

INTERLINK ELECTRONICS INC  
Form 10-Q  
August 14, 2007  
Table of Contents

---

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

Washington, D.C. 20549

---

**FORM 10-Q**

---

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

For the quarterly period ended June 30, 2007

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)

---

Delaware  
(State or other jurisdiction of  
incorporation or organization)

546 Flynn Road

77-0056625  
(I.R.S. Employer

Identification Number)

93012

Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

**Camarillo, California**  
(Address of principal executive offices)

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Shares of Common Stock Outstanding, at August 10, 2007: 13,749,310

---

**Table of Contents**

**INTERLINK ELECTRONICS, INC.**

**TABLE OF CONTENTS**

PART I.	<u>FINANCIAL INFORMATION</u>	
ITEM 1.	<u>Financial Statements (Unaudited)</u>	
	<u>Condensed Consolidated Balance Sheets June 30, 2007 and December 31, 2006</u>	1
	<u>Condensed Consolidated Statements of Operations Three and Six Months Ended June 30, 2007 and June 30, 2006</u>	2
	<u>Condensed Consolidated Statements of Cash Flows Three and Six Months Ended June 30, 2007 and June 30, 2006</u>	3
	<u>Notes to Condensed Consolidated Financial Statements June 30, 2007</u>	4
ITEM 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
ITEM 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	21
ITEM 4.	<u>Controls and Procedures</u>	22
PART II.	<u>OTHER INFORMATION</u>	
ITEM 1.	<u>Legal Proceedings</u>	23
ITEM 1A.	<u>Risk Factors</u>	23
ITEM 6.	<u>Exhibits</u>	30
	<u>SIGNATURES</u>	32

**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,	December 31,
	2007	2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,983	\$ 1,344
Short-term investments, available for sale		1,600
Accounts receivable, less allowance for doubtful accounts and product returns of \$540 and \$1,131 at June 30, 2007 and December 31, 2006, respectively	5,950	8,034
Inventories, net	9,724	10,706
Prepaid expenses and other current assets	660	560
Total current assets	18,317	22,244
Property and equipment, net	1,576	1,594
Patents and trademarks, net	213	272
Other assets	244	245
Total assets	\$ 20,350	\$ 24,355
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Notes payable	\$ 73	\$ 152
Short term borrowings	1,500	
Accounts payable and accrued liabilities	2,243	4,331
Accrued payroll and related expenses	2,513	2,243
Deferred revenue	124	765
Total current liabilities	6,453	7,491
<b>Contingencies</b>		
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, 13,749 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively)	56,715	54,946
Accumulated other comprehensive loss	(543)	(505)
Accumulated deficit	(42,275)	(37,577)
Total stockholders equity	13,897	16,864
Total liabilities and stockholders equity	\$ 20,350	\$ 24,355

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</b>		<b>Six Month Period</b>	
	<b>Ended June 30, 2007</b>	<b>2006</b>	<b>Ended June 30, 2007</b>	<b>2006</b>
Revenues	\$ 8,006	\$ 8,517	\$ 16,891	\$ 17,048
Cost of revenues	5,440	6,553	11,655	11,402
<b>Gross profit</b>	<b>2,566</b>	<b>1,964</b>	<b>5,236</b>	<b>5,646</b>
Operating expenses:				
Product development and research	1,052	1,424	2,294	2,839
Selling, general and administrative	3,679	4,247	7,568	9,147
<b>Total operating expenses</b>	<b>4,731</b>	<b>5,671</b>	<b>9,862</b>	<b>11,986</b>
Operating loss	(2,165)	(3,707)	(4,626)	(6,340)
Other income (expense):				
Interest income, net	(24)	107	(8)	234
Other expense, net	10	(23)	(12)	(39)
<b>Total other income (expense), net</b>	<b>(14)</b>	<b>84</b>	<b>(20)</b>	<b>195</b>
<b>Loss before provision for income taxes</b>	<b>(2,179)</b>	<b>(3,623)</b>	<b>(4,646)</b>	<b>(6,145)</b>
Provision for income taxes		8	52	79
<b>Net loss</b>	<b>\$ (2,179)</b>	<b>\$ (3,631)</b>	<b>\$ (4,698)</b>	<b>\$ (6,224)</b>
Loss per share basic and diluted	\$ (0.16)	\$ (0.26)	\$ (0.34)	\$ (0.45)
Weighted average shares basic and diluted	13,749	13,765	13,749	13,760

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</b>	
	<b>Ended June 30, 2007</b>	<b>2006</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (4,698)	\$ (6,224)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>		
Provision for (reduction in) allowance for doubtful accounts receivable and product returns	(23)	24
Increase (decrease) in reserves for excess inventories	(753)	593
Shareholder loan reduction		35
Stock-based compensation	1,769	2,144
Depreciation and amortization	313	321
Write off of patents and trademarks	39	
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable	2,107	2,385
Prepaid expenses and other current assets	(100)	(18)
Inventories	1,735	(2,661)
Other assets	1	(20)
Accounts payable and accrued liabilities	(2,088)	(1,661)
Deferred revenue	(641)	(208)
Accrued payroll and other accrued expenses	270	177
<b>Net cash used in operating activities</b>	<b>(2,069)</b>	<b>(5,113)</b>
<b>Cash flows from investing activities:</b>		
Sales of marketable securities	1,600	4,800
Purchases of property and equipment	(254)	(389)
Costs of patents and trademarks	(20)	(26)
<b>Net cash provided by investing activities</b>	<b>1,326</b>	<b>4,385</b>
<b>Cash flows from financing activities:</b>		
Short term borrowings	1,500	
Proceeds from exercise of employee/director stock options		50
Proceeds from payment of shareholder notes		42
Principal payments on notes payable	(80)	(62)
<b>Net cash provided by financing activities</b>	<b>1,420</b>	<b>30</b>
Effect of exchange rate changes on cash and cash equivalents	(38)	(138)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>639</b>	<b>(836)</b>
<b>Cash and cash equivalents:</b>		
Beginning of period	1,344	3,938
End of period	\$ 1,983	\$ 3,102

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

### Supplemental disclosures of cash flow information:

Interest paid	\$	48	\$	12
Income taxes paid	\$	53	\$	79

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 THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006 AND AS OF JUNE 30, 2007 AND DECEMBER 31, 2006 (UNAUDITED)**

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

The financial information as of June 30, 2007, and for the three and six month periods ended June 30, 2007 and 2006, included in this report, is unaudited. Such information, however, reflects 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.

The information included herein should be read in conjunction with the consolidated financial statements and the related notes, which are included in Amendment No. 1 to our Annual Report on Form 10-K for the year ended December 31, 2006.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As of June 30, 2007, the Company had cash, cash equivalents and short-term investments of approximately \$2.0 million, which included \$1.5 million of cash drawn on a \$5 million secured line of credit with a one-year term obtained by the Company in December of 2006. The Company has an accumulated deficit of \$42.3 million as of June 30, 2007 and cash used in operations for the six months ended June 30, 2007 of approximately \$2.1 million. On July 20, 2007, the Company raised \$5 million through a private placement of convertible notes and warrants with existing institutional shareholders. The Company may require additional cash to pursue its planned operations during the next 12 months. If the Company requires additional capital and is unable to raise such capital in the form of commercial or securitized debt, sales of equity securities or other alternatives, it would be required to curtail its operations. As of June 30, 2007, total consolidated indebtedness for money borrowed was \$1,573,000. The Company is pursuing various other financing alternatives. There is no assurance that the Company will be successful in obtaining the required capital, and any financing arrangements that may be entered into could increase future costs or be dilutive to existing stockholders. The Company's independent registered public accounting firm has informed the Company that it may include in its report on the Company's financial statements for the year ending December 31, 2007 an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern if the Company fails to successfully fund its current operations.

**2. Significant Accounting Policies**

*Revenue Recognition* The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) require management's judgments regarding the fixed nature of the fee charged for services rendered and products delivered and the collectibility of those fees. To satisfy the criteria, the Company: (1) inputs orders based upon receipt of a customer purchase order; (2) records revenue upon shipment of goods and when risk of loss and title transfer; (3) confirms pricing through the customer purchase order; and (4) validates 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. The Company complies 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 certain future transactions, such as a determination that collectibility was not reasonably assured, revenue could be adversely affected.

*Accounts Receivable and Allowance for Doubtful Accounts* The Company's accounts receivable are unsecured and are at risk to the extent such amounts become uncollectible. The Company continually monitors individual account receivable balances, and provides for an allowance of doubtful accounts at the time collection may become questionable based on payment performance or age of the receivable and other factors related to the customer's ability to pay. The Company generally offers 30-day payment terms, however, some distributors in the 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 the Company's terms and conditions of product sales except for some customers, it does, on a discretionary basis, grant product exchanges for its distribution and reseller



**Table of Contents**

customers in its Branded Products business segment for similar products of equal value if these exchanges meet certain other criteria. The Company estimates future product returns based on recent return history, inventory status and product sell-through statistics received from its major distributors, discussions regarding product sales activity with its major reseller customers, and current industry product and technology trends. Management judgment is required in evaluating the relative significance of the aforementioned data and in the determination of 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.

*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 the Company evaluates ending inventories for excess quantities and obsolescence. This evaluation includes analyses of forecasted sales levels by product and historical demand. The Company writes 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 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 (SFAS) No. 109 Accounting For Income Taxes, the Company is required to estimate income taxes in each of the jurisdictions in which it operates. 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. The Company must then assess the likelihood that deferred tax assets will be recovered from future taxable income and to the extent it believes that recovery is not likely, must establish a valuation reserve. To the extent we establish a reserve or increase this reserve in a period, the Company must include an expense within the tax provision in the statements of operations.

Significant management judgment is required in determining the Company's 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 certain 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 of being 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* The Company has established relationships with most of the major OEMs in the OEM Remotes market. Many of these OEMs are based in Japan and approximately 19%, 20% and 28% of the Company's revenues for the years ended December 31, 2006, 2005 and 2004, respectively, came from Japanese customers. Revenues from these customers are denominated in Japanese yen and as a result the Company is subject to foreign currency exchange rate fluctuations in the yen/dollar exchange rate. From time to time, the Company uses foreign currency forward and average rate option contracts to hedge this exposure. The Company uses revenue forecasts from its Japanese subsidiary to determine the amount of forward or option contracts to purchase and the Company attempts to enter into these contracts when it believes the yen value is relatively strong against the U.S. dollar. To the extent that the Company's revenue forecast may be inaccurate or the timing of forecasting the yen's strength is wrong, the Company's actual hedge gains or losses may not necessarily correlate with the effect of foreign currency rate fluctuations on its revenues. The Company marks these contracts to market value and the gain or loss from these contracts is recorded in OEM Remotes revenue. These hedge transactions are classified as economic hedges and do not qualify for hedge accounting under Statement of Financial Accounting Standards No. 133. In addition, because the Company's 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. During the three and six month periods ended June 30, 2007 and 2006, the Company did not use foreign currency forward and average rate option contracts to hedge this exposure.



**Table of Contents**

*Stock-based Compensation.* On January 1, 2006, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company's financial statements as of and for the quarter and six months ended June 30, 2007 and 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the quarters ended June 30, 2007 and 2006 were \$793,000 and \$1,074,000 respectively. Stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the six months ended June 30, 2007 and 2006 were \$1,769,000 and \$2,144,000 respectively. The effect on basic and diluted earnings per share for the quarters ended June 30, 2007 and 2006 were \$(0.06) and \$(0.08) per share, respectively. The effect on basic and diluted earnings per share for the six months ended June 30, 2007 and 2006 were \$(0.13) and \$(0.16) per share, respectively. As of June 30, 2007, the Company has \$2,822,000 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 2.75 years.

During the quarter and six months ended June 30, 2007, the Company granted options to acquire 897,375 shares of its common stock at an average exercise price of \$2.45 per share. The estimated fair value of all awards granted during the quarter and six months ended June 30, 2007 was \$1,272,000, of which \$215,000 was recorded as of June 30, 2007. There were no stock options exercised during the three and six months ended June 30, 2007. SFAS 123(R) requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statement of Operations. Stock-based compensation expense recognized in the Statement of Operations for the quarter and six months ended June 30, 2007 and 2006 included compensation expense for share-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 share-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 how the prior period pro forma information was provided. As stock-based compensation expense recognized in the Statement of Operations for the quarter ended June 30, 2007 is based on awards that vest, 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 quarter and six months ended June 30, 2007, forfeitures for employees were calculated to be 12.34% while forfeitures for executives were estimated to be 3%, with the total forfeitures for the quarter ended June 30, 2007 totaling \$82,000 and \$114,000 for the three and six months ended June 30, 2007, respectively.

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

**Table of Contents**

The weighted average fair value at the date of grant for stock options granted during the quarter ended June 30, 2006 was \$1.53 per option. The fair value of options at the date of grant was estimated using the Black-Scholes model with the following weighted average assumptions:

	Six Months Ended June 30,	
	2007	2006
Expected life (years)	5.6	5.5
Interest rate	4.4%	4.6%
Volatility	68%	90%
Dividend yield	0%	0%

A summary of the Company's nonvested shares as of June 30, 2007 and changes during the quarter ended June 30, 2007 is presented below:

	Options	Wgt. Avg. Exercise Price
Nonvested as of December 31, 2006	1,169	\$ 4.11
Granted	897	2.45
Vested	(287)	5.06
Forfeited or expired	(67)	3.72
Nonvested as of June 30, 2007	1,712	3.11

The Company has adopted the simplified method provided in SFAS 123(R) to use 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 are outstanding upon adoption of SFAS 123R. The Company has not recognized excess tax benefits related to employee stock based compensation and, therefore, does not currently have an APIC pool.

**3. Inventories**

Net inventories consisted of the following (in thousands):

	June 30, 2007	December 31, 2006
Raw material	\$ 9,395	\$ 9,365
Work in process	792	1,244
Finished goods	1,395	2,708
Reserve for excess and obsolete inventory	(1,858)	(2,611)
Total inventories	\$ 9,724	\$ 10,706

**4. Line of Credit**

In December 2006, the Company entered into a Loan and Security Agreement (the Agreement ) with a bank, which provides for a line of credit with a maximum borrowing limit of \$5 million. The line of credit is secured by the Company's accounts receivable and other assets. Under the one-year term of the Agreement, which expires on December 18, 2007, the Company has the ability to draw cash borrowings against the line up to 80% of its eligible accounts receivable as defined in the agreement. Payments against this line of credit are due upon demand if certain conditions in the Agreement are not met. As of June 30, 2007, all terms and conditions of the Agreement have been met, and the Company had drawn \$1.5 million against the line of credit. On July 18, 2007, the line of credit was amended (the Amendment ). The Amendment amends

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

certain definitions in the line of credit that governs the \$5 million borrowing limit to allow for the sale of the convertible notes (the Notes ) and warrants described in the Company s Current Report on Form 8-K dated July 23, 2007. The Amendment reduced the Company s borrowing limits under the Agreement as follows: for advances, \$0, and for letters of credit, foreign exchange contract reserves and cash management services, \$150,000 in the aggregate.

**Table of Contents**

**5. Stock Options**

Under the terms of the Company's 1996 Stock Incentive Plan, officers and key employees may be granted non-qualified or incentive stock options and outside directors and independent contractors of the Company may be granted non-qualified stock options. The aggregate number of shares which may be issued under the Plan is 7,250,000. New options are granted at fair market value on the date of grant and generally vest ratably over 36 months and have a ten-year term but terminate earlier if employment is terminated. As of June 30, 2007, options for 7,156,000 shares of stock have been granted (4,254,000 are outstanding and 2,902,000 have been exercised, forfeited or expired) and 94,000 options were available for grant. Activity under the Plan for the first three months of 2007 is summarized as follows (in thousands, except per share information):

			Options	Wgt. Avg. Exercise Price
Outstanding beginning of period	January 1, 2007		3,666	\$ 5.09
Granted			897	2.45
Exercised				
Forfeited or expired			(308)	5.13
Outstanding end of period	June 30, 2007		4,255	\$ 4.53
Exercisable end of period	June 30, 2007		2,543	\$ 5.54

The vested and exercisable stock options outstanding as of June 30, 2007 have a weighted average remaining contractual life of 71 months and have \$173,000 in intrinsic value. The following table summarizes information about stock options outstanding under the Plan as of June 30, 2007, (in thousands, except contractual life and exercise price per share information):

Exercise Price Per Share	# of Options Outstanding	Months		
		Remaining On Contractual Life	Options Exercisable	Options Un-exercisable
\$ 2.25	326	118	0	326
2.40	88	118	2	86
2.60	63	111	14	49
2.60	483	117	27	456
2.65	262	111	58	204
2.70	41	9	41	0
2.70	10	1132	2	8
2.80	30	107	11	19
2.94	340	8	340	0
3.04	13	3	13	0
3.15	951	105	594	357
3.25	10	106	6	4
3.30	5	8	5	0
4.30	14	6	14	0
5.49	12	96	8	4
5.50	2	0	2	0
5.56	7	95	5	2
5.65	16	12	16	0
5.70	410	96	273	137
6.14	18	93	13	5
6.15	188	93	135	53



Edgar Filing: INTERLINK ELECTRONICS INC - Form 10-Q

6.45	342	17	342	0
7.54	27	15	27	0
7.82	10	92	8	2
7.98	2	89	2	0
9.40	561	84	561	0
10.60	24	21	24	0
Total	4,255		2,543	1,712

**Table of Contents****6. Loss Per Share**

For all periods presented, per share information was computed pursuant to provisions of the Statement of Financial Accounting Standards No. 128, Earnings Per Share, issued by the Financial Accounting Standards Board ( FASB ). The computation of earnings per share basic is based upon the weighted average number of common shares outstanding during the periods presented. Earnings per share diluted also includes 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		Six Months	
	Ended June 30,		Ended June 30,	
	2007	2006	2007	2006
Weighted average shares outstanding basic	13,749	13,765	13,749	13,760
Effect of dilutive securities (employee/director stock options) <sup>(1)</sup>				
Weighted average shares diluted	13,749	13,765	13,749	13,760

<sup>(1)</sup> Due to the net loss for the three and six month periods ended June 30, 2007 and 2006, respectively, the diluted share calculation result was anti-dilutive. Thus, the basic weighted average shares were used and shares of common stock equivalents of approximately 4.3 million and 4.0 million shares for 2007 and 2006, respectively, were excluded from the calculations.

**7. Comprehensive Loss**

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

	Accumulated Other	
	Comprehensive	Comprehensive
	Loss	Loss
Balance at December 31, 2005	\$ (490)	
Translation adjustment	(138)	\$ (138)
Net loss		(6,224)
Balance at June 30, 2006	\$ (628)	\$ (6,362)
Balance at December 31, 2006	\$ (505)	
Translation adjustment	(38)	\$ (38)
Net loss		(4,698)
Balance at June 30, 2007	\$ (543)	\$ (4,736)

**Table of Contents****8. Segment Information**

The Company has four business segments: (i) Branded Products; (ii) OEM Remotes; (iii) E-transactions; and (iv) Specialty Components. The Company evaluates the performance of these segments based on their revenue and gross profit. The Company does not allocate any other income, expenses or assets to these segments nor does it track revenue by product. Reportable segment information for the six months ended June 30, 2007 and 2006 is as follows (in thousands):

Six months ended:	Branded Products	OEM Remotes	E-transactions	Specialty Components	Total
June 30, 2007					
Revenue	\$ 4,364	\$ 4,522	\$ 4,290	\$ 3,715	\$ 16,891
Gross profit	2,067	51	2,223	895	5,236
June 30, 2006					
Revenue	\$ 3,668	\$ 6,955	\$ 3,817	\$ 2,608	\$ 17,048
Gross profit	1,617	1,347	1,764	918	5,646

*Geographic Information* The Company attributes revenues to different geographic areas on the basis of the location of the customer. The Company's revenues and long-lived assets by geographic area for the three and six months ended June 30, 2007 and 2006 are as follows (in thousands):

	Six months ended and as of			
	2007		2006	
	June 30, Long Lived	June 30, Long Lived	June 30, Long Lived	June 30, Long Lived
	Revenues	Assets	Revenues	Assets
United States	\$ 9,460	\$ 974	\$ 9,477	\$ 1,240
Japan	3,571	218	2,559	152
Asia (other than Japan)	1,896	597	2,955	109
Europe and other	1,964		2,057	
	\$ 16,891	\$ 1,789	\$ 17,048	\$ 1,501

*Major Customers* In the first six months of 2007 and 2006, one customer represented 10% or more of total revenues. Two customers accounted for 22% and 15% of accounts receivable at June 30, 2007 while one of the same customers accounted for 12% and a different customer accounted for 13% of the accounts receivable at June 30, 2006.

*Major Suppliers* The Company buys certain 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.

**9. Income Taxes**

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 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. The Company adopted FIN 48 effective January 1, 2007. The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is 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, the Company did not recognize any increase in the liability for unrecognized tax benefits. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

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

The Inland Revenue Department (IRD) of Hong Kong commenced an examination of the Company's Hong Kong income tax returns for 2003 through 2005 in the first quarter of 2007 that is anticipated to be completed in the 2007 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 the Company's overall reported losses in Hong Kong for those periods stated above. These adjustments 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. The Company does not anticipate any further adjustments will be made, however in the event there are additional assessments, Management does not anticipate they will result in a material change to its financial position.

---

**Table of Contents**

**10. Contingencies**

*Legal Matters* On November 15, 2005, a class action alleging violations of federal securities laws was filed against the Company and two of its current and former officers in the United States District Court for the Central District of California. The complaint alleges that, between April 24, 2003 and November 1, 2005, the Company and two of its current and former officers made false and misleading statements and failed to disclose material information regarding the Company's results of operations and financial condition. The complaint includes claims under the Securities Act of 1933, as amended (the Securities Act) and Exchange Act of 1934, as amended (the Exchange Act) and seeks unspecified damages and legal expenses.

On November 3, 2006, the Court appointed new lead plaintiffs. On January 16, 2007, the lead plaintiffs filed an amended complaint. The amended complaint also includes claims under the Securities Act and the Exchange Act and seeks unspecified damages and legal expenses. On February 22, 2007, defendants filed a motion to dismiss the amended complaint. The motion was heard on June 4, 2007, at which time the court took the motion under submission. An order from the court on the motion is still pending. The Company has recorded approximately \$263,000 in expenses for 2006 and has incurred no costs to date in 2007 in connection with the class action proceeding. Because the case is at a preliminary stage, it is not possible to predict with reasonable certainty the final outcome of this matter.

On January 24, 2006, a shareholder's derivative action was filed against two of the Company's current and former officers and the members of its Board of Directors in the Central District of California. The derivative complaint contains the same factual allegations as the class action complaint and sought to recover unspecified damages from the defendants, as well as forfeiture of their equity-based compensation and contribution from them in the event that the Company is found to have violated the federal securities laws. Following a motion made by the defendants to dismiss, or in the alternative, stay the derivative action, the plaintiff voluntarily dismissed the derivative action without prejudice on June 14, 2006.

On August 17, 2006, the plaintiff re-filed the derivative action in California state court. The re-filed complaint alleges securities-related violations of the California Corporations Code, as well as various common law and Delaware corporate law claims. The members of the Company's Board of Directors are no longer named as defendants. Plaintiffs seek treble damages based on the difference between the prices at which the named defendants sold their shares and the market value that those shares would have had at the time of such sales but for the allegedly false and misleading financial statements, as well as contribution from the defendants in the event that the Company is found to have violated the federal securities laws and other unspecified damages.

On November 17, 2006, defendants removed the derivative action to federal court. On January 9, 2007, the court stayed the derivative action pending the defendants' filing of an answer in the securities class action. That stay is still in effect as of the date of the filing of this Report. Because the case 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 proceedings described above, the Company voluntarily contacted the SEC in 2006 to inform the SEC of both proceedings. Soon thereafter, the SEC responded with several inquiries, to which the Company responded promptly. The Company has not received any further inquiries from the SEC, however, the SEC may at any time resume its inquiries into the basis of the class action and derivative proceedings. Other than the amounts described above, the Company cannot estimate the possible loss or range of loss, if any, associated with the resolution of the class action and derivative proceedings. While it intends to vigorously defend against these allegations, the Company cannot predict the final disposition of these matters or whether the Company will be liable for amounts not covered by insurance. There is no assurance that the ultimate resolutions of these matters will not result in a material adverse effect on the Company's business, financial condition or results of operations.

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

**Table of Contents****11. Subsequent Events**

On July 18, 2007 the Company entered into a Purchase Agreement with certain shareholders (Investors) of the Company relating to the purchase by and sale to the Investors of the Notes and Warrants. The closing under the Purchase Agreement took place on July 20, 2007, pursuant to which the Company received aggregate cash proceeds of \$5,000,000 and issued to the Investors \$5,000,000 of 8% Convertible Notes of the Company, together with warrants to purchase an aggregate 1,984,126 shares of Common Stock of the Company. The Purchase Agreement, among other things, also grants the Investors certain rights with respect to future financings of the Company. The Notes mature on July 19, 2010 and have a conversion price of \$1.26 per share. The Warrants expire on July 19, 2012, and may be exercised, in whole or in part, prior to expiration, on either a cash or cashless basis, at an exercise price of \$1.51 per share.

On July 25, 2007, Interlink Electronics, Inc. (the Company) and Silicon Valley Bank (SVB) entered into a Second Amendment to Loan and Security Agreement (the Amendment), effective as of July 18, 2007. The Amendment amends certain definitions in the Loan and Security Agreement (the Loan Agreement) that governs the \$5 million line of credit with SVB, to allow for the sale of the convertible notes (the Notes) and warrants described in the Company's Form 8-K filed with the Securities and Exchange Commission on July 23, 2007. Under the terms of the Amendment, until such time as the Notes constitute Subordinated Debt as defined in the Loan Agreement, the Company's borrowing limits under the Loan Agreement are reduced as follows: for Advances, \$0, and for letters of credit, foreign exchange contract reserves, and cash management services, \$150,000 in the aggregate. The line of credit with SVB terminates on December 18, 2007, unless renewed.

**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 and home applications worldwide. We generate revenues from the sale of our hardware products, including pen input and signature pads, integrated cursor control devices and interactive remote input devices. Some of these products, particularly our E-transactions products, incorporate software that we have developed internally or that we license from third parties. To date, we have not had significant sales of software products that have not been incidental to the related hardware product.

We record our revenue in four market segments: E-transactions (input devices for the electronic signature markets); Specialty Components (integrated FSR-based sensors, subassemblies and modules that support cursor control and other input functions); OEM Remotes (wireless intuitive input device and sensor products for use with presentation projectors and advanced viewing devices) and Branded Products (aftermarket remote control devices sold through retail channels). We have addressed our Specialty Components market since our inception in 1985. Our other three markets have evolved out of our Specialty Components market. We have addressed our OEM Remotes market as a separate market since 1994, Branded Products since 1994 and our E-transactions market since 1999. The relative revenue and gross profit contributions of each of these segments is provided below in *Results of Operations-Business Segment Overview*.

**Quarterly Financial Performance**

The following table presents certain financial information for each of the following quarters:

**Quarter Ended (unaudited)**

(in thousands, except per share data)

	Jun. 30,	Mar. 31,	Dec. 31,	Sep. 30,	Jun. 30,	Mar. 31,	Dec. 31,	Sep. 30,
	2007	2007	2006	2006	2006	2006	2005	2005
Revenues	\$ 8,006	\$ 8,885	\$ 10,156	\$ 9,034	\$ 8,517	\$ 8,531	\$ 8,484	\$ 10,223
Gross profit	\$ 2,566	\$ 2,670	\$ 1,377	\$ 3,249	\$ 1,964	\$ 3,682	\$ 1,691	\$ 1,292
Net loss	\$ (2,179)	\$ (2,519)	\$ (3,647)	\$ (1,885)	\$ (3,631)	\$ (2,593)	\$ (3,256)	\$ (2,689)
Loss per share - basic and diluted	\$ (0.16)	\$ (0.18)	\$ (0.27)	\$ (0.14)	\$ (0.26)	\$ (0.19)	\$ (0.24)	\$ (0.20)

Quarterly revenues in the second quarter of 2007 declined 10% from the first quarter of 2007 due primarily to a decline in our OEM Remote business segment revenues, which have been declining from quarter to quarter as a result of our focus on our E-transactions and Specialty Components business segments for future growth. Revenues in the first quarter of 2007



## **Table of Contents**

declined 13% from the fourth quarter of 2006. Our revenues grew sequentially from the second quarter of 2006 through the fourth quarter of 2006, with the fourth quarter of 2006 showing the largest sequential quarterly growth due to increases in the E-transactions business segment revenues.

Gross profit margins 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. The gross profit margin for the second quarter of 2007 was 32%, 30% in the first quarter of 2007, and 23% in the second quarter of 2006. The gross profit margin for the six months ended June 30, 2007 was 31%, higher than the 28% in the 2006 fiscal year. These increases were due primarily to lower obsolete inventory charges as well as a shift in the sales and gross profit dollars from the OEM Remote business segment, which went from 41% to 27% of revenues between the six months ended June 30, 2006 and June 30, 2007. We expect quarterly gross profit margins to continue to fluctuate in 2007, but not as significantly as in 2006.

The Company continues 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 due in part to the unabsorption of manufacturing costs, increases in operating costs, inventory reserve adjustments, increased compliance and regulatory costs, and costs related to an internal investigation undertaken by the Company in 2005 and 2006.

## **Current Opportunities and Challenges**

Our principal challenges are (i) to manage margins in our OEM Remotes business and (ii) maintain existing margins in our Branded Products business segment while continuing to invest in our E-transactions and Specialty Components business segments as they grow to achieve the revenue levels that will sustain and justify our continued investments in those business segments. Our ability to manage these challenges will define the level of our success over the next two to three years.

A considerable portion of our effort is directed at emerging markets such as our E-transactions market where our success depends 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, therefore, our long-term performance.

Management faces the constant challenge of balancing the Company's 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 earnings even if the investment proves to be justified. Because we intend to pursue a growth strategy, it is probable that we will 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 quarterly results are often affected by volatility in orders for a particular product. Sales of our E-transactions 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.

We are facing a challenge in maintaining adequate capital resources to fund our business plan. While our current estimates show an improvement in cash burn rates over time, they also show that we will require additional capital over the short term to fund our anticipated operations. We are in discussions with respect to various financing options but cannot be sure that any such discussions will result in sufficient capital resources to meet our forecast cash needs. It is also possible that our actual revenue could be less than and/or that our costs could exceed our current expectations. In either event, any capital resources that are available to us may be insufficient to meet our needs.

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 below.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As of June 30, 2007, the Company had cash, cash equivalents and short-term investments of approximately \$2.0 million, which included \$1.5 million of cash drawn on a \$5 million secured line of credit with a one-year term obtained by the Company in December of 2006. The Company has an accumulated deficit of \$42.3 million as of June 30, 2007 and cash used in operations for the six months ended June 30, 2007 of approximately \$2.1 million. On July 20, 2007, the Company





**Table of Contents**

raised \$5 million through a private placement of convertible notes and warrants with existing institutional shareholders. The Company may require additional cash to pursue its planned operations during the next 12 months. If the Company requires additional capital and is unable to raise such capital in the form of commercial or securitized debt, sales of equity securities or other alternatives, it would be required to curtail its operations. As of June 30, 2007, total consolidated indebtedness for money borrowed was \$1,573,000. The Company is pursuing various other financing alternatives. There is no assurance that the Company will be successful in obtaining the required capital, and any financing arrangements that may be entered into could increase future costs or be dilutive to existing stockholders. The Company's independent registered public accounting firm has informed the Company that it may include in its report on the Company's financial statements for the year ending December 31, 2007 an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern if the Company fails to successfully fund its current operations.

Business Segment Overview Three and Six months Ended June 30, 2007 Compared To Three and Six Months Ended June 30, 2006:

For the three and six months ended June 30, 2007 and 2006, revenue and gross profit by market segment are shown in the following table:

Market Segment	Three Months		Three Months		Six Months		Six Months	
	Ended		Ended		Ended		Ended	
	June 30, 2007	Percent	June 30, 2006	Percent	June 30, 2007	Percent	June 30, 2006	Percent
	\$000 s	of Total	\$000 s	of Total	\$000 s	of Total	\$000 s	of Total
		Sales		Sales		Sales		Sales
<b>Branded Products:</b>								
- Revenue	\$ 2,178	27%	\$ 1,882	22%	\$ 4,364	26%	\$ 3,668	22%
- Gross Profit	1,055		596		2,067		1,617	
- Gross Profit % of Segment Revenue	48%		32%		47%		44%	
<b>OEM Remotes:</b>								
- Revenue	\$ 2,003	25%	\$ 2,953	35%	\$ 4,522	27%	\$ 6,955	41%
- Gross Profit (Loss)	195		331		51		1,347	
- Gross Profit (Loss) % of Segment Revenue	10%		11%		1%		19%	
<b>E-transactions:</b>								
- Revenue	\$ 2,159	27%	\$ 2,206	26%	\$ 4,290	25%	\$ 3,817	22%
- Gross Profit	1,107		744		2,223		1,764	
- Gross Profit % of segment Revenue	51%		34%		52%		46%	
<b>Specialty Components:</b>								
- Revenue	\$ 1,666	21%	\$ 1,476	17%	\$ 3,715	22%	\$ 2,608	15%
- Gross Profit	209		293		895		918	
- Gross Profit % of Segment Revenue	13%		20%		24%		35%	
<b>All Segments:</b>								
- Revenue	\$ 8,006	100%	\$ 8,517	100%	\$ 16,891	100%	\$ 17,048	100%
- Gross Profit	2,566		1,964		5,236		5,646	
- Gross Profit %	32%		23%		31%		33%	

**Branded Products**

In our Branded Products business segment, we sell Interlink-branded wireless remote controls and keyboards direct to computer products retailers, corporate resellers and distributors

Branded Products revenues for the three months ended June 30, 2007 increased 16% when compared to the three months ended June 30, 2006 while revenues for the six months ended June 30, 2007 increased 19% when compared to the six months ended June 30, 2006. The increase in revenues for the both the three and six month periods were primarily the result of the mix of products sold and the varying volume of products being offered during those periods and in part due to varying buying patterns through our distributor channels to end users.



## **Table of Contents**

The gross margin for our Branded Products in the three months ended June 30, 2007 was 48% compared to 32% for the three months ended June 30, 2006. The increased gross profit margin was attributable to lower unabsorbed manufacturing costs in the first six months of 2007. Gross profit margins for the six months ended June 30, 2007 was 47% compared to 44% in the six months ended June 30, 2006, due primarily to the mix and varying volume of products being offered during those periods.

### **OEM Remotes**

In our OEM Remotes segment, we sell wireless remote controls on an OEM basis to manufacturers of advanced viewing devices, including projectors sold for TV viewing and for use with certain computer software presentation applications. Revenues for the three and six months ended June 30, 2007 decreased 32% and 35%, from the three and six months ended June 30, 2006, respectively. These declines are related to an overall market decline for higher quality, higher selling products, resulting in a continuing decline in our selling prices and the volume of products being sold as well as our strategic decision to focus our efforts on growing our E-transactions and Specialty components business segments for future growth.

Our OEM Remotes gross margins for the three and six months ended June 30, 2007 were 10% and 1%, respectively, compared to 11% and 19% in the three and six months ended June 30, 2006. The decline between the six month periods was due primarily to higher gross margins in our Japanese subsidiary's OEM remote product sales in the first quarter 2006 and to higher unabsorbed manufacturing costs being allocated to the OEM Remote business segment in the first six months of 2007.

### **E-Transactions**

In our E-transactions 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 months ended June 30, 2007, our revenues declined 2% compared to the three months ended June 30, 2006 while for the six months ended June 30, 2007 our revenues increased 12% compared to the six months ended June 30, 2006. E-transaction gross profit margins for the three and six months ended June 30, 2007 were 51% and 52% respectively while our gross profit margins for the three and six months ended June 30, 2006 were 34% and 46% respectively. Quarterly cost of sales is impacted by varying amounts of unabsorbed manufacturing costs, which will impact gross profit margins.

Our E-transactions revenues and gross margins may fluctuate significantly from period to period due to individually significant sales transactions, which are negotiated independently and by varying amounts of unabsorbed manufacturing costs.

### **Specialty Components**

In our Specialty Components segment, we sell our *MicroNav* products and custom Force Sensing Resistors (FSR) and FSR-based subassemblies to many 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, 2007 increased 13% and 42% compared to the three and six months ended June 30, 2006, respectively. These increases were primarily due to higher sales related to a significant customer added in the latter part of 2006. Specialty component gross profit margin for the three and six months ended June 30, 2007 were 13% and 24% compared to 20% and 35% for the three and six months ended June 30, 2006, respectively. These margin decreases were due to the allocation of higher unabsorbed manufacturing costs in each of the 2007 three and six month periods.

### **Operating Expenses**

Operating expenses for the three months ended June 30, 2007 decreased to \$4,731,000, from \$5,671,000 for the three months ended June 30, 2006. This \$940,000 decrease in operating expenses was due primarily to a \$213,000 decrease in non-cash compensation costs related to SFAS 123(R), a reduction of \$197,000 in consulting fees; a \$181,000 of costs associated with the class action lawsuit occurring in the second quarter of 2006, a \$151,000 reduction in our product development outside development costs, as well as lower advertising and related marketing costs, bad debt expense and audit fees.



---

**Table of Contents**

Operating expenses for the six months ended June 30, 2007 decreased to \$9,862,000, from \$11,986,000 for the six months ended June 30, 2006. The \$2,124,000 decrease in operating expenses was due primarily to a \$282,000 decrease in non-cash compensation costs related to SFAS 123(R), a reduction of \$603,000 of consulting costs; \$248,000 of costs associated with the class action lawsuit occurring in the first six months of 2006 that did not occur in the first six months of 2007, \$321,000 reduction in Sarbanes-Oxley related costs, \$439,000 reduction in our product development outside development costs as well as lower advertising and related marketing costs and bad debt expense.

Product development and research costs include internal engineering labor, contract engineering and outside processing costs for the design and development of our products and the research of our technologies. For the second quarter of 2007, our product development and research costs decreased 26% or \$372,000 when compared to the second quarter of 2006. This decrease was due primarily to a \$53,000 decrease in non-cash compensation costs related to SFAS 123(R) and a \$151,000 reduction in outside development costs. \$117,000 of the reduction of product development costs was attributable to a reclassification to costs of sales as the Company recognized customer revenue related to these amounts.

For the first six months of 2007, our product development and research costs decreased 19% or \$545,000 when compared to the first six months of 2006 which was due primarily to a \$67,000 decrease in non-cash compensation costs related to SFAS 123(R) and to \$439,000 reduction in outside development costs. \$208,000 of the reduction of product development costs was also attributable to a reclassification to costs of sales as the Company recognized customer revenue related to these amounts. As a percentage of revenues, product developments expenses decreased to 13% and 14% in the second quarter and first six months of 2007, respectively, compared to 17% for each of the second quarter and first six months of 2006, respectively.

Selling, general & administrative (SG&A) costs include sales, marketing, legal, accounting and administrative labor, sales commissions, advertising, general marketing, and travel and entertainment costs. For the three months ended June 30, 2007, SG&A costs decreased 13%, to \$3,679,000 from \$4,247,000 for the three months ended June 30, 2006. The \$568,000 decrease was primarily attributable to \$181,000 of costs related to an internal investigation that occurred in the first six months of 2006, decreased audit, professional and consulting fees of \$230,000, and \$53,000 of decreased advertising and promotional costs. These decreases were partially offset by an increase in payroll and related costs of \$272,000. As a percentage of revenues, SG&A expenses decreased to 46% and 45% in the second quarter and first six months of 2007 compared to 50% and 54% for the second quarter and first six months of 2006, respectively.

**Operating Results**

In summary, our operating loss of \$4,626,000 for the six months ended June 30, 2007 was attributable to the following factors:

A \$1,769,000 non-cash charge for stock-based compensation related to the SFAS 123(R), which was split among several expense line items in our Consolidated Statement of Operations including cost of sales (\$311,000), product development and research (\$381,000) and selling, general and administrative (\$1,077,000).

A \$157,000 or 1% decrease in revenues for the first six months of 2007 compared to the first six months of 2006 primarily resulting from declining OEM Remote revenues, partially offset by increases in Specialty Products and E-transactions revenues.

A two percentage point decrease in the gross profit margin to 31% in the first six months of 2007 compared to 33% in the first three months of 2006. This decrease in gross profit margin was primarily attributable to significantly lower gross profit margin in the OEM Remotes business segment, which decreased from 19% for the months ended June 30, 2006 to 1% for the six months ended June 30, 2007. The lower gross profit margins in the OEM Remotes business segment in this period was due to a reduction of revenues of 35% from the first six months of 2006 compared to the first six months of 2007, resulting in increased unabsorbed manufacturing costs applied to this business segment. The decrease in gross profit margin was also affected by decreased gross profit margins in the Specialty Components business segments in the six months ended June 30, 2007 compared to the six months ended June 30, 2006, from 35% to 24% respectively. This decrease was also attributable to an increase in unabsorbed manufacturing costs. Each business segment's margins were affected by unabsorbed manufacturing costs being applied to cost of sales, which was due to production levels being below capacity levels that were sufficient to absorb all manufacturing costs.

A \$2,124,000 decrease in operating expenses.

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

Total other expense, net was \$20,000 in the six months ended June 30, 2007 as compared to total other income, net of \$195,000 for the six months ended June 30, 2006. This reduction is primarily due to lower interest income recognized in the first six months of 2007, which is the result of lower cash balances currently held by the Company. The higher interest expense for the first six months of 2007 is due to the need to borrow on the Company's \$5 million line of credit.

**Table of Contents**

For the six months ended June 30, 2007 there was a \$52,000 provision for income taxes for the six months ended June 30, 2007 as compared to a \$79,000 provision for income taxes for the six months ended June 30, 2006. These amounts both relate to statutory tax filings of one of the Company's international subsidiaries.

We have approximately \$44.0 million in net operating loss ( NOL ) carryforwards available for U.S. federal tax purposes, of which \$684,000 expire in 2007. In determining whether or not a valuation allowance is necessary against the deferred tax asset related to these NOL carryforwards, forecasts of future taxable income are not considered sufficient evidence to outweigh a history of losses. Accordingly, we have maintained the full valuation allowance against our deferred tax assets as of June 30, 2007. This has no effect on the Company's NOL carryforwards for tax purposes and they continue to be available for up to 20 years.

**Liquidity and Capital Resources**

Working capital decreased to \$11.9 million at June 30, 2007 from \$14.8 million at December 31, 2006. This decrease is due primarily to the loss from operations for the six months ended June 30, 2007, which resulted in \$2.1 million of cash used in operations for the six months ended June 30, 2007, and to the purchase of property and equipment of \$254,000.

Cash used in operations was \$2,069,000 for the first six months of 2007 as compared to \$5,113,000 in the first six months of 2006. This \$3,044,000 improvement in cash used in operations is due primarily to a lower operating loss of \$1,714,000 as well as improvements in our net changes in inventory. We spent \$254,000 in the first six months of 2007 to purchase additional manufacturing and computer equipment compared to \$389,000 in the first six months of 2006. We also invested \$20,000 in acquiring new patents and trademarks in the first six months of 2007 as compared to \$26,000 in the first six months of 2006. We wrote off \$39,000 of non usable patents in the six months ended June 30, 2007.

We made \$79,000 in payments on long-term debt during the first six months of 2007 compared to \$62,000 for the first six months of 2006. There were no proceeds from the exercise of employee and director stock options during the first months of 2007, whereas the Company received \$50,000 from the exercise of employee and director stock options in the first six months of 2006.

In December 2006, the Company entered into a Loan and Security Agreement (the Agreement ) with a bank, which provides for a line of credit with a maximum borrowing limit of \$5 million. The line of credit is secured by the Company's accounts receivable and other assets. Under the original terms of the Agreement, which expires on December 18, 2007, the Company has the ability to draw cash borrowings against the line up to 80% of its eligible accounts receivable as defined in the agreement. Payments against this line of credit are due upon demand if certain conditions in the Agreement are not met. As of June 30, 2007, all terms and conditions of the Agreement have been met, and the Company had drawn \$1.5 million against the line of credit. On July 18, 2007, the line of credit was amended (the Amendment ). The Amendment amends certain definitions in the line of credit that governs the \$5 million borrowing limit to allow for the sale of the convertible notes and warrants described in the Company's Current Report on Form 8-K dated July 23, 2007. The Amendment reduced the Company's borrowing limits under the Agreement as follows: for advances, \$0, and for letters of credit, foreign exchange contract reserves and cash management services, \$150,000 in the aggregate.

We currently have minor commitments for capital expenditures and certain commitments for material purchase obligations of inventory.

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 each seat of software sold packaged with certain products of the Company's involving its 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 for the Company to purchase the software from the software company at any time during the agreement, which is effective through June 30, 2011. Our minimum long-term debt, licensing and operating lease obligations as of December 31, 2006, the last fiscal year-end date, were as follows (in thousands):

		Less than	1-3	4 <sup>th</sup>
	Total	One Year	Years	Year
Long-term debt obligations	\$ 152	\$ 152	\$	\$
Software licensing	4,650	1,050	2,400	1,200
Operating lease obligations	1,514	509	940	65



Total \$ 6,316 \$ 1,711 \$ 3,340 \$ 1,265

---

## **Table of Contents**

These amounts may increase as we pursue our growth strategy but the amount of any such growth will depend on the particular requirements of any growth commitment, the availability and attractiveness of equity capital arrangements and our general liquidity position.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As of June 30, 2007, the Company had cash, cash equivalents and short-term investments of approximately \$2.0 million, which included \$1.5 million of cash drawn on a \$5 million secured line of credit with a one-year term obtained by the Company in December of 2006. The Company has an accumulated deficit of \$42.3 million as of June 30, 2007 and cash used in operations for the six months ended June 30, 2007 of approximately \$2.1 million. On July 20, 2007, the Company raised \$5 million through a private placement of convertible notes and warrants with existing institutional shareholders. The Company may require additional cash to pursue its planned operations during the next 12 months. If the Company requires additional capital and is unable to raise such capital in the form of commercial or securitized debt, sales of equity securities or other alternatives, it would be required to curtail its operations. As of June 30, 2007, total consolidated indebtedness for money borrowed was \$1,573,000. The Company is pursuing various other financing alternatives. There is no assurance that the Company will be successful in obtaining the required capital, and any financing arrangements that may be entered into could increase future costs or be dilutive to existing stockholders. The Company's independent registered public accounting firm has informed the Company that it may include in its report on the Company's financial statements for the year ending December 31, 2007 an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern if the Company fails to successfully fund its current operations.

### **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, and Section 21E of the Securities Exchange Act, 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 other similar 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 under the headings *Overview*, *Current Opportunities and Challenges* and *Business Segment Overview - Three and Six Months Ended June 30, 2007 Compared to Three and Six Months Ended June 30, 2006*. 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 the Company's 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. Management evaluates estimates, including those related to the valuation of inventory and the allowance for uncollectible accounts receivable, on an on-going basis. 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 (SAB) No. 104, Revenue Recognition. SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) require management's

**Table of Contents**

judgments regarding the fixed nature of the fee charged for services rendered and products delivered and the collectibility of those fees. To satisfy the 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 has transferred; (3) confirm pricing through the customer purchase order; and (4) validate 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 certain future transactions, such as a determination that collectibility was not reasonably assured, revenue recognized for any reporting period could be adversely affected.

*Accounts Receivable and Allowance for Doubtful Accounts.* Our accounts receivable are unsecured, and we are at risk to the extent such amounts become uncollectible. We continually monitor individual account receivable balances, and provide for an allowance of doubtful accounts at the time collection that may become questionable based on future payment performance or age of the receivable and other factors related to the customer's ability to pay. We evaluate our aged receivables on a regular basis and adjust our allowance for doubtful accounts based on our estimates of the ultimate collectibility. However, some of our distributors in the 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 our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of forecast sales levels by product and historical demand. We write off inventories that are considered obsolete and reserve against inventories that may become obsolete. Remaining inventory balances are adjusted to approximate the lower of our 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 our projections, additional inventory write-down may be required, and would be reflected in cost of sales in the period the revision is made.

*Stock-based compensation.* We account for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123R ( SFAS 123(R) ), *Share-Based Payment*. Under the fair value recognition provisions of this statement, share-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 share-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of share-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 year ended December 31, 2007, forfeitures for employees are estimated to be 12.34% while forfeitures for executives are estimated to be 3%, with the total forfeitures for the first six months of 2007 totaling \$114,000. Projected stock-based compensation expense recognized under SFAS 123(R) for employees and directors for the year ended December 31, 2007 is \$3,353,000. The effect on basic and diluted earnings per share for the six months ended June 30, 2007 was \$(0.13) per share. As of June 30, 2007, the Company has \$2,821,000 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 2.25 years.

*Provision for Income Tax.* As part of the process of preparing our financial statements, as required by Statement of Financial Accounting Standards ( SFAS ) No. 109 Accounting For Income Taxes , we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our 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 our balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we 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. Significant management judgment is required in determining our provision for income taxes, deferred tax asset and liabilities and any valuation reserve recorded against our net deferred tax assets. Management continually evaluates the Company's 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 certain 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 of being 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.

**Table of Contents**

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

As of December 31, 2006, the Company had NOL carryforwards for federal, state and foreign income tax purposes of \$44.0 million, \$27.2 million and \$4.7 million, respectively, which are available to offset future taxable income in those jurisdictions through 2026. Section 382 ( Section 382 ) of the Internal Revenue Code of 1986, as amended (the Code ), places a limitation on the realizability of NOLs in future periods if the ownership of the company has changed more than 50% within a three-year period. Under Section 382, we have experienced an approximate 43% change in ownership for the three-year period ended December 31, 2006. As of December 31, 2006, none of our NOLs has been limited by the Section 382 rules.

*Foreign Exchange Exposure.* We have established relationships with most of the major OEMs in the business communications market. Many of these OEMs are based in Japan and approximately 28%, 23% and 19% of our revenues for 2004, 2005 and 2006, respectively, came from Japanese customers. Revenues from these customers are denominated in Japanese yen and as a result we are subject to foreign currency exchange rate fluctuations in the yen/dollar exchange rate. We may use foreign currency forward contracts to hedge this exposure. We use revenue forecasts from our Japanese subsidiary to determine the amount of our forward 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. Accordingly, we mark these contracts to market value and the gain or loss from these contracts is recorded as revenue. These hedge transactions are classified as economic hedges and do not qualify for hedge accounting under SFAS No.133

Accounting For Derivative Instruments and Hedging Activities . 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.

The following table illustrates the impact of foreign currency fluctuations on our yen-denominated revenues and the effectiveness of our foreign currency hedging activity (in thousands).

	<b>Three Months</b>	
	<b>Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Increase (decrease) in revenues resulting from foreign currency fluctuations	\$ 80	\$
Hedging gains (losses)		(1)
<b>Net revenue impact</b>	<b>\$ 80</b>	<b>\$ (1)</b>

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.

**Recent Accounting Pronouncements**

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin ( SAB ) No. 108 Quantifying Financial Statement Misstatements (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. SAB 108 has not had a material impact on our financial condition, results of operations or liquidity.

In September 2006, the Financial Accounting Standards Board ( FASB ), issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). This new standard provides guidance for using fair value to measure assets and liabilities. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is evaluating the impact of this Statement.



## **Table of Contents**

In December 2006, FASB Staff Position ( FSP ) No. EITF 00-19-2 was posted. This FSP addresses an issuer's accounting for registration payment arrangements. This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. This SFP is effective for any registration payment arrangement entered into after the date of issuance of this FSP. The Company is evaluating this FSP to determine what, if any impact it may have on the Company's results of operations.

### **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, 2007 and 2006, 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 first six months of 2007, 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, 2007, 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 interest rate exposure at June 30, 2007, a hypothetical 10% change in interest rates applied to our outstanding debt as of June 30, 2007, would have no material impact on earnings or cash flows over a one-year period.

---

**Table of Contents**

**Item 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures as of June 30, 2007 (the 2007 Evaluation ). The 2007 Evaluation was similar in scope to the evaluation conducted at the end of our 2006 fiscal year (the 2006 Evaluation ). At the end of 2006, though we no longer classified as an accelerated filer for Exchange Act reporting purposes, we performed certain functions to make changes and improvements in our controls and procedures. The 2006 Evaluation focused on the material weaknesses related to the ineffectiveness of our disclosure controls and procedures for the 2005 fiscal year. Based on the 2007 Evaluation, our Chief Executive Officer and our Chief Financial Officer believe that our disclosure controls and procedures were effective as of June 30, 2007 to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management to allow required disclosure within the time periods specified in the Exchange Act. Notwithstanding the preceding sentence, we continue to engage in efforts to improve our disclosure controls and procedures.

**Changes in Internal Control Over Financial Reporting**

Our goal is to implement and maintain effective internal control over financial reporting and we believe we have done so as of June 30, 2007. Additional material weaknesses not known to us at this time may, however, come to our attention in the future. We believe that the 2006 Evaluation was thorough and the disclosure in our Annual Report on Form 10-K for the year ended December 31, 2006 provides investors a complete update of the material weaknesses that were remediated during 2006 and that remained as of December 31, 2006.

Material weaknesses that we were aware of at December 31, 2006, and which we believe were remediated during the first six months of fiscal year 2007, are:

*Timely Filing of all Required Exchange Act Reports.* By timely filing with the SEC our Annual Report on Form 10-K for the year ended December 31, 2006, our Quarterly Report on Form 10-Q for the period ended March 31, 2007 and this Quarterly Report on Form 10-Q for the period ended June 30, 2007, we have timely filed the required SEC reports for three consecutive quarters. Prior to this, our internal control over financial reporting was not effective to ensure that the Company was able to timely file required reports.

*Inventory Costing Methods.* By adding more resources, refinement, analysis, and timeliness to the process of identifying and updating our costs of inventory parts, we remediated the material weakness in our inventory costing methods during the period covered by this Report.

Other than as discussed above, there was no change in the Company's internal control over financial reporting during the last fiscal quarter that materially affected, or is likely to materially affect, the Company's internal control over financial reporting.

**Limitations on the Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, do 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**

The Company continues to defend itself in a class action and a shareholder derivative action. Each of these proceedings alleges violations of federal and state securities laws, and the shareholders derivative action also involves common law and Delaware corporate law claims. See Note 10 to the Financial Statements included in Item 1 of Part I of this Form 10-Q for more information about these legal proceedings and other legal matters concerning the Company.

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

*We have been incurring net losses and negative cash flow from operations and will 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 three years 2004, 2005 and 2006 and for the first two quarters of 2007 as a result of various factors, including declining gross profit margins in our OEM Remotes business segment, increases in operating costs, inventory reserve adjustments, increased compliance and regulatory costs, and internal investigation costs. We will continue to incur net quarterly losses and negative cash flow from operations as we continue to invest in new technology and emerging markets. We are incurring these losses in part to develop lines of business that we believe to be promising but that may fall short of our expectations. Accordingly, 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 a smaller revenue base or affect our future competitiveness. Continued negative cash flow from operations could also require us to seek financing, which could prove dilutive to the interests of existing investors, or to divest certain aspects of our business, including through the sale of operating assets. The Company's independent registered public accounting firm has informed the Company that it may include in its report on the Company's financial statements for the year ending December 31, 2007 an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern if the Company fails to successfully fund its current operations.

*Our existing capital resources and credit availability may not be sufficient to pursue our business plan and our auditors have expressed doubt as to our ability to continue as a going concern. The failure to secure the necessary resources would require us to limit operations, which could have an adverse impact on our ability to develop our business as currently planned.*

On July 20, 2007, the Company raised \$5 million through a private placement of convertible notes and warrants with certain institutional shareholders. The Company may require additional cash to pursue its planned operations during the next 12 months. We cannot assure you that we will be successful in obtaining additional required capital. Any financing arrangements that we may enter into may increase future costs, involve restrictions on our financing and operating activities or be dilutive to existing stockholders. If we are unable to obtain additional financing as needed, which may include commercial or securitized debt, sales of equity securities or other alternatives, we may be required to reduce the scope of, or curtail, our operations. If our revenues fall short of, or our costs exceed, our expectations, any financing that we do secure may be inadequate to meet our cash requirements.

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

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

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 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

## **Table of Contents**

have taken significant measures to improve our financial reporting process and we believe that as of June 30, 2007, no material weaknesses remain to be remediated. As of December 31, 2006, our disclosure controls and procedures were effective, though there can be no assurances that future material weaknesses will be discovered. These measures are more fully described elsewhere in this Report, including under the caption Item 4 Controls and Procedures. 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. 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.

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

As part of our business strategy, we may consider acquisitions of, or significant investments in, businesses with services, products or technologies that we believe could complement or expand our business. Such acquisitions or investments involve numerous risks, including:

unanticipated costs and liabilities;

difficulty of integrating the operations, products and personnel of the acquired business;

difficulties in managing the financial and strategic position of acquired or developed products and technologies;

difficulties in maintaining customer relationships;

diversion of management's attention;

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

impairment of relationships with acquired employees and customers occurring as a result of integration of the acquired business; and

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

Acquisitions also frequently result in recording of goodwill and other intangible assets that are subject to potential impairments in the future. Additionally, if we finance acquisitions by using convertible debt or stock, our existing stockholders may be diluted which could affect the market price of our stock. If we fail to properly evaluate and execute acquisitions or investments, we may not achieve the anticipated additional benefit to our business, and we may incur costs in excess of what we anticipate.

We may also from time to time consider the divestiture or discontinuance of aspects of our business, which may involve many of the risks identified above, including significant internal adjustments and management distractions. Any such changes could require us to amortize fixed costs over a smaller revenue base and could require other changes that could consume resources and management attention. Additionally, we may fail to replace divested operations with new business opportunities that contribute to our financial health and strategic objectives. Failure to successfully implement acquisition or divestiture plans could damage the viability of our ongoing operations.

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

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

Historically, the largest contributor to our consolidated sales was from our OEM Remotes business segment. In late 2005, we deemphasized and reorganized certain segments of this market. As a result, OEM Remotes sales in these segments have declined. At the same time, we have devoted significant resources to the development of products and the support of marketing and sales efforts in new markets, such as our *MicroNav* family of products, the E-transactions market and selected aspects of the OEM Remotes market. We expect to continue to identify and develop products for new markets. These markets change rapidly and 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 growth and demand in new markets may cause us to suffer substantial losses or reduced earnings.

## **Table of Contents**

Our OEM Remotes business is focused on consumer markets that are intensely price competitive. If we cannot generate volume and related manufacturing efficiencies required to compete in these markets, our results of operations will be adversely affected.

Historically, our OEM Remotes business was primarily focused on selling remote devices in the presentation projector market. As a specialty market, this sector generated relatively low sales volumes with correspondingly high margins. However the presentation projector market has become more consumer-oriented and price competition has increased. We have shifted our OEM Remotes business toward sales to manufacturers of advanced viewing devices which is also very consumer oriented and price competitive but which offers the potential for higher volumes. If we cannot increase production and sales volume, or if we otherwise fail to achieve production efficiencies, our results of operations and financial position will be adversely affected.

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

Sales to OEMs in our OEM Remotes and Specialty Components markets constituted 53% of our total sales for 2006. If we fail to maintain, develop and expand our relationships with significant OEMs, or if those OEMs are not successful in their marketing and sales efforts, demand for our products may decrease. If our OEM customers experience a significant reduction in demand for advanced viewing devices, televisions or presentation systems, it will significantly decrease demand for our remote devices.

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.

### ***The loss of any significant customer or any cancellation, reduction or delay of a large purchase by a significant customer could reduce our revenue and require us to write down inventory.***

Our five largest OEM customers accounted for approximately 14% of our total 2006 sales. Although we have been deemphasizing segments of our OEM business, the loss of any key OEM customer, or a significant reduction in sales to any such customer, could significantly reduce our revenue below anticipated levels. OEM sales tend to be related to specific products offered by our OEM customers and therefore fluctuate significantly as such products are introduced and discontinued. From time to time, we expect to lose significant revenue streams as the result of OEM product discontinuances and will be required constantly to seek new opportunities with new and existing customers in those segments that we choose to pursue. Because our expense levels are based on our expectations as to future revenue and are, to a large extent, fixed in the short term, a substantial reduction or delay in sales of our products to an OEM customer, the unexpected loss of any significant OEM or other customer, or unexpected returns from customers, could harm our business.

### ***Failure to increase market awareness and acceptance of E-transactions and our E-transaction products may cause our revenues in this market to fall short of our expectations.***

We are focusing considerable resources on developing our E-transactions market. The prospects for growth of our E-transactions 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 E-transactions is new and emerging and we cannot be certain that it will continue to develop or grow or that businesses will elect to adopt our products rather than continuing 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 E-transactions or our e-transaction products. We expect that we will need to continue to pursue intensive marketing and sales efforts to educate prospective customers about the benefits of E-transactions and our E-transaction products. If market awareness and acceptance of E-transactions do not occur, our revenues and profitability in this market will fall short of our expectations.

### ***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 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 demanding market, signature capture device manufacturers could elect to upgrade their existing products in an effort to compete in our markets. Such competition could reduce margins or otherwise adversely affect our prospects in our E-transactions market.



## **Table of Contents**

***If we are unable to keep pace with rapid technological change and gain market acceptance of new products, we may not be able to compete effectively.***

Technology, both in our markets and in our customers' markets, is undergoing rapid change. In order to maintain our leadership position in our existing markets and to emerge as a leader in new markets, we will have to maintain a leadership position in the technologies supporting those markets. Doing so will require, among other things, that we accomplish the following:

accurately predict the evolving needs of our customers 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 wireless communication products must communicate using whatever communication protocol is chosen by the customer. Supporting a particular communication protocol requires specific technical expertise and we expect that we will be required to establish and maintain such expertise with respect to each commonly used communication protocol. New communication protocols are constantly under development and we may fail to acquire the necessary experience to support a popular new protocol or to respond to changes in an existing protocol. In our E-transactions business, our customers will expect that our products will 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 products do not support these requirements, sales of our E-transactions products would be adversely affected.

***If we fail to manage change successfully, our operations could be adversely impacted and our business could be impaired.***

The ability to operate our business in rapidly evolving markets requires an effective planning and management process. We expect that responding to changes in our business will place a significant strain on our personnel, management systems, infrastructure and other resources. Our ability to manage change effectively will require us to attract, train, motivate and manage new employees, to reallocate human and other resources to support new undertakings and to restructure our operations to manage a restructured business effectively. If we are unable to respond effectively to change, our operations could be adversely affected and our business could be impaired.

***Most of our OEM and major retail customers order from us on a just in time basis, which requires us to estimate demand for particular products, and many of these products are customer specific.***

The agreements or understandings that we reach with most of our OEM customers specify various terms such as product design and price, but do not constitute firm purchase orders for a specific number of products or components. Our OEM and major retail customers typically place firm purchase orders on a just in time basis and expect products or components to be shipped to them as soon as they can be made. Accordingly, our backlog of firm orders is typically quite small in relation to the volume of our sales. In anticipation of customer demand, we are often required to purchase raw materials and components based on estimates of customer demand derived from non-binding information furnished by the customer. If customer purchase orders differ substantially from our estimates, we may accumulate excess inventory that has to be written off. If we underestimate demand, we may be unable to meet customer needs, which could harm our relationship with the customer.

***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 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.



**Table of Contents**

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

We currently manufacture all of our 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.

All of our non-FSR product manufacturing is currently done 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.

***Performance, reliability or quality problems with our products may cause our customers to reduce or cancel orders which would harm our operating results.***

We regularly introduce new products with new technologies or manufacturing processes. Our products have in the past contained, and may in the future contain, errors or defects that may be detected at any point in the life of the product. Detection of such errors could result in delays in shipping and sales during the period required to correct such errors. Defects may also result in product returns, loss of sales and cancelled orders, delays in market acceptance, injury to our reputation, injury to customer relationships and increased warranty costs, which could have an adverse effect on our business, operating results and financial condition.

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

Our revenue from international sales accounted for approximately 45%, 55% and 60% of net sales for the years ended December 31, 2006, 2005 and 2004, respectively. We believe that international sales will represent a substantial portion of our sales for the foreseeable future. Our non-FSR manufacturing is currently performed in China. 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 recent 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**

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

Our markets are competitive and we expect competition in our newer markets to increase. Our competitors include companies with similar products or technologies, companies that sell complementary products to our target markets and our OEM customers themselves, who could choose to manufacture products that they currently buy from us. 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 our current and future competitors.

### ***Newly adopted environmental directives could increase our costs and/or require us to reserve against inventory.***

The Restriction on Hazardous Substances Directive ( ROHS ) went into effect in the European Union on July 1, 2006. ROHS limits the use of nine hazardous raw materials in the production of electronic and electrical goods that are sold in the European Union and certain other European countries. Many of these restricted materials are found in our products and in the components we have in our inventory. Many of our OEM customers have implemented ROHS restrictions and are requiring our products to be ROHS-compliant. 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.

A separate EU Directive, Waste Electrical and Electronic Equipment (the WEEE Directive ), become effective in January of 2007. Under the WEEE Directive, companies that put electrical and electronic equipment on the EU market must 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. In addition, some EU member states require recycling fees to be paid in advance to ensure funds are available for product recycling at the end of the product's useful life or de-installation. We have begun to mark our products as required by the WEEE Directive and are actively monitoring initial implementation of the WEEE Directive by the member states. In the case of our OEM products, compliance with WEEE is the responsibility of our customer; however, we would be responsible for compliance in the case of direct sales of our products in the EU. Compliance with the WEEE Directive may increase our costs and any failure to comply with the WEEE Directive for which we are responsible could lead to monetary penalties.

### ***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 them, we could be forced to incur substantial litigation expenses, and if we were found to be infringing on someone else's patent, we could be required to pay substantial damages, pay royalties in the future or be enjoined from infringing in the future.

### ***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. 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**

***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. The costs that we are required to incur have recently increased dramatically, especially in connection with our reporting obligations under Section 404 of the Sarbanes-Oxley Act of 2002, and these expenses may continue to be incurred at historically unprecedented levels for the foreseeable future. These costs impact our profitability and therefore constitute a competitive disadvantage vis-à-vis much of our competition. These requirements may also prevent our management from focusing on other areas of our business. In addition, our public status requires us to disclose publicly information that can afford a competitor a competitive 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.

***Our ability to operate effectively could be impaired if we were to lose the services of key personnel, or if we are unable to recruit qualified managers and key personnel in the future.***

Our success is substantially dependent on the continued availability of our key management and technical personnel. Several of our key management personnel have been with us throughout most of our history and have substantial experience with our business and technology. If one or more of our key management personnel leaves Interlink and we are unable to find a replacement with the combination of skills and attributes necessary to execute our business plan, it may have an adverse impact on our business. Our success will also depend, in part, on our ability to attract and retain additional qualified professional, technical, production, managerial and marketing personnel, both domestically and internationally.

**Table of Contents**

**Item 6. Exhibits**

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

- 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 3.2 to the Registrant's Current Report on Form 8-K dated October 10, 2006).
- 10.1\* 1996 Stock Incentive Plan, as amended (incorporated by reference to Exhibit 10.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 10.2\* Form of Incentive Stock Option Agreement (incorporated by reference to Exhibit 10.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.3\* Form of Non-Statutory Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.4 Lease Agreement dated August 15, 1998 to lease premises in Camarillo, California (incorporated by reference to Exhibit 10.8 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1998), as amended by the First Amendment to Lease dated July 23, 2003 between Mobile Park Investment, Inc. and the Registrant, as amended by the Second Amendment to Lease dated January 23, 2004 between Mobile Park Investment, Inc. and the Registrant (incorporated by reference to Exhibit 10.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003), as amended by the Third Amendment to Lease dated October 14, 2004 between Mobile Park Investment, Inc. and the Registrant (incorporated by reference to Exhibit 10.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004), as amended by the Fourth Amendment to Lease dated March 24, 2005 between Mobile Park Investment, Inc. and the Registrant.
- 10.5 Pledge Agreement between Paul D. Meyer and the Registrant dated May 1, 2001 (incorporated by reference to Exhibit 10.16 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.6 Secured Promissory Note of Paul D. Meyer, as Borrower, in the amount of \$42,892 dated as of May 1, 2001, in favor of the Registrant (incorporated by reference to Exhibit 10.21 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.7 First Amendment to Secured Promissory Note dated June 11, 2002 between the Registrant Paul D. Meyer (incorporated by reference to Exhibit 10.23 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.8 Pledge Agreement between Paul D. Meyer and the Registrant dated June 11, 2001 (incorporated by reference to Exhibit 10.25 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.9 Secured Promissory Note of Paul D. Meyer, as Borrower, in the amount of \$132,109 dated as of June 11, 2001, in favor of the Registrant (incorporated by reference to Exhibit 10.28 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.10 First Amendment to Secured Promissory Note dated June 11, 2002 between the Registrant, E. Paul D. Meyer (incorporated by reference to Exhibit 10.30 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.11 Form of Purchase Agreement (incorporated by reference to Exhibit 10.11 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.12 Form of 8% Convertible Note (incorporated by reference to Exhibit 10.12 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.13 Form of Warrant (incorporated by reference to Exhibit 10.13 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.14 Form of Registration Rights Agreement (incorporated by reference to Exhibit 10.14 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.15 Loan and Security Agreement, dated December 19, 2006, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.15 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).



**Table of Contents**

- 10.16 First Amendment to Loan and Security Agreement, dated April 6, 2007, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.16 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 10.17 Second Amendment to Loan and Security Agreement, dated July 18, 2007, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.17 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 23.1 Consent of BDO Seidman, LLP (incorporated by reference to Exhibit 23.1 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 24.1 Power of Attorney (see signature page).
- 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.

---

\* Management contract or compensatory plan or arrangement



**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 14, 2007

/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:

- 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 3.2 to the Registrant's Current Report on Form 8-K dated October 10, 2006).
- 10.1\* 1996 Stock Incentive Plan, as amended (incorporated by reference to Exhibit 10.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 10.2\* Form of Incentive Stock Option Agreement (incorporated by reference to Exhibit 10.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.3\* Form of Non-Statutory Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004).
- 10.4 Lease Agreement dated August 15, 1998 to lease premises in Camarillo, California (incorporated by reference to Exhibit 10.8 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1998), as amended by the First Amendment to Lease dated July 23, 2003 between Mobile Park Investment, Inc. and the Registrant, as amended by the Second Amendment to Lease dated January 23, 2004 between Mobile Park Investment, Inc. and the Registrant (incorporated by reference to Exhibit 10.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003), as amended by the Third Amendment to Lease dated October 14, 2004 between Mobile Park Investment, Inc. and the Registrant (incorporated by reference to Exhibit 10.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004), as amended by the Fourth Amendment to Lease dated March 24, 2005 between Mobile Park Investment, Inc. and the Registrant.
- 10.5 Pledge Agreement between Paul D. Meyer and the Registrant dated May 1, 2001 (incorporated by reference to Exhibit 10.16 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.6 Secured Promissory Note of Paul D. Meyer, as Borrower, in the amount of \$42,892 dated as of May 1, 2001, in favor of the Registrant (incorporated by reference to Exhibit 10.21 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.7 First Amendment to Secured Promissory Note dated June 11, 2002 between the Registrant Paul D. Meyer (incorporated by reference to Exhibit 10.23 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.8 Pledge Agreement between Paul D. Meyer and the Registrant dated June 11, 2001 (incorporated by reference to Exhibit 10.25 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.9 Secured Promissory Note of Paul D. Meyer, as Borrower, in the amount of \$132,109 dated as of June 11, 2001, in favor of the Registrant (incorporated by reference to Exhibit 10.28 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.10 First Amendment to Secured Promissory Note dated June 11, 2002 between the Registrant, E. Paul D. Meyer (incorporated by reference to Exhibit 10.30 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 10.11 Form of Purchase Agreement (incorporated by reference to Exhibit 10.11 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.12 Form of 8% Convertible Note (incorporated by reference to Exhibit 10.12 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.13 Form of Warrant (incorporated by reference to Exhibit 10.13 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.14 Form of Registration Rights Agreement (incorporated by reference to Exhibit 10.14 to the Registrant's Current Report on Form 8-K dated July 23, 2007).
- 10.15 Loan and Security Agreement, dated December 19, 2006, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.15 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).



**Table of Contents**

- 10.16 First Amendment to Loan and Security Agreement, dated April 6, 2007, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.16 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 10.17 Second Amendment to Loan and Security Agreement, dated July 18, 2007, by and between Interlink Electronics, Inc. and Silicon Valley Bank (incorporated by reference to Exhibit 10.17 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 23.1 Consent of BDO Seidman, LLP (incorporated by reference to Exhibit 23.1 to the Registrant's Registration Statement on Form S-1 filed with the SEC on August 13, 2007).
- 24.1 Power of Attorney (see signature page).
- 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.

---

\* Management contract or compensatory plan or arrangement