

LIQUIDMETAL TECHNOLOGIES INC

Form 10-Q

November 14, 2007

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

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2007

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 No. 001-31332

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**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, CA 92688**

(address of principal executive office, zip code)

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 September 30, 2007, there were 44,662,643 shares of the registrant's common stock, \$0.001 par value, outstanding.**

As of September 30, 2007, there were 44,662,643 shares of the registrant's common stock, \$0.001 par value, outstanding.



**LIQUIDMETAL TECHNOLOGIES, INC.**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 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)

|   | September 30,<br>2007<br>(unaudited) | December 31,<br>2006 |
|---|--------------------------------------|----------------------|
| <b>ASSETS</b>   |                                      |                      |
| Current assets:   |                                      |                      |
| Cash and cash equivalents   | \$ 715                               | \$ 144               |
| Trade accounts receivables, net of allowance for doubtful accounts of \$173 and \$82  | 5,191                                | 3,934                |
| Inventories   | 2,565                                | 3,765                |
| Prepaid expenses and other current assets   | 792                                  | 830                  |
| Total current assets  | 9,263                                | 8,673                |
| Property, plant and equipment, net  | 10,378                               | 12,095               |
| Idle equipment  | 156                                  | 194                  |
| Other intangibles, net  | 1,156                                | 1,170                |
| Investment in joint venture   | 306                                  | 3                    |
| Other assets  | 1,920                                | 109                  |
| Total assets  | 23,179                               | 22,244               |
| <b>LIABILITIES AND SHAREHOLDERS DEFICIENCY</b>  |                                      |                      |
| Current liabilities:  |                                      |                      |
| Accounts payable and accrued expenses   | 8,464                                | 9,802                |
| Deferred revenue  | 250                                  | 202                  |
| Short-term debt   | 2,035                                | 2,669                |
| Long-term debt, current portion, net of debt discounts of \$861 and \$3,636   | 4,662                                | 14,480               |
| Warrant liabilities   | 2,758                                | 2,662                |
| Conversion feature liabilities  | 2,645                                | 1,838                |
| Other liabilities, current portion  | 75                                   | 177                  |
| Total current liabilities   | 20,889                               | 31,830               |
| Long-term debt, net of current portion and debt discounts of \$9,899 and \$0  | 14,650                               | 225                  |
| Other long-term liabilities, net of current portion   | 387                                  | 552                  |
| Total liabilities   | 35,926                               | 32,607               |
| Minority interests  | 66                                   |                      |
| Shareholders' deficiency:   |                                      |                      |
| Common stock, \$0.001 par value; 100,000,000 shares authorized and 44,662,643 issued and outstanding at September 30, 2007 and 44,311,768 issued and outstanding at December 31, 2006 | 45                                   | 44                   |
| Additional paid-in capital  | 137,150                              | 136,031              |
| Accumulated deficit   | (153,016)                            | (149,047)            |
| Accumulated other comprehensive income  | 3,008                                | 2,609                |
| Total shareholders' deficiency  | (12,813)                             | (10,363)             |
| Total liabilities and shareholders' deficiency  | \$ 23,179                            | \$ 22,244            |



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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)**

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(in thousands, except per share data)

(unaudited)

|   | For the Three Months Ended<br>September 30, |          | For the Nine Months Ended<br>September 30, |             |
|---|---|----------|--|-------------|
|   | 2007  | 2006     | 2007                                       | 2006        |
| Revenue   | \$ 7,106                                    | \$ 8,040 | \$ 20,504                                  | \$ 21,685   |
| Cost of sales   | 5,194                                       | 6,449    | 19,321                                     | 17,337      |
| Gross profit  | 1,912                                       | 1,591    | 1,183                                      | 4,348       |
| Operating expenses                                    |   |          |  |             |
| Selling, general, and administrative                  | 1,853                                       | 2,290    | 6,880                                      | 7,363       |
| Research and development                              | 331   | 269      | 887  | 753         |
| Total operating expenses                              | 2,184                                       | 2,559    | 7,767                                      | 8,116       |
| Loss from operations                                  | (272)                                       | (968)    | (6,584)                                    | (3,768)     |
| Loss from extinguishments of debt                     |   |          | (648)                                      |             |
| Change in value of warrants, gain (loss)              | 220   | 1,361    | 4,476                                      | (1,354)     |
| Change in value of conversion feature, gain (loss)    | 625   | 1,987    | 6,137                                      | (1,933)     |
| Other income  |   |          | 49   | 572         |
| Interest expense                                      | (1,991)                                     | (2,302)  | (7,454)                                    | (7,361)     |
| Interest income                                       | 14  | 8        | 121  | 17          |
| (Loss) income before minority interest                | (1,404)                                     | 86       | (3,903)                                    | (13,827)    |
| Minority interests                                    | (66)  |          | (66)                                       |             |
| (Loss) income from continuing operations              | (1,470)                                     | 86       | (3,969)                                    | (13,827)    |
| Net (loss) income                                     | (1,470)                                     | 86       | (3,969)                                    | (13,827)    |
| Other comprehensive (loss) income:                    |   |          |  |             |
| Foreign exchange translation gain                     | 122   | 56       | 399  | 183         |
| Comprehensive (loss) income                           | \$ (1,348)                                  | \$ 142   | \$ (3,570)                                 | \$ (13,644) |
| Net loss per share basic and diluted:                 |   |          |  |             |
| Loss per share basic and diluted                      | \$ (0.03)                                   | \$ 0.00  | \$ (0.09)                                  | \$ (0.32)   |
| Number of weighted average shares - basic and diluted | 44,652                                      | 44,100   | 44,736                                     | 43,664      |

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 Nine Months Ended September 30, 2007**

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(in thousands, except per share data)

(unaudited)

|  | Common<br>Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumu-<br>lated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>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         |
| Common stocks issued as director s<br>fees | 30,875           |                 | 28                               |                             |   | 28          |
| Stock-based compensation                   |                  |                 | 575                              |                             |   | 575         |
| Foreign exchange translation gain          |                  |                 |                                  |                             | 399   | 399         |
| Net loss                                   |                  |                 |                                  | (3,969)                     |   | (3,969)     |
| <b>Balance, September 30, 2007</b>         | 44,662,643       | \$ 45           | \$ 137,150                       | \$ (153,016)                | \$ 3,008  | \$ (12,813) |

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

**LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

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(in thousands, except per share data)

(unaudited)

|  | For the Nine Months Ended<br>September 30, |             |
|--|--|-------------|
|  | 2007                                       | 2006        |
| <b>Operating activities:</b>   |  |             |
| Net loss   | \$ (3,969)                                 | \$ (13,827) |
| Adjustments to reconcile loss from operations to net cash used for operating activities: |  |             |
| Gain on disposal of asset  | (49)                                       |             |
| Minority interests in income of consolidated subsidiary                                  | 66   |             |
| Depreciation and amortization  | 2,499                                      | 2,658       |
| Loss on extinguishment of debt   | 648  |             |
| Amortization of debt discount  | 4,385                                      | 4,517       |
| Stock-based compensation   | 575  | 831         |
| Bad debt expense   | 97   | 60          |
| Warranty expense   | 141  | 71          |
| (Gain) loss from change in value of warrants   | (4,476)                                    | 1,354       |
| (Gain) loss from change in value of conversion feature                                   | (6,137)                                    | 1,933       |
| Changes in operating assets and liabilities:   |  |             |
| Trade accounts receivable  | (1,355)                                    | (2,799)     |
| Inventories  | 1,200                                      | (470)       |
| Prepaid expenses and other current assets  | (86)                                       | (1,026)     |
| Other assets   | (2,198)                                    | 237         |
| Accounts payable and accrued expenses  | (1,123)                                    | 2,381       |
| Deferred revenue   | 48   | (1,229)     |
| Other liabilities  | 102  | (178)       |
| Net cash used for operating activities   | (9,632)                                    | (5,487)     |
| <b>Investing Activities:</b>   |  |             |
| Purchases of property and equipment  | (1,022)                                    | (665)       |
| Proceeds from the sale of property and equipment   | 400  | 104         |
| Investment in patents and trademarks   | (78)                                       | (102)       |
| Investment in joint venture  | (303)                                      |             |
| Net cash used for investing activities   | (1,003)                                    | (663)       |
| <b>Financing Activities:</b>   |  |             |
| Proceeds from borrowings   | 39,784                                     | 18,241      |
| Repayment of borrowings  | (28,375)                                   | (12,421)    |
| Repayment of other liabilities   |  | 63          |
| Net cash provided by financing activities  | 11,409                                     | 5,883       |
| Effect of foreign exchange translation   | (203)                                      | (562)       |
| Net increase (decrease) in cash and cash equivalents                                     | 571  | (829)       |
| Cash and cash equivalents at beginning of period   | 144  | 1,392       |
| Cash and cash equivalents at end of period   | \$ 715                                     | \$ 563      |
| Supplemental cash flow information   |  |             |
| Interest paid  | \$ 2,522                                   | \$ 1,664    |
| Taxes paid   | \$   | \$          |

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





During the nine months ended September 30, 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

**LIQUIDMETAL TECHNOLOGIES AND SUBSIDIARIES**



**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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For the Nine Months Ended September 30, 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 and nine months ended September 30, 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.

On July 24, 2007, the Company transferred substantially all of the assets of its Liquidmetal alloy industrial coatings business to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company ( LMC ), and LMC assumed substantially all of the liabilities of the coatings business. The transfer included the thermal spray coatings assets and liabilities acquired under a purchase agreement with Foster Wheeler Energy Services in June 2007. The Company holds a 69.25% ownership interest in LMC. The results of operation of LMC are consolidated and comprise our Liquidmetal alloy industrial coatings segment for financial reporting purposes.

### 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 \$173 and \$575 for the three and nine months ended September 30, 2007, respectively, and \$296 and \$831 for the three and nine months ended September 30, 2006, respectively, 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 nine months ended September 30, 2007 and 2006, respectively: expected volatility of approximately 100% and 58%; dividend yield of 0% for all periods; expected option life of approximately 5 years and 6 years; and a risk-free interest rate ranging from 2.57% to 6.22%.

## 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

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The Company has experienced losses from continuing operations during the last three fiscal years and has an accumulated deficit of \$153,016 as of September 30, 2007. Cash used for operations for the nine months ended September 30, 2007 was \$9,632 and cash flow from operations will likely be negative throughout fiscal year 2007. As of September 30, 2007, the Company's principal sources of liquidity are \$715 of cash and \$5,191 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.



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The Company borrowed \$10,130, which was offset by repayments of \$10,852, under a factoring, loan, and security agreement executed on April 21, 2005 to fund its working capital requirements during the nine months ended September 30, 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).

In June 2007, we entered into an equipment sale and licensing agreement with Grace Metal, a South Korean corporation, providing for \$2,000 in exchange for die casting machines and vacuum induction melters, and a 10-year exclusive license to manufacture Liquidmetal alloys for customers whose principal headquarters or major operations are based in South Korea. The principal purpose of the transactions with Grace Metal was to raise capital for the next-generation casting equipment and to shift the cost and burden of our manufacturing operations to a third party. Grace Metal was formed by an investor group that includes the former Founder and director of our company, James Kang, who is also the brother of John Kang, Chairman of the Board of our company (see Note 12).

In July 2007, we completed an \$11,500 financing transaction that provided funding to repay senior convertible notes previously issued were scheduled to become due in July and August 2007. We transferred substantially all of the assets and liabilities of Liquidmetal alloy industrial coatings business to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company ( LMC ), and LMC assumed substantially all of the liabilities of the Division (the Assumed Liabilities). LMC was capitalized through a \$6,500 subordinated debt and equity investment by C3 Capital Partners and a \$5,000 senior credit facility with Bank Midwest, N.A. (see Note 7).

We anticipate that we will not have sufficient funds to pursue our current operating plan through the fourth quarter of 2007 and we will therefore require additional funding. 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) and additional licensing and outsourcing of our manufacturing operations.

Additionally, we have approximately \$3,000 of principal and accrued interest outstanding as of September 30, 2007, under the 8% unsecured subordinated notes ( Notes ), which were due August 17, 2007. We intend to fully repay the amounts due under Notes. However, as of the filing of this report we do not have sufficient funds to repay the Notes. As a result, we are currently in default under the Notes. Such a default may have material adverse effect on our operations, financial condition, and results of operations. We have not received a formal notice of default and we are currently working to resolve this matter with investors holding our Notes.

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>September 30,<br/>2007<br/>(Unaudited)</b> | <b>December 31,<br/>2006</b> |
|-------------------|---|------------------------------|
| Raw materials     | \$ 1,205                                      | \$ 966                       |
| Work in process   | 345   | 1,729                        |
| Finished goods    | 1,015   | 1,070                        |
| Total inventories | \$ 2,565                                      | \$ 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 \$156 as of September 30, 2007 and \$194 as of December 31, 2006.

During the nine months ended September 30, 2007, the Company disposed of \$7 of its idle equipment as part of the equipment purchase agreement and transfer agreement regarding Weihai operations with Grace Metal (see Note 12). During the nine months ended September 30, 2006, the Company disposed of \$12 of its idle equipment for proceeds of \$104. The resulting gain of \$92 is included in other income.

**6. Product Warranty**

Management estimates product warranties as a percentage of certain bulk alloy product sales earned during the period. As of September 30, 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. The Company recorded a \$120 of net gain from expired warranty and \$141 of warranty expense during the three and nine months ended September 30, 2007, respectively. The Company recorded \$34 of net gain from expired warranty and \$71 of warranty expense during the three and nine months ended September 30, 2006, respectively. The product warranty accrual balances 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 ) with a conversion price of \$3.00 per share. During 2004, the Company redeemed \$4,465 of the outstanding note balance in cash and exchanged 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. 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

In connection with the March Notes, the Company issued warrants to purchase an aggregate amount for approximately 1.2 million shares of common stock, exercisable at \$3.00 per share for varying periods, all of which have expired as of September 30, 2007.

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. During the nine months ended September 30, 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 Company redeemed all outstanding notes and interest during the quarter ended September 30, 2007.

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 \$23 and \$1,218 for the three and nine months ended September 30, 2007, respectively, and a gain of \$676 and a loss \$1,072 for the three and nine months ended September 30, 2006, respectively. The fair value of conversion features outstanding at September 30, 2007 and December 31, 2006 was \$0 and \$1,218, respectively. The fair value of conversion features of outstanding at December 31, 2006 was computed using the Black-Scholes model under the following assumptions: (1) 0.57 years; (2) volatility of 55%; (3) risk free interest of 5.00% and (4) 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 Company is required to report a value of the warrant liability 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 gain of \$11 and a loss of \$7 for the three and nine months ended September 30, 2006. The warrant has expired as of December 31, 2006.

As of December 31, 2006, the Company's gross outstanding loan balance of the July 2007 Notes totaled \$2,083. As of December 31, 2006, un-amortized discounts for conversion feature and warrants totaled \$39, and other asset debt issuance costs totaled \$14. Interest expense for the amortization of debt issuance cost and discount on note was \$58 and \$405 for the three and nine months ended September 30, 2007, respectively, \$190 and \$606 for the three and nine months ended September 30, 2006, respectively. As of September 30, 2007, the effective interest rate of the July 2007 Notes was 34.5%.

#### 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 warrants have an original exercise price of \$2.00 per share. 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 \$1.75 per share and total number of warrants was increased to 1,021,434 as of September 30, 2007 as a result of our January 2007

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private placement (see Convertible Subordinated Notes below).

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).

Pursuant to EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, the Company is required to report a value of the warrant liability 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 \$29 and \$345 for the three and nine months ended September 30, 2007, respectively. The change in the fair value of the warrants resulted in a gain of \$257 and a loss of \$366 for the three and nine months ended September 30, 2006, respectively. The fair

value of warrants outstanding at September 30, 2007 and December 31, 2006 was \$142 and \$487, respectively. The fair value of warrants outstanding at September 30, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 2.70 years; (2) volatility of 58%, (3) risk free interest of 4.03% and (4) 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 are convertible into shares of the Company's common stock at \$2.00 per share.

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 September 30, 2007, the exercise price of the warrants was reduced to \$1.75 per share and total number of warrants was increased to 3,295,975. The warrants will expire on August 2, 2010.

The Company redeemed all outstanding notes and interest during the quarter ended September 30, 2007.

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 \$0 and \$354 for the three and nine months ended September 30, 2007, respectively. The change in the fair value of the conversion feature liability resulted in a gain of \$1,311 and a loss of \$860 for the three and nine months ended September 30, 2006. The fair value of conversion features outstanding at September 30, 2007 and December 31, 2006 was \$0 and \$619, respectively.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, is required to report a value of the warrant liability 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 loss of \$52 and a gain of \$1,127 for the three and nine months ended September 30, 2007, respectively. The change in the fair value of the warrants resulted in a gain of \$830 and \$1,202 for the three and nine months ended September 30, 2006, respectively. The fair value of warrants outstanding at September 30, 2007 and December 31, 2006 was \$485 and \$1,612, respectively. The fair value of the warrants outstanding at September 30, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 2.84 years; (2) volatility of 58%; (3) risk free interest of 4.03% and dividend rate of 0%.

As of December 31, 2006, our gross outstanding loan balance of the August 2007 Notes totaled \$7,188. As of December 31, 2006, un-amortized discounts for embedded conversion feature and warrants totaled \$2,441, other asset debt issuance costs totaled \$139, and contra liability debt issuance cost totaled \$172. Interest expense for the amortization of debt issuance cost and discount on note was \$302 and \$2,114 for the three and nine months ended September 30, 2007, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$1,036 and \$3,250 for the three and nine months ended September 30, 2006, respectively. As of September 30, 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. 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 September 30, 2007, the Company reduced the exercise price of the warrants to \$1.55 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.

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During the quarter ended March 31, 2007, \$1,000 of October 2006 Note was redeemed in cash (see Convertible Subordinated Notes below).

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the Company is required to report a value of the warrant liability 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 loss of \$2 and a gain of \$40 for the three and nine months ended September 30, 2007. The change in the fair value of the warrants resulted in a gain of \$35 and a loss \$5 for the three and nine months ended September 30, 2006, respectively. The fair value of warrants outstanding at September 30, 2007 and December 31, 2006 was \$10 and \$50, respectively. The fair value of warrants outstanding at September 30, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 1.46 years; (2) volatility of 58%, (3) risk free interest of 3.97% and dividend rate of 0%.

Interest expense for the amortization of discount on the note was \$0 for the three and nine months ended September 30, 2007, respectively, and interest expense for the amortization of discount on the note was \$ 29 and \$69 for the three and nine months ended September 30, 2006, respectively.

### Unsecured Subordinated Notes

The Company completed a private placement of 8% unsecured subordinated notes (the May 2006 Private Placement ) in the aggregate principal amount of \$4,584 (the August 2007 Subordinated Notes ) between May and December 2006. The August 2007 Subordinated Notes are unsecured and became due on of August 17, 2007. Interest on the unpaid principal balance of each August 2007 Subordinated Note accrues at the rate of 8% per annum until maturity date. 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 ).

As part of the May 2006 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 \$2.13 per share and total amount of warrants was increased to 1,178,651 as of September 30, 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 Company is required to report a value of the warrant liability 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 loss of \$30 and a gain of \$327 for the three and nine months ended September 30, 2007, respectively. The change in the fair value of the warrants resulted in a loss of \$228 and \$226 for the three and nine months ended September 30, 2006. The fair value of warrants outstanding at September 30, 2007 and December 31, 2006 was \$187 and \$513. The fair value of the warrants outstanding at September 30, 2007 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 3.63 years; (2) volatility of 58%; (3) risk free interest of 4.23% 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, \$900 of August Subordinated 2007 Notes and \$46 of accrued interest were redeemed in cash as of September 30, 2007.



Our gross outstanding loan balance of the August 2007 Subordinated Notes totaled \$2,759 and \$4,585 as of September 30, 2007 and December 31, 2006, respectively. As of September 30, 2007, un-amortized discounts for warrants and other asset deferred issuance costs was \$0. Interest expense for the amortization of discount on the note and deferred issuance cost was \$172 and \$630 for the three and nine months ended September 30, 2007, respectively. Interest expense for the amortization of discount on the note and deferred issuance cost was \$150 and \$248 for the three and nine months ended September 30, 2006, respectively. As of September 30, 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. 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 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 January Purchase Agreement, the Company agreed to repay, 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 October 2006 Note, and August 2007 Subordinated 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 April 2007, the Company entered into an amendment to the January Purchase Agreement (April 2007 Amendment) 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.

The April 2007 Amendment also finalized the schedule of investors in the Private Placement to show a total of \$16,300 in principal amount of Notes; decreased the conversion price of the Notes from \$1.55 to \$1.10, decreased the warrant exercise price for the warrants issued from \$1.93 to \$1.55, increased the number of shares subject to such warrants issued to equal 50% of the principal amount of Notes purchased divided by 1.10, and the purchasers of the Notes consented to the Company granting a security interest in its South Korean manufacturing plant to purchasers of convertible notes in a subsequent offering, provided a pari passu security interest is granted to the purchasers of the 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%. The original fair value of the additional embedded conversion feature of \$1,005 resulting from reduced conversion price under the amended Securities Purchase Agreement, have been recorded as conversion feature liability. The value was computed using the Black-Scholes model

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under the following assumptions: (1) expected life of 1.3 to 2.7 years; (2) volatility of 55%; (3) risk free interest of 4.6% to 4.9% 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 \$602 and \$4,565 for the three and nine months ended September 30, 2007, respectively. The fair value of conversion feature outstanding at September 30, 2007 of \$2,645 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 0.8 to 2.3 years; (2) volatility of 58%, (3) risk free interest of 3.97% to 4.05% 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 (4) dividend rate of 0%. The original fair values of the warrants of \$608 from the additional warrants issued under the amended Securities Purchase Agreement, have been recorded as additional warrant liability, which was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 4.70 years; (2) volatility of 50%; (3) risk free interest of 4.51% and (4) 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 \$275 and \$2,637 for the three and nine months ended September 30, 2007, respectively. The fair value of the warrants outstanding at September 30, 2007 of \$1,934 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.26 years; (2) volatility of 58%; (3) risk free interest of 4.23% and dividend rate of 0%.

The original fair value of the embedded conversion feature of \$7,210 was recorded as discounts of the convertible note. The original fair value of the 7,408,881 warrants issued to investors of \$4,372, 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, \$2,069 direct costs incurred relating to issuance of the convertible note was recorded as debt issuance cost in other assets.

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

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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 September 30, 2007, an aggregate of \$178 in monetary penalties under the Registration Rights Agreement had already been paid to investors, while an additional \$721 in such penalties were accrued but unpaid.

The Company's gross outstanding loan balance of the January 2010 Notes totaled \$16,300 as of September 30, 2007. As of September 30, 2007, un-amortized discounts for conversion feature, warrants, and cash discount totaled \$10,760, and other asset debt issuance costs totaled \$1,046. Interest expense for the amortization of debt issuance cost and discount on note was \$446 and \$1,200 for the three and nine months ended September 30, 2007, respectively. As of September 30, 2007, the effective interest rate of the January 2010 Notes was 74%.

#### 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. In February 2007, the Company entered into an agreement to deposit cash of \$2,083 with a rate of prime rate of interest less 2% with the financing company. The agreement is effective until July 27, 2007 and the cash deposit will be used to pay down principal amount of the July 2007 Notes. Additionally, the financing company reserves the right to offset outstanding advances against the cash deposit. In July 2007, the Company entered into a third amendment to exclude intellectual property transferred to LMC as collateral and to release security interest in receivables previously assigned in consideration of full repayment of the outstanding advances. The Company paid \$628 and the financing company applied the \$2,083 cash deposit held against the outstanding advance of \$2,711 on July 23, 2007. Additionally, the financing company reduced the borrowings against non-approved receivables assigned to 50% of the receivable value.

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 Liabilities.

For the nine months ended September 30, 2007, the Company borrowed \$10,130 and repaid \$10,852 under the Agreement. The total outstanding advance made under the agreement is \$946 and \$1,669 as of September 30, 2007 and December 31, 2006, respectively, which is presented as short-term debt. The weighted average rate of interest for borrowings made under the Agreement was 8.87% for the nine months ended September 30, 2007. As of September 30, 2007, the Company's availability for future borrowing under the agreement is \$4,054 which is contingent on approval of eligible receivables by the financing company.



Kookmin Note

On February 4, 2003, our Korean subsidiary received 6,500,000 in South Korean Won, or approximately \$5,488, under a loan from Kookmin Bank of South Korea. The loan bears interest at an annual rate of 7.1%. In the event of delayed repayment, the interest increases to a maximum of 21%, depending on the length of time the repayment is delayed. As of September 30, 2007, the interest rate was increased to 9.2% from delayed interest payments made. This loan is collateralized by the plant facilities and certain equipment in South Korea. During the first eighteen months from the origination date, interest was payable on a monthly basis. In October 2003, the Company paid \$873 of principal at the request of Kookmin Bank due to the sale of machines that had been part of the collateral on the loan. Subsequent to October 31, 2003, Kookmin Bank requested that the Company pay an additional \$866 of principal by February 2004 due to the Company's current credit rating. The Company made two payments on the requested additional loan pay down in November and December 2003 of \$320 and \$205, respectively. The remaining payment of \$341 was subsequently made in February 2004. Beginning in September 2004, the Company is required to make equal monthly installments of principal and interest to repay the remaining balance through February 2008. Principal payments made to Kookmin Bank totaled \$1,236 for the nine months ended September 30, 2007, which includes \$16 of foreign exchange translation loss. The outstanding loan balance totaled \$576 and \$1,796, of which \$576 and \$225 is included in current portion of long-term debt, as of September 30, 2007 and December 31, 2006, respectively.

Debt of Majority Owned Subsidiary

On July 24, 2007, the Company completed an \$11,500 financing transaction (the *Transaction*) that provided funding to repay convertible notes previously issued by us that were scheduled to become due in July and August 2007. In the *Transaction*, the Company transferred substantially all of the assets of the Company's Liquidmetal Coatings division to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company (*LMC*), and LMC assumed substantially all of the liabilities of the division.

LMC was capitalized through a \$6,500 subordinated debt and equity investment by C3 Capital Partners and a \$5,000 senior credit facility with Bank Midwest, N.A. This debt and equity resulted in cash proceeds of \$11,102 after related debt issuance costs of \$398, which proceeds LMC used to purchase all of the assets and liabilities from the Company. The Company incurred an additional \$459 in issuance costs directly related to the debt issuance. As a result, \$857 was recorded as deferred debt issuance costs to be amortized over the life of the debt. Interest expense for the amortization of debt issuance cost was \$35 for the three and nine months ended September 30, 2007.

The Company retains a 69.25% ownership interest in LMC, C3 Capital Partners (*C3*) holds a 19% ownership interest, Larry Buffington, the Company's President and CEO, (who also serves as the President and CEO of LMC) holds a 10% ownership interest, and CRESO Capital Partners (the Company's financial advisor in the *Transaction*) holds a 1.75% ownership interest. The equity interests acquired by C3 and issued to CRESO were not considered a discount to debt, as the unconsolidated net assets of LMC were deemed to have an initial value of \$0 upon closing of the *Transaction* for financial accounting purposes. Further, LMC is fully responsible for the repayment of debt obligations.

*Midwest Debt*

In connection with the *Transaction*, LMC entered into a Loan Agreement, dated July 24, 2007 (the *Loan Agreement*), with Bank Midwest, N.A. (*Midwest*). The *Loan Agreement* provides for total loan availability of \$5,500, consisting of a \$4,000 term loan with an annual interest rate of 8.48% and a revolving loan of up to \$1,500 with a variable interest equal to prime rate as published in the Wall Street Journal. Interest payments are due monthly. The term loan has a maturity date of July 20, 2011. The revolving loan allows for borrowings up to \$1,500 and has a maturity date of July 20, 2008. Borrowing availability under the revolving loan is based in a percentage of LMC's eligible receivables and eligible



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inventory, and the initial advance under the revolving loan was \$1,000 on July 24, 2007. LMC's obligations under the Loan Agreement are secured by a blanket security interest in all of LMC's assets and the Company's equity interest in LMC, and pursuant to an intercreditor agreement between the C3 and Midwest, Midwest's security interest in the assets is senior to C3's security interest in the same assets.

LMC is required to make monthly principal payments under the term loan of: \$63 during months 1 through 12, \$83 during months 13 through 36, and \$104 during months 37 through 48. All remaining principal is due and payable on July 20, 2011. If the term loan is prepaid within the first twenty-four (24) months after July 24, 2007, LMC will pay a prepayment penalty of 1% of the outstanding principal balance, together with accrued interest. After the twenty-four month period has lapsed, LMC will have the right to prepay the term loan without penalty.

As of September 30, 2007, the gross outstanding loan balance under the term loan and revolving loan totaled \$3,913 and \$1,088, respectively, which are presented as long term debt and short term debt of consolidated subsidiary on the Company's condensed consolidated balance sheet, respectively. Interest expense incurred under the term loan and revolving loan totaled \$63 and \$16, respectively, for the three months ended September 30, 2007.

### *C3 Debt*

In the Transaction, LMC also entered into a Securities Purchase Agreement, dated July 24, 2006 (the Securities Purchase Agreement), with C3 Capital Partners, L.P. (C3), C3 Capital Partners II, L.P. (C3 II), and with C3, the C3 entities, and Liquidmetal Coatings Solutions, LLC, a wholly owned subsidiary of LMC that will operate the thermal spray coatings business (LMCS). Pursuant to the Securities Purchase Agreement, LMC issued to the C3 entities subordinated promissory notes in the aggregate principal amount of \$6,500 (the Subordinated Notes). Under the Securities Purchase Agreement, the C3 entities have the right, beginning on the July 24, 2012 (or, if earlier, upon a default by LMC under the Subordinated Notes or Securities Purchase Agreement) to require LMC to purchase the C3 entities' membership interests in LMC for a purchase price equal to their pro rata portion of the greater of (i) the appraised fair market value of LMC or (ii) six times LMC's trailing 12-month earnings before interest taxes, depreciation, and amortization, less funded debt.

The Subordinated Notes have a maturity date of July 20, 2012 with no required principal payments before maturity other than upon specified triggering events, such as a change in control of LMC. Interest accrues under at an annual rate of 14%, with 12% interest being payable monthly beginning September 2007 and the remaining 2% interest being payable at maturity. In connection with the Securities Purchase Agreement and the Subordinated Notes, the Company and LMC entered into pledge agreements with the C3 entities in which the Company pledged its membership interest in LMC to secure the obligations under the notes and LMC pledged its membership interests in LMCS to secure its obligations under the notes. LMC and LMCS also granted to C3 a blanket security interest in all of their assets to secure their obligations under the Subordinated Notes.

The gross outstanding loan balance including accrued interest payable upon maturity of the Subordinated Note totaled \$6,524 as of September 30, 2007. Interest expense incurred under the Subordinated Notes totaled \$172 for the three and nine months ended September 30, 2007.

## **8. Stock Compensation Plan**

During the three and nine months ended September 30, 2007, under the Company's 2002 Non-employee Director Stock Option Plan which provides for the grant of stock options to non-employee directors, the Company granted options to purchase 0 and 70,000, respectively, of the Company's common shares for an average exercise price of \$0 and \$1.53, respectively. Further, all options granted under this plan had exercise prices that were equal to the fair market value on the date of grant.

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During the three and nine months ended September 30, 2007, under the Company's 2002 Equity Incentive Plan which provides for the grant of stock options to officers, employees, consultants and directors of the Company its subsidiaries, the Company granted options to purchase 1,235,500 of the Company's common shares for an average exercise price of \$0.77. Further, all options granted under this plan had exercise prices that were equal to the fair market value on the date of grant.

In August 2007, two of the non-employee directors of our company were given the opportunity to receive shares of stock under the 2002 Equity Incentive Plan in lieu of past-due director and committee fees that were due to them for periods through June 30, 2007. Such shares were issuable to them at an average price of \$0.97 and \$0.85 per share. As of September 30, 2007, a total of 30,875 shares were issued to non-employee directors in lieu of these past-due fees.

The Company canceled 257,474 and 687,627 options during the three and nine months ended September 30, 2007, respectively, for terminated employees and options expired.

## 9. Segment Reporting and Geographic Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires companies to provide certain information about their operating segments. In April 2002, the Company began classifying operations into two reportable segments: Liquidmetal alloy industrial coatings and bulk Liquidmetal alloys. The 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 market opportunities to manufacture and sell casing components for electronic devices, medical devices, sporting goods, tooling, prototype sampling, defense applications and metal processing equipment. Primarily, the expenses incurred by the bulk Liquidmetal alloy segment are research and development costs and selling expenses associated with identifying and developing market opportunities. Bulk Liquidmetal alloys products can be distinguished from Liquidmetal alloy coatings in that the bulk Liquidmetal alloy can have significant thickness, up to approximately one inch, which allows for their use in a wider variety of applications other than a thin protective coating applied to machinery and equipment. Revenue and expenses associated with research and development services and product licensing arrangements are included in the bulk Liquidmetal alloy segment. The accounting policies of the reportable segments are the same as those described in Note 4 to the consolidated financial statements included in the Company's Form 10-K filed with the Securities and Exchange Commission on March 16, 2007.

Summarized financial information concerning the Company's reportable segments is shown in the following tables:

|   | Coatings |       | Bulk Alloy |         | Segment Totals |
|---|----------|-------|------------|---------|----------------|
| <b>Three Months Ended September 30, 2007</b>                      |          |       |            |         |                |
| Revenue to external customers                                     | \$       | 3,505 | \$         | 3,601   | \$ 7,106       |
| Gross profit (loss)   |          | 1,115 |            | 797     | 1,912          |
| Income (loss) before interest expense and discontinued operations |          | 2,229 |            | (1,308) | 921            |
| Total identifiable assets at end of period                        |          | 2,942 |            | 17,708  | 20,650         |
| <b>Three Months Ended September 30, 2006</b>                      |          |       |            |         |                |
| Revenue to external customers                                     | \$       | 2,589 | \$         | 5,451   | \$ 8,040       |
| Gross profit  |          | 1,110 |            | 481     | 1,591          |
| Income (loss) before interest expense and discontinued operations |          | 905   |            | (506)   | 399            |
| Total identifiable assets at end of period                        |          | 1,515 |            | 18,971  | 20,486         |
| <b>Nine Months Ended September 30, 2007</b>                       |          |       |            |         |                |
| Revenue to external customers                                     | \$       | 9,293 | \$         | 11,211  | \$ 20,504      |
| Gross profit  |          | 3,667 |            | (2,484) | 1,183          |
| Income (loss) before interest expense and discontinued operations |          | 2,229 |            | (3,594) | (1,365)        |
| Total identifiable assets at end of period                        |          | 2,942 |            | 17,708  | 20,650         |
| <b>Nine Months Ended September 30, 2006</b>                       |          |       |            |         |                |
| Revenue to external customers                                     | \$       | 6,716 | \$         | 14,969  | \$ 21,685      |
| Gross profit (loss)   |          | 2,774 |            | 1,574   | 4,348          |
| Income (loss) before interest expense and discontinued operations |          | 2,187 |            | (860)   | 1,327          |
| Total identifiable assets at end of period                        |          | 1,515 |            | 18,971  | 20,486         |

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Reconciling information between reportable segments and the Company's consolidated totals is shown in the following table:

|   | For the Three Months<br>Ended September 30, |         | For the Nine Months<br>Ended September 30, |             |
|---|---|---------|--|-------------|
|   | 2007  | 2006    | 2007                                       | 2006        |
| Total segment (loss) income before minority interest, interest expense            | \$ 921                                      | \$ 399  | \$ (1,365)                                 | \$ 1,327    |
| General and administrative expenses, excluded                                     | (1,193)                                     | (1,367) | (5,170)                                    | (4,523)     |
| Consolidated loss before interest, other income, income taxes, minority interests | (272)                                       | (968)   | (6,535)                                    | (3,196)     |
| Loss from extinguishments of debt   |   |         | (648)                                      |             |
| Change in value of warrants, net  | 220   | 1,361   | 4,476                                      | (1,354)     |
| Change in value of conversion feature   | 625   | 1,987   | 6,137                                      | (1,933)     |
| Interest expense  | (1,991)                                     | (2,302) | (7,454)                                    | (7,361)     |
| Interest income   | 14  | 8       | 121  | 17          |
| Minority interests  | (66)  |         | (66)                                       |             |
| Consolidated net loss   | \$ (1,470)                                  | \$ 86   | \$ (3,969)                                 | \$ (13,827) |

Included in bulk alloy segment income for both the three and nine months ended September 30, 2007 is \$0 and \$49, respectively, of other income from gain on disposal of assets in connection with the equipment purchase agreement and transfer agreement of the Weihai operations to Grace Metal (see Note 12). Included in bulk alloy segment income for the three and nine months ended September 30, 2006 is \$0 and \$572 of other income, respectively, recognized from \$480 gain on termination of a distribution agreement in March 2006 and \$92 gain on disposal of idle equipment in June 2006.

Excluded general and administrative expenses are attributable to the Company's corporate headquarters. These expenses primarily include corporate salaries, consulting, professional fees and facility costs. Research and development expenses are included in the operating costs of the segment that performed the research and development.

Revenues from sales to companies in the United States were \$4,311 and \$3,212 during the three months ended September 30, 2007 and 2006, respectively. The revenue related to the United States of America was earned under defense-related research and development contracts, sales of coatings products, and sales of Liquidmetal bulk alloy products.

During the three months ended September 30, 2007, the Company had revenue from sales to companies outside of the United States of \$2,795 of which \$1,839 represented sales to companies located in South Korea. During the three months ended September 30, 2006, the Company had revenues from companies outside of the United States of \$4,828 of which \$362 represented sales to companies located in South Korea. The revenue related to sales to companies outside of the United States was from bulk alloy products.

Long-lived assets include net property, plant, and equipment, and net intangible assets. The Company had long-lived assets of \$2,713 and \$1,439 located in the United States at September 30, 2007 and December 31, 2006, respectively. The Company had long-lived assets of \$9,405 and \$11,799 located in South Korea at September 30, 2007 and December 31, 2006, respectively.



Reconciling information between reportable segments and the Company's consolidated totals is shown in the following table:

|   | <b>September 30,<br/>2007</b> |
|---|-------------------------------|
| Total segment assets                      | \$ 20,650                     |
| Cash and cash equivalents                 | 408                           |
| Prepaid expenses and other current assets | 783                           |
| Other property, plant and equipment       | 112                           |
| Intangibles, net                          | 1,135                         |
| Other assets                              | 91                            |
| Total consolidated assets                 | \$ 23,179                     |

Assets excluded from segment assets include assets attributable to the Company's corporate headquarters. The Company's largest assets consist of cash and intangible assets, which consist primarily of the Company's patents and trademarks.

#### **10. Income (Loss) Per Common Share**

Basic earnings per share (EPS) is computed by dividing earnings (loss) attributable to common shareholders by the weighted average number of common shares outstanding for the periods. Diluted EPS reflects the potential dilution of securities that could share in the earnings.

Options to purchase 8,411,464 shares of common stock at prices ranging from \$0.77 to \$15.00 per share were outstanding at June 30, 2007, but were not included in the computation of diluted EPS for the same period as the inclusion would have been antidilutive. Warrants to purchase 13,278,651 shares of common stock with prices ranging from \$1.55 to \$2.13 per share outstanding at September 30, 2007, were not included in the computation of diluted EPS for the same period as the inclusion would have been antidilutive. Additionally, 14,817,751 shares of common stock issuable upon conversion of the Company's convertible notes with conversion prices of \$1.10 per share outstanding at September 30, 2007 were not included in the computation of diluted EPS for the same period because the inclusion would have been antidilutive.

#### **11. Commitments and Contingencies**

The Company is from time to time a party to certain legal proceedings arising in the ordinary course of business. Although outcomes cannot be predicted with certainty, the Company does not believe that any legal proceeding to which it is a party will have a material adverse effect on the Company's financial position, results of operations, and cash flows.

In April 2006, we reached agreements-in-principle to settle our previously-disclosed consolidated securities class action and shareholder derivative actions for a total of \$7,500; \$7,025 for the class action and \$475 for the derivative actions. In addition, we will commit to maintain or implement various corporate governance measures in connection with the settlement of the derivative actions.

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The consolidated class action arose from a number of lawsuits filed in 2004 against our company and certain of our former and current directors and officers on behalf of persons who purchased our common stock between May 21, 2002 and May 13, 2004. These actions, which were brought under the federal securities laws, alleged that the Prospectus issued in connection with our initial public offering in May 2002 contained material misrepresentations and omissions regarding our historical financial condition and regarding a personal stock transaction by our former chief executive officer. They also alleged that our company and certain of our present and former officers and directors engaged in improper revenue recognition with respect to certain of our business transactions, failed to maintain adequate internal controls, and knowingly disclosed unrealistic but favorable information about market demand for and commercial viability of our products to artificially inflate



the value of our stock. On October 19, 2006, the presiding judge entered an Order giving final approval of the class action settlement. In connection with the settlement, our directors and officers' liability insurers contributed \$7,025 to a settlement fund, from which approved claims of eligible class members will be paid in accordance with a court-approved plan of allocation. Taking into account the insurance contribution, the net cost of the settlement to our company is approximately \$475, which is the insurance deductible we paid over several quarters ending in the third quarter of 2005, and which was previously recorded as a charge.

In addition, in May 2004, two shareholder derivative actions were filed in the Superior Court of Orange County, California and later consolidated. Shortly thereafter, one additional shareholder derivative action was filed in the United States District Court for the Middle District of Florida, Tampa Division. These derivative actions were brought by certain shareholders against certain of our present and former officers and directors as well as the company (as a nominal defendant). The suits alleged that the defendants breached various fiduciary duties and otherwise violated state law based primarily upon the same facts and circumstances underlying the federal securities class action. In early April 2006, the company's counsel and the derivative plaintiffs' counsel participate in a mediation conference, which resulted in an agreement-in-principle to settle both derivative actions. On August 2, 2006, plaintiffs' counsel in the California derivative action filed a Notice of Settlement in the Superior Court. On July 13, 2007, the settlement was approved by the court.

In August 2006, the United States Department of Justice ( DOJ ) instituted a grand jury proceeding in the Middle District of Florida to investigate, among other things, alleged accounting improprieties in relation to certain of our business transactions and a personal stock transaction by our former chief executive officer. The grand jury proceeding is based primarily upon the same underlying facts and circumstances as alleged in the federal class action and shareholder derivative actions. To date, subpoenas for the production of documents and/or grand jury testimony have been issued to our company and several present and former officers and directors. We are cooperating with the DOJ in its investigation.

On June 26, 2006, the Company entered into a joint venture agreement with SAGA, SpA in Padova, Italy, ( SAGA ) a specialist precision parts manufacturer. The joint venture is named Liquidmetal SAGA Italy, Srl ( LSI ). The Company also entered into an exclusive manufacturing license agreement for the eyewear industry with LSI. Under the joint venture agreement, the Company has option to buy ownership interest in LSI, initially, of 19.9% to up to 50%. In December 2006, the Company exercised the 19.9% interest in LSI and will have two years to purchase the additional interest at a nominal price. In January 2007 and June 2007, the Company contributed additional \$217 and \$86, respectively, into LSI as additional investment. The contribution did not change the Company's 19.9% interest in LSI. Under the licensing agreement, at any time following 18 months after the effective date of the agreement, LSI may exercise its option to sell to the Company certain business assets including manufacturing equipment acquired under the joint venture. During year ended December 31, 2006, the Company recognized revenues of \$702 of Liquidmetal alloys sold to SAGA for use in the joint venture. Company anticipates the alloys to be fully utilized by the joint venture prior to the 18 month period. During the nine months ended September 30, 2007, the Company recognized revenues of \$103 of Liquidmetal alloys sold to LSI for use in the joint venture.

On July 24, 2007, the Company transferred all the assets of its Liquidmetal alloy industrial coatings business to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company ( LMC ), and LMC assumed substantially all of the liabilities of the coatings business. Larry Buffington, the Company's President and CEO, (who also serves as the President and CEO of LMC) holds 10% ownership interest in LMC. Under the Operating Agreement dated July 24, 2007, upon termination of Mr. Buffington's employment, LMC may repurchase Mr. Buffington's ownership interest, within 6 months of termination, at 20% of the fair market value if termination occurs in the first anniversary of the transfer; 40% of the fair market value if termination occurs in the second anniversary of the transfer; 60% of the fair market value if termination occurs in the third anniversary of the transfer, 80% of the fair market value if termination occurs in the fourth anniversary of the transfer, and 100% of the fair market value if termination occurs after the fifth anniversary of the transfer.

Under a Securities Purchase Agreement, dated July 24, 2007, C3 Capital Partners has the right, beginning on July 24, 2012 (or, if earlier, upon a default by LMC under the Subordinated Notes or Securities Purchase Agreement) to require LMC to purchase the C3 entities' membership interests in LMC for a purchase price equal to their pro rata portion of the greater of (i) the appraised fair market value of LMC or (ii) six times LMC's trailing 12-month earnings before interest taxes, depreciation, and amortization, less funded debt (see Note 7).



## 12. Related Party Transactions

In June 2003, the Company entered into an exclusive, ten-year license agreement with LLPG, Inc. ( LLPG ), a corporation controlled by Jack Chitayat, a former director of the Company. Under the terms of the agreement, LLPG has the right to commercialize Liquidmetal alloys, particularly precious-metal based compositions, in jewelry and high-end luxury product markets. The Company, in turn, will receive royalty payments over the life of the contract on all Liquidmetal products produced and sold by LLPG. In conjunction with its technology licensing contract, LLPG purchased two proprietary Liquidmetal alloy melting machines and three proprietary Liquidmetal alloy casting machines for a total purchase price of \$2,000.

In December 2006, the Company entered into an amended license agreement with LLPG, which extended the license agreement to fifteen years at reduced royalty rates. Additionally, the amended license agreement includes a \$400 amendment fee to be paid out in quarterly installments in 2007. The amendment fee will be recognized as revenue when received in 2007. The Company recognized \$0 and \$25 of revenue as minimum royalty fees under the licensing agreement during the three and nine months ended September 30, 2007, respectively.

In July 2007, Carlyle Liquid, LLC, assumed \$2,000 of 8% Convertible Subordinated Notes due January 2010 with related accrued interest and warrants that were previously held by Whitebox Intermarket Partners, LP. Mr. Chitayat is a managing member of Carlyle Liquid, LLC.

The Company has a license agreement with California Institute of Technology ( Caltech ) under which we exclusively license from Caltech certain inventions and technology relating to amorphous alloys. Professor William Johnson, a member of the Company's board of directors, is a professor at Caltech, and substantially all of the amorphous alloy technology licensed to us under the Caltech license agreement was developed in Professor Johnson's Caltech laboratory. Additionally, the Company reimburses Caltech for laboratory expenses incurred by Professor Johnson's Caltech laboratory, which during the three and nine months ended June 30, 2007 amounted to \$30 and \$60, respectively. The laboratory expenses incurred by Professor Johnson's Caltech laboratory during the three and nine months ended September 30, 2006 amounted to \$15 and \$45, respectively.

Additionally, the Company is a party to a consulting agreement with Mr. Johnson. Under this agreement, Mr. Johnson provides consulting services on an as-needed basis through 2004 as it relates to marketing and development of Liquidmetal alloys. During 2005, the agreement continued on a month-to-month basis. In April 2006, the Company entered into an agreement with Mr. Johnson effective from January 1, 2006 through December 31, 2006. During the three and nine months ended September 30, 2007 the Company incurred \$15 and \$45 in consulting fees from Mr. Johnson, respectively. During the three and nine months ended September 30, 2006, the Company incurred \$15 and \$45 in consulting fees from Mr. Johnson, respectively.

In November 2004, the Company entered into an agreement with John Kang, our Chairman, President, and Chief Executive Officer, in which Mr. Kang agreed that certain stock transactions by him in 2002 involving our common stock should have resulted in a liability under Section 16(b) of the Securities Exchange Act of 1934, as amended ( Section 16(b) ). These transactions include Mr. Kang's private sale of 285,715 shares of his personal Liquidmetal Technologies common stock to Growell Metal Co., Ltd. in February 2002, prior to our initial public offering. They also include Mr. Kang's subsequent indirect purchase and disposition of Liquidmetal Technologies common stock in order to satisfy a personal agreement Mr. Kang made to Growell Metal in February 2002 regarding the guaranteed minimum value of the stock purchased by Growell Metal in February 2002 (the purchases and dispositions incident to this agreement occurred in August and November 2002, respectively). Lastly, the transactions include open-market purchases of an aggregate of 89,300 shares of our common stock made by Mr. Kang in August 2002. The Audit Committee of the Company's Board of Directors conducted an independent inquiry into these transactions with the aid of independent legal counsel and, as a result of such inquiry, the Audit Committee concluded that the transactions should have resulted in a liability to the Company under Section 16(b) in the amount of \$302. Mr. Kang has acknowledged this liability, and in an agreement negotiated between Mr. Kang and the Audit Committee and approved by the full Board, Mr. Kang will pay this liability through periodic installments in 2005 and 2007.

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As a result, the Company accrued for the \$302 receivable in other assets and other income as of December 31, 2004. The above-described transactions involving Growell Metal were reported on a new Form 4 filed by Mr. Kang on November 15, 2004, and the open-market purchases were previously reported on a timely basis in August 2002. As of September 30, 2007, the outstanding amount of the receivable was \$178, which is included in prepaid and other current assets.

On June 1, 2007, the Company entered into a transaction with Grace Metal ( GM ), under which (i) GM agreed to purchase from us various equipment (including die casting machines and vacuum induction melters) used in the Company's bulk amorphous alloy business segment and (ii) we granted GM a 10-year exclusive license to manufacture products made from bulk Liquidmetal alloys for customers whose principal headquarters or whose major operations are located in South Korea. GM was formed by an investor group that includes the former founder and director of our Company, James Kang, who is also the brother of John Kang, Chairman of the Board of our Company. Under an equipment purchase agreement between us and GM, GM agreed to buy the purchased equipment for a total purchase price of \$2,000, of which \$400 were received as of September 30, 2007. The equipment purchase agreement provides that delivery of the equipment can be delayed to accommodate our continuing manufacturing needs, and it also provides that we will retain a security interest in the purchased equipment until full payment of the purchase price.

In consideration of the license agreement with GM, we will be entitled to royalty of 10% of GM's net sales of licensed products (unless GM's margin on the products falls below specified levels, in which case a new royalty will be negotiated in good faith). The agreement provides that we may convert the license to a non-exclusive in the event that the net sales in the second year of the contract or thereafter are not sufficient to result in royalties of \$500 or more per year. The agreement also provides that GM will be required to purchase all alloy feedstock from us, and we will have the right to continue to manufacture Liquidmetal alloy products for South Korean customers until all purchased equipment has been commissioned.

Additionally, effective June 1, 2007, we discontinued our post-processing operation in Weihai, China and transferred our manufacturing staff and equipment in Weihai to GM under an amendment to the equipment purchase agreement with GM. Further, we transferred certain of our manufacturing staff from our South Korean plant to GM. As a result, GM assumed \$370 of accrued severance liability for the transferred employee. The equipment purchase agreement and the transfer agreement regarding our Weihai operations resulted in a total net gain of \$143, which is recorded as other income.

We have also changed the name of our South Korean subsidiary to Liquidmetal Technologies Korea Co., Ltd, which was formerly Liquidmetal Korea Co., Ltd. GM will assume the name Liquidmetal Korea to conduct business in South Korea.

The Company purchased production supplies and molds from Grace Metal, Lead Metal, and SDM, which are controlled by James Kang, a former director and officer of the Company and the brother of our current Chairman. The Company purchased a total of \$167 and \$411 for the three and nine months ended September 30, 2007, of which \$170 is included in accounts payable and accrued liabilities at September 30, 2007. The Company purchased a total of \$466 for the year ended December 31, 2006, of which, \$10 is included in accounts payable and accrued liabilities at December 31, 2006. The Company recognized revenue from sales of materials and royalties for a total of \$1,279 and \$3,199 for the three and nine months ended September 30, 2007, of which \$2,086 is included in accounts receivable. Effective October 20, 2006, Mr. Kang began providing services to the Company as a consultant, which will continue thru December 31, 2009. Additionally, for the three and nine months ended September 30, 2007, the Company incurred \$50 and \$150, respectively, for his services as consultant.

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



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*This management's discussion and analysis should be read in conjunction with the condensed consolidated financial statements and notes included elsewhere in this report on Form 10-Q.*

*This management's discussion and analysis, as well as other sections of this report on Form 10-Q, may contain forward-looking statements that involve risks and uncertainties, including statements regarding our plans, future events, objectives, expectations, forecasts, or assumptions. Any statement that is not a statement of historical fact is a forward-looking statement, and in some cases, words such as believe, estimate, project, expect, intend, may, anticipate, plans, seeks, and similar expressions identify forward-looking statements. These statements involve risks and uncertainties that could cause actual outcomes and results to differ materially from the anticipated outcomes or results, and undue reliance should not be placed on these statements. These risks and uncertainties include, but are not limited to, the matters discussed under the caption Factors Affecting Future Results in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and other risks and uncertainties discussed in filings made with the Securities and Exchange Commission (including risks described in subsequent reports on Form 10-Q, Form 10-K, Form 8-K, and other filings). Liquidmetal Technologies disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.*

### Overview

We are a materials technology company that develops and commercializes products made from amorphous alloys. Our Liquidmetal® family of alloys consists of a variety of coatings, powders, bulk alloys, and composites that utilize the advantages offered by amorphous alloy technology. We develop, manufacture, and sell products and components from bulk amorphous alloys that are incorporated into the finished goods of our customers, and we also market and sell amorphous alloy industrial coatings. We also partner with third-party licensees and distributors to develop and commercialize Liquidmetal alloy products. We have the exclusive right to develop, manufacture, and sell what we believe are the only commercially viable bulk amorphous alloys.

Amorphous alloys are unique materials that are distinguished by their ability to retain a random atomic structure when they solidify, in contrast to the crystalline atomic structure that forms in ordinary metals and alloys when they solidify. Liquidmetal alloys possess a combination of performance, processing, and cost advantages that we believe makes them preferable to other materials in a variety of applications. The amorphous atomic structure of our alloys enables them to overcome certain performance limitations caused by inherent weaknesses in crystalline atomic structures, thus facilitating performance and processing characteristics superior in many ways to those of their crystalline counterparts. For example, our zirconium-titanium Liquidmetal alloys are approximately 250% stronger than commonly used titanium alloys, such as Ti-6Al-4V, but they have processing characteristics similar in many respects to plastics. We believe these advantages could result in Liquidmetal alloys supplanting other incumbent materials in a wide variety of applications. Moreover, we believe these advantages will enable the introduction of entirely new products and applications that are not possible or commercially viable with other materials.

Our revenues are derived from three principal operating segments: Liquidmetal alloy industrial coatings, Liquidmetal coatings application, and bulk Liquidmetal alloy products. 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 in coal-burning power plants. The historical operating information for fiscal year 2001 is based substantially on sales of Liquidmetal alloy coatings. In the second half of 2002, we began producing bulk Liquidmetal alloy components and products for incorporation into our customers' finished goods. Liquidmetal coatings application is the service provided for applying Liquidmetal products as a protective coating. Bulk Liquidmetal alloy segment revenue includes sales of parts or components of electronic devices, medical products, and sports and leisure goods, tooling and prototype parts (including demonstration parts and test samples) for customers with products in development, product licensing and arrangements, and research and development revenue relating primarily to defense and medical applications. We expect that these sources of revenue will continue to significantly change the character of our revenue mix.

The cost of sales for our Liquidmetal coatings segment consists primarily of the costs of outsourcing our manufacturing to third parties. Consistent with our expectations, our cost of sales has been increasing over historical results as we further build our bulk Liquidmetal alloy business. Although we plan to continue outsourcing the manufacturing of our coatings, we will internally manufacture many products derived



from our bulk Liquidmetal alloys.

Selling, general, and administrative expenses currently consist primarily of salaries and related benefits, stock-based compensation, severance costs, travel, consulting and professional fees, depreciation and amortization, insurance, office and administrative expenses, and other expenses related to our operations.

Research and development expenses represent salaries, related benefits expense, depreciation of research equipment, consulting and contract services, expenses incurred for the design and testing of new processing methods, expenses for the development of sample and prototype products, and other expenses related to the research and development of Liquidmetal alloys. Costs associated with research and development activities are expensed as incurred. We plan to enhance our competitive position by improving our existing technologies and developing advances in amorphous alloy technologies. We believe that our research and development efforts will focus on the discovery of new alloy compositions, the development of improved processing technology, and the identification of new applications for our alloys.

In a connection to an equipment purchase agreement entered into with Grace Metal ( GM ), a South Korean corporation, effective June 1, 2007, we discontinued our post-processing operation in Weihai, China and transferred our manufacturing staff and equipment in Weihai to GM under an amendment to the equipment purchase agreement with GM. Further, we transferred certain of our manufacturing staff from our South Korean plant to GM. GM was formed by an investor group that includes the former Founder and director of our company, James Kang, who is also the brother of John Kang, Chairman of the Board of our company. We have also changed the name of our South Korean subsidiary to Liquidmetal Technologies Korea Co., Ltd, which was formerly Liquidmetal Korea Co., Ltd. GM will assume the name of Liquidmetal Korea to conduct business in South Korea.

On July 24, 2007, we transferred substantially all of the assets of our Liquidmetal alloy industrial coatings business to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company ( LMC ), and LMC assumed substantially all of the liabilities of the coatings business. The transfer included the thermal spray coatings assets and liabilities acquired under a purchase agreement with Foster Wheeler Energy Services in June 2007. We hold a 69.25% ownership interest in LMC. The results of operation of LMC are consolidated and comprise our Liquidmetal alloy industrial coatings segment for financial reporting purposes.

The following discussion and analysis of our financial condition and results of operations focuses on the historical results of our continuing operations.

#### **Critical Accounting Policies and Estimates**



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The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions.

We believe that the following accounting policies are the most critical to our condensed consolidated financial statements since these policies require significant judgment or involve complex estimates that are important to the portrayal of our financial condition and operating results:

Exchange rate fluctuations

Warranty accrual

Allowance for doubtful accounts

Inventories at lower of cost or net realizable value

Deferred tax assets

Valuation of derivatives of warrants and embedded conversion features

Our Annual Report on Form 10-K for the year ended December 31, 2006, contains further discussions on our critical accounting policies and estimates.

The company adopted Statement of Financial Accounting Standards No. 123, Share-Based Payment ( SFAS 123R ), on January 1, 2006. This new standard requires companies to expense the fair value of employee stock options and similar awards. The company adopted SFAS 123R using the modified prospective transition method. Therefore, stock based compensation expense measured in accordance with SFAS 123R was recorded during the first quarter of 2006, but the prior year consolidated statement of income was not restated. The adoption of SFAS 123R resulted in incremental expense of \$0.2 and \$0.6 million for the three and nine months ended September 30, 2007, respectively, and \$0.3 and \$0.8 million for the three and nine months ended September 30, 2006, respectively.

## **Results of Operations**

Comparison of the three months ended September 30, 2007 and 2006

*Revenue.* Revenue decreased \$0.9 million to \$7.1 million for the three months ended September 30, 2007 from \$8.0 million for the three months ended September 30, 2006. The decrease consisted of a decrease of \$1.8 million of sales and prototyping of parts manufactured from bulk Liquidmetal alloys to consumer electronics customers as a result of increased reliance on licensees to manufacture and sell bulk Liquidmetal alloy parts to customers based in South Korea, offset by an increase of \$0.9 million from the sales of our coating products as a result of increase in demand from oil drilling applications.

*Cost of Sales.* Cost of sales decreased to \$5.2 million, or 73% of revenue, for the three months ended September 30, 2007 from \$6.4 million, or 80% of revenue, for the three months ended September 30, 2006. The decreases were a result of a change in revenue mix during the three months ended September 30, 2006, primarily from increased royalty revenues. We also believe that higher manufacturing volumes and greater mix of higher-margin products in the future will cause the gross profit to improve over time. The cost to manufacture parts from our bulk Liquidmetal alloys is variable and differs based on the unique design of each product. However, the cost of sales for the products sold by the coatings business segment is generally consistent because the Liquidmetal coatings products are produced by third parties and sold wholesale to various industries.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses decreased to \$1.9 million, or 26% of revenue, for the three months ended September 30, 2007 from \$2.3 million, or 28% of revenue, for the three months ended September 30, 2006. This decrease was primarily a result of decreases in wages and expenses of \$0.3 million and a decrease in product warranty expense of \$0.1 million.

*Research and Development Expenses.* Research and development expenses remained at \$0.3 million, or 5% of revenue, for the three months ended September 30, 2007 versus \$0.3 million or 3% of revenue for the three months ended September 30, 2006. The Company continues to perform research and development of new Liquidmetal alloys and related processing capabilities, develop new manufacturing techniques, and contract with consultants to advance the development of Liquidmetal alloys.

*Change in Value of Warrants.* Change in value of warrants decreased to a gain of \$0.2 million, or 3% of revenue, for the three months ended September 30, 2007 from a gain of \$1.4 million, or 17% of revenue, for the three months ended September 30, 2006. The change in value of warrants consisted of warrants issued from convertible notes and subordinated notes funded between 2004 and 2007 primarily as a result of fluctuations in our stock price.

*Change in Value of Conversion Feature.* Change in the value of our conversion feature liability from our convertible notes funded between 2004 and 2007 resulted in a gain of \$0.6 million, or 9% of revenue, during the three months ended September 30, 2007 from a gain of \$2.0 million, or 25% of revenue, for the three months ended September 30, 2006, primarily as a result of fluctuations in our stock price.

*Interest Expense.* Interest expense was \$2.0 million, or 28% of revenue, for the three months ended September 30, 2007 and was \$2.3 million, or 29% of revenue, for the three months ended September 30, 2006. Interest expense consists primarily of debt amortization and interest accrued on outstanding convertible and subordinated notes, borrowings under the April 2005 factoring, loan, and security agreement, and the Kookmin loan. The decrease was due to decreased debt discount amortization during the three months ended September 30, 2007.

*Interest Income.* Interest income was \$14 thousand for the three months ended September 30, 2007 and was \$8 thousand for the three months ended September 30, 2006 from interest earned on cash deposits.

Comparison of the nine months ended September 30, 2007 and 2006



*Revenue.* Revenue decreased \$1.2 million to \$20.5 million for the nine months ended September 30, 2007 from \$21.7 million for the nine months ended September 30, 2006. The decrease included \$3.8 million decrease in sales and prototyping of parts manufactured from bulk Liquidmetal alloys to consumer electronics customers as a result of increased reliance on licensees to manufacture and sell bulk Liquidmetal alloy parts to customers based in South Korea, offset by an increase of \$2.6 million from sales of our coating products as a result of increase in demand from oil drilling applications.

*Cost of Sales.* Cost of sales increased to \$19.3 million, or 94% of revenue, for the nine months ended September 30, 2007 from \$17.3 million, or 80% of revenue, for the nine months ended September 30, 2006. The increases were a result of increases in our Liquidmetal coatings business and higher manufacturing costs of new production items in our Liquidmetal bulk alloy business during the first two quarter of 2007. We believe that higher manufacturing volumes and greater mix of higher-margin products in the future will cause the gross profit to improve over time. The cost to manufacture parts from our bulk Liquidmetal alloys is variable and differs based on the unique design of each product. However, the cost of sales for the products sold by the coatings business segment is generally consistent because the Liquidmetal coatings products are produced by third parties and sold wholesale to various industries.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses decreased to \$6.9 million, or 34% of revenue, for the nine months ended September 30, 2007 from \$7.4 million, or 34% of revenue, for the nine months ended September 30, 2006. This increase was primarily a result of decreases in wages and expenses of \$0.8 million, decreases in travel expenses of \$0.1 million, and decreases in depreciation expenses of \$0.1 million, offset by increases in professional and consulting fees of \$0.5 million.

*Research and Development Expenses.* Research and development expenses increased to \$0.9 million, or 4% of revenue, for the nine months ended September 30, 2007 from \$0.8 million, or 4% of revenue, for the nine months ended September 30, 2006. The increase was primarily due to increase in professional fees. The Company continues to perform research and development of new Liquidmetal alloys and related processing capabilities, develop new manufacturing techniques, and contract with consultants to advance the development of Liquidmetal alloys.

*Loss from Extinguishments of Debts.* Loss from extinguishments of debt increased to \$0.6 million, or 5% of revenue, for the nine months ended September 30, 2007 from \$0 for the nine months ended September 30, 2006. The \$0.6 million loss was recognized from the extinguishment of certain of our convertible and subordinated notes in January 2007.

*Change in Value of Warrants.* Change in value of warrants increased to a gain of \$4.5 million, or 22% of revenue, during the nine months ended September 30, 2007 from a loss of \$1.4 million, or 6% of revenue, during the nine months ended September 30, 2006. The change in value of warrants consisted of warrants issued from convertible notes and subordinated notes funded between 2004 and 2007 primarily as a result of fluctuations in our stock price.

*Change in Value of Conversion Feature.* Change in the value of our conversion feature liability from our convertible notes funded between 2004 and 2007 resulted in gain of \$6.1 million, or 30% of revenue, during the nine months ended September 30, 2007 from a loss of \$1.9 million, or 9% of revenue, during the nine months ended September 30, 2006 primarily as a result of fluctuation in our stock prices.

*Other Income.* Other income was \$49 thousand for the nine months ended September 30, 2007, primarily from gain recognized from disposal of assets, from \$0.6 million, or 4% of revenue, for the nine months ended September 30, 2006 from \$0.1 million gain recognized from disposal of idle equipment and \$0.5 million gain recognized from termination of a distribution agreement with a Japanese sporting goods distributor originally entered into in March 1996.

*Interest Expense.* Interest expense was \$7.5 million, or 36% of revenue, for the nine months ended September 30, 2007 and was \$7.4 million, or 34% of revenue, for the nine months ended September 30, 2006. Interest expense consists primarily of debt amortization and interest accrued on outstanding convertible and subordinated notes, borrowings under the April 2005 factoring, loan, and security agreement, the Kookmin loan and late registration and late filing fee penalties.

*Interest Income.* Interest income was \$0.1 million for the nine months ended September 30, 2007 and \$17 thousand for the nine months ended September 30, 2006, from interest earned on cash deposits.

**Liquidity and Capital Resources**



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Our cash used for operating activities was \$9.6 million for the nine months ended September 30, 2007 and \$5.5 million for the nine months ended September 30, 2006. Our working capital deficit decreased from \$23.2 million at December 31, 2006 to \$11.6 million at September 30, 2007. The Company's working capital deficit decrease of \$11.5 million was primarily attributable to decrease in long-term debt, current portion, of \$10.6 million, and decrease in short term debt of \$1.7 million, and offset by an increase in long-term debt of consolidated subsidiary of \$0.8 million.

Our cash used in investing activities was \$1.0 million for the nine months ended September 30, 2007 for the acquisition of property and equipment and investments in patents and trademarks.

Our cash provided by financing activities was \$11.4 million for the nine months ended September 30, 2007. We received net \$1.8 million in borrowings from factoring agreement executed in April 2005. The proceeds from borrowings have been used to meet working capital requirements. We have \$4.1 million available for future borrowings under the factoring agreement, which is contingent on approval of eligible receivables by the financing company.

On January 3, 2007, we completed a private placement of \$16.3 million 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 \$12.9 million, in payment of a total of \$3.4 million 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 \$0.1 million cash discount.

In June 2007, we entered into an equipment sale and licensing agreement with Grace Metal, a South Korean corporation, providing for \$2 million in exchange for die casting machines and vacuum induction melters, and a 10-year exclusive license to manufacture Liquidmetal alloys for customers whose principal headquarters or major operations are based in South Korea. The principal purpose of the transactions with Grace Metal was to raise capital for the next-generation casting equipment and to shift the cost and burden of our manufacturing operations to a third party. Grace Metal was formed by an investor group that includes the former Founder and director of our company, James Kang, who is also the brother of John Kang, Chairman of the Board of our company.

In July 2007, we completed an \$11.5 million financing transaction that provided funding to repay senior convertible notes previously issued were scheduled to become due in July and August 2007. We transferred substantially all of the assets of Liquidmetal Coatings business (the "Division") to a newly formed, newly capitalized subsidiary named Liquidmetal Coatings, LLC, a Delaware limited liability company ("LMC"), and LMC assumed substantially all of the liabilities of the Division. LMC was capitalized through a \$6.5 million subordinated debt and equity investment by C3 Capital Partners and a \$5.0 million senior credit facility with Bank Midwest, N.A. The transaction resulted in net cash proceeds of \$10.6 million after related debt issuance costs of \$0.9 million incurred by LMC and us. We will retain a 69.25% interest in LMC, and the remaining 30.75% of the equity of LMC will be held by C3 Capital Partners, Larry Buffington (who will serve as the President and CEO of LMC), and CRESO Capital Partners (the financial advisor in the transaction).

We anticipate that we will not have sufficient funds to pursue our current operating plan through the fourth quarter of 2007 and we will therefore require additional funding. 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) and additional licensing and outsourcing of our manufacturing operations.

Additionally, as of September 30, 2007, we had approximately \$3.0 million of principal and accrued interest outstanding under the 8% unsecured subordinated notes ( Notes ), which were due August 17, 2007. We intend to fully repay the amounts due under Notes. However, as of the filing of this report we do not have sufficient funds to repay the Notes. As a result, we are currently in default with the holders of the Notes. Such a default may have material adverse effect on our operations, financial condition, and results of operations. We have not received a formal notice of default and we are currently working to resolve this matter with the investors holding our Notes.

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.

**Contractual Obligations**





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The following table summarizes the Company's obligations and commitments as of September 30, 2007:

| Contractual Cash Obligations (1) | Total     | Payments Due by Period (in thousands) |           |           |            |
|----------------------------------|-----------|---------------------------------------|-----------|-----------|------------|
|                                  |           | Less Than<br>1 Year                   | 1-3 Years | 3-5 Years | Thereafter |
| Long-term debt (2)               | \$ 30,072 | \$ 5,524                              | \$ 18,023 | \$ 6,525  | \$         |
| Short-term debt (3)              | 2,034     | 2,034                                 |           |           |            |
| Operating leases and rents       | 1,306     | 374                                   | 798       | 134       |            |
| Consulting services payable      | 666       | 367                                   | 299       |           |            |
| Foster Wheeler                   | 450       | 300                                   | 150       |           |            |
| Dongyang                         | 12        | 12                                    |           |           |            |
| Nichimen                         | 315       | 315                                   |           |           |            |
|                                  | \$ 34,855 | \$ 8,926                              | \$ 19,270 | \$ 6,659  | \$         |

(1) Contractual cash obligations include Long-Term Debt comprised of \$2,758 of Unsecured Subordinated Notes issued in 2006, \$16,300 of Convertible Unsecured Notes issued in 2007, \$576 of Kookmin Bank Loan, and \$3,913 of Bank Midwest term loan, and \$6,525 of C3 Capital Partners Subordinated Notes, Short-Term Debt comprised of \$946 outstanding advances received under factoring, loan, and security agreement, \$1,088 of Bank Midwest revolving loan, and future minimum lease payments under capital and operating leases, and purchase commitments from consultants, payments due from assets purchased from Foster Wheeler thermal spray coatings business, payments due from our discontinued equipment manufacturing business (Dongyang), and minimum payments due under a distribution agreement (Nichimen).

(2) Does not include interest payments of \$7,758; and un-amortized cash discount and discounts for conversion feature and warrants of \$10,760 of our convertible notes.

(3) Does not include minimum interest and fee payments of \$30.

### Off Balance Sheet Arrangements

An off-balance sheet arrangement is any transaction, agreement or other contractual arrangement involving an unconsolidated entity under which a company has (1) made guarantees, (2) a retained or a contingent interest in transferred assets, (3) an obligation under derivative instruments classified as equity, or (4) any obligation arising out of a material variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the company, or that engages in leasing, hedging, or research and development arrangements with the company.

On June 26, 2006, we entered into a joint venture agreement with SAGA, SpA in Padova, Italy, ( SAGA ) a specialist precision parts manufacturer. The joint venture is named Liquidmetal SAGA Italy, Srl ( LSI ). We also entered into an exclusive manufacturing license agreement for the eyewear industry with LSI. Under the joint venture agreement, we have the option to buy an ownership interest in LSI, initially, of 19.9% to up to 50%. In December 2006, we purchased 19.9% interest in the joint venture. Under the licensing agreement, at any time following 18 months after the effective date of the agreement, LSI may exercise its option to sell us certain business assets including manufacturing equipment acquired under the joint venture. During the year ended December 31, 2006, we recognized revenues of \$0.7 million of Liquidmetal alloys sold to SAGA for use in the joint venture. We anticipate the alloys to be fully utilized by the joint venture prior to the 18 month period. During the nine months ended September 30, 2007, we recognized revenues of \$0.1 million of Liquidmetal alloys sold to LSI for use in the joint venture.

**Item 3 Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to various market risks in conducting the business of the Company, and we anticipate that this exposure will increase as a result of our planned growth. In an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward sales contracts, option contracts, foreign currency exchange contracts, and interest rate swaps. We have not, and do not intend to, engage in the practice of trading derivative securities for profit.

*Interest Rates.* We are exposed to market risks relating to changes in interest rates as our borrowings are subject to the volatility of interest rate risk.

*Commodity Prices.* We are exposed to price risk related to anticipated purchases of certain commodities used as raw materials by our businesses, including titanium and zirconium. Although we do not currently enter into commodity future, forward, and option contracts to manage the fluctuations in prices of anticipated purchases, we may enter into such contracts in the future as our business grows and as our purchases of these raw materials increase.

*Foreign Exchange Rates.* As a result of our operation of a manufacturing facility in South Korea, a substantial portion of our costs will be denominated in the South Korean won. Consequently, fluctuations in the exchange rates of the South Korean won to the U.S. dollar will affect our costs of goods sold and operating margins and could result in exchange losses. Although we do not currently enter into foreign exchange hedge transactions, we may do so in the future as our business grows.

**Item 4 Controls and Procedures**



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Evaluation of Disclosure Controls and Procedures. Based on an evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of September 30, 2007, the end of the period covered by this report, our Chief Executive Officer and Vice President of Finance have concluded that the disclosure controls and procedures were effective.

Changes in Internal Controls. During the quarter ended September 30, 2007, there was no change in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II**  
**OTHER INFORMATION**

**Item 1 Legal Proceedings**

Securities Class Action and Shareholder Derivative Actions

In April 2006, we reached agreements-in-principle to settle our previously-disclosed consolidated securities class action and shareholder derivative actions for a total of \$7,500; \$7,025 for the class action and \$475 for the derivative actions. In addition, we will commit to maintain or implement various corporate governance measures in connection with the settlement of the derivative actions.

The consolidated class action arose from a number of lawsuits filed in 2004 against our company and certain of our former and current directors and officers on behalf of persons who purchased our common stock between May 21, 2002 and May 13, 2004. These actions, which were brought under the federal securities laws, alleged that the Prospectus issued in connection with our initial public offering in May 2002 contained material misrepresentations and omissions regarding our historical financial condition and regarding a personal stock transaction by our former chief executive officer. They also alleged that our company and certain of our present and former officers and directors engaged in improper revenue recognition with respect to certain of our business transactions, failed to maintain adequate internal controls, and knowingly disclosed unrealistic but favorable information about market demand for and commercial viability of our products to artificially inflate the value of our stock. On October 19, 2006, the presiding judge entered an Order giving final approval of the class action settlement. In connection with the settlement, our directors and officers' liability insurers contributed \$7,025 to a settlement fund, from which approved claims of eligible class members will be paid in accordance with a court-approved plan of allocation. Taking into account the insurance contribution, the net cost of the settlement to our company is approximately \$475, which is the insurance deductible we paid over several quarters ending in the third quarter of 2005, and which was previously recorded as a charge.

In addition, in May 2004, two shareholder derivative actions were filed in the Superior Court of Orange County, California and later consolidated. Shortly thereafter, one additional shareholder derivative action was filed in the United States District Court for the Middle District of Florida, Tampa Division. These derivative actions were brought by certain shareholders against certain of our present and former officers and directors as well as the company (as a nominal defendant). The suits alleged that the defendants breached various fiduciary duties and otherwise violated state law based primarily upon the same facts and circumstances underlying the federal securities class action. In early April 2006, the company's counsel and the derivative plaintiffs' counsel participate in a mediation conference, which resulted in an agreement-in-principle to settle both derivative actions. On August 2, 2006, plaintiffs' counsel in the California derivative action filed a Notice of Settlement in the Superior Court. On July 13, 2007, the settlement was approved by the court.

Department of Justice Investigation

In August 2006, the United States Department of Justice ( DOJ ) instituted a grand jury proceeding in the Middle District of Florida to investigate, among other things, alleged accounting improprieties in relation to certain of our business transactions and a personal stock transaction by our former chief executive officer. The grand jury proceeding is based primarily upon the same underlying facts and circumstances as alleged in the federal class action and shareholder derivative actions. To date, subpoenas for the production of documents and/or grand jury testimony have been issued to our company and several present and former officers and directors. We are cooperating with the DOJ in its investigation.

**Item 1A Risk Factors**

In addition to the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2006, the following is an additional risk factor that could adversely affect our business, results of operations or financial condition.

*We are in default under our 8% unsecured subordinated notes due August 17, 2007.*

We have approximately \$3.0 million of principal and accrued interest outstanding as of September 30, 2007, under the 8% unsecured subordinated notes ( Notes ), which were due August 17, 2007. We intend to fully repay the amounts due under Notes. However, as of the filing of this report we do not have sufficient funds to repay the Notes. As a result, we are currently in default under the Notes. Such a default may have material adverse effect on our operations, financial condition, and results of operations. We have not received a formal notice of default and we are currently working to resolve this matter with the investors holding our Notes.

**Item 3 - Defaults Upon Senior Securities**

We have approximately \$3.0 million of principal and accrued interest outstanding as of September 30, 2007, under the 8% unsecured subordinated notes ( Notes ), which were due August 17, 2007. We intend to fully repay the amounts due under Notes. However, as of the filing of this report we do not have sufficient funds to repay the Notes. As a result, we are currently in default under the Notes. Such a default may have material adverse effect on our operations, financial condition, and results of operations. We have not received a formal notice of default and we are currently working to resolve this matter with investors holding our Notes.

**Item 5 Other Information**

There were no matters required to be disclosed in a current report on Form 8-K during the fiscal quarter covered by this report that were not so disclosed.

**Item 6 Exhibits**

The following documents are filed as an exhibit to this Report:

| <b>Exhibit Number</b> | <b>Description of Document</b>   |
|-----------------------|--|
| 31.1                  | Certification of the President and Chief Executive Officer, Larry Buffington, as required by Section 302 of Sarbanes-Oxley Act of 2002                               |
| 31.2                  | Certification of Principal Financial Officer, Won Chung, as required by Section 302 of Sarbanes-Oxley Act of 2002  |
| 32.1                  | Certification of Principal Executive Officer, Larry Buffington, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002 |
| 32.2                  | Certification of Principal Financial Officer, Won Chung, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002        |

**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 hereunto duly authorized.

LIQUIDMETAL TECHNOLOGIES, INC.  
(Registrant)

Date: November 14, 2007

/s/ Larry Buffington  
Larry Buffington  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 14, 2007

/s/ Won Chung  
Won Chung  
Vice President of Finance  
(Principal Financial and Accounting Officer)