

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended **June 28, 2014**

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File No. **0-19621**

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

(Exact name of registrant as specified in its charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

41-1454591
(I.R.S. Employer
Identification No.)

7400 Excelsior Boulevard, Minneapolis, Minnesota
(Address of principal executive offices)

55426-4517
(Zip Code)

952-930-9000

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of August 8, 2014, there were outstanding 5,788,318 shares of the registrant's Common Stock, without par value.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

INDEX TO FORM 10-Q

	<u>Page</u>
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1.	
<u>Financial Statements</u>	<u>2</u>
<u>Consolidated Balance Sheets as of June 28, 2014 (unaudited) and December 28, 2013</u>	<u>2</u>
<u>Unaudited Consolidated Statements of Comprehensive Income for the Three Months and Six Months ended June 28, 2014 and June 29, 2013</u>	<u>3</u>
<u>Unaudited Consolidated Statements of Cash Flows for the Six Months ended June 28, 2014 and June 29, 2013</u>	<u>4</u>
<u>Notes to Unaudited Consolidated Financial Statements</u>	<u>6</u>
Item 2.	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>16</u>
Item 3.	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>27</u>
Item 4.	
<u>Controls and Procedures</u>	<u>27</u>
<u>PART II. OTHER INFORMATION</u>	
Item 1.	
<u>Legal Proceedings</u>	<u>28</u>
Item 2.	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>28</u>
Item 3.	
<u>Defaults Upon Senior Securities</u>	<u>28</u>
Item 5.	
<u>Other Information</u>	<u>28</u>
Item 6.	
<u>Exhibits</u>	<u>29</u>
<u>SIGNATURES</u>	<u>30</u>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

**APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
CONSOLIDATED BALANCE SHEETS
(In Thousands)**

	June 28, 2014	December 28, 2013
ASSETS	(unaudited)	
Current assets:		
Cash and cash equivalents	\$ 2,534	\$ 1,948
Accounts receivable, net of allowance of \$43 and \$27, respectively	11,839	12,278
Inventories, net of reserves of \$227 and \$175, respectively	17,345	16,654
Income taxes receivable	111	82
Other current assets	782	622
Deferred income tax assets	523	523
Total current assets	33,134	32,107
Property and equipment, net	11,718	11,424
Restricted cash	—	500
Other assets	840	927
Deferred income tax assets	21	21
Total assets (a)	\$ 45,713	\$ 44,979
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 6,415	\$ 5,880
Accrued expenses	3,970	4,806
Line of credit	8,371	9,661
Current maturities of long-term obligations	1,196	1,131
Income taxes payable	270	—
Total current liabilities	20,222	21,478
Long-term obligations, less current maturities	5,592	5,447
Deferred income tax liabilities	1,092	1,092
Total liabilities (a)	26,906	28,017
Commitments and contingencies		
Shareholders' equity:		
Common Stock, no par value; 10,000 shares authorized; issued and outstanding: 5,581 shares and 5,571 shares, respectively	21,010	20,846
Accumulated deficit	(3,768)	(5,331)
Accumulated other comprehensive loss	(475)	(464)
Total shareholders' equity	16,767	15,051
Noncontrolling interest	2,040	1,911
	18,807	16,962
Total liabilities and shareholders' equity	\$ 45,713	\$ 44,979

(a) Assets of ARCA Advanced Processing, LLC (AAP), our consolidated variable interest entity, that can only be used to settle obligations of AAP were \$10,242 and \$9,949 as of June 28, 2014, and December 28, 2013, respectively. Liabilities of AAP for which creditors do not have recourse to the general credit of Appliance Recycling Centers of America, Inc. were \$2,211 and \$1,874 as of June 28, 2014, and December 28, 2013, respectively.

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In Thousands, Except Per Share Amounts)

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Revenues:				
Retail	\$ 17,461	\$ 17,801	\$ 34,062	\$ 35,860
Recycling	11,539	10,260	23,607	18,560
Byproduct	4,211	4,212	9,034	8,277
Total revenues	33,211	32,273	66,703	62,697
Costs of revenues	24,707	23,778	48,754	46,292
Gross profit	8,504	8,495	17,949	16,405
Selling, general and administrative expenses	7,296	7,295	14,671	14,780
Operating income	1,208	1,200	3,278	1,625
Other income (expense):				
Interest expense, net	(205)	(322)	(446)	(605)
Other income (expense), net	43	(7)	12	(20)
Income before income taxes and noncontrolling interest	1,046	871	2,844	1,000
Provision for income taxes	462	145	1,152	145
Net income	584	726	1,692	855
Net loss (income) attributable to noncontrolling interest	8	42	(129)	97
Net income attributable to controlling interest	\$ 592	\$ 768	\$ 1,563	\$ 952
Income per common share:				
Basic	\$ 0.11	\$ 0.14	\$ 0.28	\$ 0.17
Diluted	\$ 0.10	\$ 0.13	\$ 0.27	\$ 0.17
Weighted average common shares outstanding:				
Basic	5,581	5,556	5,579	5,556
Diluted	5,892	5,709	5,877	5,696
Net income	\$ 584	\$ 726	\$ 1,692	\$ 855
Other comprehensive income (loss), net of tax:				
Effect of foreign currency translation adjustments	70	(78)	(11)	(136)
Total other comprehensive income (loss), net of tax	70	(78)	(11)	(136)
Comprehensive income	654	648	1,681	719
Comprehensive loss (income) attributable to noncontrolling interest	8	42	(129)	97
Comprehensive income attributable to controlling interest	\$ 662	\$ 690	\$ 1,552	\$ 816

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Six Months Ended	
	June 28, 2014	June 29, 2013
Operating activities:		
Net income	\$ 1,692	\$ 855
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Depreciation and amortization	676	680
Share-based compensation	140	59
Amortization of deferred gain	(244)	(243)
Amortization of debt issuance costs	53	77
Other	32	15
Changes in assets and liabilities:		
Accounts receivable	402	(3,082)
Inventories	(691)	3,234
Other current assets	(189)	42
Other assets	(6)	(36)
Accounts payable and accrued expenses	(57)	1,376
Income taxes payable	270	91
Net cash flows provided by operating activities	2,078	3,068
Investing activities:		
Purchases of property and equipment	(216)	(103)
Decrease (increase) in restricted cash	500	(500)
Proceeds from sale of property and equipment	12	9
Net cash flows provided by (used in) investing activities	296	(594)
Financing activities:		
Net payments under line of credit	(1,290)	(2,501)
Payments on debt obligations	(515)	(444)
Proceeds from issuance of debt obligations	—	220
Proceeds from issuance of Common Stock	24	—
Payment of debt issuance costs	—	(129)
Net cash flows used in financing activities	(1,781)	(2,854)
Effect of changes in exchange rate on cash and cash equivalents	(7)	(135)
Increase (decrease) in cash and cash equivalents	586	(515)
Cash and cash equivalents at beginning of period	1,948	3,174
Cash and cash equivalents at end of period	\$ 2,534	\$ 2,659

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Six Months Ended	
	June 28, 2014	June 29, 2013
Supplemental disclosures of cash flow information:		
Cash payments for interest	\$ 390	\$ 473
Cash payments for income taxes, net of refunds	\$ 910	\$ 54
Non-cash investing and financing activities:		
Equipment acquired under capital lease and other financing obligations	\$ 725	\$ 56
Accrued debt issuance costs related to amended credit agreement	\$ —	\$ 11

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

1. Nature of Business and Basis of Presentation

Appliance Recycling Centers of America, Inc. and subsidiaries (“we,” the “Company” or “ARCA”) are in the business of providing turnkey appliance recycling and replacement services for electric utilities and other sponsors of energy efficiency programs. We also sell new major household appliances through a chain of Company-owned stores under the name ApplianceSmart®. In addition, we have a 50% interest in a joint venture operating under the name ARCA Advanced Processing, LLC (“AAP”), which recycles appliances from twelve states in the Northeast and Mid-Atlantic regions of the United States for General Electric Company (“GE”) acting through its GE Appliances business component. These appliances include units manufactured by GE as well as by other manufacturers.

The accompanying consolidated financial statements of the Company are unaudited and have been prepared in accordance with generally accepted accounting principles (“GAAP”) in the United States of America for interim financial information and Article 8 of Regulation S-X promulgated by the United States Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, normal and recurring adjustments and accruals considered necessary for a fair presentation for the periods indicated have been included. Operating results for the three- and six-month periods ended June 28, 2014, and June 29, 2013, are presented using 13- and 26-week periods, respectively. The results of operations for any interim period are not necessarily indicative of the results for the year.

These financial statements should be read in conjunction with the Company’s audited consolidated financial statements and related notes thereto for the year ended December 28, 2013, included in the Company’s Annual Report on Form 10-K filed with the SEC on March 14, 2014.

Principles of consolidation: The consolidated financial statements include the accounts of Appliance Recycling Centers of America, Inc. and our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

ApplianceSmart, Inc., a Minnesota corporation, is a wholly owned subsidiary that was formed through a corporate reorganization in July 2011 to hold our business of selling new major household appliances through a chain of Company-owned retail stores. ARCA Canada Inc., a Canadian corporation, is a wholly owned subsidiary that was formed in September 2006 to provide turnkey recycling services for electric utility energy efficiency programs. ARCA Recycling, Inc., a California corporation, is a wholly owned subsidiary that was formed in November 1991 to provide turnkey recycling services for electric utility efficiency programs. The operating results of our wholly owned subsidiaries are consolidated in our financial statements.

AAP is a joint venture that was formed in October 2009 between ARCA and 4301 Operations, LLC (“4301”) to support ARCA’s agreement, as amended, with GE acting through its GE Appliances business component. Both ARCA and 4301 have a 50% interest in AAP. GE sells its recyclable appliances generated from twelve states in the Northeast and Mid-Atlantic regions of the United States to ARCA, which collects, processes and recycles the appliances. The agreement requires that ARCA will only recycle, and will not sell for re-use or resale, the recyclable appliances purchased from GE. AAP established a regional processing center in Philadelphia, Pennsylvania, at which the recyclable appliances are processed. The term of the agreement is for six years from the first date of appliance collection, which was March 31, 2010. AAP commenced operations in February 2010 and has the exclusive rights to service the GE agreement as a subcontractor for ARCA. The financial position and results of operations of AAP are consolidated in our financial statements based on our conclusion that AAP is a variable interest entity due to our contribution in excess of 50% of the total equity, subordinated debt and other forms of financial support. We have a controlling financial interest in AAP, through our contractual agreement with GE which is material to AAP and we have provided substantially all of the financial support to fund the operations of AAP since its inception.

Fair value of financial instruments: The following methods and assumptions are used to estimate the fair value of each class of financial instrument:

Cash and cash equivalents, accounts receivable and accounts payable: Due to their nature and short-term maturities, the carrying amounts approximate fair value.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

Short- and long-term debt: The fair value of short- and long-term debt approximates carrying value and has been estimated based on discounted cash flows using interest rates being offered for similar debt having the same or similar remaining maturities and collateral requirements.

No separate comparison of fair values versus carrying values is presented for the aforementioned financial instruments since their fair values are not significantly different than their balance sheet carrying amounts. In addition, the aggregate fair values of the financial instruments would not represent the underlying value of our Company.

2. Significant Accounting Policies

Trade receivables: We carry unsecured trade receivables at the original invoice amount less an estimate made for doubtful accounts based on a monthly review of all outstanding amounts. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history and current economic conditions. We write off trade receivables when we deem them uncollectible. We record recoveries of trade receivables previously written off when we receive them. We consider a trade receivable to be past due if any portion of the receivable balance is outstanding for more than ninety days. We do not charge interest on past due receivables. Our management considers the allowance for doubtful accounts of \$43 and \$27 to be adequate to cover any exposure to loss as of June 28, 2014, and December 28, 2013, respectively.

Inventories: Inventories, consisting principally of appliances, are stated at the lower of cost, determined on a specific identification basis, or market and consist of:

	June 28, 2014	December 28, 2013
Appliances held for resale	\$ 17,116	\$ 16,449
Processed metals from recycled appliances held for resale	456	380
Less provision for inventory obsolescence	(227)	(175)
	<u>\$ 17,345</u>	<u>\$ 16,654</u>

We provide estimated provisions for the obsolescence of our appliance inventories, including adjustments to market, based on various factors, including the age of such inventory and our management's assessment of the need for such provisions. We look at historical inventory agings and margin analysis in determining our provision estimate. A revised cost basis is used once a provision for obsolescence is recorded.

Property and equipment: Property and equipment consists of the following:

	June 28, 2014	December 28, 2013
Land	\$ 1,140	\$ 1,140
Buildings and improvements	3,281	3,273
Equipment (including computer software)	21,412	20,561
Projects under construction	91	63
	<u>25,924</u>	<u>25,037</u>
Less accumulated depreciation and amortization	(14,206)	(13,613)
	<u>\$ 11,718</u>	<u>\$ 11,424</u>

Software development costs: We capitalize software developed for internal use and are amortizing such costs over their estimated useful lives of three years. Costs capitalized were \$52 and \$39 for the three months ended June 28, 2014, and June 29, 2013, respectively. Costs capitalized were \$74 and \$63 for the six months ended June 28, 2014, and June 29, 2013, respectively.

Restricted cash: Restricted cash consists of a reserve required by our bankcard processor to cover chargebacks, adjustments, fees and other charges that may be due from us. During the second quarter of 2014, our bankcard processor released the entire reserve.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

Product warranty: We provide a warranty for the replacement or repair of certain defective units, which varies based on the product sold. Our standard warranty policy requires us to repair or replace certain defective units at no cost to our customers. We estimate the costs that may be incurred under our warranty and record an accrual in the amount of such costs at the time we recognize product revenue. Factors that affect our warranty accrual for covered units include the number of units sold, historical and anticipated rates of warranty claims on these units, and the cost of such claims. We periodically assess the adequacy of our recorded warranty accrual and adjust the amounts as necessary.

Changes in our warranty accrual are as follows:

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Beginning Balance	\$ 30	\$ 42	\$ 34	\$ 47
Standard accrual based on units sold	10	15	16	26
Actual costs incurred	(4)	(4)	(8)	(8)
Periodic accrual adjustments	(5)	(12)	(11)	(24)
Ending Balance	<u>\$ 31</u>	<u>\$ 41</u>	<u>\$ 31</u>	<u>\$ 41</u>

Revenue recognition: We recognize revenue from appliance sales in the period the consumer purchases and pays for the appliance, net of an allowance for estimated returns. We recognize revenue from appliance recycling when we collect and process a unit. We recognize revenue generated from appliance replacement programs when we deliver the new appliance and collect and process the old appliance. The delivery, collection and processing activities under our replacement programs typically occur within one business day and are required to complete the earnings process; there are no other performance obligations. We recognize byproduct revenue upon shipment. We recognize revenue on extended warranties with retained service obligations on a straight-line basis over the period of the warranty. On extended warranty arrangements that we sell but others service for a fixed portion of the warranty sales price, we recognize revenue for the net amount retained at the time of sale of the extended warranty to the consumer. As a result of our recycling processes, we are able to produce carbon offsets from the destruction of certain types of ozone-depleting refrigerants. We record revenue from the sale of carbon offsets in the period when all of the following requirements have been met: (i) there is persuasive evidence of an arrangement, (ii) the sales price is fixed or determinable, (iii) title, ownership and risk of loss associated with the credits have been transferred to the customer, and (iv) collectability is reasonably assured. These requirements are met upon collection of cash due to the uncertainty around collectability and the involvement of various third parties and partners. We include shipping and handling charges to customers in revenue, which are recognized in the period the consumer purchases and pays for delivery.

Retail segment cost of revenues: Costs of revenues in our retail segment are comprised primarily of the following:

- Purchase of appliance inventories, including freight to and from our distribution centers;
- Shipping, receiving and distribution of appliance inventories to our retail stores, including employee compensation and benefits;
- Delivery and service of appliances, including employee compensation and benefits, after the appliances are sold to the consumer;
- Early payment discounts and allowances offered by appliance manufacturers; and
- Inventory markdowns and shortages.

Recycling segment cost of revenues: Costs of revenues in our recycling segment are comprised primarily of the following:

- Transportation costs, including employee compensation and benefits, related to collecting appliances for recycling and delivering appliances under our replacement programs;
- Purchase of appliance inventories, including freight to our recycling center warehouses, early payment discounts, and warehousing costs for appliances used in our replacement programs;
- Cost of recyclable appliances purchased under our GE contract; and
- Processing costs, including employee compensation and benefits, related to recycling and processing appliances.

Selling, general and administrative expenses: Selling, general and administrative expenses are comprised primarily of the following:

- Employee compensation and benefits related to management, corporate services, and retail sales;

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

- Outside and outsourced corporate service fees;
- Occupancy costs related to our retail stores and corporate office;
- Advertising costs;
- Bank charges and costs associated with credit and debit card interchange fees; and
- Other administrative costs, such as supplies, travel and lodging.

Share-based compensation: We recognize share-based compensation expense on a straight-line basis over the expected vesting period for share-based awards granted. We use the Black-Scholes option pricing model to determine the fair value of awards at the grant date. We calculate the expected volatility for stock awards using historical volatility. We estimate a 0%-5% forfeiture rate for stock awards issued to all employees and members of the Board of Directors, but will continue to review these estimates in future periods. The risk-free rates for the expected terms of the stock awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life represents the period that the stock awards are expected to be outstanding. The expected dividend yield is zero as we have not paid or declared any cash dividends on our Common Stock. Based on these valuations, we recognized share-based compensation expense of \$92 and \$55 for the three months ended June 28, 2014, and June 29, 2013, respectively, and \$140 and \$59 for the six months ended June 28, 2014 and June 29, 2013, respectively.

Based on the value of options outstanding as of June 28, 2014, estimated future share-based compensation expense is as follows:

Fiscal year 2014	215
Fiscal year 2015	191
Fiscal year 2016	113
Fiscal year 2017	15
	\$ 534

The estimate above does not include any expense for additional options that may be granted and vest during 2014, 2015, 2016 and 2017.

Income taxes: We account for income taxes under the liability method. Deferred tax liabilities are recognized for temporary differences that will result in taxable amounts in future years. Deferred tax assets are recognized for deductible temporary differences and tax operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and record a valuation allowance to reduce our deferred tax assets to the amounts we believe to be realizable. We regularly evaluate both positive and negative evidence related to either recording or retaining a valuation allowance against our deferred tax assets.

Comprehensive income (loss): Other comprehensive income (loss) refers to revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income (loss) but are excluded from net income (loss) as these amounts are recorded directly as an adjustment to shareholders' equity. Our other comprehensive income (loss) is comprised of foreign currency translation adjustments.

Basic and diluted income per share: Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per common share is computed based on the weighted average number of common shares outstanding adjusted by the number of additional shares that would have been outstanding had the potentially dilutive common shares been issued. Potentially dilutive shares of Common Stock include unexercised stock options and warrants. Basic per share amounts are computed, generally, by dividing net income attributable to controlling interest by the weighted average number of common shares outstanding. Diluted per share amounts assume the conversion, exercise or issuance of all potential Common Stock instruments unless their effect is anti-dilutive, thereby reducing the loss or increasing the income per common share. In calculating diluted weighted average shares and per share amounts, we included stock options and warrants with exercise prices below average market prices, for the respective reporting periods in which they were dilutive, using the treasury stock method. We calculated the number of additional shares by assuming the outstanding stock options were exercised and that the proceeds from such exercises were used to acquire Common Stock at the average market price during the quarter. For the three and six months ended June 28, 2014, we excluded 386 and 375, respectively, options and warrants from the diluted weighted average share outstanding calculation as the effect of these options and warrants were anti-dilutive. For the three and six months

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

ended June 29, 2013, we excluded 612 and 550, respectively, options and warrants from the diluted weighted average shares outstanding calculation as the effect of these options were anti-dilutive.

A reconciliation of the denominator in the basic and diluted income or loss per share is as follows:

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Numerator:				
Net income attributable to controlling interest	\$ 592	\$ 768	\$ 1,563	\$ 952
Denominator:				
Weighted average shares outstanding — basic	5,581	5,556	5,579	5,556
Employee stock options	111	—	101	—
Stock warrants	200	153	197	140
Weighted average shares outstanding — diluted	5,892	5,709	5,877	5,696
Income per share:				
Basic	\$ 0.11	\$ 0.14	\$ 0.28	\$ 0.17
Diluted	\$ 0.10	\$ 0.13	\$ 0.27	\$ 0.17

3. Variable Interest Entity

The financial position and results of operations of AAP are consolidated in our financial statements based on our conclusion that AAP is a variable interest entity due to our contribution in excess of 50% of the total equity, subordinated debt and other forms of financial support. We have a controlling financial interest in AAP through our contractual agreement with GE, which is material to AAP, and we have provided substantially all of the financial support to fund the operations of AAP since its inception. The financial position and results of operations for AAP are reported in our recycling segment.

The following table summarizes the assets and liabilities of AAP as of June 28, 2014, and December 28, 2013:

	June 28, 2014	December 28, 2013
Assets		
Current assets	\$ 975	\$ 1,099
Property and equipment, net	9,136	8,713
Other assets	131	137
Total Assets	\$ 10,242	\$ 9,949
Liabilities		
Accounts payable	\$ 624	\$ 861
Accrued expenses	186	202
Current maturities of long-term debt obligations	871	797
Long-term debt obligations, net of current maturities	4,101	3,796
Other liabilities (a)	379	469
Total Liabilities	\$ 6,161	\$ 6,125

(a) Other liabilities represent loans between ARCA and AAP that are eliminated in consolidation.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

The following table summarizes the operating results of AAP for the three and six months ended June 28, 2014, and June 29, 2013:

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Revenues	\$ 2,628	\$ 2,667	\$ 5,452	\$ 5,244
Gross profit	546	434	1,436	750
Operating income (loss)	51	(6)	393	(59)
Net income (loss)	(17)	(83)	257	(193)

4. Other Assets

Other assets as of June 28, 2014, and December 28, 2013, consist of the following:

	June 28, 2014	December 28, 2013
Deposits	\$ 416	\$ 411
Recycling contract, net	140	179
Debt issuance costs, net	225	278
Patent costs	21	21
Goodwill	38	38
	<u>\$ 840</u>	<u>\$ 927</u>

For the three months ended June 28, 2014, and June 29, 2013, we recorded amortization expense of \$20 and \$20, respectively, related to our recycling contract. For the six months ended June 28, 2014, and June 29, 2013, we recorded amortization expense of \$39 and \$40, respectively, related to our recycling contract. For the three months ended June 28, 2014, and June 29, 2013, we recorded non-cash interest expense of \$26 and \$28, respectively, related to debt issuance costs. For the six months ended June 28, 2014, and June 29, 2013, we recorded non-cash interest expense of \$53 and \$77, respectively, related to debt issuance costs.

5. Accrued Expenses

Accrued expenses as of June 28, 2014, and December 28, 2013, consist of the following:

	June 28, 2014	December 28, 2013
Compensation and benefits	\$ 988	\$ 1,317
Accrued incentive and rebate checks	439	461
Accrued rent	799	1,121
Warranty expense	31	34
Accrued payables	263	437
Current portion of deferred gain on sale-leaseback of building	122	365
Deferred revenue	319	346
Other	1,009	725
	<u>\$ 3,970</u>	<u>\$ 4,806</u>

6. Line of Credit

On January 24, 2011, we entered into a Revolving Credit, Term Loan and Security Agreement, as amended, (“Revolving Credit Agreement”) with PNC Bank, National Association (“PNC”) that provides us with a \$15,000 revolving line of credit. See Note 8 for further discussion regarding the Term Loan entered into with PNC. The Revolving Credit Agreement has a stated maturity date of January 24, 2016, if not renewed. The Revolving Credit Agreement includes a lockbox agreement and a subjective

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

acceleration clause and as a result we have classified the revolving line of credit as a current liability. The Revolving Credit Agreement is collateralized by a security interest in substantially all of our assets and PNC is also secured by an inventory repurchase agreement with Whirlpool Corporation for Whirlpool purchases only. We also issued a \$750 letter of credit in favor of Whirlpool Corporation. The Revolving Credit Agreement requires starting with the fiscal quarter ending March 29, 2014, and continuing at the end of each quarter thereafter, that we meet a minimum fixed charge coverage ratio of 1.1 to 1.0, measured on a trailing twelve-month basis. The Revolving Credit Agreement limits investments we can purchase, the amount of other debt and leases we can incur, the amount of loans we can issue to our affiliates and the amount we can spend on fixed assets, along with prohibiting the payment of dividends. As of June 28, 2014 and December 28, 2013, we were in compliance with all covenants under the Revolving Credit Agreement.

The interest rate on the revolving line of credit is PNC Base Rate plus 1.75%, or 1-, 2- or 3-month PNC LIBOR Rate plus 2.75%. The PNC Base Rate shall mean, for any day, a fluctuating per annum rate of interest equal to the highest of (i) the interest rate per annum announced from time to time by PNC at its prime rate, (ii) the Federal Funds Open Rate plus 0.5%, and (iii) the one-month LIBOR rate plus 100 basis points (1%). As of June 28, 2014, the outstanding line of credit balance was \$8,371 with a weighted average interest rate of 3.12%. As of December 28, 2013, the outstanding line of credit balance was \$9,661 with a weighted average interest rate of 4.27%, which included both PNC LIBOR Rate and PNC Base Rate loans.

The amount of revolving borrowings under the Revolving Credit Agreement is based on a formula using accounts receivable and inventories. We may not have access to the full \$15,000 revolving line of credit due to the formula using accounts receivable and inventories, the amount of the letter of credit issued in favor of Whirlpool Corporation and the amount of outstanding loans between PNC and our AAP joint venture. As of June 28, 2014, and December 28, 2013, our available borrowing capacity under the Revolving Credit Agreement was \$5,755 and \$3,966, respectively.

7. Deferred Gain

In connection with the September 25, 2009, sale-leaseback of our St. Louis Park, Minnesota, building, we recorded a deferred gain of \$2,436. The deferred gain is being amortized over the initial lease period of five years. For the three months ended June 28, 2014, and June 29, 2013, we amortized \$122 and \$122, respectively, of the deferred gain. For the six months ended June 28, 2014, and June 29, 2013, we amortized \$244 and \$243, respectively, of the deferred gain. The deferred gain amortization is netted against rent expense as a component of selling, general and administrative expenses in the consolidated statements of comprehensive income.

8. Borrowings

Long-term debt, capital lease and other financing obligations as of June 28, 2014, and December 28, 2013, consist of the following:

	June 28, 2014	December 28, 2013
PNC term loan	\$ 1,658	\$ 1,785
Susquehanna term loans	3,571	3,783
2.75% note, due in monthly installments of \$3, including interest, due October 2024, collateralized by equipment	366	381
10.00% note, due in monthly installments of \$13, including interest, due December 2014	75	147
Capital leases and other financing obligations	1,118	482
	<u>6,788</u>	<u>6,578</u>
Less current maturities	1,196	1,131
	<u>\$ 5,592</u>	<u>\$ 5,447</u>

On January 24, 2011, we entered into a \$2,550 Term Loan ("Term Loan") with PNC Bank to refinance the mortgage on our California facility. The Term Loan is payable as follows, subject to acceleration upon the occurrence of an event of default or termination of the Revolving Credit Agreement: 119 consecutive monthly principal payments of \$21 plus interest commencing

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

on February 1, 2011, and continuing on the first day of each month thereafter followed by a 120th payment of all unpaid principal, interest and fees on February 1, 2021. If the Revolving Credit Agreement is not renewed, a balloon payment of \$1,254 in principal plus interest and additional fees will be due on January 24, 2016. The Term Loan is collateralized with our California facility located in Compton, California. The interest rate is PNC Base Rate plus 2.25%, or 1-, 2- or 3-month PNC LIBOR Rate plus 3.25%. As of June 28, 2014, and December 28, 2013, the weighted average interest rate was 3.61% and 5.50%, respectively, which included both PNC LIBOR Rate and PNC Base Rate loans.

On March 10, 2011, ARCA Advanced Processing, LLC entered into three separate commercial term loans ("AAP Term Loans") with Susquehanna Bank, pursuant to the guidelines of the U.S. Small Business Administration 7(a) Loan Program. The total amount of the AAP Term Loans is \$4,750, split into three separate loans for \$2,100; \$1,400; and \$1,250. The AAP Term Loans mature in ten years and bear an interest rate of Prime plus 2.75%. As of June 28, 2014, and December 28, 2013, the interest rate was 6.00%. Borrowings under the AAP Term Loans are secured by substantially all of the assets of AAP along with liens on the business assets and certain personal assets of the owners of 4301 Operations, LLC. We are a guarantor of the AAP Term Loans along with 4301 Operations, LLC and its owners.

Capital leases and other financing obligations: We acquire certain equipment under capital leases and other financing obligations. The cost of the equipment was approximately \$2,728 and \$2,020 as of June 28, 2014, and December 28, 2013, respectively. Accumulated amortization as of June 28, 2014, and December 28, 2013, was approximately \$1,662 and \$1,630, respectively. Depreciation and amortization expense is included in cost of revenues and selling, general and administrative expenses.

9. Commitments and Contingencies

Contracts: We have entered into material contracts with three appliance manufacturers. Under the agreements there are no minimum purchase commitments; however, we have agreed to indemnify the manufacturers for certain claims, allegations or losses with respect to appliances we sell.

Litigation: We are party from time to time to ordinary course disputes that we do not believe to be material or have merit. We intend to vigorously defend ourselves against these ordinary course disputes.

Sales and Use Taxes: We operate in twenty-three states in the U.S. and in various provinces in Canada. From time to time, we are subject to sales and use tax audits that could result in additional taxes, penalties and interest owed to various taxing authorities. The California Board of Equalization is currently conducting a sales and use tax examination covering our California operations for 2011, 2012 and 2013. A large portion of the California operations in those years consisted of appliance replacement sales under programs conducted by utility companies on which we did not assess, collect or remit sales tax. For several reasons, including the fact that these replacement programs benefit low-income utility customers with ratepayer funds, we believe such transactions could be exempt from taxation. It is possible that the California Board of Equalization will disagree with our position and assess taxes, penalties and interest in an amount that is material to our financial position and results of operations. We intend to vigorously advance and defend our position in cooperation with local utilities and governmental regulatory entities should taxes, penalties and interest be assessed by the California Board of Equalization. At this time, we cannot estimate a range of potential impact on our consolidated financial statements.

10. Income Taxes

Our overall effective tax rate, based on projected full-year taxable income, was 40.5% and 14.5% for the six months ended June 28, 2014 and June 29, 2013, respectively. The overall effective tax rate for the three months ended June 28, 2014 and June 29, 2013 was 44.2% and 16.6%, respectively. The higher tax rate in 2014 is attributable to the use of a net operating loss with a corresponding valuation allowance in the three and six months ended June 29, 2013. The effective tax rate varies from the federal statutory rate of 34% due primarily to the impact of state taxes and share-based compensation.

We regularly evaluate both positive and negative evidence related to retaining a valuation allowance against our deferred tax assets. The realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to be available to reduce taxable income. We have concluded based on the weight of negative evidence that a valuation allowance should be maintained against certain deferred tax assets that we do not expect to utilize as of June 28, 2014.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

11. Shareholders' Equity

Stock options: The 2011 Stock Compensation Plan (the "2011 Plan") authorizes the granting of awards in any of the following forms: (i) stock options, (ii) stock appreciation rights, and (iii) other share-based awards, including but not limited to restricted stock, restricted stock units or performance shares and expires on the earlier of May 12, 2021, or the date that all shares reserved under the 2011 Plan are issued or no longer available.

The 2011 Plan provides for the issuance of up to 700 shares of Common Stock pursuant to awards granted under the 2011 Plan. Options granted to employees typically vest over two to three years while grants to non-employee directors vest in six months. As of June 28, 2014, 537 options were outstanding under the 2011 Plan. Our 2006 Stock Option Plan (the "2006 Plan") expired on June 30, 2011, but the options outstanding under the 2006 Plan continue to be exercisable in accordance with their terms. As of June 28, 2014, 381 options were outstanding under the 2006 Plan. Our Restated 1997 Stock Option Plan (the "1997 Plan") has expired, but the options outstanding under the expired 1997 Plan continue to be exercisable in accordance with their terms. As of June 28, 2014, options to purchase an aggregate of 8 shares were outstanding under the 1997 Plan.

During 2014, we granted 170 stock options from our 2011 Plan with exercise prices ranging from \$2.89 per share to \$3.47 per share, vesting periods ranging from six months to three years and weighted average fair values ranging from \$2.21 per share to \$2.94 per share.

The following table summarizes the weighted-average assumptions used to estimate the fair value of stock options granted during fiscal 2014 to date using the Black-Scholes Model:

Expected dividend yield	—
Expected stock price volatility	86.4%
Risk-free interest rate	2.2%
Expected life of options (years)	7.71

Stock warrants: As of June 28, 2014, we had warrants outstanding to purchase 278 shares of common stock that were fully vested and have exercise prices ranging from \$0.73 per share to \$3.55 per share, which begin to expire in October 2019. On June 30, 2014, a warrant was exercised to purchase 254 shares of common stock with a strike price of \$0.73 per share. The warrant was exercised on cashless basis and the warrant holder forfeited 47 shares of common stock at a market price of \$3.99 per share which resulted in the warrant holder receiving 207 shares.

Preferred Stock: Our amended Articles of Incorporation authorize two million shares of Preferred Stock that may be issued from time to time in one or more series having such rights, powers, preferences and designations as the Board of Directors may determine. To date no such preferred shares have been issued.

12. Segment Information

We operate within targeted markets through two reportable segments: retail and recycling. The retail segment is comprised of income generated through our ApplianceSmart stores, which includes appliance sales and byproduct revenues from collected appliances. The recycling segment includes all fees charged and costs incurred for collecting, recycling and installing appliances for utilities and other customers and includes byproduct revenue, which is primarily generated through the recycling of appliances. We have included the results from consolidating AAP in our recycling segment. The nature of products, services and customers for both segments varies significantly. As such, the segments are managed separately. Our Chief Executive Officer has been identified as the Chief Operating Decision Maker ("CODM"). The CODM evaluates performance and allocates resources based on revenues and income from operations of each segment. Income from operations represents revenues less cost of revenues and operating expenses, including certain allocated selling, general and administrative costs. There are no inter-segment sales or transfers.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

The following tables present our segment information for periods indicated:

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Revenues:				
Retail	\$ 17,692	\$ 18,111	\$ 34,629	\$ 36,432
Recycling	15,519	14,162	32,074	26,265
Total revenues	<u>\$ 33,211</u>	<u>\$ 32,273</u>	<u>\$ 66,703</u>	<u>\$ 62,697</u>
Operating income (loss):				
Retail	\$ (43)	\$ 129	\$ 60	\$ (53)
Recycling	1,402	1,229	3,529	2,021
Unallocated corporate	(151)	(158)	(311)	(343)
Total operating income	<u>\$ 1,208</u>	<u>\$ 1,200</u>	<u>\$ 3,278</u>	<u>\$ 1,625</u>
Assets:				
Retail	\$ 27,955	\$ 22,706	\$ 27,955	\$ 22,706
Recycling	13,223	13,410	13,223	13,410
Corporate assets not allocable	4,535	5,017	4,535	5,017
Total assets	<u>\$ 45,713</u>	<u>\$ 41,133</u>	<u>\$ 45,713</u>	<u>\$ 41,133</u>
Cash capital expenditures:				
Retail	\$ 3	\$ 6	\$ 3	\$ 6
Recycling	80	10	84	12
Corporate assets not allocable	77	42	129	85
Total cash capital expenditures	<u>\$ 160</u>	<u>\$ 58</u>	<u>\$ 216</u>	<u>\$ 103</u>
Depreciation and amortization:				
Retail	\$ 40	\$ 48	\$ 83	\$ 101
Recycling	220	201	430	395
Unallocated corporate	82	94	163	184
Total depreciation and amortization	<u>\$ 342</u>	<u>\$ 343</u>	<u>\$ 676</u>	<u>\$ 680</u>
Interest expense:				
Retail	\$ 60	\$ 134	\$ 125	\$ 246
Recycling	89	115	181	206
Unallocated corporate	56	74	140	154
Total interest expense	<u>\$ 205</u>	<u>\$ 323</u>	<u>\$ 446</u>	<u>\$ 606</u>

13. Recent Accounting Pronouncements

Revenue from Contracts with Customers: In May 2014, the Financial Accounting Standards Board (FASB) issued guidance creating Accounting Standards Codification (“ASC”) Section 606, “Revenue from Contracts with Customers”. The new section will replace Section 605, “Revenue Recognition” and creates modifications to various other revenue accounting standards for specialized transactions and industries. The section is intended to conform revenue accounting principles with a concurrently issued International Financial Reporting Standards with previously differing treatment between United States practice and those of much of the rest of the world, as well as, to enhance disclosures related to disaggregated revenue information. The updated guidance is effective for annual reporting periods beginning on or after December 15, 2016, and interim periods within those annual periods.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

We will adopt the new provisions of this accounting standard at the beginning of fiscal year 2017, given that early adoption is not an option. We will further study the implications of this statement in order to evaluate the expected impact on the consolidated financial statements.

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

Forward-Looking and Cautionary Statements

This quarterly report contains statements that are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Act of 1934, as amended. Any statements contained in this quarterly report that are not purely historical or relate to our future operations, performance and results, and anticipated liquidity are forward looking. These forward-looking statements are based on information available to us on the date of this quarterly report, but are subject to risks and uncertainties, including, but not limited to, those discussed herein. Our actual results could differ materially from those discussed in this quarterly report.

The forward-looking statements contained in this quarterly report, and other written and oral forward-looking statements made by us from time to time, are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Any forward-looking information regarding our operations will be affected primarily by individual retail stores' profitability, the volume of appliance sales, the strength of energy conservation recycling programs and general economic conditions affecting consumer demand for appliances. Any forward-looking information will also be affected by our continued ability to purchase product from our suppliers at acceptable prices, the ability of individual retail stores to meet planned revenue levels, the number of retail stores, costs and expenses being realized at higher than expected levels, our ability to secure an adequate supply of special-buy appliances for resale, the ability to secure appliance recycling and replacement contracts with sponsors of energy efficiency programs, the ability of customers to supply units under their recycling contracts with us, the performance of our consolidated variable interest entity, the continued availability of our current line of credit and the outcome of the pending sale and use tax examination in California. Other factors that might cause such a difference include, but are not limited to, those discussed in Item 1A "Risk Factors" in our annual report on Form 10-K for the year ended December 28, 2013.

The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our operations and financial condition. This discussion should be read with the consolidated financial statements appearing in Item 1.

Overview

We operate two reportable segments: recycling and retail. Our recycling segment includes all income generated from collecting, recycling and installing appliances for utilities and other customers and includes a significant portion of our byproduct revenue, which is primarily generated through the recycling of appliances. Our recycling segment also includes all income generated from our agreement with General Electric ("GE") acting through its GE Appliances business component. GE sells its recyclable appliances in certain regions of the United States to us and we collect, process and recycle the appliances. These appliances include units manufactured by GE as well as by other manufacturers. The agreement requires that we will only recycle, and will not sell for re-use or resale, the recyclable appliances purchased from GE. We have established Regional Processing Centers ("RPCs") in Philadelphia and Louisville to support our agreement with GE. The RPC in Philadelphia is operated by ARCA Advanced Processing, LLC ("AAP") through a joint venture agreement between ARCA and 4301 Operations, LLC ("4301"). Our retail segment is comprised of income generated from the sale of appliances through ApplianceSmart® stores and includes a small portion of our byproduct revenues from collected appliances.

Our business components are uniquely positioned in the industry to work together to provide a full array of appliance-related services. ApplianceSmart operates eighteen company-owned stores, sells new appliances directly to consumers and provides affordable ENERGY STAR® options for energy efficiency appliance replacement programs. Our eleven RPCs process appliances at end of life to remove environmentally damaging substances and produce byproducts for sale in North America. AAP employs advanced technology to refine traditional appliance recycling techniques to achieve optimal revenue-generating and environmental benefits. We are also the exclusive North American distributor for UNTHA Recycling Technology ("URT"), one of the world's leading manufacturers of technologically advanced refrigerator recycling systems and recycling facilities for electrical household appliances and electronic scrap.

[Table of Contents](#)

We believe the GE contract and AAP model are the future of appliance recycling and expect to open similar centers throughout the United States. We cannot predict when these centers may open or if the appropriate volumes can be obtained to support the AAP model at future locations.

Revenues and earnings in our recycling segment are impacted by seasonal variances, with the second and third quarters generally having higher levels of revenues and earnings. This seasonality is due primarily to our utility customers supporting more marketing and advertising during the spring and summer months. Our customers tend to promote the recycling programs more aggressively during the warmer months because they believe more people want to clean up their garages and basements during that time of the year. However, the addition of the GE agreement and some customers shifting to marketing their appliance recycling programs year-round has helped to mitigate some seasonality.

Our recycling segment typically operates three types of programs:

1. Fees charged for collecting and recycling appliances for utilities and other sponsors of energy efficiency programs.
2. Fees charged for recycling and replacing old appliances with new ENERGY STAR® appliances for energy efficiency programs sponsored by utilities.
3. Income generated through the processing of recyclable appliances purchased at our RPCs by selling the raw material separated during the recycling process.

Over the last twelve months, recycling-only programs continue to report declining revenues and volumes, while we have experienced growing revenues and volumes from our appliance replacement programs. We believe factors impacting this shift include a declining number of pre-1993 refrigerators eligible for recycling programs and a greater emphasis by utilities on promoting ENERGY STAR® appliances.

Our retail segment is similar to many other retailers in that it is seasonal in nature. Historically, the fourth quarter is our weakest quarter in terms of both revenues and earnings. We believe this is primarily because the fourth quarter includes several holidays during which consumers tend to focus less on purchasing major household appliances.

We derive revenues from the sale of carbon offsets created by the destruction of ozone-depleting CFCs captured at our ARCA and AAP regional processing centers. We expect to create carbon offsets and derive revenues in the future through California's market, but cannot predict the amount or frequency of carbon offset sales. Carbon offset sales are dependent on market conditions, including demand and acceptable market prices. During the six months ended June 28, 2014, the combination of ARCA and AAP recognized \$1.0 million in carbon offset revenues compared to none during the same period of the prior year.

We monitor specific economic factors such as retail trends, consumer confidence, manufacturing by the major appliance companies, sales of existing homes and mortgage interest rates as key indicators of industry demand, particularly in our retail segment. Competition in the home appliance industry is intense in the four retail markets we serve. This includes competition not only from independent retailers, but also from such major retailers as Sears, Best Buy, The Home Depot and Lowe's. We also closely monitor the metals and various other scrap markets because of the type of components recovered in our recycling process. This includes monitoring the *American Metal Market* and the regions throughout the U.S. where we have our recycling centers.

Reporting Period. Operating results for the three and six months ended June 28, 2014, and June 29, 2013, are presented using 13-week and 26-week periods. The results of operations for any interim period are not necessarily indicative of the results for the year.

Sales and Use Taxes Contingency. We operate in twenty-three states in the U.S. and in various provinces in Canada. From time to time, we are subject to sales and use tax audits that could result in additional taxes, penalties and interest owed to various taxing authorities. The California Board of Equalization is currently conducting a sales and use tax examination covering our California operations for 2011, 2012 and 2013. A large portion of the California operations in those years consisted of appliance replacement sales under programs conducted by utility companies on which we did not assess, collect or remit sales tax. For several reasons, including the fact that these replacement programs benefit low-income utility customers with ratepayer funds, we believe such transactions could be exempt from taxation. It is possible that the California Board of Equalization will disagree with our position and assess taxes, penalties and interest in an amount that is material to our financial position and results of operations. We intend to vigorously advance and defend our position in cooperation with local utilities and governmental regulatory entities should taxes,

penalties and interest be assessed by the California Board of Equalization. At this time, we cannot estimate a range of potential impact on our consolidated financial statements.

Results of Operations

The following table sets forth our consolidated financial data as a percentage of total revenues for the three and six months ended June 28, 2014, and June 29, 2013:

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Revenues:				
Retail	52.6 %	55.1 %	51.1 %	57.2 %
Recycling	34.7 %	31.8 %	35.4 %	29.6 %
Byproduct	12.7 %	13.1 %	13.5 %	13.2 %
Total revenues	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenues	74.4 %	73.7 %	73.1 %	73.8 %
Gross profit	25.6 %	26.3 %	26.9 %	26.2 %
Selling, general and administrative expenses	22.0 %	22.6 %	22.0 %	23.6 %
Operating income	3.6 %	3.7 %	4.9 %	2.6 %
Other income (expense):				
Interest expense, net	(0.6)%	(1.0)%	(0.7)%	(1.0)%
Other income (expense), net	0.1 %	— %	— %	— %
Income before income taxes and noncontrolling interest	3.1 %	2.7 %	4.2 %	1.6 %
Provision for income taxes	1.4 %	0.4 %	1.7 %	0.2 %
Net income	1.7 %	2.3 %	2.5 %	1.4 %
Net loss (income) attributable to noncontrolling interest	— %	0.1 %	(0.2)%	0.2 %
Net income attributable to controlling interest	1.7 %	2.4 %	2.3 %	1.6 %

For the Three Months Ended June 28, 2014, and June 29, 2013

The following table sets forth the key results of operations by segment for the three months ended June 28, 2014, and June 29, 2013 (dollars in millions):

	Three Months Ended		
	June 28, 2014	June 29, 2013	% Change
Revenues:			
Retail	\$ 17.7	\$ 18.1	(2)%
Recycling	15.5	\$ 14.2	10 %
Total revenues	<u>\$ 33.2</u>	<u>\$ 32.3</u>	3 %
Operating income (loss):			
Retail	\$ —	\$ 0.1	(133)%
Recycling	1.4	1.2	14 %
Unallocated corporate costs	(0.2)	(0.1)	4 %
Total operating income	<u>\$ 1.2</u>	<u>\$ 1.2</u>	1 %

Our total revenues of \$33.2 million for the three months ended June 28, 2014, increased 0.9 million or 3% from \$32.3 million for the same period of 2013. The change in segment revenues was attributed primarily to the following factors:

Retail Segment:

- Revenues were down \$0.4 million compared with the same period of 2013.
- Same-store and byproduct revenues declined by \$0.2 million and \$0.1 million, respectively compared with the same period of 2013.
- The closure of a store in the second quarter of 2013 resulted in a \$0.1 million decrease in revenues compared with the same period of 2013.

Recycling Segment:

- Revenues were up \$1.3 million compared with the same period of 2013.
- Appliance replacement program revenues increased by \$1.5 million compared with the same period of 2013.
- Recycling only program revenues declined by \$0.2 million compared with the same period of 2013.
- Byproduct revenues generated from the sale of raw materials were consistent with the same period of 2013.

Recycling segment revenues and retail segment revenues each include a portion of byproduct revenues. For the three months ended June 28, 2014, and June 29, 2013, the recycling segment accounted for approximately 95% and 93%, respectively of the byproduct revenues.

Retail segment revenues accounted for 53% of total revenues in the three months ended June 28, 2014, compared with 56% in the same period of 2013. The increase in appliance replacement program revenues impacted the overall mix of revenues between the retail and recycling segments for the three months ended June 28, 2014, compared with same period of 2013. Future revenues and related earnings from appliance replacement programs, if any, are uncertain and may fluctuate significantly from year to year. Factors impacting future appliance replacement program revenues and earnings include the type and scope of energy efficiency programs approved by regulatory agencies, competitive bidding, contract changes, non-renewals and early cancellations.

Our total operating income of \$1.2 million for the three months ended June 28, 2014, was consistent with the same period of 2013. The change in segment operating income was attributed primarily to the following factors:

Retail Segment:

- Operating income was down \$0.1 million compared with the same period of 2013.

[Table of Contents](#)

- Gross profit declined by \$0.3 million compared to the same period of the prior year due primarily to a favorable inventory reserve adjustment in the second quarter of 2013 that was not repeated in the second quarter of 2014.
- Store operating and occupancy expenses improved by \$0.2 million compared to the same period of 2013.

Recycling Segment:

- Operating income was up \$0.2 million compared with the same period of the prior year.
- The improvement was attributed primarily to the increase in appliance replacement and a 65% decline in the cost of certain recyclable appliances purchased by AAP. These two factors were partially offset by price compression under certain recycling contracts and higher general and administrative expenses to support the increased replacement revenues.

Revenues. Revenues for the three months ended June 28, 2014, and June 29, 2013, were as follows (dollars in millions):

	Three Months Ended		
	June 28, 2014	June 29, 2013	% Change
Retail	\$ 17.5	\$ 17.8	(2)%
Recycling	11.5	10.3	12 %
Byproduct	4.2	4.2	— %
	<u>\$ 33.2</u>	<u>\$ 32.3</u>	3 %

Retail Revenues. Our retail revenues of \$17.5 million for the three months ended June 28, 2014, decreased \$0.3 million, or 2%, from \$17.8 million for the same period of 2013. The decrease in retail revenues was due primarily to a decline in same-store sales along with the closure of an underperforming store that was operating for a portion of the three-month period in 2013. The store closure represented a \$0.1 million decline in revenues and same-store sales declined by \$0.2 million, or 1%. Our same-store sales includes contract sales, which increased to \$0.9 million compared to \$0.4 million in the same period of 2013. We are evaluating underperforming stores and stores with expiring leases that have a range of outcomes from right-sizing the showroom space to closure. We closed one underperforming store in May 2013 as a result of not renewing the lease.

Recycling Revenues. Our recycling revenues of \$11.5 million for the three months ended June 28, 2014, increased \$1.2 million, or 12%, from \$10.3 million in the same period of 2013. Recycling revenues are comprised of two components: (1) appliance recycling revenues generated by collecting and recycling appliances for utilities and other sponsors of energy efficiency programs and (2) replacement program revenues generated by recycling and replacing old appliances with new energy efficient models for programs sponsored by utility companies. Appliance recycling revenues decreased 6% to \$3.0 million for the three months ended June 28, 2014, compared with \$3.2 million in the same period of 2013, due primarily to lower volumes under certain contracts and the loss of certain contracts operating during the same three-month period of 2013, along with price compression under certain contracts. Revenue per-unit recycled declined by 5% compared with the same period of 2013. The number of units driving our appliance recycling revenues declined 1% compared with the same period of 2013. Appliance replacement program revenues increased 21% to \$8.5 million in the three months ended June 28, 2014, compared with \$7.1 million in the same period of 2013, due primarily to higher volumes and the mix of appliance replacements. Future revenues from appliance replacement programs, if any, are uncertain and may fluctuate significantly from period to period.

Byproduct Revenues. Our byproduct revenues of \$4.2 million for the three months ended June 28, 2014, were consistent with the same period of 2013. Byproduct revenues include all of the revenues generated by AAP. AAP revenues of \$2.6 million decreased \$0.1 million compared with the same period of 2013, due primarily to a 5% decline in recyclable appliances by weight compared with the same period of 2013. The decline in revenues was offset by an increase in revenues at ARCA due to the combination of high volumes and a higher average price per unit.

Total Gross Profit. Our gross profit of \$8.5 million for the three months ended June 28, 2014, was consistent with same period of 2013. Gross profit as a percentage of total revenues decreased to 25.6% for the three months ended June 28, 2014, compared with 26.3% in the same period of 2013. Our gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including:

1. The mix of retail products we sell.
2. The prices at which we purchase product from the major appliance manufacturers that supply product to us.

[Table of Contents](#)

3. The prices at which we can purchase recyclable appliances for processing at our RPCs.
4. The volume of appliances we receive through our recycling and replacement contracts.
5. The volume and price of byproduct materials.
6. The volume and price of carbon offset sales created by the destruction of ozone-depleting refrigerants.

Retail Segment Gross Profit Retail gross profit decreased by \$0.3 million to \$4.8 million compared with \$5.1 million in same period of 2013. The decline was primarily the result of a favorable inventory reserve adjustment recorded in the second quarter of 2013 that was not repeated in the second quarter of 2014. Gross profit as a percentage of related revenues decreased to 27.0% for the three months ended June 28, 2014, compared with 28.2% in the same period of 2013.

Recycling Segment Gross Profit Recycling gross profit increased by \$0.3 million to \$3.7 million compared with \$3.4 million in same period of 2013. The improvement was attributed primarily to the increase in appliance replacement volumes and lower cost of certain recyclable appliances purchased by AAP. Gross profit as a percentage of related revenues increased to 24.1% for the three months ended June 28, 2014, compared with 23.9% in the same period of 2013.

Selling, General and Administrative Expenses Our selling, general and administrative (“SG&A”) expenses of \$7.3 million for the three months ended June 28, 2014, were consistent with the same period of 2013. Our SG&A expenses as a percentage of total revenues decreased to 22.0% in the three months ended June 28, 2014, compared with 22.6% in the same period of 2013.

Selling expenses decreased \$0.2 million to \$4.2 million, or 12.7% of total revenues, for the three months ended June 28, 2014, compared with \$4.4 million, or 13.6% of total revenues, in the same period of 2013. The decrease in selling expenses was due primarily to closing an ApplianceSmart store mentioned previously and lower store operating expenses.

General and administrative expenses increased \$0.2 million to \$3.1 million for the three months ended June 28, 2014, compared with \$2.9 million in the same period of 2013. The increase was due primarily to an increase in recycling expenses to support the increased volume generated through our appliance replacement programs.

Interest expense, net: Interest expense for the three months ended June 28, 2014, decreased \$117,000 compared with the same period of 2013. The decline was the result of a lower interest rate under the line of credit coupled with a lower average outstanding balance under the line of credit. In connection with the interest rate reduction provisions under the third amendment to Credit Agreement with PNC Bank, National Association, the interest rate on our line of credit decreased by 100 basis points as of January 31, 2014.

Provision for Income Taxes We recorded a provision for income taxes of \$0.5 million for the three months ended June 28, 2014, compared with \$0.1 million in the same period of 2013. The provision for income taxes for the three months ended June 28, 2014, is related primarily to the projected full-year taxable income in the United States partially offset by expected benefits in Canada.

Noncontrolling Interest Noncontrolling interest represents 4301’s share of AAP’s net income (loss). Under the AAP joint venture agreement, ARCA and 4301 each have a 50% interest in AAP. AAP reported net loss of \$17,000 for the three months ended June 28, 2014, of which \$8,000 represented the loss attributable to noncontrolling interest. AAP reported a net loss of \$83,000 for the three months ended June 29, 2013, of which \$42,000 represented the loss attributable to noncontrolling interest.

For the Six Months Ended June 28, 2014, and June 29, 2013

The following table sets forth the key results of operations by segment for these six months ended June 28, 2014, and June 29, 2013 (dollars in millions):

	Six Months Ended		
	June 28, 2014	June 29, 2013	% Change
Revenues:			
Retail	\$ 34.6	\$ 36.4	(5) %
Recycling	32.1	26.3	22 %
Total revenues	<u>\$ 66.7</u>	<u>\$ 62.7</u>	6 %
Operating income (loss):			
Retail	\$ 0.1	\$ (0.1)	213 %
Recycling	3.5	2.0	75 %
Unallocated corporate costs	(0.3)	(0.3)	9 %
Total operating income	<u>\$ 3.3</u>	<u>\$ 1.6</u>	102 %

Our total revenues of \$66.7 million for the six months ended June 28, 2014, increased \$4.0 million or 6% from \$62.7 million for the six months ended June 29, 2013. The change in segment revenues was attributed primarily to the following factors:

Retail Segment:

- Revenues were down \$1.8 million compared with the same period of 2013.
- Same-store revenues declined by \$1.2 million compared with the same period of 2013.
- The closure of a store in the second quarter of 2013 resulted in a \$0.5 million decrease in revenues compared with the same period of 2013.
- Byproduct revenues declined by \$0.1 million compared with the same period of 2013.

Recycling Segment:

- Revenues were up \$5.8 million compared with the same period of 2013.
- Appliance replacement program revenues increased by \$5.6 million compared with the same period of 2013.
- Recycling only program revenues declined by \$0.5 million compared with the same period of 2013.
- Carbon offset revenues increased by \$1.0 million compared with the same period of 2013.
- Byproduct revenues generated from the sale of raw materials declined \$0.3 million compared with the same period of 2013.

Recycling segment revenues and retail segment revenues each include a portion of byproduct revenues. For these six months ended June 28, 2014, and June 29, 2013, the recycling segment accounted for approximately 94% and 93%, respectively, of the byproduct revenues.

Retail segment revenues accounted for 52% of total revenues in these six months ended June 28, 2014, compared with 58% in the same period of 2013. The increase in appliance replacement program revenues and carbon offset revenues impacted the overall mix of revenues between the retail and recycling segments for the six months ended June 28, 2014, compared with same period of 2013.

Our total operating income of \$3.3 million for the six months ended June 28, 2014, increased \$1.7 million compared with \$1.6 million for the same period of 2013. The change in segment operating income was attributed primarily to the following factors:

Retail Segment:

- Operating income was up \$0.2 million compared with the same period of 2013.

[Table of Contents](#)

- Gross profit declined by \$0.5 million compared to the same period of the prior year due primarily to a favorable inventory reserve adjustment recorded during the six months ended June 29, 2013 that was not repeated in same period of 2014.
- Store operating and occupancy expenses improved by \$0.6 million compared to the same period of 2013.

Recycling Segment:

- Operating income was up \$1.5 million compared with the same period of 2013.
- The improvement was attributed primarily to the increase in appliance replacement and carbon offset revenues mentioned previously and a 65% decline in the cost of certain recyclable appliances purchased by AAP.

Revenues. Revenues for the six months ended June 28, 2014, and June 29, 2013, were as follows (dollars in millions):

	Six Months Ended		
	June 28, 2014	June 29, 2013	% Change
Retail	\$ 34.1	\$ 35.9	(5)%
Recycling	23.6	18.5	27 %
Byproduct	9.0	8.3	9 %
	<u>\$ 66.7</u>	<u>\$ 62.7</u>	6 %

Retail Revenues. Our retail revenues of \$34.1 million for the six months ended June 28, 2014, decreased \$1.8 million, or 5%, from \$35.9 million for the same period of 2013. The decrease in retail revenues was due primarily to a decline in same-store sales along with the closure of an underperforming store that was operating for the partial period in 2013. The store closure represented a \$0.5 million decline in revenues and same-store sales declined by \$1.2 million, or 3.4%. The remaining decline was attributed to a reduction in byproduct revenues. Our same-store sales includes contract sales, which increased to \$1.9 million compared to \$0.7 million in the same period of 2013. We are evaluating underperforming stores and stores with expiring leases that have a range of outcomes from right-sizing the showroom space to closure. We closed one underperforming store in May 2013 as a result of not renewing the lease.

Recycling Revenues. Our recycling revenues of \$23.6 million for the six months ended June 28, 2014, increased \$5.1 million, or 27%, from \$18.5 million in the same period of 2013. Recycling revenues are comprised of two components: (1) appliance recycling revenues generated by collecting and recycling appliances for utilities and other sponsors of energy efficiency programs and (2) replacement program revenues generated by recycling and replacing old appliances with new energy efficient models for programs sponsored by utility companies. Appliance recycling revenues decreased 10% to \$4.9 million for the six months ended June 28, 2014, compared with \$5.4 million in the same period of 2013, due primarily to lower volumes under certain contracts and the loss of certain contracts operating during the same period of 2013, along with price compression under certain contracts. Revenue per-unit recycled declined by 2% compared with the same period of 2013. The number of units driving our appliance recycling revenues declined 8% compared with the same period of 2013. Appliance replacement program revenues increased 43% to \$18.7 million for the six months ended June 28, 2014, compared with \$13.1 million in the same period of 2013, due primarily to higher volumes and the mix of appliance replacements. Future revenues from appliance replacement programs, if any, are uncertain and may fluctuate significantly from period to period.

Byproduct Revenues. Our byproduct revenues of \$9.0 million for the six months ended June 28, 2014, increased \$0.7 million, or 9%, from \$8.3 million in the same period of 2013. The increase in byproduct revenues was primarily the result of recognizing \$1.0 million in carbon offset revenues: \$0.7 million at ARCA and \$0.3 million at AAP. Byproduct revenues include all of the revenues generated by AAP. AAP revenues of \$5.5 million increased \$0.2 million compared with the same period of the prior year, due primarily to recognizing \$0.3 million in carbon offset revenues and partially offset by a 4% decline in recyclable appliances by weight compared with the same period of 2013. We continue to recover and store refrigerants and expect to generate carbon offset revenues in the future, although the frequency of these transactions will vary based on volume levels and market conditions.

Total Gross Profit. Our gross profit of \$17.9 million in the six months ended June 28, 2014, increased \$1.5 million, or 9%, from \$16.4 million in the six months ended June 29, 2013. Gross profit as a percentage of total revenues increased to 26.9% for these six months ended June 28, 2014, compared with 26.2% in the same period of 2013.

[Table of Contents](#)

Retail Segment Gross Profit. Retail gross profit decreased by \$0.5 million to \$9.6 million compared with \$10.1 million in same period of 2013. The decline was primarily the result of a \$0.5 million favorable inventory reserve adjustment recorded for the six months ended June 29, 2013 that was not repeated in the same period of 2014. Gross profit as a percentage of related revenues of 27.9% for the six months ended June 28, 2014, was consistent with the same period of 2013.

Recycling Segment Gross Profit. Recycling gross profit increased by \$2.0 million to \$8.3 million compared with \$6.3 million in same period of 2013. The improvement was attributed primarily to the increase in appliance replacement and carbon offset revenues mentioned previously. Gross profit as a percentage of related revenues increased to 25.8% for the six months ended June 28, 2014, compared with 23.8% in the same period of 2013. The increase is primarily the result of a \$0.9 million increase in carbon offset revenues and a 65% decline in the cost of certain recyclable appliance purchased by AAP.

Selling, General and Administrative Expenses. Our selling, general and administrative (“SG&A”) expenses for the six months ended June 28, 2014, decreased \$0.1 million to \$14.7 million compared with \$14.8 million for the same period of the prior year. Our SG&A expenses as a percentage of total revenues decreased to 22.0% in the six months ended June 28, 2014, compared with 23.6% in the same period last year.

Selling expenses decreased \$0.5 million to \$8.4 million, or 12.6% of total revenues, for the six months ended June 28, 2014, compared with \$8.9 million, or 14.3% of total revenues, in the same period of 2013. The decrease in selling expenses was due primarily to closing an ApplianceSmart store mentioned previously and lower store operating expenses.

General and administrative expenses increased \$0.4 million to \$6.3 million for the six months ended June 28, 2014, compared with \$5.9 million in the same period of 2013. The increase was due primarily to an increase in recycling expenses to support the increased volume generated through our appliance replacement programs. The increase in recycling expenses was partially offset by a reduction in corporate expenses related to expense reduction initiatives implemented during the latter portion of first quarter in 2013.

Interest expense, net. Interest expense for the six months ended June 28, 2014, decreased \$160,000 compared with the same period of 2013. The decline was the result of a lower interest rate under the line of credit coupled with a lower average outstanding balance under the line of credit. In connection with the interest rate reduction provisions under the third amendment to Credit Agreement with PNC Bank, National Association, the interest rate on our line of credit decreased by 100 basis points as of January 31, 2014.

Provision for Income Taxes. We recorded a provision for income taxes of \$1.2 million, at an effective tax rate of 40.5%, for the six months ended June 28, 2014. The provision for income taxes for the six months ended June 28, 2014, is related primarily to projected full-year taxable income in the United States partially offset by expected benefits in Canada. We recorded a provision for income taxes of \$0.1 million, at an effective tax rate of 14.5% due primarily to the use of net operating losses with a corresponding valuation allowance, for the six months ended June 29, 2013. Due to uncertainties regarding the realization of deferred tax assets, we are continuing to carry a full valuation allowance against certain deferred tax assets we do not expect to realize.

Noncontrolling Interest. Noncontrolling interest represents 4301’s share of AAP’s net income (loss). Under the AAP joint venture agreement, ARCA and 4301 each have a 50% interest in AAP. AAP reported net income of \$257,000 for the six months ended June 28, 2014, of which \$129,000 represented the income attributable to noncontrolling interest. AAP reported a net loss of \$193,000 for the six months ended June 29, 2013, of which \$97,000 represented the loss attributable to noncontrolling interest.

Liquidity and Capital Resources

Summary. Cash and cash equivalents as of June 28, 2014, were \$2.5 million compared with \$1.9 million as of December 28, 2013. Working capital, the excess of current assets over current liabilities, increased to \$12.9 million as of June 28, 2014, compared with \$10.6 million as of December 28, 2013. The increase was primarily the result of a lower balance under our line of credit and a higher inventory and cash and cash equivalents balances, which was partially offset by lower outstanding trade receivables.

[Table of Contents](#)

The following table summarizes our cash flows for the six months ended June 28, 2014, and June 29, 2013 (in millions):

	Six Months Ended	
	June 28, 2014	June 29, 2013
Total cash and cash equivalents provided by (used in):		
Operating activities	\$ 2.1	\$ 3.1
Investing activities	0.3	(0.6)
Financing activities	(1.8)	(2.9)
Effect of exchange rates on cash and cash equivalents	—	(0.1)
Increase (decrease) in cash and cash equivalents	\$ 0.6	\$ (0.5)

Operating Activities. Our net cash provided by operating activities was \$2.1 million for the six months ended June 28, 2014, compared with \$3.1 million for the six months ended June 29, 2013. The change in operating cash flow was primarily the result of a swing in the accounts payable and accrued expense balances to a use of cash and partially offset by generating higher net income.

Investing Activities. Our net cash provided by investing activities was \$0.3 million for the six months ended June 28, 2014, compared with \$0.6 million net use of cash for the six months ended June 29, 2013. Net cash provided by investing activities for the six months ended June 28, 2014, was primarily related to the release of the \$0.5 million reserve required by our credit card processor. The net cash used in investing activities for the six months ended June 29, 2013, was related primarily to an increase in restricted cash as a result of a reserve required by our credit card processor.

Financing Activities. Our net cash used in financing activities was \$1.8 million for the six months ended June 28, 2014, compared with \$2.9 million for the six months ended June 29, 2013. Net cash used in financing activities for the six months ended June 28, 2014, was related primarily to net payments under our line of credit and the repayment of long-term debt obligations. Net cash used in financing activities for the six months ended June 29, 2013, was also related primarily to net payments under our line of credit and the repayment of long-term debt obligations.

Sources of Liquidity. Our principal sources of liquidity are cash from operations and borrowings under our revolving line of credit. Our principal liquidity requirements consist of long-term debt obligations, capital expenditures and working capital. Our total capital requirements for the next twelve months will depend upon, among other things, the number and size of ApplianceSmart stores operating during the period, the volumes generated from recycling and appliance replacement contracts during the period and our needs related to AAP. Currently, we have eighteen ApplianceSmart stores and eleven recycling centers, including AAP, in operation.

We believe, based on the anticipated revenues from our recycling and appliance replacement contracts, the anticipated sales per retail store, and our anticipated gross profit, that our cash balance, anticipated funds generated from operations and our revolving line of credit will be sufficient to finance our operations, long-term debt obligations and capital expenditures through at least the next twelve months. We may also need additional capital to finance our operations if our revenues are lower than anticipated, our expenses are higher than anticipated or we pursue new opportunities. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity (Common or Preferred Stock) or other financing opportunities. There can be no assurance that such additional sources of financing will be available on terms satisfactory to us or permitted by our Revolving Credit Agreement.

Outstanding Indebtedness. On January 24, 2011, we entered into a Revolving Credit, Term Loan and Security Agreement, as amended, (“Revolving Credit Agreement”) with PNC Bank, National Association (“PNC”) that provides us with a \$15.0 million revolving line of credit. The Revolving Credit Agreement has a stated maturity date of January 24, 2016, if not renewed. The Revolving Credit Agreement is collateralized by a security interest in substantially all of our assets and PNC is also secured by an inventory repurchase agreement with Whirlpool Corporation for Whirlpool purchases only. We also issued a \$750,000 letter of credit in favor of Whirlpool Corporation. The Revolving Credit Agreement requires starting with the fiscal quarter ended March 29, 2014, and continuing at the end of each quarter thereafter, that we meet a minimum fixed charge coverage ratio of 1.1 to 1.0, measured on a trailing twelve-month basis. For the fiscal quarter ended June 28, 2014, we reported a fixed charge coverage ratio of 5.0 to 1.0. The Revolving Credit Agreement limits investments we can purchase, the amount of other debt and leases we can

[Table of Contents](#)

incur, the amount of loans we can issue to our affiliates and the amount we can spend on fixed assets, along with prohibiting the payment of dividends. As of June 28, 2014 and December 28, 2013, we were in compliance with all covenants under the Revolving Credit Agreement.

The interest rate on the revolving line of credit is PNC Base Rate plus 1.75%, or 1-, 2- or 3-month PNC LIBOR Rate plus 2.75%. The PNC Base Rate shall mean, for any day, a fluctuating per annum rate of interest equal to the highest of (i) the interest rate per annum announced from time to time by PNC at its prime rate, (ii) the Federal Funds Open Rate plus 0.5%, and (iii) the one-month LIBOR rate plus 1%. As of June 28, 2014, the outstanding line of credit balance was \$8.4 million with a weighted average interest rate of 3.12%, which included both PNC LIBOR Rate and PNC Base Rate loans. As of December 28, 2013, the outstanding line of credit balance was \$9.7 million with a weighted average interest rate of 4.27%, which included both PNC LIBOR Rate and PNC Base Rate loans.

The amount of borrowings available under the Revolving Credit Agreement is based on a formula using accounts receivable and inventories. We may not have access to the full \$15.0 million revolving line of credit due to the formula using accounts receivable and inventories, the amount of the letter of credit issued in favor of Whirlpool Corporation and the amount of outstanding loans between PNC and our AAP joint venture. As of June 28, 2014, and December 28, 2013, our available borrowing capacity under the Revolving Credit Agreement was \$5.8 million and \$4.0 million, respectively.

On January 24, 2011, we entered into a \$2.55 million Term Loan ("Term Loan") with PNC Bank to refinance the mortgage on our California facility. The Term Loan is payable as follows, subject to acceleration upon the occurrence of an event of default or termination of the Revolving Credit Agreement: 119 consecutive monthly principal payments of \$21,000 plus interest commencing on February 1, 2011, and continuing on the first day of each month thereafter followed by a 120th payment of all unpaid principal, interest and fees on February 1, 2021. If the Revolving Credit Agreement is not renewed, a balloon payment of \$1,253,750 in principal plus interest and additional fees will be due on January 24, 2016. The Term Loan is collateralized with our California facility located in Compton, California. The interest rate is PNC Base Rate plus 2.25%, or 1-, 2- or 3-month PNC LIBOR Rate plus 3.25%. As of June 28, 2014, and December 28, 2013, the weighted average interest rate was 3.61% and 5.50%, respectively.

On March 10, 2011, ARCA Advanced Processing, LLC entered into three separate commercial term loans ("AAP Term Loans") with Susquehanna Bank, pursuant to the guidelines of the U.S. Small Business Administration 7(a) Loan Program. The total amount of the AAP Term Loans is \$4.75 million, split into three separate loans for \$2.1 million, \$1.4 million and \$1.25 million. The AAP Term Loans mature in ten years and bear an interest rate of Prime plus 2.75%. As of June 28, 2014, and December 28, 2013, the interest rate was 6.00%. Borrowings under the AAP Term Loans are secured by substantially all of the assets of AAP along with liens on the business assets and certain personal assets of the owners of 4301 Operations, LLC. We are a guarantor of the AAP Term Loans along with 4301 Operations, LLC and its owners.

The following table summarizes our borrowings as of June 28, 2014, and December 28, 2013 (in millions):

	June 28, 2014	December 28, 2013
Line of credit	\$ 8.4	\$ 9.7
PNC Bank Term Loan	1.7	1.8
Susquehanna Bank Term Loans ⁽¹⁾	3.6	3.8
Other financing obligations and loans ⁽¹⁾	1.4	0.7
Capital leases and other financing obligations	0.1	0.2
	15.2	16.2
Less: current portion of debt	9.6	10.8
	\$ 5.6	\$ 5.4

⁽¹⁾ Represents notes from consolidating AAP.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk and Impact of Inflation

Interest Rate Risk. We do not believe there is any significant risk related to interest rate fluctuations on our long-term fixed-rate debt. There is interest rate risk on the line of credit, PNC Term Loan and Susquehanna Bank Term Loans, since our interest rate floats. The outstanding balance on our floating rate loans as of June 28, 2014, was approximately \$13.6 million. Based on average floating rate borrowings of \$14.4 million, a hypothetical 100 basis point change in the applicable interest rate would have caused our interest expense to change for the three and six months ended June 28, 2014, by approximately \$36,000 and \$73,000, respectively.

Foreign Currency Exchange Rate Risk. We currently generate revenues in Canada. The reporting currency for our consolidated financial statements is U.S. dollars. It is not possible to determine the exact impact of foreign currency exchange rate changes; however, the effect on reported revenue and net earnings can be estimated. We estimate that the U.S. dollar against the Canadian dollar had an immaterial impact on the revenues and net income for the three and six months ended June 28, 2014. We do not currently hedge foreign currency fluctuations and do not intend to do so for the foreseeable future.

We do not hold any derivative financial instruments nor do we hold any securities for trading or speculative purposes.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have established disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), to allow timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act), at June 28, 2014. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, at June 28, 2014, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

During the second quarter of fiscal 2014, there was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

PART II. Other Information

Item 1. Legal Proceedings

In February 2012, various individuals commenced a class action lawsuit against Whirlpool Corporation (“Whirlpool”) and various distributors of Whirlpool products, including Sears, The Home Depot, Lowe’s and us, alleging certain appliances sold by Whirlpool through its distribution chain, which includes us, were improperly designated with the ENERGY STAR® qualification rating established by the U.S. Department of Energy and the Environmental Protection Agency. The claims against us include breach of warranty claims, as well as various state consumer protection claims. The amount of the claim is, as yet, undetermined. Whirlpool has offered to fully indemnify and defend its distributors in this lawsuit, including us, and has engaged legal counsel to defend itself and the distributors. We are monitoring Whirlpool’s defense of the claims and believe the possibility of a material loss is remote.

In 2007, we entered into an agreement with AMTIM Capital, Inc. (“AMTIM”) to act as our representative to market our recycling services in Canada under an arrangement that pays AMTIM for revenues generated by recycling services in Canada as set forth in the agreement between the parties. A dispute has arisen between AMTIM and us with respect to the calculation of amounts due to AMTIM pursuant to the agreement. AMTIM claims a discrepancy in the calculation of fees due to AMTIM by us of more than \$600,000 as of mid-2010. We commenced an action in the U.S. District Court for a determination of the parties’ rights under the agreement. AMTIM started its own action in Ontario, Canada, against us for amounts it claims are due pursuant to the agreement. We moved the Canadian court for a stay of that action pending the U.S. action. AMTIM requested the U.S. District Court to stay the U.S. action pending resolution of the Canadian court action. AMTIM’s motion was denied by the U.S. District Court and as a result, we obtained a default judgment against AMTIM approving the manner in which we have historically calculated fees due to AMTIM. Shortly thereafter, the Canadian court dismissed our motion to stay the Canadian action. We thereafter sought dismissal of the Canadian action for lack of jurisdiction of the Canadian courts. That motion was denied by the Canadian court. We appealed that denial and the Canadian appellate court upheld the denial indicating that the Company’s position may support a dismissal ruling on other grounds. We moved for dismissal on such other grounds and the Canadian lower court denied that motion. The Company, thereafter, appealed that decision to the Ontario appellate court. The appellate court denied the Company’s appeal, allowing the case to go forward to trial. The Company has petitioned the Supreme Court of Canada for review of the lower appellate court’s decision and is awaiting that court’s response. Although the outcome is uncertain, we believe the possibility of a material loss is remote.

We are party from time to time to other ordinary course disputes that we do not believe to be material.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit Number	Description
31.1+	Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2+	Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1†	Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2†	Certification by Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101**	The following materials from our Quarterly Report on Form 10-Q for the three- and six-month periods ended June 28, 2014, formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Comprehensive Income, (iii) the Consolidated Statements of Cash Flows, (iv) the Notes to Consolidated Financial Statements, and (v) document and entity information.

+ Filed herewith.

† Furnished herewith.

** Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filings.

SIGNATURES

Pursuant to the requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on our behalf by the undersigned, thereunto duly authorized.

Appliance Recycling Centers of America, Inc.
(Registrant)

Date: August 11, 2014

By: /s/ Edward R. Cameron
Edward R. Cameron
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 11, 2014

By: /s/ Jeffrey A. Cammerrer
Jeffrey A. Cammerrer
Chief Financial Officer
(Principal Financial and Accounting Officer)

CERTIFICATIONS:

I, Edward R. Cameron, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Appliance Recycling Centers of America, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of and for the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

/s/ Edward R. Cameron

Edward R. Cameron

President and Chief Executive Officer

CERTIFICATIONS:

I, Jeffrey A. Cammerrer, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Appliance Recycling Centers of America, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of and for the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
 - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

/s/ Jeffrey A. Cammerrer

Jeffrey A. Cammerrer
Chief Financial Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to 18 U.S.C. §1350 (as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002), the undersigned Chief Executive Officer of Appliance Recycling Centers of America, Inc. (the “Company”) hereby certifies that the Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 28, 2014 (the “Report”) fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2014

/s/ Edward R. Cameron

Edward R. Cameron

President and Chief Executive Officer

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to 18 U.S.C. §1350 (as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002), the undersigned Chief Financial Officer of Appliance Recycling Centers of America, Inc. (the "Company") hereby certifies that the Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 28, 2014 (the "Report") fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2014

/s/ Jeffrey A. Cammerrer

Jeffrey A. Cammerrer

Chief Financial Officer

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.