

SOCKET MOBILE, INC.  
Form 10-Q  
November 04, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 1-13810

**SOCKET MOBILE, INC.**

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(Exact name of registrant as specified in its charter)

**Delaware**                      **94-3155066**  
(State of incorporation) (IRS Employer Identification No.)

**39700 Eureka Drive, Newark, CA 94560**  
(Address of principal executive offices including zip code)

**(510) 933-3000**  
(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 [ X ] NO [ ]

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The number of shares of Common Stock (\$0.001 par value) outstanding as of October 31, 2016 was 5,864,505 shares.

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Index**PART I****Item 1. Financial Statements****SOCKET MOBILE, INC.**  
**STATEMENTS OF INCOME**  
(Unaudited)

|                                      | Three Months Ended    |             | Nine Months Ended     |              |
|--------------------------------------|-----------------------|-------------|-----------------------|--------------|
|                                      | September 30,<br>2016 | 2015        | September 30,<br>2016 | 2015         |
| Revenues                             | \$5,102,130           | \$4,517,898 | \$15,357,658          | \$13,008,895 |
| Cost of revenues                     | 2,472,315             | 2,279,922   | 7,641,852             | 6,848,312    |
| Gross profit                         | 2,629,815             | 2,237,976   | 7,715,806             | 6,160,583    |
| Operating expenses:                  |                       |             |                       |              |
| Research and development             | 704,335               | 576,284     | 2,102,466             | 1,701,619    |
| Sales and marketing                  | 694,061               | 609,666     | 2,063,585             | 1,837,240    |
| General and administrative           | 513,114               | 450,783     | 1,652,218             | 1,520,335    |
| Total operating expenses             | 1,911,510             | 1,636,733   | 5,818,269             | 5,059,194    |
| Operating income                     | 718,305               | 601,243     | 1,897,537             | 1,101,389    |
| Interest expense                     | (28,970 )             | (63,483 )   | (102,380 )            | (218,152 )   |
| Net income before income taxes       | 689,335               | 537,760     | 1,795,157             | 883,237      |
| Income tax expense                   | (20,285 )             | (7,985 )    | (60,855 )             | (23,955 )    |
| Net income                           | \$669,050             | \$529,775   | \$1,734,302           | \$859,282    |
| Net income per share:                |                       |             |                       |              |
| Basic                                | \$0.11                | \$0.10      | \$0.30                | \$0.16       |
| Diluted                              | \$0.10                | \$0.09      | \$0.27                | \$0.14       |
| Weighted average shares outstanding: |                       |             |                       |              |
| Basic                                | 5,842,609             | 5,560,197   | 5,769,981             | 5,539,766    |

|         |           |           |           |           |
|---------|-----------|-----------|-----------|-----------|
| Diluted | 6,924,255 | 5,980,382 | 6,849,988 | 5,959,951 |
|---------|-----------|-----------|-----------|-----------|

See accompanying notes.

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BALANCE SHEETS

|  | September 30,<br>2016 | December 31,<br>2015 |
|--|-----------------------|----------------------|
|  | (Unaudited)           |                      |
| <b>ASSETS</b>  |                       |                      |
| Current assets:  |                       |                      |
| Cash and cash equivalents                                    | \$1,146,113           | \$938,155            |
| Accounts receivable, net                                     | 2,653,824             | 2,358,883            |
| Inventories, net   | 1,139,615             | 1,326,090            |
| Prepaid expenses and other current assets                    | 227,502               | 87,556               |
| Total current assets   | 5,167,054             | 4,710,684            |
| Property and equipment:                                      |                       |                      |
| Machinery and office equipment                               | 2,175,962             | 2,124,297            |
| Computer equipment   | 1,006,144             | 1,049,234            |
|  | 3,182,106             | 3,173,531            |
| Accumulated depreciation                                     | (2,677,928 )          | (2,698,828 )         |
| Property and equipment, net                                  | 504,178               | 474,703              |
| Goodwill   | 4,427,000             | 4,427,000            |
| Other assets   | 75,918                | 75,918               |
| Total assets   | \$10,174,150          | \$9,688,305          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                  |                       |                      |
| Current liabilities:   |                       |                      |
| Accounts payable and accrued expenses                        | \$1,575,164           | \$2,214,467          |
| Accrued payroll and related expenses                         | 562,129               | 602,888              |
| Net deferred revenue on shipments to distributors            | 1,025,584             | 1,004,260            |
| Customer deposit   | —                     | 640,440              |
| Related party and other short term credit line notes payable | —                     | 500,000              |
| Related party convertible notes payable-current portion      | 752,625               | 380,696              |
| Short term portion of deferred service revenue               | 57,507                | 85,578               |
| Short term portion of capital leases and deferred rent       | 34,465                | 24,440               |
| Total current liabilities                                    | 4,007,474             | 5,452,769            |
| Related party convertible notes payable                      | —                     | 371,929              |
| Long term portion of deferred service revenue                | 30,179                | 39,800               |
| Long term portion of capital leases and deferred rent        | 339,185               | 305,016              |
| Deferred income taxes  | 199,168               | 175,214              |

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|  |              |              |
|--|--------------|--------------|
| Total liabilities  | 4,576,006    | 6,344,728    |
| Commitments and contingencies  |              |              |
| Stockholders' equity:  |              |              |
| Common stock, \$0.001 par value: Authorized – 20,000,000 shares,<br>Issued and outstanding – 5,842,945 shares at September 30, 2016 and 5,620,455<br>shares at December 31, 2015 | 5,843        | 5,620        |
| Additional paid-in capital   | 62,730,884   | 62,210,842   |
| Accumulated deficit  | (57,138,583) | (58,872,885) |
| Total stockholders' equity   | 5,598,144    | 3,343,577    |
| Total liabilities and stockholders' equity   | \$10,174,150 | \$9,688,305  |

See accompanying notes.



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**SOCKET MOBILE, INC.**  
**STATEMENTS OF CASH FLOWS**  
(Unaudited)

|   | Nine Months Ended<br>September 30, |            |
|---|------------------------------------|------------|
|   | 2016                               | 2015       |
| Operating activities  |                                    |            |
| Net income  | \$ 1,734,302                       | \$ 859,282 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |            |
| Stock-based compensation  | 244,052                            | 151,924    |
| Depreciation and amortization   | 209,707                            | 149,069    |
| Deferred income tax expense   | 23,954                             | 23,955     |
| Changes in operating assets and liabilities:                                      |                                    |            |
| Accounts receivable   | (294,941 )                         | (425,529 ) |
| Inventories   | 186,475                            | (14,795 )  |
| Prepaid expenses and other current assets   | (139,946 )                         | 37,691     |
| Other assets  | —                                  | (5,000 )   |
| Accounts payable and accrued expenses   | (639,303 )                         | (805,158 ) |
| Accrued payroll and related expenses  | (40,759 )                          | (10,758 )  |
| Net deferred revenue on shipments to distributors                                 | 21,324                             | 109,159    |
| Customer deposit  | (640,440 )                         | 800,510    |
| Deferred service revenue  | (37,692 )                          | (62,199 )  |
| Change in deferred rent   | 4,890                              | 16,611     |
| Net cash provided by operating activities   | 631,623                            | 824,762    |
| Investing activities  |                                    |            |
| Purchases of equipment  | (175,080 )                         | (278,302 ) |
| Net cash used in investing activities   | (175,080 )                         | (278,302 ) |
| Financing activities  |                                    |            |
| Payments on capital leases  | (24,798 )                          | (17,635 )  |
| Proceeds from borrowings under bank line of credit agreement                      | 350,000                            | 136,805    |
| Repayments of borrowings under bank line of credit agreement                      | (350,000 )                         | (539,574 ) |
| Repayments of related party and other short term credit line notes payable        | (500,000 )                         | (100,000 ) |
| Stock options exercised   | 118,068                            | 72,133     |
| Warrants exercised  | 158,145                            | 131,250    |
| Net cash used in financing activities   | (248,585 )                         | (317,021 ) |
| Net increase in cash and cash equivalents   | 207,958                            | 229,439    |

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|  |             |           |
|--|-------------|-----------|
| Cash and cash equivalents at beginning of period                       | 938,155     | 632,631   |
| Cash and cash equivalents at end of period                             | \$1,146,113 | \$862,070 |
| Supplemental disclosure of cash flow information                       |             |           |
| Cash paid for interest   | \$12,873    | \$115,430 |
| Supplemental disclosure of non-cash investing and financing activities |             |           |
| Equipment purchased under capital lease                                | \$64,101    | \$—       |
| Cashless exercise of warrants  | \$35        | \$—       |

See accompanying notes.

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**SOCKET MOBILE, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1 — Basis of Presentation**

The accompanying unaudited financial statements of Socket Mobile, Inc. (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring accruals considered necessary for fair presentation have been included. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future period. These financial statements should be read in conjunction with the audited financial statements and notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

**NOTE 2 — Summary of Significant Accounting Policies**

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates, and such differences may be material to the financial statements.

*Cash Equivalents and Fair Value of Financial Instruments*

The Company considers all highly liquid investments purchased with an original maturity date of three months or less at date of purchase to be cash equivalents. At September 30, 2016 and December 31, 2015, all of the Company’s cash and cash equivalents consisted of amounts held in demand deposits in banks. The aggregate cash balance on deposit in these accounts is insured by the Federal Deposit Insurance Corporation up to \$250,000. The Company’s cash balance on deposit in these accounts may, at times, exceed the federally insured limits. The Company has never experienced any losses in such accounts.

The carrying value of the Company's cash and cash equivalents, accounts receivable, accounts payable, debt and foreign exchange contracts approximate fair value due to the relatively short period of time to maturity.

Index**SOCKET MOBILE, INC.****NOTES TO FINANCIAL STATEMENTS****(Unaudited)****NOTE 3 — Inventories**

Inventories consist principally of raw materials and sub-assemblies, which are stated at the lower of cost (first-in, first-out) or market. Inventories at September 30, 2016 and December 31, 2015 were as follows:

|                                  | September<br>30,<br>2016 | December<br>31,<br>2015 |
|----------------------------------|--------------------------|-------------------------|
| Raw materials and sub-assemblies | \$2,294,799              | \$2,521,585             |
| Finished goods                   | 46,832                   | 39,083                  |
| Inventory reserves               | (1,202,016)              | (1,234,578)             |
| Inventories, net                 | \$1,139,615              | \$1,326,090             |

**NOTE 4 — Short Term Related Party Convertible Notes Payable**

The balance of short term convertible notes payable to officers and directors of the company is \$752,625 at September 30, 2016. \$380,696 of these notes have an original term of four years that accrue interest at 8% per annum compounded quarterly, mature on September 4, 2017, and have a note holder call provision. \$371,929 of these notes, previously classified as long term, are classified as a current liability as of September 30, 2016 as they now mature within one year on September 4, 2017, have an original term of four years that accrue interest at 18% per annum compounded quarterly through March 30, 2016 and at 12% thereafter, and do not have a note holder call provision. Accrued interest for all convertible notes was \$354,227 and \$265,387 at September 30, 2016 and December 31, 2015, respectively and was included in Accounts Payable and Accrued Expenses. Interest expense for the three and nine months ended September 30, 2016 was \$27,836 and \$89,507, respectively. Interest expense for the three and nine months ended September 30, 2015 was \$32,130 and \$91,945, respectively. The notes and accrued interest are convertible into common stock at the option of the holder at \$1.25 per share. The convertible notes are secured by all of the assets of the Company and are subordinated to amounts outstanding under the Company's working capital bank

line of credit with the Company's bank.

**NOTE 5 — Related Party and Other Short Term Credit Line Notes Payable**

On May 15, 2014, the Company's Board of Directors approved the issue of subordinated line of credit notes totaling \$650,000 to replace subordinated line of credit notes in the same amount maturing on June 1, 2014. The replacement subordinated notes were two-year notes maturing on June 1, 2016, were repayable by the Company at any time and had an interest rate of 18% per annum payable monthly in cash. Notes payable of \$500,000 were outstanding at December 31, 2015. On January 29, 2016, the Company completed repayment of all outstanding credit line notes to the note holders. Interest expense for 2016 related to the line of credit was \$7,645. Interest expense for the three and nine month periods ended September 30, 2015 related to the line of credit were \$24,214 and \$77,770, respectively.

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**SOCKET MOBILE, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 6 — Bank Financing Arrangements**

On February 26, 2016, the Company completed a Business Financing Modification Agreement by and between the Company and Western Alliance Bank (the “Bank”) to extend the expiration date of the revolving credit lines for both domestic and international portions to February 27, 2018. Under the terms of the credit facility agreement with the Bank, the Company may borrow up to \$2.5 million, of which up to \$2.0 million is based on qualified receivables from domestic customers and up to \$0.5 million is based on qualified receivables from international customers. In addition, the Company must maintain a minimum liquidity ratio calculated at the end of each month of quick assets (cash plus qualified accounts receivable) to outstanding obligations to the Bank not less than 1.75 to 1.0. Advances against the domestic and international lines are calculated at 70% of qualified receivables. Borrowings under the lines bear an annual interest rate equal to the Bank’s prime rate (minimum of 3.25%) plus 1.5%. There is also a collateral handling fee of 0.1% per month of the financed receivables outstanding. The applicable interest and fees are calculated based on the actual amounts borrowed. The borrowings under the credit facility are secured by a first priority security interest in the assets of the Company. All advances are at the Bank’s discretion and the Bank is not obligated to make advances. The agreement may be terminated by the Company or by the Bank at any time. At September 30, 2016, there were no amounts borrowed, and the total borrowing capacity was approximately \$1,698,000.

Total interest expense on the amounts drawn under the Company’s bank credit lines in effect during the three and nine months ended September 30, 2016, was zero and \$3,000, respectively. Total interest expense on the amounts drawn under the Company’s bank credit lines in effect during the three and nine months ended September 30, 2015, was \$6,373 and \$35,562, respectively.

**NOTE 7 — Segment Information and Concentrations**

*Segment Information*

The Company operates in one segment—mobile systems solutions for businesses. Mobile systems solutions typically consist of mobile devices such as smartphones or tablets, some with data collection peripherals, and third-party vertical applications software. The Company markets its products in the United States and foreign countries through two-tier distribution. Revenues for the geographic areas for three and nine months ended September 30, 2016 and 2015 were as follows:

|                        | Three Months Ended |             | Nine Months Ended |              |
|------------------------|--------------------|-------------|-------------------|--------------|
|                        | September 30,      |             | September 30,     |              |
|                        | 2016               | 2015        | 2016              | 2015         |
| Revenues:              |                    |             |                   |              |
| United States          | \$4,030,547        | \$3,698,721 | \$12,308,704      | \$10,107,697 |
| Europe                 | 821,782            | 519,765     | 2,237,439         | 1,919,880    |
| Asia and rest of world | 249,801            | 299,412     | 811,515           | 981,318      |
| Total revenues         | \$5,102,130        | \$4,517,898 | \$15,357,658      | \$13,008,895 |



Index**SOCKET MOBILE, INC.****NOTES TO FINANCIAL STATEMENTS****(Unaudited)**

Export revenues are attributable to countries based on the location of the Company's customers. The Company does not hold long-lived assets in foreign locations.

*Major Customers*

Customers who accounted for at least 10% of the Company's total revenues in the three and nine month periods ended September 30, 2016 and 2015 were as follows:

|                         | Three<br>Months<br>Ended |                          | Nine<br>Months<br>Ended  |                          |
|-------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
|                         | September<br>30,<br>2016 | September<br>30,<br>2015 | September<br>30,<br>2016 | September<br>30,<br>2015 |
| Ingram Micro Inc.       | 29%                      | 30%                      | 27%                      | 29%                      |
| BlueStar, Inc.          | 21%                      | 27%                      | 23%                      | 23%                      |
| ScanSource, Inc.        | 19%                      | 19%                      | 16%                      | 20%                      |
| Spinal Modulation, Inc. | *                        | *                        | 10%                      | *                        |

\* Customer accounted for less than 10% of total revenues for the period

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to significant concentrations of credit risk include cash, cash equivalents and accounts receivable. The Company invests its cash in demand deposit accounts in banks. To date, the Company has not experienced losses on the investments. The Company's trade accounts receivables are primarily with distributors. The Company performs ongoing credit evaluations of its customers' financial condition but the Company generally requires no collateral. Reserves are maintained for potential credit losses, and such losses have been within management's expectations. Customers who accounted for at least 10% of the Company's accounts receivable balances at September 30, 2016 and December 31, 2015 were as follows:

|                        | September<br>30,<br>2016 | December<br>31,<br>2015 |
|------------------------|--------------------------|-------------------------|
| Ingram Micro Inc.      | 27 %                     | 35 %                    |
| ScanSource, Inc.       | 22 %                     | 17 %                    |
| BlueStar, Inc.         | 21 %                     | 22 %                    |
| ScanSource Europe SPRL | 11 %                     | *                       |

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\* Customer accounted for less than 10% of total accounts receivable balance at period end

### *Concentration of Suppliers*

Several of the Company's component parts are produced by a sole or limited number of suppliers. Shortages could occur in these essential materials due to increased demand, or to an interruption of supply. Suppliers may choose to restrict credit terms or require advance payments causing delays in the procurement of essential materials. If the Company were unable to procure certain of such materials, it could have a material adverse effect upon its results. At September 30, 2016, 28% of the Company's accounts payable balances was concentrated in the top two suppliers. For the nine months ended September 30, 2016, these two suppliers accounted for 62% of the inventory purchases.

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The Company recognizes the compensation cost in the financial statements for all stock-based awards to employees, including grants of employee stock options, based on the fair value of the awards as of the date that the awards are issued. The fair values of stock options are generally determined using a binomial lattice valuation model that incorporates assumptions about expected volatility, risk-free interest rate, dividend yield, and expected life. Compensation cost for stock-based awards is recognized on a straight-line basis over the vesting period. Total stock-based compensation expense for the three and nine months ended September 30, 2016, was \$93,230 and \$244,052, respectively. Total stock-based compensation expense for the three and nine months ended September 30, 2015 was \$55,470 and \$151,924, respectively. In the three and nine months ended September 30, 2016, 28,800 and 329,300 stock options were granted at weighted average per share fair values estimated at \$1.94 and \$1.93, respectively.

**NOTE 9 — Net Income Per Share Applicable to Common Stockholders**

The following table sets forth the computation of basic and diluted net income per share:

|  | Three Months Ended    |            | Nine Months Ended     |            |
|--|-----------------------|------------|-----------------------|------------|
|  | September 30,<br>2016 | 2015       | September 30,<br>2016 | 2015       |
| Numerator:   |                       |            |                       |            |
| Net income   | \$ 669,050            | \$ 529,775 | \$ 1,734,302          | \$ 859,282 |
| Convertible note interest  | \$ 27,836             | —          | \$ 89,507             | —          |
| Adjusted diluted net income  | \$ 696,886            | \$ 529,775 | \$ 1,823,809          | \$ 859,282 |
| Denominator:   |                       |            |                       |            |
| Weighted average common shares outstanding used in computing net income per share: |                       |            |                       |            |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Basic   | 5,842,609 | 5,560,197 | 5,769,981 | 5,539,766 |
| Effect of dilutive stock options and warrants (treasury stock method) | 1,081,646 | 420,185   | 1,080,007 | 420,185   |
| Diluted   | 6,924,255 | 5,980,382 | 6,849,988 | 5,959,951 |
| Net income per share:   |           |           |           |           |
| Basic   | \$0.11    | \$0.10    | \$0.30    | \$0.16    |
| Diluted   | \$0.10    | \$0.09    | \$0.27    | \$0.14    |

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**SOCKET MOBILE, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 10 — Taxes**

The Company has recorded a provision for income taxes of \$20,285 and \$7,985 for the three months ended September 30, 2016 and 2015, respectively, and \$60,855 and \$23,955 for the nine-month periods ended September 30, 2016 and 2015, respectively. The provisions for income tax for 2016 include federal alternative minimum tax expense of \$27,750, state alternative minimum tax expense of \$9,150, and deferred tax expense of \$23,954. The deferred tax expense and the deferred income tax amounts shown on the Company's Balance Sheets are related to the deferred tax liability on the portion of the Company's goodwill amortized for tax purposes. Due to the indefinite characteristic of this deferred tax liability, it cannot be offset against deferred tax assets.

At December 31, 2015, the Company has an unrecognized tax benefit of approximately \$754,000, which did not change significantly during the nine months ended September 30, 2016. Future changes in the unrecognized tax benefit are unlikely to have an impact on the effective tax rate due to the full valuation allowance recorded on the Company's deferred tax assets, as realization of the deferred tax assets is dependent upon future taxable income.

The Company has maintained a full valuation allowance for all deferred tax assets due to negative evidence outweighing the positive evidence. The primary negative evidence includes the Company's history of losses, the phase out of the SoMo® product line with diminishing revenue for 2016, and no contractual commitment assuring future net income. However, the Company's short term trend of net income for the last two years allows for the possible reversal of existing taxable temporary differences. If the Company continues to remain profitable and determines that the positive evidence outweighs the negative evidence, projected future taxable income could be included in the evaluation.

**NOTE 11 — Commitments and Contingencies**

*Operating Lease*

The Company leases office space under a non-cancelable operating lease that provides the Company approximately 37,100 square feet in Newark, California. The lease agreement expires on June 30, 2022. Monthly base rent increases four percent per year annually on July 1<sup>st</sup> of each year. Rental expense was \$109,004 and \$327,049 for the three and

nine month periods ended September 30, 2016, respectively. Rental expense was \$107,352 and \$321,950 for the three and nine month periods ended September 30, 2015, respectively. The Company recorded a deferred rent obligation in accrued liabilities in the amount of \$287,944 and \$283,053 at September 30, 2016 and December 31, 2015, respectively.

Index**SOCKET MOBILE, INC.****NOTES TO FINANCIAL STATEMENTS****(Unaudited)**

Future minimum lease payments under the operating lease at September 30, 2016 are shown below:

| Annual minimum payments:                    | Amount      |
|---|-------------|
| 2016 (October 1, 2016 to December 31, 2016) | \$104,251   |
| 2017  | 425,345     |
| 2018  | 442,359     |
| 2019  | 460,053     |
| 2020 to 2022                                | 1,229,724   |
| Total minimum payments                      | \$2,661,732 |

*Capital Lease Obligations*

The Company leases certain of its equipment under capital leases. The leases are collateralized by the underlying assets. At September 30, 2016 and December 31, 2015, property and equipment with a cost of \$100,584 and \$124,427, respectively, were subject to such financing arrangements. The accumulated depreciation of the assets associated with the capital leases as of September 30, 2016 and December 31, 2015, amounted to \$16,167 and \$80,150 respectively.

Future minimum payments under capital lease and equipment financing arrangements as of September 30, 2016 are as follows:

| Annual minimum payments:                    | Amount   |
|---|----------|
| 2016 (October 1, 2016 to December 31, 2016) | \$7,409  |
| 2017  | 30,048   |
| 2018  | 27,607   |
| 2019  | 18,635   |
| 2020  | 9,545    |
| Total minimum payments                      | 93,244   |
| Less amount representing interest           | (7,537 ) |
| Present value of net minimum payments       | 85,707   |

|                                      |          |
|--------------------------------------|----------|
| Short term portion of capital leases | (26,123) |
| Long term portion of capital leases  | \$59,584 |

*Purchase Commitments*

As of September 30, 2016, the Company has non-cancelable purchase commitments for inventory to be used in the ordinary course of business of approximately \$2,873,000.

*Legal Matters*

The Company is subject to disputes, claims, requests for indemnification and lawsuits arising in the ordinary course of business. Under the indemnification provisions of the Company's customer agreements, the Company routinely agrees to indemnify and defend its customers against infringement of any patent, trademark, copyright, trade secrets, or other intellectual property rights arising from customers' legal use of the Company's products or services. The exposure to the Company under these indemnification provisions is generally limited to the total amount paid for the indemnified products. However, certain indemnification provisions potentially expose the Company to losses in excess of the aggregate amount received from the customer. To date, there have been no claims against the Company by its customers pertaining to such indemnification provisions, and no amounts have been recorded. The Company is currently not a party to any material legal proceedings.



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**SOCKET MOBILE, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(Unaudited)**

*Recently Issued Financial Accounting Standards*

In May 2014, the FASB issued authoritative guidance amending the FASB Accounting Standards Codification and creating a new Topic 606, Revenue from Contracts with Customers. The new guidance clarifies the principles for recognizing revenue and develops a common revenue standard for U.S. GAAP applicable to revenue transactions. This guidance provides that an entity should recognize revenue to depict the transfer of promised 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. The existing industry guidance will be eliminated when the new guidance becomes effective and annual disclosures will be substantially revised. Additional disclosures will also be required under the new standard. In July 2015, the FASB approved a proposal that extended the required implementation date one year to the first quarter of 2018 but also would permit companies to adopt the standard at the original effective date of 2017. Implementation may be either through retrospective application to each period from the first quarter of 2017 or with a cumulative effect adjustment upon adoption in 2018. In April 2016, the FASB issued amendments, ASU No. 2016-10, that clarify the following two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance, while retaining the related principles for those areas. The standard should be adopted concurrently with adoption of ASU No. 2014-09 which is effective for annual and interim periods beginning after December 15, 2017 with early adoption permitted. We are still assessing the impact of this new standard but anticipate to apply a cumulative effects adjustment on January 1, 2017. Going forward, we will recognize revenue upon shipment less an allowance for estimated returns.

From time to time, new accounting pronouncements are issued by the FASB or other standards setting bodies that are adopted by the Company as of the specified effective date. Unless otherwise discussed, management believes that the impact of recently issued standards that are not yet effective will not have a material impact on the Company's financial position, results of operations or cash flows.



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**Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

*This Quarterly Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include statements forecasting our future financial condition and results, our future operating activities, market acceptance of our products, expectations for general market growth of mobile data capture devices, growth in demand for our barcode scanning products, expansion of the markets that we serve, expansion of the distribution channels for our products, adoption of our embedded products by third-party manufacturers of electronic devices, and the timing of the introduction and availability of new products, as well as other forecasts discussed under “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Words such as “may,” “will,” “predicts,” “anticipates,” “expects,” “intends,” “plans,” “believes,” “seeks,” “estimates,” variations of such words, and similar expressions are intended to identify such forward-looking statements. Such forward-looking statements are based on current expectations, estimates, and projections about our industry, management’s beliefs, and assumptions made by management. These forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results and outcomes may differ materially from what is expressed or forecasted in any such forward looking statements. Factors that could cause actual results and outcomes to differ materially include, but are not limited to: weakness in the world economy generally and in the markets we serve in particular; the risk of delays in the availability of our products due to technological, market or financial factors including the availability of product components and necessary working capital; our ability to successfully develop, introduce and market future products; our ability to effectively manage and contain our operating costs; the availability of third-party hardware and software that our products are intended to work with; product delays associated with new model introductions and product changeovers by the makers of products that our products are intended to work with; continued growth in demand for barcode scanners; market acceptance of emerging standards such as RFID/Near Field Communications and of our related data capture products; the ability of our strategic relationships to benefit our business as expected; our ability to enter into additional distribution relationships; or other factors described in this Form 10-Q including “Item 1A. Risk Factors” and recent Form 8-K and Form 10-K reports filed with the Securities and Exchange Commission. We assume no obligation to update such forward-looking statements or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.*

*You should read the following discussion in conjunction with the interim financial statements and notes included elsewhere in this report, the Company’s annual financial statements in the form 10-K, and other information contained in other reports and documents filed from time to time with the Securities and Exchange Commission.*

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The Company

We are a leading producer of data capture products for the worldwide business mobility markets. Our products are incorporated into mobile applications used in mobile point of sale (mPOS), hospitality, asset management, commercial services, healthcare and other mobile business markets. Our primary products are cordless barcode scanners that connect over Bluetooth and work with applications running on smartphones, mobile computers and tablets using operating systems from Apple® (iOS), Google™ (Android™) and Microsoft® (Windows®/Windows Mobile™). We offer an easy-to-use software developer kit (SDK) to mobile application developers to enable the use of our products with their applications. Our products become an ingredient of the application solution and our products are marketed by the application developer or their resellers as part of that solution.

We offer barcode scanning products for both 1D (imager and laser) and 2D barcode scanning in standard and durable cases. Our 7 Series barcode scanners are lightweight and ergonomically designed for easy handling as a stand-alone cordless barcode scanner. Our 7 Series standard cases come in six vivid colors and our 7 Series durable barcode scanners are designed for use in environments needing a more durable barcode scanner. Our 8 Series cordless barcode scanners in linear imaging and 2D models are designed to be attachable to smartphones for one-handed barcode scanning and can also be used in handheld mode. During the third quarter, we expanded our product line with the introduction of a new family of products. These include our Durascan 2D version D750 and laser barcode scanners D730 and our upcoming 1D version D700 releasing in Q4 2016. These products were designed with a weatherproof IP54 rating and level of durability and usability to match the specific demands of the mobile point of sale, manufacturing, field service, and transportation markets. We also began shipping our new Duracase solution which creates a flexible, sled-based, onehanded barcode scanner that combines one of our 800 series 1D or 2D attachables with an iPod Touch. This is a scanning solution that is designed to work together, charge together, and stay together as one unit in a single-handed package. Variations of our Duracase for Android devices are already in development for release early next year. These products are expected to add to our revenue in 2017.

Many smartphones and tablets now offer Near Field Communications (“NFC”), and RFID technology along with digital wallet applications for loyalty cards, identification cards, payment cards, coupons, event tickets and others which leverage the exchange of electronic “tokens”. These tokens can be exchanged through another NFC enabled device. We are incorporating an NFC reader/writer into the base of a retail accessory stand that today enables customers to scan barcoded documents. The NFC reader/writer may also be used as a stand-alone base. In addition, we are developing a handheld NFC reader/writer for similar purposes. We are working with our registered developers to encourage them to include Near Field Communications capabilities in their mobile applications.

Our Software Developer Kit (“SDK”) supports all of our barcode scanners with a single installation, making it easy for a developer to integrate our data capture capabilities while giving the customer the ability to select the products that work best for them. We also support using the built-in camera in a customer’s smartphone or tablet for lower volume data capture requirements. When a developer builds in our SDK, a customer can edit and direct the placement in their application of collected data while also receiving feedback that the collection of data was successfully completed.



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We design our own products and test product components obtained from third party contract manufacturers. We perform final product assembly, test, package, and distribute our products at and from our Newark, California facility. We offer our products worldwide through two-tier distribution enabling customers to purchase from a large number of on-line resellers around the world including application developers who resell their own products along with our data capture products. We believe growth in mobile applications and the mobile workforce are resulting from technical advances in mobile technologies, cost reductions in mobile devices and the growing adoption by businesses of mobile applications, building a growing demand for our products. Our data capture products address the growing need for speed and accuracy by today's mobile workers and by the systems supporting those workers, thereby enhancing their productivity and allowing them to exploit time sensitive opportunities and improve customer satisfaction.

## **Products**

### *Cordless barcode scanners*

We offer a family of cordless barcode scanning products that connect over Bluetooth with smartphones, tablets and mobile computers running operating systems from Apple (iOS), Google (Android), and Microsoft (Windows/Windows Mobile). Our cordless barcode scanners include two dimensional (2D) and linear (1D laser and 1D imager) barcode scanners in both colorful standard cases and durable cases. Our series 7 standard models in six vivid colors are lightweight and ergonomically designed for extended use as handheld barcode scanners. Our new DuraScan family of products were designed with a weatherproof IP54 rating for use in wet, dusty or harsher environments. During the third quarter, we shipped the 2D model DuraScan D750, which was introduced at the end of the second quarter, and began shipping our laser DuraScan D730 model near the quarter end. We also began shipping our new Duracase solution which creates a flexible, sled-based, onehanded barcode scanner that combines one of our 800 series 1D or 2D attachables with an iPod Touch. This is a scanning solution that is designed to work together, charge together, and stay together as one unit in a single-handed package. Extended warranty programs are available for all of our barcode scanning products.

### *Mobile handheld computers*

Through June 30, 2016, we offered a family of SoMo® (“Socket® Mobile”) handheld computer products with standard or antimicrobial cases running the Windows Embedded Handheld System 6.5 operating system. Handheld computer accessories included plug-in 1D and 2D barcode scanners, charging cradles, durable cases, and radio frequency identification (RFID) readers with NFC (near field communication). Our handheld computers were designed with wireless LAN (802.11 b/g/n) and Bluetooth connectivity for use with applications that did not require phones. Due to the technical obsolescence of key components, we phased out this product family in Q2 2016 and exhausted the remaining SoMo® units in Q3 2016.

### *Service*

Our products are warranted for one year and we offer SocketCare extended warranty programs for up to five years including repair or replacement due to accidental breakage. We also repair or replace products that are beyond their warranty period.

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Total revenue for the third quarter of 2016 was \$5.1 million, an increase of thirteen percent compared to revenue of \$4.5 million for the same quarter a year ago. For the nine months ended September 30, 2016, revenue was \$15.4 million, compared to revenue of \$13.0 million in the comparable period one year ago. Our product revenues and the corresponding increase or decrease in revenues for the comparable periods are shown in the following table:

| (revenues in thousands)                                | Three Months Ended |         |            |    | Nine Months Ended |          |            |   |
|--|--------------------|---------|------------|----|-------------------|----------|------------|---|
|  | September 30,      |         | Increase   |    | September 30,     |          | Increase   |   |
| Product family:  | 2016               | 2015    | (Decrease) | %  | 2016              | 2015     | (Decrease) | % |
| Cordless barcode scanners and accessories              | \$4,635            | \$4,029 | 15         | %  | \$12,669          | \$11,433 | 11         | % |
| Mobile handheld computer, accessories and license fees | 400                | 379     | 6          | %  | 2,329             | 1,239    | 88         | % |
| Services   | 67                 | 110     | (39        | %) | 360               | 337      | 7          | % |
| Total  | \$5,102            | \$4,518 | 13         | %  | \$15,358          | \$13,009 | 18         | % |

Revenue of our *cordless barcode scanners and accessories* increased by 15% or \$0.6 million in the third quarter of 2016, compared to the same quarter a year ago. Revenue increase of \$0.5 million was from increased sales volumes of our cordless handheld barcode scanners. These scanners consist of entry level linear imagers, 2D, and laser barcode scanners. Revenue increase of \$0.2 million was from our attachable barcode scanners. Our attachable scanners consist of linear imager and 2D scanners. The revenue from our scanning accessories decreased \$0.1 million.

Revenue of *cordless barcode scanners and accessories* for the nine months ended September 30, 2016 was \$12.7 million, an increase of 11% or \$1.2 million compared to the revenue of \$11.4 million in the same period a year ago. Revenue increase of \$1.1 million was from increased sales volumes of our cordless handheld barcode scanners. Revenue increase of \$0.2 million was from our attachable barcode scanners. The revenue from scanning accessories decreased \$0.1 million.

The product family of *Mobile handheld computer* was phased out in Q2 2016. Revenue of *mobile handheld computer, accessories and license fees* in the nine months ended September 30, 2016 included a last buy order and a



one-time license fees from one of our legacy SoMo® customers. Other than the last time buy order and the one-time license fees, sales of our *mobile handheld computer and accessories* in the three and nine months ended September 30, 2016 were \$150,000 and \$798,000, a decrease of 60% and 36% compared to revenues of \$379,000 and \$1,239,000 in the corresponding periods one year ago.

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*Service* revenues in the three and nine months ended September 30, 2016 were \$67,000 and \$360,000, compared to revenues of \$110,000 and \$337,000 in the corresponding periods one year ago. Our SocketCare service contracts are purchased by our customers in conjunction with the purchase of cordless barcode scanners and mobile handheld computers. We also repair or replace products that are beyond their warranty period.

Gross Margins

Our third quarter margin on sale was \$2.6 million or 51.5% of revenue compared to margin of 49.5% in the previous quarter and in the same quarter a year ago. The higher margin for the third quarter was due largely to the license fee revenue which has a zero cost component. Our margins continue to benefit from manufacturing efficiencies and engineering and component price reductions for our cordless barcode scanning products. We expect operating margins in the fourth quarter to remain in the 48% to 50% range.

**Research and Development Expense**

Research and development expense in the three and nine months ended September 30, 2016 were \$704,000 and \$2,102,000, an increase of 22% and 24% compared to expenses of \$576,000 and \$1,702,000 in the corresponding periods one year ago. Increase in the level of research and development expense was primarily due to higher personnel costs reflecting additions to headcount and our annual salary increases effective late Q1. Additional increases were from higher outside services and consulting and professional fees driven by the development costs for our new DuraScan and DuraCase products. Research and development expense for the fourth quarter of 2016 is expected to remain flat with the third quarter levels.

**Sales and Marketing Expense**

Sales and marketing expense in the three and nine months ended September 30, 2016 were \$694,000 and \$2,064,000, an increase of 14% and 12% compared to expense of \$610,000 and \$1,837,000 in the corresponding periods one year ago. Increases in sales and marketing expense were primarily due to the higher personnel costs reflecting our annual salary increases and from professional consulting services for European market development and management. Sales and marketing expense for the fourth quarter is expected to be similar to the third quarter.

**General and Administrative Expense**

General and administrative expense in the three and nine months ended September 30, 2016 were \$513,000 and \$1,652,000, an increase of 14% and 9% compared to the expenses of \$451,000 and \$1,520,000 in the same periods one year ago. Increases in the level of general and administrative expense were primarily due to higher personnel costs reflecting the effect of our annual salary increases for employees and a one-time NASDAQ listing application fee of \$50,000 in the second quarter. General and administrative expense is expected to slightly increase in the fourth quarter of 2016 from third quarter levels.

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**Interest Expense, Net of Interest Income**

Interest expense and other, net of interest income and other, in the three and nine months ended September 30, 2016 was \$29,000 and \$102,000, respectively, compared to \$63,000 and \$218,000, respectively, in the same periods one year ago. Interest expense in each of the comparable periods was related to interest on subordinated credit line, interest on subordinated convertible notes payable (see “NOTE 4 — Short Term Related Party Convertible Notes Payable” and “NOTE 5 — Related Party Short Term Notes Payable” for more information), interest on amounts drawn on our bank lines of credit, and interest on equipment lease financing obligations. Lower interest expense in both comparable three and nine months in 2016 reflects reduced debt balances outstanding during the period. Subordinated credit line (\$500K) was paid off at the end of January 2016. Average outstanding balances of bank credit line during the first nine months of 2016 and 2015 were \$78,000 and \$660,000, respectively.

Interest income reflects interest earned on cash balances. Interest income was nominal in each of the comparable periods, reflecting low average rates of return.

**Income Taxes**

We have recorded a provision for income taxes of \$60,855 and \$23,955 for the nine months ended September 30, 2016 and 2015. The provisions for income tax for 2016 include federal alternative minimum tax expense, state alternative minimum tax expense, and deferred tax expense. The deferred tax expense and the deferred income tax amounts shown on the Company’s Balance Sheets are related to the deferred tax liability on the portion of the Company’s goodwill amortized for tax purposes. Due to the indefinite characteristic of this deferred tax liability, it cannot be offset against deferred tax assets.

We have maintained a full valuation allowance for all deferred tax assets. We are subject to federal and state taxes on income, but have net operating loss carryforwards sufficient to offset taxable income. The utilization of the net operating loss could be subject to annual limitations due to the ownership change limitations provided by the Internal Revenue Code Section 382 and similar state provisions.

**Cash Flows and Contractual Obligations**

As reflected in our Statements of Cash Flows, net cash provided by operating activities was \$632,000 and \$825,000 in the first nine months of 2016 and 2015, respectively. We calculate net cash provided by operating activities by

increasing our net income (\$1,734,000 and \$859,000 in the first nine months of 2016 and 2015, respectively) or reducing our net loss by those expenses that did not require the use of cash. These items consist of stock based compensation expense, depreciation, amortization of intangible assets, and deferred tax expense. These amounts totaled \$478,000 and \$325,000 in the first nine months of 2016 and 2015, respectively. In addition, we report increases in assets and reductions in liabilities as uses of cash and decreases in assets and increases in liabilities as sources of cash, together referred to as changes in operating assets and liabilities.

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In the first nine months of 2016, changes in operating assets and liabilities resulted in a net use of cash of \$1,580,000 which was primarily from decreases in accounts payable due to improvement in paying outstanding balances with our suppliers, reductions of customer deposit applied to the shipments of the last time buy order for our mobile handheld computer product, and increases in accounts receivable and prepaid expenses. The uses of cash were partially offset by reductions in SoMo® inventory which has been phased out as end of life during 2016. In the first nine months of 2015, changes in operating assets and liabilities resulted in a net use of cash of \$359,000 and were primarily from decreases in accounts payable due to increased payments to suppliers and vendors, and increases in accounts receivable due to the higher level of shipments to distributors in the third quarter 2015 compared to the fourth quarter 2014. The uses of cash were partially offset by an \$800,000 deposit collected from the OEM customer who placed a \$1.6 million last time buy order for our mobile handheld computer product and increases of the inventory levels in our distribution channel.

In the first nine months of 2016, we used \$175,000 in investing activities related to expenditures on tooling and purchases of computer software and hardware. In the comparable period of 2015, we used \$278,000 in investing activities primarily related to a new accounting and operations management ERP software system and to expenditures on tooling.

In the first nine months of 2016, cash used in financing activities was \$249,000 which consisted primarily of repayment of \$500,000 on subordinated related party notes payable, offset by the proceeds from the exercise of warrants and stock options in the amount of \$276,000. In the first nine months of 2015, \$317,000 was used in financing activities which consisted of reduction of our bank credit line balance by \$403,000, repayment of \$100,000 on subordinated related party notes payable, and partially offset by proceeds from the exercise of warrants and stock options in the amount of \$203,000.

Our contractual cash obligations at September 30, 2016 are outlined in the table below:

|  | Total       | Payments Due by Period |                 |                 |                      |
|--|-------------|------------------------|-----------------|-----------------|----------------------|
|  |             | Less than<br>1 year    | 1 to 3<br>years | 4 to 5<br>years | More than<br>5 years |
| Contractual Obligations  |             |                        |                 |                 |                      |
| Unconditional purchase obligations with contract manufacturers | \$2,873,000 | \$2,873,000            | \$—             | \$—             | \$—                  |
| Operating leases   | 2,662,000   | 421,000                | 894,000         | 966,000         | 381,000              |
| Capital leases   | 86,000      | 26,000                 | 46,000          | 14,000          | —                    |
| Total contractual obligations                                  | \$5,621,000 | \$3,320,000            | \$940,000       | \$980,000       | \$381,000            |



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At September 30, 2016, we had outstanding a total of \$753,000 in subordinated convertible notes issued to select officers and directors of the Company. \$381,000 of these notes have an original term of four years that accrue interest at 8% per annum compounded quarterly, mature on September 4, 2017, and have a note holder call provision that became effective on September 4, 2014. \$372,000 of the notes have an original term of four years that accrue interest at 18% per annum compounded quarterly through March 30, 2016 and at 12% thereafter, mature on September 4, 2017, and do not have a call provision. Accrued interest for all convertible notes is payable in cash or convertible upon redemption at the holder's option. The notes and accrued interests are convertible into common stock at the option of the holder at \$1.25 per share for the four-year notes. Accrued interest expense as of September 30, 2016 for all convertible notes outstanding was approximately \$354,000. The notes are secured by all of the assets of the Company and are subordinated to amounts outstanding under the Company's working capital bank line of credit with Western Alliance Bank.

**Off-Balance Sheet Arrangements**

As of September 30, 2016, we have no off-balance sheet arrangements as defined in Item 303 of Regulation S-K.



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Item 3. Quantitative and Qualitative Disclosures About Market Risk

**Interest Rate Risk**

Our exposure to market risk for changes in interest rates relates primarily to our bank credit line facilities. Our bank credit line facilities of up to \$2.5 million have variable interest rates based upon the lender's prime rate (minimum of 3.25%) plus 1.5%, for both the domestic line (up to \$2.0 million) and the international line (up to \$0.5 million). Accordingly, interest rate increases could increase our interest expense on our outstanding credit line balances. Based on a sensitivity analysis during the nine months ended September 30, 2016, an increase of 1% in the interest rate would have increased our year to date borrowing costs by approximately \$1,000.

**Foreign Currency Risk**

A substantial majority of our revenue, expense and purchasing activities are transacted in U.S. dollars. However, we require our European distributors to purchase our products in Euros and we pay the expenses of our European employees in Euros and British pounds. We may enter into selected future purchase commitments with foreign suppliers that may be paid in the local currency of the supplier. We hedge a significant portion of our European receivables balance denominated in Euros to reduce the foreign currency risk associated with these assets, and we have not been subject to significant losses from material foreign currency fluctuations. Based on a sensitivity analysis of our net foreign currency denominated assets at the end of the quarter ended September 30, 2016, an adverse change of 10% in exchange rates would have resulted in a decrease in our net income for the third quarter of 2016 of approximately \$32,800 if left unprotected. For the third quarter of 2016, the total net adjustment for the effects of changes in foreign currency on cash balances, collections, payables, and derivatives used to hedge foreign currency risks, was a net loss of \$2,400. We will continue to monitor, assess, and mitigate through hedging activities, our risks related to foreign currency fluctuations.

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**Item 4. Controls and Procedures**

*Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control Over Financial Reporting*

There was no change in our internal control over financial reporting that occurred during the period covered by the last fiscal quarter ended September 30, 2016 and this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II**

**Item 1A. Risk Factors**

*The risks described in this Quarterly Report on Form 10-Q are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and operating results.*

**We may not maintain ongoing profitability.**

To maintain ongoing profitability, we must accomplish numerous objectives, including continued growth in our business, ongoing support to registered developers whose applications support the use of our data capture products, and the development of successful new products. We cannot foresee with any certainty whether we will be able to achieve these objectives in the future. Accordingly, we may not generate sufficient net revenue or manage our expenses sufficiently to maintain ongoing profitability. If we cannot maintain ongoing profitability, we will not be able to support our operations from positive cash flows, and we would use our existing cash to support operating losses. If we are unable to secure the necessary capital to replace that cash, we may need to suspend some or all of our current operations.

**We may require additional capital in the future, but that capital may not be available on reasonable terms, if at all, or on terms that would not cause substantial dilution to investors' stock holdings.**

We may need to raise capital to fund our growth or operating losses in future periods. Our forecasts are highly dependent on factors beyond our control, including market acceptance of our products and delays in deployments by businesses of applications that use our data capture products. Even if we maintain profitable operating levels, we may need to raise capital to provide sufficient working capital to fund our growth. If capital requirements vary materially from those currently planned, we may require additional capital sooner than expected. There can be no assurance that such capital will be available in sufficient amounts or on terms acceptable to us, if at all.

**If application developers are not successful in their efforts to develop, market and sell their applications into which our software and products are incorporated, we may not achieve our sales projections.**

We are dependent upon application developers to integrate our scanning and software products into their applications designed for mobile workers using smartphones, tablets and mobile computers, and to successfully market and sell those application products and solutions into the marketplace. We focus on serving the needs of application developers as sales of our data capture products are application driven. However, these developers may take considerable time to complete development of their applications, may experience delays in their development timelines, may develop competing applications, may be unsuccessful in marketing and selling their application products and solutions to customers, or may experience delays in customer deployments and implementations, which would adversely affect our ability to achieve our revenue projections.

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**Global economic conditions may have a negative impact on our business and financial condition in ways that we currently cannot predict, and may further limit our ability to raise additional funds.**

Global economic conditions may have an impact on our business and our financial condition. We may face significant challenges if global economic growth slows down and conditions in the financial markets worsen. In particular, should these conditions cause our revenues to be materially less than forecast, we may find it necessary to initiate reductions in our expenses and defer product development programs. In addition, our ability to access the capital markets and raise funds required for our operations may be severely restricted at a time when we would like, or need, to do so, which could have an adverse effect on our ability to meet our current and future funding requirements and on our flexibility to react to changing economic and business conditions.

**Our quarterly operating results may fluctuate in future periods, which could cause our stock price to decline.**

We expect to experience quarterly fluctuations in operating results in the future. We generally ship orders as received, and as a result we may have little backlog. Quarterly revenues and operating results therefore depend on the volume and timing of orders received during the quarter, which are difficult to forecast. Historically, we have often recognized a substantial portion of our revenue in the last month of the quarter. This subjects us to the risk that even modest delays in orders or in the manufacture of products relating to orders received, may adversely affect our quarterly operating results. Our operating results may also fluctuate due to factors such as:

- the demand for our products;
- the size and timing of customer orders;
- unanticipated delays or problems in our introduction of new products and product enhancements;
- the introduction of new products and product enhancements by our competitors;
- the timing of the introduction and deployments of new applications that work with our products;
- changes in the revenues attributable to royalties and engineering development services;
- product mix;
- timing of software enhancements;
- changes in the level of operating expenses;
- competitive conditions in the industry including competitive pressures resulting in lower average selling prices;
- timing of distributors' shipments to their customers;
- delays in supplies of key components used in the manufacturing of our products, and
- general economic conditions and conditions specific to our customers' industries.

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Because we base our staffing and other operating expenses on anticipated revenues, unanticipated declines or delays in the receipt of orders can cause significant variations in operating results from quarter to quarter. As a result of any of the foregoing factors, or a combination, our results of operations in any given quarter may be below the expectations of public market analysts or investors, in which case the market price of our common stock would be adversely affected.

**In order to maintain the availability of our bank lines of credit we must remain in compliance with the covenants as specified under the terms of the credit agreements and the bank may exercise discretion in making advances to us.**

Our credit agreements with our bank requires us to maintain cash and qualified receivables that are at least 1.75 times amounts borrowed and outstanding under the credit agreements. The agreements contain customary representations, warranties, covenants and events of default that limit our ability to incur additional liens or indebtedness, make distributions to our stockholders and make investments. The events of default entitle our bank to accelerate our obligations and require repayment of our outstanding indebtedness thereunder. These events of default include a breach of our payment obligations or covenants, a material impairment in our financial condition or ability to repay any indebtedness to our bank and the commencement of dissolution or insolvency proceedings. The agreement may be terminated by us or by our bank at any time. Upon such termination, our bank would no longer make advances under the credit agreement and outstanding advances would be repaid as receivables are collected. All advances are at our bank's discretion and our bank is not obligated to make advances. Our bank has been granted a first priority security interest in all of our assets, including our intellectual property.

**Goodwill comprises a significant portion of our assets and may be subject to impairment write-downs in future periods which would substantially increase our losses, make it more difficult to achieve profitability, and could cause our stock price to decline.**

We review our goodwill for impairment at least annually as of September 30th, and more often if factors suggest potential impairment. Many factors are considered in evaluating goodwill including our market capitalization, comparable companies within our industry, our estimates of our future performance, and discounted cash flow analysis. Many of these factors are highly subjective and may be negatively impacted by our financial results and market conditions in the future. We may incur goodwill impairment charges in the future and any future write-downs of our goodwill would adversely affect our operating results, make it more difficult to maintain profitability, and as a result the market price of our common stock could be adversely affected.

**We may be unable to manufacture our products because we are dependent on a limited number of qualified suppliers for our components.**

Several of our component parts are produced by one or a limited number of suppliers. Shortages or delays could occur in these essential components due to an interruption of supply or increased demand in the industry. Suppliers may choose to restrict credit terms or require advance payment causing delays in the procurement of essential materials. If we are unable to procure certain component parts, we could be required to reduce our operations while we seek alternative sources for these components, which could have a material adverse effect on our financial results. To the extent that we acquire extra inventory stocks to protect against possible shortages, we would be exposed to additional risks associated with holding inventory, such as obsolescence, excess quantities, or loss.

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**If we fail to develop and introduce new products rapidly and successfully, we will not be able to compete effectively, and our ability to generate sufficient revenues will be negatively affected.**

The market for our products is prone to rapidly changing technology, evolving industry standards and short product life cycles. If we are unsuccessful at developing and introducing new products and services on a timely basis that include the latest technologies conform to the newest standards and that are appealing to end users, we will not be able to compete effectively, and our ability to generate significant revenues will be seriously harmed.

The development of new products and services can be very difficult and requires high levels of innovation. The development process is also lengthy and costly. Short product life cycles for smartphones and tablets expose our products to the risk of obsolescence and require frequent new product upgrades and introductions. We will be unable to introduce new products and services into the market on a timely basis and compete successfully, if we fail to:

- invest significant resources in research and development, sales and marketing, and customer support;
- identify emerging trends, demands and standards in the field of mobile computing products;
  - enhance our products by adding additional features;
  - maintain superior or competitive performance in our products; and
  - anticipate our end users' needs and technological trends accurately.

We cannot be sure that we will have sufficient resources to make adequate investments in research and development or that we will be able to identify trends or make the technological advances necessary to be competitive.

**A significant portion of our revenue currently comes from a limited number of distributors, and any decrease in revenue from these distributors could harm our business.**

A significant portion of our revenue comes from a limited number of distributors. In the first nine months of 2016 and 2015, Ingram Micro Inc., ScanSource, Inc., and BlueStar, Inc. together represented approximately 66% and 72%, respectively, of our worldwide revenues. We expect that a significant portion of our revenue will continue to depend on sales to a limited number of distributors. We do not have long-term commitments from our distributors to carry our products, and any of our distributors may from quarter to quarter comprise a significant concentration of our revenues. Any could choose to stop selling some or all of our products at any time, and each of these companies also carries our competitors' products. If we lose our relationship with any of our significant distributors, we would experience disruption and delays in marketing our products.



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**We may not be able to collect receivables from customers who experience financial difficulties.**

Our accounts receivable are derived primarily from distributors. We perform ongoing credit evaluations of our customers' financial conditions but generally require no collateral from our customers. Reserves are maintained for potential credit losses, and such losses have historically been within such reserves. However, many of our customers may be thinly capitalized and may be prone to failure in adverse market conditions. Although our collection history has been good, from time to time a customer may not pay us because of financial difficulty, bankruptcy or liquidation. If global financial conditions have an impact on our customers' ability to pay us in a timely manner, and consequently, we may experience increased difficulty in collecting our accounts receivable, and we may have to increase our reserves in anticipation of increased uncollectible accounts.

**We could face increased competition in the future, which would adversely affect our financial performance.**

The market in which we operate is very competitive. Our future financial performance is contingent on a number of unpredictable factors, including that:

- some of our competitors have greater financial, marketing, and technical resources than we do; we periodically face intense price competition, particularly when our competitors have excess inventories and discount their prices to clear their inventories; and
- certain manufacturers of tablets and mobile phones offer products with built-in functions, such as Bluetooth wireless technology or barcode scanning, that compete with our products.

Increased competition could result in price reductions, fewer customer orders, reduced margins, and loss of market share. Our failure to compete successfully against current or future competitors could harm our business, operating results and financial condition.

**If we do not correctly anticipate demand for our products, our operating results will suffer.**

The demand for our products depends on many factors and is difficult to forecast as we introduce and support more products, and as competition in the markets for our products intensifies. If demand is lower than forecasted levels, we could have excess production resulting in higher inventories of finished products and components, which could lead to write-downs or write-offs of some or all of the excess inventories, and reductions in our cash balances. Lower than forecasted demand could also result in excess manufacturing capacity at our third-party manufacturers and in our

failure to meet minimum purchase commitments, each of which may lower our operating results.

If demand increases beyond forecasted levels, we would have to rapidly increase production at our third-party manufacturers. We depend on suppliers to provide additional volumes of components, and suppliers might not be able to increase production rapidly enough to meet unexpected demand. Even if we were able to procure enough components, our third-party manufacturers might not be able to produce enough of our devices to meet our customer demand. In addition, rapid increases in production levels to meet unanticipated demand could result in higher costs for manufacturing and supply of components and other expenses. These higher costs could lower our profit margins. Further, if production is increased rapidly, manufacturing yields could decline, which may also lower operating results.

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**We rely primarily on distributors to sell our products, and our sales would suffer if any of these distributors stops selling our products effectively.**

Because we sell our products primarily through distributors, we are subject to risks associated with channel distribution, such as risks related to their inventory levels and support for our products. Our distribution channels may build up inventories in anticipation of growth in their sales. If such growth in their sales does not occur as anticipated, the inventory build-up could contribute to higher levels of product returns. The lack of sales by any one significant participant in our distribution channels could result in excess inventories and adversely affect our operating results and working capital liquidity.

Our agreements with distributors are generally nonexclusive and may be terminated on short notice by them without cause. Our distributors are not within our control, are not obligated to purchase products from us, and may offer competitive lines of products simultaneously. Sales growth is contingent in part on our ability to enter into additional distribution relationships and expand our sales channels. We cannot predict whether we will be successful in establishing new distribution relationships, expanding our sales channels or maintaining our existing relationships. A failure to enter into new distribution relationships or to expand our sales channels could adversely impact our ability to grow our sales.

We allow our distribution channels to return a portion of their inventory to us for full credit against other purchases. In addition, in the event we reduce our prices, we credit our distributors for the difference between the purchase price of products remaining in their inventory and our reduced price for such products. Actual returns and price protection may adversely affect future operating results and working capital liquidity by reducing our accounts receivable and increasing our inventory balances, particularly since we seek to continually introduce new and enhanced products and are likely to face increasing price competition.

**We depend on alliances and other business relationships with third-parties, and a disruption in these relationships would hinder our ability to develop and sell our products.**

We depend on strategic alliances and business relationships with leading participants in various segments of the mobile applications market to help us develop and market our products. Our strategic partners may revoke their commitment to our products or services at any time in the future or may develop their own competitive products or services. Accordingly, our strategic relationships may not result in sustained business alliances, successful product or service offerings, or the generation of significant revenues. Failure of one or more of such alliances could result in delay or termination of product development projects, failure to win new customers, or loss of confidence by current or potential customers.



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We have devoted significant research and development resources to design products to work with a number of operating systems used in mobile devices including Apple (iOS), Google (Android), and Microsoft (Windows/Windows Mobile). Such design activities have diverted financial and personnel resources from other development projects. These design activities are not undertaken pursuant to any agreement under which Apple, Google or Microsoft is obligated to collaborate or to support the products produced from such collaboration. Consequently, these organizations may terminate their collaborations with us for a variety of reasons, including our failure to meet agreed-upon standards or for reasons beyond our control, such as changing market conditions, increased competition, discontinued product lines, and product obsolescence.

**Our intellectual property and proprietary rights may be insufficient to protect our competitive position.**

Our business depends on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark, trade secret laws, and other restrictions on disclosure to protect our proprietary technologies. We cannot be sure that these measures will provide meaningful protection for our proprietary technologies and processes. We cannot be sure that any patent issued to us will be sufficient to protect our technology. The failure of any patents to provide protection to our technology would make it easier for our competitors to offer similar products. In connection with our participation in the development of various industry standards, we may be required to license certain of our patents to other parties, including our competitors that develop products based upon the adopted standards.

We also generally enter into confidentiality agreements with our employees, distributors, and strategic partners, and generally control access to our documentation and other proprietary information. Despite these precautions, it may be possible for a third-party to copy or otherwise obtain and use our products, services, or technology without authorization, develop similar technology independently, or design around our patents.

Effective copyright, trademark, and trade secret protection may be unavailable or limited in certain foreign countries.

**We may become subject to claims of intellectual property rights infringement, which could result in substantial liability.**

In the course of operating our business, we may receive claims of intellectual property infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. Many of our competitors have large intellectual property portfolios, including patents that may cover technologies that are relevant to our business. In addition, many smaller companies, universities, and individuals have obtained or applied for patents in areas of technology that may relate to our business. The industry is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights.

If we are unable to obtain and maintain licenses on favorable terms for intellectual property rights required for the manufacture, sale, and use of our products, particularly those products which must comply with industry standard protocols and specifications to be commercially viable, our results of operations or financial condition could be adversely impacted.

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In addition to disputes relating to the validity or alleged infringement of other parties' rights, we may become involved in disputes relating to our assertion of our own intellectual property rights. Whether we are defending the assertion of intellectual property rights against us or asserting our intellectual property rights against others, intellectual property litigation can be complex, costly, protracted, and highly disruptive to business operations by diverting the attention and energies of management and key technical personnel. Plaintiffs in intellectual property cases often seek injunctive relief, and the measures of damages in intellectual property litigation are complex and often subjective or uncertain. Thus, any adverse determinations in this type of litigation could subject us to significant liabilities and costs.

**New industry standards may require us to redesign our products, which could substantially increase our operating expenses.**

Standards for the form and functionality of our products are established by standards committees. These independent committees establish standards, which evolve and change over time, for different categories of our products. We must continue to identify and ensure compliance with evolving industry standards so that our products are interoperable and we remain competitive. Unanticipated changes in industry standards could render our products incompatible with products developed by major hardware manufacturers and software developers. Should any major changes, even if anticipated, occur, we would be required to invest significant time and resources to redesign our products to ensure compliance with relevant standards. If our products are not in compliance with prevailing industry standards for a significant period of time, we would miss opportunities to sell our products for use with new hardware components from mobile computer manufacturers and OEMs, thus affecting our business.

**Undetected flaws and defects in our products may disrupt product sales and result in expensive and time-consuming remedial action.**

Our hardware and software products may contain undetected flaws, which may not be discovered until customers have used the products. From time to time, we may temporarily suspend or delay shipments or divert development resources from other projects to correct a particular product deficiency. Efforts to identify and correct errors and make design changes may be expensive and time consuming. Failure to discover product deficiencies in the future could delay product introductions or shipments, require us to recall previously shipped products to make design modifications, or cause unfavorable publicity, any of which could adversely affect our business and operating results.

**The loss of one or more of our senior personnel could harm our existing business.**

A number of our officers and senior managers have been employed for more than twenty years by us, including our President, Chief Financial Officer, Vice President of Operations and Vice President of Engineering/Chief Technical

Officer. Our future success will depend upon the continued service of key officers and senior managers. Competition for officers and senior managers is intense, and there can be no assurance that we will be able to retain our existing senior personnel. The loss of one or more of our officers or key senior managers could adversely affect our ability to compete.



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**The expensing of options will continue to reduce our operating results such that we may find it necessary to change our business practices to attract and retain employees.**

Historically, we have used stock options as a key component of our employee compensation packages. We believe that stock options provide an incentive to our employees to maximize long-term stockholder value and, through the use of vesting, encourage valued employees to remain with us. The expensing of employee stock options adversely affects our net income and earnings per share, will continue to adversely affect future quarters, and will make profitability harder to achieve. In addition, we may decide in response to the effects of expensing stock options on our operating results to reduce the number of stock options granted to employees or to grant options to fewer employees. This could adversely affect our ability to retain existing employees and attract qualified candidates, and also could increase the cash compensation we would have to pay to them.

**If we are unable to attract and retain highly skilled sales and marketing and product development personnel, our ability to develop and market new products and product enhancements will be adversely affected.**

We believe our ability to achieve increased revenues and to develop successful new products and product enhancements will depend in part upon our ability to attract and retain highly skilled sales and marketing and product development personnel. Our products involve a number of new and evolving technologies, and we frequently need to apply these technologies to the unique requirements of mobile products. Our personnel must be familiar with both the technologies we support and the unique requirements of the products to which our products connect. Competition for such personnel is intense, and we may not be able to attract and retain such key personnel. In addition, our ability to hire and retain such key personnel will depend upon our ability to raise capital or achieve increased revenue levels to fund the costs associated with such key personnel. Failure to attract and retain such key personnel will adversely affect our ability to develop and market new products and product enhancements.

**Our operating results could be harmed by economic, political, regulatory and other risks associated with export sales.**

Our operating results are subject to the risks inherent in export sales, including:

- longer payment cycles;
- unexpected changes in regulatory requirements, import and export restrictions and tariffs;
- difficulties in managing foreign operations;
- the burdens of complying with a variety of foreign laws;
- greater difficulty or delay in accounts receivable collection;
- potentially adverse tax consequences; and
- political and economic instability.



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Our export sales are primarily denominated in Euros for our sales to European distributors. Accordingly, an increase in the value of the United States dollar relative to Euros could make our products more expensive and therefore potentially less competitive in European market. Declines in the value of the Euro relative to the United States dollar may result in foreign currency losses relating to collection of Euro denominated receivables if left unhedged.

**Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, and other events beyond our control.**

Our corporate headquarters is located near an earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure, and overall business is unknown. Additionally, we may experience electrical power blackouts or natural disasters that could interrupt our business. Should a disaster be widespread, such as a major earthquake, or result in the loss of key personnel, we may not be able to implement our disaster recovery plan in a timely manner. Any losses or damages incurred by us as a result of these events could have a material adverse effect on our business.

**Failure to maintain effective internal controls could have a material adverse effect on our business, operating results and stock price.**

We have evaluated and will continue to evaluate our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires an annual management assessment of the design and effectiveness of our internal control over financial reporting. If we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls, particularly those related to revenue recognition, are necessary for us to produce reliable financial reports and are important to helping prevent financial fraud. If we cannot provide reliable financial reports or prevent fraud, our business and operating results could be harmed, investors could lose confidence in our reported financial information, and the trading price of our stock could drop significantly.

**The sale of a substantial number of shares of our common stock could cause the market price of our common stock to decline.**

Sales of a substantial number of shares of our common stock in the public market could adversely affect the market price for our common stock. The market price of our common stock could also decline if one or more of our significant stockholders decided for any reason to sell substantial amounts of our common stock in the public market.

As of October 31, 2016, we had 5,864,505 shares of common stock outstanding. Substantially all of these shares are freely tradable in the public market, either without restriction or subject, in some cases, only to manner of sale, volume, and notice requirements of Rule 144 under the Securities Act.

As of October 31, 2016, we had 2,175,374 shares of common stock subject to outstanding options under our stock option plans, and 95,592 shares of common stock were available for future issuance under the plans. We have registered the shares of common stock subject to outstanding options and reserved for issuance under our stock option plans. Accordingly, the shares of common stock underlying vested options will be eligible for resale in the public market as soon as the options are exercised.

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As of October 31, 2016, we had \$752,625 in subordinated convertible notes payable. Up to 885,481 shares of common stock could be issued for conversion of the notes plus all accrued interest thru September 30, 2016.

**Volatility in the trading price of our Common Stock could negatively impact the price of our Common Stock.**

During the period from January 1, 2015 through October 31, 2016, our common stock price fluctuated between a high of \$4.05 and a low of \$1.82. We have experienced low trading volumes in our stock, and thus relatively small purchases and sales can have a significant effect on our stock price. The trading price of our common stock could be subject to wide fluctuations in response to many factors, some of which are beyond our control, including general economic conditions and the outlook of securities analysts and investors on our industry. In addition, the stock markets in general, and the markets for high technology stocks in particular, have experienced high volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

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**Item 6. Exhibits**

Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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## **SIGNATURES**

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

### SOCKET MOBILE, INC.

Registrant

Date: November 4, 2016 /s/ Kevin J. Mills  
Kevin J. Mills  
President and Chief Executive Officer  
(Duly Authorized Officer and Principal Executive Officer)

Date: November 4,  
2016 /s/ David W. Dunlap  
David W. Dunlap  
Vice President of Finance and Administration and Chief Financial Officer (Duly Authorized  
Officer and Principal Financial and Accounting Officer)





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**Index to Exhibits**

Exhibit  
Number   Description

31.1      Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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