MICROFINANCIAL INC
Form 10-Q
November 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

Commission File No. 1-14771

MICROFINANCIAL INCORPORATED
(Exact name of registrant as specified in its charter)

Massachusetts	04-2962824
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

10 M Commerce Way, Woburn, MA 01801
(Address of principal executive offices)
(781) 994-4800
(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(b) of the Securities and 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. þ Yes o No

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

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

As of October 31, 2006, 13,811,442 shares of the registrant s common stock were outstanding.

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MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

	December 31, 2005	September 30, 2006
ASSETS		
Cash and cash equivalents	$ 32,926	$ 32,580
Net investment in leases:		
Receivables due in installments	29,139	31,668
Estimated residual value	3,865	2,875
Initial direct costs	98	204
Less:		
Advance lease payments and deposits	(35)	(44)
Unearned income	(3,658)	(9,230)
Allowance for credit losses	(8,714)	(5,587)
Net investment in leases	20,695	19,886
Investment in service contracts, net	1,626	771
Investment in rental contracts, net	3,025	708
Property and equipment, net	719	751
Other assets	1,315	731
Deferred income taxes, net	4,882	3,458
Total assets	$ 65,188	$ 58,885
LIABILITIES AND STOCKHOLDERS EQUITY		
Notes payable	$ 161	$ 38
Subordinated notes payable	2,602	300
Accounts payable	1,099	821
Dividends payable	4,114	690
Other liabilities	2,094	1,825
Income taxes payable	431	
Total liabilities	10,501	3,674
Stockholders equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized; no shares issued at December 31, 2005 and September 30, 2006		
Common stock, $.01 par value; 25,000,000 shares authorized; 13,713,899 and 13,808,942 shares issued at December 31, 2005 and September 30, 2006, respectively	137	138
Additional paid-in capital	43,839	44,281
Retained earnings	10,711	10,792
Total stockholders equity	54,687	55,211

Total liabilities and stockholders equity	$	65,188	$	58,885

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

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MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)
(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2006	2005	2006
Revenues:				
Income on financing leases	$ 832	$ 1,007	$ 3,442	$ 2,403
Rental income	6,469	5,121	19,330	16,436
Income on service contracts	792	435	2,818	1,478
Loss and damage waiver fees	681	431	2,251	1,475
Service fees and other	595	848	2,559	3,124
Total revenues	9,369	7,842	30,400	24,916
Expenses:				
Selling, general and administrative	4,461	3,312	16,699	11,445
Provision for credit losses	1,576	1,887	8,870	5,124
Depreciation and amortization	2,465	1,195	7,414	4,634
Interest	203	23	986	135
Total expenses	8,705	6,417	33,969	21,338
Income (loss) before provision (benefit) for income taxes	664	1,425	(3,569)	3,578
Provision (benefit) for income taxes	310	573	(1,032)	1,424
Net income (loss)	$ 354	$ 852	($ 2,537)	$ 2,154
Net income (loss) per common share basic	$ 0.03	$ 0.06	($ 0.19)	$ 0.16
Net income (loss) per common share diluted	$ 0.03	$ 0.06	($ 0.19)	$ 0.15
Weighted-average shares:				
Basic	13,710,683	13,803,996	13,518,351	13,784,650
Diluted	13,910,948	13,942,572	13,518,351	13,928,399

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

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MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Nine Months Ended September 30,	
	2005	2006
Cash flows from operating activities:		
Cash received from customers	$ 43,772	$ 30,840
Cash paid to suppliers and employees	(16,541)	(10,905)
Cash received (paid) for income taxes	(48)	(456)
Interest paid	(413)	(105)
Interest received	276	1,049
Net cash provided by operating activities	27,046	20,423
Cash flows from investing activities:		
Investment in lease and rental contracts	(4,119)	(12,426)
Investment in inventory	(13)	
Investment in direct costs	(33)	(206)
Investment in property and equipment	(271)	(216)
Net cash used in investing activities	(4,436)	(12,848)
Cash flows from financing activities:		
Proceeds from secured debt	214	83
Repayment of secured debt	(135)	(205)
Repayment of subordinated debt	(1,500)	(2,302)
Repayment of capital leases	(41)	
Payment of dividends	(2,015)	(5,497)
Net cash used in financing activities	(3,477)	(7,921)
Net increase (decrease) in cash and cash equivalents	19,133	(346)
Cash and cash equivalents, beginning of period	9,709	32,926
Cash and cash equivalents, end of period	$ 28,842	$ 32,580

(continued on following page)

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

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MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Nine Months Ended September 30, 2005	2006
Reconciliation of net income (loss) to net cash provided by operating activities:		
Net income (loss)	($2,537)	$ 2,154
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(3,442)	(2,403)
Depreciation and amortization	7,414	4,634
Provision for credit losses	8,870	5,124
Recovery of equipment cost and residual value	16,611	9,497
Stock-based compensation expense	942	207
Non-cash interest expense (amortization of debt discount)	572	34
Changes in assets and liabilities:		
Current taxes payable	(48)	(431)
Deferred income taxes	(1,032)	1,424
Other assets	802	551
Accounts payable	(1,326)	(277)
Other liabilities	220	(91)
Net cash provided by operating activities	$ 27,046	$20,423
Supplemental disclosure of non-cash activities:		
Fair market value of stock issued for compensation	$ 63	$ 251
Warrants exercised by cancellation of debt	779	

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

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MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

A. Nature of Business

MicroFinancial Incorporated (the Company) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. LLC and Leasecomm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services in amounts generally ranging from $500 to $15,000 with an average lease term of 44 months. The average amount financed by TimePayment during the nine months ended September 30, 2006 was approximately $5,800 while Leasecomm historically financed contracts with an average amount financed of approximately $1,900. The Company primarily sources its originations through a nationwide network of independent equipment vendors, sales organizations and other dealer-based origination networks. The Company funds its operations through cash provided by operating activities, borrowings under its credit facilities and the issuance of subordinated debt.

B. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. Accordingly, the interim statements do not include all of the information and disclosures required for the annual financial statements. In the opinion of the Company s management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2006.

The balance sheet at December 31, 2005 has been derived from the audited financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Allowance for Credit Losses

The Company maintains an allowance for credit losses on its investment in leases, service contracts and rental contracts at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. Given the nature of the microticket market and the individual size of each transaction, the business does not warrant the creation of a formal credit review committee to review individual transactions. Rather, the Company developed a sophisticated, risk-adjusted pricing model and has automated the credit scoring, approval and collection processes. The Company believes that with the proper risk-adjusted pricing model, it can grant credit to a wide range of applicants provided it has priced appropriately for the associated risk inherent in the transaction. As a result of approving a wide range of credits, the Company experiences a relatively high level of delinquencies and write-offs in its portfolio. The Company periodically reviews the credit scoring and approval process to ensure that the automated system is making appropriate credit decisions. Given the nature of the microticket market and the individual size of each transaction, the business does not warrant evaluating transactions individually for the purpose of developing and determining the adequacy of the allowance for credit losses. Contracts in the portfolio are not re-graded subsequent to the initial extension of credit, nor is the allowance allocated to specific contracts. Rather, since the impaired contracts have common characteristics, the Company maintains a general allowance against the entire portfolio utilizing historical loss and recovery statistics as the basis for the amount.

The Company has adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for microticket transactions. Management reviews, on a static pool basis, the collection experience on various months originations. In addition, management reviews, on a static pool basis, the recoveries made on accounts written off. The results of these static pool analyses reflect the Company s actual collection experience given the fact that the Company obtains additional recourse in many instances in the form of personal guaranties from the borrowers, as well as, in some instances, limited recourse from the dealer. In addition, management considers current delinquency statistics, current economic conditions, and other relevant factors. The

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

combination of historical experience and the review of current factors provide the basis for the analysis to determine the adequacy of the allowance. The Company takes charge-offs against its receivables when such receivables are 360 days past due and no contact has been made with the lessee for 12 months. However, collection efforts continue and the Company recognizes recoveries in future periods when cash is received.

A summary of the activity in the Company s allowance for credit losses for the nine months ended September 30, 2006 is as follows:

Allowance for credit losses at December 31, 2005		$ 8,714
Provision for credit losses		5,124
Charge-offs	(12,683)	
Recoveries	4,432	
Charge-offs, net of recoveries		(8,251)
Allowance for credit losses at September 30, 2006		$ 5,587

Net Income (Loss) Per Share

Basic net income (loss) per common share is computed based on the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share gives effect to all potentially dilutive common shares outstanding during the period. The computation of diluted net income (loss) per share does not assume the issuance of common shares that have an antidilutive effect on net income (loss) per common share. All stock options, common stock warrants, and unvested restricted stock were excluded from the computation of diluted net income (loss) per share for the nine months ended September 30, 2005, because their inclusion would have had an antidilutive effect on net income (loss) per share. For the nine months ended September 30, 2005, 1,242,500 options, 335,957 warrants and 12,500 shares of restricted stock were excluded from the computation of diluted net income (loss) per share. For the nine months ended September 30, 2006, 1,242,500 options, 318,289 warrants and 27,500 shares of restricted stock were included in the computation of diluted net income per share.

	For Three Months Ended September 30,		For Nine Months Ended September 30,	
	2005	2006	2005	2006
Net income (loss)	$ 354	$ 852	($2,537)	$ 2,154
Shares used in computation:				
Weighted average common shares outstanding used in computation of net income (loss) per common share	13,710,683	13,803,996	13,518,351	13,784,650
Dilutive effect of common stock options, warrants and restricted stock	200,265	138,576		143,749
Shares used in computation of net income (loss) per common share - assuming dilution	13,910,948	13,942,572	13,518,351	13,928,399

Net income (loss) per common share basic	$	0.03	$	0.06	($0.19)	$	0.16
Net income (loss) per common share diluted	$	0.03	$	0.06	($0.19)	$	0.15

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MICROFINANCIAL INCORPORATED
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(Tables in thousands, except share and per share data)

Stock-Based Employee Compensation

Effective January 1, 2005, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* (SFAS 123(R)). Under the modified prospective method of adoption, compensation cost was recognized during the three and nine months ended September 30, 2005 and 2006 for stock options. Results for years prior to 2005 have not been restated.

Under the 1998 Equity Incentive Plan (the 1998 Plan) which was adopted on July 9, 1998, the Company reserved 4,120,380 shares of common stock for issuance. No options were granted, exercised or canceled during the nine months ended September 30, 2006. On February 4, 2004, a new non-employee director was granted 25,000 shares of restricted stock. On August 15, 2006, a second new non-employee director was granted 25,000 shares of restricted stock with a fair value of approximately $76,000. The fair value was estimated using an expected life of four years, annualized volatility of 92%, an expected dividend yield of 5.97% and a risk free interest rate of 4.67%. In each case, the restricted stock vested 20% upon grant and vests 5% on the first day of each quarter after the grant date. As vesting occurs, compensation expense is recognized. As of September 30, 2006, 22,500 shares were fully vested between these two directors.

Information relating to stock options at September 30, 2006 is as follows:

	Outstanding				Exercisable	
Exercise Price	Shares	Weighted-Average Life (Years)	Intrinsic Value	Weighted-Average Exercise Price	Shares	Intrinsic Value
$12.31	359,391	2.41	$	$12.31	359,391	$
$13.54	40,609	2.41		$13.54	40,609	
$ 9.78	350,000	3.41		$ 9.78	350,000	
$13.10	90,000	4.40		$13.10	90,000	
$ 6.70	235,000	5.42		$ 6.70	188,000	
$ 1.59	167,500	6.16	281	$ 1.59	157,500	264
	1,242,500	3.91	$ 281	$ 9.35	1,185,500	$264

In March 2005, the Company s Board of Directors elected to allow for the immediate vesting of all of the President and CEO s in the money options. This resulted in the acceleration of vesting for 70,000 options with an exercise price of $1.585 and 80,000 options with an exercise price of $0.86. As a result of that acceleration, the Company recognized additional compensation expense of $566,000 for the nine months ended September 30, 2005. In addition, the Company s Board of Directors elected to allow the cashless exercise of all options exercised during 2005. As a result, all awards made under the 1998 Plan have been classified as share-based liability awards. During the three months ended September 30, 2005 and 2006, the total share based employee compensation cost recognized was $83,000 and $72,000, respectively. During the nine months ended September 30, 2005 and 2006, the total share-based employee compensation cost recognized was $942,000 and $207,000, respectively.

In accordance with SFAS 123(R), for share-based liability awards, the Company must recognize compensation cost equal to the greater of (a) the grant date fair value or (b) the fair value of the modified liability when it is settled. As of September 30, 2006, a minimum of $27,000 of total unrecognized compensation costs related to non-vested awards is expected to be recognized over a weighted average period of six months. In addition, the Company will also recognize any additional incremental compensation cost as it is incurred. For the three and nine month periods ended September 30, 2005, the Company recognized a decrease of $(2,000) and an increase of $39,000, respectively, in compensation expense due to the change in the fair value of the share-based liability awards outstanding. For the three and nine month periods ended September 30, 2006, the Company recognized decreases of $(4,000) and $(3,000), respectively, in compensation expense due to the change in the fair value of the share-based liability awards outstanding.

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(Tables in thousands, except share and per share data)

The Company estimates the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 107 and the company s prior period pro forma disclosures of net earnings, including stock-based compensation (determined under a fair value method as prescribed by SFAS 123). Key input assumptions used to estimate the fair value of stock options include the expected option term, volatility of the Company s stock, the risk-free rate and the Company s dividend yield.

There were no options granted during the three and nine month periods ended September 30, 2005 and 2006, respectively. The fair values as of September 30, 2006, of the outstanding options classified as liability instruments under SFAS 123(R) were estimated using expected lives of one to three years, annualized volatility of 76%, an expected dividend yield of 6.13% and a risk free interest rate of 4.67%.

The expected life represents the average period of time that the options are expected to be outstanding given consideration to vesting schedules; annualized volatility is based on historical volatilities of the Company s common stock; dividend yield represents the current dividend yield expressed as a constant percentage of the stock price and the risk free rate is based on the U.S. Treasury yield curve in effect on the measurement date for periods corresponding to the expected life of the option. At each subsequent reporting date, the Company is required to remeasure the fair value of its share-based liability awards.

C. Notes Payable and Subordinated Debt

Borrowings outstanding under the credit facility and long-term debt agreements are as follows:

	Interest Rate	December 31, 2005	September 30, 2006
Revolving credit facility	prime + 1.5%	$ 161	$ 38
Subordinated notes	8.0%-12.0%	2,602	300
		$2,763	$ 338

On September 29, 2004, the Company entered into a three-year senior secured revolving line of credit with CIT Commercial Services, a unit of CIT Group (CIT), whereby it may borrow a maximum of $30.0 million based upon qualified lease receivables. Outstanding borrowings with respect to the revolving line of credit bear interest at Prime plus 1.5% for Prime Rate Loans or at the 90-day London Interbank Offered Rate (LIBOR) plus 4.0% for LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts into a Prime Rate Loan. The prime rates at December 31, 2005 and September 30, 2006 were 7.25% and 8.25%, respectively. The 90-day LIBOR rates at December 31, 2005 and September 30, 2006 were 4.53% and 5.37%, respectively.

D. Commitments and Contingencies

Legal Matters

Management believes, after consultation with counsel, that the allegations against the Company included in the lawsuit described below are subject to substantial legal defenses, and the Company is vigorously defending each of the allegations. The Company also is subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on the Company s results of operations or financial position.

In October 2003, the Company was served with a purported class action complaint, which was filed in United States District Court for the District of Massachusetts alleging violations of the federal securities laws. The purported class would consist of all persons who purchased Company securities between February 5, 1999 and October 30, 2002. The Complaint asserts that during this period the Company made a series of materially false or misleading statements about the Company s business, prospects and operations, including with respect to certain lease provisions, the Company s course of dealings with its vendor/dealers, and the Company s reserves for credit losses. In April 2004, an Amended Class Action Complaint was filed which added additional defendants and

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

expanded upon the prior allegations with respect to the Company. The Company filed a Motion to Dismiss the Amended Complaint. On June 13, 2006, the Court granted the Company s Motion to Dismiss the Amended Complaint with Prejudice. On July 12, 2006, the plaintiffs filed an appeal which is awaiting decision by the Court. Because of the uncertainties inherent in litigation, the Company cannot predict whether the outcome will have a material adverse effect.

Internal Revenue Service Tax Audit

The Company is currently undergoing an audit of its 1997 through 2003 tax years. As part of the audit, the Internal Revenue Service Agent has proposed several adjustments to the annual tax returns, which if final, would require the Company to pay the IRS an amount between \$8.0 and \$10.0 million. Such payments would be offset by an adjustment to the deferred tax asset such that the amount would likely be recoverable in future periods. The Company believes that its tax positions were appropriate and is vigorously defending its position. The Company filed a formal protest under the appeals process challenging these adjustments. The protest has resulted in two meetings with an Internal Revenue Service Appeals Officer. The Appeals Officer is currently preparing a report for submission to the Joint Committee on Taxation who will render a decision on this matter. The Company can give no assurance that it will be successful in this appeal; however, it does not believe the outcome will have a material adverse effect on the Company s results of operations or financial position.

Lease Commitments

The Company accepts lease applications on a daily basis and as a result has a pipeline of applications that have been approved, where a lease has not been originated. The Company s commitment to lend, however, does not become binding until all of the steps in the lease origination process have been completed, including but not limited to, the receipt of a complete and accurate lease document and all required supporting information and successful verification with the lessee. Since the Company funds on the same day a lease is successfully verified, at any given time, the Company has no firm outstanding commitments to lend.

E. Recent Accounting Pronouncements

In March 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets An Amendment of FASB Statement No. 140*. Among other requirements, Statement No. 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract related to (a) the sale of financial assets, (b) a transfer to a qualifying special-purpose entity in a securitization where the resulting retained securities are classified as available-for-sale or trading securities or (c) an acquisition or assumption of an obligation to service a financial asset of a third party. Statement 156 is effective as of the beginning of fiscal years that begin after September 15, 2006. The Company believes that the adoption of this standard will not have a material impact on its consolidated financial position or results of operations.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 prescribes a recognition threshold and measurement attribute for the recognition and measurement of a tax position taken or expected to be taken in a tax return. The new standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position is based on whether it is more likely than not that a tax position will be sustained upon examination based on its technical merits and measured at the largest amount of benefit that is more likely than not. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. Only tax positions that meet the more likely than not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption. The cumulative effect of applying the provisions of FIN 48 should be reported as an adjustment to the opening balance of retained earnings. The Company has not completed its initial assessment of the impact, if any, that this standard may have on its consolidated financial statements.

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

Introduction

The following information should be read in conjunction with the condensed consolidated financial statements and notes thereto in Part I, Item 1 of this Quarterly Report and with Management s Discussion and Analysis of Financial Condition and Results of Operations contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Forward-Looking Information

Statements in this document that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, words such as believes anticipates expects and similar expressions are intended to identify forward-looking statements. The Company cautions that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of the Company. Such statements contain a number of risks and uncertainties, including but not limited to: the Company s need for financing in order to originate new leases and contracts; the Company s dependence on point-of-sale authorization systems and expansion into new markets; the Company s significant capital requirements; risks associated with economic downturns; higher interest rates; intense competition; change in regulatory environment; the availability of qualified personnel, the ultimate outcome of the IRS tax audit, and risks associated with acquisitions. Readers should not place undue reliance on forward-looking statements, which reflect management s view only as of the date hereof. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. The Company cannot assure that it will be able to anticipate or respond timely to changes which could adversely affect its operating results in one or more fiscal quarters. Results of operations in any past period should not be considered indicative of results to be expected in future periods. Fluctuations in operating results may result in fluctuations in the price of the Company s common stock. Statements relating to past dividend payments or the Company s current dividend policy should not be construed as a guarantee that any future dividends will be paid. For a more complete description of the prominent risks and uncertainties inherent in the Company s business, see the risk factors included in the Company s most recent Annual Report on Form 10-K and other documents filed from time to time with the Securities and Exchange Commission.

Overview

MicroFinancial incurred net losses of $15.7 million, $10.2 million and $1.7 million for the years ended December 31, 2003, 2004 and 2005, respectively. Net losses incurred by the Company during the third and fourth quarters of 2002 caused the Company to be in default under certain debt covenants and the Company s credit facility failed to renew. Consequently, the Company was forced to suspend substantially all new origination activity in October 2002. Since that time, MicroFinancial has taken certain steps to improve its financial position. In June 2004, MicroFinancial secured a credit facility which enabled the Company to resume contract originations through TimePayment Corp. LLC, a new wholly owned operating subsidiary. In September 2004, MicroFinancial secured a three-year, $30.0 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group.

The Company continues to take steps to reduce overhead, including a reduction in headcount from 103 at December 31, 2004 to 87 at December 31, 2005. During the nine months ended September 30, 2006, the employee headcount was reduced to 66 in a continued effort to maintain an infrastructure that is aligned with current business conditions. In addition, during 2005, the Company began to actively increase its industry presence with a more focused and targeted sales and marketing effort. The Company continues to support new sales and marketing initiatives, and has brought in experienced sales and marketing management to spearhead the effort.

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Critical Accounting Policies

The Company s significant accounting policies are more fully described in Note B to the condensed consolidated financial statements included in this Quarterly Report and in Note B to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission. Certain accounting policies are particularly important to the portrayal of the Company s consolidated financial position and results of operations. These policies require the application of significant judgment by management and as a result, are subject to an inherent degree of uncertainty. In applying these policies, management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosures. The Company bases its estimates and judgments on historical experience, terms of existing contracts, observance of trends in the industry, information obtained from dealers and other sources, and on various other assumptions that the Company believes to be reasonable and appropriate under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The Company s critical accounting policies, including revenue recognition, maintaining the allowance for credit losses, determining provisions for income taxes, and accounting for share-based compensation are each discussed in more detail in the Company s Annual Report on Form 10-K. Management has reviewed and determined that those policies remain our critical accounting policies and did not make any changes in those policies during the nine months ended September 30, 2006.

Results of Operations Three months ended September 30, 2006 as compared to the three months ended September 30, 2005

Revenue

	For the Three Months Ended September 30,		
	2005	Change	2006
	(Dollars in thousands)		
Income on financing leases	$ 832	21.0%	$ 1,007
Rental income			