

LIQUIDMETAL TECHNOLOGIES INC  
Form 10-Q  
May 15, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2007**

**OR**

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

**For the transition period from to**

**Commission File No. 001-31332**

**LIQUIDMETAL TECHNOLOGIES, INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**33-0264467**  
(I.R.S. Employer  
Identification No.)

**30452 Esperanza**

**Rancho Santa Margarita, California 92688**

(address of principal executive office, zip code)

**25800 Commercentre Dr.**

**Lake Forest, CA 92630**

(former address of principal executive office)

Registrant's telephone number, including area code: **(949) 635-2100**

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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 at least the past 90 days.

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

**As of March 31, 2007, there were 44,631,768 shares of the registrant's common stock, \$0.001 par value, outstanding.**

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**LIQUIDMETAL TECHNOLOGIES, INC.**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED MARCH 31, 2007**

**FORWARD-LOOKING INFORMATION**

Statements in this report concerning the future sales, expenses, profitability, financial resources, product mix, market demand, product development and other statements in this report concerning the future results of operations, financial condition and business of Liquidmetal Technologies, Inc. are forward-looking statements as defined in the Securities Act of 1933 and Securities Exchange Act of 1934. Investors are cautioned that the Company's actual results in the future may differ materially from those projected in the forward-looking statements due to risks and uncertainties that exist in the Company's operations and business environment, including competition, need for increased acceptance of products, ability to continue to develop and extend our brand identity, ability to anticipate and adapt to a competitive market, ability to effectively manage rapidly expanding operations, amount and timing of operating costs and capital expenditures relating to expansion of our business, operations and infrastructure, ability to provide superior customer service, dependence upon key personnel and the like. The Company's most recent filings with the Securities and Exchange Commission, including Form 10-K, contain additional information concerning many of these risk factors, and copies of these filings are available from the Company upon request and without charge.

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## PART I

## FINANCIAL INFORMATION

## Item 1 Financial Statements

## LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	March 31, 2007 (Unaudited)	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 2,937	\$ 144
Restricted cash	2,083	
Trade accounts receivables, net of allowance for doubtful accounts of \$65 and \$82	3,086	3,934
Inventories	2,541	3,765
Prepaid expenses and other current assets	996	830
Total current assets	11,643	8,673
Property, plant and equipment, net	11,077	12,095
Idle equipment	191	194
Other intangibles, net	1,156	1,170
Investment in joint venture	220	3
Other assets	1,088	109
Total assets	25,375	22,244
<b>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</b>		
Current liabilities:		
Accounts payable and accrued expenses	7,696	9,802
Deferred revenue	125	202
Short-term debt	1,493	2,669
Long-term debt, current portion, net of debt discounts of \$1,647 and \$3,636	11,849	14,480
Warrant liabilities	2,934	2,662
Conversion feature liabilities	3,434	1,838
Other liabilities, current portion	178	177
Total current liabilities	27,709	31,830
Long-term debt, net of current portion and debt discounts of \$9,893 and \$0	6,406	225
Other long-term liabilities, net of current portion	582	552
Total liabilities	34,697	32,607
Shareholders' deficiency:		
Common stock, \$0.001 par value; 100,000,000 shares authorized and 44,631,768 issued and outstanding at March 31, 2007 and 44,311,768 issued and outstanding at December 31, 2006	45	44
Additional paid-in capital	136,776	136,031
Accumulated deficit	(148,530)	(149,047)
Accumulated other comprehensive income	2,387	2,609
Total shareholders' deficiency	(9,322)	(10,363)
Total liabilities and shareholders' deficiency	\$ 25,375	\$ 22,244

The accompanying notes are an integral part of the condensed consolidated financial statements.



## LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended March 31,	
	2007	2006 (Restated)
Revenue	\$ 5,067	\$ 6,555
Cost of sales	6,441	5,324
Gross profit	(1,374 )	1,231
Operating expenses		
Selling, general, and administrative	2,532	2,705
Research and development	263	203
Total operating expenses	2,795	2,908
Loss from operations	(4,169 )	(1,677 )
Loss from extinguishments of debt	(648 )	
Change in value of warrants, gain (loss)	3,692	(1,289 )
Change in value of conversion feature, gain (loss)	4,344	(1,783 )
Other income		480
Interest expense	(2,763 )	(1,782 )
Interest income	61	2
Income (loss) from continuing operations	517	(6,049 )
Net income (loss)	517	(6,049 )
Other comprehensive income (loss):		
Foreign exchange translation (loss) gain	(222 )	100
Comprehensive income (loss)	\$ 295	\$ (5,949 )
Net income (loss) per share basic and diluted:		
Income (loss) per share basic and diluted	\$ 0.01	\$ (0.14 )
Number of weighted average shares - basic and diluted	44,925	42,817

The accompanying notes are an integral part of the condensed consolidated financial statements.

## LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS DEFICIENCY

For the Three months ended March 31, 2007

(in thousands, except per share data)

(unaudited)

	Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
<b>Balance, December 31, 2006</b>	44,311,768	44	136,031	(149,047	) 2,609	(10,363 )
Conversion of notes payable	320,000	1	516			517
Stock-based compensation			229			229
Foreign exchange translation gain					(222	) (222 )
Net loss				517		517
<b>Balance, March 31, 2007</b>	44,631,768	\$ 45	\$ 136,776	\$ (148,530	) \$ 2,387	\$ (9,322 )

The accompanying notes are an integral part of the condensed consolidated financial statements.



**LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended	
	March 31, 2007	2006 (Restated)
<b>Operating activities:</b>		
Net income (loss)	\$ 517	\$ (6,049 )
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Gain on disposal of asset	1	
Depreciation and amortization	881	782
Loss on extinguishment of debt	648	
Amortization of debt discount	1,735	1,413
Stock-based compensation	229	224
Bad debt (recovery) expense	(17 )	28
Warranty expense	207	74
Loss (gain) from change in value of warrants	(3,692 )	1,289
Loss (gain) from change in value of conversion feature	(4,344 )	1,783
Changes in operating assets and liabilities:		
Trade accounts receivable	865	(1,174 )
Inventories	1,224	(16 )
Prepaid expenses and other current assets	(231 )	48
Other assets	(1,109 )	17
Accounts payable and accrued expenses	(2,314 )	1,388
Deferred revenue	(77 )	(868 )
Other liabilities	32	(107 )
Net cash used for operating activities	(5,445 )	(1,168 )
<b>Investing Activities:</b>		
Purchases of property and equipment	(5 )	(145 )
Proceeds from the sale of property and equipment	10	
Investment in patents and trademarks	(16 )	(39 )
Investment in joint venture	(217 )	
Net cash used for investing activities	(228 )	(184 )
<b>Financing Activities:</b>		
Proceeds from borrowings	19,894	3,995
Repayment of borrowings	(9,265 )	(2,581 )
Repayment of other liabilities		(33 )
Restricted cash	(2,083 )	
Net cash provided by financing activities	8,546	1,381
Effect of foreign exchange translation	(80 )	(158 )
Net increase (decrease) in cash and cash equivalents	2,793	(129 )
Cash and cash equivalents at beginning of period	144	1,392
Cash and cash equivalents at end of period	\$ 2,937	\$ 1,263
Supplemental cash flow information		
Interest paid	\$ 354	\$ 293
Taxes paid	\$	\$

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - continued**

**(in thousands, except per share data)**

**(unaudited)**

During the three months ended March 31, 2007, \$400 of the Company's 7% senior convertible notes due July 2007 was converted into 320,000 shares of the Company's common stock at a conversion price of \$1.25 per share.

The accompanying notes are an integral part of the condensed consolidated financial statements.

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LIQUIDMETAL TECHNOLOGIES AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Three Months Ended March 31, 2007 and 2006

(in thousands, except share data)

(unaudited)

**1. Basis of Presentation / Description of Business**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. All intercompany balances and transactions have been eliminated. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for any future periods or the year ending December 31, 2007. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Company's Form 10-K filed with the Securities and Exchange Commission on March 16, 2007.

Liquidmetal Technologies, Inc. ( Liquidmetal Technologies ) and its subsidiaries (collectively the Company ) are in the business of developing, manufacturing, and marketing products made from amorphous alloys. Liquidmetal Technologies markets and sells Liquidmetal® alloy industrial coatings and also manufactures, markets and sells products and components from bulk Liquidmetal alloys that can be incorporated into the finished goods of its customers across a variety of industries. The Company also partners with third-party licensees and distributors to develop and commercialize Liquidmetal alloy products.

The Company classifies operations into two reportable segments: Liquidmetal alloy industrial coatings and bulk Liquidmetal alloys (see Note 9). Liquidmetal alloy industrial coatings are used primarily as a protective coating for industrial machinery and equipment, such as drill pipe used by the oil drilling industry and boiler tubes used by coal-burning power plants. Bulk Liquidmetal alloys include potential market opportunities to manufacture and sell products and components for electronic devices, medical devices, defense applications, and sporting goods. In addition, the bulk Liquidmetal alloys segment includes tooling and prototype sampling. In addition, such alloys are used to generate research and development services revenue for developing uses related primarily to defense and medical applications as well as potential license fees, royalties, and other compensation from strategic partnering transactions.

Stock-based compensation

The Company previously applied Accounting Principles Board ( APB ) Opinion No. 25 for options when the exercise price of options granted to employees is less than the fair value of the underlying stock on the date of grant. As permitted, the Company had previously elected to adopt provisions of Statement of Financial Accounting Standard ( SFAS ) No. 123, *Accounting for Stock-Based Compensation* for options granted to non-employees who perform services for the Company and the disclosure-only provisions of options granted to employees.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, ( SFAS 123 ) and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, ( APB 25 ). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Under SFAS 123R, the Company is required to measure the cost of employee services received in exchange for stock options and similar awards based on the grant-date fair value of the award and recognize this cost in the income statement over the period during which an employee is required to provide service in exchange for the award. The pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition. The Company adopted SFAS 123R on January 1, 2006 using the modified prospective method and recorded \$229 for the three month period ended March 31, 2007, of non-cash charges for stock compensation related to amortization of the fair value of restricted stock and unvested stock options representing an increase from the stock compensation that would have been recorded under APB 25 and SFAS 123. Under this method, the Company will recognize compensation cost, on a prospective basis, for the portion of outstanding awards for which the requisite service has not yet been rendered as of January 1, 2006 and any new grants, based upon the grant-date fair value of those awards calculated under SFAS 123 for pro forma disclosure purposes. Accordingly, we have not restated prior period amounts.



The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants for the three months ended March 31, 2007 and 2006, respectively: expected volatility of approximately 100% for all periods; dividend yield of 0% for all periods; expected option life of approximately 5 years; and a risk-free interest rate ranging from 4.30% to 4.82%.

## 2. Basis of Presentation and Recent Accounting Pronouncements

### Translation of Foreign Currency

The Company applies *FASB No. 52, Foreign Currency Translation*, for translating foreign currency into US dollars in our consolidation of the financial statements. Upon consolidation of the Company's foreign subsidiaries into the Company's consolidated financial statements, any balances with the subsidiaries denominated in the foreign currency are translated at the exchange rate at period-end. The financial statements of Liquidmetal Korea have been translated based upon Korean Won as the functional currency. Liquidmetal Korea's assets and liabilities were translated using the exchange rate at period end and income and expense items were translated at the average exchange rate for the reporting period. The resulting translation adjustment was included in other comprehensive income (loss).

### Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159)*, which permits entities to choose to measure many financial instruments and certain other items at fair value. The effective date of SFAS 159 will be the first quarter of 2008. The Company is currently evaluating the provisions of SFAS 159 and does not expect the adoption of this new standard to have a material impact on its consolidated financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA and the SEC did not or are not believed by management to have a material impact on our company's present or future consolidated financial statements.

## 3. Liquidity

The Company has experienced losses from continuing operations during the last three fiscal years and has an accumulated deficit of \$148,530 as of March 31, 2007. Cash used for operations for the three months ended March 31, 2007 was \$5,445 and cash flow from operations will likely be negative throughout fiscal year 2007. As of March 31, 2007, the Company's principal sources of liquidity are \$2,937 of cash and \$3,086 of trade accounts receivable. Such conditions raise substantial doubt that the Company will be able to continue as a going concern. These operating results occurred while the Company was developing and continues to develop, commercialize, and manufacture products from an entirely new and unique technology. These factors have placed a significant strain on the financial resources of the Company. The ability of the Company to overcome these challenges depends on its ability to correct its production inefficiencies, reduce its operating costs, generate higher revenue, achieve positive cash flow from continuing operations and continued sources of debt and equity financing. The consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

Further, the Company borrowed \$3,667, which was offset by repayments of \$3,843, under a factoring, loan, and security agreement executed on April 21, 2005 to fund its working capital requirements during the three months ended March 31, 2007.

On January 3, 2007, the Company completed a private placement of \$16,300 in principal amount of 8% Convertible Subordinated Notes due January 2010 (the *January 2010 Notes*). The January 2010 Notes were issued for aggregate cash in the amount of \$12,850, in payment of a total of \$3,377 in principal and accrued but unpaid interest under our previously issued 7% Senior Secured Convertible Notes due August 2007 and our 8% Unsecured Subordinated Notes, and \$73 cash discount (see Note 7).

We anticipate that the \$12,850 aggregate cash raised in the private placement will be sufficient to pursue our current operating plan only through the third quarter of 2007, and we will therefore require additional funding at or prior to that time. As a result of the foregoing, we are actively seeking additional sources of capital and seeking to restructure and/or modify existing indebtedness. The amount of funding that we seek and the timing of such fundraising efforts will depend on the extent to which we are able to increase revenues through obtaining additional purchase orders for our products and/or the extent to which we can restructure or modify our debt. Because we cannot be certain that we will be able to obtain adequate funding from debt, equity, or other traditional financing sources, we are also actively exploring several strategic financing options, including the possible sale of our manufacturing plant in South Korea (which would then be replaced with a smaller facility), potential licensing and outsourcing of manufacturing operations including those in South Korea and China, and the possible sale of our Liquidmetal Coatings business. We cannot guarantee that adequate funds will be available when needed, and if we do not receive sufficient capital, we may be required to alter or reduce the scope of our operations.

#### 4. Inventories

Inventories are accounted for using the moving average basis and at standard cost, which approximate cost on a first-in, first-out basis and are valued at the lower of cost or market. Inventories were comprised of the following:

	<b>March 31, 2007 (Unaudited)</b>	<b>December 31, 2006</b>
Raw materials	\$ 1,020	\$ 966
Work in process	660	1,729
Finished goods	861	1,070
Total inventories	\$ 2,541	\$ 3,765

#### 5. Idle Equipment

Idle equipment consists of certain equipment held by the Company for use in expansion of bulk alloy parts manufacturing. While the equipment may be used internally to meet future capacity requirements, considering our current revenue and foreseeable production requirements, the Company does not anticipate utilizing this equipment internally in the near future. Total amount of idle equipment remaining was \$191 as of March 31, 2007 and \$194 as of December 31, 2006.

During the three months ended March 31, 2007, the Company disposed of \$34 of its equipment for proceeds of \$10.

#### 6. Product Warranty

Management estimates product warranties as a percentage of certain bulk alloy product sales earned during the period. As of March 31, 2007, the Company used 5% of bulk alloy product sales as an estimate of warranties to be claimed. The percentage is based on industry averages and historical information. During the three months ended March 31, 2007, and 2006, the Company recorded \$207 and \$42 of warranty expense, respectively. The product warranty accrual balance is included in accounts payable and accrued expenses.

## 7. Notes Payable

### Senior Convertible Note

On March 3, 2004, the Company issued \$9,924 of 6% senior convertible notes due 2007 (the "March Notes") to investor groups in a transaction led by Michigan Venture Capital Co., Ltd, a South Korea-based institutional investment firm, and IndiGo Ventures LLC, a New York-based investment firm (the "Placement Agents") that served as a financial advisor to the Company for the transaction. The notes were collateralized by the patents held by the Company and second priority mortgage interest in plant facilities and certain equipment in South Korea. The notes were convertible at any time into common stock at a price of \$3.00 per share. Investors in the private placement and the Placement Agents received warrants to purchase an aggregate amount of up to approximately 1.2 million shares of common stock, exercisable at \$3.00 per share for varying periods but no later than 100 days following the effectiveness of a registration statement covering the resale of shares issuable upon exercise of the warrants. The conversion and warrant exercise price are subject to price adjustments for anti-dilution purposes. In addition, the investors had the right to call for repayment of the notes prior to maturity at any time after the second anniversary of the closing of the transaction.

Pursuant to Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," EITF 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments," and EITF 05-2 "The Meaning of 'Conventional Convertible Debt Instrument' in EITF Issue No. 00-19," the original fair value of the embedded conversion feature of \$7,595 have been recorded as conversion feature liabilities as the debt is considered non-conventional convertible debt. The original fair value was computed using the Black-Scholes model under the following assumptions: (1) expected life of 3 years; (2) volatility of 82%; (3) risk free interest of 2.15% and dividend rate of 0%. The fair value of the conversion feature on the date of issuance has been recorded as debt discount to be amortized over the life the debt.

Pursuant to EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," the original fair value of the 1.2 million warrants of \$1,302 has been recorded as warrant liabilities as the shares issuable under the warrants have not been registered. The original fair value was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 3 years; (2) volatility of 82%, (3) risk free interest of 0.95% and dividend rate of 0%.

In March 2004, the original fair value of the embedded conversion feature of \$7,595 and the original fair value of the 0.6 million warrants issued to investors of \$584, and the original fair value of 0.6 million warrants issued to Placement Agents of \$718 were recorded as discounts of the convertible note. In addition, \$581 direct costs incurred relating to issuance of the convertible note were recorded as debt issuance cost in other assets.

During 2004, the Company redeemed \$4,465 of the outstanding note balance in cash. The redemption resulted in a write down of debt issuance costs and debt discount of \$3,571 to interest expense and a reduction in conversion feature liabilities of \$914 from cancellation of the embedded conversion feature of the redeemed notes to additional paid in capital during the year ended December 31, 2004. Further, 500,000 of warrants originally issued to a financial advisor for the transaction expired during June 2004 and 163,748 of unexercised warrants originally issued to investors were cancelled as a result of the Company's redemption of the note balances during the year ended December 31, 2004. The 663,748 total expired and canceled warrants immediately prior to the expiration and cancellation resulted in a reduction of warrant liability of \$7 and \$279 to additional paid in capital and change in value of warrants, respectively, during the year ended December 31, 2004.

On August 19, 2004, the Company completed a private exchange offer for its March Notes with the remaining holders after the redemption. Under terms of the exchange offer, approximately \$5,460 in aggregate principal amount of the March Notes have been exchanged for an aggregate of (i) \$2,730 of 6% Senior Secured Notes Due 2007 (the "July 2007 Notes") and (ii) \$2,730 of 10% Senior Secured Notes Due 2005 (the "July 2005 Notes"), collectively referred to as "Exchange Notes". The Exchange Notes are collateralized by certain patents owned by the Company and second priority mortgage interest in plant facilities and certain equipment at our South Korea plant. The July 2005 Notes had a maturity date of July 29, 2005, and a conversion price of \$2.00 per share (compared to a conversion price of \$3.00 per share under the March Notes). The July 2005 Notes have been exchanged and redeemed subsequent to the close of the second quarter of 2005 (see 2005 Senior Convertible Notes below). The July 2007 Notes have a maturity date of July 29, 2007, and a conversion price of \$1.00 per share. The conversion prices of the July 2007 Notes and July 2005 Notes are subject to price



adjustments for anti-dilution purposes. Further, the exchange notes are convertible into Common Stock, at the option of the Company, if at any time after the issuance of the notes, the closing per share price of the Common Stock exceeds \$4.00 (as adjusted for stock splits, reverse splits, stock dividends, and recapitalizations) for 30 consecutive trading days, and further provided that there has been effective registration during such period. The convertible price of the Exchange Notes is subject to price adjustment for anti-dilution purposes. As of March 31, 2007, the convertible price of the July 2007 Notes remained unchanged at \$1.00 per share. Holders of the July 2007 Notes also have the right to call for repayment of the July 2007 Notes prior to maturity at any time after the second anniversary of the closing of the exchange offer. The July 2007 Notes have been amended subsequent to the close of the second quarter of 2005 to provide for an Amended Registration Rights Agreement, and Amended and Restated Security Agreement (see 2005 Senior Convertible Notes below).

A total of 563,151 warrants to purchase our common stock at an exercise price of \$3.00 per share all of which were previously issued in connection with the purchase of the March Notes have been amended to provide for an extended expiration date of March 1, 2006. There are no outstanding warrants at March 31, 2007.

The exchange offer was treated as an extinguishment of the March Notes in accordance with Emerging Issues Task Force No. 96-19, Debtors Accounting for a Modification or Exchange of Debt Instruments. The exchange resulted in a \$2,941 loss from extinguishment of the March Notes, which consisted of write down of \$352 of deferred issue costs in other assets, \$670 of debt discount, and an increase of \$1,919 in conversion feature liability as a result of the change in carrying value of exchanged notes.

In connection with the private exchange offer, the Company issued \$250 of private placement notes to certain Placement Agents as issuance costs. Of the \$250 notes issued, \$125 was paid in the form of long-term notes which is due in 2007 with interest rate of 6% per annum (July 2007 Notes) and \$125 was paid in the form of short-term notes which is due in 2005 with interest rate of 10% per annum (July 2005 Notes). The July 2005 and July 2007 Notes are convertible into Common Stock at \$2.00 and \$1.00, respectively, and have the same terms as the Exchange Notes issued to the investors. Further, \$143 of original fair value of the embedded conversion feature of \$250 notes issued to Placement Agents was recorded as conversion feature liabilities during August 2004.

The Company was obligated, pursuant to a Registration Rights Agreement, as amended by the Exchange Notes, between the Company, the Placement Agents and the note holders to file a registration statement with the Securities and Exchange Commission ( SEC ) to register the shares of Common Stock issuable upon conversion of the notes payable and the related warrants within 90 days following the effective closing date of the exchange notes (July 29, 2004), and to use best efforts to cause such registration statement to become effective within 60 days following the SEC's first written comments on the registration statement. Further, if the Company is not in compliance with the registration or listing requirements, the holders have rights to late registration payments equal to between 2% and 3% of the purchase price paid for the unconverted notes for the first 30 business days of late registration, and 1% and 3% percent for each 30 business days thereafter, but no more than 18% of the purchase price of the unconverted note balance.

Interest payments are due quarterly, and failure to make timely interest payments will result in increase in interest rate to 10% and 14% on the 6% and 10% senior convertible notes ( Default Rates ). The Default Rates became effective on April 1, 2005 from non-payment of a scheduled interest payment. As of March 31, 2007, the Company has complied with all scheduled interest payments.

On August 9, 2005, the July 2005 Notes, accrued interest and late registration fees were redeemed in cash and exchanged for 7% Convertible Secured Promissory Notes due August 2007 (see 2005 Senior Convertible Notes below).

During the year ended December 31, 2006, \$286 of the July 2007 Notes were converted into 285,750 of the Company's common stock at a conversion price of \$1.00 per share.

The Company's gross outstanding loan balance of the July 2007 Notes totaled \$2,083, as of March 31, 2007 and December 31, 2006, respectively. As of March 31, 2007 and December 31, 2006, un-amortized discounts for conversion feature and warrants totaled \$224 and \$391, respectively, and other asset debt issuance costs totaled \$8 and \$14, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$174 and \$223 for the quarters ended March 31, 2007 and 2006, respectively. As of March 31, 2007, the effective interest rate of the July 2007 Notes was 34.5%.

Pursuant to Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, the Company is required to report a value of the conversion liability as a fair value and record the fluctuation to the fair value of the conversion feature liability to current operations. The change in the fair value of the conversion feature liability resulted in a gain of \$31 and a loss of \$802 for the three months ended March 31, 2007 and 2006, respectively. The fair value of conversion features outstanding at March 31, 2007 and December 31, 2006 was \$1,188 and \$1,218. The fair value of conversion features of outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) 0.33 years; (2) volatility of 55%; (3) risk free interest of 5.04% and dividend rate of 0%.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original relative fair values of the warrants of \$1,302 have been recorded as warrant liability. In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in fair value of warrants resulted in a loss of \$3 for the three months ended March 31, 2006. The warrant has expired as of December 31, 2006.

#### Convertible Notes

On June 13, 2005, the Company completed a private placement (the June 2005 Private Placement) of 10% Convertible Unsecured Notes Due June 13, 2006 in the aggregate principal amount of \$3,250 (the June 2006 Notes), together with warrants to purchase up to an aggregate of 893,750 shares of the Company's common stock (the Warrants).

The June 2006 Notes issued by the Company in the June 2005 Private Placement are unsecured and was due on the earlier of June 13, 2006 or the consummation of a follow-on equity or debt offering or restructuring transaction pursuant to which the Company receives gross proceeds of at least \$4,000. Prior to maturity, the June 2006 Notes are interest-only, with interest payments due quarterly, at the rate of 10% per year. The June 2006 Notes can be prepaid by the Company at any time without penalty. If, within 120 days following the issue date of the June 2006 Notes, the Company either fails to redeem the notes for the principal amount and accrued interest thereon or fails to close a Qualified Financing, then the June 2006 Notes will thereafter be convertible at a conversion price equal to seventy five percent (75%) of the closing price of the Company's common stock on the first trading day immediately preceding the conversion date. A Qualified Financing is defined in the June 2006 Notes as any debt or equity financing of the Company resulting in aggregate gross proceeds to the Company of at least \$5,000 and in which the holders of at least sixty percent (60%) of the aggregate principal amount of the Company's July 2007 Notes either (i) agree that the equity or debt securities to be issued in such financing shall be pari passu in order of payment to the July 2007 Notes held by them or (ii) exchange their July 2007 Notes for new securities in the financing transaction. On August 9, 2005, the Company successfully completed Qualified Financing, which resulted in exchange and redemption of the Convertible Notes (see 2005 Senior Convertible Notes below). As a result, the June 2006 Notes never became convertible.

As a part of the June 2005 Private Placement, the Company issued warrants to the purchasers of the June 2006 Notes giving them the right to purchase up to an aggregate of 812,500 shares of the Company's common stock. In addition, warrants to purchase 81,250 shares of the Company's common stock were issued to the placement agent in the transaction. The warrants have an original exercise price of \$2.00 per share, provided that upon the consummation of the first ensuing public or private equity or debt offering or restructuring transaction in which the Company receives gross proceeds of at least \$3,250 (including without limitation any restructuring of the Company's July 2005 Notes), the exercise price will be automatically adjusted downward (but not upward) as of the closing date of such offering or restructuring transaction so that it is equal to the lowest effective common stock purchase price paid for any securities issued by the Company to the investors in such offering or restructuring transaction. The warrants will expire on June 13, 2010 and are subject to exercise price adjustment for anti-dilution purposes. The exercise price of the warrants was reduced to \$1.91 per share and total number of warrants was increased 935,873 as of March 31, 2007 as a result of our January 2007 private placement (see Convertible Subordinated Notes below).

The original fair value of the 893,750 warrants totaled \$1,160 and was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 5 years; (2) volatility of 118%, (3) risk free interest of 3.87% and dividend rate of 0%. In accordance with Emerging Issues Task Force No. 00-27, Application of Issue No. 98-5 to Certain

Convertible Instruments the embedded beneficial conversion feature of the debt was not recorded as the debt is considered contingently convertible at the time of issuance, and as a result of the completion of the Qualified Financing the debt subsequent to the close of the second quarter, the debt was determined to be not convertible. In June 2005, the fair value of the 812,500 warrants issued to investors of \$1,055 was recorded as discounts of the convertible note. In addition \$105 relating to the fair value of the 81,250 warrants issued to the Placement Agents and \$278 direct costs incurred relating to issuance of the convertible note were recorded as debt issuance cost as a contra liability account in debt discount and other assets, respectively, and will be amortized using the effective interest rate method over the life of the loan.

On August 9, 2005, the June 2006 Notes were redeemed in cash and exchanged for 7% Convertible Secured Promissory Notes due August 2007 (see 2005 Senior Convertible Notes below). The exchange offer was treated as an extinguishment of the June 2006 Notes in accordance with Emerging Issues Task Force No. 96-19, Debtors Accounting for a Modification or Exchange of Debt Instruments. The exchange resulted in a \$1,247 loss from extinguishment of the June 2006 Notes as of December 31, 2005, which consists of write down of \$240 of deferred issue costs in other assets, \$92 of contra liability deferred issuance costs, and \$915 of debt discount as a result of the change in carrying value of exchanged notes.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair values of the warrants of \$1,160 have been recorded as warrant liability. In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a gain of \$281 and a loss \$302 for the three months ended March 31, 2007 and 2006, respectively. The fair value of warrants outstanding at March 31, 2007 and December 31, 2006 was \$206 and \$487, respectively. The fair value of warrants outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 3.2 years; (2) volatility of 55%, (3) risk free interest of 4.54% and dividend rate of 0%.

#### 2005 Senior Convertible Notes

On August 9, 2005, the Company completed a private placement (the August 2005 Private Placement) of \$9,878 in principal amount of new 7% Convertible Secured Promissory Notes due August 2007 (the August 2007 Notes). The issuance consisted of \$5,000 cash, exchange of \$1,284 in principal amount of the July 2005 Notes, the exchange of \$2,996 in principal amount of the June 2006 Notes, satisfaction of accrued interest and late registration fees in the amount of \$589 on the July 2005 Notes, and satisfaction of accrued interest of \$9 on the June 2006 Notes. The August 2007 Notes were issued pursuant to a Securities Purchase Agreement dated effective as of August 2, 2005 among the Company, the purchasers of the August 2007 Notes, and the holders of July 2005 Notes and June 2006 Notes of the Company.

Interest payments are due quarterly, and failure to make timely interest payments will result in increase in interest rates to 14% per annum on the August 2007 Notes (Default Rates). As of March 31, 2007, the Company has made timely interest payments.

The August 2007 Notes are convertible into shares of the Company's common stock at \$2.00 per share Pursuant to an Amended and Restated Security Agreement. The convertible price of the August 2007 Notes is subject price adjustment for anti-dilution purposes. As of March 31, 2007, the convertible price of the August 2007 Notes was reduced to \$1.91 per share.

Further, pursuant to Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, and EITF 05-2 The Meaning of Conventional Convertible Debt Instrument in EITF Issue No. 00-19, the original fair value of the embedded conversion feature of \$4,808 have been recorded as conversion feature liability as the debt is considered nonconventional convertible debt. The original fair value was computed using the Black-Scholes model under the following assumptions: (1) expected life of 2 years; (2) volatility of 93%; (3) risk free interest of 4.06% and dividend rate of 0%. In addition, the Company is required to report a value of the conversion liability as a fair value and record the fluctuation to the fair value of the conversion feature liability to current operations. The change in the fair value of the conversion feature liability resulted in a gain of \$342 and a loss of \$981 for the three months ended March 31, 2007 and 2006, respectively. The

fair value of conversion features outstanding at March 31, 2007 and December 31, 2006 was \$12 and \$619, respectively. The fair value of conversion feature outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) 0.34 year; (2) volatility of 55%, (3) risk free interest of 5.04% and dividend rate of 0%.

The August 2007 Notes are secured by substantially all assets of the Company and rank senior to all other obligations of the Company, other than the Company's loan with Kookmin Bank of South Korea (or any refinancing of such loan), the July 2007 Notes, purchase money asset financing, trade creditors in the ordinary course of business, and any inventory or receivables-based credit facility that the Company may obtain in the future, provided that the amount of the credit facility does not exceed 50% of eligible inventory and 80% of eligible receivables. The August 2007 Notes will automatically convert into common stock if the Company's common stock has an average closing price of more than \$5.00 per share during 30 consecutive trading days.

The Company also issued warrants to the purchasers of the August 2007 Notes and placement agents giving them the right to purchase up to 2,469,470 and 414,495 shares of Company common stock, respectively, with an exercise price of \$2.00 per share, which is subject to price adjustment for anti-dilution purposes. As of March 31, 2007, the exercise price of the warrants was reduced to \$1.91 per share and total number of warrants was increased to 3,019,881. The warrants will expire on August 2, 2010.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair values of the warrants of \$4,068 have been recorded as warrant liability, which was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 5 years; (2) volatility of 93%; (3) risk free interest of 4.17% and dividend rate of 0%. In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a gain of \$918 and a loss of \$985 for the three months ended March 31, 2007 and 2006, respectively. The fair value of warrants outstanding at March 31, 2007 and December 31, 2006 was \$694 and \$1,612, respectively. The fair value of the warrants outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 3.34 years; (2) volatility of 55%; (3) risk free interest of 4.54% and dividend rate of 0%.

In connection with the August 2005 Private Placement, the Company entered into an amended and restated registration rights agreement with the holders of the July 2007 Notes, the holders of the August 2007 Notes, and the holders of the above-described outstanding warrants. This amended and restated registration rights agreement replaced all other registration rights agreements previously entered into by us in connection with the private sale by us of convertible notes and warrants. Under the amended and restated registration rights agreement, the Company is required to file a resale registration statement for the shares underlying all of our outstanding convertible notes and warrants, as described above, by October 31, 2005, to enable the resale of such shares by the selling stockholders on a delayed or continuous basis under Rule 415 of the Securities Act. The Company is then required to cause such registration statement to become effective within 60 days after we receive the first written comments on the registration statement from the SEC, or if the SEC notifies us that it will not review the registration statement, within five days after such notification. The Company will be subject to certain monetary penalties, as set forth in the registration rights agreement, if the registration statement is not filed or does not become effective on a timely basis. Specifically, if the Company does not file the registration statement on a timely basis, we will be obligated to pay a late filing fee to the selling stockholders in the amount of 3% of the warrant exercise price on each of the warrants held by them plus 3% of the principal amount of the outstanding notes held by them. This fee will be payable for each period of 30 business days that the filing of the registration statement is made past the required filing date, and the payments will be due 10 business days following the end of each 30-day period. If the registration statement has not been declared effective by the required effective date, the Company will be obligated to pay a monthly late registration fee to the selling stockholders in the amount of 2% of the aggregate warrant exercise prices and aggregate note principal amounts for the first 30 business days after the required effective date, and 1% for each 30-business day period thereafter until the registration statement is declared effective. Notwithstanding the foregoing, the late filing fees and late registration fees will not exceed 18% of the aggregate warrant exercise prices and aggregate note principal amounts.

The Company filed its Registration Statement on December 9, 2005 and on August 7, 2006, the registration statement became effective. As of March 31, 2007, the Company has accrued \$1,633 and paid \$923 of the late filing and registration fees and the remaining \$710 is included in accounts payable and accrued liabilities.

On January 3, 2007 as part of a private placement offer, as amended, \$2,290 of August 2007 Notes and \$116 of late registration fees were exchanged for 8% Convertible Subordinated Notes due January 2010 (see Convertible Subordinated Notes below). As part of the January 2007 private placement offer, as amended, the Company entered into conversion agreements with the holders of August 2007 Notes totaling \$400 of principal providing for the conversion of such notes at a reduced conversion price of \$1.25 per share.

As of March 31, 2007 and December 31, 2006, our gross outstanding loan balance of the August 2007 Notes totaled \$7,188 and \$9,878, respectively. As of March 31, 2007 and December 31, 2006, un-amortized discounts for embedded conversion feature and warrants totaled \$1,022 and \$2,441, respectively, and other asset debt issuance costs totaled \$58 and \$139, respectively, and contra liability debt issuance cost totaled \$72 and \$172, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$962 for the three months ended March 31, 2007. As of March 31, 2007, the effective interest rate for the August 2007 Notes was 17.5%.

#### Subordinated Promissory Note

On March 17, 2006, the Company issued a \$1,000 10% subordinated promissory note due October 16, 2006 (the October 2006 Note ) to Atlantic Realty Group, Inc., a company controlled by Jack Chitayat, a former director of the Company. On September 30, 2006, the October 2006 Note was amended to mature on November 15, 2006 and was subsequently amended again to mature on November 30, 2006. The October 2006 Note is unsecured and subordinated to all prior indebtedness of the Company. All accrued interest and unpaid principal under the note were due November 30, 2006. The proceeds from the October 2006 Note is to be used solely for working capital purposes. In connection with the October 2006 Note, the Company issued warrants to purchase an aggregate amount of up to 125,000 shares of common stock, exercisable at \$2.00 per share. The warrants will expire on March 17, 2009, and include price adjustment provisions for anti-dilution purposes. As of March 31, 2007, the exercise price of the warrants remained unchanged at \$2.00 per share. There are no registration rights of the shares issuable from the exercise of the warrants. Further, cashless exercise of the warrants is permitted.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair value of the warrants of \$84 have been recorded as warrant liability as the warrant holders can elect to settle the warrants in cash, which was computed using Black-Scholes pricing model under the following assumptions: (1) expected life of 2.96 years; (2) volatility of 84%; (3) risk free interest of 4.64% and dividend rate of 0%. In addition, the Company is required to report a value of the warrants as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a gain of \$36 and of \$1 for the three months ended March 31, 2007 and 2006, respectively. The fair value of warrants outstanding at March 31, 2007 and December 31, 2006 was \$14 and \$50, respectively. The fair value of warrants outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 1.96 years; (2) volatility of 55%, (3) risk free interest of 4.58% and dividend rate of 0%. Interest expense for the amortization of discount on the note was \$0 and \$13 for the three months ended March 31, 2007, and 2006, respectively.

During the quarter ended March 31, 2007, \$1,000 of October 2006 Note was redeemed in cash as part of a private placement offer of 8% Convertible Subordinated Notes due January 2010 (see Convertible Subordinated Notes below).

#### Unsecured Subordinated Notes

On May 17, 2006, the Company completed a private placement of 8% unsecured subordinated notes (the May 2006 Private Placement ) in the aggregate principal amount of \$3,625 (the August 2007 Subordinated Notes ), together with warrants to purchase up to an aggregate of 705,233 shares of the Company's common stock. On September 21, 2006, and December 1, 2006 the Company completed an additional private placement under the terms of the May 2006 Private Placement in the aggregate principal amount of \$500 and \$459, respectively, together with warrants to purchase up to an aggregate of 96,900 and 88,857 shares of the Company's common stock, respectively. The May 2006 Private Placement, was made solely to accredited investors including Ricardo Salas, the Company's former President and Chief Executive Officer. Mr. Salas held \$559 of the August 2007 Subordinated Notes.



The August 2007 Subordinated Notes are unsecured and will become due on the earlier of August 17, 2007 or the consummation of a follow-on equity or debt offering pursuant to which the Company receives gross proceeds of at least \$6,000 to be used for working capital purposes and repayment of debt, but excluding financings for the purpose of purchasing capital assets (a Follow-On Financing). Interest on the unpaid principal balance of each August 2007 Subordinated Note accrues at the rate of 8% per annum from May 17, 2006 until maturity date. The August 2007 Subordinated Notes can be prepaid by the Company at any time without penalty.

The August 2007 Subordinated Notes is subordinate in right of payment and in all other respects to the July 2007 Notes, the August 2007 Notes, and any other notes that may be issued by the Company after May 17, 2006 in exchange for or in satisfaction of any July 2007 Notes or August 2007 Notes (collectively, the Senior Notes). Notwithstanding the maturity date of the August 2007 Subordinated Notes, the Company will not make any payments of principal, interest or otherwise under the August 2007 Subordinated Notes until all amounts due and payable under the Senior Notes have been satisfied in full (whether through cash payments or conversion).

The August 2007 Subordinated Notes also gives the investors the opportunity to participate in a Follow-On Financing at a discounted rate. If a holder of the August 2007 Subordinated Notes elects to participate in a Follow-On Financing, the holder of the Note will be entitled to purchase the securities being offered in the Follow-On Financing at a discount of 7% of the gross per share purchase price (in the case of an offering of common stock or preferred stock) or 7% of the face amount of the security being sold (in the case of an offering of debt securities).

As part of the August 2007 Private Placement, the Company issued warrants to the purchasers of the Notes giving them right to purchase up to an aggregate of 892,247 shares of the Company's common stock. In addition, warrants to purchase 80,717 shares of the Company's common stock were issued to the placement agent in the transaction. The warrants have an exercise price of \$2.58 per share, which is subject to price adjustment for anti-dilution purposes. The exercise price of the warrants was reduced to \$2.33 per share and total amount of warrants was increased to 1,077,480 as of March 31, 2007. The warrants will expire on May 17, 2011.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair value of the warrants of \$905 for the May 17, 2006 placement have been recorded as warrant liability, as the warrant holders can elect to settle the warrants in cash, which was computed using Black-Scholes pricing model under the following assumptions: (1) expected life of 5.00 years; (2) volatility of 80%; (3) risk free interest of 5.03% and dividend rate of 0%. The original fair value of the warrants of \$89 for the September 21, 2006 placement have been recorded as warrant liability, as the warrant holders can elect to settle the warrants in cash, which was computed using Black-Scholes pricing model under the following assumptions: (1) expected life of 4.65 years; (2) volatility of 76%; (3) risk free interest of 4.60% and dividend rate of 0%. The original fair value of the warrants of \$59 for the December 1, 2006 placement have been recorded as warrant liability, as the warrant holders can elect to settle the warrants in cash, which was computed using Black-Scholes pricing model under the following assumptions: (1) expected life of 4.46 years; (2) volatility of 67%; (3) risk free interest of 4.39% and dividend rate of 0%.

In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a gain of \$261 for the three months ended March 31, 2007. The fair value of warrants outstanding at March 31, 2007 and December 31, 2006 was \$252 and \$513. The fair value of the warrants outstanding at March 31, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.13 years; (2) volatility of 55%; (3) risk free interest of 4.54% and dividend rate of 0%.

On January 3, 2007 as part of a private placement offer, as amended, \$925 of August Subordinated 2007 Notes and \$45 of accrued interest were exchanged for 8% Convertible Subordinated Notes due January 2010 (see Convertible Subordinated Notes below). Additionally, \$650 of August Subordinated 2007 Notes and \$26 of accrued interest were redeemed in cash during the three months ended March 31, 2007.

Our gross outstanding loan balance of the August 2007 Subordinated Notes totaled \$3,009 and \$4,585 as of March 31, 2007 and December 31, 2006, respectively. As of March 31, 2007, un-amortized discounts for warrants totaled \$329 and other asset deferred issuance costs totaled \$83. Interest expense for the amortization of discount on the note and deferred issuance cost was \$218 for the three months ended March 31, 2007. As of March 31, 2007, the effective interest rate for the August 2007 Subordinated Notes was 37.6%.

#### Convertible Subordinated Notes

On January 3, 2007, the Company completed a private placement of 8% Convertible Subordinated Notes due January 2010 (the January 2010 Notes). As a result of an April 2007 amendment to this transaction, the Company ultimately issued \$16,300 in principal amount of January 2010 Notes (see Note 13). The January 2010 Notes were issued for aggregate cash in the amount of \$12,850, in payment of a total of \$3,377 in principal and accrued but unpaid interest under our previously issued 7% Senior Secured Convertible notes due August 2007 (August 2007 Notes) and our 8% Unsecured Subordinated notes (the August 2007 Subordinated Notes), and \$73 cash discount.

The payment of the previously issued notes was treated as an extinguishment of the debt in accordance with Emerging Issues Task Force No. 96-19, Debtors Accounting for a Modification or Exchange of Debt Instruments. The placement resulted in a \$648 loss from extinguishment of debt, which consisted of write down of \$64 of deferred issue costs, \$733 of debt discount, and decrease of \$149 in conversion feature liability as a result of the change in carrying value of exchanged notes.

The January 2010 Notes were originally convertible into the Company's common stock at \$1.55 per share. As a part of the private placement, the Company issued warrants to the purchasers of the notes giving them the right to purchase up to an aggregate of 5,257,921 shares of our common stock at an exercise price of \$1.93 per share. In connection with the private placement, the Company also issued to the placement agent for the transaction warrants to purchase an aggregate of 248,710 shares of our common stock at an exercise price of \$1.55 per share. The warrants will expire on January 3, 2012 and are subject to exercise price adjustment for anti-dilution purposes. The Company is required to set aside \$2,083 of the proceeds from the private placement for payment of the 6% Senior Secured Convertible notes due July 2007 (the July 2007 Notes).

Pursuant to Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, and EITF 05-2 The Meaning of Conventional Convertible Debt Instrument in EITF Issue No. 00-19, the original fair value of the embedded conversion feature of \$6,205 have been recorded as conversion feature liability as the debt is considered nonconventional convertible debt. The original fair value was computed using the Black-Scholes model under the following assumptions: (1) expected life of 1.6 to 3 years; (2) volatility of 55%; (3) risk free interest of 4.69% to 4.76% and dividend rate of 0%. In addition, the Company is required to report a value of the conversion liability as a fair value and record the fluctuation to the fair value of the conversion feature liability to current operations. The change in the fair value of the conversion feature liability resulted in a gain of \$3,971 for the three months ended March 31, 2007. The fair value of conversion feature outstanding at March 31, 2007 of \$2,234 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 1.3 to 2.6 years; (2) volatility of 55%, (3) risk free interest of 4.54% to 4.90% and dividend rate of 0%.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair values of the warrants of \$3,964 have been recorded as warrant liability, which was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 5 years; (2) volatility of 55%; (3) risk free interest of 4.68% and dividend rate of 0%. In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a gain of \$2,197 for the three months ended March 31, 2007. The fair value of the warrants outstanding at March 31, 2007 of \$1,768 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.76 years; (2) volatility of 55%; (3) risk free interest of 4.54% and dividend rate of 0%.



The original fair value of the embedded conversion feature of \$6,205 and the original fair value of the 5,257,921 warrants issued to investors of \$3,764, the original fair value of 248,710 warrants issued to Placement Agents of \$200, and \$73 cash discount were recorded as discounts of the convertible note. In addition, \$951 direct costs incurred relating to issuance of the convertible note was recorded as debt issuance cost in other assets.

The January 2010 Notes were issued pursuant to a Securities Purchase Agreement, dated January 3, 2007, between the Company and the purchasers of the January 2010 Notes (the January Purchase Agreement). Under the terms of the original January Purchase Agreement, the Company agreed to repay or otherwise satisfy, within 5 days after the closing of the private placement, approximately \$15,461 of the Company's outstanding debt under previously issued promissory notes, including the August 2007 Notes, the Atlantic Note, and New Bridge Notes (the Debt Satisfaction Covenant). The Company originally agreed to this covenant based on assurances that a substantial number of holders of the August 2007 Notes would elect to convert their August 2007 Notes at a reduced conversion price following the private placement under a note conversion agreement proposed by the Company, but most of such holders ultimately elected not to proceed with such conversion. Accordingly, in an effort to preserve funds, the Company has not yet repaid the indebtedness as required by the original January Purchase Agreement, and in April 2007, the Company entered into an amendment to the January Purchase Agreement providing that the Company will have until October 1, 2007 (or such earlier date on which the indebtedness to be repaid is due) to comply with the Debt Satisfaction Covenant (see Note 13).

The January 2010 Notes bear interest at 8% per annum with interest payable quarterly in arrears in cash, or, at our option, in the form of additional January 2010 Notes (in which case the interest rate will be 10% per annum). The ability to pay interest with additional January 2010 Notes is subject to specified conditions, including the existence of an effective registration statement covering the resale of the shares issued in payment of interest and certain minimum trading volumes in the stock to be issued. From and after an event of default under the January 2010 Notes and for so long as the event of default is continuing, the January 2010 Notes will bear default interest at a rate of 12% per annum (or 15% per annum if we elect to pay interest with additional January 2010 Notes).

Beginning July 31, 2008 and at the end of each month thereafter, the Company will be required to redeem 1/36th of the principal amount of the January 2010 Notes in cash or, at the Company's election, with shares of our common stock. The ability to pay the redemption amounts with shares of common stock will be subject to specified conditions, including the existence of an effective registration statement covering the resale of the shares issued in payment of the redemption amount and certain minimum trading volumes in the stock to be issued. Any unconverted January 2010 Notes will become due on December 31, 2009, although the Company will have the right at any time after 18 months following the issuance of the January 2010 Notes to redeem the January 2010 Notes in whole or in part for a cash redemption price of 105% of the portion of the principal amount being redeemed plus all accrued and unpaid interest thereon. The January 2010 Notes are unsecured and are subordinate to the July 2007 Notes and to certain secured financing from commercial lenders incurred by the Company in the future. The terms of the 2010 Notes also provide that the Company will be required to maintain a sufficient bank balance to provide for the timely repayment of our July 2007 Notes.

In connection with the January 2007 private placement, the Company entered into a Registration Rights Agreement with the purchasers of the January 2010 Notes under which the Company is required, on or before 45 days after the closing of the private placement, to use commercially reasonable efforts to file a registration statement with the SEC covering the resale of the shares of the common stock issuable pursuant to the January 2010 Notes and warrants and to use commercially reasonable efforts to have the registration declared effective at the earliest date (but in no event later than 90 days after filing if there is no SEC review of the registration statement, or 120 days if there is an SEC review). The Company will be subject to monetary penalties up to a maximum amount of 18% of the aggregate amount of Notes sold in the Private Placement if the registration statement is not filed or does not become effective on a timely basis. The monetary penalties will accrue at the rate of 1% per month of the then-outstanding principal amount of the January 2010 Notes. In the event that the Company is unable to include in the registration statement all shares of our common stock issuable pursuant to the January 2010 Notes and warrants, then we will be required to file up to two additional registration statements to register the resale of any shares excluded from the originally filed registration statement and to pay the foregoing monetary penalties on the January 2010 Notes convertible into the excluded shares until the resale of such excluded shares is covered by an effective registration statement or until such shares can be sold under SEC Rule 144. As of March 31, 2007, an aggregate of \$20 in monetary penalties under the Registration Rights Agreement had already been paid to investors, while an additional \$214 thousand in such penalties were accrued but unpaid.

On March 22, 2007, one of the purchasers of the January 2010 Notes (holding January 2010 Notes in the aggregate amount of \$2.0 million) sent the Company an event of default notice ( Event of Default Notice ) indicating that the Company had defaulted under the January Purchase Agreement (and therefore under the January 2010 Note) by failing to comply with the Debt Satisfaction Covenant. This holder did not execute the April 2007 amendment to the January Purchase Agreement. In general, upon a breach of the January 2010 Notes or January Purchase Agreement, a holder of the January 2010 Notes may require us to redeem the January 2010 Notes at a price equal to the greater of (i) the conversion amount to be redeemed and (ii) the product of (A) the conversion rate with respect to such conversion amount in effect at such time as the purchaser of the January 2010 Note delivers an Event of Default Redemption Notice (as defined below) and (B) the closing sale price of our common stock on the date immediately preceding such event of default. Under the terms of the January 2010 Notes and January Purchase Agreement, the Company has ten (10) business days after the receipt of an Event of Default Notice to cure a default (see Note 13).

In addition, because the Company repaid \$1,763 of principal and interest under the October 2006 Note and certain August 2007 Subordinated Notes in January and February 2007 without first repaying the August 2007 Notes and July 2007 Notes, the Company may also be in breach of the August 2007 Notes and July 2007 Notes.

The Company's gross outstanding loan balance of the January 2010 Notes totaled \$16,300 as of March 31, 2007. As of March 31, 2007, un-amortized discounts for conversion feature, warrants, and cash discount totaled \$9,894, and other asset debt issuance costs totaled \$918. Interest expense for the amortization of debt issuance cost and discount on note was \$382 for the three months ended March 31, 2007. As of March 31, 2007, the effective interest rate of the January 2010 Notes was 54%.

#### Factoring Agreement

The Company entered into a Factoring, Loan, and Security Agreement (the Agreement ) with a financing company on April 21, 2005, which allows for borrowings of up to \$1,500. The Agreement expires on April 21, 2006, and automatically renews annually thereafter. All borrowings are secured by outstanding receivables specifically assigned to the financing company. Assigned receivables are considered Approved or Non-Approved by the financing company. In January 2007, the Company entered into a second amendment to the Agreement to provide for increased borrowings against non-approved receivables assigned of 80%. Borrowings made against non-approved receivables assigned are limited to \$1,000 and total borrowings made on approved and non-approved receivables assigned are limited to \$5,000. Further, the amendment provides for interest charges of 0.5% plus prime rate of interest less 2%. The agreement will continue until February 1, 2008 and will renew annually thereafter. Payments on assigned receivables are received directly by the financing company, and applied to outstanding advances. All outstanding advances and uncollected assigned receivables are subject to fees and interest charges ranging from 0.55% to 1.5% plus prime rate as published by the Wall Street Journal, with a minimum annual fee of \$30. All receivables assigned and advances made are subject to return and recall by the financing company, respectively. As such, the advances have been classified as short-term secured borrowings in accordance with SFAS No. 140 Accounting for Transfer and Servicing of Financial Assets and Extinguishments of L