NETLIST INC
Form 10-Q
May 12, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 28, 2015

or

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

For the transition period from to

Commission file number 001-33170

NETLIST, INC.

(Exact name of registrant as specified in its charter)

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

175 Technology Drive, Suite 150

Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant's telephone number, including area code)

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

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

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

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

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

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

Common Stock, par value $0.001 per share

50,354,363 shares outstanding at April 30, 2015

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NETLIST, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED MARCH 28, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NETLIST, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(in thousands, except par value)

	(unaudited) March 28, 2015	(audited) December 27, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 19,558	$ 11,040
Restricted cash	1,600	700
Accounts receivable, net of allowance for doubtful accounts of $61 (2015) and $61 (2014)	877	1,091
Inventories	1,821	1,880
Prepaid expenses and other current assets	1,227	988
Total current assets	25,083	15,699
Property and equipment, net	284	393
Other assets	143	150
Total assets	$ 25,510	$ 16,242
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 4,846	$ 3,957
Accrued payroll and related liabilities	801	710
Accrued expenses and other current liabilities	446	420
Accrued engineering charges	500	500
Current portion of long-term debt, net of debt discount	4,261	2,205
Total current liabilities	10,854	7,792
Long-term debt, net of current portion and debt discount	5,275	3,632
Long-term warranty liability	47	99
Total liabilities	16,176	11,523
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value - 10,000 shares authorized; no shares issued and outstanding	-	-
	50	41

Common stock, $0.001 par value - 90,000 shares authorized; 50,354 (2015) and 41,498 (2014) shares issued and outstanding		
Additional paid-in capital	128,610	117,546
Accumulated deficit	(119,326)	(112,868)
Total stockholders' equity	9,334	4,719
Total liabilities and stockholders' equity	$ 25,510	$ 16,242

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended March 28, 2015	Three Months Ended March 29, 2014
Net sales	$ 2,114	$ 7,001
Cost of sales(1)	1,415	5,016
Gross profit	699	1,985
Operating expenses:		
Research and development(1)	1,384	878
Intellectual property legal fees	3,542	1,097
Selling, general and administrative(1)	1,759	1,622
Total operating expenses	6,685	3,597
Operating loss	(5,986)	(1,612)
Other expense, net:		
Interest expense, net	(480)	(395)
Other income (expense), net	9	(11)
Total other expense, net	(471)	(406)
Loss before provision for income tax	(6,457)	(2,018)
Provision for income taxes	1	-
Net loss	$ (6,458)	$ (2,018)
Net loss per common share:		
Basic and diluted	$ (0.14)	$ (0.05)
Weighted-average common shares outstanding:		
Basic and diluted	44,708	36,881

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

Cost of sales	$ 14	$ 15
Research and development	190	188
Selling, general and administrative	307	328

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Three Months Ended March 28, 2015	March 29, 2014
Cash flows from operating activities:		
Net loss	$ (6,458)	$ (2,018)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	148	282
Amortization of debt discount and debt issuance costs	241	203
Realized (gain) loss on sale of equipment	(1)	6
Stock-based compensation	511	531
Changes in operating assets and liabilities:		
Restricted cash	(900)	-
Accounts receivable	214	647
Inventories	59	192
Prepaid expenses and other assets	167	228
Accounts payable	889	86
Accrued payroll and related liabilities	91	136
Accrued expenses and other current liabilities	(26)	14
Net cash (used in) provided by operating activities	(5,065)	307
Cash flows from investing activities:		
Acquisition of property and equipment	(40)	(39)
Proceeds from sale of equipment	2	3
Net cash used in investing activities	(38)	(36)
Cash flows from financing activities:		
Proceeds from long- term loan, net of issuance costs	3,727	-
Payments on debt	(668)	(65)
Proceeds from public offering, net	10,554	10,276
Proceeds from exercise of equity awards, net of taxes remitted for restricted stock	8	791
Net cash provided by financing activities	13,621	11,002
Net change in cash and cash equivalents	8,518	11,273
Cash and cash equivalents at beginning of year	11,040	6,701
Cash and cash equivalents at end of year	$ 19,558	$ 17,974

See accompanying notes.

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NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 28, 2015

Note 1—Description of Business

Netlist, Inc. (the "Company" or "Netlist") designs and manufactures a wide variety of high performance, logic-based memory subsystems for the global datacenter, storage and high-performance computing and communications markets. The Company's memory subsystems consist of combinations of dynamic random access memory integrated circuits ("DRAM ICs" or "DRAM"), NAND flash memory ("NAND flash"), application-specific integrated circuits ("ASICs") and other components assembled on printed circuit boards ("PCBs"). Netlist primarily markets and sells its products to leading original equipment manufacturer ("OEM") customers, hyperscale datacenter operators and storage vendors. The Company's solutions are targeted at applications where memory plays a key role in meeting system performance requirements. The Company leverages a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high memory density, small form factor, high signal integrity, attractive thermal characteristics, reduced power consumption and low cost per bit. Our NVvault™ product is the first to offer both DRAM and NAND flash in a standard form factor memory subsystem as a persistent DIMM in mission critical applications.

Netlist was incorporated in June 2000 and is headquartered in Irvine, California. In 2007, the Company established a manufacturing facility in the People's Republic of China (the "PRC"), which became operational in July 2007 upon the successful qualification of certain key customers.

Liquidity

The Company incurred net losses of approximately $6.5 million and $2.0 million for the three months ended March 28, 2015 and March 29, 2014, respectively.

On February 24, 2015, the Company completed a registered firm commitment underwritten public offering (the "2015 Offering") of shares of the Company's common stock. In the 2015 Offering, the Company issued and sold to the Underwriter 8,846,154 shares of common stock pursuant to an underwriting agreement, dated as of February 19, 2015, by and between the Company and the Underwriter, at a price of $1.209 per share, including 1,153,846 shares resulting from the Underwriter's exercise in full of its option to purchase additional shares of Common Stock to cover

over-allotments. The price per share to the public in the 2015 Offering was $1.30 per share. The net proceeds from the 2015 Offering were approximately $10.6 million, after deducting underwriting discounts and commissions and estimated offering expenses.

If adequate working capital is not available when needed, the Company may be required to significantly modify its business model and operations to reduce spending to a sustainable level. Insufficient working capital could cause the Company to be unable to execute its business plan, take advantage of future opportunities, respond to competitive pressures or customer requirements or defend its trade secrets and other intellectual property. It may also cause the Company to delay, scale back or eliminate some or all of its research and development programs, or to reduce or cease operations. While there is no assurance that the Company can meet its revenue forecasts, management anticipates that it can continue operations for at least the next twelve months.

Reclassifications

Intellectual property legal fees for the three months ended March 29, 2014 are now reported under their own caption, separate from research and development expenses, in the accompanying condensed consolidated statement of operations for the three months ended March 29, 2014, in order to conform to the current period presentation. In addition, other assets are now combined with prepaids and other current assets, in the accompanying condensed consolidated statement of cash flows for the three months ended March 29, 2014, in order to conform to the current period presentation.

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Note 2—Summary of Significant Accounting Policies

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (the “U.S.”) for interim financial information and with the instructions to Securities and Exchange Commission (“SEC”) Form 10-Q and Article 8 of SEC Regulation S-X. These condensed consolidated financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. Therefore, these unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto for the year ended December 27, 2014, included in the Company’s Annual Report on Form 10-K filed with the SEC on March 27, 2015.

The condensed consolidated financial statements included herein as of March 28, 2015 are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company’s management, are necessary to present fairly the condensed consolidated financial position of the Company and its wholly-owned subsidiaries as of March 28, 2015 and the condensed consolidated statements of operations and cash flows for the three months ended March 28, 2015 and March 29, 2014. The results of operations for the three months ended March 28, 2015 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

Principles of Consolidation

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

Fiscal Year

The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2015, the Company’s fiscal year is scheduled to end on January 2, 2016 and will consist of 53 weeks. Each of the Company’s first three quarters in a fiscal year is comprised of 13 weeks.

Use of Estimates

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

Revenue Recognition

The Company's revenues primarily consist of product sales of high-performance memory subsystems to OEMs, hyperscale data center operators and storage vendors.

The Company recognizes revenues in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605. Accordingly, the Company recognizes revenues when there is

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persuasive evidence of an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

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

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

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash of $1.6 million, as of March 28, 2015, consists of cash to secure three standby letters of credit and $0.9 million to secure a bond associated with a lawsuit (see Note 7).

Fair Value of Financial Instruments

The Company's financial instruments consist principally of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of the Company's cash equivalents is determined based on quoted prices in active markets for identical assets or Level 1 inputs. The

Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Allowance for Doubtful Accounts

The Company evaluates the collectibility of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, the Company will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company records allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and its historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted. At March 28, 2015 and December 27, 2014 the Company had an allowance for doubtful accounts of $61,000.

Concentration of Credit Risk

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

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

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

Inventories

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

Deferred Financing Costs, Debt Discount and Detachable Debt-Related Warrants

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

Property and Equipment

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

Impairment of Long-Lived Assets

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows. The Company’s management believes there is no impairment of long-lived assets as of March 28, 2015. There can be no assurance, however, that market conditions will not change or demand for the Company’s products will continue, which could result in future impairment of long-lived assets.

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Warranty Reserve

The Company offers product warranties generally ranging from one to three years, depending on the product and negotiated terms of any purchase agreements with customers. Such warranties require the Company to repair or replace defective product returned to the Company during such warranty period at no cost to the customer. Warranties are not offered on sales of excess component inventory. The Company records an estimate for warranty-related costs at the time of sale based on its historical and estimated product return rates and expected repair or replacement costs (see Note 3).While such costs have historically been within management's expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on the Company, requiring additional warranty reserves, and could adversely affect the Company's gross profit and gross margins.

Stock-Based Compensation

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

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

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

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

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

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Income Taxes

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

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

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

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

Research and Development Expenses

Research and development expenditures are expensed in the period incurred.

Risks and Uncertainties

The Company is subject to certain risks and uncertainties including its ability to obtain profitable operations due to the Company's history of losses and accumulated deficits, the Company's dependence on a few customers for a significant portion of revenues, risks related to intellectual property matters, market development of and demand for the Company's products, and the length of the sales cycle. Such risks could have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

The Company invested a significant portion of its research and development budget into the design of ASIC and hybrid devices, including the HyperCloud® memory subsystem, HyperVault memory systems and NVvault family of products. These designs and the products they are incorporated into are subject to increased risks as compared to the Company's legacy products. The Company may be unable to achieve customer or market acceptance of its products, or achieve such acceptance in a timely manner. The Company experienced a longer qualification cycle than anticipated with its HyperCloud® memory subsystems, and has experienced supply chain disruption and a shortage of DRAM and flash required to create the HyperCloud® memory subsystem and NVvault products. As of March 28, 2015, Hypercloud has not generated significant revenue relative to the Company's investment in the product.

The Company's operations in the PRC are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in the PRC. These include, but are not limited to, (i) potential changes in economic conditions in the region, (ii) managing a local workforce that may subject the Company to uncertainties or certain regulatory policies, (iii) changes in other policies of the Chinese governmental and regulatory agencies, and (iv) changes in the laws and policies of the U.S. government regarding the conduct of business in foreign countries, generally, or in the PRC, in particular. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi ("RMB"), is converted into other currencies and by which dividends may be declared or capital distributed for the purpose of repatriation of earnings and investments. If restrictions in the conversion of RMB or in the repatriation of earnings and investments through dividend and capital distribution restrictions are instituted, the Company's operations and operating results may be negatively impacted. The liabilities of the Company's subsidiaries in the PRC exceeded its assets as of March 28, 2015 and December 27, 2014.

Foreign Currency Remeasurement

The functional currency of the Company's foreign subsidiary is the U.S. dollar. Local currency financial statements are remeasured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. All remeasurement gains and losses are included in determining net loss. Transaction gains and losses were not significant in the three months ended March 28, 2015 or March 29, 2014.

Net Loss Per Share

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

Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers ("ASU 2014-09"). ASU 2014-09 supersedes the revenue recognition requirements in FASB Topic 605, Revenue Recognition. ASU 2014-9 implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The amendment also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Other major provisions include the capitalization and amortization of certain contract costs, ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption. On April 29, 2015, the FASB proposed deferring the effective date by one year to December 15, 2017 for annual reporting periods beginning after that date. The FASB also proposed permitting early adoption of the standard, but not before the original effective date or for reporting periods beginning after December 15, 2016. The Company has not yet selected a transition method and is currently assessing the impact of the adoption of AUS 2014-9 will have on its consolidated financial statements and disclosures.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern. The amendments in this update provide guidance in accounting principles generally accepted in the United States of America about management's responsibilities to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The main provision of the amendments are for an entity's management, in connection with the preparation of financial statements, to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued. Management's evaluation should be based on relevant conditions and events that are known or reasonably knowable at the date the consolidated financial statements are issued. When management identifies conditions or events that raise substantial doubt about an entity's ability to continue as a going concern, the entity should disclose information that enables users of the consolidated financial statements to understand all of the following: (1) principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern (before consideration of management's plans); (2) management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations; and (3) management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern or management's plans that are intended to mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. The amendments in this update are effective for interim and annual reporting periods after December 15, 2016 and early application is permitted. The Company is currently assessing this guidance for future implementation.

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Note 3—Supplemental Financial Information

Inventories

Inventories consist of the following (in thousands):

	(unaudited) March 28, 2015	(audited) December 27, 2014
Raw materials	$ 1,117	$ 984
Work in process	207	23
Finished goods	497	873
	$ 1,821	$ 1,880

Warranty Liabilities

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

	Three Months Ended March 28, 2015	March 29, 2014
Beginning balance	$ 246	$ 249
Estimated cost of warranty claims charged to cost of sales	130	46
Cost of actual warranty claims	(258)	(35)
Ending balance	118	260
Less current portion	(71)	(156)
Long-term warranty liability	$ 47	$ 104

The allowance for warranty liabilities expected to be incurred within one year is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets.

Computation of Net Loss Per Share

The following table sets forth the computation of net loss per share, including the reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended	
	March 28, 2015	March 29, 2014
Basic and diluted net loss per share:		
Numerator: Net loss	$ (6,458)	$ (2,018)
Denominator: Weighted-average common shares outstanding, basic and diluted	44,708	36,881
Basic and diluted net loss per share	$ (0.14)	$ (0.05)

The following table sets forth potentially dilutive common share equivalents, consisting of shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively computed using the treasury

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stock method. These potential common shares have been excluded from the diluted net loss per share calculations above as their effect would be anti-dilutive for the periods then ended (in thousands):

	Three Months Ended	
	March 28, 2015	March 29, 2014
Common share equivalents	366	573

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

Major Customers

The Company's product sales have historically been concentrated in a small number of customers. The following table sets forth sales to customers comprising 10% or more of the Company's net sales as follows:

	Three Months Ended			
	March 28, 2015		March 29, 2014	
Customer:				
Customer A	25	%	14	%
Customer B	*	%	10	%
Customer C	*	%	10	%
Customer D	*	%	19	%
Customer E	*	%	19	%

* less than 10% of net sales

The Company's accounts receivable as of March 28, 2015 were concentrated with two customers, representing approximately 26% and 15% of aggregate gross receivables. At December 27, 2014, three customers represented approximately 13%, 49% and 11% of aggregate gross receivables. A significant reduction in sales to, or the inability to collect receivables from, a significant customer could have a material adverse impact on the Company. The Company mitigates risk with foreign receivables by purchasing comprehensive foreign credit insurance.

Cash Flow Information

The following table sets forth supplemental disclosures of cash flow information and non-cash investing and financing activities (in thousands):

	Three Months Ended	
	March 28, 2015	March 29, 2014
Supplemental disclosure of non-cash investing and financing activities:		
Debt financing of directors and officers insurance	$ 247	$ 197
Debt issuance costs associated with February debt financing	$ 273	$ -

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Note 4—Credit Agreements

Silicon Valley Credit Agreement

On October 31, 2009, the Company entered into a credit agreement with Silicon Valley Bank ("SVB"), which was most recently amended on April 23, 2015 (as amended, the "SVB Credit Agreement"). Currently, the SVB Credit Agreement provides that the Company can borrow up to the lesser of (i) 80% of eligible accounts receivable, or (ii) $5.0 million.

On July 18, 2013, the Company and SVB entered into a loan amendment ("SVB Amendment") to the Company's loan and security agreement with SVB. Pursuant to the SVB Amendment, SVB allowed for the financing and security interests contemplated under the loan agreement entered into with Fortress and released certain patents and related assets relating to the NVvault™ product line from the collateral subject to SVB's security interest under the SVB Credit Agreement. Additionally, pursuant to the SVB Amendment, advances under the revolving line now accrue interest at a rate equal to SVB's most recently announced "prime rate" plus 2.75%. The SVB Amendment also relaxed the Company's tangible net worth covenant under the SVB Credit Agreement. Certain reporting requirements under the SVB Credit Agreement were modified while certain reserves with respect to the borrowing base and the availability of revolving loans were removed pursuant to the SVB Amendment. Under the terms of the SVB Credit Agreement, the Company may draw revolving advances in an aggregate outstanding principal amount of up to the lesser of $5 million or the available borrowing base, subject to reserve amounts. The Company's borrowing base under the SVB Credit Agreement is subject to certain adjustments and up to the lesser of 80% of eligible accounts receivable.

SVB Credit Agreement requires letters of credit to be secured by cash, which is classified as restricted cash in the accompanying consolidated balance sheet. At March 28, 2015, letters of credit in the amount of $1.6 million were outstanding.

The following tables present details of interest expense related to borrowings on the line of credit with SVB, along with availability under our credit line with SVB (in thousands):

	Three Months Ended	
	March 28, 2015	March 29, 2014
Interest expense	$ 13	$ 24

The following table presents details of the Company’s available borrowings under our line of credit with SVB:

	(unaudited) March 28, 2015	(audited) December 27, 2014
Availability under the revolving line of credit	$ 686	$ 882

All obligations under the SVB Credit Agreement are secured by a first priority lien on the Company’s tangible and intangible assets, other than its intellectual property, which is subject to a first priority lien held by Fortress Credit Opportunities I, LP, an affiliate of Fortress Investment Group, LLC (“Fortress”) and successor to DBD Credit Funding, LLC. The SVB Credit Agreement subjects the Company to certain affirmative and negative covenants, including financial covenants with respect to the Company’s liquidity and tangible net worth and restrictions on the payment of dividends. On April 23, 2015, the SVB Credit Agreement was amended to modify the tangible net worth covenant effective as of February 1, 2015. As of March 28, 2015, the Company was in compliance with its debt covenants.

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Fortress Credit Opportunities I LP Loan and Security Agreement and Related Agreements

On July 18, 2013, the Company, entered into a loan agreement ("Loan Agreement") with Fortress, providing for up to $10 million in term loans and up to $5 million in revolving loans. The term loans are available in an initial $6 million tranche (the "Initial Term Loan") with a second tranche in the amount of $4 million becoming available upon achievement of certain performance milestones relating to intellectual property matters (the "IP Monetization Milestones" and such second tranche loan, "IP Milestone Term Loan"). The $5 million in revolving loans are available at Fortress's discretion and subject to customary conditions precedent. The $6 million Initial Term Loan was fully drawn at closing on July 18, 2013. Proceeds from the Initial Term Loan were used in part to repay the Company's existing Consolidated Term Loan with SVB. The remainder of such funds will be used to fund the Company's ongoing working capital needs. On February 17, 2015, the Loan Agreement was amended ("Loan Agreement") to accelerate the availability of the term loan and the Company borrowed the remaining $4 million in term loans.

The loans bear interest at a stated fixed rate of 11.0% per annum. Until the last business day of February 2015, the payments on the term loans are interest-only at a cash rate of 7.0% per annum and a payment-in-kind deferred cash interest rate of 4.0%, which payment-in-kind interest is capitalized semi-annually, beginning with December 31, 2013. Beginning with the last business day of February 2015, the term loans are amortized with 65% of the principal amount due in equal monthly installments over the following seventeen (17) months with a balloon payment equal to 35% of the remaining principal amount of the term loans, plus accrued interest, being payable on July 18, 2016 (the "Maturity Date"). Term loan payments, including the $4 million borrowed on February 17, 2015, of approximately $370,000 are due monthly through June 18, 2016, with the remaining amount of approximately $4.3 million due on July 18, 2016.

The Company's obligations under the Loan Agreement are secured by a first-priority security interest in the Company's intellectual property assets (other than certain patents and related assets relating to the NVvault™ product line) pursuant to an intellectual property security agreement with (the "IP Security Agreement") and a second-priority security interest in substantially all of the Company's other assets.

In connection with the Loan Agreement, the Company paid certain facility, due diligence and legal fees of Fortress on the closing date and was obligated to pay a conditional facility fee upon satisfaction of the IP Monetization Milestones. In connection with the Loan Amendment, the Company paid a facility fee and an amendment and restructuring fee; the Company must also pay an annual management and monitoring fee. The conditional facility fee due upon satisfaction of the IP Monetization Milestone was deemed fully earned pursuant to the Loan Agreement. If the Company repays or prepays all or a portion of the term loans prior to maturity, the Company is obligated to pay Fortress a prepayment fee based on a percentage of the then outstanding principal balance being prepaid, equal to 2.0% if the prepayment occurs between July 18, 2015, or 0.0% if the prepayment occurs after July 18, 2015.

The Loan Agreement contains customary representations, warranties and indemnification provisions. The Loan Agreement also contains affirmative and negative covenants that, among other things restrict the ability of the

Company to:

- incur additional indebtedness or guarantees;

- incur liens;

- make investments, loans and acquisitions;

- consolidate or merge;

- sell or exclusively license assets, including capital stock of subsidiaries;

- alter the business of the Company;

- engage in transactions with affiliates; and

· pay dividends or make distributions.

The Loan Agreement also includes events of default, including, among other things, payment defaults, breaches of representations, warranties or covenants, certain bankruptcy events, the failure to maintain the Company's listing on a nationally recognized securities exchange or alternatively for its shares to be qualified for trading on the OTC Bulletin Board and certain material adverse changes, including an impairment of the perfection or priority of the lender's lien. Upon the occurrence of an event of default and following any applicable cure periods, a default interest rate of an additional 5.0% per annum may be applied to the outstanding loan balances, and Fortress may declare all outstanding obligations immediately due and payable and take such other actions as set forth in the Loan Agreement.

Concurrently with the execution of the Loan Agreement, the Company and Drawbridge Special Opportunities Fund LP ("Drawbridge") entered into a Monetization Letter Agreement (as amended, the "Letter Agreement"). In connection with the amendment to the Loan Agreement, the Company also amended the Letter Agreement on February 17, 2015. The Letter Agreement provides, among other things, that DBD may be entitled to share in certain monetization revenues that we may derive in the future related to our patent portfolio (the "Patent Portfolio"). Monetization revenues subject to this arrangement include revenues recognized during the seven year term of the Letter Agreement from amounts (whether characterized as settlement payments, license fees, royalties, damages, or otherwise) actually paid to the Company or its subsidiaries in connection with any assertion of, agreement not to assert, or license of, the Patent Portfolio (in whole or in part) either (A) in consideration of the grant of a license or covenant not sue, or other immunity with respect to the Patent Portfolio, or (B) as a damages award with respect to such assertion of the Patent Portfolio, less certain legal fees and expenses (subject to a cap on such fees and expenses). Monetization revenues also include the value attributable to the Patent Portfolio in any sale of the Company during the seven year term, subject to a maximum amount payable to Drawbridge. The Letter Agreement also requires that the Company use commercially reasonable efforts to pursue opportunities to monetize the Patent Portfolio during the term of the Letter Agreement, provided the Company is under no obligation to pursue any such opportunities that it does not deem to be in its best interest. Notwithstanding the foregoing, there can be no assurance that the Company will be successful in these efforts, and it may expend resources in pursuit of monetization revenues that may not result in any benefit to the Company.

Concurrently with the execution of the Loan Agreement, the Company issued to an affiliate of DBD a seven-year warrant (the "Warrant") to purchase an aggregate of 1,648,351 shares of the Company's common stock at an exercise price of $1.00 per share, of all warrants are exercisable, as amended, immediately on a cash or cashless basis in whole or in part. In connection with the amendment to the Loan Agreement on February 17, 2015, the Company cancelled the Warrant and issued a new warrant in substantially the same form other than to remove the restrictions upon exercise contained in the Warrant with respect to an aggregate of 659,340 shares of the Company's common stock thereunder relating to the achievement of the Company of the IP Monetization Milestones and the borrowing by the Company of amounts under the IP Milestone Term Loan. The Warrant was issued in a private placement transaction that was exempt from registration under Section 4(2) of the Securities Act of 1933 (the "Securities Act").

The Company accounted for the warrants as a debt discount and has valued them based on the relative fair value at approximately $1,215,000, to be amortized over the term of the debt instrument, or three years, using the effective interest method. For the three months ended March 28, 2015 and March 29, 2014, the Company amortized approximately $120,000 and $123,000 respectively, as interest expense in the consolidated statements of operations.

Also in connection with the Loan Agreement, the Company agreed to pay to a consultant a consulting fee equal to (i) $300,000 to the consultant in connection with the Company's receipt of the Initial Term Loan and (ii) 5% of any additional principal amount loaned to the Company as an IP Milestone Term Loan. The initial $300,000 and $485,925 of additional debt financing costs has been recorded as debt issuance cost to be amortized over the term of the debt instrument, or three years, using the effective interest method.

In connection with the Loan Amendment on February 17, 2015, the Company modified its agreement with a consultant and agreed to pay a consulting fee of 3.5% of the $4,000,000 of additional principal loaned the Company. The amended consulting fee was equal to $140,000. The amended consulting fee and $132,899 of additional debt

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financing costs has been recorded as debt issuance cost to be amortized over the term of the debt instrument, or seventeen months, using the effective interest method.

During the three months March 28, 2015 and March 29, 2014, the Company amortized approximately $121,000 and $80,000 respectively, as interest expense in the consolidated statements of operations related to the consulting and other additional debt financing costs described above.

Note 5— Debt

Debt consists of the following (in thousands):

	(unaudited) March 28, 2015	(audited) December 27, 2014
Term Loan, Fortress, net of debt discount of $405 and $524	$ 9,371	$ 5,837
Note payable to others	165	-
	$ 9,536	$ 5,837
Less current portion (including discount)	(4,261)	(2,205)
	$ 5,275	$ 3,632

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

	Three Months Ended March 28, 2015	March 29, 2014
Interest expense	$ 468	$ 372

Note 6—Income Taxes

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

Three Months Ended

March 28, rest rate risk and replace maturing time deposits. Money Market and NOW accounts increased $2,246,000 and $854,000, respectively during the three months ended March 31, 2012 as the Corporation expands existing relationship and attracts new customers. The category experiencing the largest decline during the period was Time deposits as the Corporation reduced participation in an on-line marketing service to acquire wholesale CD s and replaced maturing CD s with Brokered deposits. This was an intentional strategy by management to extend the maturity duration of the portfolio in a more cost effective manner utilizing the brokered market.

	As of March 31, 2012		As of December 31, 2011	
	Balance	Percentage	Balance	Percentage
Non-interest bearing demand	$ 18,751	16.78%	$ 19,662	18.26%
NOW accounts	8,894	7.96%	8,040	7.47%
Money market	8,868	7.93%	6,622	6.15%
Savings	17,827	15.95%	18,188	16.89%
Time deposits < $100,000	10,773	9.64%	11,469	10.65%
Time deposits >$100,000	42,127	37.69%	43,697	40.58%
Brokered deposits	4,534	4.05%		0.00%
Total deposits	$ 111,774	100.00%	$ 107,678	100.00%

At March 31, 2012 and December 31, 2011, the Bank had no secured borrowings outstanding. The Bank did not utilize discount window during the first quarter of 2012. The Bank did utilize its line of credit from the FHBLI during the first quarter for short term financing. However, there were no FHLBI borrowings outstanding at March 31, 2012.

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RESULTS OF OPERATIONS

The Corporation reported net income applicable to common shareholders of $336,000 for the first quarter of 2012 compared to $414,000 for the same period of 2011. The reduction in earnings is directly related to the recognition of income tax expense totaling $171,000 during the period. This is the first quarter the Corporation was required to realize an income tax liability. Refer to the income tax section for further discussion. Excluding the impact of income taxes, net income before preferred dividends was $519,000 for the period ended March 31, 2012, a 12.3% increase from the first quarter of 2011. The increase in pre-tax earnings was the result of improved margins, increased revenue and lower provision expense. Net interest margin for the current period was 4.80% compared to 4.49% for the first quarter of 2011. This was achieved by improving the asset mix of the balance sheet and reducing total funding costs. The corporation also increased total revenue during the period by generating additional non-interest income. Total non-interest income for the three month period ended March 31, 2012 was $484,000, an increase of $159,000 from the same period of 2011. The majority of the revenue was generated from SBA loan sales, mortgage banking activities and the gain on sale of a foreclosed property. Provision expense totaled $20,000 during the period, a decrease of $19,000 from the first quarter of 2011. The reduction is directly related to the quality of the portfolio. Total non-interest expense for the first quarter of 2012 was $1,339,000, an increase of $255,000 from the same period in 2011. The additional costs are the associated with the increased volume from residential mortgage activity, adding new personnel to facilitate growth, expanding services and dedicating resources to improving franchise recognition in our primary markets.

The following table present trends in selected financial data for the five most recent quarters:

			Quarter Ended		
	March 31, 2012	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
Income Statement					
Interest income	$ 1,622	$ 1,630	$ 1,582	$ 1,565	$ 1,588
Interest expense	228	280	301	314	329
Net interest income	1,394	1,350	1,281	1,251	1,259
Provision for loan losses	20	75	105	15	39
Non-interest income	484	309	319	280	325
Non-interest expense	1,339	1,484	1,317	1,207	1,083
Income before income taxes	519	100	177	309	462
Income tax expense (benefit)	171	(2,885)			
Net income	348	2,985	177	309	462
Effective dividend on preferred stock	12	20	68	48	48
Net income applicable to common shareholders	336	2,965	109	261	414
Basic and diluted income per share	$ 0.19	$ 1.64	$ 0.06	$ 0.15	$ 0.23
Performance Measurements					
Net interest margin (tax equivalent)	4.80%	4.61%	4.44%	4.51%	4.49%
Return on average assets (1)	1.11%	9.60%	0.58%	1.06%	1.62%
Return on average assets (2)	1.71%	0.56%	0.92%	1.11%	1.76%
Return on average common equity (1)	12.08%	132.13%	8.50%	15.39%	24.17%
	18.72%	7.77%	13.54%	16.13%	26.21%

Return on average common equity (2)					
Efficiency ratio	71.3%	89.43%	82.37%	78.80%	68.36%
Tier 1 Leverage Ratio (Bank only)	10.13%	9.94%	9.22%	8.54%	8.33%
Equity / Assets	12.67%	12.83%	10.47%	9.86%	9.79%
Total loans / Total deposits	95.4%	98.7%	92.3%	94.1%	93.9%
Book value per share	$ 6.44	$ 6.26	$ 4.65	$ 4.60	$ 4.44
Income per share basic & diluted	$ 0.19	$ 1.64	$ 0.06	$ 0.15	$ 0.23
Shares outstanding	1,812,662	1,812,662	1,812,662	1,800,000	1,800,000

(1) Amount is computed on net income before preferred dividends (annualized).
(2) Amount is computed on pre-tax, pre-provision earnings before preferred dividends (annualized).

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Net Interest Income

Net interest income for the three month period ended March 31, 2012 totaled $1,394,000, an increase of 10.6% compared to the same period of the prior year. The increase was a result of earning assets growth and a reduction in total funding costs. The earning asset growth was concentrated in loan volume, providing the largest benefit to interest income. Total average interest bearing deposit accounts increased $275,000 in the first quarter of 2012 relative to the first quarter of 2011 but total deposit related interest expenses decreased $101,000. The lower cost of funds was achieved by changes in pricing strategy and improved mix of the portfolio.

The Corporation s net interest margin increased 31 basis points to 4.80% for the period ended March 31, 2012 compared to 4.49% for the same period in 2011. Net interest spread, the difference between the yield on earning assets and cost of funds, also increased relative to the first quarter of 2011. The increase in both spread and margin is the result of an improved mix and a reduction in deposit costs. Asset yields declined during the period due to a reduction in loan and investment rates but a more favorable mix mitigated the impact. Total cost of funds for the first quarter of 2012 was 1.02% compared to 1.48% for the same period of 2011. This was accomplished as a result of an effective pricing strategy implemented by management and access to other funding options.

The following table presents the Corporation s consolidated average balances of interest-earning assets, interest-bearing liabilities, and the amount of interest income or interest expense attributable to each category, the average yield or rate for each category, and the net interest margin for the periods ended March 31, 2012, and 2011 (000s omitted). Average loans are presented net of unearned income and the allowance for loan and lease losses. Interest on loans includes loan fees.

	Three Months Ended March 31,					
	2012			2011		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Interest-earning assets:						
Loans receivable	$ 103,873	$ 1,592	5.98%	$ 100,976	$ 1,556	6.17%
Securities available for sale	4,684	26	2.30%	3,389	28	3.41%
Federal funds sold			%	40		0.13%
Interest-bearing balances with other financial institutions	6,906	3	0.20%	9,529	4	0.20%
Total interest-earning assets	**115,463**	**1,621**	**5.50%**	**113,934**	**1,588**	**5.59%**
Noninterest-earning assets:						
Cash and due from banks	3,818			643		
All other assets	7,218			858		
Total Assets	**$ 126,499**			**$ 115,435**		
Interest-bearing liabilities:						
NOW accounts	$ 8,382	$ 7	0.37%	$ 8,274	$ 6	0.31%
Money market	7,923	7	0.40%	8,231	11	0.55%
Savings	17,894	25	0.55%	17,670	31	0.72%
Time deposits	52,877	179	1.36%	54,191	265	1.96%
Brokered deposits	2,896	9	1.22%			%
Short-term borrowing	63		0.41%	1,394	15	4.22%
Total interest-bearing liabilities:	**$ 90,035**	**$ 227**	**1.02%**	**$ 89,760**	**328**	**1.48%**
Non-interest bearing demand deposits	19,558			13,844		
All other liabilities	700			691		
Total liabilities	**110,283**			**104,295**		

Shareholders Equity	16,206			11,140		
Total liabilities and shareholders equity	**$ 126,499**			**$ 115,435**		
Net Interest Income		**$ 1,394**			**$ 1,260**	
Net spread			**4.48%**			**4.11%**
Net Interest Margin(1)			**4.80%**			**4.49%**

(1) Net interest earnings divided by average interest-earning assets.

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Provision for Loans Losses

The provision for loan losses was $20,000 and $39,000 for the three months ended March 31, 2012 and 2011, respectively. The decrease from the previous comparable period was due to the pace of loan growth and overall credit quality of the portfolio. The Corporation recorded no charge offs or recoveries during the periods ended March 31, 2012 and March 31, 2011.

Non-Interest Income

Non-interest income was $484,000 and $325,000 for the three months ended March 31, 2012 and 2011, respectively. The increase in non-interest income was the result of additional revenue from the sale of residential mortgages and additional other income. For the three months ended March 31, 2012 and 2011, other income increased by $170,000 as a result of the gain on sale of a foreclosed property and income from bank-owned life insurance. The gain on sale of SBA loans declined during the period compared to the 1st quarter of 2011 due to lower loan volumes.

The following table presents the Corporation s non-interest income for the three month periods ending March 31, 2012 and 2011:

	For the Three Months Ended		
Non-interest income	March 31, 2012	March 31, 2011	Change
Service charge income	$ 18,798	$ 11,572	$ 7,226
Mortgage banking activities	162,828	11,439	151,389
SBA loan sales	121,791	291,294	(169,503)
Other income	180,572	10,804	169,768
Total non-interest income	$ 483,989	$ 325,109	$ 158,880

Non-Interest Expense

Non-interest expense for the period ended March 31, 2012 was $1,338,000, an increase of $255,000 from the first quarter of 2011. This was the result of additional expenses associated with new employees, increased activity from mortgage banking activities and growth of the organization. The largest component of non-interest expense is Salaries and Benefits, totaling $762,000 for the current period compared $482,000 for the three months ended March 31, 2011. The increase in total compensation is a result of adding new employees to accommodate future growth and an increase in commissions for originators associated with residential mortgage activity. Occupancy, Equipment and Data Processing expenses all increased relative to the same period of the prior year as the bank invested in facilities and system applications to improve services. The Corporation continues to dedicate resources to business marketing efforts to improve franchise recognition; this is reflected in the increase in Advertising costs reported during the period relative to the prior year. Loan origination expense was $69,000 for the period, an increase of $43,000. This additional cost is directly related to an increase in loan volume from mortgage banking. Regulatory assessments declined $23,000 for the three month period ended March 31, 2012 due to a reduction in insurance rates and change in the assessment base. Other expenses totaled $95,000 for the first quarter of 2012, an increase of $19,000 compared to the same period of 2011. The additional costs are a reflection of the increase in operating costs associated with the growth of the institution and expansion of product services.

The following table presents the Corporation s non-interest expense for the three month periods ending March 31, 2012 and 2011:

	For the Three Months Ended		
Non-interest expense	March 31, 2012	March 31, 2011	Change
Salaries and employee benefits	$ 761,670	$ 582,017	$ 179,653

Occupancy expense	119,731	118,102	1,629
Equipment expense	49,152	35,400	13,752
Advertising	42,594	36,046	6,548
Data processing	59,002	49,013	9,989
Professional fees	117,034	111,524	5,510
Loan origination expenses	69,012	26,369	42,643
Regulatory assessments	25,260	48,426	(23,166)
Other expense	95,040	76,519	18,521
Total non-interest expense	$ 1,338,495	$ 1,083,416	$ 255,079

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Income Taxes

The Corporation recorded federal income tax expense of $171,000 for the three month period ended March 31, 2012. A tax liability of $166,000 was realized for the first quarter of 2011 with a corresponding reduction in the Deferred Tax Asset valuation reserve resulting in no income tax expense being reported for the first quarter of March 31, 2011.

The deferred tax asset DTA balance represents the aggregate tax effect of all deductible temporary differences and operating loss carry-forwards. DTA s are recorded when an event generating a tax benefit has been recognized in the financial statements and is measured using the applicable tax rate. When it is more likely than not a portion or all of the DTA will not be realized a valuation reserve is required. The objective of the reserve is to reduce the DTA balance to an amount that is likely to be recognized. The requirement for a valuation reserve on a DTA is based on an analysis of all existing evidence, both positive and negative.

Since inception, the Corporation established a reserve on the full amount of the outstanding DTA balance. The reserve was maintained based on the Corporation s cumulative losses and concern regarding the ability of the organization to realize the full benefit of the asset. In December 2011, as a result of improved earnings, positive performance trends and financial projections demonstrating sustainable profitability, management determined there was sufficient evidence the Corporation would be able to recognize the full benefit of the entire DTA balance and eliminated the valuation reserve of $2,884,000. The Corporation s deferred tax asset (DTA) is included in other assets on the balance sheet. During the first quarter of 2012, management performed an evaluation of the ability of the Corporation to utilize the benefit of the DTA balance and determined no reserve was required. As of March 31, 2011, the Corporation had a valuation reserve for the entire balance of the DTA balance.

The Corporation has net operating loss carry-forwards of approximately $4,940,000 that are available to reduce future taxable income. The carry-forwards begin to expire twenty years from date of origination.

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LIQUIDITY AND CAPITAL RESOURCES; ASSET/LIABILITY MANAGEMENT

The management team has responsibility for developing and recommending liquidity and risk management policies including but not limited to the determination of internal operating guidelines, contingency plans, change management and pricing to the Asset/Liability Committee (ALCO) of the Board of Directors. Management ensures that the liquidity of a bank allows it to provide funds to meet its cash flow needs, such as loan requests, outflows of deposits, other investment opportunities and general operating requirements, under multiple operating scenarios. While the current structure of the Corporation and the Bank are not complex, the objective in the management of liquidity and capital resources is to be able to take advantage of business opportunities that may arise. The major sources of liquidity for the Bank have been deposit growth, federal funds sold, and loans which mature within one year. The Bank is also a member of the Federal Home Loan Bank of Indianapolis and has access to funding from the discount window at the Federal Reserve Bank of Chicago. The ALCO committee has also approved alternate funding sources to add flexibility. Large deposit balances which might fluctuate in response to interest rate changes are closely monitored. These deposits consist mainly of certificates of deposit over $100,000. We anticipate that we will have more than sufficient funds available to meet our future commitments. As of March 31, 2012, off balance sheet loan commitments totaled $39,008,000. As a majority of the unused commitments represent commercial and equity lines of credit, the Bank expects, and experience has shown, that only a small portion of the unused commitments will normally be drawn upon.

The following table presents loan commitments by time period as of March 31, 2012 (000s omitted):

		Amount of commitment expiration by period			
	Total	**Less than 1 Year**	**1-3 Years**	**3-5 Years**	**More than 5 Years**
Commitments to grant loans	$ 20,263	$ 20,263	$	$	$
Unfunded commitments under lines of credit	18,142	12,163	2,487	1,106	2,386
Commercial and standby letters of credit	603	603			
Total commitments	$ 39,008	$ 33,029	$ 2,487	$ 1,106	$ 2,386

Commitments to grant loans are governed by the Corporation s credit underwriting standards, as established in the Corporation s Loan Policy. As the above schedule illustrates, in general, it is the Corporation s practice to grant loan commitments for a finite period of time, usually lasting one year or less. The most significant departure from this practice involves home equity lines of credit (HELOCs). The Corporation s equity lines have a contractual draw period exceeding 5 years. The Corporation has the ability to suspend the draw privileges on a HELOC where a default situation or other impairment issue is identified.

The largest sources of cash and cash equivalents for the Corporation for the three months ended March 31, 2012, as noted in the Consolidated Statement of Cash Flows, were primarily loan sales and deposit origination.

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The prompt corrective action regulations provide five classifications, well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required. The Bank was well-capitalized as of March 31, 2012. Note 8 to the financial statements is hereby incorporated by reference. At March 31, 2012, the Corporation qualifies for an exemption from regulatory capital requirements due to its asset size.

On July 28, 2011, Birmingham Bloomfield Bancshares, Inc. entered into a Securities Purchase Agreement with the Secretary of the Treasury (the Treasury), pursuant to which the Company issued and sold to the Treasury 4,621 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series D (Series D Preferred Stock), having a liquidation preference of $1,000 per share (the Liquidation Amount), for aggregate proceeds of $4,621,000. In conjunction with the issuance of the Series D Preferred Stock, the Company has redeemed from the Treasury for $3,461,000, all of the Series A Preferred Shares, Series B Preferred Shares, and Series C Preferred Shares which were issued to the Treasury in 2009 under the Treasury s Emergency Economic Stabilization Act of 2008 Capital Purchase Program.

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The Series D Preferred Stock is entitled to receive non-cumulative dividends payable quarterly, on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate Liquidation Amount, is based upon the current level of Qualified Small Business Lending , or QSBL (as defined in the Securities Purchase Agreement) by the Company s wholly owned subsidiary Bank of Birmingham (the Bank). The dividend rate for future dividend periods will be set based upon the Percentage Change in Qualified Lending (as defined in the Securities Purchase Agreement) between each dividend period and the Baseline QSBL level. Such dividend rate may vary from 1% per annum to 5% per annum for the second through tenth dividend periods, from 1% per annum to 7% per annum for the eleventh dividend period through year four and one-half. If the Series D Preferred Stock remains outstanding for more than four and one-half years, the dividend rate will be fixed at 9%. Prior to that time, in general, the dividend rate decreases as the level of the Bank s QSBL increases. Such dividends are not cumulative, but the Company may only declare and pay dividends on its common stock (or any other equity securities junior to the Series D Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series D Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities.

Managing rates on earning assets and interest bearing liabilities focuses on maintaining stability in the net interest margin, an important factor in earnings growth and stability. Emphasis is placed on maintaining a controlled rate sensitivity position to avoid wide swings in margins and to manage risk due to changes in interest rates. Some of the major areas of focus of the Corporation s Asset Liability Committee (ALCO) incorporate the following overview functions: review the interest rate risk sensitivity of the Bank to measure the impact of changing interest rates on the Bank s net interest income, review the liquidity position through various measurements, review current and projected economic conditions and the corresponding impact on the Bank, ensure that capital and adequacy of the allowance for loan losses are maintained at proper levels to sustain growth, monitor the investment portfolio, recommend policies and strategies to the Board that incorporate a better balance of our interest rate risk, liquidity, balance sheet mix and yield management, and review the current balance sheet mix and proactively determine the future product mix.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Corporation s primary market risk exposure is interest rate risk and liquidity risk. All of the Corporation s transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Any impacts that changes in foreign exchange rates would have on interest rates are assumed to be insignificant.

Interest rate risk (IRR) is the exposure of a banking organization s financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value; however, excessive levels of IRR could pose a significant threat to our earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the Corporation s safety and soundness. The Board of Directors has instituted a policy setting limits on the amount of interest rate risk that may be assumed. Management provides information to the Board of Directors on a quarterly basis detailing interest rate risk estimates and activities to control such risk.

Evaluating a financial institution s exposure to changes in interest rates includes assessing both the adequacy of the management process used to control IRR and the organization s quantitative level of exposure. When assessing the IRR management process, the Corporation seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires the Corporation to assess the existing and potential future effects of changes in interest rates on its consolidated financial condition, including capital adequacy, earnings, liquidity, and, where appropriate, asset quality. This detailed analysis is performed on a quarterly basis, but is managed daily. The Bank continues to be in a liability sensitive position and management continues to work toward creating a more closely matched portfolio to minimize any potential impact that changing rates could have on earnings in the short term. The institution is well positioned to minimize the impact of rate changes, with the rate shock analysis showing that over the long term, rate changes pose only a minimal risk to our economic value of equity (EVE ratio).

The Corporation has not experienced a material change in its financial instruments that are sensitive to changes in interest rates since December 31, 2011, which information can be located in the Corporation s annual report on Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

As of March 31, 2012, we conducted an evaluation, under the supervision and with the participation of the Corporation s management, including the Corporation s chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Corporation s disclosure controls and procedures, as such term is defined under Exchange Act Rules 13a-15(e) and 15d-15(e).

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Based on this evaluation, the Corporation s chief executive officer and chief financial officer concluded that, as of March 31, 2012, such disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and accumulated and communicated to the Corporation s management, including the Corporation s chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

In designing and evaluating the disclosure controls and procedures, the Corporation s management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and in reaching a reasonable level of assurance. The Corporation s management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

There were no changes in the Corporation s internal controls over financial reporting during the period ended March 31, 2012 that materially affected, or are reasonably likely to materially affect, the Corporation s internal controls over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

There are no known pending legal proceedings to which the Corporation or the Bank is a party or to which any of its properties are subject; nor are there material proceedings known to the Corporation, in which any director, officer or affiliate or any principal shareholder is a party or has an interest adverse to the Corporation or the Bank.

ITEM 1A. RISK FACTORS.

This item is not applicable.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

This item is not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

This item is not applicable.

ITEM 4. [Reserved]

ITEM 5. OTHER INFORMATION.

This item is not applicable.

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ITEM 6. EXHIBITS.

Exhibit Number	Description of Exhibit
3.1	Articles of Incorporation
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Interactive Data File.

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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.

BIRMINGHAM BLOOMFIELD BANCSHARES, INC.

Date: May 4, 2012

By: /s/ Robert E. Farr
Robert E. Farr
Chief Executive Officer

Date: May 4, 2012

By: /s/ Thomas H. Dorr
Thomas H. Dorr
Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Description of Exhibit
3.1	**Articles of Incorporation.**
31.1	**Certification pursuant to Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act**
31.2	**Certification pursuant to Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act**
32.1	**Certification pursuant to Rules 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act and 18 U.S.C. §1350**
101	**Interactive Data File.**