

A123 SYSTEMS, INC.
Form 10-Q
August 09, 2012

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

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: 001-34463

A123 Systems, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-3583876
(I.R.S. Employer
Identification No.)

A123 Systems, Inc.
200 West Street
Waltham, Massachusetts
(Address of principal executive offices)

02451
(Zip Code)

617-778-5700

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months

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(or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 6, 2012, there were 170,557,467 shares of the registrant's Common Stock, par value \$.001 per share, outstanding.

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For the Quarterly Period Ended June 30, 2012
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	December 31, 2011	June 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 186,893	\$ 47,670
Restricted cash and cash equivalents	668	40,758
Accounts receivable, net	47,200	25,998
Inventory	103,394	96,304
Deferred cost	6,256	6,515
Prepaid expenses and other current assets	8,011	11,134
Total current assets	352,422	228,379
Property, plant and equipment, net	145,203	138,620
Goodwill	9,581	9,581
Long-term grants receivable	101,054	101,554
Deposits and other assets	5,745	8,669
Investments	11,897	8,162
Total assets	\$ 625,902	\$ 494,965
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Revolving credit lines	\$ 38,094	\$
Current portion of long-term debt	2,069	38,490
Current portion of capital lease obligations	1,740	1,537
Accounts payable	27,220	23,422
Accrued expenses	31,910	73,470
Other current liabilities	8,329	5,705
Deferred revenue	9,577	15,073
Deferred rent	181	181
Total current liabilities	119,120	157,878
Long-term debt, net of current portion	142,755	146,715
Capital lease obligations, net of current portion	17,336	16,598
Deferred revenue, net of current portion	35,303	34,499
Deferred rent, net of current portion	1,203	1,112
Warrant derivative liability		18,650
Other long-term liabilities	13,820	12,548
Total liabilities	329,537	388,000
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Preferred stock, \$0.001 par value 5,000,000 shares authorized; 0 shares issued and outstanding at December 31, 2011 and June 30, 2012		
	134	147

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Common stock, \$0.001 par value 250,000,00 and 650,000,000 shares authorized; 134,342,974 and 147,141,066 shares issued and outstanding at December 31, 2011 and June 30, 2012, respectively		
Additional paid-in capital	946,506	965,021
Accumulated deficit	(648,958)	(856,886)
Accumulated other comprehensive loss	(1,317)	(1,317)
Total stockholders' equity	296,365	106,965
Total liabilities and stockholders' equity	\$ 625,902	\$ 494,965

See notes to condensed consolidated financial statements.

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A123 Systems, Inc.

Condensed Consolidated Statements of Operations

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
Revenue:				
Product	\$ 29,564	\$ 11,487	\$ 45,022	\$ 18,787
Services	6,789	5,498	9,428	9,087
Total revenue	36,353	16,985	54,450	27,874
Cost of revenue:				
Product	48,818	42,908	79,914	139,972
Services	5,066	3,247	7,544	7,890
Total cost of revenue	53,884	46,155	87,458	147,862
Gross loss	(17,531)	(29,170)	(33,008)	(119,988)
Operating expenses:				
Research, development and engineering	17,434	21,383	37,793	44,964
Sales and marketing	5,070	4,185	9,152	8,605
General and administrative	9,399	11,415	18,510	23,279
Production start-up	3,497		8,118	
Total operating expenses	35,400	36,983	73,573	76,848
Operating loss	(52,931)	(66,153)	(106,581)	(196,836)
Other income (expense):				
Interest expense, net	(2,105)	(4,761)	(2,746)	(6,952)
Gain (loss) on foreign exchange	77	(146)	79	(46)
Gain (loss) on change in fair value of derivative liabilities		(8,374)		181
Impairment of long-term investment		(2,930)		(2,930)
Other (expense) income, net	(353)	(338)	673	(795)
Total other expense, net	(2,381)	(16,549)	(1,994)	(10,542)
Loss from operations, before tax	(55,312)	(82,702)	(108,575)	(207,378)
Provision for income taxes	78	188	488	550
Net loss	(55,390)	(82,890)	(109,063)	(207,928)
Less: net loss attributable to the noncontrolling interest			27	
Net loss attributable to A123 Systems, Inc.	\$ (55,390)	\$ (82,890)	\$ (109,036)	\$ (207,928)
Net loss per share attributable to A123 Systems, Inc. basic and diluted:	\$ (0.44)	\$ (0.56)	\$ (0.95)	\$ (1.43)
Weighted average number of common shares outstanding basic and diluted	124,513	146,989	115,066	145,205

See notes to condensed consolidated financial statements.

Table of Contents**A123 Systems, Inc.****Condensed Consolidated Statements of Comprehensive Loss****(in thousands)**

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2012	2011	2012
Net loss	\$ (55,390)	\$ (82,890)	\$ (109,063)	\$ (207,928)
Other comprehensive loss, net of tax:				
Foreign currency translation adjustments	18		(383)	
Comprehensive loss	(55,372)	(82,890)	(109,446)	(207,928)
Less: loss attributable to the noncontrolling interest			(27)	
Comprehensive loss attributable to A123 Systems, Inc.	\$ (55,372)	\$ (82,890)	\$ (109,419)	\$ (207,928)

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A123 Systems, Inc.

Condensed Consolidated Statements of Stockholders' Equity

(in thousands, except per share data)

	Common Stock, \$0.001 Par Value		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity	Noncontrolling Interest
	Shares	Amount					
BALANCE January 1, 2011	105,194	\$ 105	\$ 790,256	\$ (391,228)	\$ (935)	\$ 398,198	\$ 334
Stock-based compensation			6,721			6,721	
Exercise of stock options	602	1	1,976			1,977	
Vesting of restricted stock units	45						
Issuance of common stock	20,184	20	115,167			115,187	
Purchase of subsidiary shares by noncontrolling interest holder							600
Deconsolidation of subsidiary							(907)
Net loss				(109,036)		(109,036)	(27)
Other comprehensive loss					(383)	(383)	
BALANCE June 30, 2011	126,025	\$ 126	\$ 914,120	\$ (500,264)	\$ (1,318)	\$ 412,664	\$
BALANCE January 1, 2012	134,343	\$ 134	\$ 946,506	\$ (648,958)	\$ (1,317)	\$ 296,365	\$
Stock-based compensation			7,052			7,052	
Exercise of stock options	11		12			12	
Vesting of restricted stock units	287						
Issuance of common stock	12,500	13	11,451			11,464	
Net loss				(207,928)		(207,928)	
Other comprehensive loss							
BALANCE June 30, 2012	147,141	\$ 147	\$ 965,021	\$ (856,886)	\$ (1,317)	\$ 106,965	\$

See notes to condensed consolidated financial statements.

Table of Contents**A123 Systems, Inc.****Condensed Consolidated Statements of Cash Flows****(in thousands)**

	Six Months Ended June 30,	
	2011	2012
Cash flows from operating activities:		
Net loss	\$ (109,063)	(207,928)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	10,697	14,059
Noncash rent	(102)	(90)
Noncash loss on equity investments	625	806
Impairment of long-lived and intangible assets	2,645	3,316
Impairment of long-term investment		2,930
Gain on change in fair value of derivative liabilities		(181)
Gain on asset transfer and subsequent deconsolidation of variable interest entity (VIE)	(1,255)	
Loss on disposal of property and equipment	28	
Amortization of debt issuance costs and noncash interest expense	1,178	3,759
Stock-based compensation	6,721	7,052
Changes in operating assets and liabilities, excluding the effect of deconsolidation of VIE:		
Accounts receivable	(10,217)	27,708
Inventory	(36,227)	7,090
Deferred cost	(1,285)	(258)
Prepaid expenses and other assets	(5,663)	(3,027)
Accounts payable	23,179	(4,767)
Accrued expenses	3,429	45,411
Deferred revenue	(363)	(1,814)
Other liabilities	2,306	(5,395)
Net cash used in operating activities	(113,367)	(111,329)
Cash flows from investing activities:		
Increase in restricted cash	(565)	(40,090)
Purchases of and deposits on property, plant and equipment	(86,279)	(15,553)
Proceeds from government grant	26,138	2,150
Purchase of investments	(1,891)	
Net cash used in investing activities	(62,597)	(53,493)
Cash flows from financing activities:		
Proceeds from issuance of common stock and warrants, net of offering costs	115,285	23,502
Net proceeds from convertible debt offering and issuance costs		46,889
Proceeds from government grant	900	
Proceeds from exercise of stock options	1,977	12
Proceeds from issuance of debt, net of offering costs	139,068	
Principal payments on revolving credit line		(38,094)
Principal payments on long term debt	(2,591)	(4,943)
Payments on capital lease obligations	(1,225)	(1,767)
Contributions from noncontrolling interest	600	
Net cash provided by financing activities	254,014	25,599
Effect of foreign exchange rates on cash and cash equivalents	(17)	

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Net decrease in cash and cash equivalents	78,033	(139,223)
Cash and cash equivalents at beginning of period	216,841	186,893
Cash and cash equivalents at end of period	\$ 294,874	\$ 47,670
Supplemental cash flow information cash paid for interest	\$ 351	\$ 2,863
Noncash investing and financing activities:		
Increase in accounts payable and accrued expenses for property, plant and equipment	\$ 27,329	\$ 6,563

See notes to condensed consolidated financial statements.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies

A123 Systems, Inc. (the "Company") was incorporated in Delaware on October 19, 2001 and has its corporate offices in Waltham, Massachusetts. The Company designs, develops, manufactures and sells advanced rechargeable lithium-ion batteries and battery systems and provides research and development services to government agencies and commercial customers.

Management Plan Note The Company has incurred significant net losses and negative operating cash flows since inception. At June 30, 2012, the Company had an accumulated deficit of \$856.9 million, including a \$207.9 million net loss incurred for the six months ended June 30, 2012. The Company had \$47.7 million in cash and cash equivalents at June 30, 2012, down from \$186.9 million at December 31, 2011.

On March 26, 2012, the Company launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million. In addition, the Company recorded an inventory charge of approximately \$15.2 million related to inventory produced at its Michigan facilities that may be defective. As a result of this field campaign and the charge for existing prismatic cell inventory, the Company has begun to rebuild its inventory and manage its backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. As a result of this field campaign, the Company expects to continue to incur significant net losses and negative operating cash flows over the next several quarters.

On May 11, 2012, the Company amended its revolving credit facility with its lead bank. This amendment eliminated the borrowing facility and provided for up to \$15.0 million as security for letters of credit. All outstanding letters of credit are required to be cash collateralized at 105% of their face amount. At June 30, 2012, the Company had \$10.8 million of restricted cash to collateralize primarily the outstanding letters of credit.

At June 30, 2012, the Company had \$47.7 million of cash and cash equivalents. Additionally, \$30.0 million of cash was released from restricted cash on July 6, 2012 as discussed below. The Company's credit facility and the 2013 Senior Notes (discussed below) contain a covenant requiring the Company to maintain an unrestricted cash balance of at least \$40.0 million. During the six months ended June 30, 2012, the Company used on average \$18.0 million to \$25.0 million per month in net operating and investing cash flows. Based on the Company's historical use of cash, the Company expects its cash balance to fall below this required minimum by the end of August 2012.

The above circumstances, along with the Company's history and near term forecast of incurring significant net losses and negative operating cash flows, raise substantial doubt regarding its ability to continue as a going concern. The Company is considering a broad set of strategic alternatives to improve its liquidity, including measures to reduce costs and improve efficiency, accessing additional sources of capital through existing and potentially new arrangements, and other strategic options. See Note 10(b) Subsequent Events *Memorandum of Understanding from Wanxiang Group Corporation*. In connection with this proposed transaction, the Company is currently in discussions with the holders of the 2013 Senior Notes and the Company's lead bank that holds the revolving credit facility to modify the respective agreements to reduce the minimum unrestricted cash balance from \$40.0 million to a lower amount. Although management's intent is to improve the Company's operating efficiencies, to obtain additional financing (as discussed in Note 10(b) Subsequent Events) and to modify the terms and covenants in its 2013 Senior Notes and its revolving credit facility, there is no assurance that it will

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

be able to obtain such financing on favorable terms, if at all, or to modify the covenants, or to successfully further reduce costs in such a way that would continue to allow the Company to operate its business.

On May 24, 2012, the Company sold to accredited investors of \$50.0 million aggregate principal amount of 6.00% senior convertible notes (the "2013 Senior Notes"), and warrants to purchase shares of common stock (the "May 2012 Warrants"), equal to 30% of the number of shares underlying the 2013 Senior Notes assuming conversion at the initial conversion price. As of June 30, 2012, \$30.0 million of proceeds subject to a control account agreement was recorded as restricted cash. Such proceeds were released from restricted cash on July 6, 2012, upon satisfaction of the conditions of the agreements with the holders of the 2013 Senior Notes. Pursuant to the agreements with the holders of such notes and its credit facility provider, the Company must maintain a minimum cash balance of \$40.0 million (See below for more details).

On July 10, 2012, the Company sold an aggregate of 7,692,308 shares of the Company's common stock and warrants to purchase additional shares of such common stock (the "July 2012 Warrants") for an exercise price of \$0.001 per share to certain existing institutional investors. The Company agreed to sell the common shares at an initial negotiated purchase price of \$1.30, subject to adjustment as described below.

Pursuant to the July 2012 Warrants, the Company issued to the institutional investors 6,662,852 additional shares of common stock in two separate issuances on July 12, 2012 and July 30, 2012 due to the decrease in the volume weighted average stock price compared to the initial purchase price of \$1.30. The Company also paid \$2.2 million to the institutional investors due to a limitation on the number of shares that could be settled under the warrants. The net offering proceeds to the Company from the issuance of 14,355,160 shares of common stock, after deducting the placement agent's fees and other estimated offering expenses of approximately \$1.0 million and the cash settlement of \$2.2 million on the warrants, were approximately \$6.8 million.

As noted above, the Company's revolving credit facility and the 2013 Senior Notes agreements require the Company to maintain a minimum cash balance of \$40.0 million. If the Company's cash balance falls below \$40.0 million, it would be considered an event of default per the covenants of the revolving credit facility and the 2013 Senior Notes.

Upon an event of default under the revolving credit facility, the bank could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If the Company was unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness. As of June 30, 2012, the Company had \$8.6 million of outstanding letters of credits and no borrowings.

An event of default under the 2013 Senior Notes would trigger redemption rights, pursuant to which a holder could require the Company to redeem all or any portion of such note by delivering an event of default redemption notice to the Company which would include the redemption price. The redemption price equals the greater of (i) the product of (A) the conversion amount to be redeemed, multiplied by (B) the redemption premium (125%) and (ii) the product of (A) the conversion rate in effect at such time as the holder delivers an event of default redemption notice with respect to the conversion amount to be redeemed, multiplied by (B) the greatest closing sale price of the shares of the Company's common stock during the period beginning on the date immediately preceding such

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

event of default and ending on the date the holder delivers the event of default redemption notice. The Company must deliver the redemption price to the holder within five business days after receiving the event of default redemption notice.

The accompanying condensed consolidated financial statements have been prepared assuming the Company will continue to operate as a going concern, which contemplates the realization of assets and settlement of liabilities in the normal course of business and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from uncertainty related to its ability to continue as a going concern.

Basis of Presentation The accompanying condensed consolidated financial statements and the related disclosures as of June 30, 2012 and for the three and six months ended June 30, 2011 and 2012 are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial information. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K filed with the SEC on March 12, 2012. The December 31, 2011 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures required by GAAP for complete financial statements.

The interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, reflect all adjustments of a normal recurring nature considered necessary to present fairly the Company's financial position as of June 30, 2012 and results of its operations for the three and six months ended June 30, 2011 and 2012, and its cash flows for the three and six months ended June 30, 2011 and 2012. The interim results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

Revisions to Amounts Previously Presented Certain prior period amounts have been reclassified to conform to the current period presentation. Deferred costs of \$1.3 million for the six months ended June 30, 2011 related to costs of product shipments where title has passed to the customer but not all of the revenue recognition criteria have been met, have been reclassified from inventory to deferred costs in the condensed consolidated statement of cash flow. Additionally, customer deposits received from customers of \$0.8 million for products that have not been shipped, have been reclassified from deferred revenue to other current liabilities in the condensed consolidated statement of cash flow. There was no impact to net cash used in operating activities for the three and six months ended June 30, 2011.

Comprehensive Income In June 2011, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update 2011-05, Comprehensive Income (Topic 220) as amended, requiring amendments to the disclosure for presentation of comprehensive income. This guidance, effective retrospectively for the interim and annual periods beginning on or after December 15, 2011, requires presentation of total comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

income or in two separate but consecutive statements. In December 2011, the FASB issued an amendment to this guidance which indefinitely defers the requirement to present reclassification adjustments out of accumulated other comprehensive income either in a single continuous statement of comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. This guidance is effective for annual periods beginning after December 15, 2011. The Company adopted the amended guidance requiring presentation of comprehensive income in two consecutive financial statements for the six months ended June 30, 2012. The implementation of this guidance did not have a material impact on the Company's condensed consolidated results of operations or financial position.

Principles of Consolidation The accompanying condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. In February 2011, the Company entered into an agreement to transfer certain of its assets held by its wholly owned Korean subsidiary to its joint venture with a quasi governmental entity in the Peoples' Republic of China. The asset transfer and subsequent deconsolidation of the joint venture resulted in a \$1.2 million gain recognized in other expense, net for the three and six months ended June 30, 2011. Prior to February 2011, the joint venture was consolidated as a variable-interest entity, but did not have a material impact on the Company's consolidated financial operations and did not represent a material portion of the Company's consolidated assets.

Use of Estimates The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expense and related disclosures. The Company bases estimates and assumptions on historical experience and on various other factors that it believes to be reasonable under the circumstances. The Company evaluates its estimates and assumptions on an ongoing basis. The Company's actual results may differ from these estimates under different assumptions or conditions.

Government Grants The Company recognizes government grants when there is reasonable assurance that the Company will comply with the conditions attached to the grant arrangement and the grant will be received. The Company evaluates the conditions of each individual grant as of each reporting period to ensure that the Company has reached reasonable assurance of meeting the conditions of each grant arrangement and that it is expected that the grant will be received as a result of meeting the necessary conditions. For example, if a grant has conditions where the Company must create and maintain a certain number of jobs, the Company records the grant in the period that it has evaluated and determined that the necessary number of jobs has been created and, based on the Company's forecasts, it is reasonably assured that the jobs will be maintained during the required employment period. Government grants are recognized in the condensed consolidated statements of operations on a systematic basis over the periods in which the Company recognizes the related costs for which the government grant is intended to compensate. Specifically, when government grants are related to reimbursements for cost of revenues or operating expenses, the government grants are recognized as a reduction of the related expense in the condensed consolidated statements of operations over the period that the Company is required to comply with the conditions of the grants. For government grants related to reimbursements of capital expenditures, the government grants are recognized as a reduction of the basis of the asset and recognized in the consolidated statements of

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

operations over the estimated useful life of the depreciable asset as reduced depreciation expense. For the three and six months ended June 30, 2011, the Company recorded \$3.4 million and \$6.1 million, respectively, as a reduction to depreciation expense related to reduced carrying value of property, plant and equipment due to government grants reimbursements. For the three and six months ended June 30, 2012, the Company recorded \$9.5 million, and \$17.7 million, respectively, as a reduction to depreciation expense related to reduced carrying value of property, plant and equipment due to government grants reimbursements.

The Company records government grant receivables in the condensed consolidated balance sheets in prepaid expenses and other current assets or long-term grant receivable, depending on when the amounts are expected to be received from the government agency. The Company does not discount long-term grant receivables. Proceeds received from government grants prior to expenditures being incurred are recorded as restricted cash and other current liabilities or other long-term liabilities, depending on when the Company expects to use the proceeds.

The Company classifies in the condensed consolidated statements of cash flows grant proceeds received in advance of spending for qualified expenditures as a cash flow from financing activities, as the proceeds are used to assist in funding future expenditures. Grant proceeds received as reimbursements for capital expenditures previously incurred are classified in cash flows from investing activities and grant proceeds received as reimbursements for operating expenditures previously incurred are classified in cash flows from operating activities.

Revenue Recognition The Company earns revenue from the sale of products and delivery of services, including products and services sold under governmental contracts. Revenue is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the price to the buyer is fixed or determinable, and collectability is reasonably assured. When collectability is not reasonably assured, the Company will record a receivable and defer the revenue and costs associated with the delivered product or services until cash is received from the customer.

If a sales arrangement contains multiple elements, the Company evaluates the agreement to determine if separate units of accounting exist within the arrangement. If separate units of accounting exist within the arrangement, the Company allocates revenue to each element based on the relative selling price of each of the elements.

Product Revenue

Product revenue is generally recognized upon transfer of title and risk of loss, which is typically upon shipment, unless an acceptance period exists. The Company's customary shipping terms are FOB shipping point or free carrier. In instances where customer acceptance of a product is required, revenue is either recognized (i) upon shipment when the Company is able to demonstrate that the customer specific objective criteria have been met or (ii) upon the earlier of customer acceptance or expiration of the acceptance period. The Company's customers may generally cancel orders at any time prior to product shipment.

The Company provides warranties for its products and records the estimated costs as a cost of revenue in the period the revenue is recorded. The Company's standard warranty period extends one to five years from the date of delivery, depending on the type of product purchased and its application.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

The warranties provide that the Company's products will be free from defects in material and workmanship and will, under normal use, conform to the specifications for the product. The standard warranties further provide that the Company will repair the product or provide replacement parts at no charge to the customer. The Company's warranty liability is based on the current field campaign and on projected product failure rates and estimated costs of fulfilling warranty claims. Projections are based on the Company's actual warranty experience and other known and expected factors. The Company monitors its warranty liability and adjusts the amounts as necessary. When the Company is unable to reasonably determine its obligation for warranty of new products, revenue from the sale of the products is deferred until expiration of the warranty period or until such time as the warranty obligation can be reasonably estimated.

In instances where the Company has deferred revenue due to not meeting all of the revenue recognition criteria but where title has passed to the customer, the Company also defers the associated costs of revenue until such time that it is able to recognize the revenue. Deferred costs of revenue are classified in the condensed consolidated balance sheets as deferred costs under current assets as these are expected to be recognized as cost of revenue in the condensed consolidated statement of operations within one year. As of December 31, 2011 and June 30, 2012, the Company had deferred cost of revenue of \$6.3 million and \$6.5 million, respectively.

Services Revenue

Revenue from services is recognized as the services are performed consistent with the performance requirements of the contract using the proportional performance method if the Company is able to reasonably estimate the contract cost and progress toward completion of the contract. If the Company does not have the ability to reasonably estimate contract costs or progress toward completion of the contract, the Company defers the related revenue and costs and recognizes the revenues and costs based on the completed performance method. When the completed performance method is used, the excess of accumulated costs over related billings, if any, are classified as an asset and the excess of accumulated billings over related costs, if any, are classified as a liability. The Company classifies the portion of the related asset or liability as long-term if such asset or liability is expected to be recognized beyond one year.

Service revenue includes revenue derived from the execution of contracts awarded by the U.S. Federal government, other government agencies and commercial customers. The Company's research and development arrangements with the federal government or other government agencies typically require the Company to provide pure research, in which the Company investigates design techniques on new battery technologies. The Company's arrangements with commercial customers consist of arrangements where the Company is paid to enhance or modify an existing product or to develop a new product to meet a customer's specifications.

Other Revenue

Fees to license the use of the Company's proprietary and licensed technologies are recognized only after both the license period has commenced and the technology has been delivered to the customer. Royalty revenue is recognized when it becomes determinable and collectability is reasonably assured; otherwise the Company recognizes revenue upon receipt of payment. To date, the Company has not recognized any significant royalty revenue.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

During the three and six months ended June 30, 2011, the Company recognized \$0.2 million in license fee revenue. During the three and six months ended June 30, 2012, the Company recognized \$0.6 million and \$1.1 million, respectively, in license fee revenue.

Deferred Revenue

The Company records deferred revenue for product sales and services revenue in several different circumstances. These circumstances include when (i) the Company has delivered products or performed services but other revenue recognition criteria have not been satisfied, (ii) payments have been received in advance of products being delivered or services being performed and (iii) all other revenue recognition criteria have been met, but the Company is not able to reasonably estimate the warranty expense. Deferred revenue includes up-front fees associated with services arrangements. Deferred revenue expected to be recognized as revenue more than one year subsequent to the balance sheet date is classified as long-term deferred revenue. Deferred revenue will vary depending on the timing and amount of cash receipts from customers and can vary significantly depending on specific contractual terms.

Currently, the Company has two outstanding technology license agreements with its customers to license certain of its technology in the field of consumer electronic devices (excluding power tools and certain other consumer products) and in the field of manufacturing advance battery systems and modules in the transportation market. In connection with the license agreements, the licensees have paid up front, non-refundable license fees and will pay ongoing royalties based on a percentage of the licensees' net sales of products that use or embody the licensed technology and know-how. The Company has commenced recognizing revenue on both of the upfront license fees over the longer of the license term or the expected customer relationship.

Deferred revenue related to the license agreements were \$34.5 million and \$33.4 million as of December 31, 2011 and June 30, 2012, respectively.

Customer Deposits

Customer deposits received from customers related to products where title has not passed are recorded in other liabilities. The Company classifies as long-term the portion of customer deposits that are expected to be recognized beyond one year. Upon transfer of title and when all of the revenue recognition criteria have been met, the Company recognizes the related revenue. If not all of the revenue recognition criteria have been met, but title to the goods has passed to the customer, the Company records the related amount in deferred revenue. As of December 31, 2011 and June 30, 2012, the Company recorded customer deposits of \$6.9 million and \$1.5 million in other current liabilities, respectively.

Production start-up Production start-up expenses consist of manufacturing salaries and personnel-related costs, site selection costs, including legal and regulatory costs, rent and the cost of operating a production line before it has been qualified for production, including the cost of raw materials run through the production line during the qualification phase. During the three and six months ended June 30, 2011, the Company incurred production start-up expenses related to its facility in Romulus, Michigan and related to the second production line in its facility in Livonia, Michigan. By the end of 2011, the Company had completed the qualification of the Livonia and Romulus, Michigan facilities.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

There were no production start-up expenses during the three and six months ended June 30, 2012 as all of the Company's facilities completed its qualification by December 31, 2011. A portion of production start-up expenses incurred during the three and six months ended June 30, 2011 was offset by government grant funding. The following table presents production start-up expenditures included in the Company's condensed consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
Production start-up expenditures				
Aggregated production start-up expenditures	\$ 4,944	\$	\$ 11,941	\$
Production start-up reimbursements	(1,447)		(3,823)	
Production start-up expenses	\$ 3,497	\$	\$ 8,118	\$

Fair Value of Financial Instruments Except for the convertible notes (the 2016 Notes as defined in Note 8 and the 2013 Senior Notes) outstanding, the carrying amount of all financial instruments approximate their fair values as of December 31, 2011 and June 30, 2012. The carrying amount of cash (level 1) and cash equivalents, restricted cash (level 1) and cash equivalents approximates fair value due to the short-term nature of these items. Management believes that the Company's debt obligations (level 2), except for the 2016 Notes outstanding as of December 31, 2011 and June 30, 2012, and the 2013 Senior Notes outstanding as of June 30, 2012, accrue interest at rates which approximate prevailing market rates for instruments with similar characteristics and, accordingly, the carrying values for these instruments approximate fair value. The Company's outstanding 2016 Notes (level 2) have an estimated fair value of \$51.4 million and \$37.4 million as of December 31, 2011 and June 30, 2012 based on available market data. As of December 31, 2011 and June 30, 2012, the 2016 Notes had a carrying value of \$140.1 million and \$140.5 million reflected in long-term debt in the Company's condensed consolidated balance sheet, which reflects the face amount of \$143.8 million, net of the unamortized discount. The Company's outstanding 2013 Senior Notes (level 2) have an estimated fair value of \$61.5 million as of June 30, 2012 (includes the fair value of the embedded derivatives) based on available market data. As of June 30, 2012, the 2013 Senior Notes had a carrying value of \$41.9 million (includes the amounts allocated to the derivative liabilities) reflected in the current portion of long-term debt and long-term debt in the Company's condensed consolidated balance sheet, which reflects the face amount of \$47.1 million, net of the unamortized discount.

Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, GAAP establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (level 1) observable inputs such as quoted prices in active markets; (level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

basis, the Company measures certain financial assets and liabilities at fair value, including the Company's cash equivalents and warrant derivative liability.

Items Measured at Fair Value on a Recurring Basis The following tables show assets measured at fair value on a recurring basis and the input categories associated with those assets (in thousands):

	As of December 31, 2011			
	Fair Value at December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Asset:				
Money market funds	\$ 160,944	\$ 160,944	\$	\$
As of June 30, 2012				
	Fair Value at June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds	\$ 65,947	\$ 65,947	\$	\$
Liabilities:				
Warrant derivative liability	\$ 18,650	\$	\$	\$ 18,650
Embedded derivatives	3,624			3,624
	\$ 22,274	\$	\$	\$ 22,274

Cash and cash equivalents include investments in money market fund investments that are measured at fair value on a recurring basis based on quoted prices in active markets for identical assets.

The Company's warrant derivative liability represents the liability for the January 2012 Warrants and May 2012 Warrants issued to institutional investors (Note 2). The warrant derivative liability is carried at fair value and is classified as Level 3 in the fair value hierarchy due to the use of significant unobservable inputs. The warrant liability is calculated using the Black-Scholes option pricing method. The initial fair value of the January 2012 Warrants at the date of issuance was determined to be \$11.9 million using the Black-Scholes option pricing method applying the following assumptions: (i) risk-free rate of 0.31%, (ii) remaining term of 2.5 years, (iii) no dividend yield, (iv) volatility of 79%, (v) the exercise price of \$2.71, and (vi) the stock price on the date of measurement. As of June 30, 2012, the fair value of the January 2012 Warrants was determined to be \$8.7 million using the Black-Scholes option pricing method applying the following assumptions: (i) risk-free rate of 0.34%, (ii) remaining term of 2.08 years, (iii) no dividend yield, (iv) volatility of 94%, (v) the exercise price of \$2.71, and (vi) the stock price on the date of measurement. A 10% change in volatility would impact the fair value of the warrant as of June 30, 2012 by \$0.8 million. In the event of a change in control, these warrants require a cash payment based on contractually defined inputs. The probability of a change in control has been factored into the valuation of the liability.

The initial fair value of the May 2012 Warrants at the date of issuance was determined to be \$7.7 million using the Black-Scholes option pricing method applying the following assumptions:

Table of Contents**A123 Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)**

(i) risk-free rate of 0.99%, (ii) remaining term of 5.5 years, (iii) no dividend yield, (iv) volatility of 77%, (v) the exercise price of \$1.29, and (vi) the stock price on the date of measurement. As of June 30, 2012, the fair value of the May 2012 Warrant was determined to be \$9.9 million using the Black-Scholes option pricing method applying the following assumptions: (i) risk-free rate of 0.80%, (ii) remaining term of 5.4 years, (iii) no dividend yield, (iv) volatility of 78%, (v) the exercise price of \$1.29, and (vi) the stock price on the date of measurement. A 10% change in volatility would impact the fair value of the warrant as of June 30, 2012 by \$0.6 million. In the event of a change in control, these warrants require a cash payment based on contractually defined inputs. The probability of a change in control has been factored into the valuation of the liability.

The Company's embedded derivative liability represents the liability for the embedded derivative conversion and redemption features within the 2013 Senior Notes that are not clearly and closely related to the debt and do not meet the criteria for equity classification. Accordingly, these embedded derivatives are measured at fair value separate from the debt obligation and recorded as a liability. While measured separately, the embedded derivatives and the debt obligation are carried on a combined basis and reflected in the current portion of long-term debt in the Company's condensed consolidated balance sheet. The embedded derivative liability is classified as Level 3 in the fair value hierarchy due to the use of significant unobservable inputs. The initial fair value of the embedded derivatives upon issuance was determined to be \$2.8 million using the binomial lattice valuation model applying the following assumptions: (i) risk-free rate of 0.22%, (ii) bond yield of 30%, (iii) no dividend yield, (iv) volatility of 100.8%, (v) recovery rate of 35%, and (vi) the stock price on the date of measurement. As of June 30, 2012, the fair value of the embedded derivatives upon issuance was determined to be \$3.6 million using the binomial lattice valuation model applying the following assumptions: (i) risk-free rate of 0.21%, (ii) bond yield of 30%, (iii) no dividend yield, (iv) volatility of 101.3%, (v) recovery rate of 35%, and (vi) the stock price on the date of measurement. The probability of a change in control and the probability of debt covenant triggers have been factored into the valuation of the embedded derivative liability.

The following table provides a roll forward of the fair value of these liabilities, where fair value is determined by Level 3 inputs (in thousands):

	Three Months Ended	
	June 30, 2012	
Balance at April 1, 2012	\$	3,346
Issuance of May 2012 Warrants		7,712
Embedded derivatives associated with the 2013 Senior Notes		2,842
Change in fair value		8,374
Balance at June 30, 2012	\$	22,274

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

1. Nature of the Business, Basis of Presentation, and Significant Accounting Policies (Continued)

	Six Months Ended June 30, 2012	
Balance at January 1, 2012	\$	
Issuance of January 2012 Warrants		11,901
Issuance of May 2012 Warrants		7,712
Embedded derivatives associated with the 2013 Senior Notes		2,842
Change in fair value		(181)
Balance at June 30, 2012	\$	22,274

Net Loss Per Share Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding during the fiscal year. Diluted net loss per share is computed by dividing net loss by the weighted-average number of dilutive common shares outstanding during the fiscal year. Dilutive shares outstanding are calculated by adding to the weighted shares outstanding any potential (unissued) shares of common stock and warrants based on the treasury stock method.

The following potentially dilutive securities were excluded from the calculation of diluted net loss per share, as the effect would have been anti-dilutive (in thousands):

	June 30,	
	2011	2012
2016 Notes upon conversion to common stock	19,965	19,965
2013 Senior Notes upon conversion to common stock(1)		39,938
Warrants to purchase common stock	45	25,257
Options to purchase common stock	11,240	12,001
Unvested restricted stock units	1,316	6,482
	32,566	103,643

- (1) The number of potentially dilutive shares attributable to the 2013 Senior Notes was calculated based on the principal outstanding as of June 30, 2012 and the initial conversion price of \$1.18 per share. The conversion price is subject to change as outlined in Note 2, Private Placement.

2. Private Placements

January Registered Direct Offering

On January 25, 2012, the Company sold an aggregate of 12,500,000 units to an institutional investor at a price of \$2.034 per unit, with each unit consisting of (i) one share of its common stock ("Common Stock") and (ii) one warrant to purchase one share of Common Stock ("January 2012 Warrants"), in a registered direct offering for gross proceeds of approximately \$25.4 million. The net proceeds to the Company from the sale of the units, after deducting the placement agent's fees and other estimated offering expenses, was approximately \$23.5 million. The January 2012 Warrants have an exercise price of \$2.71 per share, and the January 2012 Warrants can be exercised beginning on July 26, 2012 and will expire on July 28, 2014. In the event of a fundamental change, as defined in the Warrants, the Purchasers are entitled to a fair value settlement for the lost option value determined on

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

2. Private Placements (Continued)

a Black-Scholes-based calculation with defined assumptions within the agreement. The January 2012 warrants have been accounted for as a liability. The fair value of the January 2012 warrants on the date of issuance was \$11.9 million. See Note 1, Fair Value of Financial Instruments. The remaining net proceeds were allocated to common stock. In addition, at any time during both the ten trading days beginning on June 18, 2012 (the "First Option Period") and the ten trading days beginning on July 23, 2012 ("the Second Option Period"), the Company had the right, subject to certain conditions (including the Company having an arithmetic average of the daily volume weighted average common stock price of greater than \$1.00 during the 30 trading days prior to each additional sale option period), to require the investors to purchase in each such period up to an additional 6,250,000 shares of Common Stock, for an aggregate of up to 12,500,000 additional shares of Common Stock. The Company did not meet the required conditions during the First Option Period and therefore did not exercise the purchase right described above. On July 5, 2012, the Company and the institutional investor agreed to terminate the purchase right associated with the Second Option Period. Accordingly, the Company will not be able to require the investor to purchase any additional shares.

Private Senior Convertible Notes and Warrants Offering

On May 24, 2012, the Company issued \$50.0 million aggregate principal amount of senior convertible notes and warrants to purchase 12,711,864 shares of its common stock to institutional investors.

The 2013 Senior Notes and the May 2012 Warrants are detachable and legally separable. See Note 8 for a summary of the material terms on the 2013 Senior Notes.

The May 2012 Warrants have an exercise price equal to \$1.29 per share, and the May 2012 Warrants can be exercised beginning on November 26, 2012 and will expire on November 24, 2017. In the event of a fundamental change, as defined in the Warrants, the Purchasers are entitled to a fair value settlement for the lost option value determined on a Black-Scholes-based calculation with defined assumptions within the agreement. The May 2012 Warrants have customary anti-dilution adjustments as well as an exercise price reset provision upon the issuance of common stock at a per share price less than the exercise price currently in effect for the warrant. The May 2012 Warrants have been accounted for as a liability. The fair value of the May 2012 Warrants on the date of issuance was \$7.7 million. See Note 1, Fair Value of Financial Instruments. On July 13, 2012, the purchase price of the May 2012 Warrants was adjusted from \$1.29 to \$0.74 due to a common stock issuance on July 12, 2012. On July 31, 2012, the purchase price of the May 2012 Warrants was further adjusted from \$0.74 to \$0.42 due to a common stock issuance on July 30, 2012. See Note 10 for details on this common stock issuance subsequent to the June 30, 2012.

The May 2012 Warrants may not be exercised if, after giving effect to the exercise, the Purchasers, together with their affiliates, would beneficially own in excess of 4.99% (the "Maximum Percentage"). The Maximum Percentage may be raised to any other percentage not in excess of 9.99% at the option of the holder of the May 2012 Warrants, upon at least 61-days' prior notice to the Company, or lowered to any other percentage, at the option of the Purchasers, at any time.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

3. Government Grants

Center of Energy and Excellence Grant

In February 2009, the State of Michigan awarded the Company a \$10.0 million Center of Energy and Excellence grant. Under the agreement, the State of Michigan will provide cost reimbursement for 100% of qualified expenditures based on the achievement of certain milestones by March 2012. There are no substantive conditions attached to this award that would require repayment of amounts received if such conditions were not met. The Company received \$3.0 million of this grant in March 2009 and \$6.0 million of this grant in July 2010, with additional payments to be made based on the achievement of certain milestones in the facility development. Through June 30, 2012, the Company has used \$8.8 million of these funds, of which \$7.9 million and \$0.9 million was recorded as an offset to property, plant and equipment and operating expenses, respectively. For the six months ended June 30, 2011, \$0.1 million was recorded as an offset to operating expenses in the condensed consolidated statements of operations, respectively. There was no offset to operating expenses recorded for the three months ended June 30, 2011. For the three and six months ended June 30, 2012, \$0.2 million and \$0.5 million were recorded as an offset to operating expenses in the condensed consolidated statements of operations, respectively.

As of June 30, 2012, \$0.2 million of these funds were recorded in short term restricted cash, \$1.0 million in prepaid and other current assets, and \$1.2 million in other current liabilities.

Michigan Economic Growth Authority

In April 2009, the Michigan Economic Growth Authority offered the Company certain tax incentives, which can be used to offset the Michigan Business Tax owed in a tax year, carried forward for the number of years specified by the agreement, or be paid to the Company in cash at the time claimed to the extent the Company does not owe a tax. The terms and conditions of the *High-Tech Credit* were established in October 2009 and the *Cell Manufacturing Credit* in November 2009.

High Tech Credit The *High-Tech Credit* agreement provides the Company with a 15-year tax credit, based on qualified wages and benefits multiplied by the Michigan personal income tax rate beginning with payments made for the 2011 fiscal year. The tax credit has an estimated value of up to \$25.3 million, depending on the number of jobs created in Michigan. The proceeds to be received by the Company will be based on the number of jobs created, qualified wages paid and tax rates in effect over the 15 year period. The tax credit is subject to a repayment provision in the event the Company relocates a substantial portion of the jobs outside the state of Michigan on or before December 31, 2026. As of December 31, 2011 and June 30, 2012, the Company recorded undiscounted long-term receivables of \$1.0 million and \$1.6 million, respectively, with an offsetting balance in other long-term liabilities in the condensed consolidated balance sheet as it is reasonably assured that the Company will comply with the conditions of the tax credit and will receive the proceeds. The balance will be recognized in the condensed consolidated statements of operations over the term that the Company is required to maintain the required number of jobs in Michigan.

Cell Manufacturing Credit The *Cell Manufacturing Credit* agreement authorizes a tax credit or cash for the Company equal to 50% of capital investment expenses related to the construction of the Company's integrated battery cell manufacturing facilities in Michigan, commencing with costs incurred from January 1, 2009, up to a maximum of \$100.0 million over a four year period. The tax credit shall not exceed \$25.0 million per year and can be submitted for reimbursement beginning in tax year 2012.

Table of Contents**A123 Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****3. Government Grants (Continued)**

The Company is required to create 300 jobs no later than December 31, 2016 for the tax credit to be non-refundable. The tax credit is subject to a repayment provision in the event the Company relocates 51% or more of the 300 jobs outside of the state of Michigan within three years after the last year the tax credit is received. Through June 30, 2012, the Company has incurred \$200.0 million in qualified expenses related to the construction of the Livonia and Romulus facilities. When the Company has met the filing requirements for the tax year ending December 31, 2012, the Company expects to begin receiving \$100.0 million in proceeds related to these expenses. As of December 31, 2011 and June 30, 2012, the Company has recorded undiscounted receivables of \$100.0 million, as it is reasonably assured that the Company will comply with the conditions of the tax credit and will receive the proceeds. Upon recording the receivables, the Company reduced the basis in the fixed assets acquired in accordance with the tax credit and this will be recognized in the condensed consolidated statements of operations over their estimated useful lives of the depreciable asset as reduced depreciation expense.

U.S. Department of Energy Battery Initiative

In December 2009, the Company entered into an agreement establishing the terms and conditions of a \$249.1 million grant awarded under the U.S. Department of Energy ("DOE") Battery Initiative to support manufacturing expansion of new lithium-ion battery manufacturing facilities in Michigan. Under the agreement, the DOE will provide cost reimbursement for 50% of qualified expenditures incurred from December 1, 2009 to November 30, 2012. The agreement also provides for reimbursement of pre-award costs incurred from June 1, 2009 to November 30, 2009. There are no substantive conditions attached to this award that would require repayment of amounts received if such conditions were not met. In April 2012, the term of the award was extended by two years through December 2, 2014. Through June 30, 2012, the Company has incurred \$260.6 million in qualified expenses, of which 50%, or \$130.3 million, are allowable costs for reimbursement, nearly all of which have been reimbursed. For the three months ended June 30, 2011 and June 30, 2012, the Company incurred allowable costs of \$16.4 million and \$0.9 million, of which \$13.9 million and \$0.6 million was recorded as an offset to property, plant and equipment and \$2.5 million and \$0.3 million was recorded as an offset to operating expenses, respectively. For the six months ended June 30, 2011 and June 30, 2012, the Company incurred allowable costs of \$27.9 million and \$2.5 million, of which \$21.5 million and \$2.0 million was recorded as an offset to property, plant and equipment and \$6.4 million and \$0.5 million as an offset to operating expenses, respectively. As of December 31, 2011 and June 30, 2012, the Company recorded \$0.8 million and \$0.7 million, respectively, as receivables in prepaid expenses and other current assets in the condensed consolidated balance sheets.

4. Inventory

Inventory consists of the following (in thousands):

	December 31, 2011		June 30, 2012
Raw materials	\$ 44,493	\$	42,873
Work-in-process	53,924		44,133
Finished goods	4,977		9,298
	\$ 103,394	\$	96,304

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

4. Inventory (Continued)

The Company's lower of cost or market provision as of December 31, 2011 and June 30, 2012 was \$4.9 million and \$5.2 million, respectively. The inventory on hand as of June 30, 2012 was written down by \$5.2 million to reduce specific inventory items on hand with unit costs that exceed their net realizable value. The net realizable value of inventory is calculated by taking the estimated selling price of the inventory on hand based on customer contracts and forecasted sales and subtracting the remaining costs to complete and dispose of the inventory. As a result of the field campaign launched related to the defective prismatic cells produced at the Livonia, Michigan manufacturing facility, the Company wrote down \$15.2 million in inventory that was impacted by the defective prismatic cells during the six months ended June 30, 2012. See Note 1 for additional details.

5. Investments

Cost-Method Investments

In January 2010, the Company entered into an agreement to purchase preferred stock of Fisker Automotive, Inc., a maker of plug-in hybrid electric vehicles in the United States ("Fisker"). The Company agreed to invest (i) cash of \$13.0 million; and (ii) shares of the Company's common stock, which, when transferred to Fisker, had a fair market value of \$7.5 million. The Company is accounting for its investment under the cost method. In December 2011, the Company elected not to participate in Fisker's subsequent stock financing. This election not to participate resulted in the conversion of the Company's preferred shares of Fisker to common shares on a 2:1 ratio. As such, the Company performed an analysis and valuation of its investment in Fisker resulting in an adjusted investment value of \$8.9 million as of December 31, 2011.

During the three months ended June 30, 2012, the Company updated its analysis and valuation of its investment in Fisker resulting in the recognition of an impairment charge of \$2.9 million for the three and six months ended June 30, 2012. The Company's investment in Fisker at June 30, 2012 had a carrying value of \$6.0 million.

Equity-Method Investments

In December 2009, the Company entered into a joint venture agreement with SAIC Motor Co. Ltd. ("SAIC"), an automaker in China, to assist the Company in growing its business and sales in China's transportation industry and created Shanghai Advanced Traction Battery Systems, Co. Ltd. (the "Joint Venture"). Under the terms of the joint venture agreement, the Company was required to invest \$4.7 million into the Joint Venture over a period of approximately 15 months, in return for a 49% interest in the Joint Venture. The Company made the first capital contribution of \$1.9 million to the Joint Venture in July 2010 and the second capital contribution of \$1.4 million in January 2011. The Company made the final capital contribution of \$1.4 million in July 2011. The Company is accounting for its investment under the equity method.

In August 2010, the Company entered into an agreement to transfer certain patents held by the Company to a privately-held company, 24M Technologies, Inc. ("24M"), in return for a 12% ownership interest in 24M. The Company is accounting for its investment under the equity method as it has determined it has significant influence over the operating and financial decisions of the third party. The Company has recorded the investment on the condensed consolidated balance sheet at the fair value of the ownership interest received net of accumulated losses recognized under the equity method.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

5. Investments (Continued)

For the three and six months ended June 30, 2011 and for the three and six months ended June 30, 2012, the Company recorded a loss of \$0.4 million, \$0.6 million, \$0.3 million and \$0.8 million, respectively, in the condensed consolidated statements of operations related to its share of losses in investments accounted for under the equity method.

6. Commitments and Contingencies

Litigation On April 2, 2012, a complaint was filed in the United States District Court for the District of Massachusetts by Scott Heiss, purportedly acting individually and on behalf of other similarly situated persons, against the Company and its CEO, David Vieau, its CFO, David Prystash, and its former Interim CFO, John Granara. The complaint followed the Company's disclosure in March 2012 of potentially defective prismatic cells used in battery packs and a replacement program for such cells. The complaint attempts to allege that certain of the Company's disclosures were inaccurate because the potentially defective cells and their replacement were not disclosed earlier. The complaint asserts a claim under Section 10(b) of the Securities Exchange Act of 1934 against the Company and claims under Sections 10(b) and 20(a) of that statute against the individuals. It asserts a purported class period from February 28, 2011 through March 23, 2012.

On April 12, 2012, a similar complaint was filed in the United States District Court for the District of Massachusetts by Terry Leon Fike, purportedly acting individually and on behalf of other similarly situated persons, against the same defendants. The complaint makes similar allegations and also asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and a purported class period from February 28, 2011 through March 23, 2012. On June 7, 2012, the Court consolidated the two cases and appointed a lead plaintiff and lead counsel for the asserted class. No substantive response has been required at this time.

On May 14, 2012, a putative derivative action was filed in the U.S. District Court for the District of Massachusetts against the Board of Directors and certain others, as well as against the Company as a nominal defendant, captioned, Jane Ahmed v. David P. Vieau, David Prystash, John Granara, Desh Deshpande, Arthur L. Goldstein, Gary E. Haroian, Dr. Paul E. Jacobs, Mark M. Little, Jeff McCarthy and Dr. Bart Riley, 1:12-CV-10865-RGS. The complaint alleges that certain of the Company's disclosures between February 28, 2011 and March 28, 2012 were materially misleading because they failed to disclose the prismatic cell manufacturing issues and that the individual defendants violated their fiduciary duties and other causes of action on behalf of the company. The complaint alleges that demand on the board to take such actions would be "futile" and should be excused. On June 6, 2012, the defendants moved to dismiss the complaint on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On June 20, 2012, plaintiff opposed that motion, and on June 25, defendants submitted a reply in further support of their motion to dismiss. The motion to dismiss has not been decided at this time.

On May 15, 2012 the Company received a letter addressed to its Board of Directors from an attorney representing an individual claiming to be a shareholder of the Company. The letter asserts that the Company's disclosures between November 9, 2010 and March 28, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012, and asserts that the Board breached its fiduciary duties during this time. The letter makes a demand on the Board to investigate the alleged inaccurate statements and to consider potential legal action against those

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

6. Commitments and Contingencies (Continued)

deemed responsible. The Board considered the issues raised in the letter and retained independent counsel to advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the assistance of counsel and determined that it would not be in the best interest of the Company or its stockholders to commence or maintain an action against any present or former officer or director of the Company concerning the matters alleged in the demand and refused the demands.

On May 21, 2012, a putative derivative action was filed in Superior Court for the Commonwealth of Massachusetts against the Board of Directors and certain others, as well as against the Company as a nominal defendant, captioned, Murray Sussman v. David P. Vieau, Gururaj Deshpande, Gilbert N. Riley, Jr., Jeffrey McCarthy, Gary E. Haroian, Arthur L. Goldstein, Paul E. Jacobs, Mark M. Little, David Prystash, John Granara, Case No. 12-917. The complaint asserts substantially similar allegations and claims as the Ahmed complaint summarized above, including that demand on the board of directors should be excused as futile. On June 11, 2012, the defendants filed a motion asking the court to stay this litigation in favor of the derivative case pending in the U.S. District Court for the District of Massachusetts, or, in the alternative, that the complaint should be dismissed on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On July 16, 2012, the plaintiff filed a memorandum of law in opposition to defendants' motion to stay the litigation, or in the alternative, to dismiss this action. On July 27, 2012, the defendants filed a reply memorandum of law in further support of their motion to stay, or in the alternative, to dismiss the action. The motion to stay or dismiss has not been decided at this time. The court has set a hearing date of September 11, 2012 on defendants' motion to stay or dismiss.

On July 13, 2012, the Company received a demand letter addressed to its Board of Directors from an attorney representing an individual claiming to be a shareholder of the Company. The letter alleges that the Company's disclosures between March 11, 2011 and March 12, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012 and asserts that the Board and certain current and/or former executive officers of the Company breached their fiduciary duties. The letter makes a demand on the Board to investigate the alleged breach of fiduciary duties to the Company and to consider legal action against those responsible. The Board considered the issues raised in the letter and had its independent counsel advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the assistance of counsel and determined that it would not be in the best interest of the Company or its stockholders to commence or maintain an action against any present or former officer or director of the Company concerning the matters alleged in the demand and refused the demands.

The Company intends to defend the litigations vigorously. Currently, the Company is unable to determine the outcome of these matters and the effect, if any, they may have on its financial position or results of operations. The outcomes of these matters are inherently uncertain and may be affected by future events. Accordingly, there can be no assurance as to the ultimate effect of these matters.

Royalty Obligations On October 31, 2011, the Company entered into a Patent Sublicense Agreement with LiFePO₄+C Licensing AG as part of a settlement agreement with Hydro-Quebec and the Board of Regents of the University of Texas System, on behalf of the University of Texas at Austin.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

6. Commitments and Contingencies (Continued)

As partial consideration for the license grants by LiFePO₄+C Licensing AG, the Company will be required to pay royalties to LiFePO₄+C Licensing AG on a quarterly basis commencing as of January 1, 2012, based on a percentage of the Company's net sales of cells, electrode systems, and/or complex systems (plus such net sales attributed to any permitted sublicensees of the Company) during such quarterly period. The Company is required to pay royalties on a sliding scale, with a maximum possible royalty rate of 2% of net sales (based on a defined percentage of the Company's product sales revenue) through the agreement's term, and based on the fiscal year in which the royalties are calculated and the accrual of total royalty in that fiscal year. Such defined percentage may also be adjusted by mutual agreement if the Company's standalone cell or electrode system revenues increase significantly in proportion to overall product revenues. During the three and six months ended June 30, 2012, the Company incurred \$0.1 million in royalty obligations related to this agreement.

Restructuring In February 2012, as part of the Company's continuing efforts to reduce expenses and strengthen its operations, the Company decided to close down its facility in Korea while relocating a portion of its new product development and advanced manufacturing engineering teams to other facilities. The Company's need to align its manufacturing capacity with near-term customer demand and the need to reduce operating expenses are the key factors that drove the decision to restructure. The Company expects to complete the shutdown of its Korean facility in the second half of 2012. In March 2012, the Company recorded \$0.8 million as a reserve for discretionary termination benefits for the Company's Korean employees, in addition to a \$1.1 million severance benefits accrual from statutory requirements accounted for in accordance with Accounting Standards Codification ("ASC") Topic 712, Compensation - Nonretirement Postemployment Benefits. During the three and six months ended June 30, 2012, the Company paid \$1.0 million in termination benefits resulting in a severance accrual of \$0.9 million remaining as of June 30, 2012. Facility closure and other costs are accounted for in accordance with ASC Topic 420, Exit or Disposal Cost Obligations, and are recorded when the liability is incurred. During the three and six months ended June 30, 2012, the Company incurred \$0.5 million in relocation expenses attributable to the restructuring efforts, of which approximately \$0.1 million was paid during the three and six months ended June 30, 2012. Additionally, during the three and six months ended June 30, 2012, the Company recorded \$3.3 million in asset impairment charges and lease remediation costs of \$0.7 million related to the Korea facility shutdown.

Retention agreements In February 2012, the Company entered into employment agreements with approximately 40 employees. The agreements provide for severance payments ranging from 6 months to 24 months of salary in connection with a change in control and subsequent termination of employment. Certain of the agreements also provide for the above benefits if the employees' employment is terminated without cause prior to a change in control. Certain of the agreements also provide for acceleration of vesting of stock options and restricted stock units in the event of a change in control.

7. Product Warranties

The Company provides for the estimated costs to fulfill customer warranty obligations upon the recognition of the related revenue. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company's warranty obligation is affected by product failure rates, costs per failure, and supplier warranties on parts delivered to the Company. In developing the warranty estimates for each product, the Company utilizes its failure rate performance for battery systems based on actual warranty

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

7. Product Warranties (Continued)

experience and an assessment of customer-specific factors that could impact warranty costs. Based on the history of warranty claims, the Company has been able to identify the types of failures that have occurred, when in the product's life cycle they have occurred, and the frequency of its occurrence. Should actual product failure rates, costs per failure, or supplier warranties on parts differ from the Company's estimates, revisions to the estimated warranty liability would be required. During the six months ended June 30, 2012, the Company recorded an additional charge of \$51.6 million, of which \$6.6 million represented the write-off of deferred costs associated with deferred revenue, related to the Company's launch of a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility. There were no additional charges related to the field campaign resulting from the defective prismatic cells produced at its Livonia, Michigan facility for the three months ended June 30, 2012. See Note 1 for additional details.

Product warranty activity, which is recorded in accrued expenses and other long-term liabilities on the condensed consolidated balance sheets, was as follows (in thousands):

	June 30, 2012
Product warranty liability at January 1, 2012	\$ 17,527
Accruals for new warranties issued (warranty expense)	284
Accruals for preexisting warranties (warranty expense net of deferral)	49,347
Payments made (in cash or in kind)	(6,815)
Product warranty liability at June 30, 2012	60,343
Less amounts classified as current	52,005
Long-term warranty liability	\$ 8,338

8. Financing Arrangements

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

	December 31, 2011	June 30, 2012
Convertible notes (2016 Notes)	\$ 140,064	\$ 140,494
Convertible notes (2013 Senior Notes)		41,938
Term loan	2,069	
Mass Clean Energy loan	2,691	2,773
Total	144,824	185,205
Less amounts classified as current	2,069	38,490
Long-term debt	\$ 142,755	\$ 146,715

2013 Senior Notes On May 24, 2012, the Company issued \$50.0 million in aggregate principal of senior notes. The 2013 Senior Notes are convertible, at the Purchasers' option, into shares of the Company's common stock, initially at a fixed conversion price of \$1.18 per share, subject to certain adjustments. The 2013 Senior Notes bear interest at a rate of 6.00% per year, subject to certain adjustments, and mature on July 15, 2013. The 2013 Senior Notes are *pari passu* in right of payment

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

8. Financing Arrangements (Continued)

with all existing and future unsecured senior indebtedness and will be senior in right of payment to any future subordinated indebtedness.

The Purchasers also have the right at any time, and from time to time, after August 15, 2012, to elect to convert up to \$30.0 million aggregate principal amount of 2013 Senior Notes at a price equal to 85% of the closing price of the Company's common stock on the trading day immediately preceding the conversion date; provided, however, that the Purchasers may not convert more than \$3.5 million aggregate principal amount of the 2013 Senior Notes on any given trading date. The 2013 Senior Notes may not be converted if, after giving effect to the conversion, the Purchasers together with their affiliates would beneficially own in excess of 4.99% of the outstanding shares of the Company's common stock. This maximum percentage may be raised to any other percentage not in excess of 9.99% at the option of the Purchasers, upon at least 61-days' prior notice to the Company, or lowered to any other percentage, at the option of the Purchasers at any time.

The Company is required to repay the 2013 Senior Notes in twenty-seven semi-monthly installments ("Installment Dates"), commencing on June 15, 2012 and thereafter on the 1st and 15th of each month. The amortization payment on each Installment Date is $\frac{1}{29}$ th of the principal amount of the 2013 Senior Notes, subject to certain adjustments, provided that the amortization payment on the June 15, 2012, July 1, 2012 and July 15, 2012 Installment Dates will be $\frac{2}{3}$ times the amortization payment on the other Installment Dates. The Company has the right to make the interest or amortization payments and redemption payments in shares of the Company's common stock, subject to the satisfaction of certain conditions, or elect to pay in cash. Among these conditions:

there must be an effective registration statement covering such shares of common stock issuable under the terms of the 2013 Senior Notes or such shares of common stock must be eligible for sale pursuant to Rule 144 under the Securities Act without the need for registration,

the weighted average price of the Company's common stock on each of the prior 15 trading days has not been below \$0.80; and

the daily dollar trading volume of the Company's common stock for each of the prior 15 trading days was at least \$750,000.

If the Company is not permitted to deliver shares of common stock with respect to an Installment Date due to a failure to satisfy any of the conditions, it must pay the applicable portion of the principal and interest amounts in cash, unless the conditions are waived by the purchaser. Whether the Company makes repayments in cash or stock (if permitted) on any Installment Date will depend primarily on the Company's finances and its trading price at the time of the applicable Installment Date.

If the Company makes a payment in shares of common stock, the principal amount of the 2013 Senior Notes being paid will be converted into shares of the Company's common stock at a price per share equal to the lesser of the applicable conversion price and 82% of the Market Price of the Company's common stock on the applicable interest date or amortization installment date. "Market Price" means the arithmetic average of the volume weighted average price of the Company's common stock on each of the five trading days immediately preceding the applicable date, but in no event greater than the volume weighted average price of the Company's common stock on the trading date immediately preceding the applicable date.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

8. Financing Arrangements (Continued)

The Company agreed to deposit \$30.0 million of the proceeds from the 2013 Senior Notes into a bank account subject to an account control agreement. Release of these proceeds was conditioned upon:

the Company obtaining, on or prior to June 30, 2012, shareholder approval of (a) the issuance of shares of the Company's common stock in connection with the conversion, interest payments and amortization of the 2013 Senior Notes and (b) an increase in the authorized number of shares of Common Stock of the Company (the "Shareholder Approval"); and

the effectiveness, on or prior to certain deadlines, of one or more registration statements covering the shares of common stock underlying the 2013 Senior Notes and the May 2012 Warrants (the "Registration Statement Effectiveness").

On June 29, 2012, the Company received the Shareholder Approval. Subsequent to the June 30, 2012 quarter end, on July 6, 2012, the Company fulfilled the remaining conditions for release of, and subsequently received, the \$30.0 million of proceeds under the account control agreement.

The Company measured the associated May 2012 Warrants and the 2013 Senior Note embedded derivatives at fair value separate from the debt obligation. The May 2012 Warrants are recorded as a separate liability. While measured separately, the embedded derivatives and the debt obligation are carried on a combined basis and reflected in the current portion of long-term debt and long-term debt in the Company's condensed consolidated balance sheet. Accordingly, a discount was recorded on the 2013 Senior Notes to reflect the value of the May 2012 Warrants and the embedded derivatives. The debt discount is being amortized to interest expense using the effective interest method over the term of the 2013 Senior Notes. As of June 30, 2012, the unamortized discount was \$8.8 million and the carrying value of the 2013 Senior Notes, net of the unamortized discount, and the embedded derivatives was \$41.9 million. The Company recorded deferred financing costs of \$3.4 million that will be amortized as interest expense using the effective interest method over the term of the 2013 Senior Notes. During the three and six months ended June 30, 2012, the Company recognized interest expense of \$2.6 million related to the 2013 Senior Notes, of which \$0.3 million, \$1.7 million, and \$0.6 million relates to the contractual coupon interest accrual, the amortization of the discount, the amortization of the deferred financing costs, respectively. The embedded derivatives are required to be market to market each reporting period through earnings.

2016 Notes In April 2011, the Company issued \$143.8 million in principal of convertible unsecured subordinated notes (the "2016 Notes"). The 2016 Notes bear interest at 3.75%, which is payable semi-annually in arrears on April 15 and October 15 each year, beginning on October 15, 2011, and mature on April 15, 2016. Holders may surrender their Convertible Notes, in integral multiples of \$1,000 principal amount, for conversion any time prior to the close of business on the business day immediately preceding the maturity date. The initial conversion rate of 138.8889 shares of common stock per \$1,000 aggregate principal amount of 2016 Notes, equivalent to a conversion price of approximately \$7.20 per share of the Company's common stock, is subject to adjustment in certain events. Upon conversion, the Company will deliver shares of common stock. If the Company undergoes a fundamental change (as defined in the prospectus supplement relating to the 2016 Notes), the holders of the 2016 Notes have the option to require the Company to repurchase all or any portion of their 2016 Notes. The Company may not redeem the 2016 Notes prior to the maturity date.

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

8. Financing Arrangements (Continued)

The Company recorded a debt discount to reflect the value of the underwriter's discounts and commissions. The debt discount is being amortized as interest expense over the term of the 2016 Notes. As of June 30, 2012, the unamortized discount was \$3.3 million and the carrying value of the 2016 Notes, net of the unamortized discount, was \$140.5 million. During the three months ended June 30, 2012, the Company recognized interest expense of \$1.6 million related to the 2016 Notes, of which \$1.4 million and \$0.2 million relate to the contractual coupon interest accrual and the amortization of the discount, respectively. During the six months ended June 30, 2012, the Company recognized interest expense of \$3.2 million related to the 2016 Notes, of which \$2.8 million and \$0.4 million relate to the contractual coupon interest accrual and the amortization of the discount, respectively.

Revolving Credit Facilities On September 30, 2011, the Company entered into a Credit Agreement, providing it with a revolving loan facility in an aggregate principal amount of up to the lesser of (i) \$40.0 million or (ii) a Borrowing Base (as defined in the credit agreement) established at 80% of certain eligible accounts, 15% of certain eligible foreign accounts and 30% of certain eligible inventory, as more specifically described in the agreement. The agreement also provides a letter of credit sub-facility in an aggregate principal amount of up to \$10.0 million and a swing-line loan sub-facility in an aggregate principal amount of up to \$5.0 million. Any outstanding obligations under either the letter of credit sub-facility or swing-line sub-facility deduct from the availability under the \$40.0 million revolving facility. The credit agreement additionally provides a discretionary incremental facility in an aggregate principal amount of not less than \$10.0 million and up to \$35.0 million. The funding of the incremental facility is discretionary on the part of the lenders and will depend on market conditions and other factors. The credit agreement permits the Company to enter into cash management and hedging agreements with the lenders.

On March 6, 2012, the Company entered into the First Amendment to its Revolving Credit Agreement. The amendment extends the Revolving Termination Date of the agreement to June 1, 2013. On May 11, 2012, the Company entered into a subsequent amendment. This amendment eliminates the borrowing facility and provides for up to \$15.0 million as security for letters of credit. All outstanding letters of credit are required to be cash collateralized at 105% of their face amount. At June 30, 2012, the Company had \$10.8 million of restricted cash to collateralize primarily the outstanding letters of credit. One of the financial covenants in this revolving facility requires that the Company maintain a minimum cash balance of \$40.0 million.

The outstanding balance at December 31, 2011 was \$38.1 million. As of June 30, 2012, there was no balance outstanding and there was no amount available for borrowing under the facility.

Amounts outstanding under the agreement (including any cash management or hedging agreements as provided in the agreement) are secured by substantially all of the Company's existing and future assets, except intellectual property and certain other exceptions as set forth in the Agreement and related security documents.

Additionally, the Company may not create, issue, incur, assume or be liable in respect of or suffer to exist, any indebtedness, except for permitted indebtedness or create, incur, assume or suffer to exist, any lien on its property, except for permitted liens. Under the credit agreement, an event of default would occur if the Company fails to pay any obligation due or fail or neglect to perform, keep or observe any material term provision, condition, covenant or agreement within the credit agreement, and do not, or are not able to remedy the default within the allowed grace period, or a material adverse

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

8. Financing Arrangements (Continued)

change in our business occurs. Upon an event of default, the financial institution may declare all obligations immediately due and payable, it may stop advancing money or extending credit or it may apply against the obligation balances and deposits which the Company holds with the financial institution, among other remedies available to the financial institution under the terms of the credit agreement.

As of June 30, 2012, the Company was in compliance with the covenants and terms of the agreements.

9. Related Party Transactions

Transactions with Holders of Common Stock In November 2011, the Company entered into a technology license agreement, a product supply agreement and a stock purchase agreement with IHI Corporation ("IHI"), an industrial equipment manufacturer located in Japan. IHI agreed to make a \$25.0 million equity investment in the Company's common stock under the stock purchase agreement, which closed on November 18, 2011. In addition, the Company had exclusively licensed, for an initial term of 10 years, its advanced battery system technology and systems integration know-how to manufacture battery systems and modules for the transportation market in Japan for a one-time non-refundable license fee of \$7.5 million. During the license term, the Company will also receive royalty payments based on a percentage of IHI's net sales of products that use or embody the licensed technology and know-how, minus the cost of battery cells purchased by IHI from the company for use with such products. The Company will be the exclusive supplier of lithium ion battery cells to IHI under a product supply agreement for the battery systems and modules that IHI produces. As of December 31, 2011 and June 30, 2012, the balance due of \$1.6 million and \$1.1 million, respectively, is included within accounts receivable, net on the condensed consolidated balance sheets. As of December 31, 2011 and June 30, 2012, the deferred revenue balance related to the technology license fee was \$7.5 million and \$7.1 million, respectively. During the three and six months ended June 30, 2012, amortization of the license fee resulted in the recognition of \$0.2 million and \$0.4 million of revenue from IHI, respectively. In January 2012, the Company entered into a value added reseller agreement and a professional services agreement with IHI. As of June 30, 2012, the Company recorded \$0.2 million of deferred revenue related to the professional services agreement.

Transactions with Joint Venture Partner's Affiliate In December 2009, the Company entered into a joint venture with SAIC to assist the Company in growing business and sales in China's transportation industry. The Company entered into two development agreements with SAIC. During the three and six months ended June 30, 2011, the Company recorded revenue related to the development and supply agreements with SAIC of \$0.2 million and \$0.4 million, respectively. There was no revenue recorded during the three and six months ended June 30, 2012 related to the development and supply agreements. As of December 31, 2011 and June 30, 2012, the balance due from SAIC was \$0.1 million and \$40,000, respectively, which is included within accounts receivable, net on the condensed consolidated balance sheets. There was no deferred revenue recorded as of December 31, 2011 and June 30, 2012.

Transactions with Cost-Method Investment In January 2010, the Company entered into a supply agreement with Fisker. The Company also holds common stock in Fisker. The Company recognizes revenue on product shipments to Fisker, within the condensed consolidated statements of operations, when all revenue recognition criteria are met. During the three and six months ended June 30, 2011,

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

9. Related Party Transactions (Continued)

the Company recorded \$14.3 million and \$16.0 million of revenue from Fisker, respectively. During the six months ended June 30, 2012, the Company recorded \$0.2 million of revenue from Fisker. There was no revenue recorded during the three months ended June 30, 2012. At December 31, 2011 and June 30, 2012, the Company has deferred \$4.4 million and \$2.2 million, respectively, of service and product revenue related to the development and supply agreement. The balance due from Fisker as of December 31, 2011 and June 30, 2012, of \$3.7 million and \$0.2 million, respectively, is included within accounts receivable, net on the condensed consolidated balance sheets.

Transactions with Equity-Method Investment During March 2010, the Company entered into a technology license contract to license certain patents and technology to the Company's Joint Venture for the term of the Joint Venture, which extends to April 28, 2030. In conjunction with the license agreement, the Joint Venture paid the Company the first payment of the license fee of \$1.0 million in July 2010. Revenue on the license fee will be amortized over the term of the license. Revenue recognition on the license fee is expected to commence upon the successful completion of training provided to employees of the Joint Venture. As of December 31, 2011 and June 30, 2012, the \$1.0 million license fee is recorded in deferred revenue on the condensed consolidated balance sheets. Additionally, as of June 30, 2012, \$0.1 million was recorded in deferred revenue related to training services.

During December 2010, the Company entered into a service agreement to provide technical development, design, analysis and consultation services to the Joint Venture. Additionally, the Company entered into an agreement to provide sample battery system packs to the Joint Venture. For the three and six months ended June 30, 2011 and for the three and six months ended June 30, 2012, the Company recognized \$1.4 million, \$1.8 million, \$0.9 million and \$1.3 million, respectively, of product and service revenue from the Joint Venture on the condensed consolidated statements of operations. As of December 31, 2011 and June 30, 2012, \$1.5 million and \$2.8 million, respectively, is included within accounts receivable, net on the condensed consolidated balance sheets for amounts due from the Joint Venture.

10. Subsequent Events*(a) Registered Direct Offering of Common Stock and Warrants*

On July 10, 2012, the Company sold an aggregate of 7,692,308 shares of the Company's common stock and warrants to purchase additional shares of such common stock for an exercise price of \$0.001 per share to certain existing institutional investors. The Company agreed to sell the common shares at an initial negotiated purchase price of \$1.30, subject to adjustment as described below.

Pursuant to the July 2012 Warrants, the Company issued to the institutional investors 6,662,852 additional shares of common stock in two separate issuances on July 12, 2012 and July 30, 2012 due to the decrease in the volume weighted average stock price compared to the initial purchase price of \$1.30. The Company also paid \$2.2 million to the institutional investors due to a limitation on the number of shares that could be settled under the warrants. The net offering proceeds to the Company from the issuance of 14,355,160 shares of common stock, after deducting the placement agent's fees and other estimated offering expenses of approximately

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A123 Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

10. Subsequent Events (Continued)

\$1.0 million and the cash settlement of \$2.2 million on the warrants, were approximately \$6.8 million.

(b) Memorandum of Understanding from Wanxiang Group Corporation

On August 8, 2012, the Company announced a non-binding Memorandum of Understanding ("MOU") with Wanxiang Group Corporation ("Wanxiang").

Under the proposed terms of the MOU, Wanxiang would provide the Company with up to \$75.0 million in initial debt financing under a Senior Secured Bridge Facility (the "Bridge Facility") with an initial credit extension of \$25.0 million (with cash and collateral of letters of credit) and \$50.0 million to be funded after the satisfaction of certain closing conditions. Upon satisfaction of certain closing conditions, Wanxiang would purchase \$200.0 million aggregate principal amount of 8.00% Senior Secured Convertible Notes of the Company (the "8.00% Convertible Notes"). The agreement would also include the potential for Wanxiang to invest up to an additional \$175.0 million if it exercises warrants to purchase common stock of the Company that would be issued in connection with the Bridge Facility (the "Bridge Warrants") and in connection with the 8.00% Convertible Notes (the "Convertible Note Warrants" and together with the "Bridge Warrants," the "Warrants") for cash. Incurrence of the remaining \$50.0 million of loans under the Bridge Facility would be subject to the satisfaction of certain approvals and conditions, including, without limitation approval from the Committee of Foreign Investments in the United States (or "CFIUS") and Chinese regulators. Issuance of the Convertible Notes and the related warrants would also be subject to additional conditions, including, without limitation approval from the Company's shareholders, termination of the Hart-Scott-Rodino waiting period, the conversion or redemption of all of the Company's outstanding 2013 Senior Notes and the repurchase or retirement of at least 90 percent of the Company's 2016 Notes.

According to the proposed terms of the MOU, if the entire amount of the initial debt financing is provided to the Company and the full amount of the Warrants and 8.00% Convertible Notes are issued and exercised for cash, Wanxiang's total capital investment in the Company from these agreements would be approximately \$450.0 million. The total amount of shares of the Company's common stock issuable upon exercise and conversion of the Warrants and 8.00% Convertible Notes would represent approximately 80% of the then outstanding common stock of the Company. The MOU is non-binding and the execution of definitive documentation is subject to negotiation and, among other items, the amendment of agreements with certain of the Company's existing lenders. The Company and Wanxiang are currently negotiating definitive documentation and intend to close the full transaction by the end of 2012. The Company cannot provide any assurance, however, that definitive documentation will be executed, or, if it is executed, that the conditions to funding the full investment will be fulfilled.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q and the audited consolidated financial statements and notes thereto for the year ended December 31, 2011 included in the Form 8-K filed with the Securities and Exchange Commission, or SEC, on May 30, 2012 and management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2011 included in our Annual Report on Form 10-K filed with the SEC, on March 12, 2012. This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements are often identified by the use of words such as "may," "expect," "believe," "anticipate," "intend," "could," "estimate," or "continue," and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled "Risk Factors," set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q and elsewhere in this Quarterly Report. The forward-looking statements in this Quarterly Report on Form 10-Q represent our views as of the date of this Quarterly Report on Form 10-Q. We anticipate that subsequent events and developments will cause our views to change. However, while we may elect to update these forward-looking statements at some point in the future, we have no current intention of doing so except to the extent required by applicable law. You should, therefore, not rely on these forward-looking statements as representing our views as of any date subsequent to the date of this Quarterly Report on Form 10-Q.

Overview

We design, develop, manufacture and sell advanced, rechargeable lithium-ion batteries and battery systems. Our target markets are the transportation, electric grid services, commercial and government markets.

Our sales cycles vary by product and market segment. Most of our batteries and battery systems typically undergo a lengthy development and qualification period prior to commercial production. We expect that the total time from customer introduction to commercial production will range up to five years depending on the specific product and market served. Our long and unpredictable sales cycles and the potential large size of battery supply and development contracts cause our period-to-period financial results to be susceptible to significant variability. Since most of our operating and capital expenses are incurred up-front based on the anticipated timing of estimated design wins and customer orders, the loss or delay of any such orders could have a material adverse effect on our results of operations for any particular period. The variability in our period-to-period results will also be driven by likely period-to-period variations in product mix and by the seasonality experienced by some of the end markets into which we sell our products. In the electric grid market, revenue recognition is volatile due to the timing of deployment, delivery, and commissioning. As such, the timing of these events will significantly affect the comparison of period-to-period revenues.

We have experienced significant losses since inception, as we have continued to invest to fund our growth, as well as the recent significant losses, in our business. In particular, we have invested in product development and sales and marketing in order to meet product requirements of our target markets and to secure design wins that are expected to lead to strong revenue growth and in general and administrative overhead to develop the infrastructure to support the business. We have also invested in the expansion of our manufacturing capacity to meet anticipated demand and our battery systems capabilities to provide battery systems solutions to our customers. In order to improve our financial performance, we must increase revenue and diversify our revenue across the markets that we serve. Our revenue growth and revenue diversification will depend on our ability to win new business

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and meet customer demand as well as our customers' abilities to achieve their sales plans and business objectives. Higher revenue will increase gross margin, as higher production volumes will provide for increased absorption of manufacturing overhead and will reduce, on a percentage basis, the costs associated with our production capacity.

We have incurred significant net losses and negative operating cash flows since inception. At June 30, 2012, we had an accumulated deficit of \$856.9 million, including a \$207.9 million net losses incurred for the six months ended June 30, 2012. We had \$47.7 million in cash and cash equivalents at June 30, 2012, down from \$186.9 million at December 31, 2011.

On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million. In addition, we recorded an inventory charge of approximately \$15.2 million related to inventory produced at our Michigan facilities that may be defective. As a result of this field campaign and the charge for existing prismatic cell inventory, we have begun to rebuild our inventory and manage our backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. As a result of this field campaign, we expect to continue to incur significant net losses and negative operating cash flows over the next several quarters.

On May 11, 2012, we amended our revolving credit facility with our lead bank. This amendment eliminates the borrowing facility and provides for up to \$15.0 million as security for letters of credit. All outstanding letters of credit are required to be cash collateralized at 105% of their face amount. At June 30, 2012, we had \$10.8 million of restricted cash to collateralize primarily the outstanding letters of credit.

At June 30, 2012, we had \$47.7 million of cash and cash equivalents. Additionally, \$30.0 million of cash was released from restricted cash on July 6, 2012 as discussed below. Our credit facility and the 2013 Senior Notes (discussed below) contain a covenant requiring us to maintain an unrestricted cash balance of at least \$40.0 million. During the six months ended June 30, 2012, we used on average \$18.0 million to \$25.0 million per month in net operating and investing cash flows. Based on our historical use of cash, we expect our cash balance to fall below this required minimum by the end of August 2012.

The above circumstances, along with our history and near term forecast of incurring significant net losses and negative operating cash flows, raise substantial doubt on our ability to continue as a going concern. We are considering a broad set of solutions to improve our liquidity, including measures to reduce costs and improve efficiency, accessing additional sources of capital through existing and potentially new arrangements, and other strategic options. See Subsequent Event Memorandum of Understanding from Wanxiang Group Corporation following Liquidity and Capital Resources. In connection with this proposed transaction, we are currently in discussions with the holders of the 2013 Senior Notes and our lead bank that holds the revolving credit facility to modify the respective agreements to reduce the minimum unrestricted cash balance from \$40.0 million to a lower amount. Although our intent is to improve our operating efficiencies, to obtain additional financing (as discussed below in Subsequent Event) and to modify the terms and covenants in our 2013 Senior Notes and our revolving credit facility, there is no assurance that we will be able to obtain such financing on favorable terms, if at all, or to modify the covenants, or to successfully further reduce costs in such a way that would continue to allow us to operate our business.

On January 25, 2012, we sold an aggregate of 12,500,000 units to an institutional investor at a negotiated price of \$2.034 per unit, with each unit consisting of (i) one share of our common stock ("Common Stock") and (ii) one warrant to purchase one share of Common Stock ("January 2012 Warrants"), in a registered direct offering. The net proceeds from the sale of the units, after deducting the placement agent's fees and other estimated offering expenses, was approximately \$23.5 million. The

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January 2012 Warrants have an exercise price of \$2.71 per share, and the January 2012 Warrants are exercisable until July 28, 2014. In the event of a fundamental change, as defined in the January 2012 Warrants, the warrant holders are entitled to a fair value settlement for the lost option value determined on a Black-Scholes-based calculation with defined assumptions within the warrant. In addition, we had the right, subject to certain conditions, to require the investors to purchase up to a total of 12,500,00 additional shares of common stock during specified time periods in June and July. We did not meet the required conditions for the June put right and on July 5, 2012, we and the investor agreed to terminate the July put right. Accordingly, we did not sell any additional shares to this investor.

On May 24, 2012, we sold \$50.0 million in aggregate principal amount of 6.00% senior convertible notes, and warrants to purchase 12,711,864 shares of common stock, equal to 30% of the number of shares underlying the 2013 Senior Notes. As of June 30, 2012, \$30.0 million of proceeds subjected to a control account agreement was recorded as restricted cash. Such proceeds were released from restricted cash on July 6, 2012, upon satisfaction of the conditions of the agreements with the holders of the 2013 Senior Notes. Pursuant to the agreements with the holders of such notes and credit facility provider, we must maintain a minimum cash balance of \$40.0 million.

If our cash balance falls below \$40.0 million, it would be considered an event of default under our revolving credit facility and the 2013 Senior Notes.

Upon an event of default under the revolving credit facility, the bank could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we are unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness. As of June 30, 2012, we had \$8.6 million of outstanding letters of credits and no borrowings.

An event of default under our 2013 Senior Notes would trigger the 2013 Senior Notes' redemption rights in which the holder may require us to redeem all or any portion of the Note by delivering an event of default redemption notice to us which will include the redemption price. The redemption price equals the greater of (i) the product of (A) the conversion amount to be redeemed, multiplied by (B) the redemption premium (125%) and (ii) the product of (A) the conversion rate in effect at such time as the holder delivers an event of default redemption notice with respect to the conversion amount to be redeemed, multiplied by (B) the greatest closing sale price of the shares of our common stock during the period beginning on the date immediately preceding such event of default and ending on the date the holder delivers the event of default redemption notice. We must deliver the redemption price to the holder within five business days after receiving the event of default redemption notice.

On July 10, 2012, we sold an aggregate of 7,692,308 shares of our common stock and warrants to purchase additional shares of such common stock for an exercise price of \$0.001 per share to certain existing institutional investors. We agreed to sell the common shares at an initial negotiated purchase price of \$1.30, subject to adjustment as described below.

Pursuant to the July 2012 Warrants, we issued to the institutional investors 6,662,852 additional shares of common stock in two separate issuances on July 12, 2012 and July 30, 2012 due to the decrease in the volume weighted average stock price compared to the initial purchase price of \$1.30. We also paid \$2.2 million to the institutional investors due to a limitation on the number of shares that could be settled under the warrants. The net offering proceeds from the issuance of 14,355,160 shares of common stock, after deducting the placement agent's fees and other estimated offering expenses of approximately \$1.0 million and the cash settlement of \$2.2 million on the warrants, were approximately \$6.8 million.

As part of our continuing efforts to reduce expenses, in February 2012 we began closing our facility in Korea while relocating a portion of our new product development and advanced

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manufacturing engineering teams to other facilities. Our need to align our manufacturing capacity with near-term customer demand and our need to reduce operating expenses are the key factors that drove the decision to restructure. We expect to complete the shutdown of our Korean facility during the second half of 2012. During the six months ended June 30, 2012, we incurred \$1.3 million in termination benefits and relocation expenses related to the shutdown of our facility in Korea, of which \$0.6 million is reflected in research, development and engineering expenses, \$0.4 million in product cost of revenue and \$0.3 million in general and administrative expenses in the condensed consolidated statements of operations. Additionally, \$3.3 million of costs associated with the impairment of assets and lease remediation costs of \$0.7 million are reflected in product cost of revenue in the condensed consolidated statements of operations.

The accompanying condensed consolidated financial statements have been prepared assuming we will continue to operate as a going concern, which contemplates the realization of assets and settlement of liabilities in the normal course of business and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from uncertainty related to our ability to continue as a going concern.

Financial Operations Overview**Results of Consolidated Operations**

The following table sets forth the results of our operations as a percentage of revenue for each of the following periods (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
Revenue	100%	100%	100%	100%
Cost of revenue	148%	272%	161%	530%
Gross loss	(48)%	(172)%	(61)%	(430)%
Operating expenses	97%	218%	135%	276%
Operating loss	(146)%	(389)%	(196)%	(706)%
Other income (expense), net	(7)%	(97)%	(4)%	(38)%
Loss from operations, before tax	(152)%	(487)%	(199)%	(744)%
Provision for income taxes	0%	1%	1%	2%
Net loss	(152)%	(488)%	(200)%	(746)%

Other Operating Data:

Shipments (in watt hours, or Wh) (in thousands)	42,569	16,292	56,895	26,208
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Three Months Ended June 30, 2011 and 2012

Revenue

We derive revenue from product sales and providing services.

	Three Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Revenue				
Product				
Transportation	\$ 24,388	\$ 6,952	\$ (17,436)	(71.5)%
Commercial	5,176	4,501	(675)	(13.0)%
Electric grid		34	34	100.0%
Total product	29,564	11,487	(18,077)	(61.1)%
Services	6,789	5,498	(1,291)	(19.0)%
Total revenue	\$ 36,353	\$ 16,985	\$ (19,368)	(53.3)%

Product Revenue. Product revenue is derived from the sale of our batteries and battery systems. For the three months ended June 30, 2011 and 2012, product revenue represented 81% and 68% of our total revenue, respectively.

A significant portion of our revenue is generated from a limited number of customers. For the three months ended June 30, 2011, our two largest customers during the period accounted for approximately 39% and 10% of our total revenue. During the three months ended June 30, 2012, our two largest customers during the period accounted for approximately 17% and 12% of our total revenue. For the three months ended June 30, 2012, we did not recognize any revenue related to prismatic cell shipments from the Livonia facility as we are not yet able to reasonably estimate our warranty obligation resulting from the battery modules and packs produced in our Livonia, Michigan facility.

In 2012, we expect our revenue will come from a relatively small number of customers. The loss of one or more of those customers could have a material adverse effect on our short-term revenue. We expect the transportation market and the electric grid market to represent the largest portion of our revenue in the near and long term.

The decrease in sales to customers in the transportation market for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was primarily due to the decrease in demand. Additionally, revenue recognition was precluded on shipments of prismatic packs in relation to the field campaign launched in March 2012. Sales to customers in the commercial market slightly decreased for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 primarily due to variations in demand from existing customers. The amount of change in sales to customers in the electric grid market for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was insignificant. Most of our electric grid products involve project-based contracts with multiple elements in which there are separate units of accounting within the arrangement. The timing of when we complete the required deliverables for the units of accounting and when all other revenue recognition criteria are met may cause some variability in timing of revenue recognition. We anticipate that revenue recognition in the electric grid market for future periods will continue to be volatile due to the timing of deployment, delivery and commissioning of systems.

Services Revenue. Services revenue is primarily derived from contracts awarded by the U.S. federal government, other government agencies and commercial customers. These activities range from

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pure research, in which we investigate design techniques on new battery technologies at the request of a government agency or commercial customer, to custom development projects in which we are paid to enhance or modify an existing product or develop a new product to meet a customer's specifications.

The decrease in services revenue was primarily related to a \$2.8 million decrease in services revenue related to our government contracts that were completed or substantially completed in the prior year resulting to a decrease in government-related research and development work for the three months ended June 30, 2012. This decrease was partially offset by a \$1.4 million increase in services revenue for the three months ended June 30, 2012 related to a new development contract with a commercial customer. The remainder of the net change in our services revenue for the three months ended June 30, 2012 is attributable to the timing of project milestones and project completion.

Cost of Revenue and Gross Profit (Loss)

	Three Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Cost of revenue				
Product	\$ 48,818	\$ 42,908	\$ (5,910)	(12.1)%
Services	5,066	3,247	(1,819)	(35.9)%
Total cost of revenue	\$ 53,884	\$ 46,155	\$ (7,729)	(14.3)%
Gross profit (loss)				
Product	\$ (19,254)	\$ (31,421)	\$ (12,167)	(63.2)%
Services	1,723	2,251	528	30.6%
Total gross profit (loss)	\$ (17,531)	\$ (29,170)	\$ (11,639)	(66.4)%

Cost of Product Revenue. Cost of product revenue includes the cost of raw materials, labor and components that are required for the production of our products, as well as manufacturing overhead costs (including depreciation), inventory obsolescence charges, and warranty costs. Raw material costs, which are our most significant cost item over the past two years, have historically been stable, but these costs are subject to macroeconomic factors and may increase in the future. Increases may be partially offset by process innovation, dual sourcing of materials and increased volume if we achieve better economies of scale. We incur costs associated with unabsorbed manufacturing expenses prior to a factory operating at normal operating capacity. We expect these unabsorbed manufacturing costs, which include certain personnel, rent, utilities, materials, testing and depreciation costs, to begin to reduce in absolute dollars and as a percentage of revenue from present levels as our production ramps up over the course of 2012.

The decrease in cost of product revenue for the three months ended June 30, 2012 was primarily driven by the decrease in product sales offset by an increase in warranty charges of \$2.5 million, as well as asset impairment charges of \$3.3 million and lease remediation costs of \$0.7 million related to our Korea facility shutdown.

Cost of Services Revenues. Cost of services revenue includes the direct labor costs of engineering resources committed to funded service contracts, as well as third-party consulting, and associated direct material and equipment costs. Additionally, we include overhead expenses such as occupancy costs associated with the project resources, engineering tools and supplies and program management expense.

The decrease in costs of services revenue for the three months ended June 30, 2012 as compared to the three months ended June 30, 2011 is due to the timing of project based costs.

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Product Gross Profit (Loss). We experienced a product gross loss during the three months ended June 30, 2012, primarily due to the decreased operating levels in our manufacturing facilities, as well as other charges noted above.

Services Gross Profit. Services gross profit increased in the three months ended June 30, 2012 as compared to the three months ended June 30, 2011 due to the timing of project milestones and the mix of current contracts. We recognize services project costs as incurred and, for programs which include milestones, we recognize services revenue upon the completion of project milestones when collectability is reasonably assured. As such, our services gross profit will fluctuate period over period based on the timing of milestones.

Operating Expenses

Operating expenses consist of research, development and engineering, sales and marketing, general and administrative and production start-up expenses. Personnel related expenses comprise the most significant component of these expenses.

	Three Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Operating expenses				
Research, development and engineering	\$ 17,434	\$ 21,383	\$ 3,949	22.7%
Sales and marketing	5,070	4,185	(885)	(17.5)%
General and administrative	9,399	11,415	2,016	21.4%
Production start-up	3,497		(3,497)	(100.0)%
Total operating expenses	\$ 35,400	\$ 36,983	\$ 1,583	4.5%

Research, Development and Engineering Expenses. Research, development and engineering expenses consist primarily of expenses for personnel engaged in the development of new products and the enhancement of existing products, as well as lab materials, quality assurance activities and facilities costs and other related overhead. These expenses also include pre-production costs related to long-term supply agreements unless reimbursement from the customer is contractually guaranteed. A portion of research, development and engineering expenses was offset by cost-sharing funding. Our research, development and engineering expenditures are summarized as follows:

	Three Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Research, development and engineering expenses				
Aggregated research, development and engineering expenditures	\$ 18,631	\$ 22,562	\$ 3,931	21.1%
Research, development and engineering reimbursements	(1,197)	(1,179)	18	1.5%
Research, development and engineering expenses	\$ 17,434	\$ 21,383	\$ 3,949	22.7%

The increase in research, development and engineering expenses for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was primarily attributable to an increase of \$3.7 million in expenses associated with an increase in personnel. These additional employees primarily focus on process improvement, material science chemistry and battery and battery systems technology that support the increase in customer product development programs. In addition, there was an increase of \$0.2 million related to other material costs in the three months ended June 30, 2012. Research, development and engineering expense was 48% of revenue for the three months ended June 30, 2011, compared to 126% for the three months ended June 30, 2012.

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Sales and Marketing Expenses. Sales and marketing expenses consist primarily of personnel-related expenses, travel and other out-of-pocket expenses for marketing programs, such as trade shows, industry conferences, marketing materials and corporate communications, and facilities costs and other related overhead.

The decrease in sales and marketing expenses for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was primarily attributable to a decrease of \$0.9 million in payroll related expenses. Sales and marketing expense was 14% of revenue for the three months ended June 30, 2011, compared to 25% for the three months ended June 30, 2012.

General and Administrative Expenses. General and administrative expenses consist primarily of personnel-related expenses related to our executive, legal, finance, human resource and information technology functions, as well as fees for professional services, and allocated facility overhead expenses. Professional services consist principally of external legal, accounting, tax, audit and other consulting services.

The increase in general and administrative expenses for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was primarily due to an increase of \$1.4 million of personnel-related costs, \$0.8 million increase in accounting and legal services and a decrease in other general and administrative expenses of \$0.2 million. General and administrative expense was 26% of revenue for the three months ended June 30, 2011, compared to 67% for the three months ended June 30, 2012.

Production start-up. Production start-up expenses consist of salaries and personnel-related costs, site selection costs, including legal and regulatory costs, rent and the cost of operating a production line before it is qualified for production, including the cost of raw materials run through the production line during the qualification phase.

There were no production start-up expenses recognized for three months ended June 30, 2012 due to the completion of the qualification of our manufacturing facilities in Michigan. The first production line in Livonia, Michigan was qualified for production in December 2010. Our second production line in our Livonia, Michigan plant began qualification in the first quarter of 2011 and was completed in the third quarter of 2011. Our coating plant at our Romulus, Michigan facility began qualification in the first quarter of 2011 and was completed in the fourth quarter of 2011.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income on cash balances, interest expense on borrowings, change in fair value of derivative liabilities, foreign currency-related gains and losses, equity earnings and gain or loss on long-term investments.

	Three Months Ended June 30,			
	2011	2012	\$ Change	% Change
	(Dollars in thousands)			
Other income (expense), net				
Interest expense, net	\$ (2,105)	\$ (4,761)	\$ (2,656)	(126.2)%
Gain (loss) on foreign exchange	77	(146)	(223)	(289.6)%
Gain (loss) on change in fair value of derivative liabilities		(8,374)	(8,374)	(100.0)%
Impairment of long-term investment		(2,930)	(2,930)	(100.0)%
Other (expense) income, net	(353)	(338)	15	4.2%
Total other expense, net	\$ (2,381)	\$ (16,549)	\$ (14,168)	(595.0)%

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The change in interest, net for the three months ended June 30, 2012 was primarily due to the \$2.6 million increase in interest expense related to the 2013 Senior Notes issued during the three months ended June 30, 2012. The increase in net foreign exchange losses for the three months ended June 30, 2012, compared to the three months ended June 30, 2011, is due to the effect of currency exchange rate changes on transactions that are non U.S. dollar denominated and charged or credited to earnings.

The loss on the change in fair value of the derivative liabilities recognized during the three months ended June 30, 2012 relates to the decrease in fair value of \$5.4 million related to the January 2012 Warrants, the decrease in fair value of \$2.2 million related to the May 2012 Warrants and the decrease in fair value of \$0.8 million related to the embedded derivatives. During the three months ended June 30, 2012, we performed an analysis and valuation of our investment in Fisker Automotive accounted for under the cost method, resulting to an impairment charge of \$2.9 million. Other expense related to our share in the losses recognized on our Chinese joint venture accounted for under the equity method for the three months ended June 30, 2012 is consistent compared to the three months ended June 30, 2011.

Provision for Income Taxes. Through June 30, 2012, we incurred net losses since inception and have not recorded provisions for U.S. federal income taxes since the tax benefits of our net losses have been offset by valuation allowances.

We have recorded a tax provision for foreign taxes associated with our foreign subsidiaries and state income taxes where our net operating loss deductions are limited by statutes.

Six Months Ended June 30, 2011 and 2012

Revenue

	Six Months Ended June 30,			
	2011	2012	\$ Change	% Change
	(Dollars in thousands)			
Revenue				
Product				
Transportation	\$ 36,702	\$ 11,426	\$ (25,276)	(68.9)%
Commercial	8,310	7,315	(995)	(12.0)%
Electric grid	10	46	36	(360.0)%
Total Product	45,022	18,787	(26,235)	(58.3)%
Services	9,428	9,087	(341)	(3.6)%
Total revenue	\$ 54,450	\$ 27,874	\$ (26,576)	(48.8)%

Product Revenue. The decrease in sales in the transportation industry for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was primarily due to the decrease in demand. Additionally, revenue recognition was precluded on shipments of prismatic packs in relation to the field campaign launched in March 2012. Sales to customers in the commercial market slightly decreased for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 primarily due to variations in demand from existing customers.

The amount of change in sales to customers in the electric grid market for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was insignificant. Most of our electric grid products involve project-based contracts with multiple elements in which there are separate units of accounting within the arrangement. The timing of when we complete the required deliverables for the units of accounting and when all other revenue recognition criteria are met may cause some

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variability in timing of revenue recognition. We anticipate that revenue recognition in the electric grid market for future periods will continue to be volatile due to the timing of deployment, delivery and commissioning of systems.

Services Revenue. Services revenue during the six months ended June 30, 2012 is consistent compared to services revenue during the six months ended June 30, 2011.

Cost of Revenue and Gross Profit (Loss)

	Six Months Ended June 30,		\$ Change	% Change
	2011	2012		
(Dollars in thousands)				
Cost of revenue				
Product	\$ 79,914	\$ 139,972	\$ 60,058	75.2%
Services	7,544	7,890	346	4.6%
Total cost of revenue	\$ 87,458	\$ 147,862	\$ 60,404	69.1%
Gross profit (loss)				
Product	\$ (34,892)	\$ (121,185)	\$ (86,293)	(247.3)%
Services	1,884	1,197	(687)	(36.5)%
Total gross loss	\$ (33,008)	\$ (119,988)	\$ (86,980)	(263.5)%

Cost of Product Revenue. The increase in cost of product revenue was primarily due to a warranty charge of \$51.6 million related to our field campaign to replace prismatic battery modules and packs that may contain defective cells as well as a \$15.2 million inventory charge related to these defective battery cells. In addition, we increased our inventory charge by \$1.6 million due to expired aluminum foil at our Romulus facility. We also had an increase in warranty charges of \$2.6 million, as well as asset impairment charges of \$3.3 million and \$0.7 million in lease remediation costs related to our Korea facility. These increases were partially offset by a decrease in cost of product revenue driven by the decrease in product sales.

Cost of Services Revenues. The costs of services revenue for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 is consistent.

Product Gross Profit (Loss). We experienced a product gross loss during the six months ended June 30, 2012, primarily due to the aforementioned charges related to our field campaign to replace battery modules and packs that may contain defective cells and the related inventory charges. Low factory utilization also contributed to the gross loss. For the six months ended June 30, 2012, we did not recognize any revenue related to prismatic cell shipments from the Livonia facility as we are not yet able to reasonably estimate our warranty obligation resulting from the battery modules and packs produced in our Livonia, Michigan facility.

During the three months ended June 30, 2012, we restarted our manufacturing operations in our Livonia and Romulus, Michigan facilities where production had previously been halted as a result of the discovery of the defective cells. As a result, we incurred unabsorbed overhead costs of \$14.3 million during the six months ended June 30, 2012 resulting from the halting and restarting of production activities.

Services Gross Profit. Services gross profit decreased in the six months ended June 30, 2012 as compared to the six months ended June 30, 2011 due to the decreases in project costs, the timing of project milestones and the mix of current contracts. We recognize services project costs as incurred and, for programs which include milestones, we recognize services revenue upon the completion of

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project milestones when collectability is reasonably assured. As such, our services gross profit will fluctuate period over period based on the timing of milestones.

Operating Expenses

	Six Months Ended June 30,		\$ Change	% Change
	2011	2012		
(Dollars in thousands)				
Operating expenses				
Research, development and engineering	\$ 37,793	\$ 44,964	\$ 7,171	19.0%
Sales and marketing	9,152	8,605	(547)	(6.0)%
General and administrative	18,510	23,279	4,769	25.8%
Production start-up	8,118		(8,118)	(100.0)%
Total operating expenses	\$ 73,573	\$ 76,848	\$ 3,275	4.5%

Research, Development and Engineering Expenses. A portion of research, development and engineering expenses was offset by cost-sharing funding. Our research, development and engineering expenditures are summarized as follows:

	Six Months Ended June 30,		\$ Change	% Change
	2011	2012		
(Dollars in thousands)				
Research, development and engineering expenses				
Aggregated research, development and engineering expenditures	\$ 39,942	\$ 47,274	\$ 7,332	18.4%
Research, development and engineering reimbursements	(2,149)	(2,310)	(161)	(7.5)%
Research, development and engineering expenses	\$ 37,793	\$ 44,964	\$ 7,171	19.0%

The increase in research, development and engineering expenses for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was primarily attributable to an increase of \$7.6 million in expenses associated with an increase in personnel and consultants who primarily focus on process improvement, material science chemistry and battery and battery systems technology and who support the increase in customer product development programs. Other increases in research, development and engineering expenses during the six months ended June 30, 2012 include \$1.1 million in facility expenses due to the increase in lab space in Waltham, Massachusetts, \$0.9 million increase in depreciation due to an increase in fixed assets and \$0.6 million increase in relocation costs related to the closure of our facility in Korea. These were partially offset by a decrease in expenses related to lab supplies of \$2.9 million. Research, development and engineering expense was 69% of revenue for the six months ended June 30, 2011, compared to 161% for the six months ended June 30, 2012.

Sales and Marketing Expenses. The decrease in sales and marketing expenses for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was primarily attributable to a decrease in payroll related expenses.

General and Administrative Expenses. The increase in general and administrative expenses for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was primarily due to an increase in personnel-related expenses of \$3.0 million, an increase in accounting and legal services of \$1.0 million and an increase in other general and administrative expenses of \$0.8 million. General and administrative expense was 36% of revenue for the six months ended June 30, 2011, compared to 84% for the six months ended June 30, 2012.

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Production start-up. A portion of production start-up expenses was offset primarily by government grant funding. Our production start-up expenditures are summarized as follows:

	Six Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Production start-up expenditures				
Aggregated production start-up expenditures	\$ 11,941	\$	\$ (11,941)	(100.0)%
Production start-up reimbursements	(3,823)		3,823	100.0%
Production start-up expenses	\$ 8,118	\$	\$ (8,118)	(100.0)%

There was no production start-up expenses recognized for the six months ended June 30, 2012 due to the completion of the qualification of our manufacturing facilities in Michigan. The first production line in Livonia, Michigan was qualified for production in December 2010. Our second production line in our Livonia, Michigan plant began qualification in the first quarter of 2011 and was completed in the third quarter of 2011. Our coating plant at our Romulus, Michigan facility began qualification in the first quarter of 2011 and was completed in the fourth quarter of 2011. Production start-up expenses were 15% of revenue for the six months ended June 30, 2011.

Other Income (Expense), Net

	Six Months Ended June 30,			
	2011	2012	\$ Change	% Change
(Dollars in thousands)				
Other income (expense), net				
Interest expense, net	\$ (2,746)	\$ (6,952)	\$ (4,206)	(153.2)%
Gain (loss) on foreign exchange	79	(46)	(125)	(158.2)%
Gain (loss) on change in fair value of warrant derivative liabilities		181	181	100.0%
Impairment of long-term investment		(2,930)	(2,930)	(100.0)%
Other (expense) income, net	673	(795)	(1,468)	(218.1)%
Total other expense, net	\$ (1,994)	\$ (10,542)	\$ (8,548)	(428.7)%

The change in interest, net for the six months ended June 30, 2012 was primarily due to the \$2.6 million increase in interest expense related to the 2013 Senior Notes issued in May 2012 and \$1.7 million increase in interest expense related to the 2016 Notes issued in April 2011. These increases were partially offset by a \$0.1 million net decrease in other interest expense. The increase in net foreign exchange losses for the six months ended June 30, 2012, compared to the six months ended June 30, 2011, is due to the effect of currency exchange rate changes on transactions that are non U.S. dollar denominated and charged or credited to earnings.

The gain on the change in fair value of the derivative liabilities recognized during the six months ended June 30, 2012 relates to a net gain on the change in fair value of \$3.2 million related to the warrants issued on a registered direct offering in January 2012, the decrease in fair value of \$2.2 million related to the May 2012 Warrants, and the decrease in fair value of \$0.8 million related to the embedded derivatives. During the six months ended June 30, 2012, we updated our analysis and valuation of our investment in Fisker accounted for under the cost method, resulting in an impairment charge of \$2.9 million. The net decrease in other income is due to \$1.2 million recognized in the three months ended March 31, 2011 related to the deconsolidation of our joint venture and an increase in losses recognized on our Chinese joint venture accounted for under the equity method.

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Provision for Income Taxes. The provision for income taxes for the six months ended June 30, 2011 and 2012 was primarily related to foreign and state income taxes. We did not report a benefit for federal income taxes in the condensed consolidated financial statements as the deferred tax asset generated from our net operating loss has been offset by a full valuation allowance because it is more likely than not that the tax benefits of the net operating loss carry forward may not be realized.

Liquidity and Capital Resources**Sources of Liquidity**

Since inception we have funded our operations primarily through the sale and issuance of preferred stock, common stock, convertible debt, warrants, demand notes and term loans, and credit facilities. Our cash balance at December 31, 2011 and June 30, 2012 was \$186.9 million and \$47.7 million, respectively.

The following table sets forth the major sources and uses of cash for each of the periods set forth below (in thousands):

	Six Months Ended June 30,	
	2011	2012
Net cash used in operating activities	\$ (113,367)	\$ (111,329)
Net cash used in investing activities	(62,597)	(53,493)
Net cash provided by financing activities	254,014	25,599
Effect of foreign exchange rates on cash and cash equivalents	(17)	
Net decrease in cash and cash equivalents	\$ 78,033	\$ (139,223)

Cash Flows From Operating Activities

Operating activities used \$111.3 million of net cash during the six months ended June 30, 2012. We incurred a net loss of \$207.9 million in the six months ended June 30, 2012, which included non-cash share-based compensation expense of \$7.1 million, depreciation and amortization of \$14.1 million, amortization of debt issuance costs and noncash interest expense of \$3.8 million, a \$3.3 million impairment charge on long-lived assets, and \$2.9 million impairment on long-term investments. Investments in working capital and other changes in asset and liability accounts provided \$64.9 million of net cash during the six months ended June 30, 2012.

Operating activities used \$113.4 million of net cash during the six months ended June 30, 2011. We incurred a net loss of \$109.1 million in the six months ended June 30, 2011, which included non-cash share-based compensation expense of \$6.7 million and depreciation and amortization of \$10.7 million. Changes in asset and liability accounts used \$24.8 million of net cash during the six months ended June 30, 2011.

As a result of the field campaign launched related to the prismatic cell issue for which we estimate costs to be \$51.6 million, we have begun to rebuild our inventory and manage our backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. Therefore, we expect to continue to incur significant net losses and negative operating cash flows over the next several quarters.

Cash Flows From Investing Activities

Cash flows from investing activities primarily relate to capital expenditures to support our growth.

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Cash used in investing activities totaled \$53.5 million during the six months ended June 30, 2012 and consisted of capital expenditures of \$15.6 million primarily related to the purchase of manufacturing equipment and an increase in restricted cash of \$40.1 million. During the six months ended June 30, 2012, we received government grant proceeds of \$2.2 million related to reimbursements for capital expenditures previously incurred. The reimbursements received for the six months ended June 30, 2012 primarily relate to our DOE Battery Initiative grant.

Cash used in investing activities totaled \$62.6 million during the six months ended June 30, 2011 and consisted of capital expenditures of \$86.3 million primarily related to the purchase of manufacturing equipment, purchases of investments of \$1.9 million and an increase in restricted cash of \$0.6 million. During the six months ended June 30, 2011, we received government grant proceeds of \$26.1 million related to reimbursements for capital expenditures previously incurred. The reimbursements received for the six months ended June 30, 2011 primarily relate to our DOE Battery Initiative grant.

We anticipate additional capital expenditure levels in future periods. Additionally, we anticipate investing cash outflows in future periods as we may invest in joint ventures and other equity investments in order to establish strategic relationships.

Cash Flows From Financing Activities

Cash provided by financing activities totaled \$25.6 million during the six months ended June 30, 2012 and included repayments on our revolving credit line of \$38.1 million, repayments on long term debt of \$4.9 million, and repayments on capital lease obligations of \$1.8 million. These were offset by proceeds of \$23.5 million from the issuance of common stock and warrants, net of offering costs and proceeds from the issuance of debt, net of financing costs of \$46.9 million.

Cash provided by financing activities totaled \$254.0 million during the six months ended June 30, 2011 and included proceeds from the issuance of convertible debt of \$139.1 million, proceeds from the issuance of common stock, net of issuance costs paid, of \$115.3 million, proceeds from government grants of \$0.9 million and proceeds from the exercise of stock options of \$2.0 million. These proceeds were partially offset by repayments on long-term debt of \$2.6 million and payments on capital lease obligations of \$1.2 million.

Liquidity, Going Concern and Management Plans

We have incurred significant net losses and negative operating cash flows since inception. At June 30, 2012, we had an accumulated deficit of \$856.9 million, including a \$207.9 million net loss incurred for the six months ended June 30, 2012. We had \$47.7 million in cash and cash equivalents at June 30, 2012, down from \$186.9 million at December 31, 2011.

On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million. In addition, we recorded an inventory charge of approximately \$15.2 million related to inventory produced at our Michigan facilities that may be defective. As a result of this field campaign and the charge for existing prismatic cell inventory, we have begun to rebuild our inventory and manage our backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. As a result of this field campaign, we expect to continue to incur significant net losses and negative operating cash flows over the next several quarters.

On May 11, 2012, we amended our revolving credit facility with our lead bank. This amendment eliminated the borrowing facility and provided for up to \$15.0 million as security for letters of credit. All outstanding letters of credit are required to be cash collateralized at 105% of their face amount. At

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June 30, 2012, we had \$10.8 million of restricted cash to collateralize primarily the outstanding letters of credit.

At June 30, 2012, we had \$47.7 million of cash and cash equivalents. Additionally, \$30.0 million of cash was released from restricted cash on July 6, 2012 as discussed below. Our credit facility and the 2013 Senior Notes (discussed below) contain a covenant requiring us to maintain an unrestricted cash balance of at least \$40.0 million. During the six months ended June 30, 2012, we used on average \$18.0 million to \$25.0 million per month in net operating and investing cash flows. Based on our historical use of cash, we expect our cash balance to fall below this required minimum by the end of August 2012.

The above circumstances, along with our history and near term forecast of incurring significant net losses and negative operating cash flows, raise substantial doubt on our ability to continue as a going concern. We are considering a broad set of strategic alternatives to improve our liquidity, including measures to reduce costs and improve efficiency, accessing additional sources of capital through existing and potentially new arrangements, and other strategic options. See below Subsequent Event Memorandum of Understanding from Wanxiang Group Corporation. In connection with this proposed transaction, we are currently in discussions with the holders of the 2013 Senior Notes and our lead bank that holds the revolving credit facility to modify the respective agreements to reduce the minimum unrestricted cash balance from \$40.0 million to a lower amount. Although our intent is to improve our operating efficiencies, to obtain additional financing (as discussed below Subsequent Event) and to modify the terms and covenants in our 2013 Senior Notes and our revolving credit facility, there is no assurance that we will be able to obtain such financing on favorable terms, if at all, or to modify the covenants, or to successfully further reduce costs in such a way that would continue to allow us to operate our business.

On May 24, 2012, we sold to accredited investors \$50.0 million aggregate principal amount of 6.00% senior convertible notes or the 2013 Senior Notes, and warrants to purchase shares of common stock or May 2012 Warrants, equal to 30% of the number of shares underlying the 2013 Senior Notes assuming conversion at the initial conversion price. As of June 30, 2012, \$30.0 million of proceeds subjected to a control account agreement was recorded as restricted cash. Such proceeds were released from restricted cash on July 6, 2012, upon satisfaction of the conditions of the agreements with the holders of the 2013 Senior Notes. Pursuant to the agreements with the holders of such notes and our credit facility provider, we must maintain a minimum cash balance of \$40.0 million. (See below for more details.)

On July 10, 2012, we sold an aggregate of 7,692,308 shares of our common stock and warrants to purchase additional shares of such common stock for an exercise price of \$0.001 per share to certain existing institutional investors. We agreed to sell the common shares at an initial negotiated purchase price of \$1.30, subject to adjustment as described below.

Pursuant to the July 2012 Warrants, we issued to the institutional investors 6,662,852 additional shares of common stock in two separate issuances on July 12, 2012 and July 30, 2012 due to the decrease in the volume weighted average stock price compared to the initial purchase price of \$1.30. We also paid \$2.2 million to the institutional investors due to a limitation on the number of shares that could be settled under the warrants. The net offering proceeds from the issuance of 14,355,160 shares of common stock, after deducting the placement agent's fees and other estimated offering expenses of approximately \$1.0 million and the cash settlement of \$2.2 million on the warrants, were approximately \$6.8 million.

As noted above, our revolving credit facility and the 2013 Senior Notes agreements require us to maintain a minimum cash balance of \$40.0 million. If our cash balance falls below \$40.0 million, it would be considered an event of default per the covenants of the revolving credit facility and the 2013 Senior Notes.

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Upon an event of default under the revolving credit facility, the bank could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we are unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness. As of June 30, 2012, we had \$8.6 million of outstanding letters of credits and no borrowings.

An event of default under the 2013 Senior Notes, would trigger redemption rights, pursuant to which a holder could require us to redeem all or any portion of such note by delivering an event of default redemption notice to us which would include the redemption price. The redemption price equals the greater of (i) the product of (A) the conversion amount to be redeemed, multiplied by (B) the redemption premium (125%) and (ii) the product of (A) the conversion rate in effect at such time as the holder delivers an event of default redemption notice with respect to the conversion amount to be redeemed, multiplied by (B) the greatest closing sale price of the shares of our common stock during the period beginning on the date immediately preceding such event of default and ending on the date the holder delivers the event of default redemption notice. We must deliver the redemption price to the holder within five business days after receiving the event of default redemption notice.

The accompanying condensed consolidated financial statements have been prepared assuming we will continue to operate as a going concern, which contemplates the realization of assets and settlement of liabilities in the normal course of business and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from uncertainty related to our ability to continue as a going concern.

Subsequent Event Memorandum of Understanding from Wanxiang Group Corporation

On August 8, 2012, we announced a non-binding Memorandum of Understanding ("MOU") with Wanxiang Group Corporation ("Wanxiang").

Under the proposed terms of the MOU, Wanxiang would provide us with up to \$75.0 million in initial debt financing under a Senior Secured Bridge Facility (the "Bridge Facility") with an initial credit of \$25.0 million (with cash and collateral of letters of credit) and \$50.0 million to be funded after the satisfaction of certain closing conditions. Upon satisfaction of certain closing conditions, Wanxiang would purchase \$200.0 million aggregate principal amount of the 8.00% Convertible Notes.

The agreement would also include the potential for Wanxiang to invest up to an additional \$175.0 million if it exercises warrants to purchase our common stock that would be issued in connection with the Bridge Facility and the 8.00% Convertible Notes for cash. Incurrence of the remaining \$50.0 million of loans under the Bridge Facility would be subject to the satisfaction of certain approvals and conditions, including, without limitation, approval from the Committee of Foreign Investments in the United States (or "CFIUS") and Chinese regulators. Issuance of the Convertible Notes and the related warrants would also be subject to additional conditions, including, without limitation, approval from our shareholders, termination of the Hart-Scott-Rodino waiting period, the conversion or redemption of all of our outstanding 2013 Senior Notes and the repurchase or retirement of at least 90% of our 2016 Notes.

According to the proposed terms of the MOU, if the entire amount of the initial debt financing is provided to us and the full amount of the Warrants and 8.00% Convertible Notes are issued and exercised for cash, Wanxiang's total capital investment in our company from these agreements would be approximately \$450.0 million. The total amount of shares of our common stock issuable upon exercise and conversion of the Warrants and 8.00% Convertible Notes would represent approximately 80% of our then outstanding common stock. The MOU is non-binding and the execution of definitive documentation is subject to negotiation and, among other items, the amendment of agreements with certain of our existing lenders. Our company and Wanxiang are currently negotiating definitive documentation and intend to close the full transaction by the end of 2012. We cannot provide any

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assurance, however, that definitive documentation will be executed, or, if it is executed, that the conditions to funding the full investment will be fulfilled.

Private Offering

On May 24, 2012, we issued \$50.0 million aggregate principal amount of senior convertible notes (the "2013 Senior Notes") and Warrants to purchase 12,711,864 shares of our common stock (the "May 2012 Warrants"). The 2013 Senior Notes and the May 2012 Warrants are detachable. See Note 2 Private Placements, in the Notes to the Condensed Consolidated Financial Statements for further information.

On July 10, 2012, we sold an aggregate of 7,692,308 shares of our common stock and warrants to purchase additional shares of such common stock for an exercise price of \$0.001 per share to certain existing institutional investors. We agreed to sell the common shares at an initial negotiated purchase price of \$1.30, subject to adjustment as described below.

Pursuant to the July 2012 Warrants, we issued to the institutional investors 6,662,852 additional shares of common stock in two separate issuances on July 12, 2012 and July 30, 2012 due to the decrease in the volume weighted average stock price compared to the initial purchase price of \$1.30. We also paid \$2.2 million to the institutional investors due to a limitation on the number of shares that could be settled under the warrants. The net offering proceeds from the issuance of 14,355,160 shares of common stock, after deducting the placement agent's fees and other estimated offering expenses of approximately \$1.0 million and the cash settlement of \$2.2 million on the warrants, were approximately \$6.8 million. See Note 10 Subsequent Events, in the Notes to the Condensed Consolidated Financial Statements for further information.

Credit Facilities

On May 11, 2012, we amended our revolving credit facility with our lead bank. This amendment eliminates the borrowing facility and provides for up to \$15.0 million as security for letters of credit. All outstanding letters of credit are required to be cash collateralized at 105% of their face amount. At June 30, 2012, we had \$10.8 million of restricted cash to collateralize primarily our outstanding letters of credit. One of the financial covenants in this revolving facility requires that we maintain a minimum cash balance of \$40.0 million. The operating covenants limit our ability to, among other things:

sell, transfer, lease or dispose of our assets;

create, incur or assume additional indebtedness;

encumber or permit liens on certain of our assets, make restricted payments, including paying dividends on, repurchasing or making distributions with respect to our common stock;

make specified investments (including loans and advances);

consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; and

enter into certain transactions with our affiliates.

A breach of any of these covenants or a material adverse change to our business could result in a default under the credit agreement. Upon an event of default under the revolving credit facility, the bank could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we are unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness. As of June 30, 2012, we had \$8.6 million of outstanding letters of credits and no borrowings.

As of June 30, 2012, we are in compliance with the covenants and terms of the agreements in place at that time.

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License Agreements and Settlement Agreement

In November 2011, we entered into a series of agreements with IHI, including a stock purchase agreement pursuant to which, among other things, we raised \$25.0 million through the sale of common stock to IHI, and a technology license agreement and a product supply agreement. Pursuant to the technology license, we will exclusively license, for an initial term of 10 years, our advance battery system technology and systems integration know-how to manufacture battery and modules for the transportation market in Japan for a one-time non-refundable license fee of \$7.5 million. During the license term, we will also receive a royalty percentage in the low single digits based on IHI's net sales of products that use or embody the licensed technology and know-how, minus the cost of battery cells purchased by IHI from us for use with such products. We will be the exclusive supplier of lithium ion battery cells to IHI under a product supply agreement for the battery systems and modules that IHI produces. As of June 30, 2012, we had \$1.1 million due from IHI, included within accounts receivable, net on the condensed consolidated balance sheets

On October 31, 2011, we entered into a Settlement Agreement with Hydro- Quebec and related Patent Sublicense Agreement with Hydro-Quebec and LiFePO₄+C, thereby settling the patent disputes and resolving the existing litigations among the parties. For the year ended December 31, 2011, we recognized a settlement charge of \$5.0 million related to this lawsuit which is recorded within general and administrative expense in the consolidated statement of operations. We have paid \$3.5 million of the settlement amount during the year ended December 31, 2011 and the remaining \$1.5 million will be paid in two equal installments in 2013 and 2014. As partial consideration for the license grants by LiFePO₄+C Licensing AG, we will be required to pay royalties to LiFePO₄+C Licensing AG on a quarterly basis commencing as of January 1, 2012, based on a percentage of our net sales of cells, electrode systems, and/or complex systems (plus such net sales attributed to any of our permitted sublicensees) during such quarterly period. We are required to pay royalties on a sliding scale, with a maximum possible royalty rate of 2% of net sales (based on a defined percentage of our product sales revenue) through the agreement's term, and based on the fiscal year in which the royalties are calculated and the accrual of total royalty in that fiscal year. Such defined percentage may also be adjusted by mutual agreement if our standalone cell or electrode system revenues increase significantly in proportion to overall product revenues.

Certain Trends and Uncertainties

The following represents a summary of certain trends and uncertainties, which could have a significant impact on our financial condition and results of operations. This summary is not intended to be a complete list of potential trends and uncertainties that could impact our business in the long or short term. The summary, however, should be considered along with the factors identified in the section titled "*Risk Factors*" set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q.

We anticipate that we will continue to have negative cash flow and we expect we will not have sufficient revenue growth to generate positive cash flow for the foreseeable future, which will result in our continued need to raise additional capital. An inability to generate positive cash flow for the foreseeable future or raise additional capital on reasonable terms may decrease our long-term viability. At June 30, 2012, we had \$47.7 million of cash and cash equivalents. Additionally, \$30.0 million of cash was released from restricted cash on July 6, 2012. Our credit facility and the 2013 Senior Notes contain a covenant requiring us to maintain an unrestricted cash balance of at least \$40.0 million. During the six months ended June 30, 2012, we used on average \$18.0 million to \$25.0 million per month in net operating and investing cash flows. Based on our historical use of cash, we expect our cash balance to fall below this required minimum by the end of August 2012.

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On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million. In addition, we recorded an inventory charge of approximately \$15.2 million related to inventory produced at our Michigan facilities that may be defective. As a result of this field campaign and the charge for existing prismatic cell inventory, we have begun to rebuild our inventory and manage our backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. As a result of this field campaign, we expect to continue to incur significant net losses and negative operating cash flows over the next several quarters.

We believe that our future revenues depend on our ability to develop, manufacture and market products that improve upon existing battery technology and gain market acceptance. If our battery technology is not adopted by our customers, or if our battery technology does not meet industry requirements for power and energy storage capacity in an efficient and safe design, our batteries will not gain market acceptance.

We build our manufacturing capacity based on estimated demand from existing supply agreements, from our projection of future development and supply agreement wins and from anticipated timelines of customer orders. Increases in production capacity, have had, and will continue to have, an effect on our financial condition and results of operations. Our business revenues and profits will depend upon our ability to enter into and complete development and supply agreements, successfully complete these capacity expansion projects, achieve competitive manufacturing yields and drive volume sales consistent with our demand expectations.

Our revenues are expected to continue to come from a relatively small number of customers for the foreseeable future. The loss of one of our two most significant customers, several of our smaller customers, or one of our existing supply agreements for significant future revenues, could materially harm our business.

Critical Accounting Policies

Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of our condensed consolidated financial statements and related disclosures requires us to make estimates, assumptions and judgments that affect the reported amount of assets, liabilities, revenue, costs and expenses, and related disclosures. We base our estimates and assumptions on historical experience and other factors that we believe to be reasonable under the circumstances. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ from these estimates under different assumptions and conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

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Revenue Recognition

We recognize revenue once it is realized or realizable and earned when all of the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price to the buyer is fixed or determinable, and collectability is reasonably assured. In instances where final acceptance of the product is specified by the customer, revenue is deferred until all acceptance criteria have been met.

Product revenue is generally recognized upon transfer of title and risk of loss, which is generally upon shipment, unless an acceptance period or other contingency exists. In general, our customary shipping terms are FOB shipping point or free carrier. In instances where customer acceptance of a product is required, revenue is either recognized upon the shipment when we are able to demonstrate the customer specific objective criteria have been met or the earlier of customer acceptance or expiration of the acceptance period.

Services revenue is recognized as services are performed consistent with the performance requirements of the contract using the proportional performance method. Where arrangements include milestones or governmental approval that impact the fees payable to us, revenue is limited to those amounts whereby collectability is reasonably assured. We recognize revenue earned under time and materials contracts as services are provided based upon actual costs incurred plus a contractually agreed-upon profit margin. We recognize revenue from fixed-price contracts, using the proportional performance method based on the ratio of costs incurred to estimates of total expected project costs in order to determine the amount of revenue earned to date. Project costs are based on the direct salary and associated fringe benefits of the employees on the project plus all direct expenses incurred to complete the project that are not reimbursed by the client. The proportional performance method is used since reasonably dependable estimates of the revenues and costs applicable to various stages of a contract can be made. These estimates are based on historical experience and deliverables identified in the contract and are indicative of the level of benefit provided to our clients. Under the proportional performance method, there are no costs that are deferred and amortized over the contract term. If we do not have the ability to reasonably estimate contract costs or progress toward completion of the contract, we defer the related revenue and costs and recognize the revenues and costs based on the completed contract method. When the completed contract method is used, the excess of accumulated costs over related billings, if any, are classified as an asset and the excess of accumulated billings over related costs, if any, are classified as a liability. We classify the portion of the related asset or liability as long-term if such asset or liability are expected to be recognized beyond one year.

If sales arrangements contain multiple elements, we determine if separate units of accounting exist within the arrangement. If separate units of accounting exist within an arrangement, we allocate revenue to each element based on the relative selling price of each of the elements. We determine selling price using vendor-specific objective evidence or VSOE, if it exists; otherwise, we use third-party evidence or TPE. If neither VSOE nor TPE of selling price exists for a unit of accounting, we use the estimated selling price.

Fees to license the use of our proprietary and licensed technologies are recognized only after both the license period has commenced and the technology has been delivered to the customer. Royalty revenue is recognized when it becomes determinable and collectability is reasonably assured; otherwise we recognize revenue upon receipt of payment. To date, we have not recognized any significant royalty revenue.

Because of the nature of our products, revenue recognition is based on a number of quantitative and qualitative factors. This can lead to significant fluctuations in our quarterly and annual revenues.

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Product Warranty Obligations

We accrue for product warranty costs at the time revenue is recognized based on the historical rate of claims and costs to provide warranty services. Our standard warranty period extends one to five years from the date of sale, depending on the type of product purchased and its application. Our estimates of the amounts necessary to settle warranty claims are based primarily on our past experience. For our new products and products that remain under development, we will be required to base our warranty estimates on historical experience of similar products, testing of our batteries and battery systems, and performance information learned during our development activities with the customer. Although we believe our estimates are adequate and that the judgment we apply is appropriate, actual warranty costs could differ materially from our estimates. If we experience an increase in warranty claims above historical experience or our costs to provide warranty services increase, we would be required to increase our warranty accrual, and our cost of revenue would increase. If we are unable to estimate warranty costs we would defer recognizing revenue until we can make that determination.

In March 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. As a result, we charged an additional \$51.6 million to our warranty costs.

Inventory

We carry our inventory at the lower of historical cost or net realizable value assuming inventory items are consumed on a first-in, first-out basis. We recognize inventory losses based on obsolescence and levels in excess of forecasted demand. In these cases, inventory is written down to the estimated realizable value based on historical usage and expected demand. Inherent in our estimates of market value in determining inventory valuation are estimates related to economic trends, future demand for our products and technical obsolescence of our products. If future demand or market conditions are less favorable than our projections, additional inventory write-downs could be required and would be reflected in the cost of revenue in the period the revision is made.

Impairment of Long-Lived Assets

We periodically evaluate our long-lived assets for events and circumstances that indicate a potential impairment. We review long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Such circumstances would include, but are not limited to, material adverse changes in projected revenues and expenses, significant underperformance relative to historical or projected future operating results and significant negative industry or economic trends. Each impairment test is based on a comparison of the estimated undiscounted cash flows of the asset or asset group over the remaining life of the asset as compared to the recorded value of the asset. To the extent the carrying value exceeds the fair value of the asset or asset group, an impairment loss is recognized in the statement of operations in that period.

The estimates used to determine whether impairment has occurred are subject to a number of management assumptions. We group long-lived asset or assets with other assets and liabilities at the lowest level for which identifiable cash flows are available. We estimate the fair value of an asset or asset group based on market prices (i.e., the amount for which the asset could be bought by or sold to a third party), when available. When market prices are not available, we estimate the fair value of the asset group using the income approach, which are subject to a number of management assumptions. The income approach uses cash flow projections. Inherent in our development of cash flow projections are assumptions and estimates derived from a review of our operating results, approved operating budgets, expected growth rates and cost of capital. We also make certain assumptions about future

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economic conditions, interest rates, and other market data. Many of the factors used in assessing fair value are outside the control of management, and these assumptions and estimates can change in future periods.

Changes in assumptions or estimates could materially affect the determination of fair value of an asset or asset group, and therefore could affect the amount of potential impairment of the asset. We make assumptions about our product production, service sales, cost of products and services and estimated residual value of property, plant and equipment. These assumptions are key inputs for developing our cash flow projections. These projections are derived using our internal operating budgets. These projections are updated annually and reviewed by the Board of Directors. Historically, our primary variances between our projections and actual results have been related to assumptions for future production, service sales, and cost of products and services. These factors are based on our best knowledge at the time we prepare our budgets but can vary significantly due to changes in supply and demand, changes in raw material prices, and changes in other economic conditions.

During the second quarter we prepared an analysis of undiscounted cash flows by asset group. The estimated undiscounted cash flows as of June 30, 2012 exceeded the carrying value of the asset group. Accordingly, we passed step 1 of the impairment analysis. Any changes based upon our forecasted cash flow projections or manner in which the assets are used could result in an impairment in the future.

Goodwill Impairment

Goodwill is not amortized, but is subject to periodic assessments of impairment. Impairment testing is performed at the reporting unit level, which we only have one reporting unit. We test goodwill for impairment annually as of October 1, or when changes in circumstances indicate that the carrying value may not be recoverable. Events that trigger a test for recoverability include material adverse changes in projected revenues and expenses, significant underperformance relative to historical or projected future operating results and significant negative industry or economic trends.

We test goodwill for impairment by first comparing the book value of net assets to the fair value of operations. We calculate the fair market value by adding a control premium to our market capitalization at the date of the evaluation. The control premium is based on recent equity transactions within our industry. If the fair value is determined to be less than book value, a second step is performed to compute the amount of the impairment. In this process, a fair value for goodwill is estimated, based in part on the fair value of the operations, and is compared to its carrying value. The shortfall of the fair value below carrying value represents the amount of goodwill impairment. The estimates used to determine whether goodwill impairment has occurred are subject to a number of management assumptions.

During the second quarter of 2012, we determined that there were sufficient indications to warrant an interim period impairment analysis as of June 30, 2012. As such, we completed our assessment of goodwill utilizing the market capitalization method and determined that the estimated fair value of operations exceeded the carrying value. We also considered the enterprise value and also determined that the fair value of our debt and equity exceeded the carrying value as of June 30, 2012. Subsequent to the quarter ended June 30, 2012, our stock price continued to decline. Should the stock price continue to decline or remain depressed, an impairment of goodwill may need to be recorded in a future period. Our goodwill balance at June 30, 2012, was \$9.6 million.

Government Grants

We recognize government grants when there is a reasonable assurance that we will comply with the conditions attached to the grant arrangement and the grant will be received. We evaluate the conditions of each individual grant as of each reporting period to ensure that we have reached reasonable assurance of meeting the conditions of each grant arrangement and that it is expected that

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the grant will be received as a result of meeting the necessary conditions. For example, if a grant has conditions where we must create and maintain a certain amount of jobs, we will record the grant in the period that we have evaluated and determined that the necessary number of jobs has been created and, based on our forecasts, we are reasonably assured that the jobs will be maintained during the required employment period. For reimbursements of expenses, the government grants are recognized as reduction of the related expense. For reimbursements of capital expenditures, the grants are recognized as a reduction of the basis of the asset. The grant is recognized in profit or loss over the life of a depreciable asset as reduced depreciation expense. We record government grant receivables in current or long-term assets depending on when the amounts are expected to be received from the government agency. We do not discount long-term grant receivables. When funding is received in advance of complying with certain conditions, we recognize a liability and restricted cash on the consolidated balance sheets until such time as the funding has been spent.

Investments in Non-Public Companies

Our investments held in non-public companies are considered a critical accounting policy because these investments expose us to equity price risk. Strategic investments in third parties are subject to risk of changes in market value, which if determined to be other-than-temporary, could result in realized impairment losses, which could be material. We generally do not attempt to reduce or eliminate our market exposure in cost or equity method investments. We regularly monitor these non-publicly traded investments for impairment and record reductions in the carrying values when necessary. Circumstances that indicate an other-than-temporary decline include valuation ascribed to the issuing company in subsequent financing rounds, decreases in quoted market price and declines in operations of the issuer. There can be no assurance that cost or equity method investments will not face risks of loss. In December 2011, we elected not to participate in Fisker's subsequent stock financing. Our investment in Fisker is accounted for under the cost method. This election not to participate resulted in the conversion of our preferred shares of Fisker to common shares on a 2:1 ratio. As such, we performed an analysis and valuation of our investment in Fisker resulting in the recognition of an impairment charge of \$11.6 million for the year ended December 31, 2011. During the six months ended June 30, 2012, our analysis and valuation of our investment in Fisker resulted in an impairment charge of \$2.9 million. As of June 30, 2012, the carrying value of our investment in Fisker was \$6.0 million. As of June 30, 2012, non-publicly traded investments of \$2.2 million are accounted for using the equity method.

Off-Balance Sheet Arrangements

In June 2010, we entered into a supply agreement under which we committed to minimum purchase volumes for each of the years ending December 31, 2010 through December 31, 2013 for a raw material component. If our purchase volumes during any year fail to meet the minimum purchase commitments, we are required to pay the seller a variance payment for the difference between the amount actually purchased in that calendar year and the annual minimum purchase commitment for that calendar year. We will receive a credit for the amount of the variance payment to be applied to purchases in the following year and we will have until April 1, 2015 to reclaim any variance payment resulting from the minimum purchase commitments for calendar years 2012 or 2013. The table shown below in the section titled "Contractual Obligations" shows the amount of our purchase commitments payable by year inclusive of our commitment under the supply agreement described above. For the six months ended June 30, 2012, we have purchased \$2.2 million under this supply agreement.

During the periods presented, we did not have and do not currently have, any off-balance sheet arrangements, as defined under SEC rules, such as relationships with unconsolidated entities or financial partnerships, which are often referred to as structured finance or special purpose entities,

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established for the purpose of facilitating financing transactions that are not required to be reflected on our balance sheet, other than the arrangement described above.

Contractual Obligations

Our contractual obligations relate primarily to borrowings under long-term debt obligations, capital leases, operating leases, and purchase obligations which include agreements or purchase orders to purchase goods or services that are enforceable and legally binding. A table summarizing the amounts and estimated timing of these future cash payments was provided in our Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the SEC on March 12, 2012. During the six months ended June 30, 2012, except for the \$50.0 million senior convertible notes issued in May 2012 (see Note 2 Private Placements, in the Notes to the Condensed Consolidated Financial Statements), there were no material changes outside the ordinary course of business in our contractual obligations or the estimated timing of the future cash payments, except as noted below.

The following is a summary of our purchase obligations as of June 30, 2012:

	Total	Payments Due in			More than 5 Years
		Less than 1 Year	1 - 3 Years	3 - 5 Years	
			(in thousands)		
Purchase obligations(1)	69,961	51,461	18,500		
	\$ 69,961	\$ 51,461	\$ 18,500	\$	\$

(1)

Purchase obligations include agreements or purchase orders to purchase goods or services that are enforceable and legally binding and specify all significant terms. Purchase obligations exclude agreements that are cancelable without penalty.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As of June 30, 2012, we have not experienced any adverse changes in market risk exposures that materially affected the quantitative and qualitative disclosures presented in our Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the SEC on March 12, 2012. Our 2016 Notes issued in April 2011 and 2013 Senior Notes issued in May 2012 have fixed interest rates and therefore we are not subject to interest rate sensitivity on these instruments.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2012. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2012, our chief executive officer

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and our chief financial officer concluded that, as of such date, our disclosure controls and procedures were not effective at the reasonable assurance level.

As disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 12, 2012, we identified a material weakness in our internal controls over the financial statement close and reporting process. We intend to take appropriate steps to make necessary improvements to our internal controls over the financial statement close and reporting process. We expect that our remediation efforts, including design, implementation and testing will continue throughout fiscal year 2012, although the material weakness will not be considered remediated until our controls are operational for a period of time, tested, and management concludes that these controls are operating effectively.

Changes in Internal Controls. No changes in our internal controls over the financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarterly period ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On April 2, 2012, a complaint was filed in the United States District Court for the District of Massachusetts by Scott Heiss, purportedly acting individually and on behalf of other similarly situated persons, against our company and its CEO, David Vieau, its CFO, David Prystash, and its former Interim CFO, John Granara. The complaint followed the our disclosure in March 2012 of potentially defective prismatic cells used in battery packs and a replacement program for such cells. The complaint attempts to allege that certain of our disclosures were inaccurate because the potentially defective cells and their replacement were not disclosed earlier. The complaint asserts a claim under Section 10(b) of the Securities Exchange Act of 1934 against our company and claims under Sections 10(b) and 20(a) of that statute against the individuals. It asserts a purported class period from February 28, 2011 through March 23, 2012.

On April 12, 2012, a similar complaint was filed in the United States District Court for the District of Massachusetts by Terry Leon Fike, purportedly acting individually and on behalf of other similarly situated persons, against the same defendants. The complaint makes similar allegations and also asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and a purported class period from February 28, 2011 through March 23, 2012. On June 7, 2012, the Court consolidated the two cases and appointed a lead plaintiff and lead counsel for the asserted class. No substantive response has been required at this time.

On May 14, 2012, a putative derivative action was filed in the U.S. District Court for the District of Massachusetts against the Board of Directors and certain others, as well as against our company as a nominal defendant, captioned, Jane Ahmed v. David P. Vieau, David Prystash, John Granara, Desh Deshpande, Arthur L. Goldstein, Gary E. Haroian, Dr. Paul E. Jacobs, Mark M. Little, Jeff McCarthy and Dr. Bart Riley, 1:12-CV-10865-RGS. The complaint alleges that certain of our disclosures between February 28, 2011 and March 28, 2012 were materially misleading because they failed to disclose the prismatic cell manufacturing issues and that the individual defendants violated their fiduciary duties and other causes of action on behalf of the company. The complaint alleges that demand on the board to take such actions would be "futile" and should be excused. On June 6, 2012, the defendants moved to dismiss the complaint on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On June 20, 2012, plaintiff opposed that motion, and on June 25, defendants submitted a reply in further support of their motion to dismiss. The motion to dismiss has not been decided at this time.

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On May 15, 2012, we received a letter addressed to our Board of Directors from an attorney representing an individual claiming to be a shareholder of our company. The letter asserts that our disclosures between November 9, 2010 and March 28, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012, and asserts that the Board breached its fiduciary duties during this time. The letter makes a demand on the Board to investigate the alleged inaccurate statements and to consider potential legal action against those deemed responsible. The Board considered the issues raised in the letter and retained independent counsel to advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the assistance of counsel and determined that it would not be in the best interest of A123 Systems, Inc. or A123, or its stockholders to commence or maintain an action against any present or former officer or director of the A123 concerning the matters alleged in the demand and refused the demands.

On May 21, 2012, a putative derivative action was filed in Superior Court for the Commonwealth of Massachusetts against the Board of Directors and certain others, as well as against our company as a nominal defendant, captioned, Murray Sussman v. David P. Vieau, Gururaj Deshpande, Gilbert N. Riley, Jr., Jeffrey McCarthy, Gary E. Haroian, Arthur L. Goldstein, Paul E. Jacobs, Mark M. Little, David Prystash, John Granara, Case No. 12-917. The complaint asserts substantially similar allegations and claims as the Ahmed complaint summarized above, including that demand on the board of directors should be excused as futile. On June 11, 2012, the defendants filed a motion asking the court to stay this litigation in favor of the derivative case pending in the U.S. District Court for the District of Massachusetts, or, in the alternative, that the complaint should be dismissed on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On July 16, 2012, the plaintiff filed a memorandum of law in opposition to defendants' motion to stay the litigation, or in the alternative, to dismiss this action. On July 27, 2012, the defendants filed a reply memorandum of law in further support of their motion to stay, or in the alternative, to dismiss the action. The motion to stay or dismiss has not been decided at this time. The court has set a hearing date of September 11, 2012 on defendants' motion to stay or dismiss.

On July 13, 2012, we received a demand letter addressed to our Board of Directors from an attorney representing an individual claiming to be a shareholder of the company. The letter alleges that our disclosures between March 11, 2011 and March 12, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012 and asserts that the Board and certain current and/or former executive officers of the company breached their fiduciary duties. The letter makes a demand on the Board to investigate the alleged breach of fiduciary duties to our company and to consider legal action against those responsible. The Board considered the issues raised in the letter and had its independent counsel advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the assistance of counsel and determined that it would not be in the best interest of A123 or its stockholders to commence or maintain an action against any present or former officer or director of our company concerning the matters alleged in the demand and refused the demands.

We intend to defend the litigations vigorously. Currently, we are unable to determine the outcome of these matters and the effect, if any, it may have on our financial position or results of operations. The outcomes of these matters are inherently uncertain and may be affected by future events. Accordingly, there can be no assurance as to the ultimate effect of this matter.

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Item 1A. Risk Factors

Our business is subject to numerous risks. We caution you that the following important factors, among others, could cause our actual results to differ materially from those expressed in forward-looking statements made by us or on our behalf in filings with the SEC, press releases, communications with investors and oral statements. Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q and in any other public statements we make may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in the discussion below will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may differ materially from those anticipated in forward-looking statements. We undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosure we make in our reports filed with the SEC.

Risks Related to Our Business

We have had a history of losses and negative cash flow, we may be unable to achieve or sustain profitability, and we may not be able to continue as a going concern.

We have incurred significant net losses and negative operating cash flows since inception. At June 30, 2012, we had an accumulated deficit of \$856.9 million, including \$207.9 million net losses incurred for the quarter ended June 30, 2012.

At June 30, 2012, we had \$47.7 million of cash and cash equivalents. Additionally, \$30.0 million of cash was released from restricted cash on July 6, 2012. Our credit facility and the 2013 Senior Notes contain a covenant requiring us to maintain an unrestricted cash balance of at least \$40.0 million. During the six months ended June 30, 2012, we used on average \$18.0 million to \$25.0 million per month in net operating and investing cash flows. Based on our historical use of cash, we expect our cash balance to fall below this required minimum by the end of August 2012.

Our plans with respect to addressing these matters are discussed in greater detail under Item 2 of Part I: "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The above circumstances, along with our history and near term forecast of incurring significant net losses and negative operating cash flows, raise substantial doubt on our ability to continue as a going concern. We are considering a broad set of solutions to improve our liquidity, including measures to reduce costs and improve efficiency, accessing additional sources of capital through existing and potentially new arrangements, and other strategic options. Although our intent is to improve our operating efficiencies and to obtain additional financing, there is no assurance that we will be able to obtain such financing on favorable terms, if at all, or to successfully further reduce costs in such a way that would continue to allow us to operate our business. If we fail to execute these plans successfully for any reason, we would not have adequate liquidity to fund our operations or be able to continue as a going concern.

We also expect to incur significant future expenses as we develop and expand our business and our manufacturing capacity. These increased expenditures will make it harder for us to achieve and maintain future profitability. We may incur significant losses in the future for a number of reasons, including the other risks described in this section, and we may encounter unforeseen expenses, difficulties, complications, delays and other unknown events. Accordingly, we may not be able to achieve or maintain profitability.

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Our memorandum of understanding with Wanxiang is non-binding, and provides that the financing contemplated by any definitive documentation will be subject to a number of important conditions, some of which are within Wanxiang's sole discretion.

On August 8, 2012, we announced a non-binding Memorandum of Understanding, or MOU, with Wanxiang Group Corporation, or Wanxiang. According to the proposed terms of the MOU, if the entire amount of the bridge facility described below is borrowed and all of the senior secured convertible notes and warrants contemplated by the MOU are issued, and, in the case of the warrants, exercised for cash, Wanxiang's total capital investment in our company would be approximately \$450 million. The total amount of shares of our common stock issuable upon exercise and conversion of the notes and warrants would represent approximately 80% of our then outstanding common stock.

Under the proposed terms of the MOU, Wanxiang would provide us with up to \$75.0 million in initial debt financing under a Senior Secured Bridge Facility, or bridge facility, with \$25.0 million funded initially and \$50.0 million to be funded after the satisfaction of certain approvals and conditions, including approval from the Committee of Foreign Investments in the United States, or CFIUS, and Chinese regulators. Upon satisfaction of certain closing conditions, including approval from our shareholders, termination of the Hart-Scott-Rodino waiting period and the repurchase or retirement of at least 90 percent of our outstanding 3.75 percent convertible subordinated notes due 2016, Wanxiang would purchase \$200.0 million aggregate principal amount of our senior secured convertible notes.

Because the MOU is non-binding, Wanxiang is not required to provide any funding to us unless and until definitive documentation reflecting the terms of the MOU is executed. The execution of definitive documentation is subject to negotiation and, among other items, the amendment of agreements with certain of our existing lenders. Although we are currently negotiating definitive documentation with Wanxiang, we cannot provide any assurance that definitive documentation will be executed. Even if definitive documentation is executed, the financing is expected to be consummated in several closings, each of which is subject to significant closing conditions that are not within our control. In particular, the sale of \$200.0 million in senior secured convertible notes is subject to our significantly reducing the outstanding amount of our existing debt, which may be difficult to do. In addition, some of the closing conditions are within Wanxiang's sole discretion. If we are not able to satisfy the conditions precedent to fully consummate the funding contemplated by the MOU, or otherwise to obtain alternative financing or a strategic alternative to address our liquidity, we may be unable to continue as a going concern.

We could be required to make substantial cash payments upon an event of default or change of control under the 2013 Senior Notes or our credit facility.

The 2013 Senior Notes provide for events of default including, among others, payment defaults, cross-defaults, breaches of any representation, warranty or covenant that is not cured within the proper time periods, failure to perform certain required activities in a timely manner, suspension from trading or failure of our common stock to be listed on an eligible market for certain periods and certain bankruptcy-type events involving us or any significant subsidiary. Upon an event of default, the noteholders, may elect to require us to redeem all or any portion of the outstanding principal amount of such notes at a price equal to the greater of:

either 125% or 100%, depending on the type of event of default, of the principal amount being redeemed; and

the product of the principal amount being redeemed multiplied by a fraction, the numerator of which is the greatest closing sale price of our common stock on any trading day during the period starting on the date immediately preceding the event of default and ending on the day we pay the redemption amount for the 2013 Senior Notes, and the denominator of which is the

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conversion price (as defined in the 2013 Senior Notes) at the time the noteholder elects to have such notes redeemed.

In addition, under the terms of the 2013 Senior Notes, upon a change of control, the noteholders may elect to require us to redeem all or a portion of the 2013 Senior Notes at a price equal to 100% of the greater of:

the sum of such principal amount being redeemed, plus all accrued but unpaid interest, and a make-whole amount; or

the product of:

such principal amount being redeemed, plus all accrued but unpaid interest, multiplied by

the quotient determined by dividing (x) the greatest closing sale price of our common stock during the period beginning on the date immediately preceding the earlier of the consummation or public announcement of such change of control and ending on the date the holder elects to require us to redeem all or a portion of the 2013 Senior Notes, by (y) the lowest conversion price of the 2013 Senior Notes in effect during such period.

If either an event of default or change of control occurs, our available cash could be seriously depleted and our ability to fund operations could be materially harmed.

We have yet to achieve positive cash flow, and our ability to generate positive cash flow is uncertain.

To rapidly develop and expand our business, we have made significant up-front investments in our manufacturing capacity and incurred research and development, sales and marketing and general and administrative expenses. In addition, our growth has required a significant investment in working capital over the last several years. We have had negative cash flow before financing activities of \$250.4 million for 2010, \$333.8 million for 2011 and \$164.8 million for the six months ended June 30, 2012. We anticipate that we will continue to have negative cash flow for the foreseeable future. Our business will also require significant amounts of working capital to support our growth. Therefore, we must raise additional capital from investors to achieve our expected growth, and we may not achieve sufficient revenue growth to generate positive future cash flow. An inability to generate positive cash flow for the foreseeable future or raise additional capital on reasonable terms will decrease our long-term viability.

We must raise additional capital to continue to fund our operations and any fundraising we complete could result in dilution to our current stockholders or reduce our ability to compete successfully.

We must raise additional capital to continue to invest to fund our growth as well as the recent significant losses in our business, and we may not be able to obtain additional debt or equity financing on favorable terms, if at all. If we raise additional equity financing, our stockholders may experience significant dilution of their ownership interests, and the per-share value of our common stock could decline.

Stockholders will also experience further dilution if holders of our convertible notes choose to convert outstanding notes into shares of our common stock or upon making our mandatory installment payments for notes in stock.

If we engage in debt financing, we may be required to accept terms that restrict our ability to incur additional indebtedness and force us to maintain specified liquidity or other ratios. For example, our credit facility and 2013 Senior Notes contain a covenant requiring us to maintain an unrestricted cash balance of at least \$40.0 million. We are also seeking federal and state grants, loans and tax incentives some of which we intend to use to expand our operations. We may not be successful in obtaining these

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funds or incentives. If we need additional capital and cannot raise or otherwise obtain it on acceptable terms, we may not be able to, among other things:

develop or enhance our products or introduce new products;

maintain our customer base;

continue to fund our development, sales and marketing and general and administrative organizations and manufacturing operations;

attract top-tier companies as customers or as our technology and product development partners;

acquire complementary technologies, products or businesses;

fund our operations, in the United States or internationally;

expand and maintain our manufacturing capacity;

hire, train and retain employees; or

respond to competitive pressures or unanticipated working capital requirements.

We face risks related to our outstanding indebtedness.

As of June 30, 2012, we had total indebtedness of \$181.6 million. Our indebtedness could have significant negative consequences, including:

increasing our vulnerability to general adverse economic and industry conditions,

limiting our ability to obtain additional financing,

requiring the dedication of a substantial portion of any cash flow from operations to service our indebtedness, thereby reducing the amount of cash flow available for other purposes, including capital expenditures,

limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete, and

placing us at a possible competitive disadvantage to less leveraged competitors and competitors that have better access to capital resources.

The 2013 Senior Notes contain various covenants and restrictions which may limit our ability to operate our business.

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The 2013 Senior Notes contain certain covenants and restrictions, including, among others, that, for so long as the such notes are outstanding, we will not, and we will not permit any of our subsidiaries to:

incur any indebtedness (other than permitted indebtedness under the 2013 Senior Notes);

permit liens on our properties (other than permitted liens under the 2013 Senior Notes);

redeem or repurchase equity interests;

repay certain indebtedness in cash if an event of default has occurred or where to occur;

declare or pay cash dividends;

transfer certain assets; or

make or agree to make capital expenditures above \$35.0 million for the fiscal year ended December 31, 2012.

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We have also agreed to maintain on deposit cash in an aggregate amount equal to not less than \$40.0 million. These restrictions could limit our ability to plan for or react to market conditions or meet extraordinary capital needs or otherwise restrict corporate activities, any of which could have a material adverse impact on our business. See "Note 2 Private Placements of the Notes to the Condensed Consolidated Financial Statements" for a more detailed description of the 2013 Senior Notes.

Substantial leverage and debt service obligations may adversely affect our cash flows.

In connection with the issuance of the 2013 Senior Notes in May 2012, we incurred new indebtedness of \$50.0 million. As a result, as of June 30, 2012, our outstanding indebtedness was \$185.2 million. The degree to which we are leveraged could, among other things:

require us to dedicate a substantial portion of our future cash flows from operations and other capital resources to debt service, to the extent we are unable to make payments of principal or interest on our 2013 Senior Notes, in common stock, due to, among other things, failure to satisfy the equity conditions that must be met to enable us to do so;

make it difficult for us to obtain necessary financing in the future for working capital, acquisitions or other purposes on favorable terms, if at all;

make it more difficult for us to be acquired;

make us more vulnerable to industry downturns and competitive pressures; and

limit our flexibility in planning for, or reacting to, changes in our business.

Our ability to meet our debt service obligations will depend upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control.

We may not be able to generate sufficient cash to service all of our indebtedness, including the 2013 Senior Notes and the 2016 Notes, or convertible notes. Our ability to generate cash depends on many factors beyond our control. We may be forced to take other actions to satisfy our obligations under our indebtedness, which may not be successful.

Our ability to make payments on, and to refinance, our indebtedness, including the convertible notes, and to fund planned capital expenditures, research and development efforts, working capital, acquisitions and other general corporate purposes depends on our ability to generate cash in the future. This, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors, some of which are beyond our control. If we do not generate sufficient cash flow from operations or if future borrowings are not available to us in an amount sufficient to pay our indebtedness, including the convertible notes, or to fund our liquidity needs, we may be forced to:

refinance all or a portion of our indebtedness, including the convertible notes, on or before the maturity thereof;

sell assets;

reduce or delay capital expenditures; or

seek to raise additional capital.

In addition, we may not be able to affect any of these actions on commercially reasonable terms or at all. Our ability to refinance this indebtedness will depend on our financial condition at the time, the restrictions in the instruments governing our indebtedness and other factors, including market conditions.

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Our inability to generate sufficient cash flow to satisfy our debt service obligations, or to refinance or restructure our obligations on commercially reasonable terms or at all, would have an adverse effect, which could be material, on our business, financial condition and results of operations, as well as our ability to satisfy our obligations in respect of the convertible notes.

Our credit agreement contains restrictions that limit our flexibility in operating our business.

In September 2011, we entered into a credit agreement and refinanced our existing credit facility. Our credit agreement, as amended on May 11, 2012, contains various restrictions, financial and operating covenants that limit our ability to engage in specified types of transactions. The facility is restricted to collateralize outstanding letters of credit up to a maximum of \$15.0 million only and does not allow for any direct borrowings. The total amount of outstanding letters of credit must be collateralized by cash at 105% of the face amount. At June 30, 2012, we had \$10.8 million of restricted cash to collateralize primarily our outstanding letters of credit. One of the financial covenants in this revolving facility requires that we maintain a minimum cash balance of \$40.0 million. The operating covenants limit our ability to, among other things:

sell, transfer, lease or dispose of our assets;

create, incur or assume additional indebtedness;

encumber or permit liens on certain of our assets make restricted payments, including paying dividends on, repurchasing or making distributions with respect to our common stock;

make specified investments (including loans and advances);

consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; and

enter into certain transactions with our affiliates.

A breach of any of these covenants or a material adverse change to our business could result in a default under the credit agreement. Upon the occurrence of an event of default under our credit agreement, our lenders could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness.

Our limited operating history makes it difficult to evaluate our current business and future prospects.

We have been in existence since 2001, but much of our growth has occurred in recent years. Our limited operating history may make it difficult to evaluate our current business and our future prospects. We have encountered and will continue to encounter risks and difficulties frequently experienced by growing companies in rapidly changing industries, including increasing expenses as we continue to grow our business. If we do not manage these risks successfully, our business will be harmed.

In addition, we are targeting new and emerging markets for our batteries and battery systems. However, historically, a significant portion of the products that we have sold for commercial use were designed for the consumer tool market, which is a more mature market with different growth prospects than our other target markets. Several of our products are still under development, and the timing of the ultimate release, if any, of new production quality products is not determinable. Our efforts to expand beyond our existing markets may never result in new products that achieve market acceptance, create additional revenue or become profitable. Therefore, our recent historical growth trajectory may not provide an accurate representation of the market dynamics we may be exposed to in the future, making it difficult to evaluate our future prospects.

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The demand for batteries in the transportation and other markets depends on the continuation of current trends resulting from dependence on fossil fuels. Extended periods of low gasoline prices could adversely affect demand for electric and hybrid electric vehicles.

We believe that much of the present and projected demand for advanced batteries in the transportation and other markets results from increases in the cost of oil over the last several years, the dependency of the United States on oil from unstable or hostile countries, government regulations and economic incentives promoting fuel efficiency and alternate forms of energy, as well as the belief that climate change results in part from the burning of fossil fuels. If the cost of oil decreased significantly, the outlook for the long-term supply of oil to the United States improved, the government eliminated or modified its regulations or economic incentives related to fuel efficiency and alternate forms of energy, or if there is a change in the perception that the burning of fossil fuels negatively impacts the environment, the demand for our batteries could be reduced, and our business and revenue may be harmed.

Gasoline prices have been extremely volatile, and this continuing volatility is expected to persist. Lower gasoline prices over extended periods of time may lower the perception in government and the private sector that cheaper, more readily available energy alternatives should be developed and produced. If gasoline prices remain at deflated levels for extended periods of time, the demand for hybrid and electric vehicles may decrease, which would have a material adverse effect on our business.

If we are unable to develop, manufacture and market products that improve upon existing battery technology and gain market acceptance, our business may be adversely affected. In addition, many factors outside of our control may affect the demand for our batteries and battery systems.

We are researching, developing, manufacturing and selling lithium-ion batteries and battery systems. The market for advanced rechargeable batteries is at a relatively early stage of development, and the extent to which our lithium-ion batteries will be able to meet our customers' requirements and achieve significant market acceptance is uncertain. Rapid and ongoing changes in technology and product standards could quickly render our products less competitive, or even obsolete if we fail to continue to improve the performance of our battery chemistry and systems. Other companies that are seeking to enhance traditional battery technologies have recently introduced or are developing batteries based on nickel metal-hydride, liquid lithium-ion and other emerging and potential technologies. These competitors are engaged in significant development work on these various battery systems. One or more new, higher energy rechargeable battery technologies could be introduced which could be directly competitive with, or superior to, our technology. The capabilities of many of these competing technologies have improved over the past several years. Competing technologies that outperform our batteries could be developed and successfully introduced, and as a result, our products may not compete effectively in our target markets. If our battery technology is not adopted by our customers, or if our battery technology does not meet industry requirements for power and energy storage capacity in an efficient and safe design, our batteries will not gain market acceptance.

In addition, the market for our products depends upon third parties creating or expanding markets for their end-user products that utilize our batteries and battery systems. If such end-user products are not developed, if we are unable to have our products designed into these end user products, if the cost of these end-user products is too high, or the market for such end-user products contracts or fails to develop, the market for our batteries and battery systems would be expected similarly to contract or collapse. Our customers operate in extremely competitive industries, and competition to supply their needs focuses on delivering sufficient power and capacity in a cost, size and weight efficient package. The ability of our customers to adopt new battery technologies will depend on many factors outside of our control. For example, in the automotive industry, we depend on our customers' ability to develop HEV, PHEV and EV platforms that gain broad appeal among end users.

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Many other factors outside of our control may also affect the demand for our batteries and battery systems and the viability of widespread adoption of advanced battery applications, including:

performance and reliability of battery power products compared to conventional and other non-battery energy sources and products;

success of alternative battery chemistries, such as nickel-based batteries, lead-acid batteries and conventional lithium-ion batteries and the success of other alternative energy technologies, such as fuel cells and ultra capacitors;

end-users' perceptions of advanced batteries as relatively safe and reliable energy storage solutions, which could change over time if alternative battery chemistries prove unsafe, are subject to safety recalls or become the subject of significant product liability claims and negative publicity is generated on the battery industry as a whole;

cost-effectiveness of our products compared to products powered by conventional energy sources and alternative battery chemistries;

availability of government subsidies and incentives to support the development of the battery power industry;

fluctuations in economic and market conditions that affect the cost of energy stored by batteries, such as increases or decreases in the prices of electricity;

continued investment by the federal government and our customers in the development of battery powered applications;

heightened awareness of environmental issues and concern about global warming and climate change; and

regulation of energy industries.

Our principal competitors have, and any future competitors may have, greater financial and marketing resources than we do, and they may therefore develop batteries or other technologies similar or superior to ours or otherwise compete more successfully than we do.

Competition in the battery industry is intense. The industry consists of major domestic and international companies, most of which have existing relationships in the markets into which we sell as well as financial, technical, marketing, sales, manufacturing, scaling capacity, distribution and other resources and name recognition substantially greater than ours. These companies may develop batteries or other technologies that perform as well as or better than our batteries. We believe that our primary competitors are existing suppliers of lithium-ion, nickel cadmium, nickel metal-hydride and in some cases, non-starting/lighting/ignition lead-acid batteries. A number of our competitors have existing and evolving relationships with our target customers. In the transportation space for example, Bosch and Samsung formed SB LiMotive to focus on the development, production and marketing of lithium-ion battery systems for application in hybrid and other electric vehicles, and Dow Chemical has entered into a joint venture with Kokam America and others, to build a facility in Michigan for the manufacture of lithium polymer batteries for use in HEVs, PHEVs and EVs. In addition, NEC Corporation and Nissan entered into a joint venture to develop lithium-ion batteries in prismatic form, Sanyo and Volkswagen agreed to develop lithium-ion batteries for HEVs, Sanyo is providing nickel metal hydride batteries for Ford and Honda, and Toyota and Panasonic are engaged in a joint venture to make batteries for HEVs and EVs. LG Chem and its subsidiary, Compact Power, have also developed lithium-ion battery systems for hybrid and other electric vehicles. In the electric grid space for example, Saft and Xtreme Power have developed applications for grid energy storage.

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These competitors may be able to offer lower prices for their batteries than we can offer, and may even sell their batteries at below their production costs in order to compete with us, particularly in the transportation market. In addition, we expect new competitors will enter the markets for our products in the future with a continued emergence of Chinese companies entering the lithium-ion space, along with existing Chinese battery companies, including Amperex Technology Limited (ATL), BAK Battery and BYD. Potential customers may choose to do business with our more established competitors, because of their perception that our competitors are more stable, are more likely to complete various projects, can scale operations more quickly, have greater manufacturing capacity, are more likely to continue as a going concern and lend greater credibility to any joint venture. If we are unable to compete successfully against manufacturers of other batteries or technologies in any of our targeted applications, our business could suffer, and we could lose or be unable to gain market share.

Adverse business or financial conditions affecting the automobile industry have had, and may continue to have, a material adverse effect on our development and marketing partners and our battery business.

Much of our business depends on and is directly affected by the general economic state of the United States and global automobile industry. The effect of the continued economic difficulties of the major automobile manufacturers on our business is unclear. The impact of any such financial difficulties on the automobile industry and its suppliers is difficult to predict. Possible effects could include reduced spending on alternative energy systems for automobiles, a delay in the introduction of new, or the cancellation of new and existing, hybrid and electric vehicles and programs, and a delay in the conversion of existing batteries to lithium-ion batteries, each of which would have a material adverse effect on our business.

We have entered into agreements relating to joint design and development efforts with several automotive manufacturers and tier 1 suppliers regarding their HEV, PHEV and EV development efforts. Certain of these manufacturers and suppliers have in recent years experienced static or reduced revenues, increased costs, net losses, loss of market share, bankruptcy, production issues, labor issues and other business and financial challenges. As a result, these or other automotive manufacturers may discontinue or delay their planned introduction of HEVs, PHEVs or EVs as a result of adverse changes in their financial condition or other factors. Automotive manufacturers may also seek alternative battery systems from other suppliers which may be more cost-effective or require fewer modifications in standard manufacturing processes than our products. We may also experience delays or losses with respect to the collection of payments due from customers in the automotive industry experiencing financial difficulties or reductions in forecasted demand.

We have experienced rapid growth in recent periods. If we fail to manage our growth effectively, we may be unable to execute our business plan, maintain high levels of service or address competitive challenges adequately.

We increased our number of full-time employees from 904 at January 1, 2008 to 1,983 at December 31, 2011, and our revenue increased from \$68.5 million in 2008 to \$159.1 million in 2011. Our growth has placed, and may continue to place, a significant strain on our managerial, administrative, operational, financial, legal, information technology and other resources. Expanding a global organization and managing a geographically dispersed workforce will require substantial management effort and significant additional investment in our infrastructure. We will be required to continue to improve our operational, financial and management controls and our reporting procedures and we may not be able to do so effectively. As such, we may be unable to manage our expenses effectively in the future, which may negatively impact our operating results in any particular quarter.

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Because we build our manufacturing capacity based on our projection of future design wins and supply agreements, our business revenue and profits depend upon our ability to enter into and complete these agreements, successfully complete these expansion projects, achieve competitive manufacturing yields and drive volume sales consistent with our demand expectations.

In order to fulfill the anticipated demand for our products, we invest in capital expenditures in advance of actual customer orders, based on estimates of future demand. We plan to continue the expansion of our manufacturing capacity across multiple product lines based on such estimates. The build-up of our internal manufacturing capabilities, such as the expansions in Livonia and Romulus, Michigan, exposes us to significant up-front fixed costs. If market demand for our products does not increase as quickly as we have anticipated and align with our expanded manufacturing capacity, if customers' forecasts of expected demand are reduced or if we fail to enter into and complete projected development and supply agreements, we may be unable to offset these costs and to achieve economies of scale, and our operating results may be adversely affected as a result of high operating expenses, reduced margins, underutilization of capacity and asset impairment charges. Alternatively, if we experience demand for our products in excess of our estimates, our installed capital equipment may be insufficient to support higher production volumes, which could harm our customer relationships and overall reputation. In addition, we may not be able to expand our workforce and operations in a timely manner, procure adequate resources, or locate suitable third-party suppliers, to respond effectively to changes in demand for our existing products or to the demand for new products requested by our customers, and our current or future business could be materially and adversely affected. Our ability to meet such excess customer demand could also depend on our ability to raise additional capital and effectively scale our manufacturing operations.

We utilize standard manufacturing equipment that we modify and customize in order to meet our production needs. While this equipment may be available from various suppliers, its procurement requires long lead times. Therefore, we may experience delays, additional or unexpected costs and other adverse events in connection with our capacity expansion projects, including those associated with potential delays in the procurement and customization of manufacturing equipment and various components required for our products.

If we are unable to achieve and maintain satisfactory production yields and quality as we expand our manufacturing capabilities, our relationships with certain customers and overall reputation may be harmed, and our sales could decrease and our margins could be negatively impacted.

Revenue from our supply agreement with Fisker Automotive, Inc., or Fisker, represents, and is expected to continue to represent, a significant portion of our revenue. If Fisker is unable to fulfill its commitment under the supply agreement our revenues could be materially lower than our forecasts and we may have under-utilized manufacturing capacity.

We have a supply agreement with Fisker pursuant to which we are providing Fisker with advanced automotive battery systems over a multi-year period. Fisker accounted for approximately 2% of our revenue in 2010 and 26% of our revenue in 2011. If Fisker is not successful in continuing to raise additional capital necessary to fund its operations, executing on its strategic plan or does not meet the anticipated demand for our products, our revenues and profitability will be materially impacted. For example, in November 2011 and again in January, 2012, we announced revised annual revenue guidance for 2011 due to an unanticipated reduction in orders from Fisker. As we invest in capital expenditures and build our manufacturing capacity in anticipation of demand, including anticipated demand from Fisker under the supply agreement, our operating results may be adversely affected by underutilization of capacity, failure to achieve economies of scale, and reduced margins if actual orders are less than expected.

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We may not be able to obtain, or to agree on acceptable terms and conditions for, all or a significant portion of the government grants, loans and other incentives for which we have applied and may in the future apply. Our customers and potential customers applying for government grants, loans and other incentives may condition purchases of our products upon their receipt of these funds or delay purchases of our products until their receipt of these funds.

We have applied for federal and state grants, loans and tax incentives under government programs designed to stimulate the economy and support the production of electric vehicles and advanced battery technologies. Much of our planned domestic manufacturing capacity expansion depends on receipt of these funds and other incentives, and the failure to obtain these funds or other incentives could materially and adversely affect our ability to expand our manufacturing capacity and meet planned production levels. Given recent bankruptcies declared by some recipients of loans under DOE-sponsored loan programs and resulting congressional and executive branch investigations, we have observed that pending loan applications under the DOE ATVM Program, including our own, have been delayed or withdrawn by the applicant. For example, in May 2012, we notified the DOE that we had elected to withdraw our application for a loan under the DOE ATVM Program. We anticipate that in the future there will be new opportunities for us to apply for grants, loans and other incentives from the United States, state and foreign governments. Our ability to obtain funds or incentives from government sources is subject to the availability and continued availability of funds under applicable government programs and approval of our applications to participate in such programs. The application process for these funds and other incentives is and will be highly competitive. While we have received a grant under the DOE Battery Initiative and have received some state incentives, we cannot assure you that we will be successful in obtaining additional grants, loans and other incentives. Moreover, we may not be able to satisfy or continue to satisfy the requirements and milestones imposed by the granting authority as conditions to receipt of the funds or other incentives, the timing of the receipt of the funds may not meet our needs and we nevertheless may be unable to successfully execute on our business plan. Moreover, not all of the terms and conditions associated with these incentive funds have been disclosed to us, and once disclosed, there may be terms and conditions with which we are unable to comply or which are commercially unacceptable to us. In addition, the DOE Battery initiative grant and any other federal government programs which may make additional awards to us will require us to spend a portion of our own funds for every incentive dollar we receive or are permitted to borrow from the government and will impose time limits during which we must use the funds awarded to us. If we are unable to raise sufficient additional capital so that we are able to receive all of the amounts which have and may be awarded to us in a timely manner, our ability to expand our manufacturing capacity could be materially adversely affected. In addition, less than expected actual and anticipated future demand for our products may cause us to slow the pace of the expansion of our manufacturing capacity such that we are not able to use the government incentive funds awarded or made available to us in the time periods required by the granting authorities.

Our customers and potential customers applying for these government grants, loans and other incentives may condition purchases of our products upon receipt of these funds or delay purchases of our products until receipt of these funds, and if our customers and potential customers do not receive these funds or the receipt of these funds is significantly delayed, our results of operations could suffer.

We are subject to government audits related to the government grants, loans and other incentives we have received. If the findings of the audit determine we have not met the requirements of the grant, loan or other incentive, we may be required to repay all or part of the amount received to the government authority.

We have received funds under federal and state grant and loan programs. Under the terms and conditions of the programs, we are subject to governmental audits of the amounts submitted for reimbursement of costs incurred. Although we expect to satisfy the requirements of the grants, loans, and other incentives received, we cannot assure that the government audits will not result in

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determining that a portion of the costs submitted for reimbursement do not comply with the conditions of the grant. If we do not meet the conditions of the grants, loans or other incentives, we may be required to repay all or a portion of the proceeds received to date from the federal or state agencies.

We rely on a limited number of customers for a significant portion of our revenue, and the loss of, or delay in the production process, of one or more of our most significant customers, or several of our smaller customers, could materially harm our business.

A significant portion of our revenue is generated from a limited number of customers. For the year ended December 31, 2010, revenue from our two largest customers, AES and BAE Systems represented 41% of our revenue. For the year ended December 31, 2011, revenue from our two largest customers, Fisker and AES, represented 50% of our revenue. Although the composition of our significant customers will vary from period to period, we expect that most of our revenue will continue, for the foreseeable future, to come from a relatively small number of customers. In addition, our contracts with our customers generally do not include long-term commitments or minimum volumes that ensure future sales of our products. Consequently, our financial results may fluctuate significantly from period-to-period based on the actions of one or more significant customers. A customer may take actions that affect us for reasons that we cannot anticipate or control, such as reasons related to the customer's financial condition, changes in the customer's business strategy or operations, the introduction of alternative competing products, or as the result of the perceived quality or cost-effectiveness of our products. Our agreements with these customers may be cancelled if we fail to meet certain product specifications or materially breach the agreement or for other reasons outside of our control. In addition, our customers may seek to renegotiate the terms of current agreements or renewals. The loss of or a reduction in sales or anticipated sales to our most significant or several of our smaller customers could have a material adverse effect on our business, financial condition and results of operations. For example, in November 2011 and again in January 2012, we announced revised annual revenue guidance for 2011 due to an unanticipated reduction in orders from Fisker for the fourth quarter. Additionally, if one of our significant customers, several of our smaller customers, or one of our existing supply agreements with customers for significant future revenues experiences a delay in production, reduce their forecasted demand or their product is not successful, our business, financial condition and results of operations could be materially harmed.

On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility. While the field campaign has not caused us to lose any customers to date, it is possible that we may lose customers as a result. In addition, it is possible that we may lose customers as a result of our cash position.

Our financial results may vary significantly from period-to-period due to the long and unpredictable sales cycles for some of our products, the seasonality of certain end markets into which we sell our products, and changes in the mix of products we sell during a period, which may lead to volatility in our stock price.

The size and timing of our revenue from sales to our customers is difficult to predict and is market dependent. Our sales efforts often require us to educate our customers about the use and benefits of our products, including their technical and performance characteristics. Customers typically undertake a significant evaluation process that has in the past resulted in a lengthy sales cycle, which is typically many months and in some cases up to five years. In some markets such as the transportation market, there is usually a significant lag time between the design phase and commercial production. We spend substantial amounts of time and money on our sales efforts and there is no assurance that these investments will produce any sales within expected time frames or at all. For example, we have previously spent substantial time and money on several designs with auto manufacturers that were ultimately awarded to another supplier. Given the potentially large size of battery development and

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supply contracts, the loss of or delay in the signing of a contract or a customer order could significantly reduce our revenue in any period. Since most of our operating and capital expenses are incurred based on the estimated number of design wins and their timing, they are difficult to adjust in the short term. As a result, if our revenue falls below our expectations or is delayed in any period, we may not be able to reduce proportionately our operating expenses or manufacturing costs for that period, and any reduction of manufacturing capacity could have long-term implications on our ability to accommodate future demand.

Our profitability from period-to-period may also vary significantly due to the mix of products that we sell in different periods. While we have sold most of our products, in recent periods, into the transportation market, we are also focusing our sales efforts on applications in the electric grid and commercial markets. Products in these other markets have different cost profiles and are governed by different business dynamics. Further, our contracts in the electric grid market are project-driven; therefore, revenue tends to vary across periods. Consequently, sales of individual products may not necessarily be consistent across periods, which could affect product mix and cause gross and operating profits to vary significantly.

In addition, since our batteries and battery systems are incorporated into our customers' products for sale into their respective end markets, our business is exposed to the seasonal demand that may characterize some of our customers' own product sales. Because many of our expenses are based on anticipated levels of annual revenue, our business and operating results could also suffer if we do not achieve revenue consistent with our expectations for this seasonal demand.

As a result of these factors, we believe that quarter-to-quarter comparisons of our operating results are not necessarily meaningful and that these comparisons cannot be relied upon as indicators of future performance. Moreover, our operating results may not meet expectations of equity research analysts or investors. If this occurs, the trading price of our common stock could fall substantially either suddenly or over time.

If our products fail to perform as expected, or have technical issues, we could lose existing and future business, have costly field campaigns, and our ability to develop, market and sell our batteries and battery systems could be harmed.

Our products are complex and could have unknown defects or errors, which may give rise to claims against us, diminish our brand or divert our resources from other purposes. Despite testing, new and existing products have contained defects and errors and may in the future contain manufacturing or design defects, errors or performance problems when first introduced, when new versions or enhancements are released, or even after these products have been used by our customers for a period of time. These problems could result in expensive and time-consuming design modifications or warranty charges, product recalls and field repair campaigns, delays in the introduction of new products or enhancements, significant increases in our service and maintenance costs, exposure to liability for damages, damaged customer relationships and harm to our reputation, any of which may adversely affect our business and our operating results. For example, in 2010, we identified several significant technical issues in the manufacturing scale-up of our prismatic batteries. Although we identified and have taken corrective actions for these issues, the problems encountered resulted in a higher yield loss in ramp-up production, temporary halts in the production process and the distraction of personnel, some or all of which could re-occur. In addition, in October 2011, we were notified by BAE of the existence of cumulative failures of the modules within our battery pack. We identified the problem as being related to water and debris intrusion. We are currently participating in a field campaign with BAE in order to retrofit and upgrade the packs to reduce water and debris intrusion and preserve the performance and safety of the pack. In December 2011, we determined that some of the battery packs we produce for Fisker could have a potential safety issue relating to the battery cooling system due to the misalignment of certain hose clamps in the battery pack's internal cooling system. While there were

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no related battery performance or safety incidents with cars in the field and corrective actions were promptly undertaken, the problem required unanticipated management time and expense as well as the rapid re-deployment of technical personnel to the field. In March 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million.

Our success in the transportation market depends, in part, on our ability to design, develop and commercially manufacture lithium-ion batteries in prismatic form and battery systems for use in HEVs, PHEVs and EVs currently being developed and that may be developed in the future. The design and development of a lithium-ion battery in prismatic form and battery systems for use in the transportation industry is complex, expensive, time-consuming and subject to rigorous quality and performance requirements. If we are unable to design, develop and commercially manufacture lithium-ion batteries in prismatic form in a timely fashion and that are accepted for use in the transportation industry, our business and operating results may be adversely affected.

We entered into a strategic investment agreement with an early stage entity with which we have a commercial relationship.

In January 2010, we entered into an agreement with Fisker, a privately-held company, to invest \$13.0 million in cash and 479,282 shares of our common stock, which when transferred to Fisker had a value of approximately \$7.5 million. In exchange, we received shares of convertible preferred stock in Fisker which are not liquid, and we do not expect that they will be liquid for some time. Our investment in Fisker exposes us to equity price risk; if Fisker does not execute on its strategic plan, our investment may not be recovered. This investment is subject to risk of loss in value, which could result in a material realized impairment loss. During the year ended December 31, 2011, we elected not to participate in Fisker's subsequent stock financing. This election not to participate resulted in the conversion of our preferred shares of Fisker to common shares on a 2:1 ratio. As such, we performed an analysis and valuation of our investment in Fisker resulting to the recognition of an impairment charge of \$11.6 million for the year ended December 31, 2011. During the six months ended June 30, 2012, our analysis and valuation resulted in an impairment charge of \$2.9 million.

We have identified an unremediated material weakness in our internal control over financial reporting and if we fail to remediate this weakness and maintain proper and effective internal controls, our ability to produce accurate and timely financial statements could be impaired, which could harm our operating results, our ability to operate our business and investors' views of us.

For the year ended December 31, 2009, we identified two material weaknesses in our internal controls over financial reporting. For the year ended December 31, 2010, the previously identified material weaknesses were aggregated into a single material weakness. For the year ended December 31, 2011, management identified a material weakness in our internal controls and information technology controls over the financial statement close and reporting process. A material weakness is defined as a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's internal controls. As a result of our unremediated material weakness, our management cannot certify that our internal controls over financial reporting were effective at a reasonable assurance level. For a detailed discussion of the material weakness, see "Controls and Procedures" section within Part II, Item 9A, as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 12, 2012

We are in the process of taking the necessary steps to remediate the material weakness that we identified and have made enhancements to our control procedures; however, the material weakness will not be remediated until the necessary controls have been implemented and are determined to be

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operating effectively. We do not know the specific time frame needed to fully remediate the material weakness identified.

We cannot assure you that our efforts to fully remediate this internal control weakness will be successful or that similar material weaknesses will not recur.

Implementing any appropriate changes to our internal controls may distract our officers and employees, entail substantial costs to implement new processes and modify our existing processes and take significant time to complete. Moreover, these changes do not guarantee that we will be effective in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and harm our business. In addition, investors' perceptions that our internal controls are inadequate or that we are unable to produce accurate financial statements on a timely basis may harm our stock price and make it more difficult for us to effectively market and sell our products to new and existing customers.

If our warranty expense estimates differ materially from our actual claims, or if we are unable to estimate future warranty expense for new products, our business and financial results could be harmed.

Our warranty for our products ranges from one to five years from the date of sale, depending on the type of product and its application. We expect that in the future some of our warranties could extend beyond five years. In the commercial market, we typically provide a warranty against certain potential manufacturing defects, which may cause high rates of self-discharge, inaccurate voltage, and other product irregularities. In the electric grid services and transportation markets, we may also provide a warranty against a certain percentage decline in the initial power and energy density specifications of a particular product and for a warranty for system availability. Since we began selling our first products in the commercial market in the first quarter of 2006, in the transportation market in the first quarter of 2007 and in the electric grid services market in the third quarter of 2009, we have a limited product history on which to base our warranty estimates. Because of the limited operating history of our batteries and battery systems, our management is required to make assumptions and to apply judgment regarding a number of factors, including anticipated rate of warranty claims, the durability and reliability of our products, and service delivery costs. Our assumptions could prove to be materially different from the actual performance of our batteries and battery systems, which could cause us to incur substantial expense to repair or replace defective products in the future and may exceed expected levels against which we have reserved. If our estimates prove incorrect, we could be required to accrue additional expenses from the time we realize our estimates are incorrect and also face a significant unplanned cash burden at the time our customers make a warranty claim, which could harm our operating results.

On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. The cost of this field campaign is estimated at \$51.6 million. In addition, we recorded an inventory charge of approximately \$15.2 million related to inventory produced at our Michigan facilities that may be defective. As a result of this field campaign and the charge for our existing prismatic cell inventory, we must begin to rebuild our inventory and balance our backlog for existing customer orders while simultaneously replacing the defective customer modules and packs. Therefore, we expect to continue to incur significant net losses and negative operating cash flows over the next several quarters.

In addition, with our new products and products that remain under development, we will be required to base our warranty estimates on historical experience of similar products testing of our batteries and performance information learned during our development activities with the customer. If we are unable to estimate future warranty costs for any new product, we will be required to defer

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recognizing revenue for that product until we are reasonably able to estimate the associated warranty expense. As a result, our financial results could vary significantly from period-to-period.

Product liability or other claims could cause us to incur losses or damage our reputation.

The risk of product liability claims and associated adverse publicity is inherent in the development, manufacturing, marketing and sale of batteries and battery systems. Certain materials we use in our batteries, as well as our batteries and battery systems, could, if used or tested improperly, cause injuries to others or damage to property. Improperly charging or discharging our batteries could cause fires. Any accident involving our batteries or other products could decrease or even eliminate demand for our products. Because some of our batteries are designed to be used in vehicles, and because vehicle accidents can cause injury to persons and damage to property, we are subject to a risk of claims for such injuries and damages. In addition, we could be harmed by adverse publicity resulting from problems or accidents caused by third party products that incorporate our batteries. For example, our business and operating results could be harmed by adverse publicity resulting from injury to persons or damage to property caused by a defective electronic system on a battery system manufactured by a third party that incorporates our batteries.

Although we have product liability insurance for our products, this may be inadequate to cover all potential product liability claims or claims resulting from design defects. In addition, while we often seek to limit our product liability in our contracts, such limits may not be enforceable or may be subject to exceptions. Any product recall or lawsuit seeking significant monetary damages either in excess of our coverage, or outside of our coverage, may have a material adverse effect on our business and financial condition. We may not be able to secure additional product liability insurance coverage or other forms of insurance coverage on acceptable terms or at reasonable costs when needed. If we were to experience a large insured loss or business interruption, it might exceed our coverage limits or may not be covered, or our insurance carriers could decline to further cover us or raise our insurance rates to unacceptable levels, any of which could impair our financial position and results of operations. A successful product liability claim against us could require us to pay a substantial monetary award. We cannot assure that such claims will not be made in the future.

We are subject to financial and reputational risks due to product recalls resulting from product quality and liability issues.

The risk of product recalls, and associated adverse publicity, is inherent in the development, manufacturing, marketing, and sale of batteries and battery systems. Our products and the products of third parties in which our products are a component are becoming increasingly sophisticated and complicated as rapid advancements in technologies occur, and as demand increases for lighter and more powerful rechargeable batteries. At the same time, product quality and liability issues present significant risks. Product quality and liability issues may affect not only our own products but also the third-party products in which our batteries and battery systems are a component. Moreover, several of our applications have entered commercial production and are being operated in the field, so we are at increased risk of encountering unanticipated technical issues that could result in product recalls. For example, on March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility.

Our efforts and the efforts of our development partners to maintain product quality may not be successful, and if they are not, we may incur expenses in connection with, for example, product recalls and lawsuits, and our brand image and reputation as a producer of high-quality products may suffer. Any product recall or lawsuit seeking significant monetary damages could have a material adverse effect on our business and financial condition. A product recall could generate substantial negative publicity about our products and business, interfere with our manufacturing plans and product delivery obligations as we seek to replace or repair affected products, and inhibit or prevent commercialization

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of other future product candidates. Although we do have product liability insurance, we do not have insurance to cover the costs associated with a product recall nor do we have insurance for design defects, and the expenses we would incur in connection with a product recall could have a material adverse affect on our operating results.

We depend on third parties to deliver raw materials, parts, components and services in adequate quality and quantity in a timely manner and at a reasonable price.

Our manufacturing operations depend on obtaining raw materials, parts and components, manufacturing equipment and other supplies including services from reliable suppliers in adequate quality and quantity in a timely manner. It may be difficult for us to substitute one supplier for another, increase the number of suppliers or change one component for another in a timely manner or at all due to the interruption of supply or increased industry demand. This may adversely affect our operations. The prices of raw materials, parts and components and manufacturing equipment may increase due to changes in supply and demand. In addition, currency fluctuations and a weakening of the U.S. dollar against foreign currencies may adversely affect our purchasing power for raw materials, parts and components and manufacturing equipment from foreign suppliers.

We depend on sole source suppliers or a limited number of suppliers for certain key raw materials and component parts used in manufacturing and developing our products. We generally purchase raw materials pursuant to purchase orders placed from time to time and if we deem necessary (and if possible), we will enter into long-term contracts or other guaranteed supply arrangements with our sole or limited source suppliers. Therefore, our operating margins may be impacted by price fluctuations in the commodities we use as raw materials in our batteries. As a result, our suppliers may not be able to meet our requirements relative to specifications and volumes for key raw materials, and we may not be able to locate alternative sources of supply at an acceptable cost. In the past, we have experienced delays in product development due to the delivery of raw materials from our suppliers that do not meet our specifications. In addition, if a sole source supplier ceased to continue to produce a component with little or no notice to us, our business could be harmed. Any future inability to obtain high quality raw materials or manufacturing equipment in sufficient quantities on competitive pricing terms and on a timely basis, due to global supply and demand or a dispute with a supplier, may delay battery production, impede our ability to fulfill existing or future purchase orders and harm our reputation and profitability.

Our inability to obtain federal and state government environmental permits and approvals for our planned U.S. manufacturing facilities could negatively impact our ability to obtain federal and state incentive funding and materially harm our business.

Pursuant to applicable environmental and safety laws and regulations, we are required to obtain and maintain certain governmental permits and approvals and to comply with applicable federal and state environmental laws and regulations. There is no guarantee that required determinations, permits and approvals will ultimately be obtained; the failure to obtain and/or maintain required federal and state environmental permits could have an adverse effect on our financial results and could also delay or prevent us from obtaining matching fund reimbursement from the \$249.1 million grant we were awarded under the DOE Battery Initiative.

If obtained, permits and approvals may be subject to revocation, modification or denial under certain circumstances. Our operations or activities could result in administrative or private actions, revocation of required permits or licenses, or fines, penalties or damages, which could have an adverse effect on us. In addition, environmental laws will likely become more stringent over time, thereby requiring new capital expenditures and increases in operating costs.

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Our working capital requirements involve estimates based on demand expectations and may decrease or increase beyond those currently anticipated, which could harm our operating results and financial condition.

In order to fulfill the product delivery requirements of our customers, we plan for working capital needs in advance of customer orders. As a result, we base our funding and inventory decisions on estimates of future demand. If demand for our products does not increase as quickly as we have estimated or drops off sharply, our inventory and expenses could rise, and our business and operating results could suffer. Alternatively, if we experience sales in excess of our estimates, our working capital needs may be higher than those currently anticipated. Our ability to meet this excess customer demand depends on our ability to arrange for additional financing for any ongoing working capital shortages, since it is likely that cash flow from sales will lag behind these investment requirements.

Credit market volatility and illiquidity may affect our ability to raise capital to finance our operations, plant expansion and growth.

The credit markets have experienced extreme volatility in recent years, and worldwide credit markets have remained unstable despite injections of capital by the federal government and foreign governments. Despite the capital injections and government actions, banks and other lenders, such as equipment leasing companies, have significantly increased credit requirements and reduced the amounts available to borrowers. Companies with low credit ratings may not have access to the debt markets until the liquidity improves, if at all. If current credit market conditions do not improve, we may not be able to access debt or leasing markets to finance our plant expansion plans or business.

We may be unable to successfully implement or manage our manufacturing expansion of capability or realize the expected benefits of an expansion.

We expect to expand our battery manufacturing capacity to meet expected demand for our products. Much of our domestic expansion, such as our recent expansion in Livonia and Romulus, Michigan, depends upon our receipt of sufficient federal and state incentive funding and our ability to successfully ramp our manufacturing operations, particularly in the production of prismatic batteries. We may not receive the federal and state funding necessary for our planned expansion at all or on a timely basis. In addition, such funding could be subject to conditions that are commercially unacceptable to us or for which we are unable to comply. Even if we succeed in expanding our manufacturing capacity, we may not have enough demand for our products to justify the increased capacity.

Any such expansion will place a significant strain on our senior management team and our financial and other resources. Any expansion will expose us to greater overhead and support costs and other risks associated with the manufacture and commercialization of new products. Our ability to manage our growth effectively will require us to continue to improve our operations and our financial and management information systems and to train, motivate and manage our employees. Difficulties in effectively managing the budgeting, forecasting and other process control issues presented by any expansion could harm our business, prospects, results of operations and financial condition.

We may not be able to successfully recruit and retain skilled employees, particularly scientific, technical and management professionals.

We believe that our future success will depend in large part on our ability to attract and retain highly skilled technical, managerial and marketing personnel who are familiar with our key customers and experienced in the battery industry. Industry demand for such employees, especially employees with experience in battery chemistry and battery manufacturing processes, however, exceeds the number of personnel available, and the competition for attracting and retaining these employees is intense. This competition will intensify if the advanced battery market continues to grow, possibly requiring increases

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in compensation for current employees over time. We compete in the market for personnel against numerous companies, including larger, more established competitors who have significantly greater financial resources than we do and may be in a better financial position to offer higher compensation packages to attract and retain human capital. We cannot be certain that we will be successful in attracting and retaining the skilled personnel necessary to operate our business effectively in the future, especially in light of the financial challenges we face. Because of the highly technical nature of our batteries and battery systems, the loss of any significant number of our existing engineering and project management personnel could have a material adverse effect on our business and operating results.

Our future success depends on our ability to retain key personnel.

Our success will depend to a significant extent on the continued services of our senior management team, and in particular David Vieau, our chief executive officer, and Gilbert N. Riley, Jr., our chief technical officer. The loss or unavailability of either of these individuals, as well as other members of our senior management team, could harm our ability to execute our business plan, maintain important business relationships and complete certain product development initiatives, which could harm our business. We do not have agreements requiring any of our senior management team to remain with our company. In addition, each of these individuals could terminate his or her relationship with us at any time, and we may be unable to enforce any applicable employment or non-compete agreements.

If we do not continue to form and maintain economic arrangements with original equipment manufacturers, or OEMs, to commercialize our products, our profitability could be impaired.

Part of our business strategy requires us to integrate the design of our products into products being developed by OEMs, and therefore to identify acceptable OEMs and enter into agreements with them. In addition, we will need to meet their requirements and specifications by developing and introducing new products and enhanced or modified versions of our existing products on a timely basis. OEMs often require unique configurations or custom designs for batteries or battery systems which must be developed and integrated into a product well before the product is launched. This development process requires not only substantial lead time between the commencement of design efforts for a customized battery system and the commencement of volume shipments of the battery systems to the customer, but also the cooperation and assistance of the OEMs in order to determine the requirements for each specific application. Technical problems may arise that affect the acceptance of our product by OEMs. If we are unable to design and develop products that meet OEMs' requirements, we may lose opportunities to obtain purchase orders, and our reputation may be damaged. In addition, we may not receive adequate assistance from OEMs to successfully commercialize our products, which could impair our profitability.

Declines in product prices may adversely affect our financial results.

Our business is subject to intense price competition worldwide, which makes it difficult for us to maintain product prices and achieve adequate profits. Such intense price competition may adversely affect our ability to achieve profitability, especially during periods of decreases in demand. In addition, because of their purchasing size, our larger automotive customers can influence market participants to compete on price terms. If we are not able to offset pricing reductions resulting from these pressures by improved operating efficiencies and reduced expenditures, those pricing reductions may have an adverse impact on our business.

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Implementations of new software platforms or modifications to existing platforms may disrupt our business and operations and could harm our operating results.

The implementation of new software management platforms and the addition of these platforms at new locations, especially overseas, require significant management time, support and cost. As our business continues to develop, we expect to add and enhance existing management platforms in the areas of financial, inventory control, engineering, and customer support and warranty management. We cannot be sure that these platforms will be fully or effectively implemented on a timely basis, if at all. If we do not successfully implement or modify these platforms, our operations may be disrupted and our operating expenses could be harmed. In addition, the new systems may not operate as we expect them to, and we may be required to expend significant resources to correct problems or find alternative sources for performing these functions.

Our inability to effectively and quickly transfer, replicate and scale our new product manufacturing processes from low volume prototype production to high volume manufacturing facilities, could adversely affect our results of operations.

Under our manufacturing model, we develop and establish manufacturing processes and systems for the low volume prototype production of our new products. As demand increases for a product, we transfer these processes and systems to, and replicate and scale these processes and systems in our high volume manufacturing facilities. If we are unable to effectively and quickly transfer, replicate and scale these manufacturing processes and systems, such as replicating our former prismatic pilot facility in Korea to our new facilities in Livonia and Romulus, Michigan, we may be unable to meet our customers' product quality and quantity requirements and lower our costs of goods sold and our results of operations could be adversely affected.

In addition, our costs of goods sold for some of our new products exceed the purchase price for that product paid to us by our customers. If we are unable to decrease unit production costs for these products by increasing volumes, improving the manufacturing process, reducing transportation and handling costs or obtaining lower cost raw materials or component parts, we will not realize a profit from these products and our business will be harmed.

Problems in our manufacturing and assembly processes have limited, and could, in the future, limit our ability to produce sufficient batteries to meet the demands of our customers.

Regardless of the process technology used, the manufacturing and assembly of safe, high-power batteries and battery systems is a highly complex process that requires extreme precision and quality control throughout a number of production stages. Any defects in battery packaging, impurities in the electrode materials used, contamination of the manufacturing environment, incorrect welding, excess moisture, equipment failure or other difficulties in the manufacturing process could cause batteries to be rejected, thereby reducing yields and affecting our ability to meet customer expectations.

As we have scaled up our production capacity, we have experienced production problems that limited our ability to produce a sufficient number of batteries to meet the demands of certain customers. For example, in 2010, we identified several significant technical issues in the manufacturing scale-up of our prismatic batteries. Although we identified and have taken corrective actions for these issues, the problems encountered resulted in a higher yield loss in ramp-up production, temporary halts in the production process and distraction of personnel. If these or other production problems recur and we are unable to resolve them in a timely fashion, our business could suffer and our reputation may be harmed. In addition, in December 2011, we determined that some of the battery packs we produce for Fisker could have a potential safety issue relating to the battery cooling system due to the misalignment of certain hose clamps in the battery pack's internal cooling system. While there were no related battery performance or safety incidents with cars in the field and corrective actions were promptly

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undertaken, the problem required unanticipated management time and expense as well as the rapid re-deployment of technical personnel to the field. On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at our Livonia, Michigan manufacturing facility. This field campaign has limited our ability to produce sufficient batteries to meet the demands of our customers.

Our failure to cost-effectively manufacture our batteries and battery systems in quantities which satisfy our customers' demand and product specifications and their expectations for product quality and reliable delivery could damage our customer relationships and result in significant lost business opportunities for us.

We manufacture a substantial percentage of our products rather than relying upon third-party outsourcing. To be successful, we must cost-effectively manufacture commercial quantities of our complex batteries and battery systems that meet our customer specifications for quality and timely delivery. To facilitate the commercialization of our products, we must further reduce our manufacturing costs, which we intend to do by working with manufacturing partners and by improving our manufacturing and development operations in our wholly-owned operations in China. We manufacture our batteries and assemble our products in China, Massachusetts and Michigan. We depend on the performance of our manufacturing partners, as well as our own manufacturing operations, to manufacture and deliver our products to our customers. If we or any of our manufacturing partners are unable to manufacture products in commercial quantities on a timely and cost-effective basis, we could lose our customers and be unable to attract future customers.

In addition, we are shifting most of our battery assembly and all of our battery system manufacturing from contract manufacturing to in-house manufacturing, so our in-house experience with battery assembly and battery system manufacturing is limited.

On March 26, 2012, we launched a field campaign to replace battery modules and packs that may contain defective prismatic cells produced at its Livonia, Michigan manufacturing facility. As a result of this field campaign and the reserve for existing prismatic cell inventory, we must begin to rebuild our inventory and manage our backlog for existing customer orders while simultaneously replacing the defective customer modules and pack which could delay delivery of products to our customers.

We entered into a joint venture in China that, if not successful, could adversely impact our business, business prospects and operating results.

In December 2009, we formed a joint venture with SAIC Motor Co. Ltd., or SAIC, a leading automaker in China. We have a 49 percent minority interest in the joint venture, Shanghai Advanced Traction Battery Systems Co., Ltd., or ATBS, which is domiciled in Shanghai, China. Pursuant to the joint venture agreements, we are supplying ATBS with battery cells and, as requested by ATBS, we have granted necessary advanced technology licenses to ATBS for the development, manufacture and service of battery systems. In addition, we have made capital contributions to ATBS in an aggregate amount of \$4.7 million.

The business of ATBS is subject to all the operational risks that normally arise for a technology company with global operations pertaining to research and development, manufacturing, sales, service, marketing and corporate functions. In addition, there could be disagreements between us and SAIC with respect to important strategic and operational decisions. Operating a business as a joint venture often requires additional organizational formalities as well as time-consuming procedures for sharing information and making decisions. We may be required to pay more attention to our relationship with SAIC, as the co-owner of ATBS, and if SAIC ceases to be the co-owner of ATBS, our relationship with ATBS may be adversely affected. Additionally, as we are sharing intellectual property with ATBS, we face the risks that we may not be able to maintain or enforce the rights to our intellectual property.

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If the joint venture terminates, the joint venture could retain technical knowhow relating to battery systems transferred by us as part of the agreement. Additionally, we would have to find new partners or separately pursue market opportunities in China which could cause us to incur additional time and expense.

Laws regulating the manufacture or transportation of batteries may be enacted which could result in a delay in the production of our batteries or the imposition of additional costs that could harm our ability to be profitable.

Laws and regulations exist today, and additional laws and regulations may be enacted in the future, which impose environmental, health and safety controls on the storage, shipment, use and disposal of certain chemicals and metals used in the manufacture of lithium-ion batteries. Complying with any laws or regulations could require significant time and resources from our technical staff and possible redesign of one or more of our products, which may result in substantial expenditures and delays in the production of one or more of our products, all of which could harm our business and reduce our future profitability. The transportation of lithium and lithium-ion batteries and applicable customs duties are regulated both domestically and internationally. Compliance with these regulations, when applicable, increases the cost of producing and delivering our products.

We depend on contracts with the U.S. government and its agencies or on subcontracts with the U.S. government's prime contractors for revenue and research grants to fund or partially fund our research and development programs, and our failure to retain current or obtain additional contracts could preclude us from achieving our anticipated levels of revenue growth and profitability, increase our research, development and engineering expenses and delay or halt certain research and development programs.

Our ability to develop and market some of our products depends upon maintaining our U.S. government contract revenue and research grants obtained, which are recorded as incremental revenue and an offset to our research, development and engineering expenses, respectively. Many of our U.S. government contracts are funded incrementally, with funding decisions made on an annual basis. Approximately 5% of our total revenue and 8% of our research, development and engineering expenses during the year ended December 31, 2011 were derived from or funded by government contracts and subcontracts. Changes in government policies, priorities or programs that result in budget reductions could cause the government to cancel existing contracts or eliminate follow-on phases in the future which would severely inhibit our ability to successfully complete the development and commercialization of some of our products. In addition, there can be no assurance that, once a government contract is completed, it will lead to follow-on contracts for additional research and development, prototype build and test or production. Furthermore, there can be no assurance that our U.S. government contracts or subcontracts will not be terminated or suspended in the future. A reduction or cancellation of these contracts, or of our participation in these programs, would increase our research, development and engineering expenses, which could materially and adversely affect our results of operations and could delay or impair our ability to develop new technologies and products.

If we are unable to develop manufacturing facilities for our products in the United States, we may lose business opportunities and our customer relationships may suffer.

We believe that developing manufacturing facilities for our products in the United States is important, in order to address national security and economic imperatives, such as job creation, as well as to more efficiently address the needs of our U.S.-based customers. This expansion depends upon our receiving federal and state financial incentives, primarily in the form of direct grants and loans, to provide the necessary capital for facilities and equipment. If we are unable to obtain this government assistance on a timely basis and in the amounts requested, we will not be able to scale our capacity to meet current and future customer demand for our products.

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Because of the funding we receive from U.S. government entities and our government business initiatives, we are subject to U.S. federal government audits and other regulation, and our failure to satisfy audit requirements or comply with applicable regulations could subject us to material adjustments or penalties that could negatively impact our business.

The accuracy and appropriateness of our direct and indirect costs and expenses under our contracts with the U.S. government are subject to extensive regulation and audit by appropriate agencies of the U.S. government. These agencies have the right to challenge our cost estimates or allocations with respect to any such contract. Additionally, substantial portions of the payments to us under U.S. government contracts are provisional payments that are subject to potential adjustment upon audit by such agencies. Adjustments that result from inquiries or audits of our contracts could have a material adverse impact on our financial condition or results of operations. Since our inception, we have not experienced any material adjustments as a result of any inquiries or audits, but there can be no assurance that our contracts will not be subject to material adjustments in the future.

As we grow our government business, we may also need to comply with U.S. laws regulating the export of our products, particularly in our government business. We cannot be certain of our ability to obtain any licenses required to export our products or to receive authorization from the U.S. federal government for international sales or domestic sales to foreign persons. Moreover, the export regimes and the governing policies applicable to our business are subject to change. Our failure to comply with these and other applicable regulations, rules and approvals could result in the imposition of penalties, the loss of our government contracts or our suspension or debarment from contracting with the federal government generally, any of which would harm our business, financial condition and results of operations.

Our ability to sell our products to our direct, OEM and tier 1 supplier customers depends in part on the quality of our engineering and customization capabilities, and our failure to offer high quality engineering support and services could have a material adverse effect on our sales and operating results.

A high level of support is critical for the successful marketing and sale of our products. The sale of our batteries and battery systems is characterized by significant co-development and customization work in certain applications. This development process requires not only substantial lead time between the commencement of design efforts for a customized battery system and the commencement of volume shipments of the battery systems to the customer, but also the cooperation and assistance of the OEMs to determine the requirements for each specific application. Once our products are designed into an OEM or tier 1 supplier customer's products or systems, the OEM or tier 1 supplier customer depends on us to resolve issues relating to our products. If we do not effectively assist our OEM or tier 1 supplier customers in customizing, integrating and deploying our products in their own systems or products, or if we do not succeed in helping them quickly resolve post-deployment issues and provide effective ongoing technical support, our ability to sell our products would be adversely affected.

In addition, while we have supply and co-development agreements with customers located in different regions of the world, we do not have a globally distributed engineering support and services organization. Currently, any issue resolution related to our products, system deployment or integration is channeled back to our responsible business units in Massachusetts and in Michigan, from which engineers and support personnel are deployed. As we grow our business with our existing customers and beyond the markets into which we currently sell our battery technologies, we may need to increase the size of our engineering support teams and deploy them closer to our customers. Our inability to deliver a consistent level of engineering support and overall service as we expand our operations could have a material adverse effect on our business and operating results. Moreover, despite our internal quality testing, our products may contain manufacturing or design defects or exhibit performance problems at any stage of their lifecycle. These problems could result in expensive and time-consuming

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design modifications and impose additional needs for engineering support and maintenance services as well as significant warranty charges.

Our past and future operations may lead to substantial environmental liability.

The handling and use of some of the materials used in the development and manufacture of our products are subject to federal, state and local environmental laws, as well as environmental laws in other jurisdictions in which we operate. Under applicable environmental laws, we may be jointly and severally liable with prior property owners for the treatment, cleanup, remediation and/or removal of any hazardous substances discovered at any property we use. In addition, courts or government agencies may impose liability for, among other things, the improper release, discharge, storage, use, disposal or transportation of hazardous substances. If we incur any significant environmental liabilities, our ability to execute our business plan and our financial condition would be harmed. Our facilities or operations could be damaged or adversely affected as a result of disasters or unpredictable events, including widespread public health problems.

Our headquarters, including administrative offices and research and development centers, are located in Massachusetts. We also operate manufacturing, logistics, sales and research and development facilities in Michigan, Missouri, China, Korea and Germany. If major disasters such as earthquakes, fires, floods, hurricanes, wars, terrorist attacks, computer viruses, pandemics or other events occur, or our information system or communications network breaks down or operates improperly, our facilities may be seriously damaged, or we may have to stop or delay production and shipment of our products. We may incur expenses relating to such damages, some or all of which may not be covered by insurance. In addition, a renewed outbreak of a widespread public health problem in China or the United States could have a negative effect on our operations.

Risks Related to Intellectual Property

In the past, parties have asserted that they own or control patents that are infringed by our products.

In October 2011, we settled a patent litigation with Hydro-Québec and the University of Texas, or UT, involving certain patents Hydro-Québec has licensed from UT, related to electrode materials used in lithium-ion batteries. This litigation was initially commenced in 2006 and had been scheduled to go to trial in December 2011.

The mere existence, and the uncertainty with respect to the ultimate outcome, of any other patent litigation that we may become involved with, could cause our current and potential customers, development partners, the federal or state governments and licensees to stop, delay or avoid doing business with us or modify the extent to which they are willing to do business with us, and this loss or delay of business could harm our operating results and our ability to execute on our business plan.

Other parties may also bring intellectual property infringement claims against us which would be time-consuming and expensive to defend, and if any of our products or processes is found to be infringing, we may not be able to procure licenses to use patents necessary to our business at reasonable terms, if at all.

Our success depends in part on avoiding the infringement of other parties' patents and proprietary rights. We may inadvertently infringe existing third-party patents or third-party patents issued on existing patent applications. In the United States and most other countries, patent applications are published 18 months after filing. As a result, there may be third-party pending patent applications of which we are unaware, and which we may infringe once they issue. These third parties could bring claims against us that, even if resolved in our favor, could cause us to incur substantial expenses and, if resolved against us, could cause us to pay substantial damages. Under some circumstances in the United States, these damages could be triple the actual damages the patent holder incurs. If we have supplied infringing products to third parties for marketing or licensed third parties to manufacture, use

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or market infringing products, we may be obligated to indemnify these third parties for any damages they may be required to pay to the patent holder and for any losses the third parties may sustain themselves as the result of lost sales or damages paid to the patent holder. In addition, we may have, and may be required to, make representations as to our right to supply and/or license intellectual property and to our compliance with laws. Such representations are usually supported by indemnification provisions requiring us to defend our customers and otherwise make them whole if we license or supply products that infringe on third party technologies or violate government regulations. Further, if a patent infringement suit were brought against us, we and our customers, development partners and licensees could be forced to stop or delay research, development, manufacturing or sales of products based on our technologies in the country or countries covered by the patent we infringe, unless we can obtain a license from the patent holder. Such a license may not be available on acceptable terms, or at all, particularly if the third party is developing or marketing a product competitive with products based on our technologies. Even if we were able to obtain a license, the rights may be nonexclusive, which would give our competitors access to the same intellectual property.

Any successful infringement action brought against us may also adversely affect marketing of products based on our technologies in other markets not covered by the infringement action. Furthermore, we may suffer adverse consequences from a successful infringement action against us even if the action is subsequently reversed on appeal, nullified through another action or resolved by settlement with the patent holder. As a result, any infringement action against us would likely harm our competitive position, be costly and require significant time and attention of our key management and technical personnel.

We may be involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming.

Competitors or others may infringe our patents. To counter infringement or unauthorized use, we may be required to file patent infringement claims, which can be expensive and time-consuming. In addition, in an infringement proceeding, a court may decide that a patent of ours is not valid or is unenforceable, or may refuse to stop the other party from using the technology at issue on the grounds that our patents do not cover that technology. An adverse determination of any litigation or defense proceedings could put one or more of our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not issuing.

Interference proceedings brought by the United States Patent and Trademark Office may be necessary to determine the priority of inventions with respect to our patent applications. Litigation or interference proceedings may fail and, even if successful, may result in substantial costs and be a distraction to our management. We may not be able to prevent misappropriation of our proprietary rights, particularly in countries where the laws may not protect such rights as fully as in the United States.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure. In addition, during the course of this litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments. If securities analysts or investors perceive these results to be negative, it could have a substantial adverse effect on the price of our common stock.

We may not prevail in any litigation or interference proceeding in which we are involved. Even if we do prevail, these proceedings can be expensive and distract our management.

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Our patent applications may not result in issued patents, which may have a material adverse effect on our ability to prevent others from commercially exploiting products similar to ours.

Patent applications in the United States are maintained in secrecy until the patents are published or are issued. Since publication of discoveries in the scientific or patent literature tends to lag behind actual discoveries by several months, we cannot be certain that we are the first creator of inventions covered by pending patent applications or the first to file patent applications on these inventions. We also cannot be certain that our pending patent applications will result in issued patents or that any of our issued patents will afford protection against a competitor. In addition, patent applications filed in foreign countries are subject to laws, rules and procedures that differ from those of the United States, and thus we cannot be certain that foreign patent applications related to issued U.S. patents will be issued. Furthermore, if these patent applications issue, some foreign countries provide significantly less effective patent enforcement than in the United States.

The status of patents involves complex legal and factual questions and the breadth of claims allowed is uncertain. Accordingly, we cannot be certain that the patent applications that we file will result in patents being issued, or that our patents and any patents that may be issued to us in the near future will afford protection against competitors with similar technology. In addition, patents issued to us may be infringed upon or designed around by others and others may obtain patents that we need to license or design around, either of which would increase costs and may adversely affect our operations.

Our patents and other protective measures may not adequately protect our proprietary intellectual property.

We regard our intellectual property, particularly our proprietary rights in our battery and battery system technology, as critical to our success. We have received a number of patents, and filed other patent applications, for various applications and aspects of our technology or processes and other intellectual property. In addition, we generally enter into confidentiality and invention agreements with our employees and consultants. Such patents and agreements and various other measures we take to protect our intellectual property from use by others may not be effective for various reasons, including the following:

our pending patent applications may not be granted for various reasons, including the existence of conflicting patents or defects in our applications;

the patents we have been granted may be challenged, invalidated or circumvented because of the pre-existence of similar patented or unpatented intellectual property rights or for other reasons;

parties to the confidentiality and invention agreements may have such agreements declared unenforceable or, even if the agreements are enforceable, may breach such agreements;

the costs associated with enforcing patents, confidentiality and invention agreements or other intellectual property rights may make aggressive enforcement prohibitive;

even if we enforce our rights aggressively, injunctions, fines and other penalties may be insufficient to deter violations of our intellectual property rights; and

other persons may independently develop proprietary information and techniques that are functionally equivalent or superior to our intellectual proprietary information and techniques but do not breach our patented or unpatented proprietary rights.

We may be unable to adequately prevent disclosure or misappropriation of trade secrets and other proprietary information.

We rely on trade secrets to protect our proprietary technologies, especially where we do not believe patent protection is appropriate or obtainable. However, trade secrets are difficult to protect. We rely in part on confidentiality and non-compete agreements with our employees, former employees,

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contractors, consultants, outside scientific collaborators and other advisors to protect our trade secrets and other proprietary information. These agreements may not effectively prevent disclosure of confidential information and may not provide an adequate remedy in the event of unauthorized disclosure or misappropriation of confidential information. Such unauthorized disclosure or misappropriation may also be difficult to prevent or enforce against current or former employees in locations outside of the United States (e.g., in China) where the legal systems and law enforcement are less developed, extradition treaties may not exist and business practices differ. In addition, others may independently discover our trade secrets or independently develop processes or products that are similar or identical to our trade secrets, and courts outside the United States may be less willing to protect trade secrets. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could adversely affect our competitive business position.

Risks Associated With Doing Business Internationally Specifically in China

Our substantial international operations subject us to a number of risks, including unfavorable political, regulatory, labor and tax conditions.

We have significant manufacturing facilities and operations in China that are subject to the legal, political, regulatory and social requirements and economic conditions in these jurisdictions. In addition, we expect to sell a significant portion of our products to customers located outside the United States. Risks inherent to international operations and sales, include, but are not limited to, the following:

difficulty in enforcing agreements, judgments and arbitration awards in foreign legal systems;

state ownership and/or support of competitive business entities;

fluctuations in exchange rates may affect product demand and may adversely affect our profitability in U.S. dollars to the extent the cost of raw materials and labor is denominated in a foreign currency;

impediments to the flow of foreign exchange capital payments and receipts due to exchange controls instituted by certain foreign governments and the fact that the local currencies of these countries are not freely convertible;

inability to obtain, maintain or enforce intellectual property rights;

changes in general economic and political conditions;

changes in foreign government regulations and technical standards, including additional regulation of rechargeable batteries, power technology, or the transport of lithium or phosphate, which may reduce or eliminate our ability to sell or license in certain markets;

requirements or preferences of foreign nations for domestic products could reduce demand for our products;

trade barriers such as export requirements, tariffs, taxes and other restrictions and expenses, which could increase the prices of our products and make us less competitive; and

longer payment cycles typically associated with international sales and potential difficulties in collecting accounts receivable, which may reduce the future profitability of foreign sales.

Our business in foreign jurisdictions requires us to respond to rapid changes in market conditions in these countries. Our overall success as a global business depends on our ability to succeed in different legal, regulatory, economic, social and political situations and conditions. We may not be able to develop and implement effective policies and strategies in each foreign jurisdiction where we do

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business. Also, each of the foregoing risks will likely take on increased significance as we implement plans to expand foreign manufacturing operations.

Since many of our products are manufactured in China, we own and lease manufacturing facilities in China and the Chinese market is of growing importance for our products, we face risks if China loses normal trade relations status with the United States or if US-China trade relations are otherwise adversely impacted.

We manufacture and export our products from China and own and lease manufacturing facilities in China. We also sell our products in China. Our products sold in the United States have normal trade relations status and are currently not subject to United States import duties. As a result of opposition to certain policies of the Chinese government and China's growing trade surpluses with the United States, there has been, and in the future may be, opposition to normal trade relations status with China. The United States Congress may also introduce China trade legislation targeting currency manipulation, which may adversely affect our business in China. The loss of normal trade relations status for China, changes in current tariff structures or adoption in the United States of other trade policies adverse to China, and any retaliatory measures that impact our products in the Chinese market, could have an adverse effect on our business.

A change in exchange rates mandated by legislation could negatively impact the cost of imported raw materials and products.

Furthermore, our business and operations may be adversely affected by deterioration of the diplomatic and political relationships between the United States and China. If the relationship between the United States and China were to materially deteriorate, it could negatively impact our ability to control our operations and relationships in China, enforce any agreements we have with Chinese partners or otherwise deal with any assets or investments we may have in China.

Our ongoing manufacturing operations in China are complex and having these remote operations may divert management's attention, lead to disruptions in operations, delay implementation of our business strategy and make it difficult to establish adequate management and financial controls in China. Our plans to grow our business to include sales to Chinese customers may necessitate additional management attention to establishing and maintaining one or more joint venture relationships with Chinese parties.

Currently, we have significant manufacturing operations in China, including a joint venture. We may not be able to find or retain suitable employees in China and we may have to train personnel to perform necessary functions for our manufacturing, senior management and development operations. This may divert management's attention, lead to disruptions in operations and delay implementation of our business strategy, all of which could negatively impact our profitability.

China has only recently begun to adopt management and financial reporting concepts and practices like those with which investors in the United States are familiar. We may have difficulty in hiring and retaining employees in China who have the experience necessary to implement the kind of management and financial controls that are expected of a United States public company. If we cannot establish and implement such controls, we may experience difficulty in collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet U.S. standards.

In order to grow our business and sales to Chinese customers we have entered into a Chinese-foreign joint venture with a Chinese partner. A Chinese-foreign joint venture can be a complex business arrangement requiring substantial management attention to the joint venture relationship. The joint venture will also require capital contributions and due to China's foreign exchange controls, uncertainty as to the ability to repatriate profits and principal out of China. Our plans to grow our business to include sales to Chinese customers may require additional management attention to establishing and maintaining additional joint venture relationships with Chinese parties.

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Because of the relative weakness of the Chinese legal system in general, and the intellectual property regime in particular, we may not be able to enforce intellectual property rights in China.

The legal regime protecting intellectual property rights in China is weak. Because the Chinese legal system in general, and the intellectual property regime in particular, are relatively weak, it is often difficult to create and enforce intellectual property rights in China. Accordingly, we may not be able to effectively protect our intellectual property rights in China against business entities, individuals and current and former employees.

Enforcing agreements and laws in China is difficult and may be impossible because China does not have a comprehensive system of laws.

We depend on our relationships with our Chinese manufacturing partners and suppliers. In China, enforcement of contractual agreements may be sporadic, and implementation and interpretation of laws may be inconsistent. The Chinese judiciary is relatively inexperienced in interpreting agreements and enforcing China's laws, leading to a higher than usual degree of uncertainty as to the outcome of any litigation. Even where adequate law exists in China, it may not be possible to obtain swift and equitable enforcement of such law, or to obtain enforcement of a judgment or an arbitration award by a court of another jurisdiction.

The government of China may change or even reverse its policies of promoting private industry and foreign investment, in which case our assets and operations may be at risk.

Our existing and planned operations in China are subject to risks related to the business, economic and political conditions in China, which include the possibility that the central government of China will change or even reverse its policies of promoting private industry and foreign investment in China. The government of China has exercised and continues to exercise substantial control over virtually every section of the Chinese economy through regulation and state ownership. Many of the current reforms which support private business in China are of recent origin or provisional in nature. Other political, economic and social factors, such as political changes, changes in the rates of economic growth, unemployment or inflation, or in the disparities of per capita wealth among citizens of China and between regions within China, could also lead to further readjustment of the government's reform measures. It is not possible to predict whether the Chinese government will continue to be as supportive of private business in China, nor is it possible to predict how any future reforms will affect our business. For example, if the government were to limit the number of foreign personnel who could work in the country, substantially increase taxes on foreign businesses, eliminate export processing zones, restrict the transportation of goods in and out of the country, adopt policies favoring competitors or impose other restrictions on our operations, the impact may be significant.

Significantly, a reversal of current liberalizations of foreign exchange controls by the Chinese government could be disruptive and costly to our cross-border operations and our business as a whole.

Business practices in China and Korea may entail greater risk and dependence upon the personal relationships of senior management than is common in North America, and therefore some of our agreements with other parties in China and Korea could be difficult or impossible to enforce.

The business cultures of China and Korea are, in some respects, different from the business cultures in Western countries and may present some difficulty for Western investors reviewing contractual relationships among companies in China and Korea and evaluating the merits of an investment. Personal and family relationships among business principals of companies and business entities in China and Korea are very significant in their business cultures. In some cases, because so much reliance is based upon personal relationships, written contracts among businesses in China and Korea may be less detailed and specific than is commonly accepted for similar written agreements in

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Western countries. In some cases, material terms of an understanding are not contained in the written agreement but exist as oral agreements only. In other cases, the terms of transactions which may involve material amounts of money are not documented at all. In addition, in contrast to Western business practices where a written agreement specifically defines the terms, rights and obligations of the parties in a legally-binding and enforceable manner, the parties to a written agreement in China or Korea may view that agreement more as a starting point for an ongoing business relationship which will evolve and require ongoing modification. As a result, written agreements in China or Korea may appear to the Western reader to look more like outline agreements that precede a formal written agreement. While these documents may appear incomplete or unenforceable to a Western reader, the parties to the agreement in China or Korea may feel that they have a more complete understanding than is apparent to someone who is only reading the written agreement without having attended the negotiations. As a result, contractual arrangements in China and Korea may be more difficult to review and understand.

China has introduced sweeping reforms to its income tax, turnover tax and other tax laws and regulations. Some of the changes increase the taxes for foreign-invested and other businesses in China will incur on specific types of transactions as well as arising from operations generally in China. Our earnings may be affected by tax adjustments to reflect such changes in the law.

Pursuant to a comprehensive reform of China's tax system that took effect on January 1, 2008, income tax incentives granted to foreign-invested enterprises, and geographically-based incentives, have largely been eliminated and have been replaced with incentives designed to encourage enterprises, domestic and foreign-invested alike, in selected industries. For example, dividends paid by foreign-invested enterprises to foreign shareholders are no longer exempt from withholding tax. A 10% withholding tax applies to dividends, although the rate is reduced to 5% by certain tax treaties. The tax holidays and tax reduction periods and the reduced national income tax rate that foreign-invested enterprises engaged in production used to enjoy have also been removed. The tax incentives promised to our wholly foreign-owned subsidiaries located in export processing zones at the time of inception will be phased-out by the end of 2012. At that time, these subsidiaries and any new foreign-invested enterprises we might establish as part of our strategy to expand the market for our products will no longer have income tax advantages over Chinese domestic businesses.

China's turnover tax system consists of VAT, consumption tax and business tax. VAT is primarily imposed on import and sales of goods and certain services, such as repairing, processing and replacement. Export sales are exempt under VAT rules, and an exporter who incurs VAT on the purchase or manufacture of goods should be able to claim a refund from Chinese tax authorities. Depending on whether VAT export refund rates are raised or reduced for relevant goods, exporters might bear part of the VAT they incurred in conjunction with producing the exported goods. To mitigate the effects of the global economic downturn on China's export industry, the PRC Ministry of Finance and the State Administration of Taxation have raised VAT rebates on numerous exported labor-intensive and high-value-added products. However, the Chinese government may also lower rebate rates in future in response to different economic and policy objectives.

China has also introduced sweeping VAT policy reforms with effect from January 1, 2009, which facilitate China's shift from a production-based VAT scheme to a consumption-based system. Generally, the new system reduces the total output VAT of production enterprises as fixed-asset investment costs related to VAT-eligible output are no longer subject to VAT. However, our VAT costs will depend on our ability to pass on input VAT to our local suppliers and customers. As the relevant VAT law and implementing regulations are new, there may be a period of adjustment before any cost-savings are realized.

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Business tax is usually a fee of 3-5 percent levied on services such as transport, construction, education, finance, and insurance transfer of intangible assets, and sales of fixed assets, none of which are generally eligible for VAT. Business tax regulations, which took effect January 1, 2009, may impose business on services exchanged among China and foreign-based entities which previously were not subject to business tax, and the potential overall impact is to increase the tax burden of cross-border service transactions.

Frequent changes to China's tax laws can result in uncertainty and unpredictability in financial results of our operations in China. China's tax laws are supplemented with detailed implementation rules and circulars. However, the interpretation of the rules may vary among local tax authorities.

Risks Related to Ownership of Our Securities

We could lose our listing on the NASDAQ Global Select Market if the trading price of our common stock remains below \$1.00 for 30 consecutive days. The loss of the listing would make our common stock significantly less liquid and would affect its value.

Our common stock is listed on the NASDAQ Global Select Market, with a closing price of \$0.45 on August 6, 2012 and has traded below \$1.00 since July 9, 2012. If the price of our common stock remains below \$1.00 for 30 consecutive days, we are subject to being delisted from the NASDAQ Global Select Market. Subject to a 180-day compliance period, upon delisting from the NASDAQ Global Select Market, our stock would be traded on the NASDAQ Capital Market until we maintain a minimum bid price of \$1.00 for 30 consecutive days, at which time we regain our listing on the NASDAQ Global Select Market. If our stock fails to maintain a minimum bid price of \$1.00 for 30 consecutive days during a further 180-day grace period on the NASDAQ Capital Market, subject to compliance with certain core listing standards, we would receive a delisting notice from the NASDAQ Capital Market.

If we are unable to maintain the NASDAQ listing of our common stock as a result of our failure to continue to comply with these requirements or any other minimum listing requirement, our common stock may be perceived as a less desirable investment, negatively affecting the market for the common stock, which could decrease our ability to issue new shares of common stock and attract further equity investment. A delisting could also enhance the perception of our financial distress among our lenders, trade creditors, business partners, vendors, analysts, and the media, which could cause some of our trade creditors to impose increasingly less favorable terms and make it more difficult for us to obtain future financing and develop strategic alliances. We cannot assure you that we will be able to maintain the NASDAQ listing of our common stock or comply with NASDAQ's minimum listing requirements.

We are party to a securities class action litigation, and our directors and certain of our current and/or former officers are parties to two putative derivative action litigations and two shareholder demands which may be costly to investigate and/or defend and the outcome of which are uncertain.

On April 2, 2012 and April 12, respectively, complaints were filed in the United States District Court for the District of Massachusetts by individuals, purportedly acting individually and on behalf of other similarly situated persons, against the company and our CEO, David Vieau, our CFO, David Prystash, and our former Interim CFO, John Granara. The complaints followed our disclosure in March 2012 of potentially defective prismatic cells used in battery packs and a replacement program for such cells. The complaints attempt to allege that certain of our disclosures were inaccurate because the potentially defective cells and their replacement were not disclosed earlier. The complaints assert a claim under Section 10(b) of the Securities Exchange Act of 1934 against us and claims under Sections 10(b) and 20(a) of that statute against the individuals. The complaints assert a purported class period from February 28, 2011 through March 23, 2012.

On May 14, 2012, a putative derivative action was filed in the U.S. District Court for the District of Massachusetts against the Board of Directors and certain others, as well as against our company as a

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nominal defendant, captioned, Jane Ahmed v. David P. Vieau, David Prystash, John Granara, Desh Deshpande, Arthur L. Goldstein, Gary E. Haroian, Dr. Paul E. Jacobs, Mark M. Little, Jeff McCarthy and Dr. Bart Riley, 1:12-CV-10865-RGS. The complaint alleges that certain of our disclosures between February 28, 2011 and March 28, 2012 were materially misleading because they failed to disclose the prismatic cell manufacturing issues and that the individual defendants violated their fiduciary duties and other causes of action on behalf of the company. The complaint alleges that demand on the board to take such actions would be "futile" and should be excused. On June 6, 2012, the defendants moved to dismiss the complaint on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On June 20, 2012, plaintiff opposed that motion, and on June 25, defendants submitted a reply in further support of their motion to dismiss. The motion to dismiss has not been decided at this time.

On May 15, 2012, we received a letter addressed to our Board of Directors from an attorney representing an individual claiming to be a shareholder of our company. The letter asserts that our disclosures between November 9, 2010 and March 28, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012, and asserts that the Board breached its fiduciary duties during this time. The letter makes a demand on the Board to investigate the alleged inaccurate statements and to consider potential legal action against those deemed responsible. The Board considered the issues raised in the letter and retained independent counsel to advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the assistance of counsel and determined that it would not be in the best interest of A123 or its stockholders to commence or maintain an action against any of our present or former officers or directors concerning the matters alleged in the demand and refused the demands.

On May 21, 2012, a putative derivative action was filed in Superior Court for the Commonwealth of Massachusetts against the Board of Directors and certain others, as well as against our company as a nominal defendant, captioned, Murray Sussman v. David P. Vieau, Gururaj Deshpande, Gilbert N. Riley, Jr., Jeffrey McCarthy, Gary E. Haroian, Arthur L. Goldstein, Paul E. Jacobs, Mark M. Little, David Prystash, John Granara, Case No. 12-917. The complaint asserts substantially similar allegations and claims as the Ahmed complaint summarized above, including that demand on the board of directors should be excused as futile. On June 11, 2012, the defendants filed a motion asking the court to stay this litigation in favor of the derivative case pending in the U.S. District Court for the District of Massachusetts, or, in the alternative, that the complaint should be dismissed on the ground that demand on the board of directors was required under Delaware law and that plaintiff had not properly pled that demand in this case should be excused as futile. On July 16, 2012, the plaintiff filed a memorandum of law in opposition to defendants' motion to stay the litigation, or in the alternative, to dismiss this action. On July 27, 2012, the defendants filed a reply memorandum of law in further support of their motion to stay, or in the alternative, to dismiss the action. The motion to stay or dismiss has not been decided at this time. The court has set a hearing date of September 11, 2012 on defendants' motion to stay or dismiss.

On July 13, 2012, we received a demand letter addressed to our Board of Directors from an attorney representing an individual claiming to be a shareholder of the company. The letter alleges that our disclosures between March 11, 2011 and March 12, 2012 were materially misleading as a result of the prismatic cell manufacturing issue disclosed in March of 2012 and asserts that the Board and certain current and/or former executive officers of the company breached their fiduciary duties. The letter makes a demand on the Board to investigate the alleged breach of fiduciary duties to our company and to consider legal action against those responsible. The Board considered the issues raised in the letter and had its independent counsel advise them. On August 3, 2012 the Board's counsel responded to the letter on the Board's behalf indicating that the Board considered the allegations in the demands based on an investigation on behalf of the Board conducted by outside directors with the

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assistance of counsel and determined that it would not be in the best interest of A123 or its stockholders to commence or maintain an action against any present or former officer or director of our company concerning the matters alleged in the demand and refused the demands.

For a more detailed discussion of these litigations, see Item 1 of Part II: "Legal Proceedings."

While we believe that the claims in each of these matters are without merit, we can provide no assurance as to their outcome. Any conclusion of these matters in a manner adverse to us could have a material adverse effect on our business, financial condition, and results of operations. Also, the mere existence, and the uncertainty with respect to the ultimate outcome, of these matters or any other litigation or demand that we may become involved with, could cause our current and potential customers, development partners, the federal or state governments and licensees to stop, delay or avoid doing business with us or modify the extent to which they are willing to do business with us, and this loss or delay of business could harm our operating results and our ability to execute on our business plan.

In addition, during the course of these matters, there could be public announcements of the results of investigations, hearings, motions or other interim proceedings or developments. If securities analysts or investors perceive these results to be negative, it could have an adverse effect on the price of our common stock.

While we intend to defend these litigations vigorously, we may not prevail and even if we do prevail, these proceedings can be expensive and distract our management. Because the price of our common stock has been, and may continue to be, highly volatile, we have no assurance that additional securities class action complaints or putative derivative action complaints will not be filed against us in the future.

We are incurring increased costs and demands upon management as a result of complying with the laws and regulations affecting public companies, which could harm our operating results.

As a public company, we are incurring significant additional legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting requirements. We also have incurred and will incur costs associated with current corporate governance requirements, including requirements under Section 404 and other provisions of the Sarbanes-Oxley Act, as well as rules implemented by the Securities and Exchange Commission, or SEC, and the NASDAQ Global Select Market. The expenses incurred by public companies for reporting and corporate governance purposes have increased dramatically in recent years. These rules and regulations to increase our legal and financial compliance costs and to make some activities more time-consuming and costly. These new rules and regulations also make it more difficult and more expensive for us to obtain and maintain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur higher costs to obtain the same or similar coverage previously available. As a result, it may be more difficult for us to attract and retain qualified individuals to serve on our board of directors or as our executive officers.

An active trading market for our common stock may not be sustained, and you may not be able to resell your shares at or above the price at which you purchased them.

We have a limited history as a public company. An active trading market for our shares may not be sustained. In the absence of an active trading market for our common stock, investors may not be able to sell their common stock at or above the price they paid or at the time that they would like to sell.

Our stock price has been and may continue to be volatile.

The market price of our common stock is highly volatile, and we expect it to continue to be volatile for the foreseeable future. For example, from September 24, 2009 through June 30, 2012, our

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common stock traded at a high price of \$28.20 and a low price of \$0.82. As a result of this volatility, you may not be able to sell your common stock at or above the price you paid. Some of the factors that may cause the market price of our common stock to fluctuate include:

- fluctuations in our quarterly financial results or the quarterly financial results of companies perceived to be similar to us;
- fluctuations in our recorded revenue, even during periods of significant sales order activity;
- changes in estimates of our financial results or recommendations by securities analysts;
- failure of any of our products to achieve or maintain market acceptance;
- the timing of the shipment and/or installation and validation of our products;
- product liability issues involving our products or our competitors' products;
- failure of our suppliers, many of which are sole source suppliers, to deliver products in a timely fashion or at all or any other delay in our supply chain;
- changes in market valuations of similar companies;
- success of competitive products or technologies;
- changes in our capital structure, such as future issuances of securities or the incurrence of debt;
- announcements by us or our competitors of significant services, contracts, acquisitions or strategic alliances;
- developments or announcements related to our application for government stimulus funds;
- regulatory developments in the United States, foreign countries or both;
- litigation involving us, our general industry or both;
- additions or departures of key personnel;
- investors' general perception of us; and
- changes in general economic, industry and market conditions.

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In addition, if the market for technology stocks or the stock market in general experiences a loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or results of operations. If any of the foregoing occurs, it could cause our stock price to fall and may expose us to class action lawsuits that, even if unsuccessful, could be costly to defend and a distraction to management.

We expect that the market value of our convertible notes will be significantly affected by the price of our common stock, which has been and may continue to be highly volatile.

Our common stock has experienced significant price and volume fluctuations. The market price of our common stock, as well as the general level of interest rates and our credit quality, will likely significantly affect the market price of our convertible notes. This may result in significantly greater volatility in the trading value of our convertible notes than would be expected for nonconvertible debt securities we may issue. We cannot predict whether the price of our common stock or interest rates will rise or fall. The market price of our common stock is highly volatile, and we expect it to continue to be volatile for the foreseeable future.

Sales of a significant number of shares of our common stock, or the perception that such sales could occur, could depress the market price of our common stock.

Sales of a substantial number of shares of our common stock in the public market could occur at any time. These sales, or the market perception that the holders of a large number of shares intend to sell shares, could reduce the market price of our common stock. As of December 31, 2011, 8,237,232

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shares of our common stock are subject to a one-year contractual lock-up with a stockholder, subject to carve outs for certain hedging transactions.

In addition, the existence of the convertible notes may also encourage short selling by market participants because the conversion of the convertible notes could depress our common stock price. The price of our common stock could be affected by possible sales of our common stock by investors who view the convertible notes as a more attractive means of equity participation in us and by hedging or arbitrage trading activity that we expect to occur involving our common stock. This hedging or arbitrage could, in turn, affect the market price of our common stock and the convertible notes.

If securities or industry analysts do not publish or cease publishing research or reports about us, our business or our market, or if they change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

The trading market for our common stock will be influenced by the research and reports that industry or securities analysts may publish about us, our business, our market or our competitors. If any of the analysts who may cover us change their recommendation regarding our stock adversely, or provide more favorable relative recommendations about our competitors, our stock price would likely decline. If any analyst who may cover us were to cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

Our management has broad discretion over the use of our cash reserves and any government grants and loans we may receive, if any, and might not apply this cash in ways that increase the value of your investment.

Our management has broad discretion to use our cash reserves, including the proceeds received from our equity public offerings and our convertible debt offering, and you will be relying on the judgment of our management regarding the application of this cash. Our management might not apply our cash in ways that increase the value of your investment. We expect to use our cash reserves for capital expenditures, including capital expenditures related to the expansion of our manufacturing capacity in Michigan, working capital, warranty and field campaign costs, and other general corporate purposes, which may in the future include investments in, or acquisitions of, complementary businesses, joint ventures, partnerships, services or technologies. Our management might not be able to yield a significant return, if any, on any investment of this cash. You will not have the opportunity to influence our decisions on how to use our cash reserves.

We do not expect to declare any dividends in the foreseeable future.

We do not anticipate declaring any cash dividends to holders of our common stock in the foreseeable future. Consequently, investors may need to rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investment. Investors seeking cash dividends should not purchase our common stock.

Anti-takeover provisions contained in our certificate of incorporation and bylaws, as well as provisions of Delaware law and provisions governing our convertible notes, could impair a takeover attempt.

Our certificate of incorporation, bylaws and Delaware law contain provisions that could have the effect of rendering more difficult or discouraging an acquisition deemed undesirable by our board of directors. Our corporate governance documents include provisions:

authorizing blank check preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to our common stock;

limiting the liability of, and providing indemnification to, our directors and officers;

limiting the ability of our stockholders to call and bring business before special meetings and to take action by written consent in lieu of a meeting;

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requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;

controlling the procedures for the conduct and scheduling of board of directors and stockholder meetings;

providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings;

establishing a classified board of directors so that not all members of our board are elected at one time;

limiting the determination of the number of directors on our board of directors and the filling of vacancies or newly created seats on the board to our board of directors then in office; and

providing that directors may be removed by stockholders only for cause.

These provisions, alone or together, could delay hostile takeovers and changes in control of our company or changes in our management.

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation Law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of substantially all of our outstanding common stock. Any provision of our amended and restated certificate of incorporation or bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

In addition, if a "fundamental change" occurs pursuant to 2016 Notes, holders of the convertible notes will have the right, at their option, to require us to repurchase all or a portion of their convertible notes. Further, if a "change of control" occurs pursuant to 2013 Senior Notes, holders of the convertible notes will have the right, at their option, to require us to repurchase all or a portion of their outstanding notes at a premium. In the event of a "make whole adjustment event" under the 2016 Notes, we may be required to increase the conversion rate applicable to convertible notes surrendered for conversion in connection with such make whole adjustment event. In addition, the 2013 Senior Notes and the indenture governing the 2016 Notes prohibit us from engaging in certain mergers or acquisitions unless, among other things, the surviving entity assumes our obligations under the convertible notes. These provisions in the 2013 Senior Notes and the indenture governing the 2016 Notes may have the effect of delaying, deferring or preventing a change in control. These provisions may make it more difficult for other persons, without the approval of our board of directors or a committee thereof, to make a tender offer or otherwise acquire substantial amounts of our common stock or to launch other takeover attempts that a stockholder might consider to be in such stockholder's best interest. These provisions could also limit the price that some investors might be willing to pay in the future for shares of our common stock.

Item 2. Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities

On May 24, 2012, we issued to the certain purchasers \$50.0 million aggregate principal amount of the Notes (at face amount) (the "2013 Senior Notes") and Warrants to purchase 12,711,864 shares of our common stock (the "May 2012 Warrants"), subject to certain adjustments, for an aggregate purchase price of \$50.0 million. The purchasers were (1) Hudson Bay Master Fund Ltd. and J.P. Morgan Omni SPC, Ltd., which are managed by Hudson Bay Capital Management LP and (2) Tenor Special Situation Fund, L.P., Parsoon Special Situation Ltd., Tenor Opportunity Master Fund, Ltd, and Aria Opportunity Fund, Ltd., which are managed by Tenor Capital Management Company, LP. We paid fees and expenses of approximately \$3.4 million, including \$2.8 million to the placement agent, Lazard

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Frères & Co. LLC, and \$135,000 to reimburse the legal fees and expenses of the purchasers incurred in connection with the transaction. Accordingly, the net proceeds to us were \$46.6 million.

The 2013 Senior Notes and May 2012 Warrants were offered and sold to the purchasers pursuant to an exemption from registration requirements under Section 4(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation De promulgated thereunder. The 2013 Senior Notes and the May 2012 Warrants are detachable and legally separable.

The 2013 Senior Notes are convertible, at the purchasers' option, into shares of our common stock, initially at a fixed conversion price of \$1.18 per share, subject to certain adjustments. The 2013 Senior Notes bear interest at a rate of 6.00% per year, subject to certain adjustments, and mature on July 15, 2013. The 2013 Senior Notes are *pari passu* in right of payment with all existing and future unsecured senior indebtedness and will be senior in right of payment to any future subordinated indebtedness.

The purchasers also have the right at any time, and from time to time, after August 15, 2012, to elect to convert up to \$30.0 million aggregate principal amount of 2013 Senior Notes at a price equal to 85% of the closing price of our common stock on the trading day immediately preceding the conversion date; provided, however, that the Purchasers may not convert more than \$3.5 million aggregate principal amount of the 2013 Senior Notes on any given trading date. The 2013 Senior Notes may not be converted if, after giving effect to the conversion, the Purchasers together with their affiliates would beneficially own in excess of 4.99% of the outstanding shares of our common stock. This maximum percentage may be raised to any other percentage not in excess of 9.99% at the option of the Purchasers, upon at least 61-days' prior notice to us, or lowered to any other percentage, at the option of the Purchasers at any time.

The May 2012 Warrants have an exercise price equal to \$1.29 per share, and the May 2012 Warrants can be exercised beginning on November 26, 2012 and will expire on November 24, 2017. In the event of a fundamental change, as defined in the Warrants, the Purchasers are entitled to a fair value settlement for the lost option value determined on a Black-Scholes-based calculation with defined assumptions within the agreement. The May 2012 Warrants have customary anti-dilution adjustments as well as an exercise price reset provision upon the issuance of common stock at a per share price less than the exercise price currently in effect for the warrant.

The May 2012 Warrants may not be exercised if, after giving effect to the exercise, the Purchasers, together with their affiliates, would beneficially own in excess of 4.99% (the "Maximum Percentage"). The Maximum Percentage may be raised to any other percentage not in excess of 9.99% at the option of the holder of the May 2012 Warrants, upon at least 61-days' prior notice to us, or lowered to any other percentage, at the option of the Purchasers, at any time.

Item 6. Exhibits

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed (other than exhibits 32.1 and 32.2) as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

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EXHIBIT INDEX

Listed and indexed below are all Exhibits filed as part of this report.

Exhibit No.	Description
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer.
32.1+	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer.
32.2+	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Financial Officer.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF*	XTRL Taxonomy Extension Definition

+ This certification shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that Section, nor shall it be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

* Users of the XBRL data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.