

MICROFINANCIAL INC  
Form 10-Q  
August 15, 2011

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

(Mark One)

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

**For the quarterly period ended June 30, 2011**

**or**

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

04-2962824  
(I.R.S. Employer Identification No.)

16 New England Executive Park, Suite 200, Burlington, MA 01803  
(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.

☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) 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 Exchange Act).

☐ Yes ☒ No

As of July 31, 2011, 14,257,324 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)

|                                                                                                                                                           | June 30,<br>2011 | December<br>31,<br>2010 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|-------------------------|
| <b>ASSETS</b>                                                                                                                                             |                  |                         |
| Cash and cash equivalents                                                                                                                                 | \$ 434           | \$ 1,528                |
| Restricted cash                                                                                                                                           | 979              | 753                     |
| Net investment in leases:                                                                                                                                 |                  |                         |
| Receivables due in installments                                                                                                                           | 193,345          | 191,067                 |
| Estimated residual value                                                                                                                                  | 22,629           | 21,832                  |
| Initial direct costs                                                                                                                                      | 1,420            | 1,490                   |
| Less:                                                                                                                                                     |                  |                         |
| Advance lease payments and deposits                                                                                                                       | (3,603)          | (3,479)                 |
| Unearned income                                                                                                                                           | (58,993)         | (59,245)                |
| Allowance for credit losses                                                                                                                               | (12,895)         | (13,132)                |
| Net investment in leases                                                                                                                                  | 141,903          | 138,533                 |
| Investment in rental contracts, net                                                                                                                       | 732              | 461                     |
| Property and equipment, net                                                                                                                               | 2,083            | 800                     |
| Other assets                                                                                                                                              | 1,219            | 1,530                   |
| Total assets                                                                                                                                              | \$ 147,350       | \$ 143,605              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                               |                  |                         |
| Revolving line of credit                                                                                                                                  | \$ 59,574        | \$ 62,650               |
| Accounts payable                                                                                                                                          | 2,512            | 2,435                   |
| Capital lease obligation                                                                                                                                  | 6                | 26                      |
| Dividends payable                                                                                                                                         | 12               | 5                       |
| Other liabilities                                                                                                                                         | 3,222            | 1,375                   |
| Deferred income taxes                                                                                                                                     | 9,618            | 7,627                   |
| Total liabilities                                                                                                                                         | 74,944           | 74,118                  |
| Stockholders' equity:                                                                                                                                     |                  |                         |
| Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at June 30, 2011 and December 31, 2010                                    |                  |                         |
| Common stock, \$.01 par value; 25,000,000 shares authorized; 14,231,692 and 14,231,933 shares issued at June 30, 2011 and December 31, 2010, respectively | 142              | 142                     |
| Additional paid-in capital                                                                                                                                | 46,515           | 46,475                  |
| Retained earnings                                                                                                                                         | 25,749           | 22,870                  |
| Total stockholders' equity                                                                                                                                | 72,406           | 69,487                  |
| Total liabilities and stockholders' equity                                                                                                                | \$ 147,350       | \$ 143,605              |

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

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**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

*(In thousands, except share and per share data)*

(Unaudited)

|                                          | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                          | 2011                           | 2010       | 2011                         | 2010       |
| Revenues:                                |                                |            |                              |            |
| Income on financing leases               | \$ 9,136                       | \$ 8,509   | \$ 18,237                    | \$ 16,631  |
| Rental income                            | 2,073                          | 1,920      | 4,079                        | 3,878      |
| Income on service contracts              | 103                            | 132        | 211                          | 273        |
| Loss and damage waiver fees              | 1,220                          | 1,119      | 2,421                        | 2,223      |
| Service fees and other                   | 931                            | 941        | 1,863                        | 1,934      |
| Total revenues                           | 13,463                         | 12,621     | 26,811                       | 24,939     |
| Expenses:                                |                                |            |                              |            |
| Selling, general and administrative      | 4,037                          | 3,581      | 7,990                        | 6,811      |
| Provision for credit losses              | 4,251                          | 5,562      | 9,003                        | 12,493     |
| Depreciation and amortization            | 783                            | 474        | 1,464                        | 902        |
| Interest                                 | 680                            | 885        | 1,343                        | 1,696      |
| Total expenses                           | 9,751                          | 10,502     | 19,800                       | 21,902     |
| Income before provision for income taxes | 3,712                          | 2,119      | 7,011                        | 3,037      |
| Provision for income taxes               | 1,429                          | 818        | 2,699                        | 1,171      |
| Net income                               | \$ 2,283                       | \$ 1,301   | \$ 4,312                     | \$ 1,866   |
| Net income per common share basic        | \$ 0.16                        | \$ 0.09    | \$ 0.30                      | \$ 0.13    |
| Net income per common share diluted      | \$ 0.16                        | \$ 0.09    | \$ 0.30                      | \$ 0.13    |
| Weighted-average shares:                 |                                |            |                              |            |
| Basic                                    | 14,231,692                     | 14,230,670 | 14,239,180                   | 14,220,529 |
| Diluted                                  | 14,503,702                     | 14,452,575 | 14,495,745                   | 14,432,535 |

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

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**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

*(In thousands, except share and per share data)*

(Unaudited)

|                                           | Common Stock<br>Shares | Amount | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Total<br>Stockholders<br>Equity |
|-------------------------------------------|------------------------|--------|----------------------------------|----------------------|---------------------------------|
| Balance at December 31, 2009              | 14,174,326             | \$ 142 | \$ 46,197                        | \$ 20,426            | \$ 66,765                       |
| Stock issued for deferred compensation    | 88,269                 |        | 295                              |                      | 295                             |
| Stock-based compensation                  |                        |        | 112                              |                      | 112                             |
| Amortization of unearned compensation     | 3,750                  |        | 10                               |                      | 10                              |
| Stock repurchase program                  | (34,412)               |        | (139)                            |                      | (139)                           |
| Common stock dividends (\$0.20 per share) |                        |        |                                  | (2,852)              | (2,852)                         |
| Net income                                |                        |        |                                  | 5,296                | 5,296                           |
| Balance at December 31, 2010              | 14,231,933             | 142    | 46,475                           | 22,870               | 69,487                          |
| Stock issued for deferred compensation    | 51,642                 |        | 212                              |                      | 212                             |
| Stock-based compensation                  |                        |        | 68                               |                      | 68                              |
| Stock repurchase program                  | (51,883)               |        | (240)                            |                      | (240)                           |
| Common stock dividends (\$0.10 per share) |                        |        |                                  | (1,433)              | (1,433)                         |
| Net income                                |                        |        |                                  | 4,312                | 4,312                           |
| Balance at June 30, 2011                  | 14,231,692             | \$ 142 | \$ 46,515                        | \$ 25,749            | \$ 72,406                       |

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 FLOW**

*(In thousands)*

(Unaudited)

|                                                                                   | Six Months Ended<br>June 30, |           |
|-----------------------------------------------------------------------------------|------------------------------|-----------|
|                                                                                   | 2011                         | 2010      |
| Cash flows from operating activities:                                             |                              |           |
| Cash received from customers                                                      | \$ 52,469                    | \$ 44,928 |
| Cash paid to suppliers and employees                                              | (9,240)                      | (7,824)   |
| Cash paid for income taxes                                                        | (238)                        | (951)     |
| Interest paid                                                                     | (1,229)                      | (1,173)   |
| Interest received                                                                 | 1                            | 1         |
| Net cash provided by operating activities                                         | 41,763                       | 34,981    |
| Cash flows from investing activities:                                             |                              |           |
| Investment in lease and rental contracts                                          | (36,635)                     | (38,857)  |
| Investment in direct costs                                                        | (498)                        | (575)     |
| Investment in property and equipment                                              | (734)                        | (62)      |
| Net cash used in investing activities                                             | (37,867)                     | (39,494)  |
| Cash flows from financing activities:                                             |                              |           |
| Proceeds from secured debt                                                        | 48,729                       | 50,933    |
| Repayment of secured debt                                                         | (51,805)                     | (43,823)  |
| Payment of debt closing costs                                                     | (2)                          |           |
| Increase in restricted cash                                                       | (226)                        | (24)      |
| Repayment of capital lease obligation                                             | (20)                         | (33)      |
| Repurchase of common stock                                                        | (240)                        |           |
| Payment of dividends                                                              | (1,426)                      | (1,421)   |
| Net cash (used in) provided by financing activities                               | (4,990)                      | 5,632     |
| Net change in cash and cash equivalents                                           | (1,094)                      | 1,119     |
| Cash and cash equivalents, beginning of period                                    | 1,528                        | 391       |
| Cash and cash equivalents, end of period                                          | \$ 434                       | \$ 1,510  |
| Reconciliation of net income to net cash provided by operating activities:        |                              |           |
| Net income                                                                        | \$ 4,312                     | \$ 1,866  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |           |

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|                                                              |           |           |
|--------------------------------------------------------------|-----------|-----------|
| Amortization of unearned income, net of initial direct costs | (18,237)  | (16,631)  |
| Depreciation and amortization                                | 1,464     | 902       |
| Provision for credit losses                                  | 9,003     | 12,493    |
| Recovery of equipment cost and residual value                | 40,715    | 34,862    |
| Stock-based compensation expense                             | 68        | 62        |
| Changes in assets and liabilities:                           |           |           |
| Current taxes payable                                        | 137       | (74)      |
| Deferred income taxes                                        | 1,991     | 293       |
| Other assets                                                 | 311       | 111       |
| Accounts payable                                             | 289       | 328       |
| Other liabilities                                            | 1,710     | 769       |
| Net cash provided by operating activities                    | \$ 41,763 | \$ 34,981 |

Supplemental disclosure of non-cash activities:

|                                                                |        |        |
|----------------------------------------------------------------|--------|--------|
| Acquisition of property and equipment through lease incentives | \$ 791 | \$     |
| Fair market value of stock issued for compensation             | \$ 212 | \$ 169 |

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 (referred to as MicroFinancial, we, us or our ) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. and LeaseComm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. LeaseComm started originating leases in January 1986 and in October 2002 suspended virtually all originations due to an interruption in financing. TimePayment commenced originating leases in July 2004. The average amount financed by TimePayment during 2010 was approximately \$5,800 compared to the 2011 year to date average of \$6,100. LeaseComm historically financed contracts of approximately \$1,900. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our revolving line of credit.

**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, our interim statements do not include all of the information and disclosures required for our annual financial statements. In the opinion of our 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 our consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2010. The results for the six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2011.

The balance sheet at December 31, 2010 has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2010.

*Allowance for Loan Losses and Credit Quality*

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Given the nature of the microticket market and the individual size of each transaction, we do not have a formal credit review committee to review individual transactions. Rather, we developed a sophisticated, multi-tiered pricing model and have automated the credit scoring, approval and collection processes. We believe that with the proper pricing model, we can grant credit to a wide range of applicants provided we have priced appropriately for the associated risk. As a result of approving a wide range of credits, we experience a relatively high level of delinquency and write-offs in our portfolio. We periodically review the credit scoring and approval process to ensure that the automated system is making appropriate credit decisions. Contracts in our portfolio are not re-graded subsequent to the initial extension of credit and the allowance is not allocated to specific contracts. Rather, we view the contracts as having common characteristics and maintain a general allowance against our entire portfolio utilizing historical collection statistics and an assessment of current credit risk in the portfolio as the basis for the amount.

We have adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for our microticket transactions. We estimate the likelihood of credit losses net of recoveries in the portfolio at each reporting period based upon a combination of the lessee's bureau reported credit score at lease inception and the current delinquency status of the account. In addition to these elements, we also consider other relevant factors including general economic trends, trends in delinquencies and credit losses, static pool analysis of our portfolio, trends in recoveries made on charged off accounts, and other relevant factors which might affect the performance of our portfolio. This combination of historical experience, credit scores, delinquency levels, trends in credit losses, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses. We take charge-offs against our receivables when such receivables are deemed uncollectible. In general

a receivable is uncollectable when it is 360 days past due or earlier, if other adverse events occur with

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

respect to an account. Historically, the typical monthly payment under our microticket leases has been small and as a result, our experience is that lessees will pay past due amounts later in the process because of the relatively small amount necessary to bring an account current.

In 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses requiring us to provide detailed disclosures about the nature of credit risk inherent in our financing receivables, how we analyze that risk in estimating our allowance for credit losses, and the changes in the allowance for credit losses.

We segregate our lease portfolio between TimePayment Corp. and LeaseComm Corp. to perform the calculation and analysis of the allowance for credit losses. Each subsidiary consists of a single portfolio segment which we refer to as microticket equipment. We take charge-offs against our receivables when such receivables are deemed uncollectible. None of our receivables are placed on nonaccrual status as they are charged off when deemed uncollectible.

Activity in the allowance for credit losses for the six months ended June 30, 2011 and 2010 was as follows:

|                                        | Six Months Ended<br>June 30, |           |
|----------------------------------------|------------------------------|-----------|
|                                        | 2011                         | 2010      |
| Allowance for credit losses, beginning | \$ 13,132                    | \$ 13,856 |
| Provision for credit losses            | 9,003                        | 12,493    |
| Charge-offs                            | (11,733)                     | (14,946)  |
| Recoveries                             | 2,493                        | 2,028     |
| Allowance for credit losses, ending    | \$ 12,895                    | \$ 13,431 |

The following table reconciles the activity in the allowance for credit losses by portfolio segment at June 30, 2011:

|                                                                     | LeaseComm<br>Microticket<br>equipment | TimePayment<br>Microticket<br>equipment | Total                  |
|---------------------------------------------------------------------|---------------------------------------|-----------------------------------------|------------------------|
| Allowance for Credit Losses:                                        |                                       |                                         |                        |
| Beginning balance                                                   | \$ 231                                | \$ 12,901                               | \$ 13,132              |
| Charge-offs                                                         | (394)                                 | (11,339)                                | (11,733)               |
| Recoveries                                                          | 641                                   | 1,852                                   | 2,493                  |
| Provisions (credits)                                                | (290)                                 | 9,293                                   | 9,003                  |
| Ending balance                                                      | \$ 188                                | \$ 12,707                               | \$ 12,895              |
| Ending balance: Individually evaluated for impairment               |                                       |                                         |                        |
| Ending balance: Collectively evaluated for impairment               | 188                                   | 12,707                                  | 12,895                 |
| Ending balance: Contracts acquired with deteriorated credit quality |                                       |                                         |                        |
| Financing Receivables:                                              |                                       |                                         |                        |
| Ending balance                                                      | 415                                   | 154,383                                 | 154,798 <sup>(1)</sup> |



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

|                                                                     | LeaseComm<br>Microticket<br>equipment | TimePayment<br>Microticket<br>equipment | Total                  |
|---------------------------------------------------------------------|---------------------------------------|-----------------------------------------|------------------------|
| Ending balance: Individually evaluated for impairment               |                                       |                                         |                        |
| Ending balance: Collectively evaluated for impairment               | 415                                   | 154,383                                 | 154,798 <sup>(1)</sup> |
| Ending balance: Contracts acquired with deteriorated credit quality |                                       |                                         |                        |

(1) Total financing receivables include net investment in leases. For purposes of asset quality and allowance calculations, the allowance for credit losses is excluded.

Each period the provision for credit losses in the income statement results from the combination of an estimate by management of credit losses that occurred during the current period and the ongoing adjustment of prior estimates of losses occurring in prior periods.

To serve as a basis for making this provision, we maintain an internally developed proprietary scoring model that considers several factors including the lessee's bureau reported credit score at lease inception. We also consider other relevant factors including general economic trends, trends in delinquencies and credit losses, static pool analysis of our portfolio, trends in recoveries made on charged off accounts, and other relevant factors which might affect the performance of our portfolio. The combination of historical experience, credit scores, delinquency levels, trends in credit losses, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses.

We assign internal risk ratings for all lessees and determine the credit worthiness of each lease based upon this internally developed proprietary scoring model. The LeaseComm portfolio is evaluated in total with a reserve of 50% of the outstanding amount greater than 90 days plus 25% of the amount outstanding from 1 to 89 days as that portfolio is decreasing. For the TimePayment portfolio, the scoring model generates one of nine acceptable risk ratings based upon the credit worthiness of each lease or it rejects the lease application. The scores are assigned at lease inception and these scores are maintained over the lease term regardless of payment performance. To facilitate review and reporting, management aggregates these nine scores into one of three categories with similar risk profiles and delinquency characteristics identified as Gold, Silver or Bronze.

Leases assigned a gold rating represent those transactions which exhibit the highest risk rating based on our internal credit scores. They are considered of sufficient quality to preclude an otherwise adverse rating. Gold rated leases are typically represented by lessees with high bureau reported credit scores at lease inception or are supported by established businesses for those transactions which are not personally guaranteed by the lessee.

Leases assigned a silver rating fall in the middle range of the nine acceptable scores generated by the scoring model. These transactions possess a reasonable amount of risk based on their profile and may exhibit vulnerability to deterioration if adverse factors are encountered. These accounts typically demonstrate adequate coverage but warrant a higher level of monitoring by management to ensure that weaknesses do not advance.

A bronze rating applies to leases at the lower end of the nine acceptable scores generated by the scoring model whereby the lessee may have difficulty meeting the lease obligation if adverse factors are encountered. Bronze rated transactions typically have lower reported credit scores at lease inception and will typically have other less desirable credit attributes.



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

The following table presents the aging of the recorded investment in leases as of June 30, 2011, by our internally graded score:

|                   | Current    | Past Due  | Total      |
|-------------------|------------|-----------|------------|
| TimePayment Corp. |            |           |            |
| Grade             |            |           |            |
| Gold              | \$ 45,456  | \$ 3,625  | \$ 49,081  |
| Silver            | 79,753     | 18,601    | 98,354     |
| Bronze            | 4,485      | 2,463     | 6,948      |
| Total             | 129,694    | 24,689    | 154,383    |
| LeaseComm         | 183        | 232       | 415        |
| Total             | \$ 129,877 | \$ 24,921 | \$ 154,798 |

The following table presents the aged analysis of past due financing receivables by our internally developed proprietary scoring model in leases as of June 30, 2011:

|                               | Current    | 31 to 60<br>days<br>Past Due | 61 to 90<br>days<br>Past Due | Over 90<br>Days<br>Past Due | Total      | Over 90<br>Days<br>Accruing |
|-------------------------------|------------|------------------------------|------------------------------|-----------------------------|------------|-----------------------------|
| LeaseComm:                    | \$ 183     | \$ 11                        | \$ 8                         | \$ 213                      | \$ 415     | \$ 213                      |
| TimePayment Corp.             |            |                              |                              |                             |            |                             |
| Gold                          | 45,456     | 1,372                        | 540                          | 1,713                       | 49,081     | 1,713                       |
| Silver                        | 79,753     | 2,762                        | 2,488                        | 13,351                      | 98,354     | 13,351                      |
| Bronze                        | 4,485      | 261                          | 294                          | 1,908                       | 6,948      | 1,908                       |
| TimePayment Corp.<br>subtotal | 129,694    | 4,395                        | 3,322                        | 16,972                      | 154,383    | 16,972                      |
| Total                         | \$ 129,877 | \$ 4,406                     | \$ 3,330                     | \$ 17,185                   | \$ 154,798 | \$ 17,185                   |

**Percent of Total**

|                       |       |      |      |       |      |
|-----------------------|-------|------|------|-------|------|
| Financing Receivables | 83.9% | 2.8% | 2.2% | 11.1% | 100% |
|-----------------------|-------|------|------|-------|------|

***Fair Value of Financial Instruments***

For financial instruments including cash and cash equivalents, restricted cash, accounts payable, and other liabilities, we believe that the carrying amount approximates fair value due to their short-term nature. The fair value of the revolving line of credit is calculated based on the incremental borrowing rates currently available on loans with similar terms and maturities. The fair value of our revolving line of credit at June 30, 2011 approximates its carrying value.



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

*Net Income Per Share*

Basic net income per common share is computed based on the weighted-average number of common shares outstanding during the period. Diluted net income per common share gives effect to all potentially dilutive common shares outstanding during the period. The computation of diluted net income per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. At June 30, 2011 and 2010, 409,305 and 499,305 options, respectively, were excluded from the computation of diluted net income per share because their effect would have been antidilutive.

Net income per share for the three and six months ended June 30, 2011 and 2010 is as follows:

|                                                                        | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|------------------------------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                                        | 2011                           | 2010       | 2011                         | 2010       |
| Net income                                                             | \$ 2,283                       | \$ 1,301   | \$ 4,312                     | \$ 1,866   |
| Weighted average common shares outstanding                             | 14,231,692                     | 14,230,670 | 14,239,180                   | 14,220,529 |
| Dilutive effect of common stock options, warrants and restricted stock | 272,010                        | 221,905    | 256,565                      | 212,006    |
| Shares used in computation of net income per common share diluted      | 14,503,702                     | 14,452,575 | 14,495,745                   | 14,432,535 |
| Net income per common share basic                                      | \$ 0.16                        | \$ 0.09    | \$ 0.30                      | \$ 0.13    |
| Net income per common share diluted                                    | \$ 0.16                        | \$ 0.09    | \$ 0.30                      | \$ 0.13    |

*Stock-Based Employee Compensation*

Under our 2008 Equity Incentive Plan, we reserved 1,000,000 shares of common stock for issuance. In February 2011, under our 2008 Equity Incentive Plan the Compensation and Benefits Committee of our Board of Directors granted 33,044 restricted stock units to our executive officers. The restricted stock units vest over five years at 25% annually beginning on the second anniversary of the grant date. The restricted stock units were valued on the date of grant and the fair value of these awards was \$4.11 per share. For the six months ended June 30, 2011 the expense related to these units is \$11,000.

The following summarizes stock option activity for the six months ended June 30, 2011:

|                                  | Shares   | Price Per Share     | Weighted-Average Exercise Price |
|----------------------------------|----------|---------------------|---------------------------------|
| Outstanding at December 31, 2010 | 908,028  | \$ 1.585 to \$13.10 | \$ 5.07                         |
| Granted                          |          |                     |                                 |
| Expired                          | (90,000) | \$ 13.10            | \$ 13.10                        |

Forfeited

|                              |         |                    |         |
|------------------------------|---------|--------------------|---------|
| Outstanding at June 30, 2011 | 818,028 | \$ 1.585 to \$6.70 | \$ 4.19 |
|------------------------------|---------|--------------------|---------|

In February 2011, we granted our non-employee directors a total of 51,642 shares of stock with immediate vesting and a fair value of \$4.11 per share, for a total grant date fair value of \$212,249, in accordance with our director compensation policy. In February 2010, we granted our non-employee directors a total of 53,844 shares of stock with immediate vesting and a fair value of \$3.15 per share, for a total grant date value of \$169,609, in accordance with our director compensation policy.

During the six months ended June 30, 2011, 90,000 options originally granted to members of the Board of Directors in February 2001 expired. During the six months ended June 30, 2010, 350,000 options originally granted to members of the Board of Directors in February of 2000 expired. There were no options granted or exercised during the six months ended June 30, 2011.

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

The following table summarizes unvested restricted stock activity:

|                                 | Restricted<br>Stock<br>Number<br>of Shares | Restricted<br>Stock<br>Units Number<br>of Shares |
|---------------------------------|--------------------------------------------|--------------------------------------------------|
| Non-vested at December 31, 2010 |                                            | \$ 33,518                                        |
| Granted                         | 51,642                                     | 33,044                                           |
| Vested                          | (51,642)                                   |                                                  |
| Non-vested at June 30, 2011     |                                            | 66,562                                           |

During the three months ended June 30, 2011, amortized compensation expense related to the restricted stock units was \$12,000. During the six months ended June 30, 2011, amortized compensation expense related to the restricted stock units was \$22,000.

Information relating to our outstanding stock options at June 30, 2011 is as follows:

|                   |         | Outstanding          |           | Exercisable          |           |        |
|-------------------|---------|----------------------|-----------|----------------------|-----------|--------|
|                   |         | Weighted-<br>Average | Intrinsic | Weighted-<br>Average | Intrinsic |        |
| Exercise<br>Price | Shares  | Life (Years)         | Value     | Exercise<br>Price    | Shares    | Value  |
| \$ 6.70           | 235,000 | 0.66                 |           | 6.70                 | 235,000   |        |
| 1.59              | 150,000 | 1.41                 | \$ 592    | 1.59                 | 150,000   | \$ 592 |
| 5.77              | 31,923  | 5.67                 |           | 5.77                 |           |        |
| 5.85              | 142,382 | 6.58                 |           | 5.85                 | 71,191    |        |
| 2.30              | 258,723 | 7.67                 | 836       | 2.30                 | 64,681    | 209    |
|                   | 818,028 | 4.24                 | \$ 1,428  | 4.56                 | 520,872   | \$ 801 |

During the three months ended June 30, 2011 and 2010, the total share based employee compensation cost recognized was \$33,000 and \$35,000, respectively. During the six months ended June 30, 2011 and 2010, the total share based compensation cost recognized was \$68,000 and \$62,000, respectively.

***Dividends***

On January 21, 2011, we declared a dividend of \$0.05 payable on February 15, 2011 to stockholders of record on February 1, 2011.

On April 21, 2011, we declared a dividend of \$0.05 payable on May 13, 2011 to stockholders of record on May 2, 2011.

***Cash and Cash Equivalents***

We consider all highly liquid instruments purchased with original maturities of less than three months to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value.

***Concentration of Credit Risk***

We deposit our cash and invest in short-term investments primarily through national commercial banks. Deposits in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) are exposed to loss in the event of

nonperformance by the institution. The Company maintains cash deposits in excess of the FDIC insurance coverage.

**C. Revolving line of credit**

On August 2, 2007, we entered into a three-year revolving line of credit with a bank syndicate led by Sovereign Bank ( Sovereign ) based on qualified TimePayment lease receivables. The total commitment under the facility was originally \$30 million, and was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Prior to the July 2010 amendment, outstanding borrowings bore interest at Prime plus 1.75% or at a London Interbank Offered Rate

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( LIBOR ) plus 3.75%, in each case subject to a minimum rate of 5.00%. Following the July 2010 amendment, outstanding borrowings bear interest at Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

As a part of the July 2010 amendment, the maturity date of the facility was extended to August 2, 2013. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan.

At June 30, 2011, \$57.0 million of our loans were LIBOR loans and \$2.6 million of our loans were Prime Rate Loans. The interest rate on our loans at June 30, 2011 was between 3.49% and 4.50%. The amount available on our revolving line of credit at June 30, 2011 was \$40.4 million. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of June 30, 2011, we were in compliance with all covenants under the revolving line of credit.

**D. Commitments and Contingencies**

*Legal Matters*

We are involved from time to time in litigation incidental to the conduct of our business. Although we do not expect that the outcome of any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, litigation is inherently unpredictable. Therefore, judgments could be rendered, or settlements entered, that could adversely affect our operating results or cash flows in a particular period. We routinely assess all of our litigation and threatened litigation as to the probability of ultimately incurring a liability, and record our best estimate of the ultimate loss in situations where we assess the likelihood of loss as probable.

*Lease Commitments*

We accept lease applications on a daily basis and, as a result, we have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including the receipt of the lease, supporting documentation and verification with the lessee. Since we fund on the same day a lease is verified, we do not have any outstanding commitments to lend.

*Stock Repurchase*

On August 10, 2010, our Board of Directors approved a common stock repurchase program under which we are authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases may take place in either the open market or through block trades. The repurchase program will be funded by our working capital and may be suspended or discontinued at anytime.

During the first quarter of fiscal year 2011 we repurchased and retired 51,883 shares of our common stock under our stock buyback program. We did not repurchase any shares of our common stock during the second quarter of fiscal year 2011.

**E. Subsequent Events**

We have evaluated all events or transactions that occurred through the date on which we issued these financial statements. Other than the declaration of dividends we did not have any material subsequent events that impacted our consolidated financial statements.

On July 20, 2011, we declared a dividend of \$0.05 payable on August 15, 2011 to shareholders of record on August 1, 2011.

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**F. Recent Accounting Pronouncements**

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures. This update provides amendments to FASB 820-10 Fair Value Measurements and Disclosures that require new disclosures as follows:

Transfers in and out of Levels 1 and 2. A reporting entry should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers.

Activity in level 3 fair value measurements.

A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities.

In the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number). The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. We adopted the provisions of ASU 2010-6 which are required for the current year and the adoption did not have a material effect on our consolidated financial position or results of operations.

In July 2010, the FASB issued ASU 2010-20 Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. This guidance expands the disclosures pertaining to the credit quality of loans and should provide users of the financial statements with a better overall understanding of the credit risk in the loan portfolio. This guidance is effective for interim and annual periods ending after December 15, 2010. We adopted the provisions of ASU 2010-20 during the year ended December 31, 2010. In connection with the adoption of ASU 2010-20 certain additional disclosure are required for reporting periods ending after December 31, 2010, related to the activity within the Company's portfolio segments. These disclosures have been included in these notes to unaudited condensed 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 our 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 our Annual Report on Form 10-K for the year ended December 31, 2010.

**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," "intends" and similar expressions are intended to identify forward-looking statements. We caution that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Such statements contain a number of risks and uncertainties, including but not limited to those associated with: the demand for the equipment types we finance; our significant capital requirements; our inability to obtain the financing we need, or to use internally generated funds, in order to continue originating contracts; the risks of defaults on our leases; our provision for credit losses; our residual interests in underlying equipment; possible adverse consequences associated with our collection policy; the effect of higher interest rates on our portfolio; increasing competition; increased governmental regulation of the rates and methods we use in financing and collecting on our leases and contracts; acquiring other portfolios or companies; dependence on key personnel; changes to accounting standards for equipment leases; adverse results in litigation and regulatory matters, or promulgation of new or enhanced legislation or regulations; and general economic and business conditions. Readers should not place undue reliance on forward-looking statements, which reflect our view only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. We cannot assure that we will be able to anticipate or respond timely to changes which could adversely affect our operating results. 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 our common stock. Statements relating to past dividend payments or our 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 our business, see the risk factors included in our most recent Annual Report on Form 10-K and other documents we file from time to time with the Securities and Exchange Commission.

**Overview**

We are a specialized commercial finance company that provides "microticket" equipment leasing and other financing services. The average amount financed by TimePayment during 2010 was approximately \$5,800 compared to the 2011 year to date average of \$6,100. LeaseComm historically financed contracts of approximately \$1,900. Our existing portfolio consists of business equipment leased or rented primarily to small commercial enterprises.

We finance the funding of our leases and contracts primarily through cash provided by operating activities and borrowings on our revolving line of credit. On August 2, 2007, we entered into a three-year revolving line of credit with a bank syndicate led by Sovereign Bank ("Sovereign") based on qualified TimePayment lease receivables. The total commitment under the facility was originally \$30 million, and was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Prior to the July 2010 amendment, outstanding borrowings bore interest at Prime plus 1.75% or at a London Interbank Offered Rate ("LIBOR") plus 3.75%, in each case subject to a minimum rate of 5.00%. Following the July 2010 amendment, outstanding borrowings bear interest at Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime

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Rate Loan. As a part of the July 2010 amendment, the maturity date of the facility was extended to August 2, 2013. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan.

In a typical lease transaction, we originate a lease through our nationwide network of equipment vendors, independent sales organizations and brokers. Upon our approval of a lease application and verification that the lessee has received the equipment and signed the lease, we pay the dealer for the cost of the equipment, plus the dealer's profit margin.

Substantially all leases originated or acquired by us are non-cancelable. During the term of the lease, we are scheduled to receive payments sufficient to cover our borrowing costs and the cost of the underlying equipment and provide us with an appropriate profit. We pass along some of the costs of our leases and contracts by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Collection fees are imposed based on our estimate of the costs of collection. The loss and damage waiver fees are charged if a customer fails to provide proof of insurance and are reasonably related to the cost of replacing the lost or damaged equipment or product. The initial non-cancelable term of the lease is equal to or less than the equipment's estimated economic life and often provides us with additional revenues based on the residual value of the equipment at the end of the lease. Initial terms of the leases in our portfolio generally range from 12 to 60 months, with an average initial term of 45 months as of December 31, 2010.

**Critical Accounting Policies**

Our 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 our Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission. Certain accounting policies are particularly important to the portrayal of our consolidated financial position and results of operations. These policies require the application of significant judgment by us and as a result, are subject to an inherent degree of uncertainty. In applying these policies, we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosures. We base our 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 we believe 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.

Our critical accounting policies, including revenue recognition, the allowance for credit losses, determining for income taxes, and accounting for share-based compensation are each discussed in more detail in our Annual Report on Form 10-K. We have reviewed those policies and determined that they remain our critical accounting policies and that we did not make any changes in those policies during the six months ended June 30, 2011.

***Results of Operations Three months ended June 30, 2011 compared to the three months ended June 30, 2010***  
***Revenue***

|                               | Three Months Ended June 30, |        |           |
|-------------------------------|-----------------------------|--------|-----------|
|                               | 2011                        | Change | 2010      |
|                               | (Dollars in thousands)      |        |           |
| Income on financing leases    | \$ 9,136                    | 7.4%   | \$ 8,509  |
| Rental income                 | 2,073                       | 8.0    | 1,920     |
| Income on service contracts   | 103                         | (22.0) | 132       |
| Loss and damage waiver fees   | 1,220                       | 9.0    | 1,119     |
| Service fees and other income | 931                         | (1.1)  | 941       |
| Total revenues                | \$ 13,463                   | 6.7%   | \$ 12,621 |

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned

lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds

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the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Total revenues for the three months ended June 30, 2011 were \$13.5 million, an increase of \$800,000, or 6.7%, from the three months ended June 30, 2010. The overall increase was due to an increase of \$600,000 in income on financing leases, an increase of \$200,000 in rental income, an increase of \$91,000 in fees and other income, partially offset by a decrease of \$29,000 in income on service contracts. The increase in income on financing leases is a result of the continued growth in new lease originations. The increase in rental income is the result of TimePayment lease contracts coming to term and converting to rentals. Service contract revenue continues to decline since we have not funded any new service contracts since 2004.

*Selling, General and Administrative Expenses*

|                                     | Three Months Ended June 30, |        |         |
|-------------------------------------|-----------------------------|--------|---------|
|                                     | 2011                        | Change | 2010    |
|                                     | (Dollars in thousands)      |        |         |
| Selling, general and administrative | \$4,037                     | 12.7%  | \$3,581 |
| As a percent of revenue             | 30.0%                       |        | 28.3%   |

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$456,000 for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010. The increase was primarily driven by increases in compensation expense of \$147,000, increases of employee benefits of \$145,000, and a \$70,000 increase in rent expense associated with the opening of our California office location. The number of employees as of June 30, 2011 was 129 compared to 113 as of June 30, 2010.

*Provision for Credit Losses*

|                             | Three Months Ended June 30, |         |         |
|-----------------------------|-----------------------------|---------|---------|
|                             | 2011                        | Change  | 2010    |
|                             | (Dollars in thousands)      |         |         |
| Provision for credit losses | \$4,251                     | (23.6)% | \$5,562 |
| As a percent of revenue     | 31.6%                       |         | 44.1%   |

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses decreased by \$1.3 million for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010, while net charge-offs decreased by 28.3% to \$4.3 million. The provision was based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The decrease in the allowance reflects improvements in delinquency levels of the lease portfolio.

*Depreciation and Amortization*

|                                     | Three Months Ended June 30, |        |        |
|-------------------------------------|-----------------------------|--------|--------|
|                                     | 2011                        | Change | 2010   |
|                                     | (Dollars in thousands)      |        |        |
| Depreciation fixed assets           | \$ 121                      | 9.0%   | \$ 111 |
| Depreciation rental equipment       | 662                         | 82.4   | 363    |
| Total depreciation and amortization | \$ 783                      | 65.2   | \$ 474 |
| As a percent of revenue             | 5.8%                        |        | 3.8%   |

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment. Fixed assets are recorded at cost and depreciated over their expected useful lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece

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of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

Depreciation expense on rental contracts increased by \$299,000 as compared to the three months ended June 30, 2011, as compared to the three months ended June 30, 2010. The increase in depreciation is due to the increase in the overall size of our portfolio of rental equipment. Depreciation and amortization of property and equipment increased by \$10,000 for the three months ended June 30, 2011, due to additions acquired during 2011, as compared to the three months ended June 30, 2010.

*Interest Expense*

|                         | Three Months Ended June 30, |         |       |
|-------------------------|-----------------------------|---------|-------|
|                         | 2011                        | Change  | 2010  |
|                         | (Dollars in thousands)      |         |       |
| Interest                | \$680                       | (23.2)% | \$885 |
| As a percent of revenue | 5.1%                        |         | 7.0%  |

We pay interest on borrowings under our senior credit facility. Interest expense decreased by \$200,000 for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010. This decrease resulted primarily from our decreased level of borrowings as well as lower interest costs on our revolving line of credit. At June 30, 2011, the balance on our revolving line of credit was \$59.6 million compared to \$59.0 million at June 30, 2010. However, until the July 2010 amendment to the line of credit, a minimum 5% interest rate applied to outstanding borrowings. No such limit exists under the amended current line of credit. At June 30, 2011, \$57.0 million of our loans were LIBOR loans and \$2.6 million of our loans were Prime Rate Loans. The interest rate on our loans at June 30, 2011 was between 3.49% and 4.50%.

*Provision for Income Taxes*

|                                     | Three Months Ended June 30, |        |       |
|-------------------------------------|-----------------------------|--------|-------|
|                                     | 2011                        | Change | 2010  |
|                                     | (Dollars in thousands)      |        |       |
| Provision for income taxes          | \$1,429                     | 74.7%  | \$818 |
| As a percent of revenue             | 10.6%                       |        | 6.5%  |
| As a percent of income before taxes | 38.5%                       |        | 38.6% |

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary. The provision for income taxes increased by \$611,000 for the three months ended June 30, 2011, as compared to the three months ended June 30, 2010. This increase resulted primarily from the \$1.6 million increase in pre-tax income for the three months ended June 30, 2010 to the three months ended June 30, 2011.

As of December 31, 2010, we had a liability of \$15,000 for unrecognized tax benefits and a liability of \$6,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2011 we had a liability of \$17,000 for unrecognized tax benefits and a liability of \$4,000 for accrued interest and penalties related to various state income tax matters. The change in the unrecognized tax benefit relates to the closing of an audit and the notification of a new audit. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however, at this time we are unable to estimate the change.

Our federal income tax returns are subject to examination for tax years ended on or after December 31, 2007 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2006.

**Table of Contents***Other Operating Data*

Dealer funding was \$18.7 million for the three months ended June 30, 2011, a decrease of \$2.2 million or 10.6%, compared to the three months ended June 30, 2010. We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$216.9 million at March 31, 2011 to \$218.9 million at June 30, 2011. Net cash provided by operating activities increased by \$3.3 million, or 18.4%, to \$21.2 million during the three months ended June 30, 2011 as compared to the three months ended June 30, 2010.

***Results of Operations Six months ended June 30, 2011 compared to the six months ended June 30, 2010****Revenue*

|                               | Six Months Ended June 30, |        |           |
|-------------------------------|---------------------------|--------|-----------|
|                               | 2011                      | Change | 2010      |
|                               | (Dollars in thousands)    |        |           |
| Income on financing leases    | \$ 18,237                 | 9.7%   | \$ 16,631 |
| Rental income                 | 4,079                     | 5.2    | 3,878     |
| Income on service contracts   | 211                       | (22.7) | 273       |
| Loss and damage waiver fees   | 2,421                     | 8.9    | 2,223     |
| Service fees and other income | 1,863                     | (3.7)  | 1,934     |
| Total revenues                | \$ 26,811                 | 7.5%   | \$ 24,939 |

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Total revenues for the six months ended June 30, 2011 were \$26.8 million, an increase of \$1.9 million, or 7.5%, from the six months ended June 30, 2010. The overall increase was due to an increase of \$1.6 million in income on financing leases, an increase of \$200,000 in rental income, and a \$100,000 increase in fees and other income, partially offset by a decrease of \$62,000 in service contracts. The increase in income on financing leases is a result of the continued growth in new lease originations. The increase in rental income is the result of TimePayment lease contracts coming to term and converting to rentals. Service contract revenue continues to decline since we have not funded any new service contracts since 2004.

*Selling, General and Administrative Expenses*

|                                     | Six Months Ended June 30, |        |          |
|-------------------------------------|---------------------------|--------|----------|
|                                     | 2011                      | Change | 2010     |
|                                     | (Dollars in thousands)    |        |          |
| Selling, general and administrative | \$ 7,990                  | 17.3%  | \$ 6,811 |
| As a percent of revenue             | 29.8%                     |        | 27.3%    |

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$1.2 million for the six months ended June 30, 2011, as compared to the six months ended June 30, 2010. The increase was primarily driven by increases in payroll and payroll taxes of \$600,000, an increase in employee benefits of \$200,000 and an increase of \$100,000 in rent expense associated with the opening of our California office.



**Table of Contents***Provision for Credit Losses*

|                             | Six Months Ended June 30, |         |          |
|-----------------------------|---------------------------|---------|----------|
|                             | 2011                      | Change  | 2010     |
|                             | (Dollars in thousands)    |         |          |
| Provision for credit losses | \$9,003                   | (27.9)% | \$12,493 |
| As a percent of revenue     | 33.6%                     |         | 50.1%    |

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses decreased by \$3.5 million for the six months ended June 30, 2011, as compared to the six months ended June 30, 2010, while net charge-offs decreased by 28.5% to \$9.2 million. The provision is based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The decrease in the allowance reflects improvements in delinquency levels of the lease portfolio and a reduction in charge-off levels.

*Depreciation and Amortization*

|                                     | Six Months Ended June 30, |        |        |
|-------------------------------------|---------------------------|--------|--------|
|                                     | 2011                      | Change | 2010   |
|                                     | (Dollars in thousands)    |        |        |
| Depreciation fixed assets           | \$ 241                    | 6.2%   | \$ 227 |
| Depreciation rental equipment       | 1,223                     | 81.2   | 675    |
| Total depreciation and amortization | \$ 1,464                  | 62.3%  | \$ 902 |
| As a percent of revenue             | 5.5%                      |        | 3.6%   |

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment, and the amortization of service contracts. Fixed assets are recorded at cost and depreciated over their expected useful lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

Depreciation expense on rental contracts increased by \$600,000 for the six months ended June 30, 2011, as compared to the six months ended June 30, 2010. The increase in depreciation is due to the increase in the overall size of our portfolio of rental equipment. Depreciation and amortization of property and equipment increased by \$14,000 for the six months ended June 30, 2011, due to additions acquired during 2011 as compared to the six months ended June 30, 2010.

*Interest Expense*

|                         | Six Months Ended June 30, |         |         |
|-------------------------|---------------------------|---------|---------|
|                         | 2011                      | Change  | 2010    |
|                         | (Dollars in thousands)    |         |         |
| Interest                | \$1,343                   | (20.8)% | \$1,696 |
| As a percent of revenue | 5.0%                      |         | 6.8%    |

We pay interest on borrowings under our senior credit facility. Interest expense decreased by \$400,000 for the six months ended June 30, 2011, as compared to the six months ended June 30, 2010. This decrease resulted primarily from our decreased level of borrowings as well as lower interest costs on our revolving line of credit. At June 30, 2011, the balance on our revolving line of credit was \$59.6 million compared to \$59.0 million at June 30, 2010. However, until the July 2010 amendment to the line of credit, a minimum 5% interest rate applied to outstanding

borrowings. No such limit exists under the amended current line of credit. At June 30, 2011, \$57.0 million of our loans were LIBOR loans and \$2.6 million of our loans were Prime Rate Loans. The interest rate on our loans at June 30, 2011 was between 3.49% and 4.50%.

*Provision for Income Taxes*

|                                     | 2011    | Six Months Ended June 30,<br>Change<br>(Dollars in thousands) | 2010    |
|-------------------------------------|---------|---------------------------------------------------------------|---------|
| Provision for income taxes          | \$2,699 | 130.5%                                                        | \$1,171 |
| As a percent of revenue             | 10.1%   |                                                               | 4.7%    |
| As a percent of income before taxes | 38.5%   |                                                               | 38.6%   |

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The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary. The provision for income taxes increased by \$1.5 million for the six months ended June 30, 2011, as compared to the six months ended June 30, 2010. This increase resulted primarily from the \$4.0 increase in pre-tax income.

As of December 31, 2010, we had a liability of \$15,000 for unrecognized tax benefits and a liability of \$6,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2011 we had a liability of \$17,000 for unrecognized tax benefits and a liability of \$4,000 for accrued interest and penalties related to various state income tax matters. The change in the unrecognized tax benefit relates to the closing of an audit and the opening of a new one. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however, at this time we are unable to estimate the change.

Our federal income tax returns are subject to examination for tax years ended on or after December 31, 2007 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2006.

**Other Operating Data**

Dealer funding was \$37.1 million for the six months ended June 30, 2011, a decrease of \$2.0 million or 5.1%, compared to the six months ended June 30, 2010. We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$215.7 million at December 31, 2010 to \$218.9 million at June 30, 2011. Net cash provided by operating activities increased by \$6.8 million, or 19.4%, to \$41.8 million during the six months ended June 30, 2011 as compared to the six months ended June 30, 2010.

**Exposure to Credit Losses**

The amounts in the table below represent the balance of delinquent receivables on an exposure basis for all leases, rental contracts, and service contracts in our portfolio. An exposure basis aging classifies the entire receivable based on the invoice that is the most delinquent. For example, in the case of a rental or service contract, if a receivable is 90 days past due, all amounts billed and unpaid are placed in the over 90 days past due category. In the case of lease receivables, where the minimum contractual obligation of the lessee is booked as a receivable at the inception of the lease, if a receivable is 90 days past due, the entire receivable, including all amounts billed and unpaid as well as the minimum contractual obligation yet to be billed, will be placed in the over 90 days past due category.

| <i>(dollars in thousands)</i>         | June 30, 2011 |        | December 31, 2010 |        |
|---------------------------------------|---------------|--------|-------------------|--------|
| Current                               | \$ 164,584    | 85.1%  | \$ 160,674        | 84.1%  |
| 31-60 days past due                   | 5,535         | 2.9    | 6,142             | 3.2    |
| 61-90 days past due                   | 4,026         | 2.1    | 4,369             | 2.3    |
| Over 90 days past due                 | 19,200        | 9.9    | 19,882            | 10.4   |
| Gross receivables due in installments | \$ 193,345    | 100.0% | \$ 191,067        | 100.0% |

**Liquidity and Capital Resources****General**

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, free cash flow and our

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initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing the cash on hand, free cash flow, and our line of credit which matures in August 2013. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the six months ended June 30, 2011 and 2010, our primary sources of liquidity were cash provided by operating activities and borrowings on our revolving line of credit. We generated cash flow from operations of \$41.8 million for the six months ended June 30, 2011 compared to \$35.0 million for the six months ended June 30, 2010. At June 30, 2011, we had approximately \$59.6 million outstanding under our revolving line of credit facility and had available borrowing capacity of approximately \$40.4 million as described below.

We used net cash in investing activities of \$37.9 million during the six months ended June 30, 2011 and \$39.5 million for the six months ended June 30, 2010. Investing activities primarily relate to the origination of leases.

Net used in financing activities was \$5.0 million for the six months ended June 30, 2011 and net cash provided by financing activities was \$5.6 million for the six months ended June 30, 2010. Financing activities primarily consist of the borrowings and repayments under our revolving line of credit facility and dividend payments.

The maturity date of our revolving line of credit is August 2013, at which time the outstanding loan balance plus interest becomes due and payable. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan.

***Borrowings***

We utilize our revolving line of credit to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to the facility. Borrowings outstanding consist of the following:

|                                                  | June 30, 2011 |            |          |                 | December 31, 2010 |            |          |                 |
|--------------------------------------------------|---------------|------------|----------|-----------------|-------------------|------------|----------|-----------------|
|                                                  | Amounts       | Interest   | Unused   | Maximum         | Amounts           | Interest   | Unused   | Maximum         |
| (dollars in 000)                                 | Outstanding   | Rate       | Capacity | Facility Amount | Outstanding       | Rate       | Capacity | Facility Amount |
| Revolving line of credit facility <sup>(1)</sup> | \$59,574      | 3.49-4.50% | \$40,426 | \$100,000       | \$62,650          | 3.52-4.50% | \$37,350 | \$100,000       |

<sup>(1)</sup> The unused capacity is subject to the borrowing base formula.

On August 2, 2007, we entered into a three-year revolving line of credit with a bank syndicate led by Sovereign Bank (Sovereign) based on qualified TimePayment lease receivables. The total commitment under the facility was originally \$30 million, and was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Prior to the July 2010 amendment, outstanding borrowings bore interest at Prime plus 1.75% or at a London Interbank Offered Rate (LIBOR) plus 3.75%, in each case subject to a minimum rate of 5.00%. Following the July 2010 amendment, outstanding borrowings bear interest at Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan. As a part of the July 2010 amendment, the maturity date of the facility was extended to August 2, 2013. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan. At June 30, 2011, \$57.0 million of our loans were LIBOR Loans and \$2.6 million of our loans were Prime Rate Loans. The interest rate on the revolving line of credit was between 3.49% and 4.50% at June 30, 2011. As of June 30, 2011, the qualified lease receivables eligible under the borrowing base exceeded the \$100 million revolving line of credit.

**Table of Contents***Dividends*

On July 20, 2011, we declared a dividend of \$0.05 payable on August 15, 2011 to shareholders of record on August 1, 2011. On April 21, 2011, we declared a dividend of \$0.05 payable on May 13, 2011 to stockholders of record on May 2, 2011. On January 21, 2011 we declared a dividend of \$0.05 payable on February 15, 2011 to stockholders of record on February 1, 2011.

On January 22, 2010 we declared a dividend of \$0.05 payable on February 15, 2010 to shareholders of record on February 1, 2010. On April 20, 2010, we declared a dividend of \$0.05 payable on May 14, 2010 to shareholders of record on May 3, 2010.

Future dividend payments are subject to ongoing review and evaluation by our Board of Directors. The decision as to the amount and timing of future dividends, if any, will be made in light of our financial condition, capital requirements and growth plans, as well as our external financing arrangements and any other factors our Board of Directors may deem relevant. We can give no assurance as to the amount and timing of future dividends.

*Share repurchases*

On August 10, 2010, our Board of Directors approved a common stock repurchase program under which we are authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases may take place in either the open market or through block trades. The repurchase program will be funded by our working capital and may be suspended or discontinued at anytime. During the quarter ended March 31, 2011 we repurchased and retired 51,883 shares of our common stock under our stock buyback program, at a total cost of \$241,000. During the quarter ended June 30, 2011 we did not repurchase any shares.

**Contractual Obligations and Lease Commitments***Contractual Obligations*

We have entered into various agreements, such as debt and operating lease agreements that require future payments. For the six months ended June 30, 2011 we had borrowed \$48.7 million against our revolving line of credit and had repaid \$51.8 million. The \$59.6 million of outstanding borrowings as of June 30, 2011 will be repaid by the daily application of TimePayment receipts to our outstanding balance.

Our future minimum cash lease payments under non-cancelable operating leases are as follows:

|                             | 2011   | 2012   | 2013   | 2014   | 2015   | Thereafter |
|-----------------------------|--------|--------|--------|--------|--------|------------|
| Operating lease obligations | \$ 153 | \$ 622 | \$ 644 | \$ 638 | \$ 595 | \$ 1,587   |
| Lease Commitments           |        |        |        |        |        |            |

We accept lease applications on a daily basis and have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend 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, all required supporting information and successful verification with the lessee. Since we fund on the same day a lease is successfully verified, we have no firm outstanding commitments to lend.

**Recent Accounting Pronouncements**

See Note F of the notes to the unaudited condensed consolidated financial statements for a discussion of the impact of recent accounting pronouncements.

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**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

The following discussion about our risk management activities includes forward-looking statements that involve risk and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In the normal course of operations, we also face risks that are either non-financial or non-quantifiable. Such risks principally include credit risk and legal risk, and are not represented in the analysis that follows.

The implicit yield on all of our leases and contracts is on a fixed interest rate basis due to the leases and contracts having scheduled payments that are fixed at the time of origination. When we originate or acquire leases or contracts, we base our pricing in part on the spread we expect to achieve between the implicit yield on each lease or contract and the effective interest rate we expect to incur in financing such lease or contract through our credit facility. Increases in interest rates during the term of each lease or contract could narrow or eliminate the spread, or result in a negative spread.

Given the relatively short average life of our leases and contracts, our goal is to maintain a blend of fixed and variable interest rate obligations which limits our interest rate risk. As of June 30, 2011, we have repaid all of our fixed-rate debt and have \$59.6 million of outstanding variable interest rate obligations under our revolving line of credit.

Our revolving line of credit bears interest at rates which fluctuate with changes in the Prime Rate or LIBOR; therefore, our interest expense is sensitive to changes in market interest rates. The effect of a 10% adverse change in market interest rates, sustained for one year, on our interest expense would be immaterial.

We maintain an investment portfolio in accordance with our investment policy guidelines. The primary objectives of the investment guidelines are to preserve capital, maintain sufficient liquidity to meet our operating needs, and to maximize return. We minimize investment risk by limiting the amount invested in any single security and by focusing on conservative investment choices with short terms and high credit quality standards. We do not use derivative financial instruments or invest for speculative trading purposes.

**ITEM 4. Controls and Procedures**

Disclosure controls and procedures: As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

Internal control over financial reporting: During the fiscal quarter ended June 30, 2011, no changes were made in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Part II Other Information**

**ITEM 1. Legal Proceedings**

We are involved from time to time in litigation incidental to the conduct of our business. Although we do not expect that the outcome of any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, litigation is inherently unpredictable. Therefore, judgments could be rendered, or settlements entered, that could adversely affect our operating results or cash flows in a particular period. We routinely assess all of our litigation and threatened litigation as to the probability of ultimately incurring a liability, and record our best estimate of the ultimate loss in situations where we assess the likelihood of loss as probable.

**ITEM 1A. Risk Factors**

For a discussion of the material risks that we face relating to our business, financial performance and industry, as well as other risks that an investor in our common stock may face, see the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010. The risks described in our Annual Report on Form 10-K and elsewhere in this report are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition or operating results.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the quarter ended June 30, 2011 we did not repurchase any shares of our common stock under our stock buyback program.

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**ITEM 6. Exhibits**

(a) Exhibits index

- 3.1 Restated Articles of Organization, as amended (incorporated by reference to Exhibit 3.1 in the Registrant's Registration Statement on Form S-1, No. 333-56639, filed with the Securities and Exchange Commission on June 9, 1998).
- 3.2 Restated Bylaws, as amended (incorporated by reference to Exhibit 3.2 in the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 28, 2007).
- 31.1\* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101\*\* The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (eXtensible Business Reporting Language); (i) Consolidated Balance Sheets as of June 30, 2011 and December 31, 2010, (ii) Condensed Consolidated Statements of Income for the three and six months ended June 30, 2011 and 2010, (iii) Consolidated Statements of Stockholders' Equity as of June 30, 2011 and December 31, 2010, (iv) Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2011 and 2010, (v) Condensed Consolidated Statements of Stockholders' Equity as of June 30, 2011 and December 31, 2010 and 2009 and (vi) Notes to Consolidated Financial Statements, tagged as blocks of text.

\* Filed herewith

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MicroFinancial Incorporated

By: /s/ Richard F. Latour  
President and Chief Executive Officer

By: /s/ James R. Jackson Jr.  
Vice President and Chief Financial  
Officer

Date: August 15, 2011

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