

LIQUIDMETAL TECHNOLOGIES INC  
Form 10-Q/A  
August 04, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q/A**

Amendment No. 3

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

For the quarterly period ended September 30, 2005



OR

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

**For the transition period from                    to**

Commission File No. **001-31332**

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## **LIQUIDMETAL TECHNOLOGIES, INC.**

(Exact name of Registrant as specified in its charter)

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

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

**25800 Commercentre Drive, Suite 100**

**Lake Forest, California 92630**

(address of principal executive office, zip code)

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

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer Rule 12b-2 of the Exchange Act.

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 October 13, 2005, there were 42,164,121 shares of the registrant's common stock, \$.001 par value, outstanding.**

As of October 13, 2005, there were 42,164,121 shares of the registrant's common stock, \$.001 par value, 5 outstanding



**LIQUIDMETAL TECHNOLOGIES, INC.  
AMENDMENT NO. 3 TO FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2005**

**EXPLANATORY NOTE**

We are filing this Amendment No. 3 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, as filed with the U.S. Securities and Exchange Commission (SEC) on December 1, 2005, and as amended on March 16, 2006 and July 20, 2006, to make certain revisions and corrections to (i) Notes 3 and 8 to our condensed consolidated financial statements included in Item 1 of Part I thereof and (ii) the disclosure in Item 4 of Part I thereof.

Other than the changes referred to above, all other information included in the above described Form 10-Q, as amended, remains unchanged. This amendment does not reflect events occurring after the filing of such Form 10-Q and does not modify or update the disclosures therein in any way other than as required to reflect the amendment as described above and set forth below.

**FORWARD-LOOKING INFORMATION**

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





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**PART I**



**FINANCIAL INFORMATION**



## Item 1 Financial Statements

## LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

|   | (unaudited)<br>September 30,<br>2005<br>(Restated) | December 31,<br>2004<br>(Restated) |
|---|--|------------------------------------|
| <b>ASSETS</b>   |  |                                    |
| Current assets:   |  |                                    |
| Cash and cash equivalents   | \$ 933   | \$ 742                             |
| Restricted cash   |  | 754                                |
| Trade accounts receivables, net of allowance for doubtful accounts of \$82 and \$108  | 2,193  | 1,668                              |
| Inventories   | 1,499  | 2,353                              |
| Prepaid expenses and other current assets   | 1,363  | 930                                |
| Total current assets  | 5,988  | 6,447                              |
| Property, plant and equipment, net  | 13,889   | 16,434                             |
| Idle equipment  | 190  | 1,906                              |
| Long-term inventory   |  | 1,810                              |
| Other intangibles, net  | 1,151  | 1,143                              |
| Other assets  | 950  | 768                                |
| Total assets  | \$ 22,168  | \$ 28,508                          |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |  |                                    |
| Current liabilities:  |  |                                    |
| Accounts payable and accrued expenses   | \$ 5,701   | \$ 4,969                           |
| Settlement payable  | 3,234  | 3,246                              |
| Deferred revenue  | 879  | 900                                |
| Short-term debt   | 237  |                                    |
| Long-term debt, current portion, net of debt discounts of \$0 and \$2,831   | 1,204  | 4,010                              |
| Warrant liabilities   | 4,633  | 550                                |
| Conversion feature liabilities  | 6,440  | 6,650                              |
| Other liabilities, current portion  | 701  | 1,032                              |
| Total current liabilities   | 23,029   | 21,357                             |
| Long-term debt, net of current portion and debt discounts of \$9,573 and \$0  | 4,403  | 2,618                              |
| Other long-term liabilities, net of current portion   | 431  | 892                                |
| Total liabilities   | 27,863   | 24,317                             |
| Shareholders' equity (deficiency):  |  |                                    |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized and none issued and outstanding at September 30, 2005 and December 31, 2004  |  |                                    |
| Common stock, \$0.001 par value; 100,000,000 shares authorized and 42,164,121 issued and outstanding at September 30, 2005 and 41,609,652 issued and outstanding at December 31, 2004 | 42   | 42                                 |
| Additional paid-in capital  | 130,849  | 129,650                            |
| Accumulated deficit   | (138,635)  | (127,472)                          |

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|   |           |           |
|---|-----------|-----------|
| Accumulated other comprehensive income                  | 2,049     | 1,971     |
| Total shareholders' equity (deficiency)                 | (5,695)   | 4,191     |
| Total liabilities and shareholders' equity (deficiency) | \$ 22,168 | \$ 28,508 |

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**

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(in thousands, except per share data)

(unaudited)

|   | For the Three<br>Months Ended September 30, |                    | For the Nine<br>Months Ended September 30, |                    |
|---|---|--------------------|--|--------------------|
|   | 2005<br>(Restated)                          | 2004<br>(Restated) | 2005<br>(Restated)                         | 2004<br>(Restated) |
| Revenue   | \$ 4,342                                    | \$ 4,615           | \$ 10,912                                  | \$ 14,958          |
| Cost of sales   | 3,756                                       | 3,241              | 10,553                                     | 9,273              |
| Gross profit  | 586   | 1,374              | 359  | 5,685              |
| Operating expenses:   |   |                    |  |                    |
| Selling, general, and administrative                                  | 2,364                                       | 3,569              | 6,521                                      | 9,178              |
| Research and development  | 196   | 374                | 806  | 1,060              |
| Impairment of long lived assets                                       | 833   |                    | 4,227                                      |                    |
| Total expenses  | 3,393                                       | 3,943              | 11,554                                     | 10,238             |
| Loss from operations  | (2,807)                                     | (2,569)            | (11,195)                                   | (4,553)            |
| Loss from extinguishments of debt                                     | (1,247)                                     | (2,941)            | (1,247)                                    | (2,941)            |
| Change in value of warrants, gain (loss)                              | 1,112                                       | (434)              | 1,145                                      | 846                |
| Change in value of conversion feature, gain (loss)                    | 2,215                                       | (2,338)            | 4,497                                      | 3,276              |
| Other income  |   | 302                |  | 302                |
| Interest expense  | (1,659)                                     | (3,283)            | (4,377)                                    | (5,934)            |
| Interest income   | 7   |                    | 14   | 34                 |
| Loss from continuing operations                                       | (2,379)                                     | (11,263)           | (11,163)                                   | (8,970)            |
| Loss from discontinued equipment manufacturing operations, net of tax |   |                    |  | (749)              |
| Net loss  | (2,379)                                     | (11,263)           | (11,163)                                   | (9,719)            |
| Other comprehensive income (loss)                                     |   |                    |  |                    |
| Foreign exchange translation gain (loss)                              | (306)                                       | 68                 | 77   | 490                |
| Comprehensive loss  | \$ (2,685)                                  | \$ (11,195)        | \$ (11,086)                                | \$ (9,229)         |
| Net loss per share basic and diluted:                                 |   |                    |  |                    |
| Loss per share continuing operations                                  | \$ (0.06)                                   | \$ (0.27)          | \$ (0.27)                                  | \$ (0.21)          |
| Loss per share discontinued operations                                | \$  | \$                 | \$   | \$ (0.02)          |
| Loss per share basic and diluted                                      | \$ (0.06)                                   | \$ (0.27)          | \$ (0.27)                                  | \$ (0.23)          |
| Number of weighted average shares basic and diluted                   | 41,933                                      | 41,610             | 41,717                                     | 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 EQUITY (DEFICIENCY)**

**For the Nine Months Ended September 30, 2005**



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(in thousands, except per share data)

|  | Common<br>Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital<br>(Restated) | Accumulated<br>Deficit<br>(Restated) | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|------------------|-----------------|--|--------------------------------------|---|------------|
| <b>Balance, December 31, 2004<br/>(As Restated)</b>              | 41,609,652       | \$ 42           | \$ 129,650                                     | \$ (127,472)                         | 1,971   | \$ 4,191   |
| Beneficial conversion feature                                    |                  |                 |  |                                      |   |            |
| Conversion of notes payable                                      | 462,250          |                 | 982  |                                      |   | 982        |
| Common stock issued as<br>directors fees                         | 92,219           |                 | 175  |                                      |   | 175        |
| Stock based compensation   |                  |                 | 41   |                                      |   | 41         |
| Redemption of convertible<br>notes payable                       |                  |                 | 1  |                                      |   | 1          |
| Foreign exchange translation<br>gain                             |                  |                 |  |                                      | 78  | 78         |
| Net loss   |                  |                 |  | (11,163)                             |   | (11,163)   |
| <b>Balance, September 30, 2005<br/>(unaudited) (As Restated)</b> | 42,164,121       | \$ 42           | \$ 132,849                                     | \$ (138,635)                         | 2,049   | \$ (5,695) |

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

**LIQUIDMETAL TECHNOLOGIES, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

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(in thousands, except per share data)

(unaudited)

|  | For the Nine Months<br>Ended September 30, |                    |
|--|--|--------------------|
|  | 2005<br>(Restated)                         | 2004<br>(Restated) |
| <b>Operating activities:</b>   |  |                    |
| Net loss   | \$ (11,163)                                | \$ (9,719)         |
| Adjustments to reconcile net loss from operations to net cash used for operating activities: |  |                    |
| Impairment of long lived assets  | 4,227                                      |                    |
| (Gain) loss on disposal of asset   | (14)                                       | 8                  |
| Depreciation and amortization  | 2,516                                      | 2,585              |
| Loss on extinguishments of debt  | 1,247                                      | 2,941              |
| Amortization of debt discount  | 2,499                                      | 5,633              |
| Gain from change in value of warrants  | (1,145)                                    | (846)              |
| Gain from change in value of conversion feature  | (4,497)                                    | (3,276)            |
| Stock-based compensation   | 41   | 276                |
| Bad debt (recovery) expense  | (21)                                       | 111                |
| Warranty expense   | 126  | 269                |
| Changes in operating assets and liabilities:   |  |                    |
| Accounts receivable  | (504)                                      | 47                 |
| Inventories  | 178  | (1,950)            |
| Prepaid expenses and other current assets  | (404)                                      | (1,111)            |
| Other assets   | (632)                                      | (1,958)            |
| Accounts payable and accrued expenses  | 752  | 2,356              |
| Deferred revenue   | (21)                                       | (597)              |
| Other liabilities  | (142)                                      | (1,231)            |
| Net cash used for continuing operations  | (6,957)                                    | (6,281)            |
| Net cash provided by discontinued operations   |  | 822                |
| Net cash used for operating activities   | (6,957)                                    | (5,459)            |
| <b>Investing Activities:</b>   |  |                    |
| Purchases of property and equipment  | (153)                                      | (73)               |
| Proceeds from sale of property and equipment   | 69   | 11                 |
| Investment in patents and trademarks   | (92)                                       | (202)              |
| Net cash used for investing activities   | (176)                                      | (264)              |
| <b>Financing Activities:</b>   |  |                    |
| Proceeds from borrowings   | 16,180                                     | 9,924              |
| Repayment of borrowings  | (9,850)                                    | (4,898)            |
| Repayment of other liabilities   | (100)                                      | (91)               |
| Proceeds from restricted cash  | 754  | (1,000)            |
| Net cash provided by financing activities  | 6,984                                      | 3,935              |
| Effect of foreign exchange translation   | 340  | 57                 |
| Net increase in cash and cash equivalents  | 191  | (1,731)            |
| Cash and cash equivalents at beginning of period   | 742  | 3,127              |
| Cash and cash equivalents at end of period   | \$ 933                                     | \$ 1,396           |
| Supplemental cash flow information:  |  |                    |
| Interest paid  | \$ 1,400                                   | \$ 463             |
| Taxes paid   | \$   | \$                 |

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

During the nine months ended September 30, 2004, the Company sold its 51% ownership interest in Dongyang to the 49% minority shareholder, which resulted in a loss of \$46 from disposal of discontinued operations as of September 30, 2004.

During the nine months ended September 30, 2005, \$462 of the Company's 6% senior convertible notes due July 2007 was converted into 462,250 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**

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For the Nine Months Ended September 30, 2005 and 2004

(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. In addition, certain reclassifications have been made for consistent presentation. Operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for any future periods or the year ending December 31, 2005. 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 30, 2005.

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 7). In addition, such alloys are used to generate research and development services revenue for developing uses related primarily to defense and medical applications as well as potential license fees, royalties, and other compensation from strategic partnering transactions.

### Stock-based compensation

The Company applies 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. The Company applies Statement of Financial Accounting Standards ( SFAS ) No. 123 for options granted to non-employees who perform services for the Company.

Had the Company determined compensation cost based on the fair value at the grant date for stock options consistent with the method of SFAS No. 123, the Company's loss from continuing operations and basic and diluted loss per share from continuing operations would have been as follows:







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|  | For the Three<br>Months Ended September 30, |                    | For the Nine<br>Months Ended September 30, |                    |
|--|---|--------------------|--|--------------------|
|  | 2005<br>(Restated)                          | 2004<br>(Restated) | 2005<br>(Restated)                         | 2004<br>(Restated) |
| Net loss from continuing operations as reported  | \$ (2,379)                                  | \$ (11,263)        | \$ (11,163)                                | \$ (8,970)         |
| <i>Add:</i> stock-based employee compensation expense included in reported net loss, net of related tax effects  | 41  |                    | 41   | 276                |
| <i>Deduct:</i> total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects | (695)                                       | (910)              | (2,237)                                    | (3,720)            |
| Proforma net loss from continuing operations:  | \$ (3,033)                                  | \$ (12,173)        | \$ (13,359)                                | \$ (12,414)        |
| Basic and diluted loss per share:  |   |                    |  |                    |
| As reported  | \$ (0.06)                                   | \$ (0.27)          | \$ (0.27)                                  | \$ (0.21)          |
| Proforma   | \$ (0.07)                                   | \$ (0.29)          | \$ (0.32)                                  | \$ (0.30)          |

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants for the nine months ended September 30, 2005 and 2004, 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 2.9% to 4.2%.

## 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.

### Restatements

*SFAS 133 Accounting for Derivative Instruments and Hedging Activities*

As a part of the accompanying consolidated financial and the notes thereto, the Company has restated certain previously issued financial statements due to an error related to the Company's accounting for embedded convertible feature of senior convertible notes issued in March 2004 in accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, (SFAS 133) (see Note 8).

Impairment of Long-term Inventory

The company wrote-down \$833 of primarily raw material inventory considered to be long term as the carrying value of the inventory held as an impairment charge. While we may use the excess raw materials beyond one year to fulfill future demand, we did not foresee use of this inventory in the foreseeable future.

Recent Accounting Pronouncements

In March 2004, the Emerging Issues Task Force ( EITF ) reached a consensus on recognition and measurement guidance previously discussed under EITF 03-01 The consensus clarifies the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, and other investments accounted for under the cost method. The recognition and measurement guidance for which the consensus was reached in March 2004 is to be applied to other-than-temporary impairment evaluations in reporting periods beginning after June 15, 2004. In September 2004, the FASB issued a final FASB Staff Position that delays the effective date for the measurement and recognition guidance for all investments within the scope of EITF Issue No. 03-01; however, the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company does not believe that the adoption of this statement will have a material effect on the Company's results of operation and financial position.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment, which replaces SFAS No. 123. SFAS No. 123R requires public companies to recognize an expense for share-based payment arrangements including stock options and employee stock purchase plans. The statement eliminates a company's ability to account for share-based compensation transactions using APB 25, and generally requires instead that such transactions be accounted for using a fair value based method. SFAS No. 123R requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the date of grant, and to recognize the cost over the period during which the employee is required to provide service in exchange for the award. In April 2005, the SEC amended the compliance dates for SFAS 123(R), to allow companies to implement the standard at the beginning of their next fiscal year, instead of the next reporting period beginning after June 15, 2005. SFAS No. 123R is effective for the Company in the quarter ending March 31, 2006. Upon adoption of SFAS 123R, companies are allowed to select one of three alternative transition methods, each of which has different financial reporting implications. The Company is currently evaluating the transition methods, valuation methodologies and other assumptions for employee stock options in light of SFAS No. 123R. Current estimates of option values using the Black-Scholes method may not be indicative of results from valuation methodologies ultimately implemented by the Company upon adoption of SFAS No. 123R. Although the Company has not yet fully quantified the impact this standard will have on its financial statements, it is likely that the adoption of SFAS No. 123R will have a material impact on the Company's financial position and results of operations. Stock-based Compensation under Note 1 included in these Condensed Consolidated Financial Statements provides the pro forma net income and earnings per share as if the Company had used a fair-value-based method similar to the methods required under SFAS 123(R) to measure the compensation expense for employee stock awards during the three and six months ended June 30, 2005 and 2004.

On March 29, 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the Staff's interpretation of SFAS 123(R). This interpretation expresses the views of the staff regarding the interaction between SFAS 123(R) and certain SEC rules and regulations and provides the staff's views regarding the valuation of share-based payment arrangements for public companies. In particular, this SAB provides guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity status, valuation methods, the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123(R) in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123(R), the modification of employee share options prior to adoption of Statement 123(R) and disclosures in Management's Discussion and Analysis subsequent to adoption of SFAS 123(R). The Company will adopt SAB 107 in connection with its adoption of SFAS 123(R).

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements and changes the requirements for the

accounting for and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 31, 2005. The Company does not believe the adoption of SFAS No. 154 will have a material effect on its consolidated financial position, results of operations or cash flows.

In June 2005, the EITF reached a consensus on Issue No. 05-2 *The Meaning of Conventional Convertible Debt Instrument* in EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. Issuers of convertible debt are required by Statement 133 to evaluate whether it is necessary to separate the embedded conversion feature from the debt contract and account for the conversion feature as if it were a separate derivative instrument. If the issuer determines that the embedded conversion feature would be classified in equity if it were a freestanding instrument, the conversion feature is not separated from the debt contract. EITF 00-19's criteria must be applied to determine whether a conversion feature qualifies for equity classification, but it exempts a conversion feature embedded in a conventional convertible debt instrument from some of the criteria. EITF 05-2 requires convertible instruments that may be settled in a combination of cash or shares, e.g., those referred to as *Instrument C* in EITF 90-19, and instruments that may be convertible into a variable number of shares are not conventional. As a result, nonconventional instruments would need to satisfy all requirements of EITF 00-19 to support a conclusion that the conversion feature does not require accounting separate from that for the debt contract. The adoption of this Issue resulted in recognition of the beneficial conversion feature from the senior convertible notes issued in August 2005 as liabilities of \$3,826 as of September 30, 2005 and a gain of \$982 from the change in fair value of beneficial conversion feature liabilities for the year ended September 30, 2005 (see Note 8).

In June 2005, the EITF reached a consensus on Issue 05-6, *Determining the Amortization Period for Leasehold Improvements*, which requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. EITF 05-6 is effective for periods beginning after June 29, 2005. Earlier application is permitted in periods for which financial statements have not been issued. The adoption of this Issue did not have an impact on the Company's financial statements.

In September 2005, the EITF reached a consensus on Issue 05-7 *Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues*, which requires that a change in the fair value of a conversion option brought about by modifying the debt agreement be included in analyzing in accordance with EITF 96-19 *Debtor's Accounting for a Modification or Exchange of Debt Instruments* whether a debt instrument is considered extinguished. Under EITF 96-19's requirements, an issuer who modifies a debt instrument must compare the present value of the original debt instrument's cash flows to the present value of the cash flows of the modified debt. If the present value of those cash flows varies by more than 10 percent, the modification is considered significant and extinguishments accounting is applied to the original debt. If the change in the present value of the cash flows is less than 10 percent, the debt is considered to be modified and is subject to EITF 96-19's modification accounting. EITF 05-7's Consensus requires that in applying the 10 percent test the change in the fair value of the conversion option be treated in the same manner as a current period cash flow. The Consensus also requires that, if a modification does not result in an extinguishment, the change in fair value of the conversion option be accounted for as an adjustment to interest expense over the remaining term of the debt. The issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of the conversion option of a debt instrument that does not result in an extinguishment. EITF 05-7 is effective for modifications of debt instruments beginning in the first interim or annual reporting period beginning after December 15, 2005. The Company does not expect the adoption of the EITF to have material impact on the Company's financial statements.

In September 2005, the EITF reached a consensus on Issue No. 05-8, *Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature*. Under EITF 05-8, the issuance of convertible debt with a beneficial conversion feature results in a temporary difference for purposes of applying Statement 109. The deferred taxes recognized for the temporary difference should be recorded as an adjustment to paid-in capital. EITF 98-5 *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios* and EITF 00-27 *Application of Issue No. 98-5 to Certain Convertible Instruments* require that the nondetachable conversion feature of a convertible debt security be





accounted for separately if it is a beneficial conversion feature. A beneficial conversion feature is recognized and measured by allocating to additional paid-in capital a portion of the proceeds equal to the conversion feature's intrinsic value. A discount on the convertible debt is recognized for the amount that is allocated to additional paid-in capital. The debt discount is accreted from the date of issuance to the stated redemption date of the convertible instrument or through the earliest conversion date if the instrument does not have a stated redemption date. The U.S. Federal Income Tax Code includes the entire amount of proceeds received at issuance as the tax basis of the convertible debt security. The EITF 05-8 Consensus should be applied retrospectively to all instruments with a beneficial conversion feature accounted for under EITF 98-5 and EITF 00-27 for periods beginning after December 15, 2005. The Company does not expect the adoption of the EITF to have material impact on the Company's financial statements.

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

### 3. Liquidity

The Company has experienced losses from continuing operations during the last two fiscal years and has an accumulated deficit of \$138,635 as of September 30, 2005. Cash used for continuing operations for the nine months ended September 30, 2005 was \$6,957 and cash flow from continuing operations was negative through the 4<sup>th</sup> quarter of 2005. At September 30, 2005 working deficit was \$17,041. As of September 30, 2005, the Company's principal source of liquidity is \$933 of cash and \$2,193 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, continue 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 \$3,250 private placement of 10% convertible debt on June 13, 2005, and \$9,878 private placement of 7% convertible debt on August 9, 2005 for \$5,000 aggregate cash received, \$4,280 of previously issued notes, and satisfaction of accrued interest and fees of \$598 from previously issued convertible notes (see Note 8). The Company also entered into a Factoring, Loan, and Security Agreement ( Factoring Agreement ) on April 21, 2005, which allows for borrowing up to \$1,500, to meet working capital needs of the Company (see Note 8). Borrowings made under the Factoring Agreement are secured by the Company's trade receivables. Such borrowings totaled \$2,855, which was offset by \$2,618 of repayments made as September 30, 2005. The Company has \$1,263 available for future borrowings under the Factoring Agreement as of September 30, 2005, which is contingent on approval of eligible receivables by the financing company.

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, and the cost of successful implementation of Section 404 of the Sarbanes-Oxley Act of 2002. If the available funds and cash generated from operations are insufficient to satisfy liquidity requirements, the Company will need additional funds in the future to support working capital requirements and for other purposes, and will need to raise additional funds through public or private equity financing, bank debt financing, or from other sources. Adequate funds may not be available when needed or may not be available on favorable terms. The Company expects to continue to devote limited capital to our research and development activities, to further develop and strengthen our manufacturing capabilities, and for working capital and other general corporate purposes.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 ( SOX 404 ), 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

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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 the Company's annual report on Form 10-K for the fiscal year ended December 31, 2004, the Company did not comply with these requirements for such fiscal year as described in the following paragraphs.

The time and resources committed to the restatement of prior periods' financial statements as aforementioned delayed our internal timetable with respect to our documentation, assessment and evaluation of internal control over financial reporting. Due to the issues described in the foregoing paragraph, as well as limitation on financial and internal resources, management's assessment of the effectiveness of our internal control over financial reporting had been substantially delayed, which in turn had delayed the Company's independent registered public accounting firm, Stonefield Josephson, Inc. in performing its audit of management's assessment of the effectiveness of internal control over financial reporting pursuant to SOX 404. Therefore, the Company's independent registered public accounting firm issued a disclaimer of opinion with respect to the Company's internal control over financial reporting as of December 31, 2004, and such disclaimer was filed with the Company's amended Form 10-K filed on May 10, 2005.

In addition, while management has devoted as much financial and internal resources during 2005 to the SOX 404 effort as possible for compliance as of fiscal year 2005, management believes that there is significant work remaining to be done in a limited amount of time. Thus, the Company will not be able to complete its assessment of internal controls in accordance with SOX 404 requirements as of December 31, 2005 (see Item 4 Controls and Procedures on this quarterly report for further discussion on material deficiencies identified as of November 18, 2005).

The filing of a disclaimer does not comply with the SEC's rules and regulations under Section 404, and this noncompliance has resulted in the Company 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 addition to the foregoing, although the Company's common stock was admitted to the OTC Bulletin Board for quotation on June 15, 2005, the SEC has further advised that, as a result of our noncompliance with Section 404 for the 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 the Company's common stock will remain eligible for quotation on the OTC Bulletin Board.

#### 4. Inventories

The Company maintains certain of its raw material inventories in amounts in excess of our operating cycle of one year due to the nature of our manufacturing process, production lead time, and the recyclability of our raw material. These inventories were classified as long-term inventory as of December 31, 2004. The Company determined that its current and projected raw material requirements are not sufficient enough to warrant the use of such raw materials in the foreseeable future. Accordingly, the Company reduced the carrying value of raw materials held by its subsidiary, Liquidmetal Korea, by the amounts considered to be excessive during the second quarter of 2005. The write-down during the three and nine months ended September 30, 2005 was \$833 and \$1,653, respectively, and is included in Impairment of long lived assets in the accompanying Condensed Consolidated Statement of Operations and Comprehensive Loss for the nine months ended September 30, 2005. The total amount of long term inventory was \$0 and \$1,810 as of September 30, 2005 and December 31, 2004, respectively.

Inventories were comprised of the following:

| September 30,<br>2005 | December 31,<br>2004 |
|-----------------------|----------------------|
|-----------------------|----------------------|

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(Restated)

|                           |    |       |    |       |
|---------------------------|----|-------|----|-------|
| Raw materials             | \$ | 373   | \$ | 1,688 |
| Work in process           |    | 735   |    | 352   |
| Finished goods            |    | 391   |    | 313   |
| Total current inventories |    | 1,499 |    | 2,353 |
| Long-term inventories     |    |       |    | 1,810 |
| Total inventories         | \$ | 1,499 | \$ | 4,163 |

## 5. Idle Equipment

Idle equipment consists of certain equipment held by the Company for use in expansion of bulk alloy parts manufacturing. Due to excess manufacturing capacity, the Company classified the equipment as idle equipment at December 31, 2004. 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. For these reasons, during the quarter ended June 30, 2005, the Company determined to write down the carrying value of the idle equipment held by its subsidiary, Liquidmetal Korea, to its net realizable value. The write-down amounted to \$1,741 and is included in operating expenses as Impairment of long lived assets in the accompanying Condensed Consolidated Statement of Operations and Comprehensive Loss for the three and nine months ended September 30, 2005. Total amount of idle equipment remaining was \$190 and \$1,906 as of September 30, 2005 and December 31, 2004, respectively.

## 6. Discontinued Operations

### *Dongyang*

On June 28, 2002, the Company acquired a 51% interest in Chusik Hoesa Dongyang Yudoro ( Dongyang ). In March 2004, the Company sold its 51% investment in Dongyang to the 49% minority shareholder. The selling price of the Company's 51% interest in Dongyang was \$80, which was equal to the Company's net carrying value for the 51% ownership held. Further, the Company agreed to pay Dongyang \$155 for the purchase of a receivable balance from Growell. The transaction resulted in net payable to Dongyang of \$75 and a loss of \$46 from transfer of the Company's interest in Dongyang to the minority shareholder. The loss from operations for the nine months ended September, 2004 totaled \$50 and is included in the loss from discontinued equipment manufacturing operations for the period. The net payable balance of \$75 is to be paid in quarterly installments throughout 2004, with \$25 to be paid subsequent to 2004. The outstanding amount payable to Dongyang is \$11 and \$25 as of September 30, 2005 and December 31, 2004, respectively, and is included in accounts payable and accrued liabilities.

Summarized operating results of Dongyang's discontinued operations are as follows.

|   | For the Nine months<br>Ended September 30,<br>2005 | For the Nine months<br>Ended September 30,<br>2004 |
|---|--|--|
| Revenue   | \$   | \$ 22  |
| Loss from discontinued equipment manufacturing operations, net of tax |  | (96)   |

### *Taesung*

On June 14, 2004, the Company entered into an Asset Purchase Agreement whereby all the assets and liabilities of its Taesung equipment manufacturing division in Korea were sold to a third party for \$345 which is payable by the third party in four equal installments with the last installment being due on June 30, 2005. As of March 31, 2004, management determined that no impairment was anticipated on the divestiture of its Taesung division. Ultimately, the sale resulted in a loss of approximately \$184. The loss from operations for the three and nine months ended September 30, 2004 totaled \$0 and \$653 and is included in the loss from discontinued equipment manufacturing operations for the period.

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Summarized operating results of Taesung's operations are as follows:

|   | <b>For the Nine months<br/>Ended September 30,<br/>2005</b> | <b>For the Nine months<br/>Ended September 30,<br/>2004</b> |
|---|---|---|
| Revenue   | \$  | \$ 172  |
| Loss from discontinued equipment manufacturing operations, net of tax |   | (653)   |

**7. Product Warranty**

Management estimates product warranties as a percentage of bulk alloy product sales earned during the period. As of September 30, 2005, the Company used 5 percent 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 and nine months ended September 30, 2005, the Company recorded \$50 and \$126, respectively, of warranty expense. During the three and nine months ended September 30, 2004, the Company recorded \$131 and \$269, 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% senior convertible notes due 2007 (the March Notes ) to investor groups in a transaction led by Michigan Venture Capital Co., Ltd, a South Korea-based institutional investment firm, and IndiGo Ventures LLC, a New York-based investment firm (the Placement Agents ) that served as a financial advisor to the Company for the transaction. The notes were collateralized by the patents held by the Company and second priority mortgage interest in plant facilities and certain equipment in South Korea. The notes were convertible at any time into common stock at a price of \$3.00 per share. Investors in the private placement and the Placement Agents received warrants to purchase an aggregate amount of up to approximately 1.2 million shares of common stock, exercisable at \$3.00 per share for varying periods but no later than 100 days following the effectiveness of a registration statement covering the resale of shares issuable upon exercise of the warrants. The conversion and warrant exercise price are subject to price adjustments for anti-dilution purposes. In addition, the investors had the right to call for repayment of the notes prior to maturity at any time after the second anniversary of the closing of the transaction.

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

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

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

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



On August 19, 2004, the Company completed a private exchange offer for its March Notes with the remaining holders after the redemption. Under terms of the exchange offer, approximately \$5,459 in aggregate principal amount of the March Notes have been exchanged for an aggregate of (i) \$2,729 of 6% Senior Secured Notes Due 2007 (the Long-Term Notes ) and (ii) \$2,730 of 10% Senior Secured Notes Due 2005 (the Short-Term 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 Short-Term 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 Short-Term Notes have been exchanged and redeemed subsequent to the close of the second quarter of 2005 (see 2005 Senior Convertible Notes below). The Long-Term Notes have a maturity date of July 29, 2007, and a conversion price of \$1.00 per share. The conversion prices of the July 2007 Notes and July 2005 Notes are subject to price adjustments for anti-dilution purposes. Further, the exchange notes are convertible into Common Stock, at the option of the Company, if at any time after the issuance of the notes, the closing per share price of the Common Stock exceeds \$4.00 (as adjusted for stock splits, reverse splits, stock dividends, and recapitalizations) for 30 consecutive trading days, and further provided that there has been effective registration during such period. Holders of the Long-Term Notes also have the right to call for repayment of the Long-Term Notes prior to maturity at any time after the second anniversary of the closing of the exchange offer. The Long-Term 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 warrant exercise price is subject to price adjustment for anti-dilution purposes. As of September 30, 2005, the warrant price was determined to be exercisable at \$2.73.

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

In connection with the private exchange offer, the Company issued \$250 of private placement notes to certain Placement Agents as issuance costs. Of the \$250 notes issued, \$125 was paid in the form of long-term notes which is due in 2007 with interest rate of 6% per annum (Long-Term Notes) and \$125 was paid in the form of short-term notes which is due in 2005 with interest rate of 10% per annum (Short-Term Notes). The Short-Term and Long-Term Notes are convertible into Common Stock at \$2.00 and \$1.00, respectively, and have the same terms as the Exchange Notes issued to the investors. Further, \$143 of original fair value of the embedded conversion feature of 250 notes issued to Placement Agents was recorded 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 percent of the purchase price paid for the unconverted notes for the first 30 business days of late registration, and 1 and 3 percent for each 30 business days thereafter, but no more than 18 percent of the purchase price of the unconverted note balance. Late registration fee of \$0 and \$1,028 has been recorded as interest expense during the three and nine months ended September 30, 2005, respectively.

Interest payments are due quarterly, and failure to make timely interest payments will result in increase in interest rate to 10% and 14% on the 6% and 10% senior convertible notes ( Default Rates ). The Default Rates became effective on April 1, 2005 from non-payment of a scheduled interest payment. As of September 30, 2005, the Company has complied with all scheduled interest payments.

On August 9, 2005, the Short-Term 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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Subsequent to the closing of the 2005 Senior Convertible Notes in August 2005, \$462 of the Long-Term Notes were converted into 462,250 of the Company's common stock at a conversion price of \$1.00 per share as of September 30, 2005. The conversion resulted in reduction of conversion feature liabilities of \$520 to additional paid in capital for the quarter ended September 30, 2005.

As of September 30, 2005, our gross outstanding loan balance of the Short-Term and Long-Term Notes totaled \$0 and \$2,392, respectively. As of December 31, 2004, our gross outstanding loan balance of the Short-Term and Long-Term Notes totaled \$2,854 and \$2,855, respectively. As of September 30, 2005 and December 31, 2004, un-amortized discounts for conversion feature and warrants totaled \$1,411 and \$2,831, and other asset debt issuance costs totaled \$49 and \$183, respectively. Interest expense for the amortization of debt issuance cost and discount on note was \$594 and \$1,554 for the three and nine months ended September 30, 2005, and \$1,699 and \$3,314 for the three and nine months ended September 30, 2004, respectively. As of September 30, 2005, the effective interest rate for the Long-Term Notes was 37%.

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 gain of \$170 and \$457 for the three and nine months ended September 30, 2005, respectively, and a loss of \$434 and a gain of \$412 for the three and nine months ended September 30, 2004, respectively. The fair value of warrants outstanding at September 30, 2005 of \$93 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 0.42 years; (2) volatility of 90%, (3) risk free interest of 3.93% and dividend rate of 0%.

### Convertible Notes

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

The Notes issued by the Company in the 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 Notes are interest-only, with interest payments due quarterly, at the rate of 10% per year. The Notes can be prepaid by the Company at any time without penalty. If, within 120 days following the issue date of the 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 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 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 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 adjustments for anti-dilution purposes.

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 other 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 net gain of \$349 and \$95 for the three and nine months ended September 30, 2005. The fair value of warrants outstanding at September 30, 2005 of \$1,065 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.70 years; (2) volatility of 90%, (3) risk free interest of 4.18% and dividend rate of 0%.

#### 2005 Senior Convertible Debt

On August 9, 2005, the Company completed a private placement (the Private Placement) of \$9,878 in principal amount of new 7% Convertible Secured Promissory Notes due August 2007 (the 2005 Senior 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 2005 Senior Notes were issued pursuant to a Securities Purchase Agreement dated effective as of August 2, 2005 among the Company, the purchasers of the 2005 Senior 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 an increase to the interest rates to 14% per annum on the 2005 Senior Notes ( Default Rates ). As of September 30, 2005, the Company has made timely interest payments.

The 2005 Senior 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 2005 Senior Notes is subject price adjustment for anti-dilution purposes. As of September 30, 2005, the convertible price of 2005 Senior Notes remained unchanged at \$2.00 per share.

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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 beneficial conversion feature of \$4,808 have been recorded as beneficial 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 beneficial conversion liability as a fair value and record the fluctuation

to the fair value of the beneficial conversion feature liability to current operations. The change in the fair value of the beneficial conversion feature liability resulted in a gain of \$982 for the three and nine months ended September 30, 2005. The fair value of the beneficial conversion features outstanding as of September 30, 2005 of 3,826 was computed using the Black-Scholes model under the following assumptions: (1) 1.84 years; (2) volatility of 90%, (3) risk free interest of 4.18% and dividend rate of 0%.

The 2005 Senior 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 6% Senior Secured Notes Due July 29, 2007 (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 2005 Senior 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 2005 Senior 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. 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 gain of \$593 for the three and nine months ended September 30, 2005. The fair value of warrants outstanding at September 30, 2005 of \$3,475 was computed using the Black-Scholes model under the following assumptions: (1) expected life of 4.84 years; (2) volatility of 90%, (3) risk free interest of 4.18% and dividend rate of 0%.

In connection with the transaction, the Company, all purchasers of the 2005 Senior Notes, and all holders of previously issued notes entered into a single Amended and Restated Registration Rights Agreement that replaces the prior registration rights agreements entered into by the Company with the various noteholders. Under the Amended and Restated Registration Rights Agreement, the Company is required to file a resale registration statement for the shares underlying the 2005 Senior Notes, July 2007 Notes, and warrants within ninety (90) days of the closing of the 2005 Senior Notes. The Company is required to cause this registration statement to become effective within 60 days after the Company receives the first written comments on the registration statement from the SEC, or if the SEC notifies the Company 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.

As of September 30, 2005, our gross outstanding loan balance of the 2005 Senior Notes totaled \$9,878. As of September 30, 2005, unamortized discounts for beneficial conversion feature and warrants totaled \$6,133, and other asset debt issuance costs





totaled \$434, and contra liability debt issuance cost totaled \$538. Interest expense for the amortization of debt issuance cost and discount on note was \$622 and for the three and nine months ended September 30, 2005. As of September 30, 2005, the effective interest rate for the 2005 Senior Notes was 46%.

#### 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. Advances are made on 80% of Approved receivables assigned and 30% 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 0.65 percent to 2 percent plus prime rate as published by the Wall Street Journal, with a minimum annual fee of \$30. All receivables assigned and advances made are subject to return and recall by the financing company, respectively. As such, the advances have been classified as short-term secured borrowings in accordance with SFAS 140 Accounting for Transfer and Servicing of Financial Assets and Extinguishments of Liabilities. As of September 30, 2005, the Company has borrowed \$2,855 and repaid \$2,618. The total outstanding advance made under the agreement is \$237 as of September 30, 2005, which is presented as short-term debt. The Company has \$1,263 available for future borrowings under the Agreement as of September 30, 2005, which is contingent on approval of eligible receivables by the financing company.

#### Kookmin Note

On February 4, 2003, our Korean subsidiary received 6,500,000 in South Korean Won, or approximately \$5,488, under a loan from Kookmin Bank of South Korea. The loan bears interest at an annual rate of 7.1%. In the event of delayed repayment, the interest increases to a maximum of 21%, depending on the length of time the repayment is delayed. As of September 30, 2005, 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 \$841 for the nine months ended September 30, 2005, which includes \$89 of foreign exchange translation loss. The outstanding loan balance totaled \$2,910, of which \$1,204 is included in current portion of long-term debt, as of September 30, 2005.

#### **9. Stock Compensation Plan**

During the three and nine months ended September 30, 2005, under the Company's 2002 Equity Incentive Plan which provides for the grant of stock options to officers, employees, consultants and directors, the Company granted options to purchase 0 and 791,165 common shares of the Company for an average exercise price of \$0 and \$2.16, respectively, which equaled the fair market value on the date of grant

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During the three and nine months ended September 30, 2005, 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 20,000 and 200,000 common shares of the Company for an average exercise price of \$1.87 and \$2.28, respectively, under this plan. Further, all options granted under this plan had exercise prices that were equal to the fair market value on the date of grant.

In September 2005, the 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 them for periods through September 30, 2005. Such shares were issuable to such directors at an average price of \$1.89 per share. As of September 30, 2005, a total of 92,219 shares were issued to non-employee directors in lieu of these past-due fees.

The Company canceled 31,517 and 275,701 options during the three and nine months ended September 30, 2005, respectively, 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 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 30, 2005.

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

|  | Coatings | Segment<br>Bulk Alloy | Totals    |
|--|----------|-----------------------|-----------|
| <b>Three months ended September 30, 2005:</b>                        |          |                       |           |
| Revenue to external customers  | \$ 1,549 | \$ 2,793              | \$ 4,342  |
| Gross profit (loss)  | 635      | (49)                  | 586       |
| Income (loss) before interest expense and discontinued operations    | 420      | (1,429)               | (1,009)   |
| Total identifiable assets at end of period                           | 772      | 16,414                | 17,186    |
| <b>Three months ended September 30, 2004:</b>                        |          |                       |           |
| Revenue to external customers  | \$ 988   | \$ 3,627              | \$ 4,615  |
| Gross profit   | 466      | 908                   | 1,374     |
| Income before interest expense, discontinued operations, and general | 264      | 129                   | 393       |
| Total identifiable assets at end of period                           | 814      | 23,202                | 24,016    |
| <b>Nine months ended September 30, 2005:</b>                         |          |                       |           |
| Revenue to external customers  | \$ 3,930 | \$ 6,982              | \$ 10,912 |
| Gross profit   | 1,691    | (1,332)               | 359       |
| Income (loss) before interest expense and discontinued operations    | 1,182    | (7,270)               | (6,088)   |
| Total identifiable assets at end of period                           | 772      | 16,414                | 17,186    |
| <b>Nine months ended September 30, 2004:</b>                         |          |                       |           |
| Revenue to external customers  | \$ 2,710 | \$ 12,248             | \$ 14,958 |
| Gross profit   | 1,260    | 4,425                 | 5,685     |
| Income before interest expense and discontinued operations           | 804      | 2,237                 | 3,041     |
| Total identifiable assets at end of period                           | 814      | 23,202                | 24,016    |



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

|  | For the Three<br>Months Ended September 30, |                    | For the Nine<br>Months Ended September 30, |                    |
|--|---|--------------------|--|--------------------|
|  | 2005<br>(Restated)                          | 2004<br>(Restated) | 2005<br>(Restated)                         | 2004<br>(Restated) |
| Total operating income (loss) before minority interest, interest expense and discontinued operations         | \$ (1,009)                                  | \$ 393             | \$ (6,088)                                 | \$ 3,041           |
| General and administrative expenses not allocated to segments  | (1,798)                                     | (2,962)            | (5,107)                                    | (7,594)            |
| Consolidated loss before interest, other income, income taxes, minority interest and discontinued operations | (2,807)                                     | (2,569)            | (11,195)                                   | (4,553)            |
| Loss from extinguishments of debt  | (1,247)                                     | (2,941)            | (1,247)                                    | (2,941)            |
| Change in value of warrants, gain (loss)   | 1,112                                       | (434)              | 1,145                                      | 846                |
| Change in value of conversion feature gain (loss)  | 2,215                                       | 2,338              | 4,497                                      | 3,276              |
| Other income   |   | 302                |  | 302                |
| Interest expense   | (1,659)                                     | (3,283)            | (4,377)                                    | (5,934)            |
| Interest income  | 7   |                    | 14   | 34                 |
| Loss from discontinued operations, net   |   |                    |  | (749)              |
| Consolidated net loss  | \$ (2,379)                                  | \$ (11,263)        | \$ (11,163)                                | \$ (9,719)         |

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 \$2,234 and \$1,215 during the three months ended September 30, 2005 and 2004, respectively. The revenue related to the United States of America was earned under defense-related research and development contracts and sales of coatings products.

As of September 30, 2005, two customers represented 32%, or \$706, of the total outstanding trade accounts receivable. As of December 31, 2004, two customers represented 30%, or \$497, of the total outstanding trade accounts receivable. One customer represented 11%, or \$1,199, of total sales for the nine months ended September 30, 2005. Four customers represented 60%, or \$9,036, of total sales for the nine months ended of September 30, 2004.

During the three months ended September 30, 2005, the Company had revenues from companies outside of the United States of \$2,108 of which \$1,665 represented sales to companies located in South Korea. During the three months ended September 30, 2004, the Company had revenue from sales to companies outside of the United States of \$3,400 of which \$2,895 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 including equipment sales.

Long-lived assets include net property, plant, and equipment, and net intangible assets. The Company had long-lived assets of \$1,742 and \$1,594 located in the United States at September 30, 2005 and December 31, 2004, respectively. The Company had long-lived assets of \$13,298 and \$15,422 located in South Korea at September 30, 2005 and December 31, 2004, respectively.



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

|   | September 30,<br>2005 |
|---|-----------------------|
| Total segment assets                      | \$ 17,186             |
| Cash and cash equivalents                 | 933                   |
| Prepaid expenses and other current assets | 1,363                 |
| Other property, plant and equipment, net  | 585                   |
| Intangibles, net                          | 1,151                 |
| Other assets                              | 950                   |
| Total consolidated assets                 | \$ 22,168             |

Assets excluded from segment assets include assets attributable to the Company's corporate headquarters. The largest asset represents the Company's intangible assets, consisting 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. Common stock equivalents consist of 13,077,001 and 8,526,068 equity instruments and 11,672,051 and 4,844,903 senior equity convertible debt instruments at September 30, 2005 and 2004, respectively, and have not been included in the EPS calculation at September 30, 2005 and 2004 as the amounts are anti-dilutive.

#### 12. Commitments and Contingencies

In September 2004, as part of a security agreement to finance a certain insurance policy, the Company used certificates of deposits with maturities of less than one year as collateral. The \$754 held in certificates of deposits is presented as restricted cash at December 31, 2004. During the quarter ended March 31, 2005, the certificate of deposits was liquidated and the proceeds were used to paydown the balance of the financing on the insurance policy.

In August 2004, the Company entered into a consulting agreement whereby the Company was to receive services from a third party to improve the Company's bulk alloy manufacturing process. The service is to be provided from August 2004 through October 2005. The total amount of service fees is \$172, of which \$9 was included in trade accounts payable as of September 30, 2005. As of December 31, 2004, the total amount of outstanding balance included in trade accounts payable was \$15.

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

The Company and certain of its present and former officers and directors were named as defendants in nine purported class action complaints filed in the United States District Courts 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 United States District Court for 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). 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 the Company's initial public offering in May 2002 contained material misrepresentations and omissions regarding the Company's historical financial condition and regarding a personal stock transaction by the Company's 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 the Company's business transactions, failed to maintain adequate internal controls, and knowingly disclosed unrealistic but



favorable information about market demand for and commercial viability of the Company's products to artificially inflate the value of the Company's 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 on March 28, 2005. The Lead Plaintiffs served their Memorandum in Opposition to Defendants' Motion to Dismiss Consolidated Amended Class Action Complaint on June 3, 2005. The Company cannot predict when the court will rule on the Motion to Dismiss. The Company intends to vigorously defend against the class action. The Company cannot currently predict the impact or resolution of this litigation or reasonably estimate a range of possible loss, which could be material. The resolution of this lawsuit may harm our business and have a material adverse impact on our financial condition.

In addition to the above, certain present and former officers and directors of Liquidmetal Technologies, as well as Liquidmetal Technologies 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 Florida federal court styled *Robert Story v. John Kang, et al.*, Case No. 8:04-CV-1587-T-23TBM, commenced in the Middle District of Florida, Tampa Division. 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. Plaintiffs served a Consolidated Shareholder Derivative Complaint on October 12, 2004. The defendants served a Demurrer to the Consolidated Shareholder Derivative Complaint on November 22, 2004, seeking dismissal of that complaint. At a hearing on February 10, 2005, the court sustained the demurrer, dismissing the Consolidated Shareholder Derivative Complaint but giving the plaintiffs 45 days within which to amend the complaint. Plaintiffs filed their Consolidated Amended Shareholder Derivative Complaint on March 28, 2005. The Company, along with other defendants, filed a corrected demurrer on May 17, 2005, again seeking dismissal of the amended complaint. At a hearing on July 7, 2005, the Court again sustained the demurrer, dismissing the Consolidated Amended Shareholder Derivative Complaint but giving the plaintiffs 40 days within which to further amend the complaint. On August 16, 2005, the plaintiffs filed a Consolidated Second Amended Shareholder Derivative Complaint. The Company, along with the other defendants, filed a demurrer on September 15, 2005, again seeking dismissal of the second amended complaint. A hearing on that demurrer was held on October 19, 2005, but was continued pending resolution of a dispute regarding the Company's participation in discovery in the California derivative action before the Motion to Dismiss the class action is resolved. On October 28, 2005, the presiding judge in the class action resolved the discovery dispute by denying the Company's Motion to Stay Discovery in Related State Action, and the Company is now required to produce discovery materials in the California derivative action. Once those discovery materials are produced to and reviewed by the plaintiffs' counsel in the California derivative action, the judge will reconvene the hearing to determine whether the pending demurrer should be sustained without leave to amend.

In the Florida derivative action, the Plaintiff filed a First Amended Shareholder Derivative Complaint on November 22, 2004. The Company's Motion to Dismiss, which was filed on December 20, 2004, is fully briefed. The Company cannot predict when the court will rule on the Motion to Dismiss. The Company intends to vigorously defend against the derivative actions. The Company cannot currently predict the impact or resolution of this litigation or reasonably estimate a range of possible loss, which could be material. The resolution of these lawsuits may harm our business and have a material adverse impact on our financial condition.

As of September 30, 2005, the Company has accrued \$835 as receivables from insurance companies from excess legal costs incurred to defend against the class action and derivative lawsuits. The amount is included in prepaid expenses and other current assets.

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 \$1.0 million 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. 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 in the Japanese end-market. This commission will apply to golf equipment shipped by the Company or its affiliates during the period beginning on March 28, 2003 and ending on 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. The Company will recognize the unearned distribution fee of \$830 as revenue proportionately with the payment of commissions under the new agreement. As of September 30, 2005 and December 31, 2004, the unearned distribution fee remained unchanged at \$830.

Under terms of the January 2004 settlement of the dispute over certain sales transactions from 2003 and 2002 between Liquidmetal Korea and Growell Metal Co., Ltd., a South Korean metals processing company ( 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 and trade accounts payable of \$14 were to be paid to Growell (in cash or stock at the Company's discretion) by December 31, 2004. As of December 31, 2004, the settlement payable of \$3,246, net of foreign exchange translation loss, was not paid to Growell due to Growell's breach of warranty on equipment repurchased by Liquidmetal Korea. In January 2005, Growell was acquired by a third party. As of September 30, 2005, the outstanding settlement payable to the third party of \$3,234, net of foreign exchange translation gain, was not paid, and the Company is currently in negotiations to settle this balance with the third party.

### **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 a former director of the Company. Under the terms of the agreement, LLPG has the right to commercialize Liquidmetal alloys, particularly precious-metal based compositions, in jewelry and high-end luxury product markets. The Company, in turn, will receive royalty payments over the life of the contract on all Liquidmetal products produced and sold by LLPG. In conjunction with its technology licensing contract, LLPG purchased two proprietary Liquidmetal alloy melting machines and three proprietary Liquidmetal alloy casting machines for a total purchase price of \$2,000. At December 31, 2003, the Company had a remaining receivable balance of \$500 due from LLPG, which was subsequently paid in full in March 2004.

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. During the three and nine months ended September 30, 2005, we incurred \$14 and \$39, in consulting fees from Chitnis Consulting, respectively. During the three and nine months ended September 30, 2004, we incurred \$13 and \$38, in consulting fees from Chitnis Consulting, respectively.

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. The agreement currently continues on a month-to-month basis. During the three and nine months ended September 30, 2005, we incurred \$15 and \$25 in consulting fees from Mr. Johnson, respectively. During the three and nine months ended September 30, 2004, we incurred \$40 and \$54 in consulting fees from Mr. Johnson, respectively.

In November 2004, we entered into an agreement with John Kang, our Chairman, 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

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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 September 30, 2005, the outstanding amount of the receivable was \$235, which is included in other assets. Mr. Kang has paid \$0 and \$67 for the three and nine months ended of September 30, 2005. The Company has agreed to defer Mr. Kang's payment schedule until 2006 as Mr. Kang has agreed accept reduced compensation for the remainder of 2005. The remaining outstanding balance of \$235 will be due before the end of 2006.

During the period ended September 30, 2005, the Company executed a \$198 promissory note with CK Cho, member of our Board of Directors, for working capital purposes. The note was due and paid in full as of June 30, 2005. The note has an annual rate of interest of 6% resulting in the Company paying approximately \$2 in interest. Mr. Cho also is a Chief Executive Officer of Winvest Venture Partners Inc., who holds \$500 of Senior Convertible Notes as of June 30, 2005 (see Note 8). Further, during the three months ended September 30, 2005, Mr. Cho advanced approximately \$387 to cover short-term liquidity needs. The advances were made without interest and were repaid as of September 30, 2005.

#### **14. Subsequent Events**

In connection with the senior convertible debt funded in August 2005, the Company, all purchasers of the senior notes, and all holders of previously issued convertible notes entered into a single Amended and Restated Registration Rights Agreement that replaces the prior registration rights agreements entered into by the Company with the various noteholders (see Note 8). Under the Amended and Restated Registration Rights Agreement, the Company is required to file a resale registration statement for the shares underlying the convertible notes and warrants within 90 days of the closing of the August 2005 senior convertible debt. The Company is required to cause this registration statement to become effective within 60 days after the Company receives the first written comments on the registration statement from the SEC, or if the SEC notifies the Company that it will not review the registration statement, within five days after such notification. If the Company is not in compliance with the registration filing requirements, the holders of the convertible notes and warrants have rights to late registration filing payments equal to 3 percent of a) warrant exercise price multiplied by the number of outstanding warrants; plus b) the outstanding principle balance for each 30 business days of late registration, but on more than 18% of a) warrant exercise price multiplied by the number of outstanding warrants; plus b) the outstanding principle balance.

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.



**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, 2004 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 percent 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.

We have amended our third quarter financial statements originally filed on form 10-Q on December 1, 2005, in this Form 10-Q to properly account for the beneficial conversion feature of the senior convertible notes issued in August 2005. Accounting for this feature resulted in a gain of \$1.0 million from the change in value of beneficial conversion feature and an increase to interest expense of \$0.1 million from additional amortization of debt discounts related to the revaluation of the beneficial conversion feature of the senior convertible debt issued in August 2005. In addition, the company wrote-down \$0.8 million of primarily raw material inventory considered to be long term as the carrying value of the inventory held as an impairment charge. While we may use the excess raw materials beyond one year to fulfill future demand, we did not foresee use of this inventory in the foreseeable future.

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



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

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

- Exchange rate fluctuations
- Warranty accrual
- Allowance for doubtful accounts
- Inventories at lower of cost or net realizable value
- Deferred tax assets
- Valuation of derivatives of warrants and embedded conversion features

Our Annual Report on Form 10-K for the year ended December 31, 2004 contains further discussions on our critical accounting policies and estimates.

### **Results of Operations**

Comparison of the three months ended September 30, 2005 and 2004

*Revenue.* Revenue decreased \$0.3 million to \$4.3 million for the three months ended September 30, 2005 from \$4.6 million for the three months ended September 30, 2004. The decrease consisted of a decrease of \$0.8 million from the sales and prototyping

of parts manufactured from bulk Liquidmetal alloys to consumer electronics customers as a result of decreased demand for conventional hinge components used in certain cellular phone models, which is offset by an increase of \$0.6 million from sales of our coatings products.

*Cost of Sales.* Cost of sales increased to \$3.8 million, or 87% of revenue, for the three months ended September 30, 2005 from \$3.2 million, or 70% of revenue, for the three months ended September 30, 2004. The increase was a result of decreases in bulk Liquidmetal alloy business. Cost of sales as a percentage of revenue has increased as a result of lower business volumes generated from our bulk Liquidmetal alloys. 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 \$2.4 million, or 54% of revenue, for the three months ended September 30, 2005 from \$3.6 million, or 77% of revenue, for the three months ended September 30, 2004. This decrease was primarily a result of decrease professional services by \$0.8 million, decrease in insurance costs of \$0.4 million, decrease in product warranty costs of \$0.1 million, and decrease in depreciation and travel expenses of \$0.1 million, offset by an increase in wages and compensation of \$0.3 million primarily from severance costs. These and other decreases in selling, general and administrative expenses represent the Company's efforts to manage costs and focus on our core business while continuing to build our corporate infrastructure required to prepare for and support the anticipated growth of our bulk Liquidmetal alloy business.

*Research and Development Expenses.* Research and development expenses decreased to \$0.2 million, or 5% of revenue, for the three months ended September 30, 2005 from \$0.4 million, or 8% of revenue, for the three months ended September 30, 2004. 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 the related costs of \$0.1 million and decreases in other miscellaneous expenses of \$0.1 million.

*Impairment of Long Lived Assets.* Impairment of long lived assets increased to \$0.8 million, or 19% of revenue, for the three months ended September 30, 2005 from \$0 for the three months ended September 31, 2004. Impairment expense represents primarily write-down of \$0.8 million of raw materials considered to be long term inventory. While we may use the excess raw materials beyond one year to fulfill future customer order, we have determined that our current capacity was not significant enough to warrant holding this inventory as a long term asset. As such, we have reduced the carrying values of the excess raw material equipment.

*Loss from Extinguishments of Debt.* Loss from extinguishments of debt decreased to \$1.2 million, or 29% of revenue, for the three months ended September 30, 2005 from \$2.9 million, or 63% of revenue, for the three months ended September 30, 2004. The \$1.2 million loss from extinguishments of debt was recognized from the exchange of our 6%

Convertible Notes due 2006 in August 2005. The \$1.7 million loss from extinguishments of debt was recognized during the three months ended September 30, 2004 from exchange of our 6% Senior Convertible Notes due March 2007 in August 2004.

*Change in Value of Warrants.* Change in value of warrants increased to net gain of \$1.1 million, or 26% of revenue, during the three months ended September 30, 2005 from a net loss of \$0.4 million, or 9% of revenue, during the three months ended September 30, 2004. The increase was from the change in value of warrants issued from the senior convertible debt funded in March 2004 and exchanged in August 2004, convertible debt funded in June 2005, and senior convertible debt funded in August 2005 primarily as a result of fluctuations in our stock price.

*Change in Value of Conversion Feature.* Change in value of our conversion feature liability from our senior convertible debt resulted in a change in value of conversion feature gain of \$2.2 million, or 51% of revenue, and a loss of \$2.3 million, or 51% of revenue, during the three months ended September 30, 2005 and 2004, respectively, primarily due to fluctuations in our stock price.

*Interest Expense.* Interest expense was \$1.7 million, or 38% of revenue, for the three months ended September 30, 2005 and was \$3.3 million, or 71% of revenue, for the three months ended September 30, 2004. During each of the three months ended September 30, 2005 and 2004, the interest expense was primarily due to the interest accrued on the Kookmin Bank loan funded



on February 4, 2003, senior convertible debt funded on March 3, 2004 and exchanged in August 2004, convertible debt funded on June 13, 2005, and senior convertible debt funded on August 9, 2005, as well as amortization of debt issuance costs and discount on the convertible debt. The decrease was primarily due to acceleration of amortization of debt issuance costs and discount on debt during the three months ended September 30, 2004 from principal payments made.

*Interest Income.* Interest income was \$7 thousand for the three months ended September 30, 2005 from interest earned on cash deposits. There was no interest income earned for the three months ended September 30, 2004.

Comparison of the nine months ended September 30, 2005 and 2004

*Revenue.* Revenue decreased \$4.1 million to \$10.9 million for the nine months ended September 30, 2005 from \$15.0 million for the nine months ended September 30, 2004. The decrease included a \$2.6 million decrease from restatement of revenues from 2003 to 2004 as a part of our 2003 financial statement restatement which resulted in one-time recognition of revenues during the first quarter of 2004, a decrease of \$1.7 million from the sales and prototyping of parts manufactured from bulk Liquidmetal alloys to consumer electronics customers as a result of decreased demand for conventional hinge components used in certain cellular phone models, and a decrease of \$1.0 million from decreased activity from research and development services related primarily to defense, leisure, and luxury goods applications, offset by an increase of \$1.2 million from sale of our coatings products.

*Cost of Sales.* Cost of sales increased to \$10.6 million, or 97% of revenue, for the nine months ended September 30, 2005 from \$9.3 million, or 62% of revenue, for the nine months ended September 30, 2004. The increase was a result of decreases in bulk Liquidmetal alloy business. Cost of sales as a percentage of revenue has increased as a result of lower business volumes generated from our bulk Liquidmetal alloys. Significant portion 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 \$6.5 million, or 60% of revenue, for the nine months ended September 30, 2005 from \$9.2 million, or 61% of revenue, for the nine months ended September 30, 2004. This decrease was primarily a result of decrease in professional and contracted services of \$1.9 million, decrease in advertising and promotions expense of \$0.2 million, decrease in bad debt expenses of \$0.1 million, decrease in product warrant expense of 0.1 million, decrease in insurance costs of \$0.1 million, decrease in amortization and depreciation costs of \$0.1 million, and decrease in travel costs of \$0.1 million. These and other decreases in selling, general and administrative expenses represent the Company's efforts to manage costs and focus on our core business while continuing to build our corporate infrastructure required to prepare for and support the anticipated growth of our bulk Liquidmetal alloy business.

*Research and Development Expenses.* Research and development expenses decreased to \$0.8 million, or 7% of revenue, for the nine months ended September 30, 2005 from \$1.1 million, or 7% of revenue, for the nine months ended September 30, 2004. 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 decrease in laboratory and prototype supplies used by \$0.1 million and decrease in wages and related expenses by \$0.1 million.

*Impairment of Long Lived Assets.* Impairment of long lived assets increased to \$4.0 million, or 39% of revenue, for the nine months ended September 30, 2005 from \$0 for the nine months ended September 30, 2004. Impairment expense represents write-down of \$2.5 million of raw materials considered to be long term inventory and \$1.7 million of idle equipment. While we may use the excess raw materials beyond one year to fulfill future customer order, we have determined that our current capacity was not significant enough to warrant holding this inventory as a long term asset. Further, while we have actively marketed the idle equipment for ultimate sale since early 2004, we were unable to sell

this equipment. In addition, while the equipment may be used internally to meet future capacity requirements, considering our current revenue, we do not anticipate utilizing this equipment internally in the near future. As such, we have reduced the carrying values of the excess raw material and idle equipment.

*Loss from Extinguishments of Debt.* Loss from extinguishments of debt decreased to \$1.2 million, or 11% of revenue, for the nine months ended September 30, 2005 from \$2.9 million, or 20% of revenue, for the nine months ended September 30, 2004. The \$1.2 million loss from extinguishments of debt was recognized from the exchange of our 6% Convertible Notes due 2006 in August 2005. The \$1.7 million loss from extinguishments of debt was recognized during the three months ended September 30, 2004 from exchange of our 6% Senior Convertible Notes due March 2007 in August 2004.

*Change in Value of Warrants.* Change in value of warrants increased to net gain of \$1.1 million, or 10% of revenue, during the nine months ended September 30, 2005 from a net gain of \$0.8 million, or 6% of revenue, during the nine months ended September 30, 2004. The increase was from the change in value of warrants issued from the senior convertible debt funded in March 2004 and exchanged in August 2004, convertible debt funded in June 2005, and senior convertible debt funded in August 2005 primarily as a result of fluctuations in our stock price.

*Change in Value of Conversion Feature.* Change in value of our conversion feature liability from our convertible debt resulted in a change in value of conversion feature of \$4.5 million, or 41% of revenue, and \$3.3 million, or 22% of revenue, during the nine months ended September 30, 2005 and 2004, respectively, primarily due to fluctuations in our stock price.

*Interest Expense.* Interest expense was \$4.4 million, or 40% of revenue, for the nine months ended September 30, 2005 and was \$5.9 million, or 40% of revenue, for the nine months ended September 30, 2004. During each of the nine months ended September 30, 2005 and 2004, the interest expense was primarily due to the interest accrued on the Kookmin Bank loan funded on February 4, 2003, senior convertible debt funded on March 3, 2004 and exchanged in August 2004, convertible debt funded on June 13, 2005, and senior convertible debt funded in August 9, 2005, as well as amortization of debt issuance costs and discount on the convertible debt. As of September 30, 2005, \$0.1 million of interest expense was accrued from default interest rates applied to the senior convertible notes effective April 1, 2005 from non payment of quarterly scheduled interest payments and \$1.0 million of late registration penalty fee of our senior convertible debt was accrued as interest expense.

*Interest Income.* Interest income was \$14 thousand for the nine months ended September 30, 2005, and \$34 thousand for the nine months ended September 30, 2004 from interest earned on cash deposits.

#### **Liquidity and Capital Resources**



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Our cash used for operating activities was \$7.0 million for the nine months ended September 30, 2005 and \$5.5 million, which includes cash used in our discontinued equipment manufacturing business of \$0.8 million, for the nine months ended September 30, 2004. Our working deficit increased from \$14.9 million at December 31, 2004 to \$17.0 million at September 30, 2005. The Company's working deficit increase of \$2.1 million was primarily attributable to increase in cash and cash equivalents of \$0.2 million, increase in trade accounts receivable of \$0.5 million, increase in prepaid and other current assets of \$0.4 million, decrease in current portion of long term debt of \$2.8 million, decrease in conversion feature liabilities of \$0.2 million, decrease in current portion of other liabilities of \$0.3 million, offset by decrease in restricted cash of \$0.8 million, decrease in inventories of \$0.9 million, increase in accounts payable and accrued liability of \$0.7 million, increase in short-term debt of \$0.2 million, and increase in warrant liabilities of \$4.0 million.

Our cash used in investing activities was \$0.2 million for the nine months ended September 30, 2005 for the acquisition of property and equipment and investments in patents and trademarks.

Our cash provided by financing activities was \$7.0 million for the nine months ended September 30, 2005, which consists of \$0.8 million in proceeds from restricted cash and \$3.25 million and \$9.9 million in proceeds from convertible debt funded in June 2005 and senior convertible debt funded in August 2005, respectively, \$0.2 million in proceeds from borrowings from our short term debt executed in March 2005, \$2.9 million in proceeds from factoring agreement executed in April 2005, offset by \$10.0 million on repayment of borrowings. The proceeds from the convertible and senior convertible debt funded in June 2005 and August 2005, respectively have been used to meet working capital requirements.

We anticipate that our capital expenditures will be approximately less than \$0.5 million for the full year 2005 for the acquisition of furniture, fixtures, and other business equipment. This amount is subject to change, however, depending upon the nature and the amount of the product orders that we actually receive from customers.

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, and the cost of successful implementation of Section 404 of the Sarbanes-Oxley Act of 2002. During the next twelve months, based on our current business plan, we expect to have sufficient resources to continue to devote limited capital to our research and development activities, to further develop and strengthen our manufacturing technology, and to provide for working capital and other general corporate purposes. However, based on our historical operating results and the continued development of our manufacturing capabilities and alloy compositions, there exists the possibility that these resources will not be adequate to operate at the proposed business plan levels. These expenses and capital expenditures could consume a material amount of our cash resources, but the amount of these requirements will depend on the nature and amount of orders we receive for the purchase of our bulk Liquidmetal alloy products.

Our business is based on commercializing an entirely new and unique technology, and our current business plan contains a variety of assumptions and expectations that are subject to uncertainty, including assumptions and expectations about order flow, unit volumes, manufacturing efficiencies, product cost and pricing, continuing technology improvements, customer adoption practices, strategic licensing relationships and other relevant matters. These assumptions take into account recent significant cost reductions, as well as recent improvements to our manufacturing processes. We have experienced losses from continuing operations during the last two fiscal years and have an accumulated deficit of \$139.1 million as of September 30, 2005. At September 30, 2005, our principal source of liquidity was \$0.9 million of cash and cash equivalents and \$2.2 million of trade accounts receivables. Such conditions raise substantial doubt that our Company will be able to continue as a going concern for a reasonable period of time without receiving additional funding. These operating results occurred while we were developing and attempting to commercialize and manufacture products from an entirely new and unique technology. This business plan required significant spending related to start-up costs and capital expenditures. These factors have placed a significant strain on our financial resources. The ultimate success of the Company depends on our ability to continue to reduce operating costs, generate higher revenue, achieve positive cash flow from continuing operations and achieve profitability.

Our future success depends on our ability to continue reducing operating costs and ultimately to generate higher revenue and attain profitability. We cannot be certain that additional capital, whether through selling additional debt or equity securities or obtaining a line of credit or other loan, will be available to us or, if available, will be on terms acceptable to us. If we issue additional securities to raise funds, these securities may have rights, preferences, or privileges senior to those of our common stock, and our current stockholders may experience dilution.

### **Contractual Obligations**

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The following table summarizes the Company's obligations and commitments as of September 30, 2005:

| Contractual Cash Obligations (1) | Total     | Less Than 1<br>Year | Payments Due by Period (in thousands) |           |               |   |
|----------------------------------|-----------|---------------------|---------------------------------------|-----------|---------------|---|
|                                  |           |                     | 1-3 Years                             | 3-5 Years | After 5 Years |   |
| Long-term debt (2)               | \$ 15,180 | \$ 1,204            | \$ 13,976                             | \$        | \$            |   |
| Short-term debt (3)              | 237       | 237                 |                                       |           |               |   |
| Capital lease obligation (4)     | 108       | 33                  | 75                                    |           |               |   |
| Operating leases and rents       | 1,062     | 120                 | 763                                   | 178       |               | 1 |
| Growell settlement payable (5)   | 3,234     | 3,234               |                                       |           |               |   |
| Consulting services payable      | 68        | 68                  |                                       |           |               |   |
| Dongyang payable                 | 11        | 11                  |                                       |           |               |   |
|                                  | \$ 19,900 | \$ 4,907            | \$ 14,814                             | \$ 178    | \$            | 1 |

- 
- (1) Contractual cash obligations include Long-Term Debt comprised of \$2,392 of Senior Convertible Notes issued in 2004, \$9,878 of Convertible Notes issued in 2005, and \$2,910 of Kookmin Notes, Short-Term Debt comprised of \$237 advances received under factoring, loan, and security agreement, and future minimum lease payments under capital and operating leases, liabilities incurred from settlement with a former customer (Growell) and divestiture of our equipment manufacturing business, and purchase commitments from a consultant.
- (2) Does not include interest payments of \$1,869, un-amortized discounts for conversion feature and warrants \$9,573 of our convertible notes.
- (3) Does not include minimum interest and fee payments of \$30.
- (4) Includes imputed interest of \$4.
- (5) In January 2005 Growell was acquired by a third party, and we **are currently in negotiations to settle this balance with the third party.**



### **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. During the course of the re-audit of our financial statements of Liquidmetal Technologies, Inc. (the Company) for the fiscal years ended December 31, 2001, 2002, and 2003, it was determined that revenues from certain sales made by the Company to various customers were either not recognized in the proper periods or should not have been recognized as revenue. It was also determined that compensation expense related to certain stock options granted in 2001 and 2002 were not calculated in accordance with generally accepted accounting principles under APB Opinion No. 25, SFAS No. 123, and EITF 00-23. These determinations and the associated restatement of previously issued financial statements in the Form 10-K for the year ended December 31, 2003, filed on November 10, 2004, suggest that, at the time of the subject transactions and the preparation of our financial statements for the relevant periods, the Company's disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934) were ineffective as of the end of the period covered by such Form 10-K filed on November 10, 2004 for purposes of ensuring that all information required to be disclosed by the Company was adequately accumulated and communicated to the Company's management at such time

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404), 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 as of the Company's fiscal year-ended December 31, 2004. SOX 404 also requires the public accounting firm auditing a public company's financial statements to attest 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 the Company's annual

report on Form 10-K for the fiscal year ended December 31, 2004, the Company did not comply with these requirements for such fiscal year as described in the following paragraphs. Therefore, the Company's independent registered public accounting firm issued a disclaimer of opinion with respect to the Company's internal control over financial reporting as of December 31, 2004, and such disclaimer was filed with the Company's amended Form 10-K filed on May 10, 2005.

The Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of, as of September 30, 2005, the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures, as of September 30, 2005, were not effective. This determination was based primarily on the material weaknesses in internal control over financial reporting identified below.

Update on Management's Assessment of Internal Control Over Financial Reporting. The time and resources committed to the restatement of prior periods' financial statements (as aforementioned) delayed management in commencing and completing its documentation, assessment and evaluation of internal control over financial reporting. Due to the issues described in the foregoing paragraph, as well as limitation on financial and internal resources, management's assessment of the effectiveness of our internal control over financial reporting had been substantially delayed, which in turn prohibited the Company's independent registered public accounting firm, Stonefield Josephson, Inc., in performing its audit of management's assessment of the effectiveness of internal control over financial reporting pursuant to SOX 404.

The filing of the above mentioned disclaimer does not comply with the SEC's rules and regulations under Section 404, and this noncompliance has resulted in the Company 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.

During 2005, the Company has taken steps to comply with Section 404, as of December 31, 2005 including hiring independent consulting firms, Assurance Consulting 3 in January 2005 and Login Financial in July 2005, to assist the Company with its Section 404 compliance and to identify and propose remedial actions to address and mitigate deficiencies in internal controls over financial reporting. In addition, beginning July 2005 the Company has devoted additional internal resources including having an executive manager lead the SOX 404 compliance effort on a full time basis. Also, beginning August 2005, management allocated a consultant from Login Financial to our South Korean operations and re-evaluated our controls as well as implemented additional control procedures. The Company's evaluation included revising our documentation, re-performing walkthroughs and re-testing our internal controls. In addition, on November 14, 2005 management hired an additional Big 4 third party consultant who is experienced in the SOX 404 effort for companies operating in South Korea to address and mitigate material deficiencies during the fourth quarter of 2005 and into 2006. Even though the Company devoted these resources, considering the nature of the Company's operations having substantial presence in South Korea in addition to the Company's US operations in Texas and California as well as the amount of time, financial resources, complexity associated with Section 404 compliance, limited financial resources of the Company and management's late start in identifying and documenting its internal controls, the Company's auditors advised the Company and the Audit Committee of the Board of Directors that they believed it was highly unlikely that the Company's management would be able to finish its testing and assessment of the Company's internal controls in time for them to begin their testing of management's assertions over internal controls by the end of fiscal year 2005 in accordance with the standards of Section 404.

In the ongoing process of making our assessment of internal control over financial reporting, management used the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Although our work is incomplete, as of the date of this quarterly report, of the various control procedures that we have documented, performed walkthroughs, and tested as of November 18, 2005, management has identified several control deficiencies, some of which have been determined to be material weaknesses in internal control over financial reporting as follows.



1. ***Lack of adequate segregation of duties in the Company's South Korean Operations in accounts receivable involving cash receipts, shipping, delivery of products and customer invoice reconciliations.***

This deficiency resulted from the fact that the processes utilized at the Company's Korean Operations were designed to meet certain Korean business practices whereby invoices are created once a month, the invoices are confirmed by the customer prior to being sent to and received by the customer, and payments of invoices are done only through wire transfers. As part of these Korean business practices, tax invoices are generated by sellers of goods and are issued to customers as formal documents required by the Korean government to immediately document and report sales for income tax purposes.

Previously, these processes were handled by the accounting and sales departments in the Korean Operations, and to mitigate the risk of fraud or error, the Company relied on the fact that all invoices were confirmed with the customer prior to recognizing revenue, all cash receipts were received via wire transfer, and revenue accounts were reconciled by accounting on a monthly basis. Nevertheless, the Company's former auditor has informed the Company that these processes lacked certain formal documentation and segregation of duties. To remediate these weaknesses, the Company implemented the following changes in its Korean Operations during November 2005

***Segregation of Duties:*** The tax invoices are now being created by a sales accountant, an individual who has dual duties in both Accounting and Sales in the Korean Operations, whereas previously, tax invoices were created by the Assistant Sales Manager responsible for delivery of the products to the customer. This segregation of the tax invoicing function from product deliveries is an additional control procedure to mitigate the risk of fraud or error.

***Sequential Documents:*** The Company has created an internal, sequential invoice system tracked directly by the Company's SAP system which summarizes the tax invoice created by the accounting department, delivery requisitions created by the production department, and the sales transaction report created by the sales department. This three-way matching system is an additional control to ensure that revenues are properly documented and reconciled at the end of each month.

***Additional Resources:*** In November 2005, the Company began devoting additional internal resources to the Korean accounting department to segregate duties further. This included having (1) the sales accountant create all tax invoices as mentioned under *Segregation of Duties* above, (2) the Assistant Sales Manager reconcile the delivery requisitions maintained in the Production Department, and (3) the Accounting Department control vendor creation in the purchasing module of our SAP reporting system. In addition, the Company is currently conducting a search for an accountant for the Korean operations to further augment control procedures.

2. ***Lack of adequate segregation of duties in the Company's Coatings Division in Texas in order processing and invoicing.***

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The Company's coatings business in Texas (the Coatings Business) is managed by two individuals, the Vice President of Coatings and the General Accountant. The accountant handles all of the front end processes, including purchase orders, sales orders, order fulfillment, and invoicing. To mitigate the risk of fraud or error, the Company previously relied on the fact that the back end processes for all orders (such as cash receipts, vendor management, customer management, collections, and review of the results of operations) are all handled by the Company's corporate office. In addition, the Company also relied on the fact that all sales orders, inventory management, and order fulfillment are handled through the Company's SAP system, which provides real-time monitoring and review.

Despite these measures, the Company's former auditor concluded that the lack of segregation of duties in the Coatings Business constituted a material weakness in the Company's internal controls over financial reporting. As a result, in September 2005, the Company instituted additional internal control procedures in its Coatings Business, including the following: (1) requiring that all orders be supported by a written purchase order containing the customer's letterhead and address, the part number and description, and the signature of the purchaser with terms and conditions, (2) requiring that all 3rd party vendor drop shipments be supported by shipping documents faxed or mailed to the Company by the vendor, (3) periodically performing on-site audits of the accounting procedures at the Coating Business by the Company's central corporate accounting group, the first of which has been performed in December 2005 and (4) hiring an additional Accounting Manager in December 2005 in the Corporate Accounting Group to further monitor the Coatings Business and other accounting functions.

3. ***Lack of adequate controls and documentation in the Company's South Korean Operations to evidence proper customer invoicing and revenue recognition in the proper period.***

The measures taken to remedy the deficiency described in number 1 above also served to remediate this deficiency.

4. ***Lack of progress in documenting, assessing and evaluating our internal controls in our South Korean Operations evidenced by aforementioned deficiencies of which remediations will need to be completed as of December 31, 2005.***

The Company's overall assessment of its internal controls, including documentation, walkthroughs, and testwork, commenced in February of 2005. Management believes that the Company's assessment of its controls in its U.S. operations has been substantially completed in December 2005, although due to limited financial resources, the Company was unable to begin its assessment of its Korean Operations until mid-to late 2005. The Company identified and, beginning in August of 2005, retained a bi-lingual consultant from Login Financial to work in the Company's Korean Operations on a full time basis to help with the SOX 404 compliance effort. In addition, to expedite the implementation process, the Company hired, in November 2005, a consultant from Price Waterhouse Coopers-Korea who is familiar with SOX 404 implementation for Korean companies. Nevertheless, the Company's former auditor informed the Company that they believed that progress at the Korean Operations on the SOX 404 process has not been sufficient to enable the Company to complete the process in time for compliance. Although the disclosure in this paragraph may not be characterized as a material weakness in internal controls per se (but instead constitutes an update on the Company's efforts regarding SOX 404 compliance), the Company has disclosed this information based on former auditor's recommendation.

5. ***Lack of controls over internal access to the Company's SAP system of reporting by unauthorized users.***

SAP is the Company's global enterprise resource planning (ERP) software that handles the Company's financial reporting on a real-time basis. Historically, access to SAP was controlled on an ad hoc basis by the Controller and the Vice President of Operations of the Company, and formal IT procedures for SAP administration were lacking. During September 2005, the Company hired an independent IT consultant specializing in SOX implementations specifically for the Company's global IT cycle. The Company has substantially completed its assessment of IT system controls, including improving the Company's internal access controls to its SAP system.

6. ***Manual performance of numerous procedures that could be automated using current reporting systems.***

Current manual procedures include (1) creating excel spreadsheet invoices to bill customers; (2) performing manual currency translations ( FX translation ) for financial reporting in U.S. dollars; and (3) using a manual purchase requisition system. While these procedures may be automated through modules in the SAP system, due to the significant financial investment necessary to automate these procedures in SAP, the Company is not able to automate these procedures at this time. However, beginning in August 2005, the Company implemented control procedures to mitigate risks associated with manual procedures including (1) requiring additional authorizations for all purchases, journal entries, and requisitions and (2) creating checklists for month end, customer/vendor creation, human resource filing, and revenue support to ensure propriety and completeness of the Company's accounting records.

The Company has devoted significant amount of financial and internal resources during 2005 and early part of 2006 to ensure compliance with SOX 404, and on January 16, 2006, Company's management believes that the Company has substantially completed its documentation, assessment and evaluation of its internal controls over financial reporting as of December 31, 2005. However, our independent auditors, Stonefield Josephson Inc., resigned on December 1, 2005, and on January 20, 2006, the Company hired Choi, Kim & Park LLP ( CKP ) as its new independent registered public accounting firm. While the Company has advised CKP of the foregoing weaknesses in internal controls, due to the untimeliness of the foregoing events, CKP was unable to satisfactorily complete their audit of the Company's internal control over financial reporting pursuant to SOX 404, and thus, have issued a disclaimer of an opinion on the company's internal control over financial reporting as of December 31, 2005 in the fiscal 2005 annual report on Form 10-K. The Company's management will continue to monitor potential changes in the legal and regulatory requirements of SOX 404, particularly the requirements for small public companies.



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 could potentially subject a company to these same investigations and penalties. Section 404 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 the Company has discussed its Section 404 noncompliance for 2004 and 2005 with the SEC, the Company cannot predict what action, if any, the SEC may take against the Company as a result of a failure to be compliant with its obligations under Section 404.

Changes in internal controls. The Company has made various changes to the internal controls over financial reporting during the third quarter ended September 30, 2005. These material changes are described in paragraphs 2, 5, and 6 above under the caption Update on Management's Assessment of Internal Control Over Financial Reporting. In addition the Company has previously disclosed as a material weakness a lack of adequate controls and monitoring of payroll process, as such function was outsourced to a third-party payroll processor that was not certified under SAS 70 (Type II). In August 2005, the Company remediated this weakness by retaining the services of ADP for payroll processing. ADP is certified under SAS 70 (Type II).

**PART II**

**OTHER INFORMATION**

**Item 1 Legal Proceedings**

There were no material developments in our legal proceedings during the current quarter.

**Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

On August 9, 2005, we completed a private placement (the Private Placement) of \$9.9 million in principal amount of new 7% Convertible Secured Promissory Notes due August 2007 (the 2005 Senior Notes). The issuance consisted of \$5.0 million cash, exchange of \$1.3 million in principal amount of previously issued 10% Senior Secured Notes Due July 29, 2005 (the July 2005 Notes), the exchange of \$3.0 million 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 \$0.6 million on the previously issued July 2005 Notes, and satisfaction of accrued interest of \$9 thousand previously issued June 2006 Notes. The 2005 Senior Notes were issued pursuant to a Securities Purchase Agreement dated effective as of August 2, 2005 among the Company, the purchasers of the 2005 Senior Notes, and the holders of previously issued July 2005 Notes and June 2006 Notes of the Company due June 2006.

The 2005 Senior 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 2005 Senior 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 6% Senior Secured Notes Due July 29, 2007 (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 2005 Senior 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 2005 Senior 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. The Warrants will expire on August 2, 2010.

In connection with the transaction, the Company, all purchasers of the 2005 Senior Notes, and all holders of previously issued notes entered into a single Amended and Restated Registration Rights Agreement that replaces the prior registration rights agreements entered into by the Company with the various noteholders. Under the Amended and Restated Registration Rights Agreement, the Company is required to file a resale registration statement for the shares underlying the 2005 Senior Notes and July 2007 Notes and warrants within ninety (90) days of the closing of the 2005 Senior Notes. The Company is required to cause this registration statement to become effective within 60 days after the Company receives the first written comments on the registration statement from the SEC, or if the SEC notifies the Company 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.

As of September 30, 2005, we have used \$1.0 million of the net proceeds from the Private Placement for working capital purposes and used \$2.6 million to repay principal and accrued interest from the previously issued notes.



**Item 6 Exhibits**

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

| <b>Exhibit Number</b> | <b>Description of Document</b>   |
|-----------------------|--|
| 31.1                  | Certification of the President and Chief Executive Officer, Ricardo A. Salas, as required by Section 3.02 of Sarbanes-Oxley Act of 2002                              |
| 31.2                  | Certification of Chief Financial Officer, Young Ham, as required by Section 3.02 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: August 4, 2006

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

Date: August 4, 2006

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