

INTERLINK ELECTRONICS INC

Form 10-Q

August 13, 2008

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from to

Commission File No. 0-21858

**INTERLINK ELECTRONICS, INC.**

(Exact name of registrant as specified in its charter)

Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

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

**546 Flynn Road**  
**Camarillo, California**  
(Address of principal executive offices)

**77-0056625**  
(I.R.S. Employer  
Identification Number)

**93012**  
(Zip Code)

**(805) 484-8855**  
(Registrant's telephone number, including area code)

**Not applicable.**  
(Former name, former address and former fiscal year if changed since last report)

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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

(Do not check if a smaller reporting company)  
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Shares of Common Stock Outstanding, at August 7, 2008: 13,782,645

**Table of Contents**

**INTERLINK ELECTRONICS, INC.**

**TABLE OF CONTENTS**

PART I.	FINANCIAL INFORMATION	
ITEM 1.	Financial Statements (Unaudited)	
	<u>Condensed Consolidated Balance Sheets June 30, 2008 and December 31, 2007</u>	3
	<u>Condensed Consolidated Statements of Operations Three and Six Months Ended June 30, 2008 and June 30, 2007</u>	4
	<u>Condensed Consolidated Statements of Cash Flows Three and Six Months Ended June 30, 2008 and June 30, 2007</u>	5
	<u>Notes to Condensed Consolidated Financial Statements June 30, 2008</u>	6
ITEM 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
ITEM 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
ITEM 4.	<u>Controls and Procedures</u>	25
PART II.	OTHER INFORMATION	
ITEM 1.	<u>Legal Proceedings</u>	26
ITEM 1A.	<u>Risk Factors</u>	26
ITEM 4.	<u>Submission of Matters to a Vote of Security Holders</u>	32
ITEM 6.	<u>Exhibits</u>	32
	<u>SIGNATURES</u>	33

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements  
INTERLINK ELECTRONICS, INC.**

## CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

*(IN THOUSANDS, EXCEPT PAR VALUE)*

	June 30, 2008	December 31, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 7,851	\$ 12,659
Restricted cash	1,170	2,937
Accounts receivable, less allowance for doubtful accounts of \$124 and \$199 at June 30, 2008 and December 31, 2007, respectively	4,475	3,918
Inventories, net of reserves of \$646 and \$394 at June 30, 2008 and December 31, 2007, respectively	5,551	5,151
Prepaid expenses and other current assets	666	1,754
Assets held for sale		437
<b>Total current assets</b>	<b>19,713</b>	<b>26,856</b>
Property and equipment, net	1,026	999
Patents and trademarks, net	118	113
Other assets	451	364
<b>Total assets</b>	<b>\$ 21,308</b>	<b>\$ 28,332</b>
<b>Liabilities And Stockholders Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,737	\$ 1,600
Accrued payroll and related expenses	1,602	5,836
Deferred revenue	658	646
Liabilities related to assets held for sale		86
<b>Total current liabilities</b>	<b>3,997</b>	<b>8,168</b>
Convertible note, net of discounts of \$1,141 and \$1,415 at June 30, 2008 and December 31, 2007, respectively	3,706	3,413
Warrants and embedded derivatives	591	1,974
<b>Total liabilities</b>	<b>8,294</b>	<b>13,555</b>
Commitments and contingencies		
Stockholders equity:		
Preferred stock, \$5.00 par value (100 shares authorized, none issued and outstanding)		
Common stock, \$0.00001 par value (50,000 shares authorized, 13,774 and 13,749 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively)	59,329	58,463
Accumulated other comprehensive loss	(438)	(440)
Accumulated deficit	(45,877)	(43,246)
<b>Total stockholders equity</b>	<b>13,014</b>	<b>14,777</b>

Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

Total liabilities and stockholders' equity	\$ 21,308	\$ 28,332
--	-----------	-----------

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****INTERLINK ELECTRONICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)***(IN THOUSANDS, EXCEPT PER SHARE DATA)*

	<b>Three Month Period Ended June 30,</b>		<b>Six Month Period Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenues	\$ 6,713	\$ 3,825	\$ 12,482	\$ 8,005
Cost of revenues (includes stock-based compensation of \$16 and \$133 for the three months ended June 30, 2008 and 2007, respectively and \$77 and \$311 for the six months ended June 30, 2008 and 2007, respectively)	3,616	2,510	7,446	4,887
Gross profit	3,097	1,315	5,036	3,118
Operating expenses:				
Product development and research (includes stock-based compensation of \$55 and \$116 for the three months ended June 30, 2008 and 2007, respectively and \$125 and \$249 for the six months ended June 30, 2008 and 2007, respectively)	1,112	710	2,338	1,506
Selling, general and administrative (includes stock-based compensation of \$44 and \$276 for the three months ended June 30, 2008 and 2007, respectively and \$645 and \$581 for the six months ended June 30, 2008 and 2007, respectively)	2,957	2,351	6,377	4,742
Total operating expenses	4,069	3,061	8,715	6,248
Operating loss	(972)	(1,746)	(3,679)	(3,130)
Other income (expense):				
Interest income	72	21	194	42
Interest expense	(238)	(45)	(475)	(49)
Total net interest expense	(166)	(24)	(281)	(7)
Other income	655	24	1,645	57
Other expense	(39)	(14)	(316)	(70)
Total net other income (expense)	616	10	1,329	(13)
Loss from continuing operations before provision for income taxes	(522)	(1,760)	(2,631)	(3,150)
Provision for income taxes expense				52
Loss from continuing operations, net of tax	(522)	(1,760)	(2,631)	(3,202)
Loss from discontinued operations, net of tax		(419)		(1,496)
Net loss	\$ (522)	\$ (2,179)	\$ (2,631)	\$ (4,698)
Loss per share from continuing operations, net of tax:				
Basic and diluted	\$ (0.04)	\$ (0.13)	\$ (0.19)	\$ (0.23)
Loss per share on discontinued operations, net of tax:				
Basic and diluted	\$ ( )	\$ (0.03)	\$ ( )	\$ (0.11)

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

Net loss per share:				
Basic and diluted	\$	(0.04)	\$	(0.16)
	\$	(0.19)	\$	(0.34)
Weighted average shares used for loss from continuing				
operations, net of tax:				
Basic and diluted	13,764	13,749	13,757	13,749
Weighted average shares used for loss on discontinued operations, net of tax:				
Basic and diluted	13,764	13,749	13,757	13,749
Weighted average shares used for net loss:				
Basic and diluted	13,764	13,749	13,757	13,749

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****INTERLINK ELECTRONICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)***(IN THOUSANDS)*

	<b>Six Month Period Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (2,631)	\$ (4,698)
Loss from discontinued operations, net of tax		(1,496)
Net loss from continuing operations	(2,631)	(3,202)
<b>Adjustments to reconcile net loss from operations to net cash used in operating activities:</b>		
Reduction in allowance for doubtful accounts receivable	(75)	(23)
Increase in reserves for excess inventories	252	434
Stock-based compensation	847	1,769
Depreciation and amortization	264	119
Write off of patents and trademarks		39
Accretion of warrants	190	
Amortization of discounts on notes and warrants	100	
Adjustments to fair value of warrants and derivatives	(1,380)	
Issuance of restricted stock	19	
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable	(482)	858
Prepaid expenses and other current assets	1,088	(100)
Inventories	(652)	(739)
Other assets	(87)	1
Accounts payable and accrued liabilities	137	(1,529)
Deferred revenue	12	(641)
Accrued payroll and other accrued expenses	(4,234)	270
Net cash used in operating activities continuing operations	(6,632)	(2,744)
Net cash provided from discontinued operations	351	525
Net cash used in operations	(6,281)	(2,219)
<b>Cash flows from investing activities:</b>		
Sales of marketable securities, net		1,600
Purchases of property and equipment	(272)	(98)
Costs of patents and trademarks	(24)	(27)
Net cash provided by (used in) investing activities continuing operations	(296)	1,475
Net cash provided by (used in) investing activities discontinued operations		
Net cash provided by (used in) investing activities	(296)	1,475
<b>Cash flows from financing activities:</b>		
Restricted cash related to sale of assets	1,767	
Short term borrowings		1,500
Principal payments on notes payable		(80)



## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

Net cash provided by financing activities continuing operations	1,767	1,420
Net cash provided by (used in) financing activities discontinued operations		
Net cash provided by financing activities	1,767	1,420
Effect of exchange rate changes on cash and cash equivalents	2	(37)
Increase (decrease) in cash and cash equivalents	(4,808)	639
Cash and cash equivalents:		
Beginning of period	12,659	1,344
End of period	\$ 7,851	\$ 1,983
Supplemental disclosures of cash flow information:		
Interest paid	\$ 201	\$ 48
Income taxes paid	\$ 2	\$ 53

The accompanying notes are an integral part of these consolidated financial statements.

---

**Table of Contents**

**INTERLINK ELECTRONICS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2008 AND 2007, RESPECTIVELY AND AS OF JUNE 30, 2008 AND DECEMBER 31, 2007 (UNAUDITED)**

**1. Basis of Presentation of Interim Financial Data**

The financial information as of June 30, 2008, and for the three and six month periods ended June 30, 2008 and 2007, respectively, in the accompanying Condensed Consolidated Financial Statements is unaudited. Such information does, however, reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of results for the interim periods. These Condensed Consolidated Financial Statements should be read in conjunction with the audited financial statements and related notes for the fiscal year ended December 31, 2007, which are included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 28, 2008.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year. Certain prior year amounts have been reclassified to conform to the current period presentation.

On August 31, 2007, we completed the sale of our OEM Remotes and Branded Products business segments for an aggregate cash purchase price of \$11,500,000, subject to certain post-closing price adjustments. In connection with the sale of these business segments, we paid legal and investment banking fees of \$890,000. Please see Note 3 for additional information regarding this sale. As a result of the sale, the financial information included in the accompanying Condensed Consolidated Financial Statements is presented in accordance with Statement of Financial Accounting Standards No. 144 Accounting for Impairment or Disposal of Long-Lived Assets, which requires us to present the sale of these assets on a discontinued operations basis. The balance sheets have been adjusted to reflect the assets and liabilities of the OEM Remotes and Branded Products segments as held for sale for all periods presented. Additionally, the statements of operations and cash flows have been adjusted to reflect the results of these segments as discontinued operations for the periods presented.

**2. Significant Accounting Policies**

**Revenue Recognition.** We recognize revenue in accordance with SEC Staff Accounting Bulletin ( SAB ) No. 104, Revenue Recognition. SAB No. 104 requires that four basic criteria be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) a fee applies that is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) require management's judgment regarding the fixed nature of the fee charged for services rendered and products delivered and the collectibility of those fees. To satisfy these criteria, we (1) input orders based upon receipt of a customer purchase order; (2) record revenue upon shipment of goods and when risk of loss and title transfer; (3) confirm pricing through a customer purchase order; and (4) assess creditworthiness through past payment history, credit agency reports and other financial data. All customers have warranty rights and some customers also have explicit or implicit rights of return. We comply with Statement of Financial Accounting Standards No. 48 with respect to sell-through and returns and the related recording of reserves for potential customer returns. Should changes in conditions cause management to determine the revenue recognition criteria are not met for future transactions, such as a determination that collectibility was not reasonably assured, revenue could be adversely affected.

In our eTransactions business segment, a portion of our revenues are derived from the sale, service and support of software. Our software support revenues consist of post contract customer support and maintenance ( PCS ). Accordingly, when applicable, we recognize revenue by applying the provisions of the American Institute of Certified Public Accountants Statement of Position ( SOP ) 97-2, Software Revenue Recognition as amended by SOP 98-9, Software Revenue Recognition with Respect to Certain Arrangements.

When eTransactions sales involve multiple elements or multiple products, and we have vendor-specific objective evidence ( VSOE ) of fair value for each element in the arrangement, we recognize revenue based on the relative fair value of all elements within the arrangement. We determine VSOE based on sales prices charged to customers when the same element is sold separately or based upon renewal pricing for PCS. If VSOE cannot be determined for all undelivered elements of an arrangement, we defer revenue until the earlier of (i) the delivery of all elements or (ii) the establishment of VSOE for all undelivered elements, provided that if the only undelivered element is PCS or a service, the total fee of the arrangement is recognized as revenue over the PCS or service term.



**Table of Contents**

**Disposal of Long Lived Assets.** On August 31, 2007, we completed the sale of our OEM Remotes and Branded Products business segments. As a result of the sale, the financial information included in the accompanying Condensed Consolidated Financial Statements is presented in accordance with Statement of Financial Accounting Standards No. 144 Accounting for Impairment or Disposal of Long-Lived Assets, which requires us to present the sale of these assets on a discontinued operations basis. The balance sheet at December 31, 2007 reflects the assets and liabilities of the OEM Remotes and Branded Products segments as held for sale. Additionally, the statements of operations and cash flows have been adjusted to reflect the results of these segments as discontinued operations for the periods presented. Certain assumptions were used in determining amounts being presented as assets held for sale and discontinued operations. These assumptions were based on an analysis and review of costs associated with operating the ongoing business subsequent to the asset sale as compared with costs of operations prior to the asset sale.

**Accounts Receivable and Allowance for Doubtful Accounts.** Our accounts receivable are unsecured and are at risk to the extent such amounts become uncollectible. We continually monitor individual account receivable balances and add to our allowance for doubtful accounts when collection of an individual account becomes questionable based on payment performance or age of the receivable and other factors related to the customer's ability to pay. We generally offer 30-day payment terms; however, some distributors in the divested Branded Products business segment and some of our Japanese OEM customers require as long as 120-day payment terms.

**Reserve for Estimated Product Returns.** While not an explicit part of our terms and conditions of product sales, we do, on a discretionary basis, grant product exchanges for our distribution and reseller customers in our divested Branded Products business segment for similar products of equal value if these exchanges meet defined criteria. We estimate future product returns based on recent return history, inventory status and product sell-through statistics received from our major distributors, discussions regarding product sales activity with our major reseller customers, and current industry product and technology trends. Management judgment is required in evaluating the relative significance of this data and in determining the estimated value of the returns reserve. If actual returns are greater than management's estimate, revenues in the subsequent period will be adversely affected. Product returns and allowance as of June 30, 2008 and December 31, 2007 were \$54,000 and \$105,000, respectively.

**Inventories.** Inventories are stated at the lower of cost or market and include material, labor, and factory overhead. Cost is determined using the first in, first out cost method.

**Inventory Reserve.** At each balance sheet date we evaluate ending inventories for excess quantities and obsolescence. This evaluation includes analyses of forecasted sales levels by product based on historical demand. We write off inventories that are considered obsolete. Remaining inventory balances are adjusted to approximate the lower of cost or market value and result in a new cost basis in such inventory until sold. If future demand or market conditions are less favorable than internal projections, additional inventory write-downs may be required and would be reflected in our cost of sales in the period the revision is made.

**Provision for Income Tax.** As part of the process of preparing financial statements, as required by Statement of Financial Accounting Standards Accounting For Income Taxes (SFAS 109), we are required to estimate income taxes in each of the jurisdictions in which we operate. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the accompanying Consolidated Balance Sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, must establish a valuation reserve. To the extent we establish a reserve or increase this reserve in a period, we must include an expense within the tax provision in the statements of operations.

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN 48 effective January 1, 2007. We file income tax returns in the U.S. federal jurisdiction, and various state, local and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2000. As a result of the implementation of FIN 48, we did not recognize any increase in the liability for unrecognized tax benefits. In addition, we did not record a cumulative effect adjustment related to the adoption of FIN 48.

**Table of Contents**

In the first quarter of 2007, the Inland Revenue Department (IRD) of Hong Kong commenced an examination of our Hong Kong income tax returns for 2003 through 2005. The examination is anticipated to be completed in the 2008 fiscal year. Due to delinquencies in filing annual tax returns for the 2003, 2004 and 2005 fiscal years, the IRD has assessed certain adjustments to our overall reported losses in Hong Kong for those periods stated above. These adjustments, all of which have been paid by us prior to 2007, have resulted in additional income tax assessments and cash payments that have been made for 2003, 2004 and 2005 totaling \$456,000 as of the date of this filing. We do not anticipate any further adjustments will be made.

Significant management judgment is required in determining our provision for income taxes, deferred tax asset and liabilities and any valuation reserve recorded against net deferred tax assets. Management continually evaluates its deferred tax asset as to whether it is likely that the deferred tax asset will be realized.

When tax returns are filed, it is highly likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely to be realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are classified as interest and other expense in the statement of income.

**Foreign Exchange Exposure.** We have established relationships with non-U.S. OEM customers of our Specialty Components business segment. Certain of these customers have been based in Japan and approximately 19%, 6% and 3% of our revenues for the years ended December 31, 2007, 2006 and 2005, respectively, came from Japanese customers. Revenues from these customers are denominated in Japanese yen, subjecting us to fluctuations in the yen/dollar exchange rate. From time to time, we use foreign currency forward and average rate option contracts to hedge this exposure. We use revenue forecasts from our Japanese subsidiary to determine the amount of forward or option contracts to purchase and we attempt to enter into these contracts when we believe the yen value is relatively strong against the U.S. dollar. To the extent that our revenue forecast may be inaccurate or the timing of forecasting the yen's strength is wrong, our actual hedge gains or losses may not necessarily correlate with the effect of foreign currency rate fluctuations on our revenues. We mark these contracts to market value and the gain or loss from these contracts is recorded as revenue of our Specialty Components business segment. These hedge transactions are classified as economic hedges and do not qualify for hedge accounting under Statement of Financial Accounting Standards No. 133 ( SFAS 133 ). In addition, because our Japanese subsidiary's functional currency is the yen, the translation of the net assets of that subsidiary into the consolidated results will fluctuate with the yen/dollar exchange rate.

**Valuation of Derivative Instruments.** SFAS 133 requires bifurcation of embedded derivative instruments and measurement of their fair value for accounting purposes. Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in results of operations under the heading Adjustments to Fair Value of Derivatives. The effects of interactions between embedded derivatives are calculated and accounted for in arriving at the overall fair value of the financial instruments. In addition, the fair values of freestanding derivative instruments such as warrant derivatives are valued using lattice models.

**Stock-based Compensation.** On January 1, 2006, we adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees 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). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. Our financial statements as of and for the three and six months ended June 30, 2008 and 2007 reflect the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the quarter ended June 30, 2008 and 2007 were \$115,000 and \$793,000 respectively, with the effect on basic and diluted earnings per share of \$(0.01) and \$(0.06), respectively. Stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the six months ended June 30, 2008 and 2007 were \$847,000 and \$1,769,000 respectively, with the effect on basic and diluted earnings per share of \$(0.06) and \$(0.13), respectively. As of June 30, 2008, we have \$1,402,000 of unrecognized stock-based compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted average period of 1.08 years.



**Table of Contents**

During the quarters and six months ended June 30, 2008 and 2007, we granted options to purchase 429,000 and 897,000 shares, respectively of our Common Stock at an average exercise price of \$0.76 and \$2.45, respectively, with estimated fair values of \$250,000 and \$1,272,000, respectively, of which \$19,000 and \$215,000 was recorded as of June 30, 2008 and 2007, respectively. No stock options were exercised during these periods. SFAS 123(R) requires companies to estimate the fair value of stock-based payment awards to employees and directors on the date of grant using one of several option pricing models. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our statement of operations. Stock-based compensation expense recognized in the statement of operations for the quarters and six months ended June 30, 2008 and 2007 included compensation expense for stock-based payment awards granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and included compensation expense for the stock-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with the presentation of prior period pro forma information. Because stock-based compensation expense recognized in the statement of operations for the quarters and six months ended June 30, 2008 was based on awards that vest over time, SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the quarters ended June 30, 2008 and 2007, forfeitures for employees were calculated to be 12.34% while forfeitures for executives were estimated to be 3%, with total forfeitures of \$11,000 and \$82,000, respectively. For the six months ended June 30, 2008 and 2007, forfeitures for employees were also calculated to be 12.34% and forfeitures for executives were estimated to be 3%, with total forfeitures of \$95,000 and \$114,000, respectively.

For the three and six months ended June 30, 2008 we recorded the following charges within our statement of operations for stock-based compensation: \$16,000 and \$77,000 in cost of sales, \$55,000 and \$125,000 in product development and research expenses, and \$44,000 and \$645,000 in selling, general and administrative expenses, respectively. For the three and six months ended June 30, 2007, we recorded the following charges within our statement of operations for stock-based compensation: \$133,000 and \$311,000 in cost of sales, \$116,000 and \$249,000 in product development and research expenses, \$276,000 and \$581,000 in selling, general and administrative expenses, and \$268,000 and \$628,000 of stock-based compensation is included in the loss from discontinued operations, net of tax, respectively. The \$645,000 charge in selling, general and administrative expenses for the six months ended June 30, 2008 include \$339,000 of charges related to a modification of certain stock options due to the acceleration of 164,000 stock options for our former CEO, who retired on January 4, 2008.

Our determination of fair value of stock-based payment awards to employees and directors on the date of grant uses the Black-Scholes model, which is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the expected price volatility of our stock over the expected term of the awards, and actual and projected employee stock option exercise behaviors. We estimate expected volatility using historical data. The expected term is estimated using the safe harbor provisions under SAB 107.

A summary of our non-vested options as of June 30, 2008 and changes during the six months ended June 30, 2008 is presented below:

	Options	Wgt. Avg. Exercise Price
Nonvested as of December 31, 2007	1,003	\$ 2.70
Granted	429	0.76
Vested	(346)	3.07
Forfeited or expired	(62)	2.26
Nonvested as of June 30, 2008	1,024	\$ 2.09

We have adopted the simplified method provided in SFAS 123(R) for calculating the beginning balance of the additional paid in capital pool ( APIC pool ) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Statement of Cash Flows of the tax effects of employee stock-based compensation awards that were outstanding upon adoption of SFAS 123R. We have not recognized excess tax benefits related to employee stock-based compensation and, therefore, do not currently have an APIC pool.

**Table of Contents****3. Discontinued Operations and Assets Held for Sale**

As part of an overall strategy to focus our efforts on higher margin emerging markets, we sold our OEM Remotes and Branded Products business segments (the "Sale") in August of 2007. The Sale has enabled us to advance our strategic business initiatives and allowed us to focus on the two business segments we feel have the greatest potential for long-term profitable growth: eTransactions and Specialty Components. The Sale was structured as an asset sale, and included the inventory, accounts receivable, fixed assets, intangibles, accounts payable, related intellectual property rights and other assets that constituted the operations of the divested units.

Our Condensed Consolidated Financial Statements have been reclassified for all periods presented to reflect the OEM Remotes and Branded Products business segments as discontinued operations in accordance with SFAS 144. Accordingly, the revenues, costs and expenses directly associated with the OEM Remotes and Branded Products business segments have been reclassified as discontinued operations on the Statement of Operations for all periods presented. Additionally, assets and liabilities of the OEM Remotes and Branded Products business segments have been reclassified as held for sale on our Balance Sheets for all periods presented, and our Statements of Cash Flows have been reclassified to reflect the OEM Remotes and Branded Products business segments as discontinued operations for all periods presented. Corporate expenses such as general corporate overhead and interest have not been allocated to discontinued operations.

Income (loss) from discontinued operations, net of tax is summarized as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net revenue from discontinued operations	\$	\$ 4,181	\$	\$ 8,886
Loss from discontinued operations before income tax benefit		(419)		(1,496)
Income tax benefit, net of reserve				\$
Loss from discontinued operations	\$	\$ (419)	\$	\$ (1,496)

There were no amounts on the Condensed Consolidated Balance Sheets as of June 30, 2008 attributable to the discontinued operations related to the Sale. Amounts at December 31, 2007 attributable to the discontinued operations related to the Sale are as follows (in thousands):

	December 31, 2007
<b>Assets</b>	
Accounts receivable	\$ 437
Assets held for sale	437
<b>Liabilities</b>	
Accounts payable	(86)
Liabilities held for sale	(86)
Total net assets held for sale	\$ 351

**4. Restricted Cash**

As part of the Sale, we entered into an escrow agreement that required \$1,400,000 of the purchase price to be put into an escrow account to provide for, among other things, a source of recovery for any amounts owing to the purchaser pursuant to indemnification and post-closing adjustment provisions of the asset purchase agreement. Of this amount, \$250,000 was released in March 2008.



**Table of Contents**

according to the terms of the escrow agreement. As a result, \$1,400,000 and \$1,170,000 of this restricted cash remained on the balance sheet as of December 31, 2007 and June 30, 2008 respectively. 70% and 30% of the remaining \$1,170,000, net of any disputed amounts, if any, will be released 12 months and 18 months from the date of the Sale, respectively. Additionally, \$1,537,000 of cash was recorded as due to the acquiring company on December 31, 2007 for certain post closing activities, including the collection of certain purchased accounts receivables and payment of certain purchased accounts payables which resulted in a total of \$2,937,000 in restricted cash as of December 31, 2007.

**5. Inventories**

Net inventories consisted of the following (in thousands):

	June 30, 2008	December 31, 2007
Raw material	\$ 4,579	\$ 4,277
Work in process	545	457
Finished goods	1,073	811
Reserve for excess and obsolete inventory	(646)	(394)
<b>Total inventories</b>	<b>\$ 5,551</b>	<b>\$ 5,151</b>

**6. Line of Credit**

On November 8, 2007, we executed an amended and restated Loan and Security Agreement (the Agreement) with Silicon Valley Bank that provides for a line of credit with a maximum borrowing limit of \$5 million. The line of credit is secured by our accounts receivable and other assets and expires in December 2009. Under the terms of the Agreement, we have the ability to borrow against the line in amounts up to 80% of our eligible accounts receivable. At June 30, 2008 and June 30, 2007, we had drawn \$0 and \$1.5 million on the line of credit, respectively.

**7. Convertible Notes and Warrants**

On July 19, 2007, we issued 8% convertible notes, in an aggregate principal amount of \$5,000,000, and warrants exercisable for up to 1,984,125 shares of Common Stock in a private placement (the Financing) exempt from registration under Regulation D of the Securities Act, as amended. The notes mature on July 19, 2010, and some or all of the outstanding principal balance and unpaid interest may be converted into common stock at any time before the maturity date at a conversion price of \$1.26 per share (subject to adjustment). Interest on the notes accrues and is payable semiannually on January 15th and July 15th of each year. The warrants expire on July 19, 2012, and may be exercised at any time prior to expiration on a cash or cashless basis at an exercise price of \$1.51 per share (subject to adjustment). We received net proceeds of approximately \$4,796,000 from the sale of the notes and warrants, which take into account estimated legal and other fees of \$204,000 incurred in connection with the Financing.

The conversion price under the notes and the exercise price under the warrants are subject to adjustment upon the occurrence of specified events including the issuance of stock dividends to existing common stock holders, or a stock split. Also, the holders of notes and warrants are entitled to receive the economic benefit of any reorganization, consolidation or merger of Interlink which results in a payment in shares, other securities or property to our common stock holders.

In connection with the placement of the notes and warrants, we entered into a registration rights agreement with the selling securityholders under which we agreed to register with the Securities and Exchange Commission (the SEC) the common stock underlying the notes and warrants for resale to the public. The registration rights agreement requires us to pay the investors liquidated damages under certain circumstances, including if the registration statement covering the shares to be registered was not declared effective, except under specified conditions, on or prior to October 18, 2007. Such liquidated damages are calculated as 1.5% of the aggregate amount invested by each such investor for each 30-day period (or pro rata portion of such 30-day period) of such delinquency. One of the specified conditions in the registration rights agreement that precludes the accrual of liquidated damages (the Damages Exception) is an assertion by the SEC that the offering of some or all of the shares underlying the notes and warrants is not eligible to be made on a delayed or continuous basis pursuant to Rule 415 promulgated under the

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

Securities Act. The SEC staff did raise the Rule 415 issue and, as a result, the registration statement was not declared effective until April 29, 2008. The investors previously sent us a letter demanding payment of liquidated damages as a result of the failure of effectiveness to occur by October 18. We are currently discussing the issue with the investors, including a possible reduction in the amount of liquidated damages otherwise payable under the registration rights agreement.

**Table of Contents**

We evaluated the warrants under Emerging Issues Task Force Issue 00-19 ( EITF 00-19 ) and determined that the warrants qualified for liability treatment and have recorded the warrants as a derivative liability under FAS 133. The initial fair value of the warrants was \$1,146,000 which has been recorded with an offset to discount on the note payable. We determined that the conversion feature on the notes qualified for exemption from bifurcation and liability treatment as it is considered a conventional convertible instrument under EITF 00-19. We calculated a beneficial conversion feature, resulting in a discount of \$480,000 at the time of the transaction and a value of \$413,000 as of December 31, 2007. The value of the beneficial conversion feature, net of the discount at June 30, 2008, was \$333,000.

The original values of the Parisian feature of the derivative liabilities for the notes and warrants were \$6,000 and \$12,000 respectively on July 19, 2007. These amounts are being amortized and charged as interest expense over the three-year term of the notes. In addition, the adjustment to fair value of these Parisian features will be made each reporting period. Accordingly, \$27,000 of increased fair value for the derivative liability on the notes was recorded as interest charges for the six month period ended June 30, 2008 and \$21,000 was recorded as interest income for the derivative liability on the warrants for the six month period ended June 30, 2008. Each of these amounts was included in the net fair value of the notes.

We amortize our discounts using the interest method, which resulted in an interest expense of \$274,000 for the period from January 1, 2008 to June 30, 2008.

The warrants and embedded derivatives outstanding at June 30, 2008 were valued at fair value using a lattice fair value model, resulting in a net decrease in the fair value of the related liabilities for the six months ended June 30, 2008 of approximately \$1,388,000, from \$0.98 per warrant as of December 31, 2007 to \$0.24 per warrant as of June 30, 2008. The change in value of the warrants was recorded in our statement of operations as a charge to net other income. Variables used to value the warrants as of June 30, 2008 are as follows:

	<b>June 30, 2008</b>
Expected term (years)	4.0
Risk free interest rate	3.1%
Weighted Average Volatility	74.6%
Expected dividend yield	0%

The following table summarizes the activity of notes, warrants and discounts outstanding at June 30, 2008, (in thousands):

	<b>June 30, 2008</b>
Notes at fair value, net of amortized origination costs	\$ 4,847
Notes derivative discounts, net	(808)
Notes beneficial conversion feature discount, net	(333)
Net fair value of the Notes	3,706
Warrants and derivative liabilities at fair value, net of accretion	591
Notes and warrants fair value	4,297
Less current portion	
Notes and Warrants and embedded derivatives-long term	\$ 4,297

**8. Stockholders Equity**

On March 11, 2008 we entered into a restricted stock grant agreement with John A. Buckett, II, our Interim Chief Executive Officer, pursuant to which we granted Mr. Buckett 50,000 restricted shares of our Common Stock. The restricted shares will vest and be issued to Mr. Buckett, subject to his continued employment with us as our interim Chief Executive Officer, on regular monthly vesting dates through December 31,

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

2008. The value per share of any restricted shares issued to Mr. Buckett will be the market value per share of our Common Stock as of the applicable vesting date. As of June 30, 2008, 25,000 restricted shares had vested representing a value of \$19,000, which is shown in the stockholders' equity in the accompanying Condensed Consolidated Balance Sheet.

**Table of Contents**

**9. Stock Options**

Under the terms of our 1996 Stock Incentive Plan, officers and key employees may be granted non-qualified or incentive stock options and outside directors and independent contractors may be granted non-qualified stock options. The aggregate number of shares of Common Stock for which options may be granted under the Plan is 7,250,000. New stock options are granted at fair market value on the date of grant and generally vest ratably over 24 or 36 months and have a ten-year term but terminate earlier if employment is terminated. As of June 30, 2008, options for 6,004,000 shares of Common Stock have been granted (3,103,000 are outstanding and 2,902,000 have been exercised, forfeited or expired) and 1,246,000 options were available for grant. Activity under the Plan for the first six months of 2008 is summarized as follows (in thousands, except per share information):

		Options	Wgt. Avg. Exercise Price
Outstanding beginning of period	January 1, 2008	3,277	\$ 4.40
Granted		429	0.76
Exercised			
Forfeited or expired		(603)	3.09
Outstanding end of period	June 30, 2008	3,103	\$ 4.14
Exercisable end of period	June 30, 2008	2,079	\$ 5.15

The following table summarizes information about stock options outstanding as of June 30, 2008 (in thousands, except contractual life and exercise price per share information):

Range of Exercise Prices	Shares	Employee Options Outstanding		Employee Options Exercisable	
		Weighted Avg. Remaining Contractual Life (Years)	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
\$0.00 - 1.39	405	9.75	0.77	14	0.77
\$1.40 - 1.65	105	0.11	1.51	6	1.41
\$2.25 - 2.80	803	1.44	2.53	356	2.60
\$3.15 - \$3.25	653	1.24	3.15	634	3.15
\$5.49 - \$5.70	348	1.00	5.69	301	5.69
\$6.14 - \$6.45	355	0.53	6.33	375	6.34
\$7.54 - \$7.98	18	0.04	7.71	18	7.71
\$9.40 - \$10.60	416	1.69	9.45	375	9.45
	3,103	2.31	\$ 4.13	2,079	\$ 5.15

There is no intrinsic value for the stock options outstanding and vested as of June 30, 2008.

**Table of Contents****10. Income (Loss) Per Share**

For all periods presented, per share information was computed in accordance with the provisions of the Statement of Financial Accounting Standards No. 128, Earnings Per Share, issued by the Financial Accounting Standards Board ( FASB ). The computation of basic earnings per share is based upon the weighted average number of common shares outstanding during the periods presented. Earnings per share on a diluted basis includes, in addition, the effect of common shares contingently issuable from options and warrants in periods in which they have a dilutive effect.

Common Stock equivalents are calculated using the treasury stock method. Under the treasury stock method, the proceeds from the assumed conversion of options and warrants are used to repurchase outstanding shares using the average market price for the period.

The following table contains information necessary to calculate loss per share (in thousands):

	Three Months Ended June 30, 2008		Six Months Ended June 30, 2007	
Weighted average shares outstanding basic	13,764	13,749	13,757	13,749
Effect of dilutive securities (employee/director stock options) <sup>(1)</sup>				
Effect of convertible notes and warrants <sup>(1)</sup>				
Weighted average shares diluted	13,764	13,749	13,757	13,749

<sup>(1)</sup> Due to the net loss for the three and six months ended June 30, 2008 and 2007, any diluted share calculation would be anti-dilutive. Thus, the basic weighted average shares were used and shares of common stock equivalents of 9.0 million and 4.3 million for 2007 and 2006, respectively, were excluded from the diluted share calculation because they were anti-dilutive.

**11. Comprehensive Loss**

The following table provides the data required to calculate comprehensive loss (in thousands):

	Accumulated Other Comprehensive Loss		Comprehensive Loss	
Balance at December 31, 2006	\$	(505)		
Translation adjustment		(38)	\$	(38)
Net loss				(4,698)
Balance at June 30, 2007	\$	(543)	\$	(4,736)
Balance at December 31, 2007	\$	(440)		
Translation adjustment		2	\$	2
Net loss				(2,631)
Balance at June 30, 2008	\$	(438)	\$	(2,629)

**12. Segment Information**

After the Sale (described in Note 3) we have two remaining business segments: eTransactions and Specialty Components. We evaluate the performance of these segments based on their revenue and gross profit. We do not consistently allocate any other income, expenses or assets to these segments nor do we track revenue by product. Reportable segment information for the six months ended June 30, 2008 and 2007 is as follows (in thousands):

<b>Six Months Ended:</b>	<b>eTransactions</b>	<b>Specialty Components</b>	<b>Total</b>
<b>June 30, 2008</b>			
Revenue	\$ 5,780	\$ 6,702	\$ 12,482
Gross profit	2,643	2,393	5,036
<b>June 30, 2007</b>			
Revenue	\$ 4,290	\$ 3,715	\$ 8,005
Gross profit	2,223	895	3,118

**Table of Contents**

*Geographic Information* We attribute revenues to different geographic areas on the basis of the location of the customer. Our revenues and long-lived assets by geographic area for the six months ended June 30, 2008 and 2007, respectively, are as follows (in thousands):

	Six Months Ended and as of June 30,			
	2008		2007	
	Revenues	Long Lived Assets	Revenues	Long Lived Assets
United States	\$ 6,334	\$ 738	\$ 3,705	\$ 730
Japan	2,940	78	1,289	132
Asia (other than Japan)	1,216	328	1,134	380
Europe and other	1,992		1,877	
	\$ 12,482	\$ 1,144	\$ 8,005	\$ 1,242

*Major Customers* For the first six months of fiscal 2008 we had one customer representing more than 10% of total revenues. For the first six months of fiscal 2007 we did not have any customers represent more than 10% of total revenues. One customer accounted for 15% and one customer accounted for 16% of accounts receivable at June 30, 2008, while two different customers each accounted for 18% and 10% of the accounts receivable at June 30, 2007.

*Major Suppliers* We buy some dies and adhesives that are used in various products from single source suppliers. Due to a limited number of suppliers for these items, a sudden change to a different supplier could cause delays in manufacturing.

**13. Income Taxes**

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN 48 effective January 1, 2007. We or one of our subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2000. As a result of the implementation of Interpretation No. 48, we did not recognize any increase in the liability for unrecognized tax benefits. In addition, we did not record a cumulative effect adjustment related to the adoption of FIN 48.

In the first quarter of 2007, the Inland Revenue Department (IRD) of Hong Kong commenced an examination of our Hong Kong income tax returns for 2003 through 2005. The examination is anticipated to be completed in the 2008 fiscal year. Due to delinquencies in filing annual tax returns for the 2003, 2004 and 2005 fiscal years, the IRD has assessed certain adjustments to our overall reported losses in Hong Kong for those periods stated above. These adjustments, all of which have been paid by us prior to 2007, have resulted in additional income tax assessments and cash payments that have been made for 2003, 2004 and 2005 totaling \$456,000 as of the date of this filing. We do not anticipate any further adjustments will be made.

**14. Contingencies**

*Legal Matters* On November 15, 2005, a class action alleging violations of the federal securities laws was filed against Interlink and two of our former officers in the United States District Court for the Central District of California. In connection with our announcement in November 2005 that we would restate certain of our prior financial results, plaintiffs in the action allege that Interlink's financial and various other public statements made during the period from April 24, 2003 through November 1, 2005 were materially false and misleading when made. Plaintiffs have asserted claims under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended.





## **Table of Contents**

The Court appointed the current lead plaintiffs and lead counsel in November 2006 and subsequently entered an order staying any discovery in the action until motions to dismiss were adjudicated. In September 2007, the Court granted in part and denied in part the Company's motion to dismiss the lead plaintiffs' operative complaint. The lead plaintiffs filed an amended complaint in May 2008, which the Company has moved to dismiss in part. That motion to dismiss is currently pending. In June 2008, the Court entered a scheduling order instructing the parties to meet and confer regarding discovery.

On April 24, 2008, the parties participated in a mediation with Justice Howard B. Wiener (Retired) in Los Angeles. The parties were unable to reach resolution. In connection with the class action, we have recorded approximately \$263,000 in expenses for 2006, \$40,000 in expenses in 2007 and \$5,000 in expenses to date in 2008. Because the class action is at a preliminary stage, it is not possible to predict with reasonable certainty the final outcome.

On January 24, 2006, a shareholder's derivative action (now pending in the United States District Court for the Central District of California) was filed against several of Interlink's former officers and directors, alleging the same or similar facts as those alleged in the class action. On January 9, 2007, the Court stayed the derivative action pending final adjudication of any motions to dismiss in the class action. In June 2008, after the Company in the class action filed a motion to dismiss plaintiffs' operative complaint, the Court entered a scheduling order in the derivative action, instructing the parties to meet and confer regarding discovery. The parties have filed a stipulation with the Court, requesting that the Court continue to stay the derivative action until motions to dismiss in the class action are resolved. Because the derivative action is at a preliminary stage, it is not possible to predict with reasonable certainty the final outcome.

In connection with the class action and the derivative action, Interlink voluntarily contacted the SEC in 2006 to inform the SEC of both actions. The SEC responded with several inquiries, to which we responded promptly. On November 16, 2007, we were advised by letter from the SEC that it does not intend to recommend any enforcement action by the Commission. We have not received any further inquiries from the SEC. The SEC may, however, choose to resume its inquiries at any time.

We cannot estimate the possible loss or range of loss, if any, associated with the resolution of the class and derivative actions. While we intend to vigorously defend the actions, we cannot predict their final disposition, or whether we will be liable for amounts not covered by insurance. There is no assurance that the ultimate resolutions of the actions will not result in a material adverse effect on our business, financial condition, or results of operations.

In addition to the matters identified above, from time to time, Interlink is involved in various legal actions that arise in the ordinary course of business.

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

We develop, manufacture, market and sell intuitive interface devices and components for a variety of business applications worldwide. We generate revenues from the sale of our hardware products, including pen input and signature pads and integrated cursor control. Some of these products, particularly our eTransactions products, incorporate software that we have developed internally or that we license from third parties.

We record our revenues in two business segments: eTransactions (input devices for the electronic signature markets) and Specialty Components (integrated FSR-based sensors, subassemblies and modules that support cursor control and other input functions). We have addressed our Specialty Components market since our inception in 1985 and our eTransactions market since 1999.

In August 2007, we sold our OEM Remote and Branded Products business segments, which had historically accounted for more than half of our revenues. Unless otherwise indicated, all operating trends and comparisons in this Item 2 reflect the operations of our continuing business segments or components thereof. Information with respect to the performance in 2007 and prior years of our discontinued operations is reflected in the line item so captioned in our Consolidated Statements of Operations.

Gross profit margins in our business segments fluctuate significantly from quarter to quarter due to various factors, including the allocation of unabsorbed overhead costs and the mix of products produced and sold. We expect quarterly gross profit margins to continue to fluctuate in the future.



## **Table of Contents**

We continue to incur losses as a result of various factors, including fluctuating quarterly sales levels due to market conditions and customer ordering patterns, fluctuations in gross profit margins described above, increases in operating costs, inventory reserve adjustments, and increased compliance and regulatory costs.

The relative revenue and gross profit contributions of our continuing business segments is provided below in *Results of Operations-Business Segment Overview Three and Six Months Ended June 30, 2008 Compared to Three and Six Months Ended June 30, 2007*.

## **Current Opportunities and Challenges**

As part of an overall strategy to deemphasize our declining margin businesses and focus our efforts on higher margin emerging markets, we sold our OEM Remotes and Branded Products business segments in August of 2007. The sale of these business segments has enabled us to advance our strategic business initiatives and allow us to focus on our eTransactions and Specialty Components business segments, which we feel have the greatest potential for long-term profitable growth. While the higher margins in our retained businesses are anticipated to result in improved cash flow by the end of fiscal 2008 and into the future, we support a constant level of fixed general and administrative expenses with a revenue base that has been reduced by half, which is likely to result in continued net losses and may affect our ability to generate positive cash flow. In this regard, we evaluate our cost structure on a regular basis and continue to make efforts to reduce fixed costs where appropriate. Our principal and ongoing challenge, therefore, is to grow our eTransactions and Specialty Components business segments to achieve the revenue levels, cost efficiencies and profitability that will sustain and justify our continued investments in these segments. Our ability to manage this challenge will define the level of our success over the next two to three years. Managing this challenge may also require further divestitures or other reorganizations to realize increased organizational efficiencies.

A considerable portion of our effort has been, and will continue to be, directed at emerging markets, such as our eTransactions market, where our success depends, in part, on our ability to accurately forecast the nature, amount and timing of market requirements in an environment in which historical precedent is limited or non-existent. We rely on information generated by our internal staff and industry partners and on independent market studies for forecasts of market demand in our focus areas, but these studies are themselves based on limited empirical data. An inaccurate forecast of market demand in any of our core market areas would impact our short-term performance and could impact our competitive position and, consequently, our long-term performance.

We are making significant efforts to develop new and improved products for our Specialty Components markets that use our proprietary FSR technology. The inability to develop and deliver these products to our customers on a timely basis would impact our ability to become profitable in our Specialty Components business segment in the timeframe we are anticipating.

Management faces the constant challenge of balancing our investment in new technology, product development and marketing initiatives against the objective of steady earnings growth. A decision to make a significant investment in a new technology, product or marketing effort may have a short-to-medium term negative impact on cash and earnings even if the investment proves to be justified. We may make investments in new business opportunities that will increase operating costs, decrease margins and negatively impact earnings until the investment produces significant revenue growth.

Our revenues from continuing operations were \$6.7 million and \$12.4 million for the three and six months ended June 30, 2008, respectively, representing a 76% and 56% increase over the three and six months ended June 30, 2007, respectively. Our current projections show that revenue will continue to grow in both the eTransactions and Specialty Components business segments for the fiscal year ended December 31, 2008 when compared to the fiscal year ended December 31, 2007. If revenues grow as projected in 2008, operating expenses will experience a relatively lower growth rate, with the result that operating expenses, as a percentage of revenues, should decrease.

Our quarterly results are often affected by volatility in orders for a particular product. Sales of our eTransactions products to large institutions are typically made pursuant to large purchase orders, which can be one-time events or can occur at widely dispersed intervals. Sales of our Specialty Components products typically depend on our ability to design the product required by our customer and on the product life of the product of its customer. Both of these factors could result in large quarterly and annual revenue fluctuations. Other factors that could cause our estimates to be wrong or could result in trends that are not apparent from our financial statements are described under **Risk Factors** in Part II, Item 1(A) below.

**Table of Contents****Business Segment Overview Three and Six Months Ended June 30, 2008 Compared To Three and Six Months Ended June 30, 2007:**

For the Three and Six Months Ended June 30, 2008 and 2007, revenue and gross profit by market segment are shown in the following table:

Market Segment	Three Months Ended June 30, 2008		Three Months Ended June 30, 2007		Six Months Ended June 30, 2008		Six Months Ended June 30, 2007	
	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales
<b>eTransactions:</b>								
- Revenue	\$ 3,450	51%	\$ 2,159	56%	\$ 5,780	46%	\$ 4,290	54%
- Gross Profit	1,802		1,106		2,643		2,223	
- Gross Profit % of segment Revenue	52%		51%		46%		52%	
<b>Specialty Components:</b>								
- Revenue	\$ 3,263	49%	\$ 1,666	44%	\$ 6,702	54%	\$ 3,715	46%
- Gross Profit	1,295		209		2,393		895	
- Gross Profit % of Segment Revenue	40%		13%		36%		24%	
<b>All Segments:</b>								
- Revenue	\$ 6,713	100%	\$ 3,825	100%	\$ 12,482	100%	\$ 8,005	100%
- Gross Profit	3,097		1,315		5,036		3,118	
- Gross Profit %	46%		34%		40%		39%	
<b>All Segments</b>								

Our revenues increased 76% in the second quarter of 2008 compared to the second quarter of 2007, attributable to a 60% and 96% increase in eTransactions and Specialty Components revenues, respectively. Our gross margin increased to 46% for the three months ended June 30, 2008 compared to 34% for the three months ended June 30, 2007, which was attributable to a 1% and 27% improvement in eTransactions and Specialty Components gross margins, respectively.

Our revenues increased 56% in the first six months of 2008 compared to the first six months of 2007, attributable to a 35% and 80% increase in eTransactions and Specialty Components revenues, respectively. Our gross margin increased to 40% for the six months ended June 30, 2008 compared to 39% for the six months ended June 30, 2007, which was attributable to a 12% improvement in Specialty Components gross margins, due to improved manufacturing efficiencies, offset by a 6% reduction in eTransactions due to higher unabsorbed manufacturing costs compared the first six months of 2007.

**eTransactions**

In our eTransactions segment, we sell electronic signature capture devices and, depending on the customer requirement, signature-capture software. We offer annual software maintenance agreements and hardware upgrade programs to our existing customers; however, historically we have not recorded significant revenues from those types of sales.

For the three and six months ended June 30, 2008, our revenues increased 60% and 35%, respectively compared to the three and six months ended June 30, 2007 primarily due to higher sales of our hardware products. eTransactions revenues will continue to see fluctuations in revenue growth from period to period based on the large revenue size of the transactions generated by this business segment. eTransactions gross profit margin for the three and six months ended June 30, 2008 was 52% and 46%, respectively, compared with 51% and 52% for the three and six months ended June 30, 2007.

---

## **Table of Contents**

### **Specialty Components**

In our Specialty Components business, we sell our *MicroNav* products and custom Force Sensing Resistors ( FSR ) and FSR-based subassemblies to many types of customers in several vertical markets, such as medical devices, industrial input and military input products.

Specialty Components revenues for the three and six months ended June 30, 2008 increased 96% and 80%, respectively, compared to the three and six months ended June 30, 2007. The increase was primarily due to higher sales related to key customers added in the latter part of 2007. Specialty Component gross profit margin for the three and six months ended June 30, 2008 was 40% and 36%, respectively, compared to 13% and 24% for the three and six months ended June 30, 2007. As the Specialty Components business segment increases its revenues and operational efficiencies, scales its operations, reduces its manufacturing costs in the United States and builds its infrastructure in China, gross profit margin should continue to increase.

### **Operating Expenses From Continuing Operations**

Operating expenses for the three months ended June 30, 2008 increased to \$4,069,000, from \$3,061,000 for the three months ended June 30, 2007. This \$1,008,000 increase in operating expenses was primarily due to \$606,000 in increased selling, general and administrative expenses and \$402,000 in increased product development and research costs. In selling, general and administrative expenses, \$692,000 was attributable to increased payroll and related costs, which included \$288,000 in severance costs related to a reduction of employees in the second quarter of 2008, and an aggregate of \$123,000 in increased consulting, bad debt expense and other general activities. These costs were offset by a decrease of \$232,000 in non-cash compensation costs related to SFAS 123(R). Product development and research costs, which include internal engineering labor, contract engineering and outside processing costs for the design and development of our products and the research of our technologies, increased \$402,000, from \$710,000 for the three months ended June 30, 2007 to \$1,112,000 for the three months ended June 30, 2008. This increase was due primarily to \$484,000 in increased payroll and related costs, which included the realignment of certain personnel from manufacturing to product development, and \$47,000 in increased patent legal fees, partially offset by a decrease of \$61,000 in non-cash compensation costs related to SFAS 123(R).

Operating expenses for the six months ended June 30, 2008 increased to \$8,715,000, from \$6,248,000 for the six months ended June 30, 2007. This \$2,467,000 increase in operating expenses was primarily due to \$1,635,000 in increased selling, general and administrative expenses and \$832,000 in increased product development and research costs. In selling, general and administrative expenses, \$1,327,000 was attributable to increased payroll and related costs, including recruiting expenses, \$149,000 in various general and administrative activities including repairs and maintenance, and travel and entertainment. We also had a decrease of \$64,000 in non-cash compensation costs related to SFAS 123(R). Product development and research costs increased \$832,000, from \$1,506,000 for the six months ended June 30, 2007 to \$2,338,000 for the six months ended June 30, 2008. This increase was due primarily to \$826,000 in increased payroll and related costs, which, as discussed in the preceding paragraph, includes the realignment of personnel and increased professional services, and by \$85,000 in increased patent legal fees. This was offset by \$76,000 less in costs moved to cost of sales to align with service revenues and a decrease of \$124,000 in non-cash compensation costs related to SFAS 123(R).

Net interest expense for the three months ended June 30, 2008 was \$166,000, compared to \$24,000 for the three months ended June 30, 2007. Net interest expense for the six months ended June 30, 2008 was \$281,000 compared to \$7,000 for the six months ended June 30, 2007. These increases in 2008 compared to 2007 were attributable to interest expenses related the \$5,000,000 convertible notes we issued to existing shareholders in July 2007.

Net other income for the three months ended June 30, 2008 was \$616,000, compared to \$10,000 for the three months ended June 30, 2007. Net other income for the six months ended June 30, 2008 was \$1,329,000, compared to a net other loss of \$13,000 for the six months ended June 30, 2007. These increases were primarily attributable to the change in fair value calculations of the convertible notes and warrants from the beginning of the year to June 30, 2008.

### **Operating Results From Continuing Operations**

The primary factors attributable to the \$774,000 decrease in our operating loss from continuing operations, net of tax, to \$972,000 for the three months ended June 30, 2008, from \$1,746,000 for the three months ended June 30, 2007, were (i) a 76% increase in revenues attributable to growth in both business segments and (ii) an increase in gross margin from 34% to 46%, with both segments showing increases, each of which were offset by a \$1,008,000 increase in operating expenses that was primarily related to payroll and associated costs.

The primary factors attributable to the \$549,000 increase in our operating loss from continuing operations, net of tax, to \$3,679,000 for the six months ended June 30, 2008, from \$3,130,000 for the six months ended June 30, 2007 were (i) a 56% increase in revenues attributable to growth

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

in both business segments and (ii) an increase in gross margin from 39% to 40%, each of which were offset by a \$2,467,000 increase in operating expenses that was primarily related to payroll and associated costs.

**Table of Contents**

For the three and six months ended June 30, 2008 and for the three months ended June 30, 2007, there was no provision for income taxes from continuing operations. We do have a \$51,000 provision for income taxes for the six months ended June 30, 2007, which relates to statutory tax filings of our Hong Kong subsidiary.

**Loss from Discontinued Operations**

As a result of the sale of our OEM Remote and Branded Products business segments, we have included in the Condensed Consolidated Financial Statements financial information presented in accordance with Statement of Financial Accounting Standards 144 Accounting for Impairment or Disposal of Long-Lived Assets which requires us to present the sale of these assets on a discontinued operations basis. We recorded a net loss from discontinued operations, net of tax, for the three and six months ended June 30, 2007 of \$419,000 (\$0.03 loss per share) and \$1,496,000 (\$0.11 loss per share), respectively.

**Liquidity and Capital Resources**

Our primary cash needs have been for working capital and general corporate purposes. Working capital decreased to \$15.7 million at June 30, 2008 from \$18.7 million at December 31, 2007. This \$3.0 million decrease is due primarily to our \$2.6 million loss from continuing operations.

Cash used in continuing operations was \$6.6 million for the first six months of 2008 as compared to cash used in operations of \$2.7 million in the first six months of 2007. This \$4.0 million increase in cash used in continuing operations is due primarily to net payments made that were associated with the sale of assets in August 2007 and reflected in accrued payroll and other accrued expenses. We spent \$272,000 in the first six months of 2008 to purchase additional manufacturing and computer equipment compared to \$98,000 in the first six months of 2007.

There were no proceeds from the exercise of employee and director stock options during the six months ended June 30, 2008 and 2007. We made \$48,000 in interest payments, \$53,000 in income tax payments and \$80,000 in principal payments on long-term debt during the first six months of 2007. We made no principal payments and incurred interest payments of \$201,000 on the long term note payable during the first six months of 2008.

On November 8, 2007, we executed an Amended and Restated Loan and Security Agreement with Silicon Valley Bank that provides for a line of credit with a maximum borrowing limit of \$5 million. The line of credit is secured by our accounts receivable and other assets and expires in December 2009. Under the terms of the Security Agreement, we have the ability to borrow against the line in amounts up to 80% of our eligible accounts receivable. At June 30, 2008 and June 30, 2007, we had drawn \$0 and \$1.5 million on the line of credit, respectively.

We currently have modest commitments for capital expenditures and no material purchase obligations.

In February 2007, we signed a new software licensing agreement with a company for the continued use of software in certain of our products. This agreement supersedes a previous agreement with the same software company and became effective April 1, 2007. The agreement provides for payments of \$15 per set of software sold packaged with certain of our electronic signature pads. Minimum payments under the agreement are \$300,000 per quarter, and quarterly minimum amounts are permitted to be carried forward and applied to future product shipments. The agreement allows us to purchase the software from the software company at any time during the agreement, which is effective through September 30, 2011.

Our minimum long-term debt, licensing and operating lease obligations as of December 31, 2007 were as follows (in thousands):

	Total	Less Than 1 Year	2-3 Years	3-5 Years	More than 5 Years
Software license	\$ 3,900	\$ 1,200	\$ 2,400	\$ 300	\$
Operating lease obligations	854	414	440		
Convertible notes and interest	6,017	400	5,617		
Total	\$ 10,771	\$ 2,014	\$ 8,457	\$ 300	\$

The amounts attributable to our software license and operating lease obligation may increase as we pursue our growth strategy, but the size of any increase will depend on the particular requirements of any growth commitment, the availability and attractiveness of equity capital



arrangements and our general liquidity position. The \$5 million in convertible notes that we issued to existing

**Table of Contents**

investors in July 2007 accrue interest at 8% per annum, have a three year term and mature on July 19, 2010. Interest on the notes is payable semi-annually, and the outstanding principal balance and all accrued and unpaid interest is convertible into Common Stock at any time during the term of the notes at the election of the note holder. If the notes are not converted into Common Stock before maturity, the principal balance and all outstanding interest become immediately due and payable, in cash, at maturity.

**Disclosure Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains 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, that involve substantial risks and uncertainties and which are intended to be covered by the safe harbors created thereby. These statements can be identified by the fact that they do not relate strictly to historical information and may include the words *expects*, *believes*, *anticipates*, *plans*, *may*, *will*, *intends*, *estimates*, *continue* or expressions. These forward-looking statements are subject to various risks and uncertainties that could cause actual results to differ materially from those currently anticipated. These risks and uncertainties include, but are not limited to, items discussed earlier in this Item 2 under the headings *Overview*, *Current Opportunities and Challenges* and *Business Segment Overview* three and six months ended June 30, 2008 compared to three and six months ended June 30, 2007. Forward-looking statements speak only as of the date made. We undertake no obligation to publicly release or update forward-looking statements, whether as a result of new information, future events or otherwise.

**Application of Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations are based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, management evaluates estimates, including those related to the valuation of inventory and the allowance for uncollectible accounts receivable. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue Recognition.* We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104) requires that four basic criteria be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) a fee applies that is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) require management's judgment regarding the fixed nature of the fee charged for services rendered and products delivered and the collectibility of those fees. To satisfy these criteria, we: (1) input orders based upon receipt of a customer purchase order; (2) record revenue upon shipment of goods and when risk of loss and title transfer; (3) confirm pricing through customer purchase order; and (4) assess creditworthiness through past payment history, credit agency reports and other financial data. All customers have warranty rights and some customers also have explicit or implicit rights of return. We comply with Statement of Financial Accounting Standards No. 48 with respect to sell-through and returns and the related recording of reserves for potential customer returns. Should changes in conditions cause management to determine the revenue recognition criteria are not met for future transactions, such as a determination that collectibility was not reasonably assured, revenue could be adversely affected.

In our eTransactions business segment, a portion of our revenues are derived from the sale, service and support of software. Our software support revenues consist of post contract customer support and maintenance (PCS). Accordingly, when applicable, we recognize revenue by applying the provisions of the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition* as amended by SOP 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*.

When a eTransactions sales involve multiple elements or multiple products, and we have vendor-specific objective evidence (VSOE) of fair value for each element in the arrangement, we recognize revenue based on the relative fair value of all elements within the arrangement. We determine VSOE based on sales prices charged to customers when the same element is sold separately or based upon renewal pricing for PCS. If VSOE cannot be determined for all undelivered elements of an arrangement, we defer revenue until the earlier of (i) the delivery of all elements or (ii) the establishment of VSOE for all undelivered elements, provided that if the only undelivered element is PCS or a service, the total fee of the arrangement is recognized as revenue over the PCS or service term.

**Table of Contents**

*Disposal of Long Lived Assets.* On August 31, 2007, we completed the sale of our OEM Remotes and Branded Products business segments. As a result of the sale, the financial information included in the accompanying Condensed Consolidated Financial Statements is presented in accordance with Statement of Financial Accounting Standards 144 Accounting for Impairment or Disposal of Long-Lived Assets ( SFAS 144 ), which requires us to present the sale of these assets on a discontinued operations basis. The balance sheet at December 31, 2006 has been adjusted to reflect the assets and liabilities of the OEM Remotes and Branded Products segments as held for sale. Additionally, the statements of operations and cash flows have been adjusted to reflect the results of these segments as discontinued operations for the periods presented. Certain assumptions were used in determining amounts being presented as assets held for sale and discontinued operations. These assumptions were based on an analysis and review of costs associated with operating the ongoing business subsequent to the asset sale as compared with costs of operations prior to the asset sale.

*Accounts Receivable and Allowance for Doubtful Accounts.* Our accounts receivable are unsecured and are at risk to the extent such amounts become uncollectible. We continually monitor individual account receivable balances and add to our allowance for doubtful accounts at the time collection becomes questionable based on payment performance or age of the receivable and other factors related to the customer's ability to pay. We generally offer 30-day payment terms; however, some distributors in the divested Branded Products business segment and some of our Japanese OEM customers require as long as 120-day payment terms.

*Inventory Reserve.* At each balance sheet date we evaluate ending inventories for excess quantities and obsolescence. This evaluation includes analyses of forecasted sales levels by product based on historical demand. We write off inventories that are considered obsolete. Remaining inventory balances are adjusted to approximate the lower of cost or market value and result in a new cost basis in such inventory until sold. If future demand or market conditions are less favorable than internal projections, additional inventory write-down may be required and would be reflected in our cost of sales in the period the revision is made.

*Valuation of Derivative Instruments.* SFAS 133 requires bifurcation of embedded derivative instruments and measurement of their fair value for accounting purposes. Derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in results of operations under the heading Adjustments to Fair Value of Derivatives. The effects of interactions between embedded derivatives are calculated and accounted for in arriving at the overall fair value of the financial instruments. In addition, the fair values of freestanding derivative instruments such as warrant derivatives are valued using lattice models.

*Stock-based compensation.* We account for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* ( SFAS 123(R) ). Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted. For the three and six months ended June 30, 2008, forfeitures for employees were estimated to be 12.34% while forfeitures for executives were estimated to be 3%, with total forfeitures for the three and six months ended June 30, 2008 totaling \$11,000 and \$95,000, respectively. Stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the three and six months ended June 30, 2008 was \$115,000 and 847,000 respectively. The effect on basic and diluted earnings per share for the three and six months ended June 30, 2008 was \$(0.01) per share and \$(.05) per share, respectively. As of June 30, 2008, we have \$1,401,000 of unrecognized stock-based compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted average period of 1.08 years, of which \$326,000 will be recognized in the remaining six months of our 2008 fiscal year.

*Provision for Income Tax.* As part of the process of preparing financial statements, as required by Statement of Financial Accounting Standards ( SFAS ) No. 109 Accounting For Income Taxes , we are required to estimate income taxes in each jurisdiction in which we operate. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the accompanying Consolidated Balance Sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, establish a valuation reserve. To the extent we establish a reserve or increase this reserve in a period, we must include an expense within the tax provision in the statements of operations.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes ( FAS 109 ). This interpretation prescribes a

**Table of Contents**

recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN 48 effective January 1, 2007. We file income tax returns in the U.S. federal jurisdiction, and various state, local and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2000. As a result of the implementation of Interpretation No. 48, we did not recognize any increase in the liability for unrecognized tax benefits. In addition, we did not record a cumulative effect adjustment related to the adoption of FIN 48.

In the first quarter of 2007, the Inland Revenue Department (IRD) of Hong Kong commenced an examination of our Hong Kong income tax returns for 2003 through 2005. The examination is anticipated to be completed in the 2008 fiscal year. Due to delinquencies in filing annual tax returns for the 2003, 2004 and 2005 fiscal years, the IRD has assessed certain adjustments to our overall reported losses in Hong Kong for those periods stated above. These adjustments, all of which have been paid by us prior to 2007, have resulted in additional income tax assessments and cash payments that have been made for 2003, 2004 and 2005 totaling \$456,000 as of the date of this filing. We do not anticipate any further adjustments will be made.

Significant management judgment is required in determining our provision for income taxes, deferred tax asset and liabilities and any valuation reserve recorded against net deferred tax assets. Management continually evaluates its deferred tax asset to determine whether it is likely that the deferred tax asset will be realized.

When tax returns are filed, it is likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely to be realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits are classified as other interest and expense in the statement of income.

*Foreign Exchange Exposure.* We have established relationships with non-U.S. OEM customers of our Specialty Components business segment. Certain of these customers have been based in Japan and approximately 19%, 6% and 3% of our revenues for the years ended December 31, 2007, 2006 and 2005, respectively, came from Japanese customers. Revenues from these customers are denominated in Japanese yen, subjecting us to fluctuations in the yen/dollar exchange rate. From time to time, we use foreign currency forward and average rate option contracts to hedge this exposure. We use revenue forecasts from our Japanese subsidiary to determine the amount of forward or option contracts to purchase and we attempt to enter into these contracts when we believe the yen value is relatively strong against the U.S. dollar. To the extent that our revenue forecast may be inaccurate or the timing of forecasting the yen's strength is wrong, our actual hedge gains or losses may not necessarily correlate with the effect of foreign currency rate fluctuations on our revenues. We mark these contracts to market value and the gain or loss from these contracts is recorded as revenue of our Specialty Components business segment. These hedge transactions are classified as economic hedges and do not qualify for hedge accounting under SFAS 133. In addition, because our Japanese subsidiary's functional currency is the yen, the translation of the net assets of that subsidiary into the consolidated results will fluctuate with the yen/dollar exchange rate.

We calculate the increase (decrease) in revenues resulting from foreign currency fluctuations by calculating the U.S. dollar equivalent of our yen-denominated revenues for the year using the yen/dollar exchange rate at the beginning of the year. The resulting product is compared to our yen-denominated revenues converted to United States dollars according to Generally Accepted Accounting Principles and the difference is shown in the table above.

*Sale of Assets.* On August 31, 2007, we completed the sale of our OEM Remotes and Branded Products business segments for an aggregate cash purchase price of \$11,500,000, subject to certain post-closing price adjustments. As a result of this sale, we have included in these consolidated financial statements financial information presented in accordance with SFAS144 which requires us to present the sale of these assets on a discontinued operations basis.

---

**Table of Contents****Recent Accounting Pronouncements**

In February 2007, the Financial Accounting Standards Board ( FASB) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115 ( SFAS No. 159 )*. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value, nor does it eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS No. 157, *Fair Value Measurements* and SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of SFAS No. 157, *Fair Value Measurements*. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 2007. The adoption of this statement does not have a material effect on our financial conditions, its results of operations or its liquidity.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 141R, *Business Combinations* ( SFAS 141R ). SFAS 141R requires most identifiable assets, liabilities, noncontrolling interests, and goodwill acquired in a business combination to be recorded at full fair value. SFAS 141R applies to all business combinations, including combinations among mutual entities and combinations by contract alone. Under Statement 141R, all business combinations will be accounted for by applying the acquisition method. Statement 141R is effective for 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. We are currently evaluating SFAS 141R to understand the impact it may have on future consolidated financial statements.

In December 2007, FASB issued Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 requires the ownership interests in subsidiaries held by parties other than the parent to be treated as a separate component of equity and be clearly identified, labeled, and presented in the consolidated financial statements. SFAS 160 is effective for periods beginning on or after December 15, 2008. Earlier adoption is prohibited. We are currently evaluating SFAS 160 to understand its impact it may have on future consolidated financial statements.

In January 2008, the SEC issued Staff Accounting Bulletin No. 110, *Certain Assumptions Used in Valuation Methods* ( SAB 110 ) which amends Staff Accounting Bulletin No. 107, *Share-Based Payment* ( SAB 107 ). SAB 110 allows for the continued use, under certain circumstances, of the simplified method in developing an estimate of expected term of so-called plain vanilla stock options accounted for under FAS 123R. SAB 110 amends SAB 107 to permit the use of the simplified method beyond December 31, 2007. The adoption of SAB 110 did not have a significant effect on the Company's consolidated financial statements.

In March 2008, FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* ( FAS 161 ). The standard requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative agreements. FAS 161 is effective for financial statements issued after November 15, 2008. The adoption of FAS 161 will not have a significant effect on the Company's consolidated financial statements.

In May of 2008, FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS No. 162 ). The pronouncement mandates that the Generally Accepted Accounting Principles ( GAAP ) hierarchy reside in the accounting literature as opposed to in the audit literature. This has the practical impact of elevating FASB Statements of Financial Accounting Concepts in the GAAP hierarchy. This pronouncement will become effective 60 days following SEC approval, which has not yet occurred. The adoption of SFAS No. 162 will not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

**Table of Contents****Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Foreign Currency Exchange Rate Risk.** Our Japanese subsidiary, Interlink Electronics K.K., generally makes sales and collects its accounts receivable in Japanese yen. To hedge these revenues against future movements in exchange rates, we may purchase foreign exchange forward and average rate option contracts. When we do purchase foreign exchange forward and average rate option contracts, gains or losses are offset by gains or losses on the underlying revenue exposure and consequently a sudden or significant change of foreign exchange rates would not have a material impact on net income or cash flows to the extent future revenues are protected by forward currency contracts. These contracts, however, typically have a three month duration. Thus, yen/dollar fluctuations lasting more than three months will have an impact on our revenues. For the three month periods ended June 30, 2008 and 2007, we did not enter into foreign currency exchange contracts in the normal course of business to manage our exposure against foreign currency fluctuations on revenues denominated in foreign currencies. The principal objective of such contracts is to minimize the risks and costs associated with financial and global operating activities. We do not utilize financial instruments for trading or other speculative purposes. The fair value of foreign currency exchange contracts is estimated by obtaining quotes from bankers. During the three month period ended June 30, 2008, we recognized no gains on foreign currency exchange contracts which are reflected in revenue in the accompanying Consolidated Statements of Operations. Our hedging policies are designed to offset the effect of a yen devaluation on our revenues; thus, a hypothetical 10% devaluation of the yen would reduce our yen denominated revenues by 10%; but our theoretical hedging gains would offset that effect for a period of time, to the extent we have such foreign currency exchange contracts outstanding. As of June 30, 2008, we do not have any contracts outstanding to hedge our foreign exchange exposure and thus we are exposed to foreign currency exchange rate risk.

**Interest Rate Exposure.** Based on our overall international interest rate exposure at June 30, 2008, a hypothetical 10% change in interest rates applied to our international outstanding debt as of June 30, 2008, would have no material impact on earnings or cash flows over a one-year period.

**Item 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures.** Our management has evaluated, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(b) under the Securities Exchange Act. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to ensure that (i) information required to be disclosed by us is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure and (ii) information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Notwithstanding the preceding sentence, we continue to engage in efforts to improve our disclosure controls and procedures.

**Changes in Internal Control Over Financial Reporting.** There have been no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Limitations on the Effectiveness of Controls.** Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all error and all fraud. A control system no matter how well designed and implemented, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within a company are detected. The inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the controls. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

---

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We continue to defend ourselves in a class action and a shareholder derivative action. Each of these proceedings alleges violations of federal and state securities laws. Note 14 to the Financial Statements included in Item 1 of Part I of this Form 10-Q, which is hereby incorporated by reference, contains additional information about these legal proceedings and other legal matters concerning Interlink.

**Item 1(A). Risk Factors**

*We have incurred net losses and negative cash flow from operations for the past five fiscal years and expect to experience future quarterly losses. Continued losses and negative cash flow would reduce our internal resources, limit our growth options, require additional cash infusions and could ultimately place our continued viability in question.*

We have incurred losses and negative cash flow from operations in each of the previous five fiscal years. These losses resulted from various factors, including declining gross profit margins in our divested OEM Remotes business segment, increases in operating costs, increased compliance and regulatory costs, inventory reserve adjustments and internal investigation costs, some of which will continue to affect future results.

As part of an overall strategy to deemphasize our declining margin businesses and focus our efforts on higher margin emerging markets, we sold our OEM Remotes and Branded Products business segments in August of 2007. While we expect the higher margins in our retained businesses to result in positive cash flow by the end of fiscal 2008, we support a constant level of fixed general and administrative expenses with a revenue base that has been reduced by half, which is likely to result in continued net losses and may affect our ability to generate positive cash flow. The report of our independent registered public accounting firm contained in our fiscal 2006 audited financial statements included a going concern qualification. The going concern qualification has been eliminated in our 2007 fiscal year audited financial statements.

Despite our projections and best efforts, we cannot assure you that we will achieve or sustain profitability or positive cash flow. If we do not achieve profitability and positive cash flow, our financial resources will be adversely affected and we may be forced to curtail or discontinue certain operations, which could result in the allocation of fixed costs over an even smaller revenue base or affect our future competitiveness. If we were to require additional financing, such financing could prove dilutive to the interests of existing investors, or we may be required to divest additional business assets.

*Our former President and Chief Executive Officer retired on January 4, 2008. Our ability to execute our business strategy may be impaired if we are unable to find and retain a new Chief Executive Officer with necessary skills and experience. The loss of the services of other key personnel, or if we are unable to recruit other qualified managers and key personnel in the future, may also impair our ability to operate effectively.*

E. Michael Thoben, III, our former President and Chief Executive Officer, retired on January 4, 2008. Mr. Thoben had been with Interlink for the past seventeen years and has substantial experience with our business and technology. John Buckett, Chairman of the Board, has been appointed our interim Chief Executive Officer until a permanent replacement is found. Our Board of Directors is conducting a search for a replacement and is in discussions with a prospective new Chief Executive Officer. If we are unable to find a permanent replacement for Mr. Thoben with the combination of skills and industry experience necessary to execute our business plan and manage our company, our business may suffer. We also may incur significant costs in identifying, hiring, training and retaining Mr. Thoben's permanent replacement.

Our success also will depend, in part, on our ability to attract and retain additional qualified professional, technical, production, managerial and marketing personnel, both domestically and internationally. The loss of other key employees during this transition period would be particularly difficult and could cause significant delays in the implementation of our business plan and an adverse effect on our operations.

*Business divestitures, acquisitions and partnering arrangements may disrupt our business, dilute stockholder value and distract management's attention.*

In August 2007 we completed the sale of our OEM Remotes and Branded Products business segments. As part of our business strategy to focus on higher margin emerging markets, we may consider additional divestitures or acquisitions or discontinue other aspects of our business. Such

strategic decisions involve numerous risks, including:

unanticipated costs and liabilities;

difficulty of separating or combining the operations, products and personnel of the divested or acquired business;



**Table of Contents**

difficulties in maintaining customer relationships and managing the strategic position of products and technologies;

diversion of management's attention;

inability to maintain uniform standards, controls, policies and procedures;

accounting results that are unrelated to the performance of either business;

amortization of fixed costs over a smaller revenue base;

goodwill and other intangible assets that are subject to potential impairments in the future;

dilution of the ownership of existing shareholders, to the extent that acquisitions are financed with convertible debt or stock; and

other changes that consume resources and management's attention.

We may fail to replace divested operations with new business segments that contribute to our financial health and strategic objectives. If we fail to properly evaluate and execute acquisitions, investments or divestitures, we may not achieve the anticipated additional benefit to our business and we may incur costs in excess of what we anticipate, which could damage the viability of our ongoing operations.

***Our MicroNav sensor sales are dependent on a relatively small number of relatively large contracts; our failure to obtain contracts that we expect to obtain or any event that results in the loss or reduction in size of a contract below our expectations could have a material adverse effect on our results of operation.***

The focus of our *MicroNav* sales effort targets a small number of large OEM manufacturers of handheld products and relates to specific products for which the OEM manufacturer is developing product specifications. We expend considerable effort in preparing for and bidding these contracts and make capacity planning decisions based on our expectations as to the number and size of contracts on which we will be the successful bidder. If our expectations are too optimistic, we are at risk of incurring expense in preparation for sales that we are not able to make. If our expectations are too pessimistic, we are at risk of being unprepared to perform on a contract that we could otherwise have obtained. In addition, the value of any OEM contract to us depends in part on the success of the device in which our products are included. We rely on the OEM customer's estimates as to the size of the market for their individual products and these estimates are often inaccurate. We cannot assure you that we will be successful in predicting volume and timing in this aspect of our business.

***We are a public company and are therefore required to incur costs and to disclose information that private companies are not required to incur or disclose.***

As a public company, we are required to comply with complex and costly accounting and disclosure requirements that do not apply to foreign companies that are not public in the United States, private companies or to subsidiaries or divisions of very large companies for whom the results of the subsidiary or division are not material. These costs impact our profitability and therefore constitute a competitive disadvantage vis-à-vis much of our competition, especially in light of the recent divestiture of two of our four business segments, which has caused these costs to increase substantially as a percentage of our revenues. These requirements also consume substantial management time that could otherwise be focused on other areas of our business. In addition, our public status requires us to disclose publicly information that can afford a competitor an advantage. If we are unable to maintain costs associated with our public company status within reasonable parameters, or if we are required to disclose information that our competitors can use to compete with us, our ability to remain competitive in our markets could be adversely affected.

***A limited number of investors own a majority of our stock and, working together, could control us.***

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

The majority of our stock is owned by institutions managed by a small number of fund managers. To our best knowledge, neither these stockholders nor their fund managers have any agreement or understanding under which they have agreed to act together with respect to the voting of our stock. However, they have expressed common views with respect to various matters relating to our management and governance and these views have influenced related decisions of our Board of Directors. If they were to act together as a group, these fund managers would have the ability to control various aspects of our business and governance, including the replacement of our Board of Directors. Accordingly, other investors may not have the practical ability to oppose management and/or governance decisions that have the support of our institutional investors.

***We are facing litigation based on our restatements of historical financial statements, which may have a material adverse impact on our cash reserves and may impair our ability to achieve our business objectives.***

Certain former Interlink stockholders have filed a class action lawsuit claiming damages under various federal securities laws based on our restatement of historical financial statements. Other stockholders have brought a derivative action against our former Chief Executive Officer and our former Chief Financial Officer that alleges, among other things, securities-related violations of the California Corporations Code. These actions will require a vigorous defense and could result in a settlement or adverse award that is not covered by insurance or that exceeds applicable insurance limits. The time and expense required to defend these claims may also affect our ability to pursue our business strategy. There is also no assurance that additional lawsuits will not be filed or that the ultimate resolution of these matters will not result in a material adverse effect on our financial condition or results of operations.

***We are emphasizing new markets and if we fail to accurately predict the growth of these new markets, we may suffer reduced earnings.***

Historically, the largest contributor to our consolidated sales was our OEM Remotes business segment. In late 2005, we deemphasized and reorganized segments of this business, and in August 2007 we sold this business, together with our Branded Products business. We have devoted significant resources to the development of products and the support of marketing and sales

## **Table of Contents**

efforts in new markets, such as the *MicroNav* family of file navigation products in our Specialty Components business, and the biometric input pads in our eTransactions business. As we transition to becoming a company with two, rather than four, business units and focus on our remaining businesses, we expect to continue to identify and develop products for new markets. These markets change rapidly and may not all prove to be attractive. We cannot assure you that they will grow or that we will be able to accurately forecast market demand in time to respond appropriately. Our investment of resources in these markets may either be insufficient to meet actual demand or result in expenses that are excessive in light of actual sales volumes. Failure to accurately predict successful new products and markets and the growth and demand in new markets may cause us to suffer substantial losses or reduced earnings.

***Failure to increase market awareness and acceptance of eTransactions and our eTransaction products may cause our revenues in this market to fall short of our expectations.***

We are focusing considerable resources on developing our eTransactions market. The prospects for growth of our eTransactions business depend in part on the acceptance by our target markets of electronic signatures as a replacement for traditional pen and ink signatures. The market for eTransactions is new and emerging and we cannot be certain that it will continue to develop or grow in a timely manner or that businesses will elect to adopt our products rather than competitive products or to continue to rely on traditional pen and ink signatures. Businesses that have invested substantial resources in traditional infrastructures may be reluctant to adopt an electronic approach to replace their existing systems. Concerns about privacy and fraud may cause businesses not to adopt eTransactions or our eTransaction products. We expect that we will need to continue to pursue intensive marketing and sales efforts to educate prospective customers about the benefits of eTransactions and our eTransaction products. If market awareness and acceptance of eTransactions do not occur, our revenues and profitability in this market will fall short of our expectations.

***If we are unable to keep pace with rapid technological developments, we may not be able to compete effectively.***

Technology in our target markets is undergoing rapid change. In order to maintain our position in our existing markets and succeed in new markets, we will have to develop and support innovative technologies. Doing so will require, among other things, that we accomplish the following:

accurately predict customer needs and develop, in a timely manner, the technology required to support those needs;

provide products that are not only technologically sophisticated and well supported but are also available at a price within market tolerances and competitive with comparable products;

establish and effectively defend our ownership of the intellectual property supporting our products; and

enter into relationships with other companies that have developed complementary technology on which our products also depend. We cannot assure you that we will be able to achieve any of these objectives.

***If our products do not support evolving industry standards, they may not achieve or maintain market acceptance and our revenues may decline.***

Our eTransactions business customers expect our products to enable them to comply with applicable requirements relating to electronic signatures, such as the Electronic Signatures in Global Commerce Act and procedures adopted by the National Notary Association. If our eTransactions products do not support these requirements, they will not be competitive and will not be adopted by the market.

***We rely on others for aspects of our technology development.***

Our in-house research and development expertise is focused on our sensor and communication technologies. We do not have broadly based expertise in software development, chip design or other critical technological aspects of a complete product. We rely on other companies with whom we may contract or enter into joint development agreements to provide these aspects of our product technologies. We cannot assure you that we will be able to contract or otherwise arrange for these services in the future or on a consistent basis. We also cannot assure you that a

developer with whom we contract for technology will not use or permit others to use similar technology in competition with us.

## **Table of Contents**

***If we are not able to protect our intellectual property or if we infringe on the intellectual property of others, our business and operating results could be adversely affected.***

We consider our intellectual property to be a key element of our ability to compete in our chosen markets. We rely on a combination of patents, trade secrets and proprietary software to establish and protect our intellectual property rights. We cannot assure you that patents will be issued from any of our pending applications or that any claims allowed from existing or pending patents will be sufficiently broad to protect our technology. We also cannot assure you that any patents issued to us will not be challenged, invalidated or circumvented, or that the rights granted will provide proprietary protection. Litigation may be necessary to enforce our patents, trade secrets and other intellectual property rights, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement. Such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, regardless of the final outcome of the litigation.

We are not currently engaged in any patent infringement suits but we have been threatened with one such suit in recent years. Despite our efforts to maintain and safeguard our proprietary rights, we cannot assure you that we will be successful in doing so or that our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technologies. If any of the holders of these patents assert claims that we are infringing on them, we could be forced to incur substantial litigation expenses, and if we were found to have infringed a third-party patent, we could be required to pay substantial damages, pay royalties in the future or be enjoined from infringing in the future.

***Sales of simple signature capture devices are growing rapidly and the manufacturers of these devices could broaden their product range to include products that compete with our ePad.***

Simple signature capture devices, distinct from our more sophisticated ePad products, have recently become a common sight at retail checkout counters and a number of companies manufacture and sell these devices. While our ePad product is targeted at a more advanced market, signature capture device manufacturers could elect to expand their existing product lines in an effort to compete in our markets. Such competition could reduce margins or otherwise adversely affect our prospects in our eTransactions market.

***Our markets are intensely competitive and many of our potential competitors have resources that we lack.***

Our markets are competitive and we expect competition to increase. Our competitors include companies with similar products or technologies and companies that sell complementary products to our target markets. Our competitors and potential competitors may have established business relationships that afford them a competitive advantage or may create technologies that are superior to ours or that set a new industry standard that will define the successful product for that market. If any of our competitors establish a close working relationship with our customers, they may obtain advance knowledge of our customers' technology choices or may be afforded an opportunity to work in partnership to develop compatible technologies and may therefore achieve a competitive advantage. We may be unable to compete successfully against current and future competitors.

***We identified material weaknesses in our internal control over financial reporting in prior fiscal periods and have been required to restate our historical financial statements.***

In our Annual Reports for the years ended December 31, 2005 and 2006, we reported material weaknesses in our internal control over financial reporting. As a result of the errors caused by these material weaknesses, we were required to restate our historical financial statements for the fiscal years 2001 through 2004, as well as for the first and second quarters of fiscal 2005. We have taken significant measures to improve our financial reporting process and as of June 30, 2008, we had identified no material weaknesses that remained to be remediated.

Despite our substantial efforts to ensure the integrity of our financial reporting process, we cannot guarantee that we will not identify additional weaknesses as we continue to work with the new systems that we have implemented over the past year and a half. Any continuing material weaknesses in our internal control over financial reporting could result in errors in our financial statements. Such errors could cause our internal planning and assessment of our business to be based on false information and could cause our published financial statements to fail to fairly present our financial condition and results of operations, which could erode market confidence in our company, cause the price of our stock to be based on false or misleading information and result in litigation based on such false or misleading information.

***We rely on third parties for the materials that we use to manufacture our products and a shortage of supply could adversely affect our revenues, operating results and customer relationships.***

## Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

We rely on third-party suppliers for the raw material components of our products. We cannot assure you that our suppliers will be able to maintain an adequate supply of these raw materials to enable us to fulfill all of our customers' orders on a timely basis. A failure to obtain an adequate supply of the materials for our products could increase our costs of goods sold, cause us to fail to meet

## **Table of Contents**

delivery commitments and cause our customers to purchase from our competitors, which could adversely affect our operating results and customer relationships. In some situations, we rely on a single supplier for raw material components of our products. Any disruption in these supplier relationships could prevent us from maintaining an adequate supply of materials and could adversely affect our results of operation and financial position.

### ***Disruptions in our manufacturing facilities or arrangements could cause our revenues and operating results to decline.***

We currently manufacture FSR sensors at our Camarillo, California facility. This facility is vulnerable to damage from earthquakes, floods, fires, power loss and similar events. It could also be subject to break-ins, sabotage and intentional acts of vandalism. Our insurance may not cover such events and, if the event is covered, our insurance may not be sufficient to compensate us for any losses that may occur. Despite any precautions we may take, the occurrence of a natural disaster or other unanticipated problem at our manufacturing facility could result in delayed shipment of products, missed delivery deadlines and harm to our reputation, which may cause our revenues and operating results to decline.

Manufacturing is also being done by our China subsidiary and by third parties in China that are identified and managed through our Hong Kong and China subsidiaries. We rely on our subsidiaries to select and contract with contract manufacturers with suitable manufacturing facilities and appropriately trained employees. An interruption in our current manufacturing arrangements could adversely affect our revenues, operating results and customer relationships.

### ***International sales and manufacturing risks could adversely affect our operating results.***

Our revenues from international sales accounted for approximately 54%, 62% and 34% of net sales for the years ended December 31, 2007, 2006 and 2005, respectively. We believe that international sales will represent a substantial portion of our sales for the foreseeable future. Our manufacturing is currently performed in China and Camarillo. Our international operations involve a number of risks, including:

import-export license requirements, tariffs, taxes and other trade barriers;

difficulty in staffing and managing foreign operations;

ability to secure credit and funding;

difficulty in maintaining an effective system of internal controls at our foreign manufacturing facility;

foreign collection problems;

foreign exchange exposure

reduced protection of intellectual property rights;

international unrest and terrorism;

political and economic instability; and

transportation risks.

Any of the above factors could adversely affect our operating results.

***Our operating results could be adversely affected by fluctuations in the value of foreign currencies.***

International sales made through our Japanese subsidiary are generally denominated in yen. A weak yen would materially affect total revenue and could result in a decrease in dollar revenue even though sales remained constant or increased. We also contract for most of our large-volume, non-technical manufacturing in China. Although we contract in U.S. dollars, a weakening of the dollar could cause existing contracts to be uneconomic to the vendor and therefore require a renegotiation. Over the past two years, the valuations of many foreign currencies have fluctuated significantly relative to the U.S. dollar. The Japanese yen, in particular, has fluctuated in value due in part to the economic problems experienced by Asian countries and the depreciation of the U.S. dollar. Although we at times engage in currency hedging transactions in order to protect ourselves from risks of Japanese yen currency fluctuations, we cannot assure you that these activities will protect us from such risks.



**Table of Contents**

***Environmental directives could increase our costs and/or require us to reserve against inventory.***

Environmental directives that affect our manufacturing processes and inventory may be enacted from time to time in the United States and abroad. Any such directives could require us to increase our inventory reserves due to obsolescence or otherwise increase the cost of doing business. In 2006, the Restriction on Hazardous Substances Directive ( ROHS ) went into effect which limited the use of hazardous raw materials in the production of electronic and electrical goods that we sell in the European Union and certain other European countries. While we currently believe our inventory reserve is adequate, we may have additional inventory write downs due to ROHS or other similar restrictions implemented by other markets. In 2007, the Waste Electrical and Electronic Equipment became effective and required companies that sell electronic equipment on the EU market to register with individual member states, mark their products, submit annual reports, provide recyclers with information about product recycling, and either recycle their products or participate in or fund mandatory recycling schemes.

***Failure to maintain, develop and expand our OEM relationships could cause demand for our products to decrease.***

Our Specialty Components products are sold to OEM customers. If we fail to maintain, develop and expand our relationships with our OEM customers or if those customers are not successful in their marketing and sales efforts, demand for our products may decrease.

Our ability to generate increased revenues also depends significantly on the extent to which our OEM customers develop, promote and sell products that incorporate our technology and products. If our OEM customers do not successfully develop and market products that incorporate our products, sales of our products to our OEM customers would be adversely affected. The extent to which our OEM customers develop, promote and sell our products is based on a number of factors that are largely beyond our ability to control.

**Table of Contents****Item 4. Submission of Matters to a Vote of Security Holders**

At the Annual Meeting of Stockholders of the Company held on June 24, 2008, the holders of our outstanding Common Stock took actions described below. At April 28, 2008, the record date, 13,761,810 shares of Common Stock were outstanding and eligible to vote at the Annual Meeting of Stockholders.

The only matter submitted to the stockholders for a vote was the election of two nominees to serve as directors. By the votes indicated below, the stockholders voted to re-elect Messrs. George Gu and Lawrence S. Barker to the Board of Directors:

	<b>George Gu</b>	<b>Lawrence S. Barker</b>
Shares in favor:	9,858,756	10,223,946
Shares against:		
Shares withheld:	512,810	147,620

E. Michael Thoben III did not stand for re-election as a director and his term as director expired at the close of the 2008 Annual Meeting of Stockholders. In addition to Messrs. Gu and Barker, Messrs. Edward Hamburg, Tom Thimot and John A. Buckett, II continued to serve as directors after the meeting.

**Item 6. Exhibits**

The following exhibits are filed herewith or incorporated by reference as indicated below:

**Exhibit  
Number**

- 3.1 Certificate of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 3.2 Bylaws (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K dated September 26, 2007).
- 10.1 Change in Control Agreement by and between the Registrant and Rodney G. Vesling, dated April 22, 2008 (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated April 23, 2008).
- 10.2 Change in Control Agreement by and between the Registrant and Rostamian Farhad, dated April 22, 2008 (incorporated by reference to Exhibit 10.5 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008).
- 31.1 Certification of Chief Executive Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**SIGNATURES**

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

**INTERLINK ELECTRONICS, INC.**

DATE: August 13, 2008

/s/ Charles C. Best  
Charles C. Best  
Chief Financial Officer

**Table of Contents**

**Exhibit Index.**

The following exhibits are filed herewith or incorporated by reference as indicated below:

**Exhibit  
Number**

- 3.1 Certificate of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 3.2 Bylaws (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K dated September 26, 2007).
- 10.1 Change in Control Agreement by and between the Registrant and Rodney G. Vesling, dated April 22, 2008 (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated April 23, 2008).
- 10.2 Change in Control Agreement by and between the Registrant and Rostamian Farhad, dated April 22, 2008 (incorporated by reference to Exhibit 10.5 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008).
- 31.1 Certification of Chief Executive Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.