DATA I/O CORP
Form 10-Q
August 14, 2008

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

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarter ended **June 30, 2008**

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
Or the transition period from ___________ to ______________

Commission File No. **0-10394**

DATA I/O CORPORATION
(Exact name of registrant as specified in its charter)

Washington	91-0864123
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6464 185th Ave NE, Suite 101, Redmond, Washington, 98052
(Address of principal executive offices, including zip code)

(425) 881-6444
(Registrant's telephone number, including area code)

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company x

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

8,809,989 shares of no par value of the Registrant's Common Stock were issued and outstanding as of May 8, 2008.

DATA I/O CORPORATION

FORM 10-Q
For the Quarter Ended June 30, 2008

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PART I - FINANCIAL INFORMATION

Item 1. **Financial Statements**

DATA I/O CORPORATION

CONSOLIDATED BALANCE SHEETS

	June 30, 2008	Dec. 31, 2007
(in thousands, except share data)	**(unaudited)**	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 10,764	$ 7,637
Trade accounts receivable, less allowance for doubtful accounts of $147 and $130	6,938	5,299
Inventories	5,061	4,980
Other current assets	255	323
TOTAL CURRENT ASSETS	23,018	18,239
Property and equipment - net	2,240	2,257
Other assets	122	124
TOTAL ASSETS	$ 25,380	$ 20,620
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,404	$ 1,204
Accrued compensation	1,369	1,025
Deferred revenue	1,664	1,715
Other accrued liabilities	1,055	1,104
Accrued costs of business restructuring	—	8
Income taxes payable	52	3
Notes payable	121	118
TOTAL CURRENT LIABILITIES	5,665	5,177
Long-term other payables	23	20
Long-term debt	279	337
COMMITMENTS	—	—
STOCKHOLDERS' EQUITY:		
Preferred stock -		
Authorized, 5,000,000 shares, including 200,000 shares of Series A Junior Participating		
Issued and outstanding, none	—	—
Common stock, at stated value -		
Authorized, 30,000,000 shares		

Issued and outstanding, 8,821,296 and 8,765,767 shares	20,994	20,724
Accumulated deficit	(2,585)	(6,429)
Accumulated other comprehensive income	1,004	791
TOTAL STOCKHOLDERS' EQUITY	19,413	15,086
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 25,380	$ 20,620

See accompanying notes to consolidated financial statements.

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DATA I/O CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three months ended June 30, 2008	Three months ended June 30, 2007	Six months ended June 30, 2008	Six months ended June 30, 2007
(in thousands, except per share data)				
Net sales	$ 8,023	$ 5,778	$ 14,211	$ 11,806
Cost of goods sold	3,465	2,940	5,891	5,648
Gross margin	4,558	2,838	8,320	6,158
Operating expenses:				
Research and development	1,166	1,286	2,265	2,657
Selling, general and administrative	2,287	2,027	4,315	4,565
Net provision for business restructure	(2)	632	7	832
Total operating expenses	3,451	3,945	6,587	8,054
Operating income (loss)	1,107	(1,107)	1,733	(1,896)
Non-operating income (expense):				
Interest income	46	30	86	52
Interest expense	(8)	(10)	(16)	(20)
Gain on sale	—	—	2,115	—
Foreign currency exchange	77	11	(22)	9
Total non-operating income (expense)	115	31	2,163	41
Income (loss) before income taxes	1,222	(1,076)	3,896	(1,855)
Income tax expense (benefit)	19	3	52	9
Net income (loss)	$ 1,203	($ 1,079)	$ 3,844	($ 1,864)
Basic earnings (loss) per share	$ 0.14	($ 0.13)	$ 0.44	($ 0.22)
Diluted earnings (loss) per share	$ 0.13	($ 0.13)	$ 0.42	($ 0.22)
Weighted average shares outstanding - basic	8,806	8,562	8,790	8,527
Weighted average and potential shares outstanding - diluted	9,091	8,562	9,062	8,527

See accompanying notes to consolidated financial statements.

DATA I/O CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

For the six months ended	**June 30, 2008**	**June 30, 2007**
(in thousands)		
OPERATING ACTIVITIES:		
Net income (loss)	$ 3,844	($ 1,864)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	200	513
Write-off of property, plant and equipment	2	7
Gain on sale of patent	(2,115)	—
Equipment transferred to cost of goods sold	180	234
Share-based compensation	200	153
Net change in:		
Deferred revenue	5	154
Trade accounts receivable	(1,488)	2,280
Inventories	(13)	(519)
Other current assets	74	178
Accrued costs of business restructuring	(8)	407
Accounts payable and accrued liabilities	603	(812)
Deposits and other long-term assets	(1)	1
Net cash provided by (used in) operating activities	1,483	732
INVESTING ACTIVITIES:		
Purchases of property and equipment	(112)	(311)
Net proceeds from sale of patent	2,115	—
Net cash provided by (used in) investing activities	2,003	(311)
FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	70	225
Payment of capital lease obligation	(55)	(50)
Net cash provided by (used in) financing activities	15	175
Increase/(decrease) in cash and cash equivalents	3,501	596
Effects of exchange rate changes on cash	(374)	(170)
Cash and cash equivalents at beginning of year	7,637	2,478
Cash and cash equivalents at end of quarter	$ 10,764	$ 2,904

See accompanying notes to consolidated financial statements.

DATA I/O CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 - FINANCIAL STATEMENT PREPARATION

Data I/O prepared the financial statements as of June 30, 2008 and 2007, according to the rules and regulations of the Securities and Exchange Commission ("SEC"). These statements are unaudited but, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the results for the periods presented. The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date. We have condensed or omitted certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America according to such SEC rules and regulations. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. These financial statements should be read in conjunction with the annual audited financial statements and the accompanying notes included in the Company's Form 10-K for the year ended December 31, 2007.

Revenue Recognition

Data I/O recognizes revenue at the time of shipment. When arrangements include multiple elements, we use objective evidence of fair value to allocate revenue to the elements pursuant to EITF 00-21, "Revenue Arrangements with Multiple Deliverables," and recognize revenue when the criteria for revenue recognition have been met for each element according to SAB 104, "Revenue Recognition." The amount of revenue recognized is affected by our judgments as to the collectibility of the transaction or whether an arrangement includes multiple elements and if so, whether specific objective evidence of fair value exists for those elements.

Installation that is considered perfunctory includes any installation that can be performed by other parties, such as distributors, other vendors, or in most cases the customers themselves. This takes into account the complexity, skill, and training needed as well as customer expectations regarding installation. The revenue related to products requiring installation that is perfunctory is recognized at the time of shipment provided that persuasive evidence of an arrangement exists, shipment has occurred, the price is fixed or determinable, and collectibility is reasonably assured. We measure the standalone fair value of the product versus the service installation value component by the amount paid to independent representative service groups or the amount of additional discount given to independent distributors to provide the service installation.

We record revenue from the sale of service and update contracts as deferred revenue and we recognize it on a straight-line basis over the contractual period, which is typically one year. We establish a reserve for sales returns based on historical trends in product returns and estimates for new items. We have a stated return policy that customers can return standard products for any reason within 30 days after delivery, provided that the returned product is received in its original condition, including all packaging materials, for a refund of the price paid less a restocking charge of 30% of the total amount invoiced for the product returned, unless such restocking charge is waived in writing by Data I/O.

Data I/O's software products are not normally sold separately from sales of programming systems. However, on those occasions where we sell software separately, we recognize revenue when a sales agreement exists, when delivery has occurred, when the fee is fixed or determinable, and when collection is probable.

Stock-Based Compensation Expense

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") and the Securities and Exchange Commission issued Staff Accounting Bulleting No. 107 ("SAB 107") requiring the measurement and recognition of compensation expense for all share-based payment awards, including employee stock options, stock awards, and employee stock purchases, based on estimated fair values on the grant dates. The Company adopted SFAS 123(R) using the modified prospective method, which required the application of the accounting standard as of January 1, 2006. Total share-based compensation for the three and six months ended June 30, 2008 was $106,000 and $200,000, respectively. Total share-based compensation for the three and six months ended June 30, 2007 was $70,000 and $153,000, respectively.

Income Tax

The Company adopted the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes"* ("FIN 48") on January 1, 2007. FIN 48 clarifies the accounting and disclosure for uncertainty in income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, measurement, classification, interest and penalties, accounting for interim periods, disclosure and transition, and clearly scopes income taxes out of Financial Accounting Standards Board Statement No. 5, "*Accounting for Contingencies*."

Historically, the Company has not incurred any interest or penalties associated with tax matters and no interest or penalties were recognized during the three and six months ended June 30, 2008. However, the Company has adopted a policy whereby amounts related to interest and penalties associated with tax matters are classified as general and administrative expense when incurred.

The Company has incurred net operating losses in certain past years. The Company continues to maintain a valuation allowance for the full amount of the net deferred tax asset balance associated with its net operating losses as sufficient uncertainty exists regarding its ability to realize such tax assets in the future. There was $66,000 of unrecognized tax benefits related to uncertain tax positions as of June 30, 2008. The Company expects the amount of the net deferred tax asset balance and full valuation allowance in future periods to decrease if we have future net income or increase if we incur future net operating losses.

Tax years that remain open for examination include 2004, 2005, 2006, and 2007 in the United States of America. In addition, tax years from 1999 to 2003 may be subject to examination in the event that the Company utilizes the NOL's or other carry forwards from those years in its current or future year tax return.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157,*Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position ("FSP") 157-2,*Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are required to adopt SFAS 157 in the first quarter of 2009; FSP 157-2 delays the effective date for certain items to the first quarter of 2010 We are evaluating the impact of adopting SFAS 157 on our financial statements.

In February 2007, the FASB issued Statement 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to elect to measure certain financial instruments and other items at fair value through earnings. The fair value option may be applied on an instrument by instrument basis, is irrevocable and is applied only to entire instruments. SFAS 159 requires additional financial statement presentation and disclosure requirements for those entities that elect to adopt the standard and is effective for fiscal years beginning after November 15, 2007. The implementation of this standard relating to the assets and liabilities carried at fair value on a recurring basis did not have a material impact on our consolidated financial statements.

In December 2007, the FASB issued Statement No. 141(Revised 2007), *"Business Combinations"* ("Statement. No. 141R"), which establishes principles and requirements for the reporting entity in a business combination, including recognition and measurement in the financial statements of the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. This statement also establishes disclosure requirements to enable financial statement users to evaluate the nature and financial effects of the business combination. Statement No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, and interim periods within those fiscal years. We have not yet evaluated the effect the adoption of Statement No. 141R could have on our consolidated financial statements, if any.

NOTE 2 - RECLASSIFICATIONS

Certain prior period balances may have been reclassified to conform to the presentation used in the current period.

NOTE 3 - INVENTORIES

Inventories consisted of the following components (in thousands):

	June 30, 2008	Dec. 31, 2007
Raw material	$ 2,809	$ 3,047
Work-in-process	1,166	1,125
Finished goods	1,086	808
Inventories	$ 5,061	$ 4,980

NOTE 4 – PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following components (in thousands):

	June 30, 2008	Dec. 31, 2007
Leasehold improvements	$ 392	$ 389
Equipment	9,301	8,853
	9,693	9,242
Less accumulated depreciation	7,453	6,985
Property and equipment - net	$ 2,240	$ 2,257

NOTE 5 – BUSINESS RESTRUCTURING

During 2007, we continued our restructuring activities during the first and second quarters, to further improve our operating results and the effectiveness of our sales and marketing organization and sales channels. During the first quarter of 2007, we recorded restructuring charges of approximately $200,000 primarily related to severance charges. During the second quarter of 2007, we recorded an additional $632,000 of restructuring charges. These actions included re-engineering some internal processes, integrating some activities, transferring some activities to our lower cost base of operations in China, reducing resources applied to declining legacy products, moving some engineering positions to production, reducing the number of taxable entities, outsourcing some functions such as payroll, combining some positions, eliminating some functions, and shifting some responsibilities and resources to our channels. During the third quarter of 2007, we recorded a net expense reversal of $107,000 comprised of $54,000 of additional expense, primarily relating to facilities, and a reversal of $161,000 of previously accrued severance primarily because certain employees who had been scheduled for termination had their termination notice rescinded. At June 30, 2008, we have completed the previously planned restructuring actions with no remaining amounts accrued.

An analysis of the restructuring is as follows (in thousands):

Description	**Reserve Balance 12/31/06**	**2007 Expense**	**2007 Payments/ Write-offs**	**Reserve Balance 12/31/07**	**2008 Expense**	**2008 Payments/ Write-offs**	**Reserve Balance 6/30/08**
Downsizing US operations:							
Employee severance	$ 2	$ 411	$ 413	$ —	$ 9	$ 9	$ —
Facility & other costs	—	5	5	—	—	—	—
Downsizing foreign operations:							
Employee severance	—	204	199	5	—	5	—
Facility & other costs	—	105	102	3	—	3	—
Total	$ 2	$ 725	$ 719	$ 8	$ 9	$ 17	$ —

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NOTE 6 – OTHER ACCRUED LIABILITIES

Other accrued liabilities consisted of the following components (in thousands):

	June 30, 2008	Dec. 31, 2007
Product warranty liability	$ 423	$ 401
Sales return reserve	175	158
Accrued rent	175	187
Other taxes	67	65
Other	215	293
Other accrued liabilities	$ 1,055	$ 1,104

The changes in Data I/O's product warranty liability are as follows (in thousands):

	June 30, 2008
Liability, beginning balance	$ 401
Net expenses	387
Warranty claims	(387)
Accrual revisions	22
Liability, ending balance	$ 423

NOTE 7 – OPERATING LEASE AND OTHER COMMITMENTS

Data I/O has purchase obligations for inventory and production costs as well as other obligations such as capital expenditures, service contracts, marketing, and development agreements. Arrangements are considered purchase obligations if a contract specifies all significant terms, including fixed or minimum quantities to be purchased, a pricing structure and approximate timing of the transaction. Most arrangements are cancelable without a significant penalty, and with short notice, typically less than 90 days. At June 30, 2008, the purchase and other obligations totaled $956,000. Data I/O has commitments under non-cancelable operating leases and other agreements, primarily for factory and office space, with initial or remaining terms of one year or more as follows:

Future annual lease payments at June 30, 2008 (in thousands):

	Operating leases
2009	$ 1,135
2010	895
2011	783
2012	2
Total	$ 2,815

NOTE 8 – CONTINGENCIES

As of June 30, 2008, Data I/O was not a party to any legal proceedings, the adverse outcome of which in management's opinion, individually or in the aggregate, would have a material adverse effect on our results of operations or financial position except as described below.

On January 22, 2008, our former landlord, (now known as Rowley Properties, Inc.), filed a Complaint in the Superior Court of Washington for King County (No. 08-2-03518-2 SEA) against Data I/O, Robert/Barbara Hiester and Steven/Jane Doe Hiester. The claims against Data I/O include breach of agreement, waste, and an environmental remediation claim for contribution under RCW 70.105D.080. No claim amount is specified in the Complaint. The claims relate to a former circuit board fabrication business that Data I/O operated from 1978 to October 1988. We sold that business to Circuit Partners whose officers and principal shareholders were Robert and Barbara Heister. As stated in Data I/O's 1988 10-K: "An environmental and regulatory compliance audit was performed prior to the sale, per the guidelines of the Comprehensive Environmental Response Compensation and Liability Ace ("Cercla/Superfund") Section 107. Audit results indicated no heavy metals or volatile organics in excess of existing or proposed Washington State or federal remedial action levels." We are in the very early stages of investigating and responding to this claim and have engaged counsel to represent us on this matter. We filed an Answer to the Complaint on March 12, 2008. At this time, we are not able to determine the probable outcome of this legal proceeding or if it will have an adverse effect on the results of operations or financial position of Data I/O. We intend to defend this claim vigorously and are in the process of determining the insurance coverage for this claim.

NOTE 9 – LONG-TERM DEBT

On September 27, 2006, the Company entered into a five year capital lease agreement in the amount of $591,145. The imputed interest rate is 7.69%.

At June 30, 2008 scheduled maturities of the capital lease obligation for the years ending December 31 are as follows (in thousands):

2008	70
2009	140
2010	140
2011	106
Total minimum lease payments	456
Less: Amount representing interest	(56)
Present value of capital lease obligation	400
Current portion long-term debt	(121)
Non-current portion long-term debt	$ 279

NOTE 10 – EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is calculated based on the weighted average number of common shares outstanding during each period. Diluted earnings per share is calculated based on these same weighted average shares outstanding plus the effect of potential shares issuable upon assumed exercise of stock options based on the treasury stock method. Potential shares issuable upon the exercise of stock options are excluded from the calculation of diluted earnings per share to the extent their effect would be antidilutive.

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The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Numerator for basic and diluted earnings per share:				
Net income (loss)	$ 1,203	($1,079)	$ 3,844	($1,864)
Denominator:				
Denominator for basic earnings per share - weighted-average shares	8,806	8,562	8,790	8,527
Employee stock options and awards	285	—	272	—
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions of stock options	9,091	8,562	9,062	8,527
Basic and diluted earnings (loss) per share:				
Total basic earnings (loss) per share	$ 0.14	($ 0.13)	$ 0.44	($ 0.22)
Total diluted earnings (loss) per share	$ 0.13	($ 0.13)	$ 0.42	($ 0.22)

The computation for the three and six months ended June 30, 2008 excludes 93,247 and 148,835 options, respectively, to purchase common stock as their effect is anitdilutive. The computation for the three and six months ended June 30, 2007 excludes 1,056,855 to purchase common stock as the effect of their inclusion was anitdilutive.

NOTE 11 – SHARE-BASED COMPENSATION

The impact on our results of operations of recording share-based compensation for the three and six month period ended June 30, 2008 and June 30, 2007 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Cost of goods sold	$ 6	$ 3	$ 11	$ 8
Research and development	12	8	24	20
Selling, general and administrative	88	59	165	125

	Three Months Ended June 30,		Six Months Ended June 30,	
Total share-based compensation	$ 106	$ 70	$ 200	$ 153
Impact on net income (loss) per share: Basic and diluted	$ (0.01)	($0.01)	$ (0.02)	($0.02)

The fair value of share-based awards for employee stock options was estimated using the Black-Scholes valuation model. The following weighted average assumptions were used to calculate the fair value of stock options granted during the three and six months ended June 30, 2008 and 2007: At June 30, 2008, there remained $859.000 of unamortized expected future compensation expense associated with unvested option grants and restricted stock awards, with a remaining weighted average amortization period of 2.7 years.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Risk-free interest rates	3.11%	4.97%	3.11%	4.96%
Volatility factors				