

LIQUIDMETAL TECHNOLOGIES INC
Form 10-Q
May 10, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from to

Commission File No. 001-31332

LIQUIDMETAL TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

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

25800 Commercentre Drive, Suite 100

Lake Forest, California 92630

(address of principal executive office, zip code)

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Registrant's telephone number, including area code: **(949) 206-8000**

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 April 26, 2006, there were 44,056,058 shares of the registrant's common stock, \$.001 par value, outstanding.

As of April 26, 2006, there were 44,056,058 shares of the registrant's common stock, \$.001 par value, outstanding.

**LIQUIDMETAL TECHNOLOGIES, INC.
FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2006**

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.

TABLE OF CONTENTS

PART I

Item 1 Financial Statements

Condensed Consolidated Balance Sheets (unaudited)
Condensed Consolidated Statements of Operations and Comprehensive Loss (unaudited)
Condensed Consolidated Statements of Shareholders' Deficiency (unaudited)
Condensed Consolidated Statements of Cash Flows (unaudited)
Notes to Condensed Consolidated Financial Statements (unaudited)

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

Item 3 Quantitative and Qualitative Disclosures about Market Risk

Item 4 Controls and Procedures

PART II Other Information

Item 1 Legal Proceedings

Item 1A Risk Factors

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

Item 3 Defaults Upon Senior Securities

Item 4 Submission of Matters to a Vote of Security Holders

Item 5 Other Information

Item 6 Exhibits

Signatures

Certifications

PART I

FINANCIAL INFORMATION

Item 1 Financial Statements

LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	(unaudited) March 31, 2006	December 31, 2005
<u>ASSETS</u>		
Current Assets:		
Cash and cash equivalents	\$ 1,263	\$ 1,392
Trade accounts receivables, net of allowance for doubtful accounts of \$69 and \$61	3,506	2,360
Inventories	1,764	1,748
Prepaid expenses and other current assets	561	609
Total current assets	7,094	6,109
Property, plant and equipment, net	13,300	13,437
Idle equipment	199	193
Other intangibles, net	1,196	1,185
Other assets	547	639
Total assets	\$ 22,336	\$ 21,563
<u>LIABILITIES AND SHAREHOLDERS' DEFICIENCY</u>		
Current liabilities:		
Accounts payable and accrued expenses	7,977	\$ 6,530
Settlement payable		3,331
Deferred revenue	407	1,275
Short-term debt	2,286	550
Long-term debt, current portion	1,391	1,343
Other liabilities, current portion	300	483
Warrant liabilities	3,165	1,792
Conversion feature liabilities	1,940	959
Total current liabilities	17,466	16,263
Long-term debt, net of current portion and debt discount of \$6,285 and \$7,354	7,080	6,338
Other long-term liabilities, net of current portion	391	348
Total liabilities	24,937	22,949
Shareholder's equity (deficiency):		
Common stock, \$0.001 par value; 100,000,000 shares authorized and 43,956,621 issued and outstanding at March 31, 2006 and 42,187,621 issued and outstanding at December 31, 2005	44	42

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Additional paid-in capital	136,607	132,861
Accumulated deficit	(141,622)	(136,559)
Accumulated other comprehensive income	2,370	2,270
Total shareholder deficiency	(2,601)	(1,386)
Total liabilities and shareholders' deficiency	\$ 22,336	\$ 21,563

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 LOSS

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended March 31,	
	2006	2005
Revenue	\$ 6,555	\$ 2,843
Cost of sales	5,324	2,835
Gross profit	1,231	8
Operating expenses		
Selling, general, and administrative	2,705	2,590
Research and development	203	397
Total operating expenses	2,908	2,987
Loss from operations	(1,677)	(2,979)
Change in value of warrants, (loss) gain	(1,289)	133
Change in value of conversion feature, (loss)	(981)	
Other income	480	
Interest expense	(1,598)	(1,257)
Interest income	2	6
Loss from continuing operations	(5,063)	(4,097)
Net Loss	(5,063)	(4,097)
Other comprehensive gain (loss):		
Foreign exchange translation gain	100	321
Comprehensive loss	\$ (4,963)	\$ (3,776)
Per common share basic and diluted:		
Net loss per share basic and diluted	(0.12)	(0.10)
Number of weighted average shares - basic and diluted	42,817	41,610

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

LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS DEFICIENCY

For the Three Months Ended March 31, 2006

(in thousands, except per share data)

(unaudited)

	Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (loss)	Total
Balance, December 31, 2005	42,187,621	\$ 42	\$ 132,861	\$ (136,559)	\$ 2,270	\$ (1,386)
Conversion of notes payable	59,000		59			59
Common stock issued as director's fees	10,000		15			15
Common stock issued to Innometal	1,700,000	2	3,448			3,450
Stock-based compensation			224			224
Foreign exchange translation gain					100	100
Net loss				(5,063)		(5,063)
Balance, March 31, 2006	\$ 43,956,621	\$ 44	\$ 136,607	\$ (141,622)	\$ 2,370	\$ (2,601)

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

LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended March 31,	
	2006	2005
Operating activities:		
Net loss	\$ (5,063)	(4,097)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
(Gain) on disposal of asset		(1)
Depreciation and amortization	782	843
Amortization of debt discount	1,229	197
Stock-based compensation	224	
Bad debt expense (recovery)	28	(20)
Warranty expense	74	42
Loss (gain) from change in value of warrants	1,289	(133)
Loss from change in value of beneficial conversion feature	981	
Changes in operating assets and liabilities:		
Trade accounts receivable	(1,174)	(97)
Inventories	(16)	198
Prepaid expenses and other current assets	48	496
Other assets	17	16
Accounts payable and accrued expenses	1,388	1,546
Deferred revenue	(868)	(20)
Other liabilities	(107)	(81)
Net cash used for operating activities	(1,168)	(1,111)
Investing Activities:		
Purchases of property and equipment	(145)	
Investment in patents and trademarks	(39)	(45)
Net cash used for investing activities	(184)	(45)
Financing Activities:		
Proceeds from borrowings	3,995	158
Repayment of borrowings	(2,581)	(308)
Repayment of other liabilities	(33)	(33)
Proceeds from restricted cash		754
Net cash provided by financing activities	1,381	571
Effect of foreign exchange translation	(158)	184
Net (decrease) in cash and cash equivalents	(129)	(401)
Cash and cash equivalents at beginning of period	1,392	742
Cash and cash equivalents at end of period	1,263	341
Supplemental cash flow information		
Interest paid	\$ 293	\$ 88

Taxes paid	\$	\$
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The accompanying notes are an integral part of the condensed consolidated financial statements.

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During the three months ended March 31, 2006, the \$59 of the Company's 6% senior convertible notes due July 2007 was converted into 59,000 shares of the Company's common stock at a conversion price of \$1.00 per share.

During the three months ended March 31, 2006, the Company fulfilled its settlement payable to Innometal (formerly known as Growell Metal) of \$3,450, net of foreign exchange translation loss, through stock issuance of 1,700,000 shares of the Company's common stock at a conversion price of \$1.00 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

For the Three Months Ended March 31, 2006 and 2005

(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. In addition, certain reclassifications have been made for consistent presentation. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for any future periods or the year ending December 31, 2006. 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, 2006, as amended by Form 10-K/A filed on April 25, 2006.

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. 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, and the manufacture and sale of die casting equipment (see Note 10). In addition, such alloys are used to generate research and development services revenue for developing uses related primarily to defense and medical applications as well as potential license fees, royalties, and other compensation from strategic partnering transactions.

Stock-based compensation

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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 \$224 of non-cash charges for stock compensation related to amortization of the fair value of restricted stock and unvested stock options representing a \$224 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 following

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table illustrates the pro forma effect on net income for periods prior to the adoption of SFAS 123R as if we had applied the fair value recognition provisions of SFAS 123 during such periods:

		For the Three Months Ended March 31, 2005
Net loss as reported	\$	(4,097)
<i>Add:</i> stock-based employee compensation expense included in reported net loss, net of related tax effects		
<i>Deduct:</i> total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects		(783)
Proforma net loss:	\$	(4,880)
Basic and diluted loss per share:		
As reported	\$	(0.10)
Proforma	\$	(0.12)

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants for the three months ended March 31, 2006 and 2005, respectively: expected volatility of approximately 100% for all periods; dividend yield of 0.0% for all periods; expected option life of approximately 5 years; and a risk-free interest rate ranging from 3.6% to 4.3%.

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 year-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).

Reclassifications

Certain amounts from the prior year have been reclassified to conform to current year's presentation.

Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, (SFAS No. 155), Accounting for Certain Hybrid Instruments, which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company does not expect the adoption of this new standard to have a material impact on its financial position, results of operations or cash flows.

3. Liquidity

The Company has experienced losses from continuing operations during the last three fiscal years and has an accumulated deficit of \$141,622 as of March 31, 2006. Cash used for operations for the three months ended March 31, 2006 was \$1,168 and cash flow from operations will likely be negative throughout fiscal year 2006. As of March 31, 2006, the Company's principal source of liquidity is \$1,263 of cash and \$3,506 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 and to 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, continues to reduce its operating costs, generate higher revenue, and achieve positive cash flow from continuing operations and profitability and continued sources of debt and equity financing. The consolidated financial statements do not include any adjustments that might result from the outcome of the uncertainty.

The Company completed a \$1,000 10% subordinated promissory note on March 17, 2006 for \$1,000 aggregate cash received. Further, the Company borrowed \$2,995, offset by repayments of \$2,259, under a factoring, loan, and security agreement executed on April 21, 2005 during the three months ended March 31, 2006 to fund our working capital requirements. (See Note 8)

Capital requirements during the next 12 months will depend on numerous factors, including the success of existing products, the development of new applications for Liquidmetal alloys, the resources devoted to develop and support Liquidmetal alloy products. Specifically, we anticipate that we could need \$1,000 to \$5,000 over the next twelve months to pursue our current operating plan, although this amount may be lower depending on the orders we receive for our products. The amount of funding that we plan to 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, particularly components for cellular phones and flash memory drive casings, and our ability to continue to improve our manufacturing processes. We evaluate our working capital needs and operating plan assumptions on a monthly basis to determine whether any adjustment to our cash and liquidity outlook is warranted, and we also review potential sources of financing on an ongoing basis. However, adequate funds may not be available when needed, and if we raise additional funds by issuing equity securities, existing stockholders may be diluted. If we don't receive sufficient funding to operate under our current plan, we intend to reduce operations and expenses and shift our focus to the pursuit of licensing transactions and other strategic transactions that are less capital intensive.

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:

	March 31, 2006	December 31, 2005
Raw materials	\$ 659	\$ 565
Work in process	587	763
Finished goods	518	420
Total inventories	\$ 1,764	\$ 1,748

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 \$199 and \$193 as of March 31, 2006 and December 31, 2005, respectively.

6. Settlement Payable

The settlement payable balance consists of payables to Growell Metal Co., Ltd. (Growell), a South Korean metals processing company, as a result of a settlement agreement executed in January 2004. Under terms of the January 2004 settlement of the dispute over certain sales transactions from 2003 and 2002 between Liquidmetal Korea and Growell, Liquidmetal Korea agreed to pay Growell \$4,895 to purchase Growell's investment in alloy inventories, proprietary alloying equipment purchased from Liquidmetal Korea, and supporting equipment purchased from other suppliers. Also as part of the settlement, Growell satisfied in full a balance of \$2,058 owed to Liquidmetal Korea for the die casting machines Growell purchased from Liquidmetal Korea in the first quarter of 2003 as part of a license agreement to manufacture Liquidmetal alloy parts for the South Korean automotive industry. **The remaining settlement payable of \$2,837 was to be paid to Growell (in cash or stock at the Company's discretion) by December 31, 2004. As of December 31, 2005, the settlement payable was not paid to Growell due to Growell's breach of warranty on equipment repurchased by Liquidmetal Korea. The outstanding balance of payables to Growell from the settlement was \$3,331 as of December 31, 2005, net of foreign exchange translation loss.**

Under the settlement agreement between the parties, the Company and Growell granted to the other party (and the other party's affiliates) a release of all known and unknown claims of any nature arising between the parties through the date of settlement, as well as a release against future claims under agreements between the parties that were terminated as a part of the settlement. The settlement agreement provided that all agreements of any nature between the parties and their respective affiliates were terminated as of the date of settlement, with the exception of certain confidentiality agreements, a Liquidmetal coatings distribution agreement, and future rights under the die casting agreement pursuant to which Growell purchased the die casting machines and obtained a license to make auto parts from Liquidmetal alloys. The settlement agreement also includes, as an accommodation to Growell, if the Company becomes aware of any prospective customer that desires to purchase a proprietary Company casting machine at a time when Growell desires to sell any of its Liquidmetal die casting machines, then the Company will not sell such die casting machine to the prospective customer unless the Company first directs the prospective customer to Growell and encourages the prospective customer to purchase the machine from Growell.

In January 2005, Growell was acquired by a third party, Innometal Co., Ltd., and on March 21, 2006, the Company entered into an Amendment to Settlement Agreement (the Settlement Amendment) with Innometal Co., Ltd. (Innometal). Under the Settlement Amendment, Innometal and the Company have agreed that the Company's obligation of \$3,331 under the Settlement Agreement will be fully satisfied through the issuance to Innometal of 1,700,000 shares of our common stock. The Company issued 1,700,000 shares to Innometal on March 22, 2006. The shares were issued to Innometal in a private placement exempt from registration under the Securities Act of 1933, as amended (the Securities Act). Specifically, the shares were issued by virtue of Section 4(2) of the Securities Act in that the issuance did not involve a public offering, Innometal has adequate access to information about the company, and appropriate restrictive legends were affixed to all certificates representing the shares issued to Innometal. The shares received by Innometal under the Settlement Amendment are restricted securities within the meaning of Rule 144 under the Securities Act, and Innometal has not been granted any registration rights by the company with respect to such shares.

As an inducement for Innometal to enter into the Settlement Amendment, James Kang, a director and founder of the Company, has entered into a buy-sell agreement with Innometal whereby Mr. Kang has agreed to personally purchase from Innometal, and Innometal has agreed to sell to Mr. Kang, the 1,700,000 shares issued to Innometal under the Settlement Amendment, with such purchase and sale to take place on October 31,

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2006. The aggregate purchase price for the shares payable by Mr. Kang under this buy-sell agreement will be approximately \$2,800. In order to secure his obligations under the buy-sell agreement, Mr. Kang has pledged to Innometal 500,000 shares of the company's common stock currently held by him. Mr. Kang will receive no consideration from us in connection with his entering into this buy-sell agreement, and Mr. Kang will not have any registration rights with respect to the shares purchased under the buy-sell agreement.

7. Product Warranty

Management estimates product warranties as a percentage of bulk alloy product sales earned during the period. As of March 31, 2006, the Company used 5% of bulk alloy product sales as an estimate of warranties to be claimed. The percentage is based on industry averages and historical information. During the three months ended March 31, 2006 and 2005, the Company recorded \$74 and \$42, respectively, of warranty expense. The product warranty accrual balance is included in accounts payable and accrued expenses.

8. Notes Payable

Senior Convertible Note

On March 3, 2004, the Company issued \$9,924 of 6.0% senior convertible notes due 2007 (the March Notes) to investor groups in a transaction led by Michigan Venture Capital Co., Ltd, a South Korea-based institutional investment firm, and IndiGo Ventures LLC, a New York-based investment firm (the Placement Agents) that served as a financial advisor to the Company for the transaction. The notes were collateralized by the patents held by the Company and second priority mortgage interest in plant facilities and certain equipment in South Korea. The notes were convertible at any time into common stock at a price of \$3.00 per share. Investors in the private placement and the Placement Agents received warrants to purchase an aggregate amount of up to approximately 1.2 million shares of common stock, exercisable at \$3.00 per share for varying periods but no later than 100 days following the effectiveness of a registration statement covering the resale of shares issuable upon exercise of the warrants. In addition, the investors had the right to call for repayment of the notes prior to maturity at any time after the second anniversary of the closing of the transaction.

The fair value of the 1.2 million warrants totaled \$1,883 and was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 3 years; (2) volatility of 82%, (3) risk free interest of 0.95% and dividend rate of 0%. In addition, since this debt is convertible into equity at the option of the note holder at beneficial conversion rates, an embedded beneficial conversion feature was recorded as a debt discount and will be amortized using the effective interest rate method over the life of the debt in accordance with Emerging Issues Task Force No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments. In March 2004, total cost of beneficial conversion feature of \$3,395 and the fair value of the 0.6 million warrants issued to investors of \$584 were recorded as discounts of the convertible note. In addition, \$718 relating to the fair value of the 0.6 million warrants issued to the Placement Agents and \$581 direct costs incurred relating to issuance of the convertible note were recorded as debt issuance cost as a contra liability account in warrant liability and other assets, respectively.

During 2004, the Company redeemed \$4,465 of the outstanding note balance in cash. The redemption resulted in a write down of debt issuance costs and debt discount of \$2,071 to interest expense during the year ended December 31, 2004. Further, 500,000 of warrants originally issued to a financial advisor for the transaction expired during June 2004 and 163,748 of unexercised warrants originally issued to investors were cancelled as a result of the Company's redemption of the note balances during the year ended December 31, 2004. The 663,748 total expired and canceled warrants immediately prior to the expiration and cancellation resulted in a reduction of warrant liability of \$7 and \$279 to paid in capital and change in value of warrants, respectively, during the year ended December 31, 2004.

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

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

A total of 563,151 warrants to purchase our common stock at an exercise price of \$3.00 per share all of which were previously issued in connection with the purchase of the March Notes have been amended to provide for an extended expiration date of March 1, 2006. The warrants issued to placement agents are to expire the later of March 1, 2006 or 100 days after the effectiveness of registration of shares issuable under the warrants and senior convertible debt. The warrant exercise price is subject to price adjustment for anti-dilution purposes. As of March 31, 2006, there were 149,894 warrants outstanding and the exercise price of the warrants was \$2.73 per share.

The exchange offer was treated as an extinguishment of the March Notes in accordance with Emerging Issues Task Force No. 96-19, Debtors Accounting for a Modification or Exchange of Debt Instruments. The exchange resulted in a \$1,663 loss from extinguishment of the March Notes, write down of \$352 of deferred issue costs in other assets, \$189 of contra liability deferred issuance costs, and \$1,122 of debt discount as a result of the change in carrying value of exchanged notes.

In connection with the private exchange offer, the Company issued \$250 of private placement notes to certain Placement Agents as issuance costs. Of the \$250 notes issued, \$125 was paid in the form of long-term notes which is due in 2007 with interest rate of 6% per annum (July 2007 Notes) and \$125 was paid in the form of short-term notes which is due in 2005 with interest rate of 10% per annum (July 2005 Notes). The Short-Term and July 2007 Notes are convertible into Common Stock at \$2.00 and \$1.00, respectively, and have the same terms as the Exchange Notes issued to the investors. Further, a beneficial conversion feature was recorded from the \$125 July 2007 Notes issued to Placement Agents of \$29 during August 2004.

The Company was obligated, pursuant to a Registration Rights Agreement, as amended by the Exchange Notes, between the Company, the Placement Agents and the note holders to file a registration statement with the Securities and Exchange Commission (SEC) to register the shares of Common Stock issuable upon conversion of the notes payable and the related warrants within 90 days following the effective closing date of the exchange notes (July 29, 2004), and to use best efforts to cause such registration statement to become effective within 60 days following the SEC's first written comments on the registration statement. Further, if the Company is not in compliance with the registration or listing requirements, the holders have rights to late registration payments equal to between 2% and 3% of the purchase price paid for the unconverted notes for the first 30 business days of late registration, and 1% and 3% for each 30 business days thereafter, but no more than 18% of the purchase price of the unconverted note balance. Late registration fee of \$856 has been accrued as interest expense as of March 31, 2005.

Interest payments are due quarterly, and failure to make timely interest payments will result in increase in interest rate to 10% and 14% on the 6% and 10% senior convertible notes (Default Rates). The Default Rates became effective on April 1, 2005 from non-payment of a scheduled interest payment. The Company became compliant with timely interest payments during the third quarter of fiscal year 2006, and as of March 31, 2006, the Company has complied with all scheduled interest payments.

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

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During the year end December 31, 2005, \$485 of the July 2007 Notes were converted into 485,750 of the Company's common stock at a conversion price of \$1.00 per share. Additionally, during the three months ended March 31, 2006, \$59 of the July 2007 Notes were converted into 59,000 of the Company's common stock at a conversion price of \$1.00 per share.

The Company's gross outstanding loan balance of the July 2007 Notes totaled \$2,310 and \$2,369 as of March 31, 2006 and December 31, 2005, respectively. As of March 31, 2006 and December 31, 2005, un-amortized discounts for beneficial conversion feature and warrants totaled \$272 and \$303, and other asset debt issuance costs totaled \$35 and \$43, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$39 and \$197, respectively, for the three months ended March 31, 2006 and 2005. As of March 31, 2006, the effective interest rate for the July 2007 Notes was 32%.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original relative fair values of the warrants of \$1,302 have been recorded as warrant liability as the Company has not yet filed the registration statement. 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 loss of \$3 and a gain of \$133 for the three months ended March 31, 2006 and 2005, respectively. The fair value of warrants outstanding was \$3 and \$0 as of March 31, 2006 and December 31, 2005, respectively. The fair value of warrants outstanding as of March 31, 2006 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 0.27 years; (2) volatility of 82%, (3) risk free interest of 4.63% and dividend rate of 0%.

Convertible Notes

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

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

As a part of the June 2005 Private Placement, the Company issued warrants to the purchasers of the Notes giving them the right to purchase up to an aggregate of 812,500 shares of the Company's common stock. In addition, warrants to purchase 81,250 shares of the Company's common stock were issued to the placement agent in the transaction. The warrants have an exercise price of \$2.00 per share, provided that upon the consummation of the first ensuing public or private equity or debt offering or restructuring transaction in which the Company receives gross proceeds of at least \$3,250 (including without limitation any restructuring of the Company's previously issued 10% Senior Secured Notes Due July 29, 2005), the exercise price will be automatically adjusted downward (but not upward) as of the closing date of such offering or restructuring transaction so that it is equal to the lowest effective common stock purchase price paid for any securities issued by the Company to the investors in such offering or restructuring transaction. The warrants will expire on June 13, 2010 and are subject to exercise price adjustment for anti-dilution purposes. The exercise price of the warrants remained unchanged at \$2.00 per share as of March 31, 2006.

The fair value of the 893,750 warrants totaled \$1,160 and was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 5 years; (2) volatility of 118%, (3) risk free interest of 3.87% and dividend rate of 0%. In accordance with Emerging Issues Task Force No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments the embedded beneficial conversion feature of the debt was not recorded as the debt is considered contingently convertible at the time of issuance, and as a result of the completion of the Qualified Financing the debt subsequent to the close of the second quarter, the debt was determined to be not convertible. In June 2005, the fair value of the 812,500 warrants issued to investors of \$1,055 was recorded as discounts of the convertible note. In addition \$105 relating to the fair value of the 81,250 warrants issued to the Placement Agents and \$278 direct costs incurred relating to issuance of the convertible note were recorded as debt issuance cost as a contra liability account in debt discount and other assets, respectively, and will be amortized using the

effective interest rate method over the life of the loan.

On August 9, 2005, the Notes were redeemed in cash and exchanged for 7% Convertible Secured Promissory Notes due August

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

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair values of the warrants of \$1,160 have been recorded as warrant liability as the Company has not yet filed the registration statement. 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 loss of \$302 and \$0 for the three months ended March 31, 2006 and 2005. The fair value of warrants outstanding at March 31, 2006 of \$719 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.20 years; (2) volatility of 82%, (3) risk free interest of 4.82% and dividend rate of 0%.

2005 Senior Convertible Debt

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 previously issued 10% Senior Secured Notes Due July 29, 2005 (the July 2005 Notes), the exchange of \$2,996 in principal amount of previously issued 10% Convertible Unsecured Notes Due June 2006 (the June 2006 Notes), satisfaction of accrued interest and late registration fees in the amount of \$589 on the previously issued July 2005 Notes, and satisfaction of accrued interest of \$9 previously issued June 2006 Notes. The August 2007 Notes were issued pursuant to a Securities Purchase Agreement dated effective as of August 2, 2005 among the Company, the purchasers of the August 2007 Notes, and the holders of previously issued July 2005 Notes and June 2006 Notes of the Company due June 2006.

Interest payments are due quarterly, and failure to make timely interest payments will result in increase in interest rates to 14% per annum on the August 2007 Notes (Default Rates). As of March 31, 2006, the Company has made timely interest payments.

The August 2007 Notes are convertible into shares of the Company's common stock at \$2.00 per share pursuant to an Amended and Restated Security Agreement. The convertible price of the August 2007 Notes is subject to price adjustment for anti-dilution purposes. As of March 31, 2006, the convertible price of the August 2007 Notes remained unchanged at \$2.00 per share.

Further, pursuant to Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, and EITF 05-2 The Meaning of Conventional Convertible Debt Instrument in EITF Issue No. 00-19, the original fair value of the embedded conversion feature of \$4,808 have been recorded as conversion feature liability as the debt is considered nonconventional convertible debt. The original fair value was computed using the Black-Scholes model under the following assumptions: (1) expected life of 2 years; (2) volatility of 93%; (3) risk free interest of 4.06% and dividend rate of 0%. In addition, the Company is required to report a value of the conversion liability as a fair value and record the fluctuation to the fair value of the conversion feature liability to current operations. The change in the fair value of the conversion feature liability resulted in a loss of \$981 for the three months ended March 31, 2006. The fair value of the conversion features outstanding as of March 31, 2006 of \$1,940 was computed using the Black-Scholes model under the following assumptions: (1) 1.34 years; (2) volatility of 82%, (3) risk free interest of 4.82% and dividend rate of 0%. The fair value of conversion features outstanding at December 31, 2005 of \$959 was computed using the Black-Scholes model under the following assumptions: (1) 1.59 years; (2) volatility of 88%, (3) risk free interest of 4.41% and dividend rate of 0%.

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The August 2007 Notes are secured by substantially all assets of the Company and rank senior to all other obligations of the Company, other than the Company's loan with Kookmin Bank of South Korea (or any refinancing of such loan), the July 2007 Notes, purchase money asset financing, trade creditors in the ordinary course of business, and any inventory or receivables-based credit facility that the Company may obtain in the future, provided that the amount of the credit facility

does not exceed 50% of eligible inventory and 80% of eligible receivables. The August 2007 Notes will automatically convert into common stock if the Company's common stock has an average closing price of more than \$5.00 per share during 30 consecutive trading days.

The Company also issued warrants to the purchasers of the August 2007 Notes and placement agents giving them the right to purchase up to 2,469,470 and 414,495 shares of Company common stock, respectively, with an exercise price of \$2.00 per share, which is subject to price adjustment for anti-dilution purposes. As of March 31, 2006, the convertible price of the August 2007 Notes remained unchanged at \$2.00 per share. The warrants will expire on August 2, 2010.

Pursuant to EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, the original fair values of the warrants of \$4,068 have been recorded as warrant liability as the Company has not yet filed the registration statement, which was computed using the Black-Scholes pricing model under the following assumptions: (1) expected life of 5 years; (2) volatility of 93%; (3) risk free interest of 4.17% and dividend rate of 0%. In addition, the Company is required to report a value of the warrant as a fair value and record the fluctuation to the fair value of the warrant liability to current operations. The change in the fair value of the warrants resulted in a net loss of \$985 for the three months ended March 31, 2006. The fair value of warrants outstanding was \$2,359 as of March 31, 2006, which was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.34 years; (2) volatility of 82%, (3) risk free interest of 4.82% and dividend rate of 0%. The fair value of warrants outstanding at December 31, 2005 of \$1,375 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.59 years; (2) volatility of 88%, (3) risk free interest of 4.35% and dividend rate of 0%.

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

On December 6, 2005, the Company received a letter from a representative of the holders of the August 2007 Notes demanding the payment of a late filing fee by us for the period following October 31, 2005, but under the terms of the amended and restated registration rights agreement, the Company does not believe that it is obligated to pay any late filing fees unless and until the Company fails to file the registration statement by December 13, 2005, which is the last day of the first 30-business day period following October 31, 2005. The letter also stated that the letter was serving as a notice of default under the Senior Notes as a result of our failure to file a registration statement by October 31, 2005, although under the terms of the Senior Notes, the Company has thirty days after delivery of the letter in which to cure such default. On December 9, 2005 the Company filed the registration statement, which was within the 30-day period and has cured the default notice.

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The Company has received first written comments in January 2006. However, the registration statement has not been made effective within the 60 day period called for by the registration rights agreement and the Company may be subject to default

notices by the holders of the convertible notes and warrants. As of the filing of this report, the Company's management is not aware of any outstanding default notices.

Our gross outstanding loan balance of the August 2007 Notes totaled \$9,878 as of March 31, 2006 and December 31, 2005. As of March 31, 2006 and December 31, 2005, un-amortized discounts for beneficial conversion feature and warrants totaled \$5,551 and \$6,587, and other asset debt issuance costs totaled \$316 and \$384, and contra liability debt issuance cost totaled \$391 and \$464, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$1,177 for the three months ended March 31, 2006. As of March 31, 2006, the effective interest rate for the August 2007 Notes was 54%.

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. The October 2006 Note is unsecured and subordinated to all prior indebtedness of the Company. All accrued interest and unpaid principal under the note will be due October 16, 2006. The proceeds from the October 2006 Note is to be used solely for working capital purposes. In connection with the October 2006 Note, the Company issued warrants to purchase an aggregate amount of up to 125,000 shares of common stock, exercisable at \$2.00 per share. The warrants will expire on March 17, 2009, and include price adjustment provisions for anti-dilution purposes. As of March 31, 2006, the exercise price of the warrants remained unchanged at \$2.00 per share. There are no registration rights of the shares issuable from the exercise of the warrants. Further, cashless exercise of the warrants is permitted.

Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, the original fair value of the warrants of \$84 have been recorded as warrant liability as the warrant holders can elect to settle the warrants in cash, which was computed using Black-Scholes pricing model under the following assumptions: (1) expected life of 2.96 years; (2) volatility of 84%; (3) risk free interest of 4.64% and dividend rate of 0%. In addition, the Company is required to report a value of the 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 net gain of \$1 which is recorded as change in value of warrants for the three months ended March 31, 2006. The fair value of warrants outstanding at March 31, 2006 of \$83 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 2.96 years; (2) volatility of 82%, (3) risk free interest of 4.83% and dividend rate of 0%.

Our gross outstanding loan balance of the October 2006 Note totaled \$1,000 as of March 31, 2006. As of March 31, 2006, un-amortized discounts for warrants totaled \$71. Interest expense for the amortization of discount on the note was \$13 for the three months ended March 31, 2006. As of March 31, 2006, the effective interest rate for the October 2006 Note was 22%.

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. On January 27, 2006, the terms of the agreement were amended whereas advances are made on 85% of Approved receivables assigned and 50% of Non-Approved receivables assigned. 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

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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 140 Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities. As of March 31, 2006, the Company has borrowed \$2,995 and repaid \$2,259 during the three months ended March 31, 2006. The total outstanding advance made under the agreement is \$1,286 and \$550 as of March 31, 2006 and December 31, 2005, which is presented as short-term debt. The weighted average rate of interest for borrowings made under the Agreement was 9% for the three months ended March 31, 2006. The Company has \$214 available for future borrowings under the Agreement as of March 31, 2006, 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 March 31, 2006, 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 of the loan over a 36-month period. Principal payments made to Kookmin Bank totaled \$221 for the three months ended March 31, 2006, which includes \$100 of foreign exchange translation loss. The outstanding loan balance totaled \$2,568 and \$2,790, of which \$1,391 and \$1,343 is included in current portion of long-term debt, as of March 31, 2006 and December 31, 2005, respectively.

9. Stock Compensation Plan

During the three months ended March 31, 2006, 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 60,000 common shares of the Company 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 March 2006, one of the former non-employee directors of our company were given the opportunity to receive shares of stock under the plan in lieu of past-due director and committee fees that were due to him for periods through December 31, 2005. Such shares were issuable to him at an average price of \$1.50 per share. As of March 31, 2006, a total of 10,000 shares were issued to non-employee directors in lieu of these past-due fees.

The Company canceled 423,032 options during the three months ended March 31, 2006, for terminated employees and directors.

10. 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

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described in Note 3 to the consolidated financial statements included in the Company's Form 10-K filed with the Securities and Exchange Commission on March 16, 2006, as amended by Form 10-K/A filed on April 25, 2006.

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

	Coatings		Bulk Alloy		Segment Totals
Three months ended March 31, 2006					
Revenue to external customers	\$	2,384	\$	4,171	\$ 6,555
Gross profit		990		241	1,231
Total segment income		805		(385)	419
Total identifiable assets at end of period		878		17,488	18,366
Three months ended March 31, 2005					
Revenue to external customers	\$	1,049	\$	1,794	\$ 2,843
Gross profit (loss)		568		(560)	8
Income (loss) before interest expense and discontinued operations		327		(1,149)	(822)
Total identifiable assets at end of period		701		22,054	22,755

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

	For the Three Months Ended March 31,	
	2006	2005
Total segment income (loss) before minority interest, interest expense	\$ 419	\$ (822)
General and administrative expenses, excluded	(1,616)	(2,157)
Consolidated loss before interest, other income, income taxes, minority interest	(1,197)	(2,979)
Change in value of warrants, net	(1,289)	133
Change in value of conversion feature	(981)	
Interest expense	(1,598)	(1,257)
Interest income	2	6
Consolidated net loss	\$ (5,063)	\$ (4,097)

Included in bulk alloy segment net income for the three months ended March 31, 2006 is \$480 of other income recognized from termination of a distribution agreement in March 2006 (see Note 12).

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 \$2,266 and \$1,401 during the three months ended March 31, 2006 and 2005, respectively. The revenue related to the United States of America was earned under defense-related research and development contracts and sales of coatings products.

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As of December 31, 2005, one customer represented 12%, or \$288, of the total outstanding trade accounts receivable. There are no customers with greater than 10% of accounts receivable as of March 31, 2006. One customer represented 13%, or \$845 of total sales for the three months ended March 31, 2006. Three customers represented 80%, or \$2,266, of total sales for the three months ended of March 31, 2005.

During the three months ended March 31, 2006, the Company had revenues from companies outside of the United States of \$4,289 of which \$3,087 represented sales to companies located in South Korea. During the three months ended March 31,

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2005, the Company had revenue from sales to companies outside of the United States of \$1,442 of which \$934 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 \$1,604 and \$2,107 located in the United States at March 31, 2006 and December 31, 2005, respectively. The Company had long-lived assets of \$12,678 and \$12,846 located in South Korea at March 31, 2006 and December 31, 2005, respectively.

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

	March 31, 2006
Total segment assets	\$ 18,366
Cash and cash equivalents	1,263
Prepaid expenses and other current assets	561
Other property, plant and equipment	403
Intangibles, net	1,196
Other assets	547
Total Consolidated Assets	\$ 22,336

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.

11. 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 7,630,723 shares of common stock at prices ranging from \$0.77 to \$15.00 per share were outstanding at March 31, 2006, but were not included in the computation of diluted EPS for the same period because the inclusion would have been antidilutive. Warrants to purchase 3,777,715 shares of common stock at \$2.00 per share outstanding at March 31, 2006 were not included in the computation of diluted EPS for the same period because the inclusion would have been antidilutive. 7,248,685 of convertible shares from the senior convertible debt were not included in the computation of diluted EPS for the same period because the inclusion would have been antidilutive.

12. 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

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Company's financial position, results of operations, and cash flows.

The Company and certain of the present and former officers and directors were named as defendants in nine purported class action complaints filed in the United States District Court for the Middle District of Florida, Tampa Division, and the Central District of California, Southern Division, alleging violations of Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. In August 2004, four complaints were consolidated in the Middle District of Florida under the caption *Primavera Investors v. Liquidmetal Technologies, Inc., et al.*, Case No. 8:04-CV-919-T-23EAJ. John Lee, Chris Cowley, Dwight Mamanteo, Scott Purcell and Mark Rabold were appointed co-lead plaintiffs (the Lead Plaintiffs), but Mr. Mamanteo later withdrew. In September 2004, the five complaints filed in the Central District of California were transferred to the Middle District of Florida for

consolidation with the *Primavera Investors* action. The Lead Plaintiffs served their Consolidated Amended Class Action Complaint on January 12, 2005. The Amended Complaint alleges 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. The Lead Plaintiffs further generally allege that during the proposed Class Period of May 21, 2002, through May 13, 2004, the defendants 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. The Amended Complaint seeks unspecified compensatory damages and other relief. The Company, along with other defendants, filed a Motion to Dismiss Plaintiffs' Consolidated Amended Class Action Complaint in March 2005. The Motion to Dismiss was denied in December 2005, and the defendants served their Answer and Affirmative Defenses to the Consolidated Amended Class Action Complaint on December 16, 2005. The Lead Plaintiffs Motion for Class Certification was presently due in April 2006.

In addition to the above, certain of present and former officers and directors, as well as the Company as a nominal defendant, have been named in three shareholder derivative actions. Two shareholder derivative complaints were filed in California state court styled *Brian Clair, Derivatively on Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al.*, Case No. 04CC00551, and *Joseph Durgin, Derivatively on Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al.*, Case No. 04CC00553, both commenced in the Superior Court of Orange County, California. A third shareholder derivative complaint was filed in the United States District Court for the Middle District of Florida, Tampa Division, styled *Robert Story v. John Kang, et al.*, Case No. 8:04-CV-1587-T-23TBM. These shareholder derivative lawsuits allege that the defendants breached various fiduciary duties and otherwise violated state law based primarily upon the same underlying facts and circumstances as alleged in the federal shareholder class action. The plaintiffs seek unspecified compensatory damages, restitution and disgorgement of profits, equitable and/or injunctive relief as permitted by law and other relief.

The two shareholder derivative complaints in California state court have been consolidated. The Company, along with other defendants, have thrice succeeded in having the Plaintiffs' complaints dismissed for their failure to adequately plead demand futility. Most recently, on September 15, 2005, we, along with other defendants, filed a demurrer to the Plaintiffs' Consolidated Second Amended Shareholder Derivative Complaint dated August 16, 2005. In hearings on October 19, 2005, and January 20, 2006, the presiding judge sustained the demurrer, dismissing the second amended complaint but giving the plaintiffs until February 3, 2006, within which to serve a third amended complaint. The plaintiffs filed their Consolidated Third Amended Shareholder Derivative Complaint on February 3, 2006. The Company anticipates filing a demurer, seeking dismissal of the third amended complaint.

In the Florida derivative action, the Plaintiff filed a First Amended Shareholder Derivative Complaint on November 22, 2004. The Company, along with other defendants, filed a Motion to Dismiss in December 2004, to which the Plaintiff responded in opposition in February 2005. On January 20, 2006, the presiding judge granted our Motion to Dismiss, dismissing the complaint based upon the plaintiff's failure to adequately plead futility. On February 17, 2006, the plaintiff filed its Notice of Appeal of the Court's Order granting the Motion to Dismiss. The plaintiff's initial brief is presently due on April 4, 2006.

In April 2006, the Company reached agreements in principal to settle the Company's consolidated securities class action and shareholder derivative actions (see Note 14).

In March 1996, the Company entered into a distribution agreement whereby it granted to a third party exclusive rights to market and sell golf products incorporating Liquidmetal Technology to certain Japanese sporting equipment companies. The third party paid the Company a \$1,000 distribution fee as part of this agreement, of which a portion was refundable according to a formula based on the gross profit earned by the third party. The remaining unearned distribution fee of \$830 has not been refunded. On March 28, 2003, the distribution agreement was terminated and the Company entered into a new agreement to pay to the same third party a commission on the net sales price of all Liquidmetal golf equipment that is shipped by the Company or its affiliates to Japanese golf companies for sale into the Japanese end-market. This commission was to be applied to golf equipment shipped by the Company or its affiliates during the period beginning on March 28, 2003 and ending on

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March 28, 2006. If, by March 28, 2006, the Company has not paid \$350 in commission payments, the balance between commission paid and \$350 will be paid by April 30, 2006, thereby guaranteeing the third party a \$350 minimum payment during the term of the agreement. As of December 31, 2005, the unearned distribution fee remained unchanged at \$830. As

of March 31, 2006, the Company has not paid the minimum commission and accrued \$350 from the unearned distribution fee for minimum payments due in accounts payable and accrued liabilities. Further, the Company recognized net balance of the unearned distribution fee of \$480 as other income during the three months ended March 31, 2006. The Company is currently in the process of renegotiating the distribution agreement with the same third party to settle the balance.

13. Related Party Transactions

In June 2003, the Company entered into an exclusive, ten-year license agreement with LLPG, Inc. (LLPG), a corporation headed 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.

We are a party to a consulting agreement with Chitnis Consulting, Inc., which is owned 100% by Shekhar Chitnis, a former director and executive officer of our company. Under this agreement, we have engaged Chitnis Consulting to provide consulting services on an as-needed basis through December 31, 2005. On January 1, 2006, the term of the agreement was extended to December 31, 2006. During the three months ended March 31, 2006 and 2005, we incurred \$0 and \$13 in consulting fees from Chitnis Consulting.

We are a party to a consulting agreement with William Johnson, a board member. Under this agreement, Mr. Johnson provides consulting services on an as-needed basis through 2004 as it relates to marketing and development Liquidmetal alloy. In April 2006, the Company entered into an agreement with Mr. Johnson effective from January 1, 2006 through December 31, 2006. During the three months ended March 31, 2006 and 2005, we incurred \$15 and \$15 in consulting fees from Mr. Johnson, respectively.

In November 2004, we 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 our Board of Directors conducted an independent inquiry into the above-described 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 2006. 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 was 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 December 31, 2005, the outstanding amount of the receivable was \$235, which is included in other assets, and has remained unchanged as of March 31, 2006.

14. Subsequent Events

In April 2006, the Company has reached agreements in principle to settle the Company's previously-disclosed consolidated securities class action and shareholder derivative actions (see Note 12).

If approved by the courts, the agreements would settle the consolidated class action litigation entitled *Primavera Investors v. Liquidmetal Technologies, Inc., et al.*, the consolidated shareholder derivative actions entitled *Brian Clair, Derivatively on*

Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al. and Joseph Durgin, Derivatively on Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al., and the shareholder derivative action entitled *Robert Story v. John Kang, et al.*, pending in the United States District Court for the Middle District of Florida, Tampa Division, the Superior Court of Orange County, California, and the United States District Court for the Middle District of Florida, Tampa Division, respectively. The consolidated class action arose from a number of lawsuits filed in 2004 under the federal securities laws against Liquidmetal and certain of its former and current directors and officers. The derivative actions also arose from lawsuits originally filed in 2004 and was based upon the same facts and circumstances underlying the class action.

As part of the agreements, Liquidmetal's directors and officers' liability insurance carriers will contribute a total of \$7,500 to settle all of the actions: \$7,025 for the consolidated class action and \$475 for the two derivative actions. The funds paid to settle the consolidated class action will be principally paid into an escrow account within a specified period of time after the federal court grants preliminary approval of the settlement. The funds will be disbursed to certain purchasers of Liquidmetal securities according to a distribution plan to be devised and approved by the federal court. In addition, Liquidmetal will commit to maintaining or implementing various corporate governance measures in connection with the settlement of the derivative actions.

Taking into account the insurance contribution, the net cost of the settlement to the company should be approximately \$500, which is the insurance deductible the company paid over several quarters ending in the third quarter of 2005, and which the Company previously recorded as a charge.

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, 2005 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 two principal operating segments: Liquidmetal alloy industrial coatings 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. 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, 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, stock-based compensation, 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.

On August 4, 2004, the Company established a plant in the city of Weihai in Shandong province of China under Weihai Liquidmetal Company Limited, which is 100% owned by Liquidmetal Korea, to facilitate our bulk alloy manufacturing business. Weihai Liquidmetal is consolidated into Liquidmetal Technologies with all intercompany transactions eliminated.

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

Our Annual Report on Form 10-K for the year ended December 31, 2005, 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 in the first quarter of 2006 of \$0.2 million. See Note 1 for further information.

Results of Operations

Comparison of the three months ended March 31, 2006 and 2005

Revenue. Revenue increased \$3.8 million to \$6.6 million for the three months ended March 31, 2006 from \$2.8 million for the three months ended March 31, 2005. The increase consisted of an increase of \$2.1 million from the sales and prototyping of parts manufactured from bulk Liquidmetal alloys to consumer electronics customers as a result of increased demand from electronic casings applications, an increase of \$0.3 million from our research and development contracts, and an increase of

\$1.3 million from sales of our coatings products as a result of increase in demand from oil drilling applications.

Cost of Sales. Cost of sales increased to \$5.3 million, or 81% of revenue, for the three months ended March 31, 2006 from \$2.8 million, or 100% of revenue, for the three months ended March 31, 2005. The decrease in cost of sales as a percentage of revenue was a result of continued maturing of our manufacturing process, which represents the Company's efforts to manage costs and focus on our core business, and an increase in revenues generated from our higher margin coatings products. Significant portions of our manufacturing costs continue to remain fixed. 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 \$2.7 million, or 41% of revenue, for the three months ended March 31, 2006 from \$2.6 million, or 91% of revenue, for the three months ended March 31, 2005. This increase was primarily a result of increase wages and compensation of \$0.7 million primarily from recognition of stock based compensation expense during the quarter and increases in employees, advertising and promotions costs of \$0.1 million primarily from higher commissions costs, travel expenses of \$0.1 million, offset by decreases in professional services by \$0.2 million, decrease in insurance costs of \$0.4 million, and decrease in depreciation expenses of \$0.1 million.

Research and Development Expenses. Research and development expenses decreased to \$0.2 million, or 3% of revenue, for the three months ended March 31, 2006 from \$0.4 million, or 14% of revenue, for the three months ended March 31, 2005. 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. The decrease was primarily due to decreases in salaries, wages and related costs of \$0.2 million

Change in Value of Warrants. Change in value of warrants decreased to a net loss of \$1.3 million, or 20% of revenue, for the three months ended March 31, 2006 from a net gain of \$0.1 million, or 5% of revenue, for the three months ended March 31, 2005. The change in value of warrant consisted of warrants issued from the senior convertible debt funded in March 2004 and exchanged in August 2004, convertible debt funded in June 2005, senior convertible debt funded in August 2005, and subordinated promissory note funded in March 2006 primarily as a result of fluctuations in our stock price.

Change in Value of Conversion Feature. Change in value of conversion feature was a net loss of \$1.0 million, or 15% of revenue, during the three months ended March 31, 2006 from the change in value of conversion feature liability from the senior convertible debt funded in August 2005 primarily as a result of fluctuations in our stock price. There were no amounts recorded as change in value of conversion feature for the three months ended March 31, 2005.

Other Income. Other income was \$480, or 7% of revenue, for the three months ended March 31, 2006 from net gain recognized from termination of a distribution agreement with a Japanese sporting goods distributor originally entered into in March 1996. There were no amounts recognized as other income during the three months ended March 31, 2005.

Interest Expense. Interest expense was \$1.6 million, or 24% of revenue, for the three months ended March 31, 2006 and was \$1.3 million, or 44% of revenue, for the three months ended March 31, 2005. Interest expense consists primarily of interest accrued on the Kookmin Bank loan funded in February 2003, senior convertible debt funded in March 2004 and exchanged in August 2004, senior convertible debt funded in August 2005, subordinated promissory note funded in March 2006, fees charged from short-term borrowings under the April 2005 factoring, loan, and security agreement, as well as amortization of debt issuance costs and discount on the convertible debt. The increase was primarily due to additional amortization of debt issuance costs and discount on debt funded in June 2005 and August 2005 as well as fees from borrowings made under the April 2005 factoring, loan, and security agreement.

Interest Income. Interest income was \$2 thousand for the three months ended March 31, 2006 and was \$6 thousand for the three months ended March 31, 2005 from interest earned on cash deposits.

Liquidity and Capital Resources

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Our cash used for operating activities was \$1.2 million for the three months ended March 31, 2006 and \$1.1 million for the three months ended March 31, 2005. Our working deficit increased from \$10.2 million at December 31, 2005 to \$10.4 million at March 31, 2006. The Company's working deficit increase of \$0.2 million was primarily attributable to increase in accounts payable and accrued liability of \$1.4 million, increase in short term debt of \$1.7 million, increase in warrant liabilities of \$1.4 million, increase in conversion feature liability of \$1.0 million, offset by increase in trade accounts receivable of \$1.1 million, decrease in settlement payable of \$3.3 million, and decrease in deferred revenue of \$0.9 million.

Our cash used in investing activities was \$0.2 million for the three months ended March 31, 2006 for the acquisition of property and equipment and investments in patents and trademarks.

Our cash provided by financing activities was \$1.4 million for the three months ended March 31, 2006, which consists of \$1.0 million in proceeds from borrowings from our subordinated promissory note executed in March 2006 and \$3.0 million in proceeds from factoring agreement executed in April 2005, offset by \$2.6 million on repayment of borrowings. The proceeds from borrowings have been used to meet working capital requirements.

Our capital requirements during the next twelve months will depend on numerous factors, including the success of existing products either in manufacturing or development, the development of new applications for Liquidmetal alloys, the resources we devote to develop and support our Liquidmetal alloy products, the success of pursuing strategic licensing and funded product development relationships with external partners.

We have experienced significant operating losses since our inception. Our net loss for the three months ended March 31, 2006 and 2005 was \$5.1 million and \$4.1 million, respectively. In the audit report on our financial statements for our fiscal years ended December 31, 2005 and 2004, our auditors included a going-concern qualification indicating that our significant operating losses and working capital deficit cause substantial doubt about our ability to continue as a going concern. By issuing an opinion stating that there is substantial doubt about our ability to continue as a going concern, our auditors have indicated that they are uncertain as to whether we have the capability to continue our operations without additional funding. Accordingly, we anticipate that we will need additional funding during the next 12 months, and we plan to seek to raise such funds through public or private equity financing, bank debt financing, or from other sources. Specifically, we anticipate that we could need \$1 to \$5 million over the next twelve months to pursue our current operating plan, although this amount may be lower depending on the orders we receive for our products. The amount of funding that we plan to 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, particularly components for cellular phones and flash memory drive casings, and our ability to continue to improve our manufacturing processes. We evaluate our working capital needs and operating plan assumptions on a monthly basis to determine whether any adjustment to our cash and liquidity outlook is warranted, and we also review potential sources of financing on an ongoing basis. However, adequate funds may not be available when needed, and if we raise additional funds by issuing equity securities, existing stockholders may be diluted. If we don't receive sufficient funding to operate under our current plan, we intend to reduce operations and expenses and shift our focus to the pursuit of licensing transactions and other strategic transactions that are less capital intensive.

Contractual Obligations

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The following table summarizes the Company's obligations and commitments as of March 31, 2006:

Contractual Cash Obligations (1)	Total	Less Than 1 Year	Payments Due by Period (in thousands)		
			1-3 Years	3-5 Years	After 5 Years
Long-term debt (2)	14,756	1,391	13,365		
Short-term debt (3)	2,286	2,286			
Capital lease obligation (4)	42	42			
Operating leases and rents	1,009	492	516	1	
Consulting services payable	86	86			
Dongyang	11	11			
Nichimen	350	350			
	18,540	4,658	13,881	1	

(1) Contractual cash obligations include Long-Term Debt comprised of \$2,310 of Senior Convertible Notes issued in 2004 and \$9,878 of Convertible Notes issued in 2005, Short-Term Debt comprised of \$1,286 advances received under factoring, loan, and security agreement, \$1,000 of unsecured subordinated promissory note issued in 2006, future minimum lease payments under capital and operating leases, and purchase commitments from consultants, 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 \$1,342; and un-amortized discounts for beneficial conversion feature and warrants of \$6,285 of our convertible notes.

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

(4) Includes imputed interest of \$1.

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.

We have made no arrangements of the types described in any of the categories that may have a material current or future effect on our financial condition, liquidity or results of operations.

Item 3 Quantitative and Qualitative Disclosures about Market Risk

We are exposed to various markets 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. Some of the proceeds of our initial public offering are invested in short-term, interest-bearing, investment grade securities. The value of these securities will be subject to interest rate risk and could fall in value if interest rates rise.

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 contacts 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

Evaluation of disclosure controls and procedures. As directed by Section 404 of the Sarbanes-Oxley Act of 2002, or SOX, the SEC has adopted rules requiring public companies to include a report of management on the company's internal controls over financial reporting in their annual reports on Form 10-K. In addition, the public accounting firm auditing a public company's financial statements must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. Although these requirements were first applicable to our annual report on Form 10-K for our fiscal year ending December 31, 2004, we were unable to comply with these requirements for such fiscal year. As disclosed in our amended Form 10-K filed with the SEC on May 10, 2005, the time and resources necessary to complete the restatement of prior periods' financial statements delayed our ability to complete the internal documentation, assessment and evaluation of internal control over financial reporting, all of which are required to be undertaken to comply with Section 404 of SOX. This delay prevented our independent auditor from being able to satisfactorily complete a timely audit of our internal control over financial reporting as of December 31, 2004.

Due to these delays, we and our independent auditor determined that it would not be possible to complete the management's assessment and auditor's audit of our internal controls over financial reporting as of December 31, 2004, and accordingly our independent auditor has issued a disclaimer of opinion with respect to our internal control over financial reporting as of December 31, 2004, and such disclaimer was filed with our amended Form 10-K filed on May 10, 2005. The filing of this disclaimer does not comply with the SEC's rules and regulations under Section 404, and this noncompliance has resulted in us being in violation of Section 13(a) under the Securities Exchange Act of 1934. Section 13(a) establishes the general requirement that public companies must file with the SEC, in accordance with such rules and regulations as the SEC may prescribe, such information,

documents, and reports as the SEC may from time to time require for the protection of investors, including Form 10-Ks and 10-Qs.

In general, the SEC has broad authority under the Securities Exchange Act of 1934 to institute investigations, to seek injunctions, to seek monetary penalties, and to otherwise pursue enforcement actions for violations of Section 13(a), including a failure to file a Form 10-K or for the omission of necessary statements in a Form 10-K. Therefore, a violation under Section 404 of SOX or Section 13(a) of the Securities Exchange Act of 1934 could potentially subject an issuer to these same investigations and penalties. Section 404 of SOX is a relatively new legal requirement, and there is very little precedent establishing the consequences or appropriate response to a public company's failure to comply with Section 404. Accordingly, although we have discussed our Section 404 noncompliance with the SEC, we cannot predict what action, if any, the SEC may take against our company as a result of a failure to be compliant with our obligations under Section 404 of SOX or Section 13(a) of the Securities Exchange Act of 1934.

Effective December 27, 2005, the SEC announced final rulings on revisions to accelerated filer definition and deadlines for periodic reports. The ruling revised the definition of the term "accelerated filer" to permit an accelerated filer that has voting and non-voting common equity held by non-affiliates of less than \$50 million to exit accelerated filer status at the end of the fiscal year in which its equity falls below \$50 million and to file its annual report for that year and subsequent periodic reports on a non-accelerated basis. As of the fiscal year ended December 31, 2005, we are considered an accelerated filer and are required to comply with SOX 404 requirements for the 2005 fiscal year.

In addition to the foregoing, although our common stock was admitted to the OTC Bulletin Board for quotation on June 15, 2005, as a result of our noncompliance with Section 404 for our 2005 fiscal year, it may not have been appropriate for the OTC Bulletin Board to admit our common stock for quotation on June 15, 2005. Consequently, there is no assurance that our common stock will remain eligible for quotation on the OTC Bulletin Board.

On January 16, 2006, our management completed and concluded its documentation, assessment and evaluation of its internal controls over financial reporting as of December 31, 2005. During the course of its assessment, management identified the control deficiencies described in Item 9A of our Form 10-K for the 2005 fiscal year. However, our independent auditors, Stonefield Josephson Inc., resigned on December 1, 2005, and on January 20, 2006, we engaged Choi, Kim & Park LLP (CKP) as our new independent registered public accounting firm. While we have advised CKP of the foregoing weaknesses in internal controls, due to the untimeliness of the foregoing events, CKP was unable to conduct an audit of our internal control over financial reporting pursuant to Section 404 of SOX, and thus, have issued a disclaimer of an opinion on the company's internal control over financial reporting as of December 31, 2005.

[Update on Management's Assessment of Internal Control Over Financial Reporting.](#)

Changes in internal controls. As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of the company's management, including its Chief Executive Officer and Chief Financial Officer, of its disclosure controls and procedures (as defined by Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective. There has been no change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1 Legal Proceedings

In April 2006, the Company reached agreements in principle to settle the Company's previously-disclosed consolidated securities class action and shareholder derivative actions.

If approved by the courts, the agreements would settle the consolidated class action litigation entitled *Primavera Investors v. Liquidmetal Technologies, Inc., et al.*, the consolidated shareholder derivative actions entitled *Brian Clair, Derivatively on Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al.* and *Joseph Durgin, Derivatively on Behalf of Liquidmetal Technologies, Inc. v. John Kang, et al.*, and the shareholder derivative action entitled *Robert Story v. John Kang, et al.*, pending in the United States District Court for the Middle District of Florida, Tampa Division, the Superior Court of Orange County, California, and the United States District Court for the Middle District of Florida, Tampa Division, respectively. The consolidated class action arose from a number of lawsuits filed in 2004 under the federal securities laws against the Company and certain of its former and current directors and officers. The derivative actions also arose from lawsuits originally filed in 2004 and was based upon the same facts and circumstances underlying the class action.

As part of the agreements, the Company's directors' and officers' liability insurance carriers will contribute a total of \$7.5 million to settle all of the actions: \$7.0 million for the consolidated class action and \$0.5 million for the two derivative actions. The funds paid to settle the consolidated class action will be principally paid into an escrow account within a specified period of time after the federal court grants preliminary approval of the settlement. The funds will be disbursed to certain purchasers of the Company securities according to a distribution plan to be devised and approved by the federal court. In addition, the Company will commit to maintaining or implementing various corporate governance measures in connection with the settlement of the derivative actions.

Taking into account the insurance contribution, the net cost of the settlement to the company should be approximately \$0.5 million, which is the insurance deductible the company paid over several quarters ending in the third quarter of 2005, and which the company previously recorded as a charge.

Item 1A Risk Factors

There have been no material changes to the risk factors that are included in our Annual Report on Form 10-K for the year ended December 31, 2005 that could affect our business, results of operations or financial condition.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

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On March 17, 2006, in exchange for a \$1.0 million loan, we issued a \$1.0 million 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 our company. The October 2006 Note is unsecured and subordinated to all prior indebtedness of the company. All accrued interest and unpaid principal are due October 16, 2006. The proceeds from the October 2006 Note were used for working capital purposes. In connection with the October 2006 Note, we issued warrants to Atlantic Realty 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. There are no registration rights of the shares issuable from the exercise of the warrants. Further, cashless exercise of the warrants is permitted. We claimed exemption from registration for this transaction under the Securities Act of 1933, as amended (the Securities Act), by virtue of Section 4(2) of the Securities Act. The grant of this Note and the accompanying warrant (and the offer of the shares issuable upon exercise of the warrant) did not involve any public offering, was made without general solicitation or advertising, and Atlantic Realty is an accredited investor with access to all relevant information necessary to evaluate the investment and represented to us that the Note, warrant, and underlying shares were being acquired for investment.

Item 3 - Defaults Upon Senior Securities

None

Item 4 - Submission of Matters to a Vote of Security Holders

None

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:

Exhibit Number	Description of Document
31.1	Certification of the President and Chief Executive Officer, Ricardo A. Salas, as required by Section 302 of Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer, Young Ham, as required by Section 302 of Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer, Ricardo A. Salas, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer, Young Ham, 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
(Registrant)

Date: May 10, 2006

/s/ Ricardo A. Salas
Ricardo A. Salas
President and Chief Executive Officer
(Principal Executive Officer)

Date: May 10, 2006

/s/ Young Ham
Young Ham
Chief Financial Officer
(Principal Financial and Accounting Officer)