activities:		
Acquisition of property and equipment	(75)	(1,648)
Proceeds from sale of property and equipment	25	
Proceeds from maturities and sales of investments in marketable securities	415	
Net cash provided by (used in) investing activities	365	(1,648)
Cash flows from financing activities:		
Borrowings on line of credit		3,200
Payments on line of credit		(400)
Proceeds from bank term loan, net of issuance costs	2,483	1,319
Payments on debt	(1,024)	(1,149)
Proceeds from public offering, net	1,006	3,613
Proceeds from exercise of equity awards, net of taxes remitted for restricted stock	24	621
Net cash provided by financing activities	2,489	7,204
Decrease in cash and cash equivalents	(726)	(94)
Cash and cash equivalents at beginning of period	7,755	10,535
Cash and cash equivalents at end of period	\$ 7,029	\$ 10,441

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 28, 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, storage 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 \$9.2 million and \$9.9 million for the nine months ended September 28, 2013 and September 29, 2012, respectively, and has an accumulated deficit of approximately \$95.9 million as of September 28, 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 ("DBD"), a Delaware limited liability company, an affiliate of Fortress Investment Group, LLC (see Note 6). 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 which also waived certain events of default related to noncompliance. The new financing with DBD 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 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.

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Pursuant to the Company's sales agreement with Ascendant Capital Markets LLC (Ascendant), the Company raised net proceeds of approximately \$48,000 during the nine months ended September 28, 2013, approximately \$3.9 million in the year ended December 29, 2012 and approximately \$1.9 million in the year ended December 31, 2011. The sales agreement expires on November 21, 2013.

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 September 28, 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 September 28, 2013, the condensed consolidated statements of its operations and comprehensive loss for the three and nine months ended September 28, 2013 and September 29, 2012, and the condensed consolidated statements of cash flows for the nine months ended September 28, 2013 and September 29, 2012. The results of operations for the nine months ended September 28, 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 transactions 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.

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 nine month periods ended September 28, 2013 and September 29, 2012.

Table of Contents

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.

Restricted Cash

Restricted cash of \$1 million, as of September 28, 2013, consists of cash to secure two standby letters of credit.

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.

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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 \$1.3 million of Federal Deposit Insurance Corporation and Securities Investor Protection Corporation insured cash and cash equivalents at September 28, 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.

Deferred Financing Costs, Debt Discount and Detachable Debt-Related Warrants

Costs incurred to issue debt are deferred and included in debt issuance costs in the accompanying consolidated balance sheet. The Company amortizes debt issuance costs over the expected term of the related debt using the effective interest method. Debt discounts relate to the relative fair value of any warrants issued in conjunction with the debt are recorded as a reduction to the debt balance and accreted over the expected term of the debt to interest expense using the effective interest method.

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.

Table of Contents

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 September 28, 2013. 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

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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.

Table of Contents

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.

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 Company's 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

Table of Contents

such acceptance in a timely manner. The Company has experienced a longer qualification cycle than anticipated with its HyperCloud® memory subsystems, and as of September 28, 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.

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 September 28, 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 nine months ended September 28, 2013 or September 29, 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, warrants 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):

	September 28, 2013	December 29, 2012
Raw materials	\$ 2,639	\$ 4,544
Work in process	330	70
Finished goods	1,300	2,766
	\$ 4,269	\$ 7,380

Table of Contents*Warranty Liabilities*

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

	Nine Months Ended	
	September 28, 2013	September 29, 2012
Beginning balance	\$ 235	\$ 189
Estimated cost of warranty claims charged to cost of sales	93	148
Cost of actual warranty claims	(70)	(105)
Ending balance	258	232
Less current portion	(155)	(139)
Long-term warranty obligations	\$ 103	\$ 93

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		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Basic and diluted net loss per share:				
Numerator: Net loss	\$ (3,141)	\$ (4,822)	\$ (9,174)	\$ (9,883)
Denominator: Weighted-average common shares outstanding, basic and diluted	31,268	28,199	30,599	27,680
Basic and diluted net loss per share	\$ (0.10)	\$ (0.17)	\$ (0.30)	\$ (0.36)

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

Nine Months Ended

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	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Common share equivalents	232	424	225	764

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.

Table of Contents*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		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Customer:				
Customer A	51%	32%	39%	65%
Customer B	14%	28%	17%	12%

The Company's accounts receivable as of September 28, 2013 were concentrated with two customers, representing approximately 60% 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.

Cash Flow Information