

NETLIST INC  
Form 10-Q  
August 15, 2011

**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 July 2, 2011**

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.)

**51 Discovery, Suite 150**

**Irvine, CA 92618**

(Address of principal executive offices) (Zip Code)

**(949) 435-0025**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 each of the registrant's classes of common stock as of the latest practicable date:

Common Stock, par value \$0.001 per share

25,344,448 shares outstanding at August 3, 2011

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NETLIST, INC. AND SUBSIDIARIES  
QUARTERLY REPORT ON FORM 10-Q  
FOR THE THREE AND SIX MONTHS ENDED JULY 2, 2011

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## NETLIST, INC. AND SUBSIDIARIES

## Condensed Consolidated Balance Sheets

(in thousands, except par value)

|   | (unaudited)<br>July 2,<br>2011 | (audited)<br>January 1,<br>2011 |
|---|--------------------------------|---------------------------------|
| <b>ASSETS</b>   |                                |                                 |
| Current assets:   |                                |                                 |
| Cash and cash equivalents   | \$ 11,690                      | \$ 14,210                       |
| Investments in marketable securities  |                                | 824                             |
| Accounts receivable, net  | 9,337                          | 6,451                           |
| Inventories   | 11,370                         | 4,509                           |
| Prepaid expenses and other current assets   | 519                            | 1,396                           |
| Total current assets  | 32,916                         | 27,390                          |
| Property and equipment, net   | 3,153                          | 4,077                           |
| Long-term investments in marketable securities  | 456                            | 890                             |
| Other assets  | 234                            | 337                             |
| Total assets  | \$ 36,759                      | \$ 32,694                       |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                                |                                 |
| Current liabilities:  |                                |                                 |
| Accounts payable  | \$ 11,427                      | \$ 6,256                        |
| Accrued payroll and related liabilities   | 1,483                          | 1,762                           |
| Accrued expenses and other current liabilities  | 401                            | 369                             |
| Accrued engineering charges   | 932                            | 638                             |
| Current portion of long-term debt   | 1,971                          | 674                             |
| Total current liabilities   | 16,214                         | 9,699                           |
| Long-term debt, net of current portion  | 2,111                          | 1,063                           |
| Other liabilities   | 101                            | 85                              |
| Total liabilities   | 18,426                         | 10,847                          |
| Commitments and contingencies   |                                |                                 |
| Stockholders' equity:   |                                |                                 |
| Common stock, \$0.001 par value - 90,000 shares authorized; 25,344 (2011) and 25,284 (2010) shares issued and outstanding | 25                             | 25                              |
| Additional paid-in capital  | 89,827                         | 89,074                          |
| Accumulated deficit   | (71,474)                       | (67,141)                        |
| Accumulated other comprehensive loss  | (45)                           | (111)                           |
| Total stockholders' equity  | 18,333                         | 21,847                          |
| Total liabilities and stockholders' equity  | \$ 36,759                      | \$ 32,694                       |

See accompanying notes.



## NETLIST, INC. AND SUBSIDIARIES

## Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Net sales  | \$ 16,001          | \$ 9,304        | \$ 28,001        | \$ 17,194       |
| Cost of sales(1)                                 | 11,064             | 7,486           | 19,260           | 13,558          |
| Gross profit                                     | 4,937              | 1,818           | 8,741            | 3,636           |
| Operating expenses:                              |                    |                 |                  |                 |
| Research and development(1)                      | 3,755              | 3,190           | 7,439            | 6,198           |
| Selling, general and administrative(1)           | 2,583              | 2,607           | 5,500            | 5,177           |
| Total operating expenses                         | 6,338              | 5,797           | 12,939           | 11,375          |
| Operating loss                                   | (1,401)            | (3,979)         | (4,198)          | (7,739)         |
| Other (expense) income:                          |                    |                 |                  |                 |
| Interest (expense) income, net                   | (50)               | 3               | (75)             | 4               |
| Other (expense) income, net                      | (59)               | 4               | (59)             | 71              |
| Total other (expense) income, net                | (109)              | 7               | (134)            | 75              |
| Loss before provision (benefit) for income taxes | (1,510)            | (3,972)         | (4,332)          | (7,664)         |
| Provision (benefit) for income taxes             | 1                  | 2               | 1                | (725)           |
| Net loss   | \$ (1,511)         | \$ (3,974)      | \$ (4,333)       | \$ (6,939)      |
| Net loss per common share:                       |                    |                 |                  |                 |
| Basic and diluted                                | \$ (0.06)          | \$ (0.16)       | \$ (0.17)        | \$ (0.31)       |
| Weighted-average common shares outstanding:      |                    |                 |                  |                 |
| Basic and diluted                                | 24,988             | 24,780          | 24,935           | 22,734          |

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

|                                     |       |       |       |       |
|-------------------------------------|-------|-------|-------|-------|
| Cost of sales                       | \$ 18 | \$ 12 | \$ 31 | \$ 22 |
| Research and development            | 146   | 117   | 288   | 163   |
| Selling, general and administrative | 242   | 297   | 440   | 623   |

See accompanying notes.

## NETLIST, INC. AND SUBSIDIARIES

## Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

|   | Six Months Ended |                 |
|---|------------------|-----------------|
|   | July 2,<br>2011  | July 3,<br>2010 |
| Cash flows from operating activities:                                       |                  |                 |
| Net loss  | \$ (4,333)       | \$ (6,939)      |
| Adjustments to reconcile net loss to net cash used in operating activities: |                  |                 |
| Depreciation and amortization   | 1,183            | 1,130           |
| Stock-based compensation  | 759              | 808             |
| Amortization of deferred gain on sale and leaseback transaction             |                  | (59)            |
| Realized loss on sale of investments in marketable securities               | 59               |                 |
| Changes in operating assets and liabilities:                                |                  |                 |
| Accounts receivable   | (2,885)          | (2,846)         |
| Inventories   | (6,861)          | (2,027)         |
| Prepaid expenses and other current assets                                   | 1,046            | 167             |
| Other assets  | 104              | (21)            |
| Accounts payable  | 5,165            | 2,078           |
| Accrued payroll and related liabilities                                     | (279)            | (493)           |
| Accrued expenses and other current liabilities                              | 46               | (98)            |
| Accrued engineering charges   | 293              | 770             |
| Net cash used in operating activities                                       | (5,703)          | (7,530)         |
| Cash flows from investing activities:                                       |                  |                 |
| Acquisition of property and equipment                                       | (244)            | (392)           |
| Purchase of investments in marketable securities                            |                  | (2,380)         |
| Proceeds from maturities and sales of investments in marketable securities  | 1,266            | 1,110           |
| Net cash provided by (used in) investing activities                         | 1,022            | (1,662)         |
| Cash flows from financing activities:                                       |                  |                 |
| Borrowings on line of credit  | 500              | 2,000           |
| Payments on line of credit  | (500)            | (2,000)         |
| Proceeds of bank term loan, net of issuance costs                           | 2,934            |                 |
| Payments on debt  | (767)            | (57)            |
| Proceeds from public offering, net  |                  | 16,210          |
| Proceeds from exercise of stock options and warrants, net of taxes remitted | (6)              | 90              |
| Net cash provided by financing activities                                   | 2,161            | 16,243          |
| Decrease (increase) in cash and cash equivalents                            | (2,520)          | 7,051           |
| Cash and cash equivalents at beginning of period                            | 14,210           | 9,942           |
| Cash and cash equivalents at end of period                                  | \$ 11,690        | \$ 16,993       |

See accompanying notes.



**NETLIST, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**JULY 2, 2011**

**Note 1 Description of Business**

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

**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 January 1, 2011, included in the Company's Annual Report on Form 10-K filed with the SEC on March 3, 2011.

The condensed consolidated financial statements included herein as of July 2, 2011 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 July 2, 2011, the condensed consolidated results of its operations for the three and six months ended July 2, 2011 and July 3, 2010, and the condensed consolidated cash flows for the six months ended July 2, 2011 and July 3, 2010. The results of operations for the six months ended July 2, 2011 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

*Reclassifications*

Certain amounts in the 2010 financial statements have been reclassified to conform to the current year presentation.

*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 2011, the Company's fiscal year is scheduled to end on December 31, 2011 and will consist of 52 weeks. Each of the Company's first three quarters in a fiscal year is comprised of 13 weeks.

*Use of Estimates*

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

*Revenue Recognition*

The Company's revenues primarily consist of product sales of high-performance memory subsystems to OEMs. Revenues also include sales of excess component inventories to distributors and other users of memory integrated circuits ( ICs ). Such sales amounted to less than \$0.1 million for each of the three and six month periods ended July 2, 2011 and July 3, 2010.

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 collectability 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 collectability based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer's payment history.

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

*Cash and Cash Equivalents*

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

*Investments in Marketable Securities*

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

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

### *Fair Value of Financial Instruments*

The Company's financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities and short-term corporate bonds (see Note 4), the fair value of the Company's cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 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.

*Allowance for Doubtful Accounts*

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

*Concentration of Credit Risk*

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

The Company invests its cash equivalents primarily in money market mutual funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. The Company had \$0.4 million of Federal Deposit Insurance Corporation insured cash and cash equivalents at July 2, 2011. Investments in marketable securities are generally in high-credit quality debt instruments. Such investments are made only in instruments issued or enhanced by high-quality institutions. The Company has not incurred any credit risk losses related to these investments.

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

*Inventories*

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

*Property and Equipment*

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

*Impairment of Long-Lived Assets*

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows. The Company's management believes there is no impairment of long-lived assets as of July 2, 2011. There can be no assurance, however, that market conditions will not change or demand for the Company's products will continue, which could result in future impairment of long-lived assets.

### *Warranties*

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

### *Stock-Based Compensation*

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

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

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

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

### *Income Taxes*

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



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

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

#### *Research and Development Expenses*

Research and development expenditures are expensed in the period incurred.

#### *Collaborative Arrangement*

The Company has entered into a collaborative arrangement with a partner in order to develop products using certain of the Company's proprietary technology. Under the arrangement, the development partner was granted a non-exclusive license to specified intellectual property for exclusive use in the development and production of ASIC chipsets for the Company. Both the Company and the development partner provided and continue to provide engineering project management resources at their own expense. The development partner is entitled to non-recurring engineering fees based upon the achievement of development milestones, and to a minimum portion of the Company's purchasing allocations for the component. Expenses incurred and paid to the development partner are included in research and development expense in the accompanying condensed consolidated statements of operations.

#### *Comprehensive Loss*

ASC Topic 220 establishes standards for reporting and displaying comprehensive income and its components in the condensed consolidated financial statements. Accumulated other comprehensive loss includes unrealized gains or losses on investments.

#### *Risks and Uncertainties*

The Company has invested a significant portion of its research and development budget into the design of ASIC devices, including the HyperCloud memory subsystem. This new design and the products it is incorporated into are subject to increased risks as compared to our existing products. The Company may be unable to achieve customer or market acceptance of the HyperCloud memory subsystem or other new products, or achieve such acceptance in a timely manner. The Company has experienced a longer qualification cycle than anticipated with its HyperCloud memory subsystems, and as of July 2, 2011 the product has not generated significant revenue. Further delays or any failure in placing or qualifying this product with customers would adversely impact the Company's results of operations.

The Company's operations in the People's Republic of China ( PRC ) are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in China. 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 China, 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. Restricted net assets of the Company's subsidiary in the PRC totaled \$1.2 million and \$2.0 million at July 2, 2011 and January 1, 2011, respectively.

*Foreign Currency Re-measurement*

The functional currency of the Company's foreign subsidiary is the U.S. dollar. Local currency financial statements are re-measured 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 re-measured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are re-measured using historical exchange rates. All re-measurement gains and losses are included in determining net loss.

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

*New Accounting Pronouncements*

In May 2011, the FASB issued Accounting Standards Update ( ASU ) No. 2011-4, Fair Value Measurement ( ASU 11-4 ). ASU 11-4 amends existing guidance to achieve convergence in measurement and disclosure between U.S. Generally Accepted Accounting Standards ( GAAP ) and International Financial Reporting Standards ( IFRS ). ASU 11-4 is effective for fiscal year 2012. The Company is currently evaluating the impact that ASU 11-4 will have on its consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-5, Comprehensive Income ( ASU 11-5 ). ASU 11-5 amends existing guidance to increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS. ASU 11-5 is effective for fiscal year 2012. The Company is currently evaluating the impact that ASU 11-4 will have on its consolidated financial statements.

**Note 3 Supplemental Financial Information***Inventories*

Inventories consist of the following (in thousands):

|                 | July 2,<br>2011 | January 1,<br>2011 |
|-----------------|-----------------|--------------------|
| Raw materials   | \$ 7,694        | \$ 2,631           |
| Work in process | 1,108           | 171                |
| Finished goods  | 2,568           | 1,707              |
|                 | \$ 11,370       | \$ 4,509           |

*Warranty Liabilities*

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

|                                | <b>Six Months Ended</b> |                         |
|--------------------------------|-------------------------|-------------------------|
|                                | <b>July 2,<br/>2011</b> | <b>July 3,<br/>2010</b> |
| Beginning balance              | \$ 194                  | \$ 240                  |
| Charged to costs and expenses  | 214                     | 81                      |
| Cost of warranty claims        | (207)                   | (111)                   |
| Ending balance                 | 201                     | 210                     |
| Less current portion           | (100)                   | (125)                   |
| Long-term warranty obligations | \$ 101                  | \$ 85                   |

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.

*Facility Relocation Costs*

The following table summarizes the activity related to the Company's accrual for facility relocation costs during the period indicated (in thousands):

|  | Six Months Ended |                 |
|--|------------------|-----------------|
|  | July 2,<br>2011  | July 3,<br>2010 |
| Beginning balance                      | \$               | \$ 84           |
| (Reduction) increase in expected costs |                  | (28)            |
| Net payments                           |                  | (6)             |
| Ending balance                         | \$               | \$ 50           |

As a result of the relocation of the Company's domestic headquarters and manufacturing facility during the third quarter of 2007, the Company vacated its previous manufacturing facility. The Company subleased this facility, but remained obligated under a non-cancellable operating lease through November 2010. In accordance with ASC Topic 420, the Company recorded a net charge and related liability of approximately \$134,000 in 2007, which approximated the estimated fair value of the net remaining lease payments. At the conclusion of the master lease and sublease terms, the Company determined that its original estimates regarding the net remaining lease payments exceeded its actual liability by approximately \$33,000. Accordingly, the excess accrual was reversed, and the liability for facility relocation was reduced to zero at January 1, 2011.

In May 2009, the Company entered into an agreement to sublease a portion of its new domestic headquarters facility to another tenant at a discount from the rent required under its lease commitment. As a result, the Company recorded an additional charge of approximately \$61,000. In February 2010, the sublessor vacated the space that it had subleased. The Company determined that the space could be used in its operations. As a result, the Company reversed approximately \$28,000 of its accrual for facility relocation costs, and the liability was reduced to zero at January 1, 2011.

The expenses and reversal of accruals described above are included as a component of selling, general and administrative expense in the accompanying condensed consolidated statements of operations.

*Comprehensive Loss*

The components of comprehensive loss, net of taxes, consist of the following (in thousands):

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|   | Three Months Ended |                 | Six Months Ended |                 |
|---|--------------------|-----------------|------------------|-----------------|
|   | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Net loss  | \$ (1,511)         | \$ (3,974)      | \$ (4,333)       | \$ (6,939)      |
| Other comprehensive loss:   |                    |                 |                  |                 |
| Unrealized loss transferred from other comprehensive loss to earnings | 59                 |                 | 59               |                 |
| Net unrealized gain (loss) on investments, net of tax                 | (1)                | (12)            | 7                | (47)            |
| Total comprehensive loss  | \$ (1,453)         | \$ (3,986)      | \$ (4,267)       | \$ (6,986)      |

Accumulated other comprehensive loss reflected on the condensed consolidated balance sheets at July 2, 2011 and January 1, 2011, represents accumulated net unrealized losses on investments.

*Computation of Net Loss Per Share*

Basic and diluted net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period. The following table sets forth the computation of net loss per share (in thousands, except per share data):

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Numerator: Net loss  | \$ (1,511)         | \$ (3,974)      | \$ (4,333)       | \$ (6,939)      |
| Denominator: Weighted-average common shares outstanding, basic and diluted | 24,988             | 24,780          | 24,935           | 22,734          |
| Net loss per share, basic and diluted                                      | \$ (0.06)          | \$ (0.16)       | \$ (0.17)        | \$ (0.31)       |

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, and the exercise of warrants, 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 |                 |
|--------------------------|--------------------|-----------------|------------------|-----------------|
|                          | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Common share equivalents | 1,530              | 1,798           | 1,572            | 2,070           |

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 |                 |
|------------|--------------------|-----------------|------------------|-----------------|
|            | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Customer A | 64%                | 49%             | 67%              | 44%             |
| Customer B | *%                 | 32%             | *%               | 32%             |

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\* less than 10% of net sales

The Company's accounts receivable are concentrated with two customers at July 2, 2011 and January 1, 2011, representing approximately 63% and 10% and 75% and 13%, respectively, 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 associated with foreign receivables by purchasing comprehensive foreign credit insurance.



*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 |                 |
|--|------------------|-----------------|
|  | July 2,<br>2011  | July 3,<br>2010 |
| Supplemental disclosure of non-cash investing and financing activities:    |                  |                 |
| Purchase of equipment not paid for at the end of the period                | \$ (6)           | \$ 44           |
| Debt financed acquisition of assets  | \$ 169           | \$              |
| Change in unrealized (gain) loss from investments in marketable securities | \$ (66)          | \$ 47           |

**Note 4 Fair Value Measurements**

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

|  | Fair Value Measurements at July 2, 2011 Using |  |   |  |
|--|---|--|---|--|
|  | Fair Value at<br>July 2,<br>2011              | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Money market mutual funds                | \$ 7,083                                      | \$ 7,083   | \$  | \$   |
| Auction and variable floating rate notes | 456   |  |   | 456  |
| Total                                    | \$ 7,539                                      | \$ 7,083   | \$  | \$ 456   |

|  | Fair Value Measurements at January 1, 2011 Using |  |   |  |
|--|--|--|---|--|
|  | Fair Value at<br>January 1,<br>2011              | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Money market mutual funds                | \$ 12,654  | \$ 12,654  | \$  | \$   |
| Corporate notes and bonds                | 824  |  | 824   |  |
| Auction and variable floating rate notes | 890  |  |   | 890  |
| Total                                    | \$ 14,368  | \$ 12,654  | \$ 824  | \$ 890   |

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The following tables summarize the Company's assets measured at fair value on a recurring basis as presented in the Company's condensed consolidated balance sheets at July 2, 2011 and January 1, 2011:

|                                     | Fair Value Measurements at July 2, 2011 Using |  |   |   |
|-------------------------------------|---|--|---|---|
|                                     | Fair Value at July 2, 2011                    | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Cash equivalents                    | \$ 7,083                                      | \$ 7,083   | \$  | \$  |
| Long-term marketable securities     | 456   |  |   | 456                                       |
| Total assets measured at fair value | \$ 7,539                                      | \$ 7,083   | \$  | \$ 456                                    |

|                                     | Fair Value Measurements at January 1, 2011 Using |  |   |   |
|-------------------------------------|--|--|---|---|
|                                     | Fair Value at January 1, 2011                    | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Cash equivalents                    | \$ 12,654  | \$ 12,654  | \$  | \$  |
| Short-term marketable securities    | 824  |  | 824   |   |
| Long-term marketable securities     | 890  |  |   | 890                                       |
| Total assets measured at fair value | \$ 14,368  | \$ 12,654  | \$ 824  | \$ 890                                    |

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

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

|   | Six Months Ended |              |
|---|------------------|--------------|
|   | July 2, 2011     | July 3, 2010 |
| Beginning balance   | \$ 890           | \$ 941       |
| Proceeds from sales of available-for-sale marketable securities       | (441)            |              |
| Realized loss included in other income (expense), net                 | (59)             |              |
| Unrealized loss transferred from other comprehensive loss to earnings | 59               |              |
| Unrealized (loss) gain included in other comprehensive loss           | 7                | (39)         |
| Ending balance  | \$ 456           | \$ 902       |

**Note 5 Investments in Marketable Securities**

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

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|  | <b>Amortized<br/>Cost</b> | <b>July 2, 2011<br/>Net<br/>Unrealized<br/>Gain (Loss)</b> | <b>Fair<br/>Value</b> |
|--|---------------------------|--|-----------------------|
| Auction and variable floating rate notes | \$ 500                    | \$ (44)  | \$ 456                |

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|  | Amortized<br>Cost | January 1, 2011<br>Net<br>Unrealized<br>Gain (Loss) | Fair<br>Value |
|--|-------------------|---|---------------|
| Corporate notes and bonds                | \$ 824            | \$  | \$ 824        |
| Auction and variable floating rate notes | 1,001             | (111)   | 890           |
|  | \$ 1,825          | \$ (111)  | \$ 1,714      |

Realized gains and losses on the sale of investments in marketable securities are determined using the specific identification method. Net realized gains and losses recorded were not significant in any of the periods reported upon.

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

|  | July 2, 2011<br>Continuous Unrealized Loss |                    |                                       |                    |
|--|--|--------------------|---------------------------------------|--------------------|
|  | Less than 12 months<br>Fair<br>Value       | Unrealized<br>Loss | 12 months or greater<br>Fair<br>Value | Unrealized<br>Loss |
| Auction and variable floating rate notes | \$   | \$                 | \$ 456                                | \$ (44)            |

|  | January 1, 2011<br>Continuous Unrealized Loss |                    |                                       |                    |
|--|---|--------------------|---------------------------------------|--------------------|
|  | Less than 12 months<br>Fair<br>Value          | Unrealized<br>Loss | 12 months or greater<br>Fair<br>Value | Unrealized<br>Loss |
| Auction and variable floating rate notes | \$  | \$                 | \$ 890                                | \$ (111)           |

As of July 2, 2011, the Company held one investment that was in an unrealized loss position. As of January 1, 2011, the Company held two investments that were in an unrealized loss position.

*Auction Rate Securities*

Disruptions in the credit market continue to adversely affect the liquidity and overall market for auction rate securities. As of July 2, 2011, the Company held one investment in a Baa1 rated auction rate debt securities of a municipality with a total purchase cost of \$0.5 million. An additional A3 rated debt obligation backed by pools of student loans guaranteed by the U.S. Department of Education with a total purchase cost of \$0.5 was owned at January 1, 2011, and disposed of in June 2011 for a realized loss of \$59,000.

The Company does not believe that the current illiquidity of its remaining investment in auction rate securities will materially impact its ability to fund its working capital needs, capital expenditures or other business requirements. The Company, however, remains uncertain as to when full

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liquidity will return to the auction rate markets, whether other secondary markets will become available or when the underlying security may be called by the issuer. Given these and other uncertainties, the Company's investments in auction rate securities have been classified as long-term investments in marketable securities in the accompanying unaudited condensed consolidated balance sheets. The Company has concluded that the estimated gross unrealized losses on these investments, which totaled approximately \$44,000 and \$111,000 at July 2, 2011 and January 1, 2011, respectively, are temporary because (i) the Company believes that the liquidity limitations that have occurred are due to general market conditions, (ii) the remaining auction rate security continues to be of a high credit quality and interest is paid as due and (iii) the Company has the intent and ability to hold this investment until a recovery in the market occurs.

*Other Investments in Marketable Securities*

The Company maintains an investment portfolio of various holdings, types and maturities. The Company invests in instruments that meet high quality credit standards, as specified in its investment policy guidelines. These guidelines generally limit the amount of credit exposure to any one issue, issuer or type of instrument. Excluding its auction rate securities, there were no unrealized gains or losses at July 2, 2011 or January 1, 2011.

The following table presents the amortized cost and fair value of the Company's investments in marketable securities classified as available-for-sale at July 2, 2011 by contractual maturity (in thousands):

|                         | July 2, 2011      |               |
|-------------------------|-------------------|---------------|
|                         | Amortized<br>Cost | Fair<br>Value |
| <b>Maturity</b>         |                   |               |
| Greater than two years* | \$ 500            | \$ 456        |

\* Comprised of auction rate securities which generally have reset dates of 90 days or less but final contractual maturity dates in excess of 15 years.

**Note 6 Credit Agreement**

On October 31, 2009, the Company entered into a credit agreement with Silicon Valley Bank, which was amended on March 24, 2010, June 30, 2010, September 30, 2010, May 11, 2011 and August 10, 2011 (the "Credit Agreement"). Currently, the Credit Agreement provides that the Company can borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) \$10.0 million. The Company has the option to increase credit availability to \$15.0 million at any time through the maturity date of September 30, 2013, subject to the conditions of the Credit Agreement.

The Credit Agreement contains an overall sublimit of \$10.0 million to collateralize the Company's contingent obligations under letters of credit, foreign exchange contracts and cash management services. Amounts outstanding under the overall sublimit reduce the amount available pursuant to the Credit Agreement. At July 2, 2011, letters of credit in the amount of \$2.8 million were outstanding. The letters of credit expire on various dates through October 31, 2011.

Interest on the line of credit provided by the Credit Agreement is payable monthly at either (i) prime plus 1.25%, as long as the Company maintains \$8.5 million in revolving credit availability plus unrestricted cash on deposit with the bank, or (ii) prime plus 2.25%. Additionally, the Credit Agreement requires payments for an unused line, as well as anniversary and early termination fees, as applicable.

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

|  | Three Months Ended |                 | Six Months Ended        |                 |                            |    |    |
|--|--------------------|-----------------|-------------------------|-----------------|----------------------------|----|----|
|  | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011         | July 3,<br>2010 |                            |    |    |
| Interest expense   | \$                 | \$              | 13                      | \$              | 2                          | \$ | 24 |
|  |                    |                 | <b>July 2,<br/>2011</b> |                 | <b>January 1,<br/>2011</b> |    |    |
| Availability under the revolving line of credit                      | \$                 |                 | 7,200                   | \$              | 5,100                      |    |    |
| Outstanding borrowings on the revolving line of credit               |                    |                 |                         |                 |                            |    |    |
| Amounts reserved under credit sublimits                              |                    |                 | (2,800)                 |                 | (2,900)                    |    |    |
| Unutilized borrowing availability under the revolving line of credit | \$                 |                 | 4,400                   | \$              | 2,200                      |    |    |

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In connection with the September 30, 2010 amendment to the Credit Agreement, Silicon Valley Bank extended a \$1.5 million term loan, which bears interest at a rate of prime plus 1.75% ( Term Loan I ). The Company is required to make monthly principal payments of \$41,666 over the 36 month term of the loan, or \$0.5 million annually. Term Loan I matures in September 2013. In May 2011, Silicon Valley Bank extended an additional \$3.0 million term loan ( Term Loan II ), and extended the term of the existing credit facility through September 2013. The Term Loan II bears interest at a rate of prime plus 2.5%, and is payable in equal installments of \$125,000 over the 24 month term of the loan, or \$1.5 million annually. Term Loan II matures in May 2013.

The term loans are classified in long-term debt in the accompanying condensed consolidated balance sheets.

Obligations under the Credit Agreement are secured by a first priority lien on the Company's tangible and intangible assets.

The 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 July 2, 2011, the Company was in compliance with its financial covenants.

### Note 7 Long-Term Debt

Long-term debt consists of the following (in thousands):

|  | July 2,<br>2011 | January 1,<br>2011 |
|--|-----------------|--------------------|
| Term Loan I  | \$ 1,083        | \$ 1,375           |
| Term Loan II, net of unamortized issuance cost of \$57 | 2,693           |                    |
| Obligations under capital leases                       | 257             | 362                |
| Note payable to others                                 | 49              |                    |
|  | 4,082           | 1,737              |
| Less current portion                                   | (1,971)         | (674)              |
|  | \$ 2,111        | \$ 1,063           |

Notes payable to others represents short-term financing of annual insurance premiums.

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

| Three Months Ended |                 | Six Months Ended |                 |
|--------------------|-----------------|------------------|-----------------|
| July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
|                    |                 |                  |                 |



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|                  |    |    |    |   |    |    |    |   |
|------------------|----|----|----|---|----|----|----|---|
| Interest expense | \$ | 54 | \$ | 2 | \$ | 82 | \$ | 5 |
|------------------|----|----|----|---|----|----|----|---|

**Note 8 Income Taxes**

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

|                                      | Three Months Ended |                 | Six Months Ended |                 |    |        |    |       |
|--------------------------------------|--------------------|-----------------|------------------|-----------------|----|--------|----|-------|
|                                      | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |    |        |    |       |
| Provision (benefit) for income taxes | \$                 | 1               | \$               | 2               | \$ | 1      | \$ | (725) |
| Effective tax rate                   |                    | (0.1)%          |                  | (0.1)%          |    | (0.0)% |    | 9.5%  |

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 July 2, 2011 and January 1, 2011. Accordingly, no benefit has been recognized for net deferred tax assets, including net operating losses that cannot be realized currently via carryback to periods of taxable income.

During the six months ended July 3, 2010, the Company carried back approximately \$1.7 million of gross net operating losses under the Worker, Homeownership, and Business Act and received a federal income tax refund of approximately \$0.7 million.

The Company had unrecognized tax benefits at July 2, 2011 and January 1, 2011 of approximately \$0.1 million that, if recognized, would affect the Company's annual effective tax rate.

## **Note 9 Commitments and Contingencies**

### *Patent Claims*

In May 2008, the Company initiated discussions with Google, Inc. ( Google ) regarding the Company's claim that Google has infringed on a U.S. patent owned by the Company, U.S. Patent No. 7,289,386 ( the 386 patent ), which relates generally to rank multiplication in memory modules. On August 29, 2008, Google filed a declaratory judgment lawsuit against the Company in the U.S. District Court for the Northern District of California, seeking a declaration that Google did not infringe the 386 patent and that the 386 patent is invalid. Google is not seeking any monetary damages. On November 18, 2008, the Company filed a counterclaim for infringement of the 386 patent by Google. Claim construction proceedings were held on November 14, 2009, and the Company prevailed on every disputed claim construction issue. On June 1, 2010, the Company filed a motion for summary judgment of patent infringement and a motion for summary judgment to dismiss Google's affirmative defenses based on Netlist's activities in the JEDEC standard-setting organization. The hearings for these motions have been postponed indefinitely by the Court. On September 1, 2010, the United States Patent and Trademark Office ( USPTO ) granted Google's request for reexamination of the 386 patent. On September 14, 2010, the Court granted Google's request to stay the litigation pending the conclusion of the reexamination by the USPTO. On October 20, 2010, Smart Modular, Inc. ( SMOD ) filed a request for reexamination of the 386 patent with the USPTO. In January 2011, the USPTO granted SMOD's request for reexamination. The two reexaminations requested by Google and SMOD were merged by the USPTO into a single proceeding on March 3, 2011 and a Non-Final Action was issued by the USPTO on April 6, 2011. The Company filed its response to the Non-Final Action on July 6, 2011 and intends to vigorously pursue its infringement claims against Google and to continue to vigorously defend its patent rights in the USPTO.

On September 22, 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 suit alleges that Inphi is contributorily infringing and actively inducing the infringement of a U.S. patent owned by the Company, U.S. Patent No. 7,532,537 ( the 537 patent ), which relates generally to memory modules with load isolation and memory domain translation capabilities. The Company is seeking damages and injunctive relief based on Inphi's use of its patented technology. On December 22, 2009, the Company filed an Amended Complaint against Inphi asserting claims of patent infringement based on two additional patents, U.S. Patent No. 7,619,912 ( the 912 patent ), which is related to the 386 patent and relates generally to rank multiplication, 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. Inphi has denied infringement and has asserted that the patents-in-suit are invalid. On April 19, 2010, Inphi filed requests for reexamination of the three patents-in-suit, and on April 21, 2010, Inphi filed a paper with the USPTO intended to provoke an interference proceeding on the three patents-in-suit. Inphi then filed a motion to stay the lawsuit, which was granted on May 18, 2010. On September 1, 2010, in the reexamination of the 912 patent, the USPTO confirmed the patentability of all fifty-one claims of the 912 patent.

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On December 4, 2009, the Company filed a patent infringement lawsuit against Google in the U.S. District Court for the Northern District of California, seeking damages and injunctive relief based on Google's infringement of the '912 patent. On February 11, 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 Netlist's activities in the JEDEC standard-setting organization. The counterclaim seeks unspecified compensatory damages. On October 20 and October 21, 2010, respectively, SMOD and Google each filed requests for reexamination of the '912 patent, which were each granted in January 2011. On January 26, 2011, the Court granted the parties' joint request to stay the patent infringement lawsuit against Google until the completion of the reexamination proceedings. On February 28, 2011, the USPTO merged the latter two reexaminations and the Inphi reexamination into a single proceeding. A Non-Final Action in the merged reexamination proceeding dated April 4, 2011 stated that the USPTO rejected claims 1-20 and 22-51 and confirmed the patentability of claim 21 of the '912 patent. The Company filed its response to the Non-Final Action on July 5, 2011 and intends to vigorously pursue its infringement claims against Inphi and to continue to vigorously defend its patent rights in the USPTO.

With regard to the 537 patent, Inphi's request for reexamination was granted and a Non-Final Action was issued on September 8, 2010 by the USPTO. The Company filed its response on October 8, 2010, Inphi filed its comments on November 9, 2010, and the USPTO issued an Action Closing Prosecution (ACP) on June 21, 2011. The Company is preparing its response to the ACP and intends to vigorously pursue its infringement claims against Inphi and to continue to vigorously defend its patent rights in the USPTO.

With regard to the 274 patent, Inphi's request for reexamination was granted on August 27, 2010. To date, there have not been further developments in the USPTO regarding this reexamination.

On November 30, 2009, Inphi filed a patent infringement lawsuit against the Company in the U.S. District Court for the Central District of California alleging infringement of two Inphi patents generally related to memory module output buffers. On April 18, 2011 the Court dismissed the entire case without prejudice pursuant to a joint stipulation filed by Inphi and the Company under which each party agreed to bear its own costs and attorney's fees. The case is now closed.

On March 24, 2010, Ring Technologies Enterprises filed a patent infringement lawsuit in the U.S. District Court for the Eastern District of Texas against Dell and its suppliers. The suit alleged that the Company and forty-two (42) other defendants infringed on its U.S. Patent No. 6,879,526. On July 18, 2011 the Court dismissed all claims in this action against the Company, without prejudice, with each party to bear its own costs, expenses and attorney's fees. The case against the Company is now closed.

#### *Other Contingent Obligations*

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under 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.

#### *Commitment to Purchase Component Inventory*

In September, 2010, the Company entered into a \$2.5 million commitment to purchase ASIC devices for use in certain of its high-performance memory modules that are in the evaluation process with OEM and end-user customers, providing a \$1.1 million letter of credit to secure payment for the purchase commitment. At January 1, 2011, the Company had made a prepayment of \$0.7 million as additional security for the commitment. The prepayment is included in prepaid expenses and other current assets in the accompanying condensed consolidated balance sheet. As of July 2, 2011, the Company had received all ASIC devices under the purchase commitment, with the prepayment applied to the purchase obligation. The letter of credit issued to the vendor expired in April 2011.

**Note 10 Stockholders Equity**

*Common Stock*

During the six months ended July 2, 2011, the Company cancelled 19,730 shares of common stock valued at approximately \$47,000 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.

*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 July 2, 2011, the Company was authorized to issue a maximum of 4,205,566 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 July 2, 2011, the Company had 113,429 shares available for grant under the 2006 Plan. At July 2, 2011, an additional 180,000 shares were reserved for issuance upon exercise of inducement grants. Options granted under the 2000 Plan, the 2006 Plan and outside the equity incentive plans primarily vest at a rate of at least 25% per year over four years and expire 10 years from the date of grant. Restricted stock awards vest in eight equal increments at intervals of approximately six months from the date of grant.

A summary of the Company's common stock option activity for the six months ended July 2, 2011 is presented below (shares in thousands):

|  | <b>Options Outstanding</b>  |   |
|--|-----------------------------|---|
|  | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> |
| Options outstanding at January 1, 2011 | 4,634                       | \$ 2.57   |
| Options granted                        | 1,388                       | 2.23  |
| Options exercised                      | (90)                        | 0.45  |
| Options cancelled                      | (118)                       | 3.96  |
| Options outstanding at July 2, 2011    | 5,814                       | \$ 2.51   |

The intrinsic value of options exercised in the six months ended July 2, 2011 was \$0.2 million.

A summary of the Company's restricted stock awards as of and for the six months ended July 2, 2011 is presented below (shares in thousands):

|  | <b>Restricted Stock Outstanding</b> |  |
|--|-------------------------------------|--|
|  | <b>Number of<br/>Shares</b>         | <b>Weighted-<br/>Average<br/>Grant-Date<br/>Fair Value<br/>per Share</b> |
| Balance outstanding at January 1, 2011 | 426                                 | \$ 3.46  |
| Restricted stock forfeited             | (10)                                | 3.26   |
| Restricted stock vested                | (60)                                | 3.46   |
| Balance outstanding at July 2, 2011    | 356                                 | \$ 3.47  |



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

|  | Six Months Ended |                 |
|--|------------------|-----------------|
|  | July 2,<br>2011  | July 3,<br>2010 |
| Expected term (in years)                         | 6.0              | 5.5             |
| Expected volatility                              | 136%             | 146%            |
| Risk-free interest rate                          | 2.20%            | 2.43%           |
| Expected dividends                               |                  |                 |
| Weighted-average grant date fair value per share | \$ 2.28          | \$ 3.30         |

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 weighted-average fair value per share of the restricted stock granted in the six months ended July 3, 2010 was \$3.48, calculated based on the fair market value of the Company's common stock on the respective grant dates. There was no restricted stock granted in the six month period ended July 2, 2011.

At July 2, 2011, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2011 through fiscal 2014 related to unvested common stock options and restricted stock awards is approximately \$4.3 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 3.1 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.

### Note 11 Segment and Geographic Information

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

At July 2, 2011 and January 1, 2011, approximately \$1.9 million and \$2.3 million, respectively, of the Company's net long-lived assets were located in the PRC.

### Note 12 Subsequent Event

On August 10, 2011, the Company and Silicon Valley Bank amended the Credit Agreement to reset the financial covenants with respect to the Company's liquidity and tangible net worth.



## 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 January 1, 2011 and subsequent reports on Form 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 continuing development, qualification and volume production of EXPRESSvault, NVvault and HyperCloud; the rapidly-changing nature of technology; risks associated with intellectual property, including the costs and unpredictability of litigation over infringement of our intellectual property and the possibility of our patents being reexamined by the USPTO; volatility in the pricing of DRAM ICs and NAND; changes in and uncertainty of customer acceptance of, and demand for, our existing products and products under development, including uncertainty of and/or delays in product orders and product qualifications; delays in our and our customers' product releases and development; introductions of new products by competitors; changes in end-user demand for technology solutions; our ability to attract and retain skilled personnel; our reliance on suppliers of critical components and vendors in the supply chain; fluctuations in the market price of critical components; evolving industry standards; and the political and regulatory environment in the PRC. Other risks and uncertainties are described under the heading Risk Factors in Part II, Item IA of this Quarterly Report on Form 10-Q, and similar discussions in our other SEC filings. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.*

### Overview

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

### Products

In November 2009, we introduced HyperCloud DDR3 memory technology. HyperCloud utilizes an ASIC chipset that incorporates Netlist patented rank multiplication technology that increases memory capacity and load reduction functionality that increases memory bandwidth. We expect that this technology 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

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computing. HyperCloud memory is being evaluated by several of our OEM customers for use in their server products. HyperCloud is interoperable with JEDEC standard DDR3 memory modules. Our HyperCloud products are designed to allow for installation in servers without the need for a BIOS change. As such, their anticipated sales launch is not dependent on the design plans or product cycle of our OEM customers. However, we have experienced a longer qualification cycle than anticipated.

In February 2010, we announced general availability of NVvault™ battery-free, a non-volatile cache memory subsystem targeting RAID storage applications. NVvault™ battery-free provides server and storage OEMs a solution for enhanced datacenter fault recovery. Unlike our traditional battery-powered fault tolerant cache product which relied solely on batteries to power the cache, NVvault™ battery-free utilizes a combination of DRAM for high throughput performance and flash for extended data retention. The introduction of NVvault™ battery-free, as well as the launch of the current version of the battery-powered module in connection with Dell introduction of the PERC 7 line of servers in December 2009, has resulted in RAID controller subsystem revenues of \$17.2 million, or 61% of total revenues for the six months ended July 2, 2011, including \$10.4 million of NVvault . This compares favorably with \$7.0 million in RAID controller subsystem revenues, or 41% of total revenues for the six months ended July 3, 2010. Although revenues in 2011 and 2010 have been primarily for shipments to Dell, in the fourth quarter of 2010 we qualified NVvault™ battery-free with other OEMs, and continue to pursue further qualifications. We are also pursuing end-user opportunities with the introduction of EXPRESSvault™ in March 2011.

The remainder of our revenues arose primarily from OEM sales of custom memory modules, the majority of which were 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 custom modules have declined as a result of certain of our OEM product placements nearing the end of their product life. The reversal of this trend is dependent on our ability to qualify our memory modules on new platforms as current platforms reach the end of their life cycles, and on the state of the global economy.

Consistent with the concentrated nature of the OEM customer base in our target markets, a small number of large customers have historically accounted for a significant portion of our net sales. One customer represented approximately 67% of our net sales for the six months ended July 2, 2011. Two customers represented approximately 44% and 32%, respectively, of our net sales for the six months ended July 3, 2010.

## Key Business Metrics

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

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

*Cost of Sales.* Our cost of sales includes the cost of materials, manufacturing costs, depreciation and amortization of equipment, inventory valuation provisions, stock-based compensation, and occupancy costs and other allocated fixed costs. The DRAM ICs and NAND incorporated into our products constitute a significant portion of our cost of sales, and thus our cost of sales will fluctuate based on the current price of

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DRAM ICs and NAND. We attempt to pass through such DRAM IC and NAND flash memory cost fluctuations to our customers by frequently renegotiating pricing prior to the placement of their purchase orders. However, the sales prices of our memory subsystems can also fluctuate due to competitive situations unrelated to the pricing of DRAM ICs and NAND, which affects gross margins. The gross margin on our sales of excess component DRAM IC and NAND inventory is much lower than the gross margin on our sales of our memory subsystems. As a result, fluctuations in DRAM IC and NAND inventory sales as a percentage of our overall sales could impact our overall gross margin. We assess the valuation of our inventories on a quarterly basis and record a provision to cost of sales as necessary to reduce inventories to the lower of cost or net realizable value.

*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. 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. As we continue to service existing and establish new customers, we anticipate that our sales and marketing expenses will increase.

#### **Critical Accounting Policies**

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

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

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

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

*Fair Value of Financial Instruments.* Our financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities and short-term corporate bonds, the fair value of our cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 inputs. The fair value of our auction rate securities is determined based on Level 3 inputs. We recognize transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. We believe that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

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

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

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

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

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

*Warranty Reserve.* We offer product warranties generally ranging from one to three years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during the warranty period at no cost to the customer. Warranties are not offered on sales of excess inventory. Our estimates for warranty-related costs are recorded at the time of sale based on historical and estimated future product return rates and expected repair or replacement costs. While such costs have

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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.



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

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

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

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

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

*Income Taxes.* Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements, calculated at enacted tax rates for expected periods of realization. We regularly review our deferred tax assets for recoverability and establish a valuation allowance, when determined necessary, based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. Because we have operated at a loss for an extended period of time, we did not recognize deferred tax assets related to losses incurred in 2011. Benefits recognized in 2010 were limited to those made available as a one-time carry-back through economic recovery legislation. 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.

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

## Results of Operations

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

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2011    | July 3,<br>2010 | July 2,<br>2011  | July 3,<br>2010 |
| Net sales  | 100%               | 100%            | 100%             | 100%            |
| Cost of sales                                    | 69                 | 80              | 69               | 79              |
| Gross profit                                     | 31                 | 20              | 31               | 21              |
| Operating expenses:                              |                    |                 |                  |                 |
| Research and development                         | 23                 | 34              | 27               | 36              |
| Selling, general and administrative              | 16                 | 28              | 20               | 30              |
| Total operating expenses                         | 40                 | 62              | 46               | 66              |
| Operating loss                                   | (9)                | (43)            | (15)             | (45)            |
| Other (expense) income:                          |                    |                 |                  |                 |
| Interest (expense) income, net                   |                    |                 |                  | 1               |
| Other (expense) income, net                      |                    |                 |                  | 1               |
| Total other (expense) income, net                |                    |                 |                  | 1               |
| Loss before provision (benefit) for income taxes | (9)                | (43)            | (16)             | (44)            |
| Provision (benefit) for income taxes             |                    |                 |                  | (4)             |
| Net loss   | (9)%               | (43)%           | (15)%            | (40)%           |

*Three and Six Months Ended July 2, 2011 Compared to Three and Six Months Ended July 3, 2010**Net Sales, Cost of Sales and Gross Profit*

The following table presents net sales, cost of sales and gross profit for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

|               | Three Months Ended |                 | Change   | %<br>Change |
|---------------|--------------------|-----------------|----------|-------------|
|               | July 2,<br>2011    | July 3,<br>2010 |          |             |
| Net sales     | \$ 16,001          | \$ 9,304        | \$ 6,697 | 72%         |
| Cost of sales | 11,064             | 7,486           | 3,578    | 48%         |
| Gross profit  | \$ 4,937           | \$ 1,818        | \$ 3,119 | 172%        |
| Gross margin  | 31%                | 20%             | 11%      |             |

|               | Six Months Ended |                 | Change    | %<br>Change |
|---------------|------------------|-----------------|-----------|-------------|
|               | July 2,<br>2011  | July 3,<br>2010 |           |             |
| Net sales     | \$ 28,001        | \$ 17,194       | \$ 10,807 | 63%         |
| Cost of sales | 19,260           | 13,558          | 5,702     | 42%         |
| Gross profit  | \$ 8,741         | \$ 3,636        | \$ 5,105  | 140%        |
| Gross margin  | 31%              | 21%             | 10%       |             |

*Net Sales.* The increase in net sales for the three months ended July 2, 2011 as compared with the three months ended July 3, 2010 resulted primarily from increases of approximately (i) \$5.5 million in sales of NVvault non-volatile cache systems used in RAID controller subsystems, including \$4.3 million from NVvault battery-free, the flash-based cache system that became generally available in 2010, and (ii) \$1.0 million in sales of flash memory products, resulting from existing and new customer qualifications.

The increase in net sales for the six months ended July 2, 2011 as compared with the six months ended July 3, 2010 resulted from increases of approximately (i) \$10.2 million in sales of NVvault non-volatile cache systems used in RAID controller subsystems, including \$7.8 million from NVvault battery-free, the flash-based cache system, and (ii) \$1.3 million in sales of flash memory products, offset by a decrease of \$1.7 million in sales of memory modules used in industrial applications as one customer slowed production as a result of its product nearing the end of its life cycle.

*Gross Profit and Gross Margin.* The overall improvements in gross profit are due to increased sales and manufacturing volume, as well as a shift in sales toward higher margin products. Gross profit for the three months ended July 2, 2011 as compared to the three months ended July 3, 2010 increased due to the 72% increase in net sales between the two periods, resulting in variable cost profits earned on each unit sold, as well as an improved ability to absorb fixed manufacturing costs. These volume-based improvements were augmented by decreased DRAM prices, which positively affected margins in some product categories. Gross profits for the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 were impacted by the same trends, including a 63% increase in net sales between the two periods.



**Research and Development.**

The following table presents research and development expenses for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

|                          | <b>Three Months Ended</b> |                         |               |                     |
|--------------------------|---------------------------|-------------------------|---------------|---------------------|
|                          | <b>July 2,<br/>2011</b>   | <b>July 3,<br/>2010</b> | <b>Change</b> | <b>%<br/>Change</b> |
| Research and development | \$ 3,755                  | \$ 3,190                | \$ 565        | 18%                 |

|                          | <b>Six Months Ended</b> |                         |               |                     |
|--------------------------|-------------------------|-------------------------|---------------|---------------------|
|                          | <b>July 2,<br/>2011</b> | <b>July 3,<br/>2010</b> | <b>Change</b> | <b>%<br/>Change</b> |
| Research and development | \$ 7,439                | \$ 6,198                | \$ 1,241      | 20%                 |

The increase in research and development expense in the three months ended July 2, 2011 as compared to the three months ended July 3, 2010 resulted primarily from increases of (i) \$0.6 million in engineering expenses as a result of an increase in both internal engineering headcount and outside contractors engaged in new product development activities, (ii) \$0.2 million in material expenses related to product builds and testing, primarily related to our HyperCloud and NVvault products, partially offset by a decrease of \$0.2 million in legal and professional fees due to deferral of certain patent protection court cases while the Company responds to reexamination requests at the USPTO.

The increase in research and development expense in the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 resulted primarily from increases of (i) \$1.2 million in internal engineering and headcount and (ii) \$0.4 million in material expenses related to product builds and testing, partially offset by a decrease of \$0.4 million in legal and professional fees, all impacted by the same trends noted in the comparison for the second quarter.

**Selling, General and Administrative.**

The following table presents selling, general and administrative expenses for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

|                                     | <b>Three Months Ended</b> |                         |               |                     |
|-------------------------------------|---------------------------|-------------------------|---------------|---------------------|
|                                     | <b>July 2,<br/>2011</b>   | <b>July 3,<br/>2010</b> | <b>Change</b> | <b>%<br/>Change</b> |
| Selling, general and administrative | \$ 2,583                  | \$ 2,607                | \$ (24)       | (1)%                |

|  | <b>Six Months Ended</b> |                |  |
|--|-------------------------|----------------|--|
|  | <b>July 2,</b>          | <b>July 3,</b> |  |

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|                                     | 2011     | 2010     | Change | Change |
|-------------------------------------|----------|----------|--------|--------|
| Selling, general and administrative | \$ 5,500 | \$ 5,177 | \$ 323 | 6%     |

Selling, general and administrative expense was flattish for the three months ended July 2, 2011 as compared to the three months ended July 3, 2010, as we improve operating efficiency through leveraging our selling and administrative expenditures.

The increase in selling, general and administrative expense in the six months ended July 2, 2011 as compared to the six months ended July 3, 2010 resulted primarily from increases of \$0.5 million in product sample cost as a result of activities related to the OEM qualification process for HyperCloud and NVvault NV, offset by a decrease of \$0.2 million in personnel-related expenses, primarily due to lower facilities cost.

**Other (Expense) Income.**

The following table presents other (expense) income for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

|                                   | Three Months Ended |                 | Change   | %<br>Change |
|-----------------------------------|--------------------|-----------------|----------|-------------|
|                                   | July 2,<br>2011    | July 3,<br>2010 |          |             |
| Interest (expense) income, net    | \$ (50)            | \$ 3            | \$ (53)  | (1,767)%    |
| Other (expense) income, net       | (59)               | 4               | (63)     | (1,575)%    |
| Total other (expense) income, net | \$ (109)           | \$ 7            | \$ (116) | (1,657)%    |

|                                   | Six Months Ended |                 | Change   | %<br>Change |
|-----------------------------------|------------------|-----------------|----------|-------------|
|                                   | July 2,<br>2011  | July 3,<br>2010 |          |             |
| Interest (expense) income, net    | \$ (75)          | \$ 4            | \$ (79)  | (1,975)%    |
| Other (expense) income, net       | (59)             | 71              | (130)    | (183)%      |
| Total other (expense) income, net | \$ (134)         | \$ 75           | \$ (209) | (279)%      |

Net interest (expense) income for the three and six months ended July 2, 2011 and July 3, 2010 was comprised of nominal interest income, offset by nominal interest expense. The increase in interest expense for the three months ended July 2, 2011 compared with the three months ended July 3, 2010 was the result of our term loans, which were originated in September, 2010 and May 2011.

Other expense, net, for the three and six months ended July 2, 2011 was primarily comprised of a realized loss of \$59,000 from the sale of an auction rate security that was purchased in 2008. Illiquidity in the market for auction rate securities had resulted in unrealized losses on two securities that we owned. The unrealized loss was recorded as a component of other comprehensive loss through the date of disposal. We were able to liquidate one of the securities at approximately its book value as a result of a tender request from the issuer. We continue to own one auction rate security which has been marked to its fair value through other comprehensive loss. Other income, net, for the six months ended July 3, 2010 was primarily comprised of cash proceeds from the early termination of a sublease of our headquarters facility.

**Benefit of Income Taxes.**

The following table presents the benefit of income taxes for the three and six months ended July 2, 2011 and July 3, 2010 (in thousands, except percentages):

|  | Three Months Ended |                 | Change | %<br>Change |
|--|--------------------|-----------------|--------|-------------|
|  | July 2,<br>2011    | July 3,<br>2010 |        |             |



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|                                      |    |   |    |   |    |     |       |
|--------------------------------------|----|---|----|---|----|-----|-------|
| Provision (benefit) for income taxes | \$ | 1 | \$ | 2 | \$ | (1) | (50)% |
|--------------------------------------|----|---|----|---|----|-----|-------|

|                                      | Six Months Ended |                 |        |       |             |     |        |
|--------------------------------------|------------------|-----------------|--------|-------|-------------|-----|--------|
|                                      | July 2,<br>2011  | July 3,<br>2010 | Change |       | %<br>Change |     |        |
| Provision (benefit) for income taxes | \$               | 1               | \$     | (725) | \$          | 726 | (100)% |

We did not record a benefit of income taxes for the three months ended July 2, 2011 and July 3, 2010 and the six months ended July 2, 2011, as operating losses generated were fully reserved. During the six months ended July 3, 2010, we carried back approximately \$1.7 million of gross net operating losses under the Worker, Homeownership, and Business Act and recorded a tax benefit and income tax receivable of approximately \$0.7 million, which was received in April 2010.

**Liquidity and Capital Resources**

Since our inception, we have financed our operations primarily through issuances of equity, debt, and cash generated from operations. We have also funded our operations with a revolving line of credit under our bank credit facility, from capitalized lease obligations and from the sale and leaseback of our domestic manufacturing facility.

**Working Capital and Cash and Marketable Securities**

The following table presents working capital, cash and cash equivalents and investments in marketable securities (in thousands):

|                                     | July 2,<br>2011 | January 1,<br>2011 |
|-------------------------------------|-----------------|--------------------|
| Working Capital                     | \$ 16,702       | \$ 17,691          |
| Cash and cash equivalents(1)        | \$ 11,690       | \$ 14,210          |
| Short-term marketable securities(1) |                 | 824                |
| Long-term marketable securities     | 456             | 890                |
|                                     | \$ 12,146       | \$ 15,924          |

(1) Included in working capital

Our working capital decreased in the six months ended July 2, 2011 primarily as a result of our net loss. Additionally, we experienced increases in certain operating liabilities, offset by increases in certain operating assets resulting from our increase in sales and inventory acquired in satisfaction of our ASIC device purchase commitment.

**Cash Provided by and Used in the Six Months Ended July 2, 2011 and July 3, 2010**

The following table summarizes our cash flows for the periods indicated (in thousands):

|  | July 2,<br>2011 | Six Months Ended<br>July 3,<br>2010 |
|--|-----------------|-------------------------------------|
| <b>Net cash provided by (used in):</b>               |                 |                                     |
| Operating activities                                 | \$ (5,703)      | \$ (7,530)                          |
| Investing activities                                 | 1,022           | (1,662)                             |
| Financing activities                                 | 2,161           | 16,243                              |
| Net increase (decrease) in cash and cash equivalents | \$ (2,520)      | \$ 7,051                            |

*Operating Activities.* Net cash used in operating activities for the six months ended July 2, 2011 was primarily a result of (i) net loss of approximately \$4.3 million and (ii) cash used by changes in operating assets and liabilities of approximately \$3.4 million, partially offset by approximately \$2.0 million in net non-cash operating expenses, primarily consisting of depreciation and amortization and stock-based compensation expense. Net cash used in operating activities for the six months ended July 3, 2010 was primarily a result of (i) net loss of approximately \$6.9 million and (ii) cash used by changes in operating assets and liabilities of approximately \$2.5 million, partially offset by approximately \$1.9 million in net non-cash operating expenses, primarily comprising depreciation and amortization and stock-based compensation.

Accounts receivable increased approximately \$2.9 million during the six months ended July 2, 2011 primarily as a result of the increase in our net sales during the period compared with the six months ended January 1, 2011. During the same period, we were successful in collecting cash from sales to our customers substantially in accordance with our standard payment terms with those customers. Inventories increased approximately \$6.9 million during the six months ended July 2, 2011 as we continued the qualification process and prepared for production of our HyperCloud products. Specifically, we received \$2.5 million under a purchase commitment for ASIC devices. Additionally, we purchased inventory to secure supply in the wake of the earthquake in Japan, to secure volume discounts and to support production during customer re-qualifications necessary as a result of vendor component product transition. During the six months ended July 2, 2011, we were able to partially fund the growth in our accounts receivable and inventory through an increase in accounts payable of \$5.2 million, primarily from component vendors.

*Investing Activities.* Net cash provided by investing activities for the six months ended July 2, 2011 was primarily the result of the sale of \$1.3 million in marketable securities, partially offset by the acquisition of \$0.2 million in property and equipment. Net cash used in investing activities for the six months ended July 3, 2010 was primarily the result of purchases of \$2.4 million of investments in marketable securities, offset by sales of \$1.1 million. Additionally, we acquired \$0.4 million in property and equipment.

*Financing Activities.* Net cash provided by financing activities for the six months ended July 2, 2011 was a result of net proceeds of \$2.9 million from a new bank term loan, offset by repayment of bank debt, capital leases and other notes payable of \$0.8 million. Net cash provided by financing activities for the six months ended July 3, 2010 was a result of the net proceeds of \$16.2 million from the sale of 4,594,250 shares of our common stock in a registered public offering.

### *Capital Resources*

On October 31, 2009, we entered into a credit agreement with Silicon Valley Bank, which was amended on March 24, 2010, June 30, 2010, September 30, 2010, May 11, 2011 and August 10, 2011. Currently, the credit agreement provides for a line of credit pursuant to which we can borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) \$10.0 million. We have the option to increase credit availability to \$15.0 million at any time through the maturity date of September 30, 2013, subject to the conditions of the credit agreement.

The credit agreement contains an overall sublimit of \$10.0 million to collateralize our contingent obligations under letters of credit, foreign exchange contracts and cash management services. Amounts outstanding under the overall sublimit reduce the amount available pursuant to the credit agreement. At July 2, 2011, letters of credit in the amount of \$2.8 million were outstanding. The letters of credit expire on various dates through October 31, 2011.

Interest on the line of credit is payable monthly at either (i) prime plus 1.25%, as long as we maintain \$8.5 million in revolving credit availability plus unrestricted cash on deposit with the bank, or (ii) prime plus 2.25%. Additionally, the credit agreement requires payments for an unused line, as well as anniversary and early termination fees, as applicable.

The following table presents details of outstanding borrowings and availability under our line of credit (in thousands):

|  | <b>July 2,<br/>2011</b> | <b>January 1,<br/>2011</b> |
|--|-------------------------|----------------------------|
| Availability under the revolving line of credit                      | \$ 7,200                | \$ 5,100                   |
| Outstanding borrowings on the revolving line of credit               |                         |                            |
| Amounts reserved under credit sublimits                              | (2,800)                 | (2,900)                    |
| Unutilized borrowing availability under the revolving line of credit | \$ 4,400                | \$ 2,200                   |

Outstanding borrowings under the Silicon Valley Bank line of credit did not exceed \$1.0 million at any time during the six months ended July 2, 2011 or the year ended January 1, 2011.

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In addition, in connection with the September 30, 2010 amendment, Silicon Valley Bank extended a \$1.5 million term loan under the credit agreement, which bears interest at a rate of prime plus 1.75%. We are required to make equal monthly principal payments over the 36 month term, which total \$0.5 million annually. In May 2011, Silicon Valley Bank extended an additional \$3.0 million term loan, and extended the term of the existing credit facility through September 2013, which eliminated the potential balloon payment on the first term loan. The second term loan bears interest at a rate of prime plus 2.5%, and is payable in equal installments over the 24 month term of the loan, totaling \$1.5 million annually. As of July 2, 2011, \$3.8 million was outstanding under the term loans.

All obligations under the credit agreement are secured by a first priority lien on our tangible and intangible assets. The only restriction on the use of funds under the revolving line of credit is that we must be in compliance with the covenants of the credit agreement. The credit agreement includes affirmative and negative covenants, including financial covenants

with respect to our liquidity and tangible net worth. As of July 2, 2011, we were in compliance with all financial covenants and expect to maintain compliance for the foreseeable future. However, we have in the past been in violation of one or more covenants of other credit agreements, and we could violate one or more covenants in the future. If we were to be in violation of covenants under our credit agreement, our lender could choose to accelerate payment on all outstanding loan balances and we could lose vendor credit should the letters of credit issued under the credit agreement become unavailable. If that were to occur, we may be unable to quickly obtain equivalent or suitable replacement financing. If we were not able to secure alternative sources of funding, such acceleration would have a material adverse impact on our financial condition.

We have in the past utilized equipment leasing arrangements to finance certain capital expenditures. Equipment leases continue to be a financing alternative that we expect to pursue in the future.

We believe our existing cash balances, borrowing availability under our bank credit facility, and the cash expected to be generated from operations, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including our levels of net sales, the timing and extent of expenditures to support research and development activities, the expansion of manufacturing capacity both domestically and internationally and the continued market acceptance of our products. We could be required, or may choose, to seek additional funding through public or private equity or debt financings. In addition, in connection with any future acquisitions, we may require additional funding which may be provided in the form of additional debt or equity financing or a combination thereof. These additional funds may not be available on terms acceptable to us, or at all.

#### *New Accounting Pronouncements*

In May 2011, the FASB issued Accounting Standards Update ( ASU ) No. 2011-4, Fair Value Measurement ( ASU 11-4 ). ASU 11-4 amends existing guidance to achieve convergence in measurement and disclosure between U.S. Generally Accepted Accounting Standards ( GAAP ) and International Financial Reporting Standards ( IFRS ). ASU 11-4 is effective for fiscal year 2012. We are currently evaluating the impact that ASU 11-4 will have on our consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-5, Comprehensive Income ( ASU 11-5 ). ASU 11-5 amends existing guidance to increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS. ASU 11-5 is effective for fiscal year 2012. We are currently evaluating the impact that ASU 11-4 will have on our consolidated financial statements.

#### *Off-Balance Sheet Arrangements*

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

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

*(a) Evaluation of Disclosure Controls and Procedures.* We carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, ( Exchange Act )) as of the end of our fiscal quarter ended July 2, 2011. Based upon that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer as appropriate to allow timely decisions regarding required disclosure.

*(b) Change in internal controls over financial reporting.* During the fiscal quarter that ended July 2, 2011, there were no changes in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information set forth in the sections entitled Patent Claims under Note 9 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item I of this Report, is incorporated herein by reference.

**Item 1A. Risk Factors**

*You should consider each of the following factors as well as the other information in this Report in evaluating our business and our prospects. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks, and you could lose all or part of your investment. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Report, including our consolidated financial statements and related notes.*

*Risks related to our business*

**We expect a number of factors to cause our operating results to fluctuate on a quarterly and annual basis, which may make it difficult to predict our future performance.**

Our operating results have varied significantly in the past and will continue to fluctuate from quarter-to-quarter or year-to-year in the future due to a variety of factors, many of which are beyond our control. Factors relating to our business that may contribute to these quarterly and annual fluctuations include the following factors, as well as other factors described elsewhere in this Report:

- general economic conditions, including the possibility of a prolonged period of limited economic growth in the U.S. and Europe; disruptions to the credit and financial markets in the U.S., Europe and elsewhere; adverse effects of the ongoing sovereign debt crisis in Europe; the impact of a failure of the U.S. to maintain its debt levels within authorized limits or its credit rating;
- our inability to develop new or enhanced products that achieve customer or market acceptance in a timely manner, including our HyperCloud memory module and our flash-based memory products;
- our failure to maintain the qualification of our products with our current customers or to qualify current and future products with our current or prospective customers in a timely manner or at all;



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- the timing of actual or anticipated introductions of competing products or technologies by us or our competitors, customers or suppliers;
- the loss of, or a significant reduction in sales to, a key customer;
- the cyclical nature of the industry in which we operate;
- a reduction in the demand for our high performance memory subsystems or the systems into which they are incorporated;
- our customers' failure to pay us on a timely basis;
- costs, inefficiencies and supply risks associated with outsourcing portions of the design and the manufacture of integrated circuits;
- our ability to absorb manufacturing overhead if our revenues decline or vary from our projections;
- delays in fulfilling orders for our products or a failure to fulfill orders;
- our ability to procure an adequate supply of key components, particularly DRAM ICs and NAND;

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- dependence on large suppliers who are also competitors and whose manufacturing priorities may not support our production schedules;
- changes in the prices of our products or in the cost of the materials that we use to build our products, including fluctuations in the market price of DRAM ICs and NAND;
- our ability to effectively operate our manufacturing facility in the PRC;
- manufacturing inefficiencies associated with the start-up of new manufacturing operations, new products and initiation of volume production;
- our failure to produce products that meet the quality requirements of our customers;
- disputes regarding intellectual property rights and the possibility of our patents being reexamined by the USPTO;
- the costs and management attention diversion associated with litigation;
- the loss of any of our key personnel;
- changes in regulatory policies or accounting principles;
- our ability to adequately manage or finance internal growth or growth through acquisitions; and
- the effect of our investments and financing arrangements on our liquidity.

Due to the various factors mentioned above, and others, the results of any prior quarterly or annual periods should not be relied upon as an indication of our future operating performance. In one or more future periods, our results of operations may fall below the expectations of securities analysts and investors. In that event, the market price of our common stock would likely decline. In addition, the market price of our common stock may fluctuate or decline regardless of our operating performance.

**We have historically incurred losses and may continue to incur losses.**

Since the inception of our business in 2000, we have only experienced one fiscal year (2006) with profitable results. In order to regain profitability, or to achieve and sustain positive cash flows from operations in the future, we must further reduce operating expenses and/or increase our revenues. Although we have in the past engaged in a series of cost reduction actions, and believe that we could reduce our current level of expenses through elimination or reduction of strategic initiatives, such expense reductions alone may not make us profitable or allow us to sustain profitability if it is achieved. Our ability to achieve profitability will depend on increased revenue growth from, among other things, increased demand for our memory subsystems and related product offerings, as well as our ability to expand into new and emerging markets. We may not be successful in achieving the necessary revenue growth or the expected expense reductions. Moreover, we may be unable to sustain past or expected future expense reductions in subsequent periods. We may not achieve profitability or sustain such profitability, if achieved, on a quarterly or annual basis in the future.

Any failure to achieve profitability could result in increased capital requirements and pressure on our liquidity position. We believe our future capital requirements will depend on many factors, including our levels of net sales, the timing and extent of expenditures to support sales, marketing, research and development activities, the expansion of manufacturing capacity both domestically and internationally and the continued market acceptance of our products. Our capital requirements could result in our having to, or otherwise choosing to, seek additional funding through public or private equity offerings or debt financings. Such funding may not be available on terms acceptable to us, or at all, either of which could result in our inability to meet certain of our financial obligations and other related commitments.

**Our revenues and results of operations are substantially dependent on NVvault .**

For the six months ended July 2, 2011 our NVvault non-volatile cache systems used in RAID controller subsystems, including our NVvault battery-free, the flash-based cache system, accounted for 61% of total revenues. We expect a significant portion of our revenues in 2011 to continue to come from sales of NVvault . Accordingly, our future operating results will depend on the demand for this product. We cannot assure you that the market will continue to demand NVvault or that we will be successful in marketing any new or enhanced products. If our competitors produce new products that are superior to NVvault in performance or price, demand for our product may decline. A decline in demand for NVvault as a result of competition, technological change, economic conditions, or other factors would reduce sales of NVvault . Any significant reduction in sales of NVvault would significantly reduce our revenues and negatively affect our results of operations.

**We are subject to risks relating to our focus on developing our HyperCloud product and lack of market diversification.**

We have historically derived a substantial portion of our net sales from sales of our high performance memory subsystems for use in the server market. We expect these memory subsystems to continue to account for a significant portion of our net sales in the near term. Continued market acceptance of these products for use in servers is critical to our success.

In an attempt to set our products apart from those of our competitors, we have invested a significant portion of our research and development budget into the design of ASIC devices, including the HyperCloud memory subsystem, introduced in November 2009. This new design and the products it is incorporated into are subject to increased risks as compared to our existing products. For example:

- we 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 HyperCloud memory subsystem or other new products may contain currently undiscovered flaws, the correction of which would result in increased costs and time to market;
- we are dependent on a limited number of suppliers for both the DRAM ICs and the ASIC devices that are essential to the functionality of the HyperCloud memory subsystem, and could experience supply chain disruption as a result of business issues that are specific to our suppliers or the industry as a whole; and
- we will be required to demonstrate the quality and reliability of the HyperCloud memory subsystem or other new products to our customers, and will be required to qualify these new products with our customers, both of which will require a significant investment of time and resources prior to the receipt of any revenue from such customers.

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We have experienced a longer qualification cycle than anticipated with our HyperCloud memory subsystems, and as of July 2, 2011 we have not generated significant HyperCloud product revenues. Further delays or any failure in placing or qualifying this product with our customers would adversely impact our results of operations.

Additionally, if the demand for servers deteriorates or if the demand for our products to be incorporated in servers declines, our operating results would be adversely affected, and we would be forced to diversify our product portfolio and our target markets. We may not be able to achieve this diversification, and our inability to do so may adversely affect our business.

**We may lose our competitive position if we are unable to timely and cost-effectively develop new or enhanced products that meet our customers requirements and achieve market acceptance.**

Our industry is characterized by intense competition, rapid technological change, evolving industry standards and rapid product obsolescence. Evolving industry standards and technological change or new, competitive technologies could render our existing products obsolete. Accordingly, our ability to compete in the future will depend in large part on our ability to identify and develop new or enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements. In order to develop and introduce new or enhanced products, we need to:

- identify and adjust to the changing requirements of our current and potential customers;

- identify and adapt to emerging technological trends and evolving industry standards in our markets;
- design and introduce cost-effective, innovative and performance-enhancing features that differentiate our products from those of our competitors;
- develop relationships with potential suppliers of components required for these new or enhanced products;
- qualify these products for use in our customers' products; and
- develop and maintain effective marketing strategies.

Our product development efforts are costly and inherently risky. It is difficult to foresee changes or developments in technology or anticipate the adoption of new standards. Moreover, once these things are identified, if at all, we will need to hire the appropriate technical personnel or retain third party designers, develop the product, identify and eliminate design flaws, and manufacture the product in production quantities either in-house or through third-party manufacturers. As a result, we may not be able to successfully develop new or enhanced products or we may experience delays in the development and introduction of new or enhanced products. Delays in product development and introduction could result in the loss of, or delays in generating, net sales and the loss of market share, as well as damage to our reputation. Even if we develop new or enhanced products, they may not meet our customers' requirements or gain market acceptance.

**Our customers require that our products undergo a lengthy and expensive qualification process without any assurance of net sales.**

Our prospective customers generally make a significant commitment of resources to test and evaluate our memory subsystems prior to purchasing our products and integrating them into their systems. This extensive qualification process involves rigorous reliability testing and evaluation of our products, which may continue for six months or longer and is often subject to delays. In addition to qualification of specific products, some of our customers may also require us to undergo a technology qualification if our product designs incorporate innovative technologies that the customer has not previously encountered. Such technology qualifications often take substantially longer than product qualifications and can take over a year to complete. Qualification by a prospective customer does not ensure any sales to that prospective customer. Even after successful qualification and sales of our products to a customer, changes in our products, our manufacturing facilities, our production processes or our component suppliers may require a new qualification process, which may result in additional delays.

In addition, because the qualification process is both product-specific and platform-specific, our existing customers sometimes require us to requalify our products, or to qualify our new products, for use in new platforms or applications. For example, as our OEM customers transition from prior generation DDR2 DRAM architectures to current generation DDR3 DRAM architectures, we must design and qualify new products for use by those customers. In the past, this process of design and qualification has taken up to six months to complete, during which time our net sales to those customers declined significantly. After our products are qualified, it can take several months before the customer begins production and we begin to generate net sales from such customer.

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We must devote substantial resources, including design, engineering, sales, marketing and management efforts, to qualify our products with prospective customers in anticipation of sales. Significant delays in the qualification process, such as those experienced with our HyperCloud product, could result in an inability to keep up with rapid technology change or new, competitive technologies. If we delay or do not succeed in qualifying a product with an existing or prospective customer, we will not be able to sell that product to that customer, which may result in our holding excess and obsolete inventory and harm our operating results and business.

**Sales to a limited number of customers represent a significant portion of our net sales and the loss of, or a significant reduction in sales to, any one of these customers could materially harm our business.**

Sales to certain of our OEM customers have historically represented a substantial majority of our net sales. Approximately 67% of our net sales in the six months ended July 2, 2011 were to one of our customers and approximately 44% and 32% of our net sales in the six months ended July 3, 2010 were to two of our customers. We currently expect that sales to major OEM customers will continue to represent a significant percentage of our net sales for the foreseeable future. We do not have long-term agreements with our OEM customers, or with any other customer. Any one of these customers could decide at any time to discontinue, decrease or delay their purchase of our products. In addition, the prices that these customers pay for our products could change at any time. The loss of any of our OEM customers, or a significant reduction in sales to any of them, could significantly reduce our net sales and adversely affect our operating results.

Our ability to maintain or increase our net sales to our key customers depends on a variety of factors, many of which are beyond our control. These factors include our customers' continued sales of servers and other computing systems that incorporate our memory subsystems and our customers' continued incorporation of our products into their systems. Because of these and other factors, net sales to these customers may not continue and the amount of such net sales may not reach or exceed historical levels in any future period. Because these customers account for a substantial portion of our net sales, the failure of any one of these customers to pay on a timely basis would negatively impact our cash flow. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers.

**A limited number of relatively large potential customers dominate the markets for our products.**

Our target markets are characterized by a limited number of large companies. Consolidation in one or more of our target markets may further increase this industry concentration. As a result, we anticipate that sales of our products will continue to be concentrated among a limited number of large customers in the foreseeable future. We believe that our financial results will depend in significant part on our success in establishing and maintaining relationships with, and effecting substantial sales to, these potential customers. Even if we establish these relationships, our financial results will be largely dependent on these customers' sales and business results.

**If a standardized memory solution which addresses the demands of our customers is developed, our net sales and market share may decline.**

Many of our memory subsystems are specifically designed for our OEM customers' high performance systems. In a drive to reduce costs and assure supply of their memory module demand, our OEM customers may endeavor to design JEDEC standard DRAM modules into their new products. Although we also manufacture JEDEC modules, this trend could reduce the demand for our higher priced customized memory solutions which in turn would have a negative impact on our financial results. In addition, customers deploying custom memory solutions today may in the future choose to adopt a JEDEC standard, and the adoption of a JEDEC standard module instead of a previously custom module might allow new competitors to participate in a share of our customers' memory module business that previously belonged to us.

If our OEM customers were to adopt JEDEC standard modules, our future business may be limited to identifying the next generation of high performance memory demands of OEM customers and developing solutions that addresses such demands. Until fully implemented, this next generation of products may constitute a much smaller market, which may reduce our net sales and market share.

**We may not be able to maintain our competitive position because of the intense competition in our targeted markets.**

We participate in a highly competitive market, and we expect competition to intensify. Many of our competitors have longer operating histories, significantly greater resources and name recognition, a larger base of customers and longer-standing relationships with customers and suppliers than we have. As a result, some of these competitors are able to devote greater resources to the development, promotion and sale of products and are better positioned than we are to influence customer acceptance of their products over our products. These competitors also may be able to respond better to new or emerging technologies or standards and may be able to deliver products with comparable or superior performance at a lower price. For these reasons, we may not be able to compete successfully against these competitors. We also expect to face competition from new and emerging companies that may enter our existing or future markets. These potential competitors may have similar or alternative products which may be less costly or provide additional features.



In addition to the competition we face from DRAM and logic suppliers such as Hynix, Samsung, Micron, Inphi and IDT, some of our OEM customers have their own internal design groups that may develop solutions that compete with ours. These design groups have some advantages over us, including direct access to their respective companies' technical information and technology roadmaps. Our OEM customers also have substantially greater resources, financial and otherwise, than we do, and may have lower cost structures than ours. As a result, they may be able to design and manufacture competitive products more efficiently or inexpensively. If any of these OEM customers are successful in competing against us, our sales could decline, our margins could be negatively impacted and we could lose market share, any or all of which could harm our business and results of operations. Further, some of our significant suppliers are also competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration.

We expect our competitors to continue to improve the performance of their current products, reduce their prices and introduce new or enhanced technologies that may offer greater performance and improved pricing. If we are unable to match or exceed the improvements made by our competitors, our market position would deteriorate and our net sales would decline. In addition, our competitors may develop future generations and enhancements of competitive products that may render our technologies obsolete or uncompetitive.

**Our operating results may be adversely impacted by worldwide economic and political uncertainties and specific conditions in the markets we address, including the cyclical nature of and volatility in the memory market and semiconductor industry.**

Adverse changes in domestic and global economic and political conditions have made it extremely difficult for our customers, our vendors and us to accurately forecast and plan future business activities, and they have caused and could continue to cause U.S. and foreign businesses to slow spending on our products and services, which would further delay and lengthen sales cycles. In addition, sales of our products are dependent upon demand in the computing, networking, communications, printer, storage and industrial markets. These markets have been cyclical and are characterized by wide fluctuations in product supply and demand. These markets have experienced significant downturns, often connected with, or in anticipation of, maturing product cycles, reductions in technology spending and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and the erosion of average selling prices.

We may experience substantial period-to-period fluctuations in future operating results due to factors affecting the computing, networking, communications, printers, storage and industrial markets. A decline or significant shortfall in demand in any one of these markets could have a material adverse effect on the demand for our products. As a result, our sales will likely decline during these periods. In addition, because many of our costs and operating expenses are relatively fixed, if we are unable to control our expenses adequately in response to reduced sales, our gross margins, operating income and cash flow would be negatively impacted.

During challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may be required to increase our allowance for doubtful accounts and our days sales outstanding would be negatively impacted. Furthermore, our vendors may face similar issues gaining access to credit, which may limit their ability to supply components or provide trade credit to us. We cannot predict the timing, strength or duration of any economic slowdown or subsequent economic recovery, worldwide, or in the memory market and related semiconductor industry. If the economy or markets in which we operate do not continue to improve or if conditions worsen, our business, financial condition and results of operations will likely be materially and adversely affected. Additionally, the combination of our lengthy sales cycle coupled with challenging macroeconomic conditions could compound the negative impact on the results of our operations.

**Our lack of a significant backlog of unfilled orders, and the difficulty inherent in forecasting customer demand, makes it difficult to forecast our short-term production requirements to meet that demand, and any failure to optimally calibrate our production capacity and inventory levels to meet customer demand could adversely affect our revenues, gross margins and earnings.**

We make significant decisions regarding the levels of business that we will seek and accept, production schedules, component procurement commitments, personnel needs and other resource requirements, based on our estimates of customer requirements. We do not have long-term purchase agreements with our customers. Instead, our customers often place purchase orders no more than two weeks in advance of their desired delivery date, and these purchase orders generally have no cancellation or rescheduling penalty provisions. The short-term nature of commitments by many of our customers, the fact that our customers may cancel or defer purchase orders for any reason, and the possibility of unexpected changes in demand for our customers' products each reduce our ability to accurately estimate future customer requirements for our products. This fact, combined with the quick turn-around times that apply to each order, makes it difficult to forecast our production needs and allocate production capacity efficiently. We attempt to forecast the demand for the DRAM ICs, NAND, and other components needed to

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manufacture our products. Lead times for components vary significantly and depend on various factors, such as the specific supplier and the demand and supply for a component at a given time.

Our production expense and component purchase levels are based in part on our forecasts of our customers' future product requirements and to a large extent are fixed in the short term. As a result, we likely will be unable to adjust spending on a timely basis to compensate for any unexpected shortfall in those orders. If we overestimate customer demand, we may have excess raw material inventory of DRAM ICs and NAND. If there is a subsequent decline in the prices of DRAM ICs or NAND, the value of our inventory will fall. As a result, we may need to write-down the value of our DRAM IC or NAND inventory, which may result in a significant decrease in our gross margin and financial condition. Also, to the extent that we

manufacture products in anticipation of future demand that does not materialize, or in the event a customer cancels or reduces outstanding orders, we could experience an unanticipated increase in our finished goods inventory. In the past, we have had to write-down inventory due to obsolescence, excess quantities and declines in market value below our costs. Any significant shortfall of customer orders in relation to our expectations could hurt our operating results, cash flows and financial condition.

Also, any rapid increases in production required by our customers could strain our resources and reduce our margins. If we underestimate customer demand, we may not have sufficient inventory of DRAM ICs and NAND on hand to manufacture enough product to meet that demand. We also may not have sufficient manufacturing capacity at any given time to meet our customers' demands for rapid increases in production. These shortages of inventory and capacity will lead to delays in the delivery of our products, and we could forego sales opportunities, lose market share and damage our customer relationships.

**Declines in our average sales prices, driven by volatile prices for DRAM ICs and NAND, among other factors, may result in declines in our revenues and gross profit.**

Our industry is competitive and historically has been characterized by declines in average sales price, based in part on the market price of DRAM ICs and NAND, which have historically constituted a substantial portion of the total cost of our memory subsystems. Our average sales prices may decline due to several factors, including overcapacity in the worldwide supply of DRAM and NAND memory components as a result of worldwide economic conditions, increased manufacturing efficiencies, implementation of new manufacturing processes and expansion of manufacturing capacity by component suppliers.

Once our prices with a customer are negotiated, we are generally unable to revise pricing with that customer until our next regularly scheduled price adjustment. Consequently, we are exposed to the risks associated with the volatility of the price of DRAM ICs and NAND during that period. If the market prices for DRAM ICs and NAND increase, we generally cannot pass the price increases on to our customers for products purchased under an existing purchase order. As a result, our cost of sales could increase and our gross margins could decrease. Alternatively, if there are declines in the price of DRAM ICs and NAND, we may need to reduce our selling prices for subsequent purchase orders, which may result in a decline in our expected net sales.

In addition, since a large percentage of our sales are to a small number of customers that are primarily distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions. If not offset by increases in volume of sales or the sales of newly-developed products with higher margins, decreases in average sales prices would likely have a material adverse effect on our business and operating results.

**We use a small number of custom ASIC, DRAM IC and NAND suppliers and are subject to risks of disruption in the supply of custom ASIC, DRAM ICs and NAND.**

Our ability to fulfill customer orders or produce qualification samples is dependent on a sufficient supply of DRAM ICs and NAND, which are essential components of our memory subsystems. We are also dependent on a sufficient supply of custom ASIC devices to produce our HyperCloud memory modules. There are a relatively small number of suppliers of DRAM ICs and NAND, and we purchase from only a subset of these suppliers. We have no long-term DRAM or NAND supply contracts. Additionally, we could face obstacles in moving production of our ASIC components away from our current design and production partners. Our dependence on a small number of suppliers and the lack of any guaranteed sources of ASIC components, DRAM and NAND supply expose us to several risks, including the inability to obtain an adequate supply of these important components, price increases, delivery delays and poor quality.

Historical declines in customer demand and our revenues caused us to reduce our purchases of DRAM ICs and NAND. Such fluctuations could occur in the future. Should we not maintain sufficient purchase levels with some suppliers, our ability to obtain supplies of raw materials may be impaired due to the practice of some suppliers to allocate their products to customers with the highest regular demand.

From time to time, shortages in DRAM ICs and NAND have required some suppliers to limit the supply of their DRAM ICs and NAND. As a result, we may be unable to obtain the DRAM ICs or NAND necessary to fill customers' orders for our products in a timely manner. If we are unable to obtain a sufficient supply of DRAM ICs or NAND to meet our customers' requirements, these customers may reduce future orders for our products or not purchase our products at all, which would cause our net sales to decline and harm our operating results. In addition, our reputation could be harmed, we may not be able to replace any lost business with new customers, and we may lose market share to our competitors.

Our customers qualify the ASIC components, DRAM ICs and NAND of our suppliers for use in their systems. If one of our suppliers should experience quality control problems, it may be disqualified by one or more of our customers. This would disrupt our supplies of ASIC components, DRAM ICs and NAND and reduce the number of suppliers available to us, and may require that we qualify a new supplier. If our suppliers are unable to produce qualification samples on a timely basis or at all, we could experience delays in the qualification process, which could have a significant impact on our ability to sell that product.

**If the supply of other component materials used to manufacture our products is interrupted, or if our inventory becomes obsolete, our results of operations and financial condition could be adversely affected.**

We use consumables and other components, including PCBs, to manufacture our memory subsystems. We sometimes procure PCBs and other components from single or limited sources to take advantage of volume pricing discounts. Material shortages or transportation problems could interrupt the manufacture of our products from time to time in the future. These delays in manufacturing could adversely affect our results of operations.

Frequent technology changes and the introduction of next-generation products also may result in the obsolescence of other items of inventory, such as our custom-built PCBs, which could reduce our gross margin and adversely affect our operating performance and financial condition. We may not be able to sell some products developed for one customer to another customer because our products are often designed to address specific customer requirements, and even if we are able to sell these products to another customer, our margin on such products may be reduced.

**A prolonged disruption of our manufacturing facility could have a material adverse effect on our business, financial condition and results of operations.**

We maintain a manufacturing facility in the PRC for producing most of our products, which allows us to utilize our materials and processes, protect our intellectual property and develop the technology for manufacturing. A prolonged disruption or material malfunction of, interruption in or the loss of operations at our manufacturing facility, or the failure to maintain a sufficient labor force at such facility, would limit our capacity to meet customer demand and delay new product development until a replacement facility and equipment, if necessary, were found. The replacement of the manufacturing facility could take an extended amount of time before manufacturing operations could restart. The potential delays and costs resulting from these steps could have a material adverse effect on our business, financial condition and results of operations.

**If we are unable to manufacture our products efficiently, our operating results could suffer.**

We must continuously review and improve our manufacturing processes in an effort to maintain satisfactory manufacturing yields and product performance, to lower our costs and to otherwise remain competitive. As we manufacture more complex products, the risk of encountering delays or difficulties increases. The start-up costs associated with implementing new manufacturing technologies, methods and processes, including the purchase of new equipment, and any resulting manufacturing delays and inefficiencies, could negatively impact our results of operations.

If we need to add manufacturing capacity, an expansion of our existing manufacturing facility or establishment of a new facility could be subject to factory audits by our customers. Any delays or unexpected costs resulting from this audit process could adversely affect our net sales and results of operations. In addition, we cannot be certain that we will be able to increase our manufacturing capacity on a timely basis or meet the standards of any applicable factory audits.

**We depend on third-parties to design and manufacture custom components for some of our products.**

Significant customized components, such as ASICs, that are used in some of our products such as HyperCloud are designed and manufactured by third parties. The ability and willingness of such third parties to perform in accordance with their agreements with us is largely outside of our control. If one or more of our design or manufacturing partners fails to perform its obligations in a timely manner or at satisfactory quality levels, our ability to bring products to market or deliver products to our customers, as well as our reputation, could suffer. In the event of any such failures, we may have no readily available alternative source of supply for such products, since, in our experience, the lead time needed to establish a relationship with a new design and/or manufacturing partner is at least 12 months, and the estimated time for our OEM customers to re-qualify our product with components from a new vendor ranges from four to nine months. We cannot assure you that we can redesign, or cause to have redesigned, our customized components to be manufactured by a new manufacturer in a timely manner, nor can we assure you that we will not infringe on the intellectual property of our current design or manufacture partner when we redesign the custom components, or cause such components to be redesigned by a

new manufacturer. A manufacturing disruption experienced by our manufacturing partners, the failure of our manufacturing partners to dedicate adequate resources to the production of our products, the financial instability of our manufacturing or design partners, or any other failure of our design or manufacturing partners to perform according to their agreements with us, would have a material adverse effect on our business, financial condition and results of operations.

We have many other risks due to our dependence on third-party manufacturers, including: reduced control over delivery schedules, quality, manufacturing yields and cost; the potential lack of adequate capacity during periods of excess demand; limited warranties on products supplied to us; and potential misappropriation of our intellectual property. We are dependent on our manufacturing partners to manufacture products with acceptable quality and manufacturing yields, to deliver those products to us on a timely basis and to allocate a portion of their manufacturing capacity sufficient to meet our needs. Although our products are designed using the process design rules of the particular manufacturers, we cannot assure you that our manufacturing partners will be able to achieve or maintain acceptable yields or deliver sufficient quantities of components on a timely basis or at an acceptable cost. Additionally, we cannot assure you that our manufacturing partners will continue to devote adequate resources to produce our products or continue to advance the process design technologies on which the qualification and manufacturing of our products are based.

**If our products do not meet the quality standards of our customers, we may be forced to stop shipments of products until the quality issues are resolved.**

Our customers require our products to meet strict quality standards. Should our products not meet such standards, our customers may discontinue purchases from us until we are able to resolve the quality issues that are causing us to not meet the standards. Such quality holds could have a significant adverse impact on our revenues and operating results.

**If our products are defective or are used in defective systems, we may be subject to warranty, product recalls or product liability claims.**

If our products are defectively manufactured, contain defective components or are used in defective or malfunctioning systems, we could be subject to warranty and product liability claims and product recalls, safety alerts or advisory notices. While we have product liability insurance coverage, it may not be adequate to satisfy claims made against us. We also may be unable to obtain insurance in the future at satisfactory rates or in adequate amounts. Warranty and product liability claims or product recalls, regardless of their ultimate outcome, could have an adverse effect on our business, financial condition and reputation, and on our ability to attract and retain customers. In addition, we may determine that it is in our best interest to accept product returns in circumstances where we are not contractually obligated to do so in order to maintain good relations with our customers. Accepting product returns may negatively impact our operating results.

**If we fail to protect our proprietary rights, our customers or our competitors might gain access to our proprietary designs, processes and technologies, which could adversely affect our operating results.**

We rely on a combination of patent protection, trade secret laws and restrictions on disclosure to protect our intellectual property rights. We have submitted a number of patent applications regarding our proprietary processes and technology. It is not certain when or if any of the claims in the remaining applications will be allowed. To date we have had only eighteen patents issued. We intend to continue filing patent applications with respect to most of the new processes and technologies that we develop. However, patent protection may not be available for some of these processes or technologies.



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It is possible that our efforts to protect our intellectual property rights may not:

- prevent challenges to, or the invalidation or circumvention of, our existing intellectual property rights;
- prevent our competitors from independently developing similar products, duplicating our products or designing around any patents that may be issued to us;
- prevent disputes with third parties regarding ownership of our intellectual property rights;
- prevent disclosure of our trade secrets and know-how to third parties or into the public domain;
- result in valid patents, including international patents, from any of our pending or future applications; or
- otherwise adequately protect our intellectual property rights.

Others may attempt to reverse engineer, copy or otherwise obtain and use our proprietary technologies without our consent. Monitoring the unauthorized use of our technologies is difficult. We cannot be certain that the steps we have taken will prevent the unauthorized use of our technologies. This is particularly true in foreign countries, such as the PRC, where we have established a manufacturing facility and where the laws may not protect our proprietary rights to the same extent as applicable U.S. laws.

If some or all of the claims in our patent applications are not allowed, or if any of our intellectual property protections are limited in scope by a court or circumvented by others, we could face increased competition with regard to our products. Increased competition could significantly harm our business and our operating results.

**We are involved in and expect to continue to be involved in costly legal and administrative proceedings to defend against claims that we infringe the intellectual property rights of others or to enforce or protect our intellectual property rights.**

As is common to the semiconductor industry, we have experienced substantial litigation regarding patent and other intellectual property rights. Lawsuits claiming that we are infringing others' intellectual property rights have been and may in the future be brought against us, and we are currently defending against claims of invalidity in the USPTO. See Note 9 of Notes to Condensed Consolidated Financial Statements, included in Part I, Item I of this Report, for a description of our legal contingencies.

The process of obtaining and protecting patents is inherently uncertain. In addition to the patent issuance process established by law and the procedures of the USPTO, we must comply with JEDEC administrative procedures in protecting our intellectual property within its industry standard setting process. These procedures evolve over time, are subject to variability in their application, and may be inconsistent with each other. Failure to comply with JEDEC's administrative procedures could jeopardize our ability to claim that our patents have been infringed.

By making use of new technologies and entering new markets there is an increased likelihood that others might allege that our products infringe on their intellectual property rights. Litigation is inherently uncertain, and an adverse outcome in existing or any future litigation could subject us to significant liability for damages or invalidate our proprietary rights. An adverse outcome also could force us to take specific actions, including causing us to:

- cease manufacturing and/or selling products, or using certain processes, that are claimed to be infringing a third party's intellectual property;
- pay damages (which in some instances may be three times actual damages), including royalties on past or future sales;
- seek a license from the third party intellectual property owner to use their technology in our products, which license may not be available on reasonable terms, or at all; or
- redesign those products that are claimed to be infringing a third party's intellectual property.

If any adverse ruling in any such matter occurs, any resulting limitations in our ability to market our products, or delays and costs associated with redesigning our products or payments of license fees to third parties, or any failure by us to develop or license a substitute technology on commercially reasonable terms could have a material adverse effect on our business, financial condition and results of operations.

There is a limited pool of experienced technical personnel that we can draw upon to meet our hiring needs. As a result, a number of our existing employees have worked for our existing or potential competitors at some point during their careers, and we anticipate that a number of our future employees will have similar work histories. In the past, some of these competitors have claimed that our employees misappropriated their trade secrets or violated non-competition or non-solicitation agreements. Some of our competitors may threaten or bring legal action involving similar claims against us or our existing employees or make such claims in the future to prevent us from hiring qualified candidates. Lawsuits of this type may be brought, even if there is no merit to the claim, simply as a strategy to drain our financial resources and divert management's attention away from our business.

We also may find it necessary to litigate against others, including our competitors, customers and former employees, to enforce our intellectual property, contractual and commercial rights including, in particular, our trade secrets, as well as to challenge the validity and scope of the proprietary rights of others. We could become subject to counterclaims or countersuits against us as a result of this litigation. Moreover, any legal disputes with customers could cause them to cease buying or using our products or delay their purchase of our products and could substantially damage our relationship with them.

Any litigation, regardless of its outcome, would be time consuming and costly to resolve, divert our management's time and attention and negatively impact our results of operations. We cannot assure you that current or future infringement claims by third parties or claims for indemnification by customers or end users of our products resulting from infringement claims will not be asserted in the future or that such assertions, if proven to be true, will not materially adversely affect our business, financial condition or results of operations.

**We may become involved in non-patent related litigation and administrative proceedings that may materially adversely affect us.**

From time to time, we may become involved in various legal proceedings relating to matters incidental to the ordinary course of our business, including commercial, product liability, employment, class action, whistleblower and other litigation and claims, and governmental and other regulatory investigations and proceedings. Such matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Furthermore, because litigation is inherently unpredictable, there can be no assurance that the results of any of these actions will not have a material adverse effect on our business, results of operations or financial condition.

**If we are required to obtain licenses to use third party intellectual property and we fail to do so, our business could be harmed.**

Although some of the components used in our final products contain the intellectual property of third parties, we believe that our suppliers bear the sole responsibility to obtain any rights and licenses to such third party intellectual property. While we have no knowledge that any third party licensor disputes our belief, we cannot assure you that disputes will not arise in the future. The operation of our business and our ability to compete successfully depends significantly on our continued operation without claims of infringement or demands resulting from such claims, including demands for payments of money in the form of, for example, ongoing licensing fees.

We are also developing products to enter new markets. Similar to our current products, we may use components in these new products that contain the intellectual property of third parties. While we plan to exercise precautions to avoid infringing on the intellectual property rights of third parties, we cannot assure you that disputes will not arise.

If it is determined that we are required to obtain inbound licenses and we fail to obtain licenses, or if such licenses are not available on economically feasible terms, our business, operating results and financial condition could be significantly harmed.

**The flash memory market is constantly evolving and competitive, and we may not have rights to manufacture and sell certain types of products utilizing emerging flash formats, or we may be required to pay a royalty to sell products utilizing these formats.**

The flash-based storage market is constantly undergoing rapid technological change and evolving industry standards. Many consumer devices, such as digital cameras, PDAs and smartphones, are transitioning to emerging flash memory formats, such as the Memory Stick, and xD Picture Card formats, which we do not currently manufacture and do not have rights to manufacture. Although we do not currently serve the consumer flash market, it is possible that certain OEMs may choose to adopt these higher-volume, lower-cost formats. This could result in a decline in demand, on a relative basis, for other products that we manufacture such as CompactFlash, SD and embedded USB drives. If we decide to manufacture flash memory products utilizing emerging formats such as those mentioned, we will be required to secure licenses to give us the right to manufacture such products that may not be available at reasonable rates or at all. If we are not able to supply flash card formats at competitive prices or if we were to have product shortages, our net sales could be adversely impacted and our customers would likely cancel

orders or seek other suppliers to replace us.

**Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.**

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and

litigate these types of indemnification obligations. Although our suppliers may bear responsibility for the intellectual property inherent in the components they sell to us, they may lack the financial ability to stand behind such indemnities. Additionally, it may be costly to enforce any indemnifications that they have granted to us. Accordingly, any indemnification claims by customers could require us to incur significant legal fees and could potentially result in the payment of substantial damages, both of which could result in a material adverse effect on our business and results of operations.

**We depend on a few key employees, and if we lose the services of any of those employees or are unable to hire additional personnel, our business could be harmed.**

To date, we have been highly dependent on the experience, relationships and technical knowledge of certain key employees. We believe that our future success will be dependent on our ability to retain the services of these key employees, develop their successors, reduce our reliance on them, and properly manage the transition of their roles should departures occur. The loss of these key employees could delay the development and introduction of, and negatively impact our ability to sell our products and otherwise harm our business. We do not have employment agreements with any of these key employees other than Chun K. Hong, our President, Chief Executive Officer and Chairman of the Board. In 2010, we obtained Key Man life insurance on Chun K. Hong; however, we do not carry Key Man life insurance on any of our other key employees.

Our future success also depends on our ability to attract, retain and motivate highly skilled engineering, manufacturing, and other technical and sales personnel. Competition for experienced personnel is intense. We may not be successful in attracting new engineers or other technical personnel, or in retaining or motivating our existing personnel. If we are unable to hire and retain engineers with the skills necessary to keep pace with the evolving technologies in our markets, our ability to continue to provide our current products and to develop new or enhanced products will be negatively impacted, which would harm our business. In addition, the shortage of experienced engineers, and other factors, may lead to increased recruiting, relocation and compensation costs for such engineers, which may exceed our expectations and resources. These increased costs may make hiring new engineers difficult, or may increase our operating expenses.

Historically, a significant portion of our workforce has consisted of contract personnel. We invest considerable time and expense in training these contract employees. We may experience high turnover rates in our contract employee workforce, which may require us to expend additional resources in the future. If we convert any of these contract employees into permanent employees, we may have to pay finder's fees to the contract agency.

**We rely on third-party manufacturers' representatives and the failure of these manufacturers' representatives to perform as expected could reduce our future sales.**

We sell some of our products to customers through manufacturers' representatives. We are unable to predict the extent to which our manufacturers' representatives will be successful in marketing and selling our products. Moreover, many of our manufacturers' representatives also market and sell other, potentially competing products. Our representatives may terminate their relationships with us at any time. Our future performance will also depend, in part, on our ability to attract additional manufacturers' representatives that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products. If we cannot retain our current manufacturers' representatives or recruit additional or replacement manufacturers' representatives, our sales and operating results will be harmed.

**The operation of our manufacturing facility in the PRC could expose us to significant risks.**

During 2007, we invested significant time and effort in establishing a manufacturing facility in the PRC and preparing it for full-scale operations. This manufacturing facility became operational in July 2007 and was successfully qualified by certain key customers at that time. As of February 1, 2009, substantially all of our world-wide manufacturing production was being performed in the PRC. Language and cultural differences, as well as the geographic distance from our headquarters in Irvine, California, further compound the difficulties of running a manufacturing operation in the PRC. Our management has limited experience in creating or overseeing foreign operations, and this new facility may divert substantial amounts of their time. We cannot assure you that we will be able to maintain control over product quality, delivery schedules, manufacturing yields and costs as we increase our output. We also have to manage a local workforce that may subject us to uncertainties or regulatory policies and we remain subject to risks related to managing the increased production capacity provided by the facility. Should anticipated demand not materialize, the costs related to having excess capacity would have an adverse impact on our gross margins and operating results.

Changes in the labor laws of the PRC could increase the cost of employing the local workforce. The increased industrialization of the PRC could also increase the price of local labor. Either of these factors could negatively impact the cost savings we currently enjoy from having our manufacturing facility in the PRC.

In the future, some of our net sales may be denominated in Chinese Renminbi ( RMB ). The Chinese government controls the procedures by which RMB is converted into other currencies, and conversion of RMB generally requires government consent. As a result, RMB may not be freely convertible into other currencies at all times. If the Chinese government institutes changes in currency conversion procedures, or imposes restrictions on currency conversion, those actions may negatively impact our operations and could reduce our operating results. In addition, fluctuations in the exchange rate between RMB and U.S. dollars may adversely affect our expenses and results of operations as well as the value of our assets and liabilities. These fluctuations may also adversely affect the comparability of our period-to-period results. If we decide to declare dividends and repatriate funds from our Chinese operations, we will be required to comply with the procedures and regulations of applicable Chinese law. Any changes to these procedures and regulations, or our failure to comply with those procedures and regulations, could prevent us from making dividends and repatriating funds from our Chinese operations, which could adversely affect our financial condition. If we are able to make dividends and repatriate funds from our Chinese operations, these dividends would be subject to U.S. corporate income tax.

The PRC currently provides for favorable tax rates for certain foreign-owned enterprises operating in specified locations in the PRC through 2012. We have established our PRC facility in such a tax-favored location. Should we fail to achieve profitability while favorable tax rates are in effect, or before our loss carryforwards in the PRC expire, it is possible that we would not realize the tax benefits to the extent originally anticipated and this could adversely impact our operating results.

**Economic, political and other risks associated with international sales and operations could adversely affect our net sales.**

Part of our growth strategy involves making sales to foreign corporations and delivering our products to facilities located in foreign countries. To facilitate this process and to meet the long-term projected demand for our products, we have set up a manufacturing facility in the PRC. Selling and manufacturing in foreign countries subjects us to additional risks not present with our domestic operations. We are operating in business and regulatory environments in which we have limited previous experience. We will need to continue to overcome language and cultural barriers to effectively conduct our operations in these environments. In addition, the economies of the PRC and other countries have been highly volatile in the past, resulting in significant fluctuations in local currencies and other instabilities. These instabilities affect a number of our customers and suppliers in addition to our foreign operations and continue to exist or may occur again in the future.

International turmoil and the threat of future terrorist attacks, both domestically and internationally, have contributed to an uncertain political and economic climate, both in the U.S. and globally, and have negatively impacted the worldwide economy. The occurrence of one or more of these instabilities could adversely affect our foreign operations and some of our customers or suppliers, each of which could adversely affect our net sales. In addition, our failure to meet applicable regulatory requirements or overcome cultural barriers could result in production delays and increased turn-around times, which would adversely affect our business.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the U.S. or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.



**Our operations could be disrupted by power outages, natural disasters or other factors.**

Due to the geographic concentration of our manufacturing operations and the operations of certain of our suppliers, a disruption resulting from equipment failure, power failures, quality control issues, human error, government intervention or natural disasters, including earthquakes like those that have struck Japan in recent months, fires or floods, could interrupt or interfere with our manufacturing operations and consequently harm our business, financial condition and results of operations. Such disruptions would cause significant delays in shipments of our products and adversely affect our operating results.

**Our failure to comply with environmental laws and regulations could subject us to significant fines and liabilities or cause us to incur significant costs.**

We are subject to various and frequently changing U.S. federal, state and local and foreign governmental laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, the cleanup of contaminated sites and the maintenance of a safe workplace. In particular, some of our manufacturing processes may require us to handle and dispose of hazardous materials from time to time. For example, in the past our manufacturing operations have used lead-based solder in the assembly of our products. Today, we use lead-free soldering technologies in our manufacturing processes, as this is required for products entering the European Union. We could incur substantial costs, including clean-up costs, civil or criminal fines or sanctions and third-party claims for property damage or personal injury, as a result of violations of, or noncompliance with, environmental laws and regulations. These laws and regulations also could require us to incur significant costs to remain in compliance.

**Our internal controls over financial reporting may not be effective, which could have a significant and adverse effect on our business.**

Section 404 of the Sarbanes-Oxley Act of 2002 and the rules and regulations of the SEC, which we collectively refer to as Section 404, require us to evaluate our internal controls over financial reporting to allow management to report on those internal controls as of the end of each year. Effective internal controls are necessary for us to produce reliable financial reports and are important in our effort to prevent financial fraud. In the course of our Section 404 evaluations, we may identify conditions that may result in significant deficiencies or material weaknesses and we may conclude that enhancements, modifications or changes to our internal controls are necessary or desirable. Implementing any such matters would divert the attention of our management, could involve significant costs, and may negatively impact our results of operations.

We note that there are inherent limitations on the effectiveness of internal controls, as they cannot prevent collusion, management override or failure of human judgment. If we fail to maintain an effective system of internal controls or if management or our independent registered public accounting firm were to discover material weaknesses in our internal controls, we may be unable to produce reliable financial reports or prevent fraud, and it could harm our financial condition and results of operations, result in a loss of investor confidence and negatively impact our stock price.

**If we do not effectively manage future growth, our resources, systems and controls may be strained and our results of operations may suffer.**

We have in the past expanded our operations, both domestically and internationally. Any future growth may strain our resources, management information and telecommunication systems, and operational and financial controls. To manage future growth effectively, including the expansion of volume in our manufacturing facility in the PRC, we must be able to improve and expand our systems and controls. We may not be able to do this in a timely or cost-effective manner, and our current systems and controls may not be adequate to support our future operations. In addition, our officers have relatively limited experience in managing a rapidly growing business or a public company. As a result, they may not be able to provide the guidance necessary to manage future growth or maintain future market position. Any failure to manage our growth or improve or expand our existing systems and controls, or unexpected difficulties in doing so, could harm our business.

**If we acquire other businesses or technologies in the future, these acquisitions could disrupt our business and harm our operating results and financial condition.**

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We will evaluate opportunities to acquire businesses or technologies that might complement our current product offerings or enhance our technical capabilities. We have no experience in acquiring other businesses or technologies. Acquisitions entail a number of risks that could adversely affect our business and operating results, including, but not limited to:

- difficulties in integrating the operations, technologies or products of the acquired companies;
- the diversion of management's time and attention from the normal daily operations of the business;
- insufficient increases in net sales to offset increased expenses associated with acquisitions or acquired companies;
- difficulties in retaining business relationships with suppliers and customers of the acquired companies;

- the overestimation of potential synergies or a delay in realizing those synergies;
- entering markets in which we have no or limited experience and in which competitors have stronger market positions; and
- the potential loss of key employees of the acquired companies.

Future acquisitions also could cause us to incur debt or be subject to contingent liabilities. In addition, acquisitions could cause us to issue equity securities that could dilute the ownership percentages of our existing stockholders. Furthermore, acquisitions may result in material charges or adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred stock-based compensation expense and identifiable purchased intangible assets or impairment of goodwill, any or all of which could negatively affect our results of operations.

**Our existing indebtedness and any future indebtedness we incur could adversely affect our cash flow and prevent us from fulfilling our financial obligations.**

On September 30, 2010 and May 11, 2011, we amended our revolving credit agreement and concurrently obtained term loan financing. Incurring debt could have material consequences, such as:

- requiring us to dedicate a portion of our cash flow from operations and other capital resources to debt service, thereby reducing our ability to fund working capital, capital expenditures, and other cash requirements;
- increasing our vulnerability to adverse economic and industry conditions;
- limiting our flexibility in planning for, or reacting to, changes and opportunities in, our business and industry, which may place us at a competitive disadvantage; and
- limiting our ability to incur additional debt on acceptable terms, if at all.

Additionally, if we are unable to maintain liquidity levels, as defined in the credit agreement, or if we were to default under our credit agreement and were unable to obtain a waiver for such a default, interest on the obligations would accrue at an increased rate. In the case of a default, the lenders could accelerate our obligations under the credit agreement; however, acceleration will be automatic in the case of bankruptcy and insolvency events of default.

Additionally, to the extent we have made intercompany loans to our subsidiaries and have pledged such loans to the lenders under the credit agreement, our subsidiaries would be required to pay the amount of the intercompany loans to the lenders in the event we are in default under the credit agreement. Any actions taken by the lenders against us in the event we are in default under the credit agreement could harm our financial condition. Finally, the credit facility contains certain restrictive covenants, including provisions restricting our ability to incur additional indebtedness, guarantee certain obligations, create or assume liens and pay dividends.

**Our investment in an auction rate security is subject to risks which may cause losses and affect the liquidity of this investment.**

We hold an investment in an auction rate security that has failed, or may in the future fail, its auction. An auction failure means that the parties wishing to sell their securities could not do so. As a result of failed auctions, our ability to liquidate and fully recover the carrying value of our investment in the near term may be limited or not exist. If the issuer of this investment is unable to close future auctions and its credit rating deteriorates, we may in the future be required to record an impairment charge on this investment. We also may be required to wait until market stability is restored for this investment or until the final maturity of the underlying note (up to 30 years) to realize our investment's cost value.

***Risks related to our common stock***

**Our principal stockholders have significant voting power and may take actions that may not be in the best interest of our other stockholders.**

As of July 2, 2011, our executive officers, directors and 5% stockholders beneficially own, in total, approximately 31% of our outstanding common stock. As a result, these stockholders, acting together, have the ability to exert substantial

influence over all matters requiring approval by our stockholders, including the election and removal of directors and any proposed merger, consolidation or sale of all or substantially all of our assets and other corporate transactions. This concentration of control could be disadvantageous to other stockholders with interests different from those of our executive officers, directors and principal stockholders. For example, our executive officers, directors and principal stockholders could delay or prevent an acquisition or merger even if the transaction would benefit other stockholders. In addition, this significant concentration of share ownership may adversely affect the trading price for our common stock because investors may perceive disadvantages in owning stock in companies with stockholders that have the ability to exercise significant control.

**Anti-takeover provisions under our charter documents and Delaware law could delay or prevent a change of control and could also limit the market price of our stock.**

Our certificate of incorporation and bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors that our stockholders might consider favorable. In addition, these provisions could limit the price that investors would be willing to pay in the future for shares of our common stock. The following are examples of provisions which are included in our certificate of incorporation and bylaws, each as amended:

- our board of directors is authorized, without prior stockholder approval, to designate and issue preferred stock, commonly referred to as blank check preferred stock, with rights senior to those of our common stock;
- stockholder action by written consent is prohibited;
- nominations for election to our board of directors and the submission of matters to be acted upon by stockholders at a meeting are subject to advance notice requirements; and
- our board of directors is expressly authorized to make, alter or repeal our bylaws.

In addition, we are governed by the provisions of Section 203 of the Delaware General Corporate Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our certificate of incorporation and bylaws, and of Delaware law, could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by the then-current board of directors, including delaying or impeding a merger, tender offer, or proxy contest or other change of control transaction involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could prevent the consummation of a transaction in which our stockholders could receive a substantial premium over the then-current market price for their shares.

**The price of and volume in trading of our common stock has and may continue to fluctuate significantly.**

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Our common stock has been publicly traded since November 2006. The price of our common stock and the trading volume of our shares are volatile and have in the past fluctuated significantly. There can be no assurance as to the prices at which our common stock will trade in the future or that an active trading market in our common stock will be sustained in the future. The market price at which our common stock trades may be influenced by many factors, including but not limited to, the following:

- our operating and financial performance and prospects, including our ability to achieve and sustain profitability in the future;
- investor perception of us and the industry in which we operate;
- the availability and level of research coverage of and market making in our common stock;
- changes in earnings estimates or buy/sell recommendations by analysts;
- general financial and other market conditions; and
- changing and recently volatile domestic and international economic conditions.

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In addition, shares of our common stock and the public stock markets in general, have experienced, and may continue to experience, extreme price and trading volume volatility. These fluctuations may adversely affect the market price of our common stock and a shareholders ability to sell their shares into the market at the desired time or at the desired price.

In 2007, following a drop in the market price of our common stock, securities litigation was initiated against us. Given the historic volatility of our industry, we may become engaged in this type of litigation in the future. Securities litigation is expensive and time-consuming.

### **Item 6. Exhibits**

| <b>Exhibit Number</b> | <b>Description of Document</b>  |
|-----------------------|---|
| 3.1(1)                | Restated Certificate of Incorporation of Netlist, Inc.  |
| 3.2(1)                | Amended and Restated Bylaws of Netlist, Inc.  |
| 10.1(2)               | Amendment to Loan Documents entered into as of August 10, 2011, by and between Silicon Valley Bank and Netlist, Inc., a Delaware Corporation.   |
| 31.1(2)               | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as Amended.  |
| 31.2(2)               | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as Amended.  |
| 32(3)                 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and furnished herewith pursuant to SEC Release No. 33-8238. |
| 101.INS(4)            | XBRL Instance Document  |
| 101.SCH(4)            | XBRL Taxonomy Extension Schema Document   |
| 101.CAL(4)            | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.LAB(4)            | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE(4)            | XBRL Taxonomy Extension Presentation Linkbase Document  |
| 101.DEF(4)            | XBRL Taxonomy Extension Definition Linkbase Document  |

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(1) Incorporated by reference to the corresponding exhibit number of the registration statement on Form S-1 of the registrant (No. 333-136735) filed with the Securities and Exchange Commission on October 23, 2006.

(2) Filed herewith.



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(3) The information in Exhibit 32 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless the registrant specifically incorporates the foregoing information into those documents by reference.

(4) Furnished herewith. In accordance with Rule 406T of Regulation S-T, the information in these exhibits shall not be deemed to be filed for purposes of Section 18 of the Securities and Exchange Act of 1934, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, except as expressly set forth by specific reference in such filing.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 15, 2011

NETLIST, INC.  
a Delaware corporation  
(Registrant)

By: **/s/ Chun K. Hong**  
**Chun K. Hong**  
**President, Chief Executive Officer and**  
**Chairman of the Board**  
**(Principal Executive Officer)**

By: **/s/ Gail M. Sasaki**  
**Gail M. Sasaki**  
**Vice President and Chief Financial**  
**Officer**  
**(Principal Financial Officer)**

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