APPLIANCE RECYCLING CENTERS OF AMERICA INC /MN
Form 10-Q
August 16, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended July 2, 2016

or

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

Commission File No. 0-19621

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-1454591**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
175 Jackson Avenue North Suite 102, Minneapolis, Minnesota	**55343**
(Address of principal executive offices)	(Zip Code)

952-930-9000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ý Yes o 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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company ý

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

As of August 10, 2016, there were outstanding 5,950,818 shares of the registrant's Common Stock, without par value.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

CONSOLIDATED BALANCE SHEETS

(In Thousands)

ASSETS	**July 2, 2016**	**January 2, 2016**
Current assets:	**(unaudited)**	
Cash and cash equivalents	$2,249	$1,969
Accounts receivable, net of allowance of $28 and $73, respectively	6,656	11,536
Inventories	15,932	16,733
Income taxes receivable	242	1,126
Other current assets	1,073	1,350
Deferred income tax assets	1,301	1,657
Total current assets	27,453	34,371
Property and equipment, net	10,566	10,985
Restricted cash	500	500
Other assets	583	596
Deferred income tax assets	244	327
Total assets (a)	$39,346	$46,779
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$7,427	$7,019
Accrued expenses	8,241	8,934
Line of credit	7,786	12,668
Current maturities of long-term obligations	2,803	1,251
Total current liabilities	26,257	29,872
Long-term obligations, less current maturities	3,270	4,506
Other noncurrent liabilities	402	357
Total liabilities (a)	29,929	34,735
Commitments and contingencies		
Shareholders' equity:		
Common Stock, no par value; 10,000 shares authorized; issued and outstanding: 5,951 shares and 5,901 shares, respectively	21,607	21,466
Accumulated deficit	(12,132)	(9,577)
Accumulated other comprehensive loss	(522)	(565)
Total shareholders' equity	8,953	11,324
Noncontrolling interest	464	720

	9,417	12,044
Total liabilities and shareholders' equity	$39,346	$46,779

(a) Assets of ARCA Advanced Processing, LLC (AAP), our consolidated variable interest entity that can only be used to settle obligations of AAP were $8,443 and $8,856 as of July 2, 2016 and January 2, 2016, respectively. Liabilities of AAP for which creditors do not have recourse to the general credit of Appliance Recycling Centers of America, Inc. were $3,414 and $2,838 as of July 2, 2016 and January 2, 2016, respectively.

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(In Thousands, Except Per Share Amounts)

	Three Months Ended		Six Months Ended	
	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues:				
Retail	$16,096	$17,494	$32,666	$34,592
Recycling	6,413	9,366	13,349	17,189
Byproduct	2,247	3,304	4,086	5,921
Total revenues	24,756	30,164	50,101	57,702
Costs of revenues	18,320	22,287	37,474	43,957
Gross profit	6,436	7,877	12,627	13,745
Selling, general and administrative expenses	7,529	7,255	14,507	15,123
Operating income (loss)	(1,093)	622	(1,880)	(1,378)
Other income (expense):				
Interest expense, net	(304)	(245)	(587)	(566)
Other income (expense), net	(26)	8	94	(141)
Income (loss) before income taxes and noncontrolling interest	(1,423)	385	(2,373)	(2,085)
Provision for (benefit of) income taxes	758	(101)	438	(586)
Net income (loss)	(2,181)	486	(2,811)	(1,499)
Net loss attributable to noncontrolling interest	78	116	257	401
Net income (loss) attributable to controlling interest	$(2,103)	$602	$(2,554)	$(1,098)
Income (loss) per common share:				
Basic	$(0.35)	$0.10	$(0.43)	$(0.19)
Diluted	$(0.35)	$0.10	$(0.43)	$(0.19)
Weighted average common shares outstanding:				
Basic	5,929	5,801	5,915	5,798
Diluted	5,929	5,802	5,915	5,798
Net income (loss)	$(2,181)	$486	$(2,811)	$(1,499)
Other comprehensive income (loss), net of tax:				
Effect of foreign currency translation adjustments	24	(15)	43	(133)
Total other comprehensive income (loss), net of tax	24	(15)	43	(133)
Comprehensive income (loss)	(2,157)	471	(2,768)	(1,632)
Comprehensive loss attributable to noncontrolling interest	78	116	257	401
Comprehensive income (loss) attributable to controlling interest	$(2,079)	$587	$(2,511)	$(1,231)

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Six Months Ended	
	July 2, 2016	**July 4, 2015**
Operating activities:		
Net loss	$(2,811)	$(1,499)
Adjustments to reconcile net loss to net cash and cash equivalents (used in) provided by operating activities:		
Depreciation and amortization	634	648
Share-based compensation	141	48
Deferred tax assets	439	–
Amortization of debt issuance costs	89	54
Other	(37)	(25)
Changes in assets and liabilities:		
Accounts receivable	4,917	(161)
Inventories	801	544
Other assets	(145)	(225)
Accounts payable and accrued expenses	744	1,517
Income taxes receivable/payable	885	(159)
Net cash flows provided by operating activities	5,657	742
Investing activities:		
Purchases of property and equipment	(193)	(209)
Proceeds from sale of property and equipment	–	5
Other	(3)	(46)
Net cash flows used in investing activities	(196)	(250)
Financing activities:		
Net payments under line of credit	(4,882)	(133)
Payments on debt obligations	(307)	(486)
Proceeds from issuance of debt obligations	100	356
Proceeds from issuance of common stock	–	24
Payment of debt issuance costs	(125)	–
Net cash flows used in financing activities	(5,214)	(239)
Effect of changes in exchange rate on cash and cash equivalents	33	(135)
Increase in cash and cash equivalents	280	118
Cash and cash equivalents at beginning of period	1,969	3,523
Cash and cash equivalents at end of period	$2,249	$3,641

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Six Months Ended	
	July 2, 2016	**July 4, 2015**
Supplemental disclosures of cash flow information:		
Cash payments for interest	$213	$355
Cash receipts for income taxes	$871	$403
Non-cash investing and financing activities:		
Debt issuance costs related to credit agreement renewal	$63	$–

See Notes to Unaudited Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(In Thousands, Except Per Share Amounts)

1. Nature of Business and Basis of Presentation

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

The accompanying balance sheet as of January 2, 2016, which has been derived from audited consolidated financial statements and the unaudited consolidated financial statements have been prepared by the Company in accordance with generally accepted accounting principles (“GAAP”) in the United States of America for interim financial information and Article 8 of Regulation S-X promulgated by the United States Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, normal and recurring adjustments and accruals considered necessary for a fair presentation for the periods indicated have been included. Operating results for the three-month and six-month periods ended July 2, 2016 and July 4, 2015, are presented using 13-week and 26-week periods, respectively. The results of operations for any interim period are not necessarily indicative of the results for the year.

In preparation of the Company’s financial statements, management is required to make estimates and assumptions that affect reported amounts of assets and liabilities and related revenues and expenses during the reporting periods. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates.

These financial statements should be read in conjunction with the Company’s audited consolidated financial statements and related notes thereto for the year ended January 2, 2016, included in the Company’s Annual Report on Form 10-K filed with the SEC on April 4, 2016.

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

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

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

2. Inventories

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

	July 2, 2016	January 2, 2016
Appliances held for resale	$15,666	$16,360
Processed metals from recycled appliances held for resale	260	367
Other	6	6
	$15,932	$16,733

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

3. Earnings per Share

Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per common share is computed based on the weighted average number of common shares outstanding adjusted by the number of additional shares that would have been outstanding had the potentially dilutive common shares been issued. Potentially dilutive shares of Common Stock include unexercised stock options and warrants. Basic per share amounts are computed, generally, by dividing net income attributable to controlling interest by the weighted average number of common shares outstanding. Diluted per share amounts assume the conversion, exercise or issuance of all potential Common Stock instruments unless their effect is anti-dilutive, thereby reducing the loss or increasing the income per common share. In calculating diluted weighted average shares and per share amounts, we included stock options and warrants with exercise prices below average market prices, for the respective reporting periods in which they were dilutive, using the treasury stock method. We calculated the number of additional shares by assuming the outstanding stock options were exercised and that the proceeds from such exercises were used to acquire Common Stock at the average market price during the quarter. For both the three months and the six months ended July 2, 2016, we excluded options and warrants to purchase 754 shares of common stock from the diluted weighted average share outstanding calculation as the effect of these options and warrants were anti-dilutive. For the three months and six months ended July 4, 2015, we excluded options and warrants to purchase 507 and 717 shares of common stock from the diluted weighted average shares outstanding calculation as the effect of these options were anti-dilutive.

4. Share-Based Compensation

We recognized share-based compensation expense (benefit) of $102 and $(15) for the three months ended July 2, 2016, and July 4, 2015, respectively and $141 and $48 for the six months ended July 2, 2016 and July 4, 2015, respectively.

Based on the value of options outstanding as of July 2, 2016, estimated future share-based compensation expense is as follows:

Balance of fiscal year 2016	$59
Fiscal year 2017	44
	$103

The estimate above does not include any expense for additional options that may be granted and vest during the remainder of 2016 and 2017.

5. Product Warranty

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

Changes in our warranty accrual are as follows:

	Three Months Ended		Six Months Ended	
	July 2, 2016	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Beginning Balance	$39	$28	$42	$30
Standard accrual based on units sold	3	13	9	19
Actual costs incurred	(5)	(4)	(8)	(8)
Periodic accrual adjustments	(4)	(4)	(10)	(8)
Ending Balance	$33	$33	$33	$33

6. Variable Interest Entity

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

The following table summarizes the assets and liabilities of AAP as of July 2, 2016, and January 2, 2016:

	July 2, 2016	**January 2, 2016**
Assets		
Current assets	$659	$ 696
Property and equipment, net	7,701	8,077
Other assets	83	83
Total Assets	$8,443	$ 8,856
Liabilities		
Accounts payable (a)	$1,809	$ 1,872
Accrued expenses	461	399
Current maturities of long-term debt obligations	1,050	946
Long-term debt obligations, net of current maturities	3,337	3,439
Other liabilities (b)	859	759
Total Liabilities	$7,516	$ 7,415

(a) As of July 2, 2016, AAP has $311 in advances payable to 4301 included in accounts payable.

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

In April 2016, an officer of the Company loaned $75 to AAP through the issuance of an 8% promissory note. The note is expected to be repaid with the collection of carbon offset program revenues in August 2016.

The following table summarizes the operating results of AAP for the three months and six months ended July 2, 2016, and July 4, 2015:

	Three Months Ended		**Six Months Ended**	
	July 2, 2016	**July 4, 2015**	**July 2, 2016**	**July 4, 2015**
Revenues	$1,695	$2,028	$3,480	$3,878
Gross profit	319	297	475	303
Operating loss	(93)	(166)	(364)	(682)
Net loss	(159)	(230)	(514)	(800)

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7. Other Assets

Other assets as of July 2, 2016, and January 2, 2016, consist of the following:

	July 2, 2016	January 2, 2016
Deposits	$ 423	$ 416
Cash surrender value	102	102
Finite intangible assets	20	40
Goodwill	38	38
	$ 583	$ 596

For the three months ended July 2, 2016, and July 4, 2015, we recorded amortization expense of $0 and $20, respectively, related to our recycling contract. For the six months ended July 2, 2016, and July 4, 2015, we recorded amortization expense of $20 and $40, respectively, related to our recycling contract. For the three months ended July 2, 2016, and July 4, 2015, we recorded non-cash interest expense of $50 and $26, respectively, related to debt issuance costs. For the six months ended July 2, 2016, and July 4, 2015, we recorded non-cash interest expense of $92 and $54, respectively, related to debt issuance costs.

8. Accrued Expenses

Accrued expenses as of July 2, 2016, and January 2, 2016, consist of the following:

	July 2, 2016	January 2, 2016
Sales tax estimates, including interest	$4,147	$ 4,804
Compensation and benefits	2,083	1,446
Accrued incentive and rebate checks	274	293
Accrued rent	188	235
Warranty expense	33	42
Accrued payables	258	749
Deferred revenue	386	413
Other	872	952
	$8,241	$ 8,934

9. Line of Credit

We have a Revolving Credit, Term Loan and Security Agreement, as amended, ("Revolving Credit Agreement") with PNC Bank, National Association ("PNC") that provides us with a $15,000 revolving line of credit. See Note 10 for further discussion regarding the Term Loan entered into with PNC. The Revolving Credit Agreement had a stated maturity date of January 24, 2016, and was renewed on January 22, 2016. Our financial covenants were reset in connection with this renewal.

The renewed Revolving Credit Agreement has a stated maturity of January 31, 2017, if not renewed. The Revolving Credit Agreement includes a lockbox agreement and a subjective acceleration clause and as a result we have classified the revolving line of credit as a current liability. The Revolving Credit Agreement is collateralized by a security interest in substantially all of our assets and PNC is also secured by an inventory repurchase agreement with Whirlpool Corporation for Whirlpool purchases only. We also issued a $750 letter of credit in favor of Whirlpool Corporation. The Revolving Credit Agreement requires, starting with the fiscal quarter ending April 2, 2016, that we meet a minimum earnings before interest, taxes, depreciation and amortization, and continuing at the end of each quarter thereafter, that we meet a minimum fixed charge coverage ratio of 1.1 to 1.0. The Revolving Credit Agreement limits investments we can purchase, the amount of other debt and leases we can incur, the amount of loans we can issue to our affiliates and the amount we can spend on fixed assets, along with prohibiting the payment of dividends. In the January 22, 2016 renewal, the affiliate loan balance is capped at $1,000 on December 31, 2015, and thereafter. As of July 2, 2016, we were not in compliance with the fixed charge coverage ratio covenant of the Revolving Credit Agreement. We are working with PNC to obtain an Amended Credit Agreement. As of January 2, 2016, we were not in compliance with all covenants under the Revolving Credit Agreement which were subsequently waived with the January 22, 2016 renewal.

The interest rate on the Revolving Credit Agreement, in our renewal agreement on January 22, 2016, is PNC Base Rate plus 1.75% to 3.25%, or 1-, 2- or 3-month PNC LIBOR Rate plus 2.75% to 4.25%, with the rate being dependent on our level of fixed charge coverage. The PNC Base Rate shall mean, for any day, a fluctuating per annum rate of interest equal to the highest of (i) the interest rate per annum announced from time to time by PNC as its prime rate, (ii) the Federal Funds Open Rate plus 0.5%, and (iii) the one-month LIBOR rate plus 100 basis points (1%). As of July 2, 2016, the outstanding line of credit balance was $7,786 with a weighted average interest rate of 4.70%, which included both PNC LIBOR and PNC Base Rate loans. As of January 2, 2016, the outstanding line of credit balance was $12,668 with a weighted average interest rate of 7.25%, which was the PNC Base Rate plus a default premium.

The amount of revolving borrowings under the Revolving Credit Agreement is based on a formula using accounts receivable and inventories. We may not have access to the full $15,000 revolving line of credit due to the formula using accounts receivable and inventories, the amount of the letter of credit issued in favor of Whirlpool Corporation and the amount of outstanding loans between PNC and our AAP joint venture. As of July 2, 2016, and January 2, 2016, our available borrowing capacity under the Revolving Credit Agreement was $2,587 and $1,382, respectively.

10. Borrowings

Long-term debt, capital lease and other financing obligations as of July 2, 2016, and January 2, 2016, consist of the following:

	July 2, 2016	**January 2, 2016**
PNC term loan	$1,148	$ 1,275
Susquehanna term loans	3,242	3,242
2.75% note, due in monthly installments of $3, including interest, due October 2024, collateralized by equipment	300	319
Capital leases and other financing obligations	1,547	988
Debt issuance costs, net	(164)	(67)
	6,073	5,757
Less current maturities	2,803	1,251
	$3,270	$ 4,506

On January 24, 2011, we entered into a $2,550 Term Loan (“Term Loan”) with PNC Bank to refinance the mortgage on our California facility. The Term Loan is payable as follows, subject to acceleration upon the occurrence of an event of default or termination of the Revolving Credit Agreement: 119 consecutive monthly principal payments of $21 plus interest commencing on February 1, 2011, and continuing on the first day of each month thereafter followed by a 120th payment of all unpaid principal, interest and fees on February 1, 2021. If the Revolving Credit Agreement is not renewed, a balloon payment of $1,020 in principal plus interest and additional fees will be due on January 31, 2017. The Term Loan is collateralized with our California facility located in Compton, California. The Term Loan interest rate is PNC Base Rate plus 2.25% to 3.75%, or 1-, 2- or 3-month PNC LIBOR Rate plus 3.25% to 4.75%, with the rate being dependent on our level of fixed charge coverage.

The interest rate will be fixed for the first half of 2016 at PNC Base Rate plus 3.75%, or 1-,2- or 3-month PNC LIBOR Rate plus 4.75%. As of July 2, 2016, the weighted average interest rate was 5.28%. As of January 2, 2016, the weighted average interest rate was 7.75%, which was the PNC Base Rate plus a default rate premium. As of July 2, 2016, the balance due on the Term Loan is classified as current as the maturity of our credit facility is January 31, 2017.

On March 10, 2011, AAP entered into three separate commercial term loans (“Term Loans”) with Susquehanna Bank, pursuant to the guidelines of the U.S. Small Business Administration 7(a) Loan Program. The total amount of the Term Loans is $4,750, split into three separate loans for $2,100; $1,400; and $1,250. The Term Loans mature in ten years and bear an interest rate of Prime plus 2.75%. As of July 2, 2016, and January 2, 2016, the interest rate was 6.00%. Borrowings under the Term Loans are secured by substantially all of the assets of AAP along with liens on the business assets and certain personal assets of the owners of 4301 Operations, LLC. We are a guarantor of the Term Loans along with 4301 Operations, LLC and its owners. In connection with these Term Loans, Susquehanna Bank also has a security interest in the assets of the Company.

In March of 2015, an entity controlled by one of the noncontrolling interest holders of AAP loaned AAP $325 through the issuance of promissory notes. The notes bear interest at an annual rate of 8%. In May of 2015, one of the March 2015 notes totaling $125 was repaid in full by AAP. In February 2016, an entity controlled by one of the noncontrolling interest holders of AAP loaned AAP $100 through the issuance of an 8% promissory note. The remaining notes totaling $300 are expected to be repaid with the collection of the carbon offset program revenues by the end of the third quarter of 2016.

Capital leases and other financing obligations: We acquire certain equipment under capital leases and other financing obligations. The cost of the equipment was $2,611 and $2,667 as of July 2, 2016, and January 2, 2016, respectively. Accumulated amortization as of July 2, 2016, and January 2, 2016, was approximately $1,724 and $1,635, respectively. Depreciation and amortization expense is included in cost of revenues and selling, general and administrative expenses.

11. Commitments and Contingencies

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

Litigation: On March 6, 2015, a complaint was filed in United States District Court for the Central District of California by Jason Feola, individually and as a representative of a putative class consisting of purchasers of the Company’s common stock between March 15, 2012 and February 11, 2015, against Appliance Recycling Centers of America, Inc. and certain current and former officers of the Company. Mr. Feola, pursuant to terms of his retainer agreement with The Rosen Law Firm, certified that he purchased 240 shares of the Company’s common stock for approximately $1 in total consideration. On May 7, 2015, the Company and the individual defendants were served the complaint. In July 2015, the Company and the individual defendants received an amended complaint. The complaint alleges that misstatements and omissions occurred in press releases and filings by the Company with the Securities and Exchange Commission and that these misstatements or omissions constitute violations of Section 20 (a) and Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act of 1934. In October 2015, the court held a hearing on the Company's motion to dismiss the complaint. On November 24, 2015, the United States District Court for the Central District of California entered an order granting the motion to dismiss the amended complaint. The Court’s order provided that the dismissal was without prejudice and that the plaintiffs may file an amended complaint within 21 days of the issuance of the order. On December 15, 2015, the Company and the individual defendants were served with a second amended complaint. In May 2016, the court held a hearing on the Company's motion to dismiss the second amended complaint. We are currently awaiting the United States District Court for the Central District of California's ruling on our motion to dismiss the second amended complaint. This matter has been forwarded to our insurance carriers and we intend to contest vigorously the claims made in the complaint.

On November 6, 2015, a complaint was filed in the Minnesota District Court for Hennepin County, Minnesota, by David Gray and Michael Boller, purporting to bring suit derivatively and on behalf of the Company against twelve current and former officers and directors of the Company. The complaint alleges that the defendants breached their fiduciary duties based on substantially similar allegations to those asserted in Mr. Feola's putative securities class action complaint, and that the defendants have been unjustly enriched as a result thereof. The complaint seeks damages, disgorgement, an award of attorneys’ fees and other expenses, and an order compelling changes to the Company’s corporate governance and internal procedures. This matter has been stayed by the court, pursuant to a stipulation of the parties, until the United States District Court for the Central District of California determines the legal sufficiency of Mr. Feola's complaint or other specified developments occur in that case. This matter has been submitted to our insurance carriers.

Given the uncertainty of litigation and the preliminary stage of these cases, we cannot reasonably estimate the possible loss or range of loss that may result from these actions. The Company maintains liability insurance policies that may reduce the Company’s exposure, if any.

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

AMTIM Capital, Inc. (“AMTIM”) acts as our representative to market our recycling services in Canada under an arrangement that pays AMTIM for revenues generated by recycling services in Canada as set forth in the agreements between the parties. A dispute has arisen between AMTIM and us with respect to the calculation of amounts due to AMTIM pursuant to the agreement. In a lawsuit filed in the province of Ontario, AMTIM claims a discrepancy in the calculation of fees due to AMTIM by us of approximately $2,000. Although the outcome of this claim is uncertain, we believe that no further amounts are due under the terms of the agreement and will continue to defend our position relative to this lawsuit.

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

Sales and Use Taxes: We operate in twenty-three states in the U.S. and in various provinces in Canada. From time to time, we are subject to sales and use tax audits that could result in additional taxes, penalties and interest owed to various taxing authorities.

As previously disclosed, the California Board of Equalization ("BOE") is conducting a sales and use tax examination covering the California operations of Appliance Recycling Centers of America, Inc. (the "Company") for 2011, 2012 and 2013. The Company believed it was exempt from collecting sales taxes under service agreements with utility customers that included appliance replacement programs. During the fourth quarter of 2014, the Company received communication from the BOE indicating they are not in agreement with the Company's interpretation of the law. As a result, the Company applied for and, as of February 9, 2015, received approval to participate in the California Board of Equalization's Managed Audit Program. The period covered under this program includes 2011, 2012, 2013 and extends through the nine-month period ended September 30, 2014. At this time, our best estimate of the amount that will be assessed by the BOE covering all periods under audit is approximately $4.1 million in sales tax and interest related to the appliance replacement programs that we administered on behalf of our customers on which we did not assess, collect or remit sales tax. The Company has been working with outside consultants to arrive at our assessment estimate and will continue to engage the services of these sales tax experts throughout the Managed Audit Program process. The sales tax amounts that we will likely be assessed relate to transactions in the period under examination by the BOE. Such assessment, however, will be subject to protest and appeal, and would not need to be funded until the matter has been fully resolved. Resolution could take up to two years.

12. Income Taxes

Our overall effective tax rate, based on projected full-year taxable loss, was (33.3)% and (26.2)% for the three months ended July 2, 2016 and July 4, 2015, respectively. Our overall effective tax rate, based on projected full-year taxable loss, was (20.7)% and (28.1)% for the six months ended July 2, 2016 and July 4, 2015, respectively. The effective tax rate varies from the federal statutory rate of 34% due primarily to the impact of lower foreign tax rates, state taxes, share-based compensation and the book income (loss) of consolidated AAP attributable to noncontrolling interest.

We regularly evaluate both positive and negative evidence related to retaining a valuation allowance against our deferred tax assets. The realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to be available to reduce taxable income. We have concluded based on the weight of negative evidence that a valuation allowance should be maintained against certain deferred tax assets that we do not expect to utilize as of July 2, 2016.

13. Segment Information

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

The following tables present our segment information for periods indicated:

	Three Months Ended		Six Months Ended	
	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues:				
Retail	$16,294	$17,713	$32,943	$34,933
Recycling	8,462	12,451	17,158	22,769
Total revenues	$24,756	$30,164	$50,101	$57,702
Operating income (loss):				
Retail	$(487)	$(20)	$(437)	$(636)
Recycling	(469)	820	(1,232)	(357)
Unallocated corporate	(137)	(178)	(211)	(385)
Total operating income (loss)	$(1,093)	$622	$(1,880)	$(1,378)
Cash capital expenditures:				
Retail	$(10)	$9	$9	$38
Recycling	20	32	87	47
Corporate assets not allocable	46	86	97	124
Total cash capital expenditures	$56	$127	$193	$209
Depreciation and amortization:				
Retail	$51	$47	$105	$96
Recycling	219	217	454	436
Unallocated corporate	39	54	75	116
Total depreciation and amortization	$309	$318	$634	$648

14. Recent Accounting Pronouncements

New Accounting Standards Not Yet Effective

Revenue from Contracts with Customers: In May 2014, the Financial Accounting Standards Board (FASB) issued guidance creating Accounting Standards Codification ("ASC") Section 606, "Revenue from Contracts with Customers". The new section will replace Section 605, "Revenue Recognition" and creates modifications to various other revenue accounting standards for specialized transactions and industries. The section is intended to conform revenue accounting principles with a concurrently issued International Financial Reporting Standards with previously differing treatment between United States practice and those of much of the rest of the world, as well as, to enhance disclosures related to disaggregated revenue information. Entities will have the option to apply the standard retrospectively to all prior periods presented, or to apply it retrospectively only to contracts existing at the effective date, with the cumulative effect of the standard recorded as an adjustment to beginning retained earnings. The updated guidance will be effective for us for the annual reporting period beginning with our fiscal 2018, and interim periods within that year. We will adopt the new provisions of this accounting standard at the beginning of fiscal year 2018, given that early adoption is not an option. We will further study the implications of this statement in order to evaluate the expected impact on the consolidated financial statements.

ASU 2015-02, Amendments to the Consolidation Analysis: This standard, became effective January 1, 2016 for the Company, provides amended guidance on whether reporting entities should consolidate certain legal entities, including limited partnerships. We are evaluating the impact of the standard on the consolidated financial statements.

ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs: This standard, which will be effective January 1, 2016 for the Company, requires that debt issuance costs be presented as a direct deduction from the carrying amount of long-term debt on the balance sheet. Presently, debt issuance costs are reported as an asset. The new guidance aligns the presentation of debt issuance costs with debt discounts and premiums. The standard is to be applied retrospectively to all prior periods presented. As of July 4, 2015, we had $0.1 million of unamortized debt issuance costs. This amount is recorded in other non-current assets on the consolidated balance sheets.

In July 2015, FASB issued ASU 2015-11, *Inventory (Topic 330) Related to Simplifying the Measurement of Inventory which* applies to all inventory except that which is measured using last-in, first-out (LIFO) or the retail inventory method. Inventory measured using first-in, first-out (FIFO) or average cost is included in the new amendments. Inventory within the scope of the new guidance should be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The amendments will take effect for public business entities for fiscal years beginning after Dec. 15, 2016, including interim periods within those fiscal years. The new guidance should be applied prospectively, and earlier application is permitted as of the beginning of an interim or annual reporting period. We are evaluating the impact of the standard on the consolidated financial statements.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to provide a reader of our financial statements with a narrative from the perspective of our management on our financial condition, results of operations, liquidity and certain other factors that may affect our future results. Our MD&A is presented in seven sections:

- Forward-Looking Cautionary Statements
- Overview
- Fiscal 2016 Trends
- Results of Operations
- Liquidity and Capital Resources
- New Accounting Pronouncements

Forward-Looking and Cautionary Statements

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

The forward-looking statements contained in this quarterly report, and other written and oral forward-looking statements made by us from time to time, are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Any forward-looking information regarding our operations will be affected primarily by individual retail stores' profitability, the volume of appliance sales, the strength of energy conservation recycling programs and general economic conditions affecting consumer demand for appliances. Any forward-looking information will also be affected by our continued ability to purchase product from our suppliers at acceptable prices, the ability of individual retail stores to meet planned revenue levels, the number of retail stores, costs and expenses being realized at higher than expected levels, our ability to secure an adequate supply of special-buy appliances for resale, the ability to secure appliance recycling and replacement contracts with sponsors of energy efficiency programs, the ability of customers to supply units under their recycling contracts with us, the performance of our consolidated variable interest entity, the continued availability of our current line of credit and the outcome of the pending sales and use tax examination in California. Our MD&A should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended January 2, 2016 (including the information presented therein under *Risk Factors*), as well as our reports on Forms 10-Q and other publicly available information. All amounts herein are unaudited.

Overview

Appliance Recycling Centers of America, Inc. and Subsidiaries ("we," the "Company" or "ARCA") are in the business of being the bridge between utilities or manufacturers to their customers by recycling, replacing, and selling major household appliances in North America. We are committed to energy efficiency and have been a pioneer in appliance recycling programs. We operate two reportable segments:

- Retail: Our retail segment offers the latest in innovative appliance from major manufactures. We generate income from the sale of appliances and related services through 18 ApplianceSmart® stores in four geographic areas. We have an online presence and also include a portion of our revenue from byproducts from collected appliances. We have two product lines, new and out-of-the-box that give the large manufacturers a channel to move their product without disrupting their normal distribution channels.

- Recycling: Our recycling segment is a turnkey appliance recycling program. We receive fees charged for recycling, replacement and additional services for utility energy efficiency programs and have established 17 Regional Processing Centers ("RPCs") for this segment throughout the United States and Canada. Our recycling segment also includes all income generated from our agreement with GE Appliances, a Haier Group Company ("GE"). GE sells us recyclable appliances in certain regions of the United States and we collect, process, and recycle the appliances. These appliances include units manufactured by GE and by other manufacturers. The agreement requires that we will only recycle, and will not sell for re-use or resale, the recyclable appliances. We have established Regional Processing Centers ("RPCs") in Philadelphia and Louisville to support our agreement with GE. The RPC in Philadelphia is operated by ARCA Advanced Processing, LLC ("AAP") through a joint venture agreement between ARCA and 4301 Operations, LLC ("4301"). AAP employs advanced technology to refine traditional appliance recycling techniques to achieve optimal revenue-generating and environmental benefits. We are also the exclusive North American distributor for UNTHA Recycling Technology ("URT"), one of the world's leading manufacturers of technologically advanced refrigerator recycling systems and recycling facilities for electrical household appliances and electronic scrap.

With more than 850 million major household appliances currently used in the United States and Canada, ARCA's business segments are positioned to work together to provide a full array of appliance-related services. ARCA's recycling centers maximize materials recycling while protecting natural resources from the environmentally-damaging substances found in old appliances. We believe we are the future of appliance sales and recycling to manage a full life cycle that will maximize the economic, environmental and societal benefits that recycling provides for the next generation.

Fiscal 2016 Trends

Segments

Our retail segment revenues were down $1.4 million from the three months ended July 2, 2016 over the same period in 2015. There are several economic reasons as well as downward price pressures of the units by our competitors, this is causing price compression between new and out-of-box units and consumers are selecting the new units. We have seen an overall decrease in sales of out-of-box products for the quarter. Historically, as we enter the fourth quarter it is our weakest quarter in terms of both revenues and earnings. We believe this is primarily because the fourth quarter is not a time for our consumers to purchase major household appliances.

Our recycling segment typically operates three types of programs which include:

1. Fees charged for collecting and recycling appliances
2. Fees charged for recycling and providing a replacement with an Energy Star appliance
3. Income from the sale of processing appliances into raw materials

Our recycling segment has decreased revenue of $4 million from the three months ended July 2, 2016 over the same period in 2015. Despite this we gained over 20 new contracts with customers in our recycling-only programs and experienced an increase in revenues as of a result with the closure of our largest competitor. At the same time we have experienced declining revenues from our existing clients as the replacement programs have slowed. The primary decline in replacement revenues can be attributed to lower volumes on several of our programs as programs were not renewed with several large customers. We anticipate some of our replacement programs will increase their volumes in the next quarter as utility customers are lagging on their stated energy efficiency goals. Recycling segment revenues have also experienced declines this year as a result of the decreases in the selling prices of byproducts chiefly scrap steel. The selling price of scrap steel has impacted our income as the price of steel experienced a four year low entering 2016 and has had a slight recovery during the second quarter.

We derive revenues from the sale of carbon offsets created by the destruction of ozone-depleting CFCs captured at our ARCA and AAP regional processing centers. We expect to create carbon offsets and derive revenues in the future through the California market but cannot predict the amount or frequency of carbon offset sales. Carbon offset sales are dependent on market conditions, including demand and acceptable market prices.

In July 2016, we received final approval by the California Air Resource Board for our Carbon Offset Credits. In August 2016, we received proceeds of $1.6 million from the sale of those Carbon Offset Credits which will be recognized in the third quarter. A $0.3 million holdback will be recognized when certain conditions are met with the buyer. We expect additional carbon offset revenues of approximately $0.6 million by the end of 2016; however, this is dependent on various parties and authorities for approval and we cannot be certain it will occur in the fourth quarter.

In the second quarter of 2016, we had a management change which included a signing bonus, severance and additions to the leadership team. This will help drive positive changes to this organization. These costs increased SGA expense by $0.7 million in the second quarter of 2016 and are one time charge to earnings.

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

For the Three Months Ended July 2, 2016 and July 4, 2015

The following table sets forth the key results of operations by segment for the three months ended July 2, 2016 and July 4, 2015 (dollars in millions):

	Three Months Ended		
	July 2, 2016	July 4, 2015	% Change
Revenues:			
Retail	$16.3	$17.7	(8.0)%
Recycling	8.5	12.5	(32.0)%
Total revenues	$24.8	$30.2	(17.9)%
Operating income (loss):			
Retail	$(0.5)	$–	–
Recycling	(0.5)	0.8	(157.2)%
Unallocated corporate costs	(0.1)	(0.2)	23.0%
Total operating income (loss)	$(1.1)	$0.6	(275.7)%

Our total revenues of $24.8 million for the three months ended July 2, 2016, decreased $(5.4) million or (17.9) % from $30.2 million for the same period of 2015. The change in segment revenues was attributed primarily to the following factors:

Retail Segment Revenues:

· Revenues were down $1.4 million from the three months ended July 2, 2016 over the same period in 2015. There are several economic reasons as well as downward price pressures of the units by our competitors, this is causing price compression between new and out-of-box units and consumers are selecting the new units. We have seen an overall decrease in sales of out-of-box products for the quarter.

Recycling Segment Revenues

· Revenues were down $4.0 million compared with the same period of 2015.
· Appliance replacement program revenues decreased by $3.4 million compared with the same period of 2015.
· Recycling-only program revenues increased by $0.5 million compared with the same period of 2015.

- Byproduct revenues generated from the sale of raw materials and carbon offsets decreased $.9 million compared with the same period of 2015.

Retail segment revenues accounted for 65.8% of total revenues in the three months ended July 2, 2016, compared with 59.2% in the same period of 2015. The decrease in appliance replacement program and recycling byproduct revenues impacted the overall mix of revenues between the retail and recycling segments for the three months ended July 2, 2016, compared with same period of 2015. Future revenues and related earnings from energy efficiency programs, if any, are uncertain and may fluctuate significantly from year to year. Factors impacting future energy efficiency program revenues and earnings include the type and scope of energy efficiency programs approved by regulatory agencies, competitive bidding, contract changes, non-renewals and early cancellations.

Recycling segment revenues and retail segment revenues each include a portion of byproduct revenues. For the three months ended July 2, 2016, and July 4, 2015, the recycling segment accounted for approximately 91.7% and 93.4%, respectively of the byproduct revenues.

Operating Income and Loss

Our total operating results declined by $1.7 million to a $1.1 million loss for the three months ended July 2, 2016 compared with operating income of $0.6 million in the same period of 2015. The change in segment operating income was attributed primarily to the following factors:

Retail Segment Operating Loss:

- Operating loss was $0.5 million for the three months ended July 2, 2016, a decline of $0.5 million due to decreased revenue compared with the same period of 2015.

Recycling Segment Operating Loss:

- Operating loss was $0.5 million for the three months ended July 2, 2016, a decline of $1.3 million compared with the same period in 2015. The decline is attributed to a decrease in scrap steel byproduct revenue and revenue. The recycling segment operating loss during the second quarter of 2016 included approximately $0.4 million in expenses related to the startup efforts for the new contracts and programs. We received these new contracts following the business failure of our largest competitor JACO Environmental late in 2015. We continue to invest in business development activities as we respond to customer demands in the industry and work to on-board new customers and programs. We anticipate similar investment levels in the third quarter of 2016 and improvements in operating income for this segment based on the expected revenue growth.

Retail Segment Gross Profit.

- Retail gross profit decreased by $0.3 million to $4.4 million for the three months ended July 2, 2016 compared with $4.7 million in the same period of 2015. The decline was primarily the result of lower sales, sales mix and margin compression on certain products. Gross profit as a percentage of related revenues increased to 26.9% for the three months ended July 2, 2016, compared with 26.6% in the same period of 2015.

Recycling Segment Gross Profit.

- Recycling gross profit of $2.1 million for the three months ended July 2, 2016 decreased $1.1 million compared with the same period of 2015. We experienced declines in gross profit as a result of reduction in appliance replacement with existing customers and lower selling prices of scrap metals. Gross profit as a percentage of related revenues decreased to 24.3% for the three months ended July 2, 2016, compared with 25.4% for the same period of 2015.

For the Six Months Ended July 2, 2016, and July 4, 2015

The following table sets forth the key results of operations by segment for the six months ended July 2, 2016, and July 4, 2015 (dollars in millions):

	Six Months Ended		
	July 2, 2016	July 4, 2015	% Change
Revenues:			
Retail	$ 32.9	$ 34.9	(5.7)%
Recycling	17.2	22.8	(24.6)%
Total revenues	$ 50.1	$ 57.7	(13.2)%
Operating loss:			
Retail	$ (0.5)	$ (0.6)	31.3%
Recycling	(1.2)	(0.4)	(245.1)%
Unallocated corporate costs	(0.2)	(0.4)	45.2)%
Total operating loss	$ (1.9)	$ (1.4)	(36.4)%

Our total revenues of $50.1 million for the six months ended July 2, 2016, decreased $(7.6) million or (13.2)% from $57.7 million for the same period of 2015. The change in segment revenues was attributed primarily to the following factors:

Retail Segment Revenues:

- Revenues were down $2.0 million compared with the same period of 2015. One store moved location in 2015 contributed $1.0 less in revenue which included an inventory liquidation event in 2015. The market was also soft compared to last year and price compression is driving average sale price per unit down.

Recycling Segment Revenues:

- Revenues were down $5.6 million for the six month ended July 2, 2016 compared with the same period of 2015.
- Appliance replacement program revenues decreased by $6.5 million compared with the same period of 2015.
- Recycling only program revenues increased by $1.3 million compared with the same period of 2015.

Recycling segment revenues and retail segment revenues each include a portion of byproduct revenues. For the six months ended July 2, 2016, and July 4, 2015, the recycling segment accounted for approximately 99.0% of the byproduct revenues for both periods.

Retail segment revenues accounted for 65.8% of total revenues in the six months ended July 2, 2016, compared with 60.5% in the same period of 2015. The decrease in energy efficiency program and recycling byproduct revenues impacted the overall mix of revenues between the retail and recycling segments for the six months ended July 2, 2016, compared with same period of 2015. Future revenues and related earnings from our utility customer energy efficiency programs, if any, are uncertain and may fluctuate significantly from year to year. Factors impacting future energy efficiency program revenues and earnings include the type and scope of energy efficiency programs approved by regulatory agencies, competitive bidding, contract changes, non-renewals and early cancellations.

Operating Loss

Our total operating loss of $1.9 million for the six months ended July 2, 2016, increased $0.5 million compared with operating loss of $1.4 million in the same period of 2015. The change in revenues is the primary reason for the additional operating loss.

Retail Segment Gross Profit. Retail gross profit remained the same as $9.1 million in same period of 2015. Gross profit as a percentage of related revenues increased to 27.5% for the six months ended July 2, 2016, compared with 26.1% in the same period of 2015.

Recycling Segment Gross Profit. Recycling gross profit of $3.6 million for the six months ended July 2, 2016 decreased $1.0 million compared with the same period of 2015. This was due to decrease in revenues and lower scrap prices for products.

Product Lines

Percentages for the three months and six months ended July 2, 2016 and July 4, 2015 were as follows:

	Three Months Ended		Six Months Ended	
	July 2, 2016	July 4, 2015	July 2, 2016	July 4, 2015
Revenues:				
Retail	65.0%	58.0%	65.2%	59.9%
Recycling	25.9%	31.0%	26.6%	29.8%
Byproduct	9.1%	11.0%	8.2%	10.3%
Total revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	74.0%	73.9%	74.8%	76.2%
Gross profit	26.0%	26.1%	25.2%	23.8%
Selling, general and administrative expenses	30.4%	24.0%	29.0%	26.2%
Operating income (loss)	(4.4)%	2.1%	(3.8)%	(2.4)%
Other income (expense):				
Interest expense, net	(1.2)%	(0.8)%	(1.2)%	(1.0)%
Other income (expense), net	(0.1)%	–	0.2%	(0.2)%
Income (loss) before income taxes and noncontrolling interest	(5.7)%	1.3%	(4.8)%	(3.6)%
Provision for (benefit from) income taxes	3.1%	(0.3)%	0.9%	(1.0)%
Net income (loss)	(8.8)%	1.6%	(5.7)%	(2.6)%
Net loss attributable to noncontrolling interest	0.3%	0.4%	0.5%	0.7%
Net income (loss) attributable to controlling interest	(8.5)%	2.0%	(5.2)%	(1.9)%

By Product Lines for the Three Months Ended July 2, 2016 and July 4, 2015

Revenues. Revenues for the three months ended July 2, 2016, and July 4, 2015, were as follows (dollars in millions):

	Three Months Ended		
	July 2, 2016	July 4, 2015	% Change
Retail	$16.1	$17.5	(8.0)%
Recycling	6.4	9.4	(31.5)%
Byproduct	2.3	3.3	(32.0)%
	$24.8	$30.2	(17.9)%

Retail Revenues. Our retail revenues of $16.1 million for the three months ended July 2, 2016, was $1.4 million lower with the same period of 2015.

Recycling Revenues. Our recycling revenues of $6.4 million for the three months ended July 2, 2016, decreased $3.0 million, or 31.5%, from $9.4 million in the same period of 2015. Recycling revenues are comprised of two components: (1) appliance recycling revenues generated by collecting and recycling appliances for utilities and other sponsors of energy efficiency programs and (2) replacement program revenues generated by recycling and replacing old appliances with new energy efficient models for programs sponsored by utility companies. As we have entered new contracts we expect to see more revenue but at the same time several of our large replacement programs have declined.

Byproduct Revenues. Our byproduct revenues of $2.2 million for the three months ended July 2, 2016, decreased $1.0 million compared with the same period of 2015. Byproduct revenues include all of the revenues generated by AAP. The decrease was due primarily to the decline in steel prices and less units received at our RPC.

Total Gross Profit. Our gross profit of $6.4 million for the three months ended July 2, 2016, decreased $1.5 million or 18.3% compared with $7.9 million in the same period of 2015. Gross profit as a percentage of total revenues decreased to 26.0% for the three months ended July 2, 2016, compared with 26.1% in the same period of 2015. Our gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including:

1. The mix of retail products we sell.

2. The prices at which we purchase product from the major appliance manufacturers and retailers that supply product to us.
3. The prices at which we can purchase recyclable appliances for processing at our RPCs.
4. The volume of appliances we receive through our utility company energy efficiency programs.
5. The volume and price of commodity/byproduct materials we sell.
6. The volume and price of carbon offset sales created by the destruction of ozone-depleting refrigerants.

Selling, General and Administrative Expenses. Our selling, general and administrative ("SG&A") expenses of $7.5 million for the three months ended July 2, 2016, was comparable with the same period of 2015. Our SG&A expenses as a percentage of total revenues increased 30.4% in the three months ended July 2, 2016, compared with 24.0% in the same period of 2015.

Selling expenses of $4.0 million for the three months ended July 2, 2016, compared with $4.1 in the same period in 2015 due to decrease in direct advertising expense.

General and administrative expenses increased $0.5 million to $3.6 million for the three months ended July 2, 2016, compared with $3.1 million in the same period of 2015. The increase was due primarily to a $0.7 million increase in the management change which included signing bonus, severance and two additional positions.

Interest expense, net. Interest expense for the three months ended July 2, 2016, increased $0.1 million compared with the same period of 2015. The increase was the result raising interest rates by our bank. Our credit agreement ends in January 2017, and we are actively looking for ways to reduce our costs of debt.

Provision for (benefit from) Income Taxes. We recorded a provision for income taxes of $0.8 million for the three months ended July 2, 2016, compared with a benefit of $0.1 million in the same period of 2015. The provision for income taxes for the three months ended July 2, 2016, is related primarily to the projected full-year taxable loss in the United States and the decrease in the prior year's tax assets.

Noncontrolling Interest. Noncontrolling interest represents 4301's share of AAP's net income (loss). Under the AAP joint venture agreement, ARCA and 4301 each have a 50% interest in AAP. AAP reported net loss of $0.2 million for the three months ended July 2, 2016, of which $0.1 million represented the loss attributable to noncontrolling interest. This is comparable with 2015.

Product Lines for the Six Months Ended July 2, 2016, and July 4, 2015

Revenues. Revenues for the six months ended July 2, 2016, and July 4, 2015, were as follows (dollars in millions):

	Six Months Ended		
	July 2, 2016	**July 4, 2015**	**% Change**
Retail	$32.7	$34.6	(5.6)%
Recycling	13.3	17.2	(22.3)%
Byproduct	4.1	5.9	(31.0)%
	$50.1	$57.7	(13.2)%

Retail Revenues. Our retail revenues of $32.7 million for the six months ended July 2, 2016, decreased $1.9 million, or 5.6%, from $34.6 million for the same period of 2015. The decrease in retail revenues was due to softness in the market and in same-store sales resulting from a holiday weekend sales events and the movement of one store to a new location. We are continuing to evaluate underperforming stores and stores with expiring leases and are considering a range of outcomes from right-sizing the showroom space to closure.

Recycling Revenues. Our recycling revenues of $13.3 million for the six months ended July 2, 2016, decreased $3.9 million, or (22.3) %, from $17.2 million in the same period of 2015. Recycling revenues are comprised of two components of energy efficiency programs: (1) appliance recycling revenues generated by collecting and recycling appliances for utilities and other sponsors of energy efficiency programs and (2) replacement program revenues generated by recycling and replacing old appliances with new energy efficient models for programs sponsored by utility companies. Future revenues from appliance energy efficiency programs, if any, are uncertain and may fluctuate significantly from period to period.

Byproduct Revenues. Our byproduct revenues of $4.1 million for the six months ended July 2, 2016, decreased $1.8 million compared with the same period of 2015. Byproduct revenues include all of the revenues generated by AAP. AAP revenues of $3.4 million decreased $.4 million compared with the same period of 2015, due primarily to a decline in the revenues generated from sale of nonferrous scrap metal byproducts compared with the same period of 2015. ARCA experienced a decrease in byproduct revenues due primarily to lower average byproduct price per unit in certain markets and $1.0 million lower sales of refrigerants as compared with the same period of fiscal 2015.

Total Gross Profit. Our gross profit of $12.6 million for the six months ended July 2, 2016, decreased $1.1 million or 8.1% compared with $13.7 million in the same period of 2015. Gross profit as a percentage of total revenues increased to 25.2% for the six months ended July 2, 2016, compared with 23.8% in the same period of 2015. Our gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including:

1. The mix of retail products we sell.
2. The prices at which we purchase product from the major appliance manufacturers and retailers that supply product to us.
3. The prices at which we can purchase recyclable appliances for processing at our RPCs.
4. The volume of appliances we receive through our recycling and utility company energy efficiency programs.
5. The volume and price of commodity/byproduct materials.
6. The volume and price of carbon offset sales created by the destruction of ozone-depleting refrigerants.

Selling, General and Administrative Expenses. Our selling, general and administrative ("SG&A") expenses of $14.5 million for the six months ended July 2, 2016, decreased $0.6 million or 4.1% compared with $15.1 million in the same period of 2015. Our SG&A expenses as a percentage of total revenues increased to 29.0% in the six months ended July 2, 2016, compared with 26.2% in the same period of 2015.

Selling expenses decreased $0.5 million to $8.0 million, or 16.0% of total revenues, for the six months ended July 2, 2016, compared with $8.5 million, or 14.8% of total revenues, in the same period of 2015. The decrease in selling expenses was due primarily to lower occupancy costs of $0.3 million and lower advertising of $0.2 million.

General and administrative expenses decreased by $.1 million to $6.5 million for the six months ended July 2, 2016, compared with $6.6 million in the same period of 2015. The decrease was due to reductions in costs offset by management change.

Interest expense, net. Interest expense for the six months ended July 2, 2016, increased $23,000 compared with the same period of 2015. The increase was the result of higher interest rate on our line of credit.

Provision for (benefit from) Income Taxes. We recorded a provision for income taxes of $0.4 million for the six months ended July 2, 2016, compared with a benefit of $0.6 million in the same period of 2015. The provision of income taxes for the six months ended July 2, 2016, is related primarily to a valuation allowance of prior year assets.

Noncontrolling Interest. Noncontrolling interest represents 4301's share of AAP's net income (loss). Under the AAP joint venture agreement, ARCA and 4301 each have a 50% interest in AAP. AAP reported net loss of $0.5 million for the six months ended July 2, 2016, of which $0.3 million represented the loss attributable to noncontrolling interest. AAP reported net income of $0.8 million for the six months ended July 4, 2015, of which $0.4 million represented the income attributable to noncontrolling interest.

Liquidity and Capital Resources

Summary. Cash and cash equivalents as of July 2, 2016, were $2.2 million compared with $2.0 million as of January 2, 2016. Working capital, the excess of current assets over current liabilities, decreased to $1.2 million as of July 2, 2016, compared with $4.5 million as of January 2, 2016. The decrease was primarily the result of the classification of the term loan with PNC as a current liability and operating losses.

The following table summarizes our cash flows for the six months ended July 2, 2016, and July 4, 2015 (in millions):

	Six Months Ended	
	July 2, 2016	**July 4, 2015**
Total cash and cash equivalents provided by (used in):		
Operating activities	$5.7	$ 0.7
Investing activities	(0.2)	(0.3)
Financing activities	(5.2)	(0.2)
Effect of exchange rates on cash and cash equivalents	–	(0.1)
Increase in cash and cash equivalents	$0.3	$ 0.1

Operating Activities. Our net cash provided by operating activities was $5.7 million for the six months ended July 2, 2016, compared with $0.7 million for the six months ended July 4, 2015. The increase of cash generated from operating activities was primarily the result of $4.9 million in cash from operations through the collection of trade receivables and $0.9 million through the collection of tax receivables in 2016. In 2015, offsetting the losses to date we generated $2.0 million in cash from operations through the collection of receivables.

Investing Activities. We used approximately $0.2 million of cash and used $0.3 million for investing activities for the six months ended July 2, 2016, and the six months ended July 4, 2015, respectively. The use of cash for the purchase of equipment was $0.2 million in both six months ended July 2, 2016, and the six months ended July 4, 2015.

Financing Activities. Our net cash used in financing activities was $5.2 million for the six months ended July 2, 2016, compared with $0.2 million for the six months ended July 4, 2015. Net cash used in financing activities for the six months ended July 2, 2016, was related primarily to net payments under our line of credit and the repayment of long-term debt obligations offset by approximately $5.2 million in cash provided in AAP. Net cash used in financing activities for the six months ended July 4, 2015, was also related primarily to net payments under our line of credit and the repayment of long-term debt obligations offset with $0.4 million of new debt.

Sources of Liquidity. Our principal sources of liquidity are cash from operations and borrowings under our revolving line of credit. Our principal liquidity requirements consist of long-term debt obligations, capital expenditures and working capital. Our total capital requirements for the next twelve months will depend upon, among other things, the number and size of ApplianceSmart stores operating during the period, the volumes generated from recycling and appliance replacement contracts during the period and our needs related to AAP. Currently, we have eighteen ApplianceSmart stores and seventeen recycling centers, including AAP, in operation. Approximately $1.5 million of our cash at the end of the July 2, 2016 is held in Canadian banks.

We believe, based on the anticipated revenues from our recycling and appliance replacement contracts, the anticipated sales per retail store, and our anticipated gross profit, that our cash balance, anticipated funds generated from operations and our revolving line of credit will be sufficient to finance our operations, long-term debt obligations and capital expenditures through at least the next twelve months. We may need additional capital to finance our operations if our revenues are lower than anticipated, our expenses are higher than anticipated or we pursue new opportunities. If our Revolving Credit, Term Loan and Security Agreement, as amended, ("Revolving Credit Agreement") with PNC Bank, National Association ("PNC") is not renewed on the stated maturity date of January 31, 2017 or PNC accelerates the maturity date of our Revolving Credit Agreement, we would need to seek a replacement credit facility. We believe that we have adequate collateral to support a replacement facility if needed. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity (Common or Preferred Stock) or other financing opportunities. There can be no assurance that such additional sources of financing will be available on terms satisfactory to us or permitted by our Revolving Credit Agreement.

Outstanding Indebtedness. We have a Revolving Credit, Term Loan and Security Agreement, as amended, ("Revolving Credit Agreement") with PNC Bank, National Association ("PNC") that provides us with a $15.0 million revolving line of credit. The Revolving Credit Agreement had a stated maturity date of January 24, 2016, and was renewed on January 22, 2016. Our financial covenants were reset in connection with this renewal. The renewed Revolving Credit Agreement has a stated maturity of January 31, 2017, if not renewed. The Revolving Credit Agreement includes a lockbox agreement and a subjective acceleration clause and, as a result, we have classified the revolving line of credit as a current liability. The Revolving Credit Agreement is collateralized by a security interest in substantially all of our assets and PNC is also secured by an inventory repurchase agreement with Whirlpool Corporation for Whirlpool purchases only. We also issued a $750,000 letter of credit in favor of Whirlpool Corporation. The Revolving Credit Agreement requires, starting with the fiscal quarter ended April 2, 2016, that we meet a minimum earnings before interest, taxes, depreciation and amortization, and continuing at the end of each quarter thereafter, that we meet a minimum fixed charge coverage ratio of 1.1 to 1.0. The Revolving Credit Agreement limits investments we can purchase, the amount of other debt and leases we can incur, the amount of loans we can issue to our affiliates and the amount we can spend on fixed assets, along with prohibiting the payment of dividends. In the January 22, 2016 renewal, the affiliate loan balance is capped at $1.0 million on December 31, 2015, and thereafter. As of July 2, 2016, we were not in compliance with all the covenants of the Revolving Credit Agreement. As of January 2, 2016, we were not in compliance with all covenants under the Revolving Credit Agreement, which was subsequently waived with the January 22, 2016 renewal.

The interest rate on the revolving line of credit is PNC Base Rate plus 1.75% to 3.25%, or 1-, 2- or 3-month PNC LIBOR Rate plus 2.75% to 4.25%, with the rate being dependent on our level of fixed charge coverage. The PNC Base Rate shall mean, for any day, a fluctuating per annum rate of interest equal to the highest of (i) the interest rate per annum announced from time to time by PNC at its prime rate, (ii) the Federal Funds Open Rate plus 0.5%, and (iii) the one-month LIBOR rate plus 1%. As of July 2, 2016, the outstanding line of credit balance was $7.8 million with a weighted average interest rate of 4.70%, which included both PNC LIBOR Rate and PNC Base Rate loans. As of January 2, 2016, the outstanding line of credit balance was $12.7 million with a weighted average interest rate of 7.25%, which was the PNC Base Rate plus a default premium.

The amount of borrowings available under the Revolving Credit Agreement is based on a formula using accounts receivable and inventories. We may not have access to the full $15.0 million revolving line of credit due to the formula using accounts receivable and inventories, the amount of the letter of credit issued in favor of Whirlpool Corporation and the amount of outstanding loans between PNC and our AAP joint venture. As of July 2, 2016, and January 2, 2016, our available borrowing capacity under the Revolving Credit Agreement was $2.6 million and $1.4 million, respectively.

On January 24, 2011, we entered into a $2.55 million Term Loan ("Term Loan") with PNC Bank to refinance the mortgage on our California facility. The Term Loan is payable as follows, subject to acceleration upon the occurrence of an event of default or termination of the Revolving Credit Agreement: 119 consecutive monthly principal payments of $21,000 plus interest commencing on February 1, 2011, and continuing on the first day of each month thereafter followed by a 120th payment of all unpaid principal, interest and fees on February 1, 2021. If the Revolving Credit Agreement is not renewed, a balloon payment of $1,020,000 in principal plus interest and additional fees will be due on January 31, 2017. The Term Loan is collateralized with our California facility located in Compton, California. The interest rate is PNC Base Rate plus 2.25% to 3.75%, or 1-, 2- or 3-month PNC LIBOR Rate plus 3.25% to 4.75%. The interest rate will be fixed for the first half of 2016 at PNC Base Rate plus 3.75%, or 1-,2- or 3-month PNC LIBOR Rate plus 4.75%. As of July 2, 2016, the weighted average interest rate was 5.28%. As of January 2, 2016, the weighted average interest rate was 7.75% which was the PNC Base Rate plus a default rate premium. As of July 2, 2016, the balance due on the Term Loan is classified as current as the maturity of our credit facility is January 31, 2017.

On March 10, 2011, ARCA Advanced Processing, LLC entered into three separate commercial term loans ("AAP Term Loans") with Susquehanna Bank, pursuant to the guidelines of the U.S. Small Business Administration 7(a) Loan Program. The total amount of the AAP Term Loans is $4.75 million, split into three separate loans for $2.1 million, $1.4 million and $1.25 million. The AAP Term Loans mature in ten years and bear an interest rate of Prime plus 2.75%. As of July 2, 2016, and January 2, 2016, the interest rate was 6.00%. Borrowings under the AAP Term Loans are secured by substantially all of the assets of AAP along with liens on the business assets and certain personal assets of the owners of 4301 Operations, LLC. We are a guarantor of the AAP Term Loans along with 4301 Operations, LLC and its owners.

In March 2015, an entity controlled by one of the noncontrolling interest holders of AAP loaned AAP $325,000 through the issuance of promissory notes. The notes bear interest at an annual rate of 8%. In May 2015, one of the March 2015 notes totaling $125,000 was repaid in full by AAP. In February 2016, an entity controlled by one of the noncontrolling interest holders of AAP loaned AAP $100,000 through the issuance of an 8% promissory note. The remaining notes totaling $300,000 are expected to be repaid with the collection of the carbon offset program revenues by the end of the third quarter of 2016.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market Risk and Impact of Inflation

Interest Rate Risk. We do not believe there is any significant risk related to interest rate fluctuations on our long-term fixed-rate debt. There is interest rate risk on the line of credit, PNC Term Loan and Susquehanna Bank Term Loans, since our interest rate floats. The outstanding balance on our floating rate loans as of July 2, 2016, was approximately $12.2 million. Based on average floating rate borrowings of $14.7 million, a hypothetical 100 basis point change in the applicable interest rate would have caused our interest expense to change for the three and six months ended July 2, 2016, by approximately $37,000 and $73,000.

Foreign Currency Exchange Rate Risk. We currently generate revenues in Canada. The reporting currency for our consolidated financial statements is U.S. dollars. It is not possible to determine the exact impact of foreign currency exchange rate changes; however, the effect on reported revenue and net earnings can be estimated. We estimate that the U.S. dollar against the Canadian dollar had an immaterial impact on revenues and net income for the three and six months ended July 2, 2016. We do not currently hedge foreign currency fluctuations and do not intend to do so for the foreseeable future.

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Our management, including our Chief Executive Officer and Acting Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act), at July 2, 2016. Based on that evaluation, our Chief Executive Officer and Acting Chief Financial Officer concluded that, at July 2, 2016, our disclosure controls and procedures were effective.

Changes in Internal Control over Financial Reporting

During the second quarter of fiscal 2016, covered by this Quarterly Report on Form 10-Q, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

On March 6, 2015, a complaint was filed in United States District Court for the Central District of California by Jason Feola, individually and as a representative of a class consisting of purchasers of the Company's common stock between March 15, 2012 and February 11, 2015, against Appliance Recycling Centers of America, Inc. and certain current and former officers of the Company. Mr. Feola, pursuant to terms of his retainer agreement with The Rosen Law Firm, certified that he purchased 240 shares of the Company's common stock for $984 in total consideration. In May 2015, the Company and the individual defendants were served the complaint. In July 2015, the Company and the individual defendants received an amended complaint. The complaint alleges that misstatements and omissions occurred in press releases and filings by the Company with the Securities and Exchange Commission and that these misstatements or omissions constitute violations of Section 20 (a) and Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act of 1934. This matter has been submitted to our insurance carrier and we intend to contest vigorously the claims made in the complaint.

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

Litigation: On March 6, 2015, a complaint was filed in United States District Court for the Central District of California by Jason Feola, individually and as a representative of a putative class consisting of purchasers of the Company's common stock between March 15, 2012 and February 11, 2015, against Appliance Recycling Centers of America, Inc. and certain current and former officers of the Company. Mr. Feola, pursuant to terms of his retainer agreement with The Rosen Law Firm, certified that he purchased 240 shares of the Company's common stock for approximately $1 in total consideration. On May 7, 2015, the Company and the individual defendants were served the complaint. In July 2015, the Company and the individual defendants received an amended complaint. The complaint alleges that misstatements and omissions occurred in press releases and filings by the Company with the Securities and Exchange Commission and that these misstatements or omissions constitute violations of Section 20 (a) and Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act of 1934. In October 2015, the court held a hearing on the Company's motion to dismiss the complaint. On November 24, 2015, the United States District Court for the Central District of California entered an order granting the motion to dismiss the amended complaint. The Court's order provided that the dismissal was without prejudice and that the plaintiffs may file an amended complaint within 21 days of the issuance of the order. On December 15, 2015, the Company and the individual defendants were served with a second amended complaint. In May 2016, the court held a hearing on the Company's motion to dismiss the second amended complaint. We are currently awaiting the United States District Court for the Central District of California's ruling on our motion to dismiss the second amended complaint. This matter has been forwarded to our insurance carriers and we intend to contest vigorously the claims made in the complaint.

On November 6, 2015, a complaint was filed in the Minnesota District Court for Hennepin County, Minnesota, by David Gray and Michael Boller, purporting to bring suit derivatively and on behalf of the Company against twelve current and former officers and directors of the Company. The complaint alleges that the defendants breached their fiduciary duties based on substantially similar allegations to those asserted in Mr. Feola's putative securities class action complaint, and that the defendants have been unjustly enriched as a result thereof. The complaint seeks damages, disgorgement, an award of attorneys' fees and other expenses, and an order compelling changes to the Company's corporate governance and internal procedures. This matter has been stayed by the court, pursuant to a stipulation of the parties, until the United States District Court for the Central District of California determines the legal sufficiency of Mr. Feola's complaint or other specified developments occur in that case. This matter has been submitted to our insurance carriers.

Given the uncertainty of litigation and the preliminary stage of these cases, we cannot reasonably estimate the possible loss or range of loss that may result from these actions. The Company maintains liability insurance policies that may reduce the Company's exposure, if any.

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

AMTIM Capital, Inc. (“AMTIM”) acts as our representative to market our recycling services in Canada under an arrangement that pays AMTIM for revenues generated by recycling services in Canada as set forth in the agreements between the parties. A dispute has arisen between AMTIM and us with respect to the calculation of amounts due to AMTIM pursuant to the agreement. In a lawsuit filed in the province of Ontario, AMTIM claims a discrepancy in the calculation of fees due to AMTIM by us of approximately $2,000. Although the outcome of this claim is uncertain, we believe that no further amounts are due under the terms of the agreement and will continue to defend our position relative to this lawsuit.

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

Sales and Use Taxes: We operate in twenty-three states in the U.S. and in various provinces in Canada. From time to time, we are subject to sales and use tax audits that could result in additional taxes, penalties and interest owed to various taxing authorities.

As previously disclosed, the California Board of Equalization (“BOE”) is conducting a sales and use tax examination covering the California operations of Appliance Recycling Centers of America, Inc. (the “Company”) for 2011, 2012 and 2013. The Company believed it was exempt from collecting sales taxes under service agreements with utility customers that included appliance replacement programs. During the fourth quarter of 2014, the Company received communication from the BOE indicating they are not in agreement with the Company’s interpretation of the law. As a result, the Company applied for and, as of February 9, 2015, received approval to participate in the California Board of Equalization’s Managed Audit Program. The period covered under this program includes 2011, 2012, 2013 and extends through the nine-month period ended September 30, 2014. At this time, our best estimate of the amount that will be assessed by the BOE covering all periods under audit is approximately $4.1 million in sales tax and interest related to the appliance replacement programs that we administered on behalf of our customers on which we did not assess, collect or remit sales tax. The Company has been working with outside consultants to arrive at our assessment estimate and will continue to engage the services of these sales tax experts throughout the Managed Audit Program process. The sales tax amounts that we will likely be assessed relate to transactions in the period under examination by the BOE. Such assessment, however, will be subject to protest and appeal, and would not need to be funded until the matter has been fully resolved. Resolution could take up to two years.

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

We are monitoring Whirlpool's defense of the claims and believe the possibility of a material loss is remote.

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

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

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

None.

Item 3. Defaults Upon Senior Securities

As of July 2, 2016, ARCA had borrowings totaling $1.1 million on its Term Loan with PNC Bank, National Association (“PNC”) and $7.8 million under its $15 million Revolving Credit Agreement. The PNC loan agreements (“Loan Agreements”) require ARCA to, among other things, satisfy certain financial covenants as of the end of each fiscal quarter. A failure to satisfy any covenant constitutes an event of default under the Loan Agreements. As of July 2, 2016, ARCA was not in compliance with the foregoing covenants due to the loss recorded for the first six months of 2016. ARCA has notified PNC of its non-compliance. We are working with PNC to obtain an Amended Credit Agreement.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit Number	**Description**
31.1+	Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2+	Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1†	Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2†	Certification by Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101**	The following materials from our Quarterly Report on Form 10-Q for the three-month and six month periods ended July 2, 2016 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated

Balance Sheets, (ii) the Consolidated Statements of Operations and Comprehensive Income (Loss), (iii) the Consolidated Statements of Cash Flows, (iv) the Notes to Consolidated Financial Statements, and (v) document and entity information.

\+ Filed herewith.

† Furnished herewith.

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

SIGNATURES

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

Appliance Recycling Centers of America, Inc.
(Registrant)

Date: August 16, 2016 By: /s/ Tony Isaac
Tony Isaac
Chief Executive Officer
(Principal Executive Officer)

Date: August 16, 2016 By: /s/ Tony Isaac
Tony Isaac
Acting Chief Financial Officer
(Principal Financial and Accounting Officer)