

NETLIST INC
Form 10-Q
August 12, 2014
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 28, 2014

or

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

For the transition period from to

Commission file number 001-33170

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
(Do not check if a smaller reporting company)

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

41,479,584 shares outstanding at July 31, 2014

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NETLIST, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE AND SIX MONTHS ENDED JUNE 28, 2014

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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 28, 2014	(audited) December 28, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 16,184	\$ 6,701
Restricted cash	1,100	1,100
Accounts receivable, net	2,981	4,866
Inventories	2,463	2,620
Prepaid expenses and other current assets	715	823
Total current assets	23,443	16,110
Property and equipment, net	678	1,143
Other assets	255	422
Total assets	\$ 24,376	\$ 17,675
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 3,361	\$ 3,795
Accrued payroll and related liabilities	760	635
Accrued expenses and other current liabilities	488	533
Accrued engineering charges	500	500
Current portion of long-term debt, net of debt discount	919	
Total current liabilities	6,028	5,463
Long-term debt, net of current portion and debt discount	4,635	5,099
Other liabilities	98	100
Total liabilities	10,761	10,662
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value - 90,000 shares authorized; 41,480 (2014) and 31,776 (2013) shares issued and outstanding	41	31
Additional paid-in capital	116,572	104,469
Accumulated deficit	(102,998)	(97,487)
Total stockholders' equity	13,615	7,013
Total liabilities and stockholders' equity	\$ 24,376	\$ 17,675

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Net sales	\$ 4,887	\$ 5,065	\$ 11,888	\$ 11,029
Cost of sales(1)	3,908	4,818	8,924	10,216
Gross profit	979	247	2,964	813
Operating expenses:				
Research and development(1)	2,302	1,457	4,277	3,299
Selling, general and administrative(1)	1,781	1,571	3,403	3,327
Total operating expenses	4,083	3,028	7,680	6,626
Operating loss	(3,104)	(2,781)	(4,716)	(5,813)
Other income (expense), net:				
Interest expense, net	(393)	(88)	(788)	(218)
Other expense, net	6	7	(5)	1
Total other expense, net	(387)	(81)	(793)	(217)
Loss before provision for income taxes	(3,491)	(2,862)	(5,509)	(6,030)
Provision for income taxes	2	1	2	3
Net loss	\$ (3,493)	\$ (2,863)	\$ (5,511)	\$ (6,033)
Net loss per common share:				
Basic and diluted	\$ (0.08)	\$ (0.09)	\$ (0.14)	\$ (0.20)
Weighted-average common shares outstanding:				
Basic and diluted	41,472	30,320	39,134	30,263

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

Cost of sales	\$ 14	\$ 11	\$ 29	\$ 23
Research and development	181	118	369	278
Selling, general and administrative	320	240	648	502

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended	
	June 28, 2014	June 29, 2013
Cash flows from operating activities:		
Net loss	\$ (5,511)	\$ (6,033)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	535	813
Amortization of debt discount and debt issuance costs	402	
Realized loss on disposal of property and equipment	6	1
Capitalized payment-in-kind interest	123	
Stock-based compensation	1,046	803
Changes in operating assets and liabilities:		
Accounts receivable	1,885	1,370
Inventories	157	2,075
Prepaid expenses and other current assets	481	491
Other assets	(167)	4
Accounts payable	(434)	71
Accrued payroll and related liabilities	125	(74)
Accrued expenses and other liabilities	(47)	(51)
Net cash used in operating activities	(1,399)	(530)
Cash flows from investing activities:		
Acquisition of property and equipment	(79)	(52)
Proceeds from sale of property and equipment	3	2
Proceeds from maturities and sales of investments in marketable securities		415
Net cash (used in) provided by investing activities	(76)	365
Cash flows from financing activities:		
Payments on debt	(109)	(830)
Proceeds from public offering, net of offering costs of \$116	10,276	28
Proceeds from exercise of equity awards, net of taxes remitted for restricted stock	791	29
Net cash provided by (used in) financing activities	10,958	(773)
Increase (decrease) in cash and cash equivalents	9,483	(938)
Cash and cash equivalents at beginning of period	6,701	7,755
Cash and cash equivalents at end of period	\$ 16,184	\$ 6,817

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 28, 2014

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, hyperscale datacenter operators and storage vendors. 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.

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 28, 2013, included in the Company's Annual Report on Form 10-K filed with the SEC on March 18, 2014.

The condensed consolidated financial statements included herein as of June 28, 2014 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 28, 2014 and the condensed consolidated statements of operations for the three and six months ended June 28, 2014 and June 29, 2013 and the condensed consolidated statements of cash flows for the six months ended June 28, 2014 and June 29, 2013. The results of operations for the six months ended June 28, 2014 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 2014, the Company's fiscal year is scheduled to end on December 27, 2014 and will consist of 52 weeks. Each of the Company's first three quarters in a fiscal year is comprised of 13 weeks.

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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, hyperscale datacenter operators and storage vendors.

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

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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 \$1.1 million, as of June 28, 2014, consists of cash to secure three standby letters of credit.

Fair Value of Financial Instruments

The Company's financial instruments consist principally of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of the Company's cash equivalents 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.

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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, 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. At times, deposits held with financial institutions may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation.

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.

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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.

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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 28, 2014. 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.

Warranty Reserve

The Company offers product warranties generally ranging from one to three years, depending on the product and negotiated terms of any purchase agreements with customers. Such warranties require the Company to repair or replace defective product returned to the Company during such 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). While such costs have historically been within management's expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on the Company, requiring additional warranty reserves, and could adversely affect the Company's gross profit and gross margins.

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

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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.

If there are any modifications or cancellations of the underlying vested or unvested stock-based awards, the Company 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 the Company grants additional common stock options or other stock-based awards.

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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.

The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations may 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 the Company's estimates, which could require the Company to record additional tax liabilities or to reduce previously recorded tax liabilities, as applicable.

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Risks and Uncertainties

The Company is subject to certain risks and uncertainties including its 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.

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The Company invested a significant portion of its research and development budget into the design of ASIC devices, including the HyperCloud® memory subsystem. This 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 experienced a longer qualification cycle than anticipated with its HyperCloud® memory subsystems, and has experienced supply chain disruption and a shortage of DRAM required to create the HyperCloud® memory subsystem. As of June 28, 2014, the product has not generated significant revenue relative to the Company's investment in the product.

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 28, 2014 and December 28, 2013.

Table of Contents*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 28, 2014 or June 29, 2013.

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):

	(unaudited) June 28, 2014	(audited) December 28, 2013
Raw materials	\$ 1,346	\$ 1,737
Work in process	214	67
Finished goods	903	816
	\$ 2,463	\$ 2,620

Warranty Liabilities

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

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	Six Months Ended	
	June 28, 2014	June 29, 2013
Beginning balance	\$ 249	\$ 235
Estimated cost of warranty claims charged to cost of sales	109	62
Cost of actual warranty claims	(114)	(38)
Ending balance	244	259
Less current portion	(146)	(154)
Long-term warranty obligations	\$ 98	\$ 105

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.

Table of Contents*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 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Basic and diluted net loss per share:				
Numerator: Net loss	\$ (3,493)	\$ (2,863)	\$ (5,511)	\$ (6,033)
Denominator: Weighted-average common shares outstanding, basic and diluted	41,472	30,320	39,134	30,263
Basic and diluted net loss per share	\$ (0.08)	\$ (0.09)	\$ (0.14)	\$ (0.20)

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 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Common share equivalents	335	193	460	215

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:

Customer:	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Customer A	19%	48%	16%	35%
Customer B	20%	17%	14%	18%
Customer C	*%	*%	11%	*%
Customer D	30%	*%	24%	*%

The Company's accounts receivable as of June 28, 2014 were concentrated with three customers, representing approximately 14%, 18%, and 48% of aggregate gross receivables. At December 28, 2013, one customer represented approximately 73% 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 28, 2014	June 29, 2013
Supplemental disclosure of non-cash investing and financing activities:		
Debt financed acquisition of fixed assets	\$	\$ 240
Issuance costs associated with February public offering	\$ 125	\$

Note 4 Credit Agreements*Silicon Valley Credit Agreement*

On October 31, 2009, the Company entered into a credit agreement with Silicon Valley Bank (SVB), which was 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, an affiliate of Fortress Investment Group, LLC (DBD), the Consolidated Term Loan and outstanding interest was paid in full.

On July 18, 2013, the Company and SVB entered into an amendment (the SVB Amendment) to the SVB Credit Agreement. Pursuant to the SVB Amendment, SVB allowed for the financing and security interests contemplated under the loan agreement entered into with DBD and released certain patents and related assets relating to the NVvault product line from the collateral subject to 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 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 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 or 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.

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The SVB Amendment requires letters of credit to be secured by cash, which is classified as restricted cash in the accompanying condensed consolidated balance sheets. At June 28, 2014, letters of credit in the amount of \$1.1 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 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Interest expense	\$ 25	\$ 28	\$ 49	\$ 95

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

	(unaudited) June 28, 2014	(audited) December 28, 2013
Availability under the revolving line of credit	\$ 2,492	\$ 4,042

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. 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 28, 2014, the Company was in compliance with its debt covenants.

On January 23, 2013, the Company entered into a Forbearance Agreement with SVB (the Forbearance Agreement). Pursuant to the Forbearance Agreement that was in effect prior to the July 18, 2013 loan amendment, any principal amount outstanding under the revolving line accrued 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 was payable monthly. In addition, the reserve on the revolving line was increased to \$2 million. On July 18, 2013, as part of the SVB Amendment, the Streamline Period interest was eliminated and any principal amount outstanding under the Revolving Line accrues interest at 2.75% above the Prime Rate. The SVB Amendment eliminated the reserve on the revolving line of \$2 million, thereby increasing the borrowing availability.

DBD Credit Funding, LLC Loan and Security Agreement and Related Agreements

On July 18, 2013, the Company, entered into a loan agreement (as amended, the Loan Agreement) with DBD, 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 DBD'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 SVB. The remainder of such funds have been or are expected to be used to fund the Company's ongoing working capital needs. Effective July 18, 2014, DBD agreed to extend the repayment date for the Company's early repayment option to August 15, 2014.

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

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with DBD (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 DBD 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 DBD 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 August 15, 2014, as amended (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 August 15, 2014, as amended and July 18, 2015, or 0.0% if the prepayment occurs after July 18, 2015.

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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.

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 DBD 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 DBD entered into a Patent Monetization Side Letter Agreement (the "Letter Agreement"). The Letter Agreement provides, among other things, that DBD 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 NVvault 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 DBD. 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

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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 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"). The Company accounted for the warrants as a debt discount and has valued them based on the relative fair value at approximately \$1,215,000, to be amortized over the term of the debt instrument, or three years, using the effective interest method. For the three and six months ended June 28, 2014, the Company amortized approximately \$120,000 and \$243,000, respectively, as interest expense in the consolidated statements of operations.

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Also in connection with the Loan Agreement, the Company agreed to pay to a consultant a consulting fee equal to (i) \$300,000 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. The initial \$300,000 has been recorded as debt issuance cost to be amortized over the term of the debt instrument, or three years, using the effective interest method. During the three and six months ended June 28, 2014, the Company amortized approximately \$78,000 and \$159,000, respectively, as interest expense in the condensed consolidated statements of operations.

Note 5 Debt

Debt consists of the following (in thousands):

	(unaudited) June 28, 2014	(audited) December 28, 2013
Term Loan, DBD, net of debt discount of \$768 for 2014 and \$1,012 for 2013	\$ 5,466	\$ 5,099
Note payable to others	88	
	5,554	5,099
Less current portion	(919)	
	\$ 4,635	\$ 5,099

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

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Interest expense	\$ 370	\$ 61	\$ 742	\$ 125

Note 6 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 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Provision for income taxes	\$ 2	\$ 1	\$ 2	\$ 3
Effective tax rate	(0.1)%	(0.0)%	(0.0)%	(0.0)%

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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 28, 2014 and December 28, 2013. Accordingly, no benefit has been recognized for net deferred tax assets.

The Company does not have any unrecognized tax benefits as of June 28, 2014 and December 28, 2013.

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Note 7 Commitments and Contingencies

Facility Lease

On July 26, 2013, the Company entered into an amendment for a three year lease with the Irvine Company. The amendment terminated the existing lease of the 51 Discovery, Suite 150, Irvine, California, 92618 premise in exchange for office space located at 175 Technology Drive, Suite 150, Irvine, California, 92618 USA. The lease payments range from approximately \$9,000 per month to \$10,000 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.

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 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.

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.

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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.

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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.

SanDisk, Smart Modular, Smart Worldwide, and Diablo Litigations

In September 2012, Smart Modular, Inc. (Smart Modular) 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 Smart Modular, U.S. Patent No. 8,250,295 (the 295 patent), and seeks damages and injunctive relief. Smart Modular 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 Smart Modular'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 Smart. Smart Modular 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 Smart Modular 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.

On February 7, 2013, Smart Modular filed a response to the Office Action in the reexamination of the 295 patent. Thereafter, the Company and Smart Modular made various filings to address certain apparent defects contained in Smart Modular's response. On March 13, 2013, the USPTO issued a Notice of Defective Paper, in which the USPTO found Smart Modular's responses, both the initial filing and a supplemental filing, to be improper, and both responses were expunged from the record. The USPTO gave Smart Modular 15 days to submit another response, which Smart Modular submitted on March 26, 2013. The Company timely filed its comments on Smart Modular's corrected response on April 25, 2013. The USPTO ultimately accepted Smart Modular's corrected response on July 17, 2013. On April 29, 2014, the USPTO issued an Action Closing Prosecution (ACP), confirming some claims and rejecting others. Smart Modular filed a response to the ACP on May 29, 2014, and Netlist filed comments related to Smart Modular's response on June 30, 2014. Thus, the reexamination of the 295 patent remains pending and will continue in accordance with established procedures for reexamination proceedings.

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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 Smart Modular's motion for preliminary injunction.

On July 1, 2013, Netlist filed a complaint against Smart Modular in the Santa Ana Division of the U.S. District Court for the Central District of California (Central District Court), seeking, among other things, relief under federal antitrust laws for Smart Modular's violation of Section 2 of the Sherman Act, and damages and other equitable relief under California statutory and common law for Smart Modular's unfair competition, deceptive trade practices and fraud.

On August 23, 2013, Netlist filed an amended complaint for patent infringement, antitrust violations and trade secret misappropriation against Smart Modular, Smart Storage Systems (Smart Storage), Smart Worldwide Holdings (Smart Worldwide) and Diablo Technologies (Diablo) in the Central District Court. Smart Storage was acquired by SanDisk Corporation (SanDisk) on August 22, 2013. Netlist's amended complaint alleges infringement of five Netlist patents by the defendants based on the manufacture and sale of the ULLtraDIMM memory module. Netlist's complaint also alleges antitrust violations by Smart Modular and Smart Worldwide, contending that Smart Modular procured a patent (U.S. Patent No. 8,250,295) with blatant inequitable conduct at the USPTO, withheld the patent application leading to the patent from relevant JEDEC committees for more than eight years, sought to

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improperly enforce that patent against Netlist's JEDEC-compliant HyperCloud® product by seeking a preliminary injunction against Netlist based on the patent, which was denied by the Eastern District Court, and made deceptive statements to the public about its lawsuit against Netlist. Netlist's complaint also alleges trade secret misappropriation and trademark infringement against Diablo, claiming that Diablo misused Netlist trade secrets to create the ULLtraDIMM product for Smart Storage (now SanDisk), and that Diablo used Netlist's HyperCloud® technology to create competing products.

On the same day Netlist filed its amended complaint, Smart Modular and Diablo each filed a complaint in the San Francisco Division of the U.S. District Court Northern District of California (Northern District Court), seeking declaratory judgment of non-infringement and invalidity of the patents asserted in the Netlist's amended complaint. On September 9, 2013, Netlist filed a Motion to Dismiss or Transfer these declaratory judgment complaints to the Central District Court. This motion was denied by the Northern District Court on October 10, 2013.

In the Central District Court, Smart Modular and Smart Worldwide filed motions on September 13, 2013, to dismiss or sever various counts related to the 295 patent. On September 26, 2013, Diablo filed a motion to dismiss Netlist's claims for trade secret misappropriation, breach of contract, and unfair competition. On October 29, 2013, Smart Modular and Diablo filed motions to dismiss or transfer the patent claims related to the ULLtraDIMM memory module. On November 26, 2013, the Central District Court: (i) severed and transferred the claims related to the 295 patent to the Eastern District Court, which were stayed by the Eastern District Court on March 7, 2014, along with the other 295 related claims pending results of the 295 reexamination; (ii) severed and transferred to the Northern District Court the patent claims related to the ULLtraDIMM memory module; (iii) issued an order to show cause why the remaining claims should not also be transferred to the Northern District Court; and (iv) held in abeyance Diablo's pending motion to dismiss and motion for judgment on the pleadings. The parties filed briefs in response to the order to show cause, and then on December 23, 2013, the Central District Court ordered the remaining claims to be transferred to the Northern District Court. All of the claims from the amended complaint filed on August 23, 2013, in the Central District Court have now been transferred to either the Northern District Court or the Eastern District Court.

As reported in its Form 8-K filed on December 13, 2013, Netlist received a whistleblower letter postmarked from Canada (where Diablo is based) on November 13, 2013, and obviously written by a current or former Diablo employee. The letter begins by bluntly stating that Diablo stole Netlist's architecture and design, and goes on to explain that Diablo used Netlist's HyperCloud™ product to create the ULLtraDIMM product, which it then used in demonstrations to major customers including IBM and Hewlett-Packard. The letter further states that Diablo's management conspired to hide this theft by instructing its employees not to speak to customers about the fact that Netlist's product was incorporated into ULLtraDIMM. The letter includes diagrams showing how Diablo implemented the theft of Netlist's trade secrets, as well as the names of former Diablo employees, customers and suppliers who can verify the theft. The Form 8-K included as an exhibit a partially redacted copy of the whistleblower letter. On December 13, 2013, Diablo filed an ex parte application in the Northern District Court requesting that the Court issue an order to show cause why Netlist should not be sanctioned for attaching the redacted copy of the whistleblower letter to the Form 8-K. The Northern District Court heard the parties' arguments on December 16, 2013, and on January 3, 2014, issued an order denying Diablo's application for sanctions, finding that Diablo had not established a basis for finding the information in the Form 8-K and its attachments confidential and therefore had not shown why it should be granted the relief sought.

On January 21, 2014, Netlist filed a motion for leave to file a second amended answer and counterclaims in the Northern District Court to assert two additional patents, bringing the total to seven patents asserted against the ULLtraDIMM. Diablo did not oppose Netlist's motion, and the parties filed a joint stipulation and proposed order on February 3, 2014, requesting an additional two months be added to the case schedule to account for the additional patents. On February 5, 2014, the Northern District Court granted Netlist's motion to add the two patents and entered a new case schedule. On February 12, 2014, the Northern District Court granted the parties' joint stipulation dismissing Smart Modular without prejudice. On April 7, 2014, the Northern District Court granted Netlist's motion for leave to file a Second Amended Complaint in the patent case.

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On March 21, 2014, Netlist filed a Second Amended Complaint against Diablo in the Northern District Court, Case No. 4:13-CV-05962 (the trade secret case), alleging, among other things, that in stealing Netlist's proprietary HyperCloud® and DxD and LRD technologies, Diablo breached its contracts with Netlist, committed trademark violations, and misappropriated Netlist's trade secrets. Also on March 21, 2014, Netlist served Diablo with its Amended Trade Secret Disclosure, detailing approximately 60 trade secrets Netlist taught to Diablo in connection with the contracted and confidential work on the HyperCloud® project. On April 9, 2014, Diablo filed a motion to dismiss Netlist's Second Amended Trade Secret Complaint, as well as a motion for judgment on the pleadings. That motion was heard by the Northern District Court on May 13, 2014, and is currently under submission.

On April 1, 2014, the Northern District Court denied Diablo's motion to strike Netlist's infringement contentions, finding that Netlist's contentions did indeed satisfy the relevant requirements and, on April 7, 2014, granted Netlist's motion to compel defendants to produce certain discovery materials related to the ULLtraDIMM. Diablo filed a motion for relief from these two rulings, which was denied on April 8, 2014. Also on April 7, 2014, the Northern District Court granted Netlist's motion for issuance of Letters Rogatory to the Canadian courts requesting that summons be issued for two former Diablo employees living in Canada and named in the whistleblower letter to produce documents and to be deposed. These depositions are currently scheduled to occur in late August, 2014.

On April 8, 2014, the Northern District Court granted Netlist's motion to consolidate the patent related cases (Case Nos. 4:13-CV-05889-YGR and 4:13-CV-03901-YGR) and to coordinate discovery with the trade secret case (4:13-CV-05962-YGR), and denied Diablo's motion to further consolidate the patent and trade secret cases. On April 15, 2014, the Northern District Court granted the parties' joint stipulation dismissing Smart Worldwide without prejudice. On April 30, 2014, the Northern District Court denied Diablo's request that Netlist's Amended Trade Secret Disclosure and exhibits thereto be re-designated as Confidential from the current designation of Highly Confidential Attorneys Eyes Only.

Between June 18 and June 24, 2014 SanDisk filed petitions in the USPTO requesting *Inter Partes* Review (IPR) of the five Netlist patents asserted in the August 23, 2013 amended complaint. Diablo similarly filed petitions requesting IPR of the two Netlist patents added in the second amended answer filed on January 21, 2014. Netlist has three months from the IPR petition filing dates to file a preliminary response. The USPTO has an additional three months to decide whether or not to institute one or more of the IPRs. SanDisk filed a motion on June 24, 2014, to stay the Northern District patent cases pending completion of the IPRs (Diablo later joined this motion). Netlist filed its opposition to the motion to stay on July 10, 2014. The Northern District Court is currently scheduled to hear oral arguments on the motion to stay in early August 2014.

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, Smart Modular requested and was later granted an *Inter Partes* Reexamination of the 386 patent. The reexaminations requested by Google and Smart Modular 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 Smart Modular filed their comments to the Company's response in October 2011. In October 2012, the USPTO issued an 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 examiner maintained his rejection of the claims. Netlist filed a notice of appeal on July 19, 2013. Google filed a notice of cross-appeal on August 2, 2013, and a cross-appeal brief on October 1, 2013. The Company filed an appeal brief and an amendment canceling some of the remaining claims on October 2, 2013 to further focus the issues on appeal. On February 24, 2014, the examiner entered the amendment canceling claims, withdrew the rejections related to those claims, but otherwise maintained the positions previously set forth in the RAN. 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 Smart Modular each filed and were later granted requests for reexamination of the '912 patent. In February 2011, the USPTO merged the Inphi, Google and Smart Modular '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 Smart Modular 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 Smart Modular filed their comments to the Company's response in February 2012. The USPTO determined that Smart Modular's comments were defective, and issued a notice to Smart Modular to rectify and resubmit its comments. Smart Modular filed corrected

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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. On March 21, 2014, the USPTO issued an ACP, confirming the patentability of 92 claims and maintaining the rejection of 11 other claims. On June 18, 2014, the USPTO issued a RAN, maintaining the substantive positions taken by the examiner in the ACP. 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, Smart Modular 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 Smart Modular'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. Smart Modular filed its comments to the Company's response in March 2012. The USPTO determined that Smart Modular's comments were defective and issued a notice in April 2012 to Smart Modular to rectify and resubmit its comments. Smart Modular 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. Smart Modular filed its comments on the Office Action on April 24, 2013. The USPTO issued another Non-Final Office Action on September 26, 2013, withdrawing certain rejections while adopting new rejections for certain of the pending claims. The Company responded to the Non-Final Office Action on November 26, 2013, by amending some of the claims and making arguments as to the validity of the rejected claims. On March 27, 2014, the USPTO issued an ACP, maintaining the claim rejections. On June 27, 2014, the USPTO issued a RAN, maintaining the substantive positions taken by the examiner in the ACP. The reexamination of the 627 patent remains pending and will continue in accordance with established *Inter Partes* Reexamination procedures.

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. Inphi filed a rebuttal brief on May 16, 2013. Netlist filed a request for oral hearing on June 14, 2013. The Company and the examiner jointly defended the 537 patent in a hearing on November 20, 2013 before the Patent Trial and Appeal Board (PTAB) at the USPTO. On January 16, 2014, the PTAB issued a decision upholding the validity of all 60 claims, dismissing every single validity challenge raised by Inphi and affirming the examiner's decision to allow the claims. The reexamination of the 537 patent remains pending and will continue 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

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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. Inphi filed a rebuttal brief on May 16, 2013. Netlist filed a request for oral hearing on June 14, 2013. The Company and the USPTO examiner jointly defended the '274 patent in a hearing on November 20, 2013 before the PTAB, in accordance with established procedures for *Inter Partes* Reexamination. On January 16, 2014, the PTAB issued a decision affirming the examiner in part, but reversing the examiner on new grounds and rejecting the one hundred and four (104) claims. On March 28, 2014, Netlist filed a Patent Owner's Response Requesting to Reopen Prosecution along with certain claim amendments and arguments. On June 26, 2014, the PTAB issued a decision granting-in-part Inphi's request to modify the January 16, 2014, decision as to two of the rejected claims. The reexamination of the '274 patent remains pending and will continue 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 8 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 of Serial Preferred Stock were outstanding at June 28, 2014 or December 28, 2013.

Common Stock

In November 2011, the Company entered into a sales agreement with Ascendant Capital Markets, LLC (Ascendant), 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 2013, the Company received net proceeds of approximately \$0.2 million raised through the sale of 240,373 shares of common stock. The sales agreement with Ascendant expired on

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November 21, 2013.

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 (2013 Offering) of its securities for gross proceeds of \$1.0 million. The 2013 Offering closed on July 19, 2013, and the Company received net proceeds of \$960,000 after deducting commissions and offering costs. The 2013 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).

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On July 18, 2013, concurrent with the execution of the Loan Agreement, the Company issued to an affiliate of DBD, 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). See Note 4 for treatment of the Warrant.

On February 3, 2014, the Company issued 750,000 shares of common stock upon exercise of warrants at a purchase price of \$0.89 per share, resulting in proceeds to the Company of \$667,500.

Sale of Common Stock Pursuant to Securities Purchase Agreement

On February 11, 2014, the Company completed a registered firm commitment underwritten public offering (the 2014 Offering) of shares of the Company s common stock. In the 2014 Offering, the Company issued and sold to Craig-Hallum Capital Group LLC (the Underwriter) 8,680,775 shares of common stock pursuant to an underwriting agreement (the Underwriting Agreement), dated as of February 6, 2014, by and between the Company and the Underwriter, at a price of \$1.2115 per share, including 1,132,275 shares resulting from the Underwriter s exercise in full of its option to purchase additional shares of Common Stock to cover over-allotments. The price per share to the public in the 2014 Offering was \$1.30 per share. The net proceeds from the 2014 Offering were approximately \$10.3 million, after deducting underwriting discounts and commissions and estimated offering expenses.

Cancellation of Shares of Common Stock

During the six months ended June 28, 2014 and the year ended December 28, 2013, the Company cancelled 10,015 and 19,575 shares of common stock, respectively, valued at approximately \$21,000 and \$14,000, 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 28, 2014, the Company was authorized to issue a maximum of 7,805,566 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 28, 2014, the Company had 476,136 shares available for grant under the 2006 Plan. Options granted under the 2000 Plan and the 2006 Plan 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.

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A summary of the Company's common stock option activity for the six months ended June 28, 2014 is presented below (shares in thousands):

	Number of Shares	Options Outstanding Weighted- Average Exercise Price
Options outstanding at December 28, 2013	5,837	\$ 2.58
Options granted	1,500	1.71
Options exercised	(283)	1.83
Options cancelled	(23)	3.20
Options outstanding at June 28, 2014	7,031	\$ 2.47

The intrinsic value of options exercised in the six months ended June 28, 2014 was \$400,953.

A summary of the Company's restricted stock awards as of and for the six months ended June 28, 2014 is presented below (shares in thousands):

	Number of Shares	Restricted Stock Outstanding Weighted- Average Grant-Date Fair Value per Share
Balance outstanding at December 28, 2013	54	\$ 3.17
Restricted stock vested	(46)	3.39
Balance outstanding at June 28, 2014	8	\$ 1.92

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:

	June 28, 2014	Six Months Ended June 29, 2013
Expected term (in years)	6.3	6.1
Expected volatility	121%	121%
Risk-free interest rate	1.90%	1.26%
Expected dividends		
Weighted-average grant date fair value per share	\$ 1.51	\$ 0.65

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 \$0.10 and \$0.03 million in the six months ended June 28, 2014 and June 29, 2013, respectively.

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At June 28, 2014, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2014 through fiscal 2017 related to unvested common stock options and restricted stock awards is approximately \$3.7 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2.6 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.

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Note 9 Segment and Geographic Information

The Company operates in one reportable segment, which is 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 28, 2014 and December 28, 2013, approximately \$0.3 and \$0.6 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 10 Subsequent Events

We have evaluated subsequent events through the filing date of this Form 10-Q, and have determined that no subsequent events have occurred that would require recognition in the condensed consolidated financial statements or disclosure in the notes thereto other than as discussed in the accompanying notes.

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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 28, 2013 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; our reliance on suppliers of critical components and vendors in the supply chain; continuing development, qualification and volume production of EXPRESSvault, NVvault, HyperCloud and VLP Planar-X RDIMM; the impact on us of substantially diminished sales to Dell; 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; 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 1A of this Quarterly Report on Form 10-Q, and similar discussions in our other SEC filings. Given these risks, uncertainties and other important factors, you should not place undue reliance on these forward-looking statements. These forward-looking statements represent our estimates and assumptions only as of the date made. 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 a wide variety of high performance, logic-based memory subsystems for the global datacenter, storage and high-performance computing 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, hyperscale datacenter operators and storage vendors. 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 combining discrete semiconductor technologies from third parties such as DRAM and NAND flash to function as one, efficient planar design, and alternative packaging techniques to deliver memory subsystems with persistence, high 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 dual-in line memory module (DIMM) in mission critical applications. Our HyperCloud® technology incorporates our patented rank multiplication and load reduction technologies.

Intellectual Property and Licensing

Our high performance memory subsystems are developed in part using our proprietary intellectual property, and we believe that the strength of our intellectual property rights will be important to the success of our business. We utilize patent and trade secret protection, confidentiality agreements with customers and partners, disclosure and invention assignment agreements with employees and consultants and other contractual provisions to protect our intellectual property and other proprietary information. We plan to license specific, custom designs to our customers, charging royalties at a fixed amount per product or a percentage of sales. More generally, we intend to vigorously defend and monetize our intellectual property through licensing arrangements and, where necessary, enforcement actions against those entities using our patented solutions in their products. Royalties resulting from these patent monetization efforts can be structured in a variety of ways, including but not limited to one-time paid up licenses or on-going royalty arrangements. However, our efforts may not result in significant revenues from these licensing agreements.

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As of June 28, 2014, we had 49 U.S. patents issued, 2 foreign patents granted and over 30 pending applications worldwide. Assuming that they are properly maintained, our patents will expire at various dates between 2022 and 2029. Our issued patents and patent applications relate to the use of custom logic in high performance memory subsystems, PCB design, layout and packaging techniques. We intend to actively pursue the filing of additional patent applications related to our technology advancements. While we believe that our patent and other intellectual property rights are important to our success, our technical expertise and ability to introduce new products in a timely manner also will continue to be important factors in developing and maintaining our competitive position. Accordingly, we believe that our business is not materially dependent upon any one claim in any of our existing patents or pending patent applications.

Our Products

NVvault and EXPRESSvault

We were the first to develop and market memory subsystems that incorporate both DRAM and NAND in a single NVvault persistent DIMM solution. NVvault was originally used for mission critical backups during power interruption in Redundant Array of Independent Disks (RAID) and main memory. NVvault has moved beyond its original application to a variety of other applications, including hyperscale computing for Cloud, Big Data, on-line banking and other real time applications. Recently, we have experienced increased demand for NVvault for use as a data accelerator. We are working to further enhance the capabilities of our NVvault technology in these new applications, and we are also seeking to expand our customer base through the integration of NVvault into leading storage motherboards. NVvault is incorporated in our EXPRESSvault PCIe solution for both acceleration and backup in storage applications. Our NVvault product line consists primarily of battery-free and battery-powered flash backed cache memory subsystems targeting RAID storage, application acceleration and mission critical data integrity. NVvault battery-free provides server and storage OEMs a solution for enhanced datacenter fault recovery. Our 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 steady decline in NVvault sales to Dell. There were no sales of NVvault products to Dell in the three and six months ended June 28, 2014 and \$0.5 million and \$0.9 million in the three and six months ended June 29, 2013. We expect minimal demand from Dell for our DDR2 NVvault during the remainder of 2014. We continue to pursue qualifications with other potential significant customers within the industry, however, our efforts may not result in significant revenues from the sale of NVvault products.

For the six months ended June 28, 2014 and June 29, 2013, our NVvault non-volatile RDIMM used in cache-protection and data logging applications, including our NVvault battery-free, the flash-based cache system, accounted for approximately 48% and 30% of total net sales, respectively. For the three months ended June 28, 2014 and June 29, 2013, our NVvault non-volatile RDIMM used in cache-protection and data logging applications, including our NVvault battery-free, the flash-based cache system, accounted for approximately 38% and 19% of total net sales, respectively.

HyperCloud®

Our HyperCloud® technology incorporates our patented rank multiplication technology that increases memory capacity and our patented 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.

Specialty Memory Modules and Flash-Based Products

The remainder of our revenue is primarily from OEM sales of specialty memory modules and flash-based products, the majority of which are utilized in data center and industrial applications. When developing custom modules for an equipment product launch, we engage with 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.

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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 NVvault™ product line of RDIMMS.

NVvault . We were the first to develop and market memory subsystems that incorporate both DRAM and NAND flash in a single NVvault persistent DIMM solution. NVvault combines the best attributes of DRAM; speed, durability and reliability with high densities, lower power and lowest costs provided by NAND to provide application acceleration and mission critical backup during power interruption for cloud infrastructure, virtualization, analytics and database applications. NVvault is incorporated in our EXPRESSvault PCIe solution for both acceleration and backup in storage applications.

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.

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.

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.

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

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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. Depending on our inventory levels, we may also sell excess component inventory of DRAM ICs and NAND, if any, 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, labor and other 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. In addition, we have experienced shortages of DRAM required for our HyperCloud® product from time to time, which can cause disruptions in our revenues and gross profits. In addition, the gross margin on our sales of any 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.

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 year over year revenue decline, we have reduced our selling, general and administrative expenditures by eliminating headcount and other related expenses.

Recent Developments

February 2014 Public Offering of Common Stock

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On February 11, 2014, we completed a registered firm commitment underwritten public offering (the 2014 Offering) of shares of our common stock, par value \$0.001 per share (Common Stock). In the 2014 Offering, we issued and sold to Craig-Hallum Capital Group LLC (the Underwriter) 8,680,775 shares of Common Stock pursuant to an underwriting agreement (the Underwriting Agreement), dated as of February 6, 2014, by and between the Company and the Underwriter, at a price of \$1.2115 per share, including 1,132,275 shares resulting from the Underwriter 's exercise in full of its option to purchase additional shares of Common Stock to cover over-allotments. The price per share to the public in the 2014 Offering was \$1.30 per share. The net proceeds from the 2014 Offering were approximately \$10.3 million, after deducting underwriting discounts and commissions and estimated offering expenses.

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Exercise of Warrant

On March 3, 2014, the holder of a warrant issued in December 2012 purchased 750,000 shares of Common Stock upon exercise of the warrant at a purchase price of \$0.89 per share, resulting in proceeds to us of \$667,500.

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, restricted cash, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of our cash equivalents is determined based on quoted prices in active markets for identical assets or level 1 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.

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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.

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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.

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. We amortize debt issuance costs over the expected term of the related debt using the effective interest method. Debt discounts related 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.

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.

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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.

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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 have not recognized deferred tax assets related to losses incurred since 2010. 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.

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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.

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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 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Net sales	100%			