NETLIST INC
Form 10-Q
August 14, 2018
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 June 30, 2018

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	95-4812784
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)

175 Technology Drive, Suite 150

Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically 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 (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer	Accelerated filer	Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 10, 2018, there were 111,311,243 shares of the registrant’s common stock outstanding.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2018

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NETLIST, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(in thousands, except par value)

	June 30, 2018 (unaudited)	December 30, 2017 (audited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 6,981	$ 6,720
Restricted cash	1,100	2,800
Accounts receivable, net of reserves of $41 (2018) and $44 (2017)	2,831	2,997
Inventories	3,465	4,105
Prepaid expenses and other current assets	581	303
Total current assets	14,958	16,925
Property and equipment, net	364	459
Other assets	1,396	1,406
Total assets	$ 16,718	$ 18,790
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current Liabilities:		
Accounts payable	$ 6,805	$ 6,120
Revolving line of credit	2,133	2,024
Accrued payroll and related liabilities	595	807
Accrued expenses and other current liabilities	356	338
Note payable	115	-
Total current liabilities	10,004	9,289
Convertible promissory note and accrued interest, net of debt discount	15,022	14,766
Long-term warranty liability	70	61
Total liabilities	25,096	24,116
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, $0.001 par value - 10,000 shares authorized: Series A preferred stock, $0.001 par value; 1,000 shares authorized; none issued and outstanding	-	-
	102	80

Common stock, $0.001 par value - 150,000 shares authorized; 102,333 (2018) and 79,314 (2017) shares issued and outstanding		
Additional paid-in capital	157,656	152,640
Accumulated deficit	(166,136)	(158,046)
Total stockholders' deficit	(8,378)	(5,326)
Total liabilities and stockholders' deficit	$ 16,718	$ 18,790

See accompanying notes.

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
Net revenues	$ 8,426	$ 11,404	$ 17,305	$ 20,830
Cost of sales(1)	7,944	10,760	16,444	19,506
Gross profit	482	644	861	1,324
Operating expenses:				
Research and development(1)	783	1,487	1,791	2,983
Intellectual property legal fees	1,388	915	3,599	1,381
Selling, general and administrative(1)	1,585	1,951	3,276	3,865
Total operating expenses	3,756	4,353	8,666	8,229
Operating loss	(3,274)	(3,709)	(7,805)	(6,905)
Other expense, net:				
Interest expense, net	(133)	(138)	(280)	(286)
Other (expense) income, net	(10)	-	(5)	2
Total other expense, net	(143)	(138)	(285)	(284)
Loss before provision for income taxes	(3,417)	(3,847)	(8,090)	(7,189)
Provision for income taxes	-	-	-	-
Net loss	$ (3,417)	$ (3,847)	$ (8,090)	$ (7,189)
Net loss per common share:				
Basic and diluted	$ (0.04)	$ (0.06)	$ (0.09)	$ (0.12)
Weighted-average common shares outstanding:				
Basic and diluted	91,685	61,844	87,073	61,763

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

Cost of sales	$ 6	$ 13	$ 12	$ 29
Research and development	56	114	136	180
Selling, general and administrative	111	254	266	436
Total stock-based compensation	$ 173	$ 381	$ 414	$ 645

See accompanying notes.

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended	
	June 30, 2018	July 1, 2017
Cash flows from operating activities:		
Net loss	$ (8,090)	$ (7,189)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	132	144
Interest accrued on convertible promissory note	150	150
Amortization of debt discount	107	108
Stock-based compensation	414	645
Issuance of warrant in lieu of payment	12	-
Changes in operating assets and liabilities:		
Accounts receivable	166	(68)
Inventories	640	(1,748)
Prepaid expenses and other assets	76	122
Accounts payable	685	2,620
Accrued payroll and related liabilities	(212)	(296)
Accrued expenses and other liabilities	27	2
Net cash used in operating activities	(5,893)	(5,510)
Cash flows from investing activities:		
Acquisition of property and equipment	(37)	(53)
Net cash used in investing activities	(37)	(53)
Cash flows from financing activities:		
Net borrowings under line of credit	109	656
Payments on debt	(230)	(230)
Proceeds from issuance of common stock, net	4,612	-
Proceeds from exercise of stock options and warrants	-	157
Net cash provided by financing activities	4,491	583
Net change in cash, cash equivalents and restricted cash	(1,439)	(4,980)
Cash, cash equivalents and restricted cash at beginning of period	9,520	12,576
Cash, cash equivalents and restricted cash at end of period	$ 8,081	$ 7,596
Reconciliation of cash, cash equivalents and restricted cash at end of period:		
Cash and cash equivalents	$ 6,981	$ 4,496
Restricted cash	1,100	3,100
Cash, cash equivalents and restricted cash at end of period	$ 8,081	$ 7,596

See accompanying notes.

5

Table of Contents

NETLIST, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

June 30, 2018

Note 1—Description of Business

Netlist, Inc. together with its wholly owned subsidiaries (hereinafter collectively referred to as the “Company” or “Netlist,” unless the context or the use of the term indicates otherwise), provides high-performance modular memory subsystems to customers in diverse industries that require enterprise and storage class memory solutions to empower critical business decisions. The Company has a history of introducing disruptive new products, such as one of the first load-reduced dual in-line memory modules (“LRDIMM”) based on its distributed buffer architecture, which has been adopted by the industry for DDR4 LRDIMM. The Company was also one of the first to bring NAND flash memory (“NAND flash”) to the memory channel with its NVvault non-volatile dual in-line memory modules (“NVDIMM”) using software-intensive controllers and merging dynamic random access memory integrated circuits (“DRAM ICs” or “DRAM”) and NAND flash to solve data bottleneck and data retention challenges encountered in high-performance computing environments. The Company recently introduced a new generation of storage class memory products called HybriDIMM to address the growing need for real-time analytics in Big Data applications, in-memory databases, high performance computing and advanced data storage solutions. The Company also resells NAND flash, DRAM products and other component products to end-customers that are not reached in the distribution models of the component manufacturers, including storage customers, appliance customers, system builders and cloud and datacenter customers.

Due to the ground-breaking product development of its engineering teams, Netlist has built a robust portfolio of over 100 issued and pending U.S. and foreign patents, many seminal, in the areas of hybrid memory, storage class memory, rank multiplication and load reduction. Since its inception, the Company has dedicated substantial resources to the development, protection and enforcement of technology innovations it believes are essential to its business. The Company’s early pioneering work in these areas has been broadly adopted in industry-standard registered dual in-line memory module (“RDIMM”) LRDIMM and NVDIMM. Netlist’s objective is to continue to innovate in its field and invest further in its intellectual property portfolio, with the goal of monetizing its intellectual property through a combination of product sales and licensing, royalty or other revenue-producing arrangements, which may result from joint development or similar partnerships or defense of the Company’s patents through enforcement actions against parties it believes are infringing them.

Netlist was incorporated in June 2000 and is headquartered in Irvine, California. The Company has established a manufacturing facility in the People’s Republic of China (“PRC”), which became operational in July 2007.

Liquidity

The Company incurred net losses of $3.4 million and $8.1 million for the three and six months ended June 30, 2018, respectively, and $13.4 million and $11.2 million for the fiscal years ended December 30, 2017 and December 31, 2016, respectively. The Company has historically financed its operations primarily with revenues generated from operations, including product sales, proceeds from issuances of equity and debt securities including convertible debt and a non-recurring engineering (“NRE”) fee from its Joint Development and License Agreement (“JDLA”) with Samsung Electronics Co., Ltd. (“Samsung”), discussed below. The Company has also funded its operations with a revolving line of credit and term loans under a bank credit facility, a funding arrangement for costs associated with certain of its legal proceedings and, to a lesser extent, equipment leasing arrangements (see Notes 5, 6 and 8).

On August 22, 2017, the Company completed an underwritten public offering (the “2017 Offering”), pursuant to which it sold 8,500,000 shares of its common stock at a price to the public of $0.60 per share. The net proceeds to the Company from the 2017 Offering were $4.4 million, after deducting underwriting discounts and commissions and offering expenses paid by the Company.

On November 14, 2017, the Company entered into an At Market Issuance Sales Agreement (the “Sales Agreement”) with B. Riley FBR, Inc. (the “Agent”) to sell shares of its common stock, with aggregate gross proceeds of up to $9.0 million, from time to time, through an “at-the-market” equity offering program under which the Agent will act

Table of Contents

as sales agent (the "ATM Program") (see Note 9). As of June 30, 2018, the Company had sold 25,983,098 shares of its common stock in the ATM Program for net proceeds of $6.6 million, after deducting sales commissions and other offering expenses paid by the Company. In addition, subsequent to June 30, 2018 through August 10, 2018, the Company sold 8,978,094 shares of its common stock for approximate net proceeds of $1.3 million, after deducting sales commissions and other offering expenses paid by the Company.

On May 17, 2018, the Company entered into a Board approved arm's length Share Purchase Agreement (the "Purchase Agreement") with a trust controlled by C.K. Hong, the Company's President, Chief Executive Officer and Chairman of the Board, pursuant to which the Company sold to Mr. Hong's trust 5,405,405 shares of the Company's common stock, par value $0.001 per share, at a price per share of $0.148 (which equals the most recent consolidated closing bid price of the Company's common stock, as reported by the Nasdaq Capital Market, as of the signing of the Purchase Agreement). The aggregate net proceeds received by the Company were $0.8 million.

Inadequate working capital would have a material adverse effect on the Company's business and operations and could cause the Company to fail to execute its business plan, fail to take advantage of future opportunities or fail to respond to competitive pressures or customer requirements. A lack of sufficient funding may also require the Company to significantly modify its business model and/or reduce or cease its operations, which could include implementing cost-cutting measures or delaying, scaling back or eliminating some or all of its ongoing and planned investments in corporate infrastructure, research and development projects, business development initiatives and sales and marketing activities, among other activities. While the Company's estimates of its operating revenues and expenses and working capital requirements could be incorrect and the Company may use its cash resources faster than it anticipates, management believes the Company's existing cash balance, together with cash provided by the Company's operations and borrowing availability under a bank credit facility (see Note 5) and funds raised through the ATM Programs, will be sufficient to meet the Company's anticipated cash needs for at least the next 12 months.

Note 2—Summary of Significant Accounting Policies

Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and the instructions to the Securities and Exchange Commission's ("SEC") Form 10-Q and Article 8 of the SEC's Regulation S-X. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. Therefore, these condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of and for the year ended December 30, 2017, included in the Company's Annual Report on Form 10-K filed with the SEC on March 30, 2018 and Form 10-K/A as of April 30, 2018, as amended to include in Part III the information that was to be incorporated by reference from the definitive proxy statement for the 2018 annual meeting of our stockholders in reliance on General Instruction G(3) to Form 10-K, because such proxy statement was not expected to be filed until July of 2018 in connection with a date for such annual meeting in August 2018.

The accompanying condensed consolidated financial statements as of and for the three and six months ended June 30, 2018 are unaudited. In the opinion of management, all adjustments for the fair presentation of the Company's condensed consolidated financial statements have been made. The adjustments are of a normal recurring nature except as otherwise noted. The results of operations for the interim periods are not necessarily indicative of the results to be expected for other periods or the full fiscal year.

Principles of Consolidation

The accompanying 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.

Table of Contents

Fiscal Year

The Company operates under a 52 or 53 week fiscal year ending on the Saturday closest to December 31. For 2018, the Company's fiscal year is scheduled to end on December 29, 2018 and will consist of 52 weeks, and each of the Company's quarters within such fiscal year will be comprised of 13 weeks.

Use of Estimates

The preparation of the accompanying condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of net revenues and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. The Company bases its estimates and assumptions on its historical experience, knowledge of current conditions and the Company's belief of what could occur in the future considering available information. The Company reviews its estimates and assumptions on an ongoing basis. Actual results may differ materially from these estimates, which may result in material adverse effects on the Company's consolidated operating results and financial position.

The Company believes the following critical accounting policies involve its more significant assumptions and estimates used in the preparation of the accompanying condensed consolidated financial statements: provisions for uncollectible receivables and sales returns; warranty liability; valuation of inventories; fair value of financial instruments; recoverability of long-lived assets; valuation of stock-based transactions; estimates for completion of NRE and other revenue milestones and the realization of deferred tax assets. The Company bases its estimates on historical experience, knowledge of current conditions and the Company's belief of what could occur in the future considering available information. The Company reviews its estimates on an ongoing basis. Actual results may differ materially from these estimates which may result in material adverse effects on the Company's operating results and financial position.

Revenue Recognition

Our net sales are generated primarily from (i) resales of NAND flash, DRAM products and other component products to end-customers that are not reached in the distribution models of the component manufacturers, including storage customers, appliance customers, system builders and cloud and datacenter customers and (ii) sales of high-performance modular memory subsystems primarily to original equipment manufacturers ("OEMs") in the server, high-performance computing and communications markets.

The Company’s products are sold through ship-and-bill performance obligations, and the revenue is recognized at the point in time when the ownership is transferred to customers. 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. Product returns are estimated at the time of sale using the expected value method and are recorded as a reduction in sales. The Company offers a standard product warranty to its customers and has no other post-shipment obligations. All amounts billed to customers related to shipping and handling are included in net sales, while costs incurred by the Company for shipping and handling are included in cost of sales. See Note 3.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less.

Table of Contents

Restricted Cash

Restricted cash consists of cash to secure standby letters of credit. Restricted cash was $1.1 million as of June 30, 2018 and related to two standby letters of credit. Restricted cash was $2.8 million as of December 30, 2017 and related to three standby letters of credit.

Fair Value of Financial Instruments

The Company follows Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, Fair Value Measurement, to account for the fair value of certain assets and liabilities. ASC Topic 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC Topic 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, ASC Topic 820 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. An active market is defined as a market in which transactions for the assets or liabilities occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

The Company's financial instruments consist principally of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses, a revolving line of credit, a note payable and a convertible promissory note. The Company considers the carrying values of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses, and a note payable to approximate the fair value for these financial instruments based upon an evaluation of the underlying characteristics, market data and because of the short period of time between origination of the instruments and their expected realization. The fair values of the Company's revolving line of credit and convertible promissory note are determined using current applicable rates for similar instruments as of the balance sheet date and an assessment of the credit rating of the Company. The carrying value of the Company's revolving line of credit at June 30, 2018 and December 30, 2017 approximates fair value because the Company's interest rate yield is near current market rates for comparable debt instruments. The fair value of the Company's convertible promissory note was estimated using a discounted cash flow analysis using borrowing rates available to the Company for debt instruments with similar terms and maturities. The Company has determined that the valuation of its convertible promissory note is classified in Level 2 of the fair value hierarchy. The carrying value and estimated fair value of the convertible promissory note as of June 30, 2018 were $14.2 million and $12.0 million, respectively. The carrying value and estimated fair value of the convertible promissory note as of December 30, 2017 were $14.1 million and $12.3 million, respectively.

Allowance for Doubtful Accounts

The Company performs credit evaluations of its customers' financial condition and limits the amount of credit extended to its customers as deemed necessary, but generally requires no collateral. The Company evaluates the

Table of Contents

collectability 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. Generally, the Company's credit losses have been within expectations and the provisions established. However, the Company cannot guarantee that it will continue to experience credit loss rates similar to those experienced in the past.

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

Concentration of Credit Risk

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

The Company invests its cash equivalents primarily in money market accounts. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. At times, deposits held with financial institutions may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation.

The Company's trade accounts receivable are primarily derived from sales to OEMs in the server, high-performance computing and communications markets, as well as from sales to storage customers, appliance customers, system builders and cloud and datacenter customers. 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 the concentration of credit risk in its trade receivables is moderated by its credit evaluation process, relatively short collection terms, a high level of credit worthiness of its customers (see Note 4), foreign credit insurance, and letters of credit issued in its favor. Reserves are maintained for potential credit losses, and such losses historically have not been significant and have been within management's expectations.

Inventories

Inventories are valued at the lower of actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. 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 inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. In addition, the Company considers changes in the market value of components in determining the net realizable value of its inventory. Once established, lower of cost or net realizable value 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. Expenditures for repairs and maintenance are expensed as incurred. Upon retirement or sale, the cost and related accumulated depreciation and amortization of disposed assets are removed from the accounts and any resulting gain or loss is included in other expense, net.

Debt Issuance Costs, Debt Discount and Detachable Debt-Related Warrants

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

Impairment of Long-Lived Assets

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company in its operations for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, 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 the Company’s 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. The Company’s management believes there is no impairment of long-lived assets as of June 30, 2018. However, market conditions could change or demand for the Company’s products could decrease, which could result in future impairment of long-lived assets.

Warranty Liability

The Company offers standard product warranties generally ranging from one to three years, depending on the product and negotiated terms of any purchase agreements with its customers and has no other post-shipment obligations. 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, and the Company does not offer separately priced extended warranty or product maintenance contracts. The Company records an estimate for warranty related costs at the time of sale in cost of sales based on its historical and estimated future product return rates and expected repair or replacement costs (see Note 4). While such costs have historically been within management’s expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on the Company, requiring additional warranty reserves and could adversely affect the Company’s gross profit and gross margins.

Stock-Based Compensation

Prior to the early-adoption of FASB ASU No. 2018-07, Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting (“ASU 2018-07”) in the second quarter of 2018, the Company accounted for equity issuances to non-employees in accordance with ASC Topic 505, Equity. All transactions in which goods or services were the consideration received for the issuance of equity instruments were accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever was more reliably measurable. The measurement date used to determine the estimated fair value of the equity instrument issued was the earlier of the date on which the third-party performance was complete or the date on which it was probable that performance would occur. Upon the adoption of ASU No. 2018-07, the Company accounts for all stock-based awards in accordance with ASC Topic 718.

In accordance with ASC Topic 718, 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 accompanying condensed consolidated statements of

Table of Contents

operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. The Company estimates its forfeitures at the time of grant and revises such estimates, 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 estimated fair value of common stock option awards is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of the Company's common stock option awards. The expected term of options granted is calculated as the weighted-average of the vesting period and the contractual expiration date of the option. This calculation is in accordance with ASC Topic 718, as amended by certain SEC guidance providing for a safe harbor method in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. The expected volatility is based on the historical volatility of the Company's common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividend assumption is based on the Company's history and management's expectation regarding dividend payouts. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award, provided that the accumulated cost recognized as of any date at least equals the value of the vested portion of the award.

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

Income Taxes

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 accompanying 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. Deferred tax liabilities, deferred tax assets and valuation allowances are classified as non-current in the accompanying condensed consolidated balance sheets.

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

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

Contingent Legal Expense

Contingent legal fees are expensed in the condensed consolidated statements of operations in the period that the related revenues are recognized. In instances where there are no recoveries from potential infringers, no contingent legal fees are paid; however, the Company may be liable for certain out of pocket legal costs incurred pursuant to the underlying legal services agreement.

Table of Contents

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Interest Expense

Interest expense consists primarily of interest associated with our debt instruments, including fees related to the term loans, accretion of debt discounts and amortization of debt issuance costs. The Company recognizes the accretion of debt discounts and the amortization of interest costs using the effective interest method.

Foreign Currency Remeasurement

The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Local currency financial statements are remeasured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. All remeasurement gains and losses are included in determining net loss. Transaction gains and losses were not significant during the three and six months ended June 30, 2018 and July 1, 2017.

Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period, excluding unvested shares issued pursuant to restricted share awards under the Company's share-based compensation plans. Diluted net loss per share is calculated by dividing the net loss by the weighted-average shares and dilutive potential common shares outstanding during the period. Dilutive potential shares consist of dilutive shares issuable upon the exercise or vesting of outstanding stock options, warrants and restricted stock awards, computed using the treasury stock method and shares issuable upon conversion of the Samsung Venture Investment Co. ("SVIC") Note (see Note 6). In periods of losses, basic and diluted loss per share are the same, as the effect of stock options, warrants and unvested restricted share awards on loss per share is anti-dilutive.

Business Risks and Uncertainties

The Company’s results of operations, liquidity and financial condition are exposed to a number of risks and uncertainties. See the discussion in “Risk Factors” in Part II, Item 1A of this Quarterly Report on Form 10-Q in which these condensed consolidated financial statements are included for more discussion.

Adoption of New Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes nearly all existing revenue recognition guidance, including industry-specific guidance. Subsequent to the issuance of ASU No. 2014-09, the FASB clarified the guidance through several Accounting Standards Updates; hereinafter the collection of revenue guidance is referred to as “Topic 606.” Topic 606 is based on the principle that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Topic 606 also requires additional disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to fulfill a contract. The Company adopted Topic 606 on December 31, 2017 using the modified retrospective transition method; accordingly, Topic 606 has been applied to the fiscal 2018 financial statements and disclosures going forward, but the comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. We expect the impact of the adoption of Topic 606 to be immaterial to our operating results on an ongoing basis. See Note 3, “Revenue Recognition,” for additional details on this implementation and the required disclosures.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which is intended to reduce the existing diversity in practice

Table of Contents

in how certain cash receipts and cash payments are classified in the statement of cash flows. In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230), Restricted Cash (“ASU 2016-18”), which enhances and clarifies the guidance on the classification and presentation of restricted cash in the statement of cash flows. The Company adopted these standards in the first quarter of 2018 by using the retrospective transition method, which required the following disclosures and changes to the presentation of its consolidated financial statements: cash, cash equivalents and restricted cash reported on the condensed consolidated statements of cash flows now includes restricted cash of $3.1 million, $3.1 million and $2.8 million as of December 31, 2016, July 1, 2017 and December 30, 2017, respectively, as well as previously reported cash and cash equivalents.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740), Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. This amends current U.S. GAAP which prohibits recognition of current and deferred income taxes for all types of intra-entity asset transfers until the asset has been sold to an outside party. ASU 2016-16 is effective for fiscal years beginning after December 15, 2017, including interim periods therein with early application permitted. The Company adopted ASU 2016-16 in the first quarter of 2018 by using the modified retrospective transition approach, which did not have an impact on its consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting (“ASU 2017-09”), which provides clarity and reduces diversity in practice and reduce cost and complexity when calculating stock compensation, on a change to the terms and conditions of a share-based award. ASU 2017-09 is effective beginning after December 15, 2017 for annual reporting periods, and interim periods within those annual periods. The Company adopted ASU 2017-09 in the first quarter of 2018, which did not have an impact on its consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting, which expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees, which is currently addressed in FASB ASC Topic 505, Equity. ASU 2018-07 specifies that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendments also clarify that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606. ASU 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Early adoption is permitted, but no earlier than an entity’s adoption date of Topic 606, Revenue from Contracts with Customers. The Company adopted ASU 2018-07 on April 1, 2018, which did not have a material impact on its consolidated financial statements.

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), as amended ("ASC 842"), which amends a number of aspects of lease accounting, including requiring lessees to recognize operating leases with a term greater than one year on their balance sheet as a right-of- use asset and corresponding liability, measured at the present value of the lease payments. ASC 842 is effective for interim and annual reporting periods beginning after December 15, 2018 (fiscal year 2019 for the Company), with early adoption permitted. ASC 842 should be applied under a modified retrospective transition approach with an option to apply the guidance either at the beginning of the earliest comparative period presented in the adoption-period financial statements, or to apply the new guidance at the adoption date. The Company is currently evaluating the impact of adopting ASC 842 on its consolidated financial statements.

Note 3—Revenue Recognition

In May 2014, the FASB issued Topic 606, which modifies how all entities recognize revenue. Topic 606 outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. We adopted Topic 606 on December 31, 2017 using the modified retrospective transition method. For the three and six months ended June 30, 2018 and July 1, 2017,

Table of Contents

the vast majority of our revenue was derived from the sale of tangible products for which we recognize revenue at a point in time. The contracts that relate to these product shipments are predominantly purchase orders that have firm purchase commitments generally only for a short period of time. As a result, the adoption of Topic 606 did not have a material effect on our condensed consolidated financial statements, and no cumulative catch-up adjustment to the opening balance of accumulated deficit was required. We used the related practical expedients that allow us to not disclose the transaction price allocated to remaining unsatisfied obligations and an explanation of when we expect to recognize the related revenue. In adopting Topic 606, we applied the new guidance only to contracts that were not completed on December 30, 2017.

Revenues are recognized when control is transferred to customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods and services. Revenue recognition is evaluated through the following five steps: (i) identification of the contract, or contracts, with a customer; (ii) identification of the performance obligations in the contract; (iii) determination of the transaction price; (iv) allocation of the transaction price to the performance obligations in the contract; and (v) recognition of revenue when or as a performance obligation is satisfied.

Nature of Goods and Services

The Company derives revenue primarily from: (i) resales of NAND flash, DRAM products and other component products to end-customers that are not reached in the distribution models of the component manufacturers, including storage customers, appliance customers, system builders and cloud and datacenter customers; (ii) sales of high-performance modular memory subsystems primarily to OEMs in the server, high-performance computing and communications markets; and (iii) engineering services. However, the Company had no engineering services revenues for the three and six months ended June 30, 2018 and July 1, 2017.

Substantially all of the Company’s net product revenues relate to products sold at a point in time through ship-and-bill performance obligations. At contract inception, an assessment of the goods and services promised in the contracts with customers is performed and a performance obligation is identified for each distinct promise to transfer to the customer a good or service (or bundle of goods or services). To identify the performance obligations, the Company considers all of the goods or services promised in the contract regardless of whether they are explicitly stated or are implied by customary business practices. Contracts with customers are comprised of customer purchase orders, invoices (including the Company’s standard terms and conditions), and written contracts.

Revenue Disaggregation

The Company operates in one reportable segment, which is the design, manufacture and sale of high-performance memory subsystems for the server, high-performance computing and communications markets and component products purchased for the purpose of resale. The Company evaluates financial performance on a Company-wide basis.

We consider sales disaggregated at the product and service level to depict how the nature, amount, timing and uncertainty of revenues and cash flows are impacted by changes in economic factors. The following table disaggregates our sales by major source for the three and six months ended June 30, 2018:

Product:

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
	(in thousands)	
Resales of third-party products	$ 6,335	$ 13,442
Specialty DIMMs	2,091	3,863
Total net product revenues	$ 8,426	$ 17,305

Performance Obligations

Our net product revenues and related cost of sales are primarily the result of promises to transfer products to our customers. For performance obligations related to substantially all of our ship-and-bill products, control transfers at a point in time when title transfers upon shipment of the product to the customer, and for some sales, control transfers when title is transferred at time of receipt by the customer. Once a product has shipped or has been delivered, the customer is able to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The Company considers control to have transferred upon shipment or delivery because the Company has a present right to payment at that time, the customer has legal title to the asset, the Company has transferred physical possession of the asset, and the customer has the significant risks and rewards of ownership of the asset.

Amounts billed to our customers for shipping and handling are recorded in net product revenues. Shipping and handling costs incurred by the Company are included in cost of sales.

Significant Payment Terms

For ship-and-bill type contracts with customers, the invoice states the final terms of the sale, including the description, quantity, and price of each product purchased. Payment terms are typically due within 30 days after delivery but, in limited instances, can range up to 60 days after delivery. Accordingly, our contracts with customers do not include a significant financing component.

Variable Consideration

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. Product returns give rise to variable consideration that decreases the transaction price. Estimates of variable consideration and determination of whether to include estimated amounts in the transaction price are based largely on an assessment of the anticipated performance and all information (historical, current and forecasted) that is reasonably available.

Returns for products sold are estimated using the expected value method and are recorded as a reduction in reported revenues at the time of sale based upon historical product return experience and is adjusted for known trends to arrive at the amount of consideration to which the Company expects to receive. Estimated amounts are included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved.

Warranties

The Company offers a standard product warranty to customers of its memory subsystem products and has no other post-shipment obligations. Our liability associated with this warranty is, at our option, to repair the product, replace the product, or provide the customer with a credit.

The Company establishes provisions for estimated warranties. Estimated future warranty costs are recorded in the period in which the sale is recorded and are included in “Cost of sales.” The Company calculates its accrual requirements based on historic warranty loss experience that is periodically adjusted for recent actual experience, including the timing of claims during the warranty period and actual costs incurred.

The Company does not offer separately priced extended warranty or product maintenance contracts.

Contract Assets

Typically, we invoice the customer and recognize revenue once we have satisfied our performance obligation. Accordingly, our contract assets comprise accounts receivable. Generally, we do not have material amounts of other contract assets since revenue is recognized as control of goods is transferred or as services are performed.

Table of Contents

Contract Liabilities (Deferred Revenue)

Contract liabilities are recorded when cash payments are received in advance of the Company's performance. There were no such contract liabilities (deferred revenue) as of June 30, 2018.

Practical Expedients and Exemptions

We have elected the following practical expedients allowed under Topic 606:

- Payment terms with our customers, which are one year or less, are not considered a significant financing component.
- Shipping and handling fees and costs incurred in connection with products sold are recorded in cost of sales and are not considered a performance obligation to our customers.
- Our performance obligations on our orders are generally satisfied within one year from a given reporting date and, therefore, we omit disclosure of the transaction price allocated to remaining performance obligations on open orders.
- The Company expenses incremental direct costs of obtaining a contract (sales commissions) when incurred because the amortization period is generally 12 months or less. The Company does not incur costs to fulfill a customer contract that meet the requirements for capitalization.
- The Company has applied the portfolio approach to its ship-and-bill contracts that have similar characteristics as it reasonably expects that the effects on the financial statements of applying this guidance to the portfolio of contracts would not differ materially from applying this guidance to the individual contracts within the portfolio.

Note 4—Supplemental Financial Information

Inventories

Inventories consisted of the following as of the dates presented: