

NETLIST INC
Form 10-Q
November 16, 2010
[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 2, 2010

or

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

For the transition period from to

Commission file number 001-33170

NETLIST, INC.

(Exact name of registrant as specified in its charter)

Delaware

State or other jurisdiction of incorporation or organization

95-4812784

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

51 Discovery, Suite 150

Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

Edgar Filing: NETLIST INC - Form 10-Q

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

Common Stock, par value \$0.001 per share

25,305,603 shares outstanding at November 1, 2010

Table of Contents

NETLIST, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE AND NINE MONTHS ENDED OCTOBER 2, 2010

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets at October 2, 2010 (unaudited) and January 2, 2010 (audited)</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 2, 2010 and October 3, 2009</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 2, 2010 and October 3, 2009</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 4. Controls and Procedures</u>	34
<u>PART II. OTHER INFORMATION</u>	34
<u>Item 1. Legal Proceedings</u>	34
<u>Item 1A. Risk Factors</u>	34
<u>Item 5. Other Information</u>	50
<u>Item 6. Exhibits</u>	51

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NETLIST, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets****(in thousands, except par value)**

	(unaudited) October 2, 2010	(audited) January 2, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 14,722	\$ 9,942
Investments in marketable securities	3,426	3,949
Accounts receivable, net	6,951	4,273
Inventories	3,861	2,232
Prepaid expenses and other current assets	1,522	854
Total current assets	30,482	21,250
Property and equipment, net	4,275	4,779
Long-term investments in marketable securities	894	941
Other assets	172	221
Total assets	\$ 35,823	\$ 27,191
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 6,234	\$ 4,057
Accrued payroll and related liabilities	1,884	2,332
Accrued expenses and other current liabilities	566	605
Accrued engineering charges	573	661
Current portion of long-term debt	640	108
Deferred gain on sale and leaseback transaction	20	108
Total current liabilities	9,917	7,871
Long-term debt, net of current portion	1,078	51
Total liabilities	10,995	7,922
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value - 90,000 shares authorized; 25,306 (2010) and 20,111 (2009) shares issued and outstanding	25	20
Additional paid-in capital	88,812	71,332
Accumulated deficit	(63,904)	(52,026)
Accumulated other comprehensive loss	(105)	(57)
Total stockholders' equity	24,828	19,269
Total liabilities and stockholders' equity	\$ 35,823	\$ 27,191

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Net sales	\$ 10,565	\$ 6,446	\$ 27,759	\$ 11,781
Cost of sales(1)	7,545	4,879	21,103	10,507
Gross profit	3,020	1,567	6,656	1,274
Operating expenses:				
Research and development(1)	4,958	1,975	11,156	5,619
Selling, general and administrative(1)	2,986	2,115	8,163	6,170
Total operating expenses	7,944	4,090	19,319	11,789
Operating loss	(4,924)	(2,523)	(12,663)	(10,515)
Other income (expense):				
Interest income (expense), net	(3)	(25)	1	75
Other income, net		4	71	134
Total other income (expense), net	(3)	(21)	72	209
Loss before provision (benefit) for income taxes	(4,927)	(2,544)	(12,591)	(10,306)
Provision (benefit) for income taxes	12	(458)	(713)	(409)
Net loss	\$ (4,939)	\$ (2,086)	\$ (11,878)	\$ (9,897)
Net loss per common share:				
Basic and diluted	\$ (0.20)	\$ (0.11)	\$ (0.51)	\$ (0.50)
Weighted-average common shares outstanding:				
Basic and diluted	24,799	19,855	23,422	19,855

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

Cost of sales	\$ 11	\$ 146	\$ 33	\$ 213
Research and development	134	156	297	262
Selling, general and administrative	268	329	891	753

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended	
	October 2, 2010	October 3, 2009
Cash flows from operating activities:		
Net loss	\$ (11,878)	\$ (9,897)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,691	1,710
Amortization of deferred gain on sale and leaseback transaction	(88)	(89)
Gain on disposal of assets		(118)
Stock-based compensation	1,221	1,228
Changes in operating assets and liabilities:		
Accounts receivable	(2,678)	(815)
Inventories	(1,629)	(57)
Income taxes receivable		1,880
Prepaid expenses and other current assets	(668)	126
Other assets	49	(18)
Accounts payable	1,907	183
Income taxes payable		78
Accrued payroll and related expenses	(448)	320
Accrued expenses and other current liabilities	(39)	179
Accrued engineering charges	(88)	511
Net cash used in operating activities	(12,648)	(4,779)
Cash flows from investing activities:		
Acquisition of property and equipment	(718)	(89)
Proceeds from sales of equipment		342
Purchase of investments in marketable securities	(2,395)	(10,837)
Proceeds from maturities and sales of investments in marketable securities	2,917	12,170
Net cash (used in) provided by investing activities	(196)	1,586
Cash flows from financing activities:		
Borrowings on line of credit	3,000	12,784
Payments on line of credit	(3,000)	(12,784)
Proceeds from public offering, net	16,210	
Proceeds from exercise of stock options and warrants	54	
Proceeds of bank term loan	1,500	
Payments on debt	(140)	(520)
Net cash provided by (used in) financing activities	17,624	(520)
Increase (decrease) in cash and cash equivalents	4,780	(3,713)
Cash and cash equivalents at beginning of period	9,942	15,214
Cash and cash equivalents at end of period	\$ 14,722	\$ 11,501
Supplemental disclosure of non-cash investing activities:		
Unrealized losses from investments in marketable securities	\$ 48	\$ 32
Purchase of assets under capital lease	\$ 199	\$ 108
Increase in purchases of property and equipment accrued in accounts payable	\$ 270	\$

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

October 2, 2010

Note 1 Description of Business

Netlist, Inc. (the Company or Netlist) designs, manufactures and sells high-performance, logic-based memory subsystems for the server, storage and communications equipment markets. The Company's memory subsystems consist of combinations of dynamic random access memory integrated circuits, NAND flash memory, application-specific integrated circuits (ASICs) and other components assembled on printed circuit boards. The Company primarily markets and sells its products to leading original equipment manufacturer (OEM) customers. Netlist's solutions are targeted at applications where memory plays a key role in meeting system performance requirements.

Note 2 Summary of Significant Accounting Policies

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (the U.S.) for interim financial information and with the instructions to Securities and Exchange Commission (SEC) Form 10-Q and Article 8 of SEC Regulation S-X. These financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. Therefore, these unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended January 2, 2010, included in the Company's Annual Report on Form 10-K filed with the SEC on February 19, 2010.

The condensed consolidated financial statements included herein as of October 2, 2010 are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company's management, are necessary to present fairly the condensed consolidated financial position of the Company and its wholly-owned subsidiaries as of October 2, 2010, the condensed consolidated results of its operations for the three and nine months ended October 2, 2010 and October 3, 2009, and the condensed consolidated cash flows for the nine months ended October 2, 2010 and October 3, 2009. The results of operations for the three and nine months ended October 2, 2010 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

Reclassifications

Certain amounts in the 2009 financial statements have been reclassified to conform to the current year presentation.

Principles of Consolidation

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

Fiscal Year

The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2010, the Company's fiscal year is scheduled to end on January 1, 2011 and will consist of 52 weeks. Each of the Company's first three quarters in a fiscal year is comprised of 13 weeks.

Use of Estimates

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

Table of Contents

Revenue Recognition

The Company's revenues primarily consist of product sales of high-performance memory subsystems to OEMs. Revenues also include sales of excess component inventories to distributors and other users of memory integrated circuits (ICs). Such sales amounted to less than \$0.1 million for each of the three and nine months ended October 2, 2010, and totaled approximately \$0.6 million and \$0.7 million, respectively, for each of the three and nine months ended October 3, 2009.

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

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

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

Cash and Cash Equivalents

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

Investments in Marketable Securities

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

are reported in other income, net in the unaudited condensed consolidated statements of operations.

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

Fair Value of Financial Instruments

The Company's financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities (see Note 4) commercial paper and short-term corporate bonds, the fair value of the Company's cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, commercial paper and short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 inputs. The Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Table of Contents

Allowance for Doubtful Accounts

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

Concentration of Credit Risk

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

The Company invests its cash equivalents primarily in money market funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. The Company had \$0.4 million of Federal Deposit Insurance Corporation insured cash and cash equivalents at October 2, 2010. Investments in marketable securities are generally in high-credit quality debt instruments with an active resale market. Such investments are made only in instruments issued or enhanced by high-quality institutions. The Company has not incurred any credit risk losses related to these investments.

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

Inventories

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

Property and Equipment

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

Impairment of Long-Lived Assets

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

Table of Contents

Warranties

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

Stock-Based Compensation

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

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

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

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

Income Taxes

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

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

Table of Contents

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

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Collaborative Arrangement

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

Comprehensive Loss

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

Risks and Uncertainties

The Company's operations in the People's Republic of China (PRC) are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in China. These include, but are not limited to, (i) potential changes in economic conditions in the region, (ii) managing a local workforce that may subject the Company to uncertainties or certain regulatory policies, (iii) changes in other policies of the Chinese governmental and regulatory agencies, and (iv) changes in the laws and policies of the U.S. government regarding the conduct of business in foreign countries, generally, or in China, in particular. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi (RMB), is converted into other currencies and by which dividends may be declared or capital distributed for the purpose of repatriation of earnings and investments. If restrictions in the conversion of RMB or in the repatriation of earnings and investments through dividend and capital distribution restrictions are instituted, the Company's operations and operating results may be negatively impacted. Restricted net assets of the Company's subsidiary in the PRC totaled \$2.5 million and \$2.7 million at October 2, 2010 and January 2, 2010, respectively.

Foreign Currency Re-measurement

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

Net Loss Per Share

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

Table of Contents*New Accounting Pronouncements*

In September 2009, the FASB issued Accounting Standards Update (ASU) 2009-13, *Multiple-Deliverable Revenue Arrangements* (ASU 2009-13), which amends the revenue guidance under ASC Topic 605, which describes the accounting for multiple element arrangements. ASU 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-13 is effective on a prospective basis for the Company's fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the adoption of ASU 2009-13 and the impact that ASU 2009-13 will have on its condensed consolidated financial statements.

In September 2009, the FASB issued ASU 2009-14, *Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14), which excludes tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of ASC Topic 985, which describes the accounting for software revenue recognition. ASU 2009-14 is effective on a prospective basis for the Company's fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the impact that ASU 2009-14 will have on its condensed consolidated financial statements.

Note 3 Supplemental Financial Information*Inventories*

Inventories consist of the following (in thousands):

	October 2, 2010		January 2, 2010
Raw materials	\$ 2,103	\$	997
Work in process	345		342
Finished goods	1,413		893
	\$ 3,861	\$	2,232

Warranty Liability

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

Nine Months Ended	
October 2, 2010	October 3, 2009

Edgar Filing: NETLIST INC - Form 10-Q

Beginning balance	\$	240	\$	277
Charged to costs and expenses		176		122
Usage		(214)		(155)
Ending balance	\$	202	\$	244

The warranty liability is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets.

Table of Contents*Facility Relocation Costs*

The following table summarizes the activity related to the Company's accrual for facility relocation costs during the nine months ended October 2, 2010 and October 3, 2009 (in thousands):

	Nine Months Ended	
	October 2, 2010	October 3, 2009
Beginning balance	\$ 84	\$ 80
(Reduction) increase in expected costs	(28)	61
Net payments	(10)	(16)
Ending balance	\$ 46	\$ 125

In May 2009, the Company entered into an agreement to sublease a portion of its new domestic headquarters facility to another tenant at a discount from the rent required under its lease commitment. As a result, the Company recorded an additional charge of approximately \$61,000. In February 2010, the sublessor vacated the space that it had subleased. The Company determined that the space could be used in its operations. As a result, the Company reversed \$28,000 of its accrual for facility relocation costs. The resulting expense increase and reduction are included as a component of selling, general and administrative expenses in the accompanying condensed consolidated statement of operations for the nine months ended October 2, 2010 and October 3, 2009.

The liability for facility relocation costs is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets.

Comprehensive Loss

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

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Net loss	\$ (4,939)	\$ (2,086)	\$ (11,878)	\$ (9,897)
Other comprehensive loss:				
Change in net unrealized gain (loss) on investments, net of tax	(1)	(6)	(48)	32
Total comprehensive loss	\$ (4,940)	\$ (2,092)	\$ (11,926)	\$ (9,865)

Accumulated other comprehensive loss reflected on the condensed consolidated balance sheets at October 2, 2010 and January 2, 2010, represents accumulated net unrealized losses on investments in marketable securities.

Computation of Net Loss Per Share

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

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Numerator: Net loss	\$ (4,939)	\$ (2,086)	\$ (11,878)	\$ (9,897)
Denominator: Weighted-average common shares outstanding, basic and diluted	24,799	19,855	23,422	19,855
Net loss per share, basic and diluted	\$ (0.20)	\$ (0.11)	\$ (0.51)	\$ (0.50)

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Common share equivalents	1,779	600	1,978	420

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

Major Customers

Net sales to some of the Company's OEM customers include memory modules that are qualified by the Company directly with the OEM customer and sold to electronic manufacturing services providers (EMSs), for incorporation into products manufactured exclusively for the OEM customer or in some instances, to facilitate credit and logistics. These net sales to EMSs have historically fluctuated period to period as a portion of the total net sales to the OEM customers. Net sales to Hon Hai Precision Industry Co. Ltd., an EMS operating under the trade name Foxconn that purchases memory modules from the Company for incorporation into products manufactured exclusively for Dell, Inc. (Dell), represented approximately 94% and 61% of net sales to Dell for the nine months ended October 2, 2010 and October 3, 2009, respectively. Arrow Electronics Inc. (Arrow) is an EMS for DRS Electronics, Inc. (DRS Electronics). Substantially all of the Company's products sold to Arrow are incorporated into components manufactured for DRS Electronics. Similarly, Flextronics International Ltd. (Flextronics) distributes substantially all of the products purchased from the Company to F5 Networks, Inc. (F5 Networks). The following table sets forth sales to customers comprising 10% or more of the Company's net sales for the periods presented:

Customer:	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
Dell (including Foxconn)	69%	47%	53%	48%
Flextronics (F5 Networks)	13%	*%	25%	*%
Arrow Electronics (DRS Electronics)	*%	10%	*%	13%
Hewlett Packard	*%	18%	*%	10%

* less than 10% of net sales

The Company's accounts receivable are concentrated with two customers at October 2, 2010 representing approximately 70% and 18%, and two customers at January 2, 2010, representing approximately 68% and 10%, of aggregate gross receivables. A significant reduction in sales to, or the inability to collect receivables from, a significant customer could have a material adverse impact on the Company. The Company mitigates risk associated with foreign receivables by purchasing comprehensive foreign credit insurance.

Edgar Filing: NETLIST INC - Form 10-Q

Cash Flow Information

The following table sets forth cash (received) paid for income taxes and interest for the periods presented (in thousands):

	Nine Months Ended	
	October 2, 2010	October 3, 2009
Income taxes	\$ (725)	\$ (1,175)
Interest	\$ 52	\$ 78

Table of Contents**Note 4 Fair Value Measurements**

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

	Fair Value Measurements at October 2, 2010 Using			
	Fair Value at October 2, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale debt securities:				
Obligations of the U.S. government	\$ 1,000	\$ 1,000	\$	\$
Federal agency notes and bonds	501	501		
Corporate notes and bonds	1,925		1,925	
Auction and variable floating rate notes	894			894
Total	\$ 4,320	\$ 1,501	\$ 1,925	\$ 894

	Fair Value Measurements at January 2, 2010 Using			
	Fair Value at January 2, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale debt securities:				
Obligations of the U.S. government	\$ 997	\$ 997	\$	\$
Federal agency notes and bonds	61	61		
Commercial paper	1,048	1,048		
Corporate notes and bonds	1,843	1,843		
Auction and variable floating rate notes	941			941
Total	\$ 4,890	\$ 3,949	\$	\$ 941

As of January 3, 2010, the Company reclassified its investments in commercial paper and corporate notes and bonds, with a fair value of \$2.9 million, from assets measured at fair value using Level 1 inputs to assets measured at fair value using Level 2 inputs. The transfer resulted solely from management's reassessment of the level of activity in the secondary market for these investments, which historically has been low due to the short-term nature of the instruments. Management does not believe that the reassessment in any way reflects a change in the actual liquidity or credit quality of these investments. The reassessment was precipitated by a change in custodial institutions in connection with the Company's new revolving credit agreement (see Note 6).

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

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

Edgar Filing: NETLIST INC - Form 10-Q

	Nine Months Ended	
	October 2, 2010	October 3, 2009
Beginning balance	\$ 941	\$ 960
Unrealized (loss) gain included in other comprehensive loss	(47)	15
Ending balance	\$	