

DATA I/O CORP
Form 10-Q
August 14, 2006

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

FORM 10-Q

(Mark One)

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

For the quarter ended June 30, 2006

OR

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
(State or other jurisdiction of
incorporation or organization)

91-0864123
(I.R.S. Employer
Identification No.)

**10525 Willows Road N.E.,
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 No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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8,442,231 shares of no par value of the Registrant's Common Stock were issued and outstanding as of August 10, 2006.

DATA I/O CORPORATION
FORM 10-Q
For the Quarter Ended June 30, 2006

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PART I FINANCIAL INFORMATION**Item 1. Financial Statements**

DATA I/O CORPORATION
CONSOLIDATED BALANCE SHEETS

	June 30, 2006	December 31, 2005
(in thousands, except share data)	(unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 3,660	\$ 4,362
Marketable securities		800
Trade accounts receivable, less allowance for doubtful accounts of \$184 and \$165	6,298	6,828
Inventories	4,805	3,529
Other current assets	549	329
	15,312	15,848
TOTAL CURRENT ASSETS		
Property and equipment - net	2,363	2,274
Other assets	80	15
	\$ 17,755	\$ 18,137
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 1,932	\$ 1,608
Accrued compensation	1,244	1,249
Deferred revenue	1,262	1,329
Other accrued liabilities	1,075	1,100
Accrued costs of business restructuring	13	33
Income taxes payable	135	147
Deferred gain on sale of property	194	388
	5,855	5,854
TOTAL CURRENT LIABILITIES		
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, 8,419,624		

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and 8,362,369 shares	19,723	19,408
Accumulated deficit	(8,345)	(7,436)
Accumulated other comprehensive income	522	311
	<hr/>	<hr/>
TOTAL STOCKHOLDERS' EQUITY	11,900	12,283
	<hr/>	<hr/>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 17,755	\$ 18,137
	<hr/>	<hr/>

See accompanying notes to consolidated financial statements.

DATA I/O CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
<hr/>				
(in thousands, except per share data)				
Net sales	\$7,163	\$6,642	\$13,575	\$13,379
Cost of goods sold	3,420	2,709	6,421	5,432
	<hr/>	<hr/>	<hr/>	<hr/>
Gross margin	3,743	3,933	7,154	7,947
Operating expenses:				
Research and development	1,513	1,350	2,819	2,687
Selling, general and administrative	2,626	2,378	5,266	5,010
Net provision for business restructure		55		55
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	4,139	3,783	8,085	7,752
	<hr/>	<hr/>	<hr/>	<hr/>
Operating income (loss)	(396)	150	(931)	195
Non-operating income (expense):				
Interest income	37	20	80	44
Interest expense		(9)		(12)
Gain on sale			6	
Foreign currency exchange	(13)	(3)	(9)	(24)

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Total non-operating income (expense)	24	8	77	8
Income (loss) before income taxes	(372)	158	(854)	203
Income tax expense	26	105	55	111
Net income (loss)	(\$398)	\$53	(\$ 909)	\$92
Basic and diluted earnings (loss) per share	(\$ 0.05)	\$0.01	(\$ 0.11)	\$0.01
Weighted average shares outstanding - basic	8,415	8,202	8,401	8,178
Weighted average and potential shares outstanding - diluted	8,415	8,486	8,401	8,518

See accompanying notes to consolidated financial statements.

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DATA I/O CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

For the three months ended	June 30, 2006	December 31, 2005
(in thousands)	(unaudited)	
OPERATING ACTIVITIES:	(\$909)	\$92
Net income (loss)		
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	549	550
Write-off of assets	14	10
Gain on sale of fixed asset	(6)	326
Equipment transferred to cost of goods sold	155	
Amortization of deferred gain on sale	(194)	(194)
Share-based compensation	195	
Net change in:		

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Deferred revenue	(36)	(534)
Trade accounts receivable	668	(1,399)
Inventories	(1,240)	199
Other current assets	(219)	128
Accrued costs of business restructuring	(20)	(21)
Accounts payable and accrued liabilities	350	(214)
Security deposits	(45)	
	<hr/>	<hr/>
Net cash provided by (used in) operating activities	(738)	(1,057)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(640)	(1,313)
Acquisition of intangibles	(25)	
Purchases of marketable securities		(600)
Proceeds from sales of marketable securities	804	792
	<hr/>	<hr/>
Net cash provided by (used in) investing activities	139	(1,121)
FINANCING ACTIVITIES:		
Sale of common stock	59	70
Proceeds from exercise of stock options	61	25
	<hr/>	<hr/>
Net cash provided by (used in) financing activities	120	95
	<hr/>	<hr/>
Increase/(decrease) in cash and cash equivalents	(479)	(2,083)
Effects of exchange rate changes on cash	(223)	323
Cash and cash equivalents at beginning of year	4,362	5,534
	<hr/>	<hr/>
Cash and cash equivalents at end of quarter	\$3,660	\$3,774
	<hr/>	<hr/>

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, 2006 and June 30, 2005, 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, 2005 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 six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. 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, 2005.

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)) which requires the measurement and recognition of compensation expense for all share-based payment awards, including employee stock options and employee stock purchases, based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's Consolidated Financial Statements as of and for the three and six months ended June 30, 2006 reflect the effect of SFAS 123(R). The total stock-based compensation amount for the three and six months ended June 30, 2006 was \$93,000 and \$195,000, respectively.

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, 2006	December 31, 2005
Raw material	\$3,215	\$2,076
Work-in-process	712	767
Finished goods	878	686
Inventories	\$4,805	\$3,529

NOTE 4 PROPERTY AND EQUIPMENT, NET

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

	June 30, 2006	December 31, 2005
Leasehold improvements	\$598	\$343
Equipment	9,961	9,935
	<hr/>	<hr/>
	10,559	10,278
Less accumulated depreciation	8,196	8,004
	<hr/>	<hr/>
Property and equipment - net	\$2,363	\$2,274
	<hr/>	<hr/>

NOTE 5 BUSINESS RESTRUCTURING

During 2005, we took restructuring related charges of \$96,000 primarily related to severance and completing actions that had been started in the second half of 2004. This aligned management operations with the changes made in 2004 to control costs in North America and Europe and the need to build staff serving China and Eastern Europe. At December 31, 2005, \$33,000 remained as accrued but unpaid restructure charges, which will be paid in 2006.

During the first quarter of 2006, we paid out approximately \$20,000 of the remaining 2005 previously accrued restructure charges as outlined above. There was no activity during the second quarter of 2006. As of June 30, 2006, restructuring charges of \$13,000 remain accrued, which are expected to be paid in 2006.

During the third quarter of 2006, as part of our effort to reduce expenses, we incurred a restructuring charge of approximately \$150,000 which has not yet been paid. The restructuring charge is primarily related to severance charges incurred at our Redmond, Germany and China offices. In view of our declining margins and operating results during the first and second quarters of 2006, these actions were taken to reduce our quarterly revenue breakeven point to approximately \$7 million per quarter. This restructure charge is expected to be paid out in 2006.

NOTE 6 OTHER ACCRUED LIABILITIES

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

	June 30, 2006	December 31, 2005
Product warranty liability	\$465	\$459
Sales return reserve	135	150
Other	475	491
	<hr/>	<hr/>
Other accrued liabilities	\$1,075	\$1,100
	<hr/>	<hr/>

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

	June 30, 2006
Liability, beginning balance	\$ 459
Net expenses	370
Warranty claims	(370)

NOTE 6 OTHER ACCRUED LIABILITIES

	June 30, 2006
Accrual revisions	6
Liability, ending balance	<u>\$ 465</u>

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NOTE 7 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.

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,	
	2006	2005	2006	2005
Numerator for basic and diluted earnings per share:				
Net income (loss)	(\$398)	\$53	(\$909)	\$92
Denominator:				
Denominator for basic earnings per share - weighted-average shares	8,415	8,202	8,401	8,178
Employee stock options		284		340
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions of stock options	8,415	8,486	8,401	8,518
Basic and diluted earnings (loss) per share				
Total basic and diluted earnings (loss) per share	(\$0.05)	\$0.01	(\$0.11)	\$0.01

The computation for the three and six months ended June 30, 2006 excludes 1,171,824 options to purchase common stock as the effect of their inclusion was antidilutive. The computation for the three and six months ended June 30, 2005 excluded 447,265 and 432,220 options respectively to purchase common stock as these options were antidilutive.

NOTE 8 SHARE-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123(R) which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options, stock awards and employee stock purchases made under our Employee Stock Purchase Plan (ESPP). Data I/O previously applied the provisions of APB No. 25 and related Interpretations and provided the required pro forma disclosures under SFAS No. 123, Accounting for Stock-Based Compensation. The following table illustrates the effect on net income and net income per common share for the three and six months ended June 30, 2005. No share-based compensation expense was reflected in our results of operations for the three and six month period ended June 30, 2005 as all options were granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, option forfeitures were accounted for as they occurred.

Data I/O's pro forma information follows (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income - as reported	\$53	\$92
Deduct: Total stock-based employee compensation expense determined under fair value based method for awards granted, modified, or settled, net of related tax effects	(95)	(186)
Net income (loss) - pro forma	(\$42)	(\$94)
Basic and diluted income per share - as reported	\$0.01	\$0.01
Basic income (loss) per share - pro forma	(\$0.01)	(\$0.01)
Diluted earnings (loss) per share - pro forma	\$0.00	(\$0.01)

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Data I/O adopted SFAS No. 123(R) using the modified prospective method beginning January 1, 2006. Accordingly, during the three and six month period ended June 30, 2006, we recorded share-based compensation expense for awards granted prior to but not yet vested as of January 1, 2006 as if the fair value method required for pro forma disclosure under SFAS No. 123 were in effect for expense recognition purposes adjusted for estimated forfeitures. For share-based awards granted after January 1, 2006, we have recognized compensation expense based on the estimated grant date fair value method required under SFAS No. 123(R). For these awards we have recognized compensation expense using a straight-line amortization method and reduced for estimated forfeitures. The impact on our results of operations of recording share-based compensation for the three and six month period ended June 30, 2006 was as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Costs of goods sold	\$6	\$13
Research and development	21	44
Selling, general and administrative	66	138
Total share-based compensation expense	\$ 93	\$ 195
Impact on net income (loss) per share: Basic and diluted	(\$0.01)	(\$0.02)

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Approximately \$1,500 and \$3,000 of share-based compensation was capitalized within inventory for the three and six months ended June 30, 2006, respectively.

At June 30, 2006, there were 1,684,632 shares of Common Stock reserved for issuance under Data I/O's employee stock option plans with 512,808 shares available for grant. Pursuant to the stock option plans, options are granted to our officers and key employees with exercise prices equal to the fair market value of the Common Stock at the date of grant and generally vest over four years. Options granted under the plans generally have a maximum term of six years from the date of grant. Beginning in the second quarter of 2006, we granted restricted stock awards and performance-based stock awards to our officers and key employees at fair market value. The restricted stock awards vest in equal installments over four years. The performance-based stock awards vest on 12/31/2008 based on obtaining a revenue growth target of \$34,694,935 for the fiscal year ending December 31, 2008. For purposes of share-based compensation measurement, we assume that the performance goal will be achieved. If the performance goals are not met, no compensation cost is recognized and any recognized compensation cost will be reversed. Under our Employee Stock Purchase Plan (ESPP), 130,491 shares were available for purchase at June 30, 2006. Under the ESPP, purchase options have been granted every six months with a six month term and an exercise price equal to the lower of the fair market value of the Common Stock on the first or last day of the six month period, with a 15% discount. As of August 1, 2006, ESPP purchase options will be granted on the first day of the six month period, with a 5% discount and an exercise price equal to the fair market value on the last day of the six month period.

The fair value of share-based awards for employee stock option awards and employee stock purchases made under our Employee Stock Purchase Plan were estimated using the Black-Scholes valuation model. The following weighted average assumptions were used to calculate the fair value of options granted during the three and six months ended June 30, 2006 and 2005:

Employee Stock Options

Three Months Ended

Six Months Ended

June 30,
2006

June 30,
2005