

DATA I/O CORP  
Form 10-Q  
August 10, 2012

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

**FORM 10-Q**

(Mark One)  
(X)

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

For the quarterly period ended **June 30, 2012**

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 number: **0-10394**

**DATA I/O CORPORATION**

(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of incorporation or  
organization)

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

**6464 185<sup>th</sup> Ave NE, Suite 101, Redmond, Washington, 98052**

(Address of principal executive offices, including zip code)

**(425) 881-6444**

(Registrant's telephone number, including area code)

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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

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

Shares of Common Stock, no par value, outstanding as of July 30, 2012:

7,738,114

**DATA I/O CORPORATION**  
**FORM 10-Q**  
**For the Quarter Ended June 30, 2012**

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

**DATA I/O CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

|                                                                                        | (unaudited)<br>June 30,<br>2012 | December 31,<br>2011 |
|----------------------------------------------------------------------------------------|---------------------------------|----------------------|
| <b>ASSETS</b>                                                                          |                                 |                      |
| <b>CURRENT ASSETS:</b>                                                                 |                                 |                      |
| Cash and cash equivalents                                                              | \$11,031                        | \$18,120             |
| Trade accounts receivable, net of allowance for<br>doubtful accounts of \$89 and \$115 | 3,639                           | 4,351                |
| Inventories                                                                            | 4,635                           | 3,964                |
| Other current assets                                                                   | 397                             | 543                  |
| <b>TOTAL CURRENT ASSETS</b>                                                            | <b>19,702</b>                   | <b>26,978</b>        |
| Property, plant and equipment – net                                                    | 1,255                           | 1,489                |
| Intangible software technology – net                                                   | 2,572                           | 2,793                |
| Other assets                                                                           | 84                              | 85                   |
| <b>TOTAL ASSETS</b>                                                                    | <b>\$23,613</b>                 | <b>\$31,345</b>      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                            |                                 |                      |
| <b>CURRENT LIABILITIES:</b>                                                            |                                 |                      |
| Accounts payable                                                                       | \$946                           | \$1,122              |
| Accrued compensation                                                                   | 1,317                           | 1,255                |
| Deferred revenue                                                                       | 1,413                           | 1,464                |
| Other accrued liabilities                                                              | 698                             | 710                  |
| Income taxes payable                                                                   | 63                              | 72                   |
| <b>TOTAL CURRENT LIABILITIES</b>                                                       | <b>4,437</b>                    | <b>4,623</b>         |
| Long-term other payables                                                               | 242                             | 253                  |
| <b>COMMITMENTS</b>                                                                     |                                 |                      |
| <b>STOCKHOLDERS' EQUITY</b>                                                            |                                 |                      |
| Preferred stock -                                                                      |                                 |                      |
| Authorized, 5,000,000 shares, including<br>200,000 shares of Series A Junior           |                                 |                      |
| Participating                                                                          |                                 |                      |

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|                                                        |          |          |
|--------------------------------------------------------|----------|----------|
| Issued and outstanding, none                           | -        | -        |
| Common stock, at stated value -                        |          |          |
| Authorized, 30,000,000 shares                          |          |          |
| Issued and outstanding, 7,738,114 shares as of June 30 |          |          |
| 2012 and 9,207,730 shares as of December 31, 2011      | 17,674   | 23,414   |
| Accumulated earnings                                   | 228      | 1,963    |
| Accumulated other comprehensive income                 | 1,032    | 1,092    |
| TOTAL STOCKHOLDERS' EQUITY                             | 18,934   | 26,469   |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY             | \$23,613 | \$31,345 |

*See notes to consolidated financial statements*

**DATA I/O CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)  
**(UNAUDITED)**

|                                          | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|------------------------------------------|----------------------------------------|-------------|--------------------------------------|-------------|
|                                          | <b>2012</b>                            | <b>2011</b> | <b>2012</b>                          | <b>2011</b> |
| Net Sales                                | \$5,360                                | \$6,849     | \$9,039                              | \$13,892    |
| Cost of goods sold                       | 2,419                                  | 2,841       | 4,157                                | 5,720       |
| Gross margin                             | 2,941                                  | 4,008       | 4,882                                | 8,172       |
| Operating expenses:                      |                                        |             |                                      |             |
| Research and development                 | 1,427                                  | 1,276       | 2,819                                | 2,627       |
| Selling, general and administrative      | 1,996                                  | 2,215       | 4,245                                | 4,388       |
| Total operating expenses                 | 3,423                                  | 3,491       | 7,064                                | 7,015       |
| Operating income(loss)                   | (482)                                  | 517         | (2,182)                              | 1,157       |
| Non-operating income (expense):          |                                        |             |                                      |             |
| Interest income                          | 174                                    | 19          | 207                                  | 32          |
| Interest expense                         | -                                      | (1)         | -                                    | (2)         |
| Foreign currency transaction gain (loss) | (45)                                   | (32)        | (36)                                 | (66)        |
| Total non-operating income (expense)     | 129                                    | (14)        | 171                                  | (36)        |
| Income (loss) before income taxes        | (353)                                  | 503         | (2,011)                              | 1,121       |
| Income tax (expense) benefit             | 296                                    | (105)       | 276                                  | (191)       |
| Net income(loss)                         | (\$57)                                 | \$398       | (\$1,735)                            | \$930       |
|                                          |                                        |             |                                      |             |
| Basic earnings per share                 | (\$0.01)                               | \$0.04      | (\$0.21)                             | \$0.10      |
| Diluted earnings per share               | (\$0.01)                               | \$0.04      | (\$0.21)                             | \$0.10      |
| Weighted-average basic shares            | 7,734                                  | 9,176       | 8,250                                | 9,103       |
| Weighted-average diluted shares          | 7,734                                  | 9,343       | 8,250                                | 9,289       |

*See notes to consolidated financial statements*

**DATA I/O CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(in thousands)  
**(UNAUDITED)**

|                                          | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|------------------------------------------|----------------------------------------|-------------|--------------------------------------|-------------|
|                                          | <b>2012</b>                            | <b>2011</b> | <b>2012</b>                          | <b>2011</b> |
| Net Income (loss)                        | (\$57)                                 | \$398       | (\$1,735)                            | \$930       |
| Other comprehensive income:              |                                        |             |                                      |             |
| Foreign currency translation gain (loss) | (163)                                  | 128         | (60)                                 | 327         |
| Comprehensive income (loss)              | (\$220)                                | \$526       | (\$1,795)                            | \$1,257     |

*See notes to consolidated financial statements*

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

|                                                                                                       | Six Months Ended<br>June 30, |          |
|-------------------------------------------------------------------------------------------------------|------------------------------|----------|
|                                                                                                       | 2012                         | 2011     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                                          |                              |          |
| Net income (loss)                                                                                     | (\$1,735)                    | \$930    |
| Adjustments to reconcile net income (loss)<br>to net cash provided by (used in) operating activities: |                              |          |
| Depreciation and amortization                                                                         | 649                          | 573      |
| Equipment transferred to cost of goods sold                                                           | 185                          | 83       |
| Share-based compensation                                                                              | 281                          | 210      |
| Net change in:                                                                                        |                              |          |
| Trade accounts receivable                                                                             | 683                          | (182)    |
| Inventories                                                                                           | (681)                        | (313)    |
| Other current assets                                                                                  | 143                          | 73       |
| Accounts payable and accrued liabilities                                                              | (126)                        | (779)    |
| Deferred revenue                                                                                      | (71)                         | (222)    |
| Other long-term liabilities                                                                           | 20                           | 189      |
| Deposits and other long-term assets                                                                   | (1)                          | 59       |
| Net cash provided by (used in) operating activities                                                   | (653)                        | 621      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                                          |                              |          |
| Additions to property, plant and equipment                                                            | (378)                        | (596)    |
| Purchase of software technology                                                                       | -                            | (2,089)  |
| Cash provided by (used in) investing activities                                                       | (378)                        | (2,685)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                                          |                              |          |
| Proceeds from issuance of common stock                                                                | 6                            | 5        |
| Repurchase of common stock                                                                            | (6,026)                      | -        |
| Payment of capital lease obligation                                                                   | -                            | (69)     |
| Cash provided by (used in) financing activities                                                       | (6,020)                      | (64)     |
| Decrease in cash and cash equivalents                                                                 | (7,051)                      | (2,128)  |
| Effects of exchange rate changes on cash                                                              | (38)                         | 176      |
| Cash and cash equivalents at beginning of period                                                      | 18,120                       | 18,942   |
| Cash and cash equivalents at end of period                                                            | \$11,031                     | \$16,990 |
| <b>Supplemental disclosure of non-cash financing activities:</b>                                      |                              |          |
| Issuance of common stock for consideration in asset purchase<br>163,934 shares                        | \$ -                         | \$ 1,000 |

*See notes to consolidated financial statements*



**DATA I/O CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**NOTE 1 - FINANCIAL STATEMENT PREPARATION**

Data I/O prepared the financial statements as of June 30, 2012 and June 30, 2011 according to the rules and regulations of the Securities and Exchange Commission ("SEC"). These statements are unaudited but, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the results for the periods presented. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date. We have condensed or omitted certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America according to such SEC rules and regulations. Operating results for the three months and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These financial statements should be read in conjunction with the annual audited financial statements and the accompanying notes included in the Company's Form 10-K for the year ended December 31, 2011.

Revenue Recognition

Data I/O generally recognizes revenue at the time products are shipped. We have determined that our programming equipment has reached a point of maturity and stability such that product acceptance can be assured by testing at the factory prior to shipment and that the installation meets the criteria to be considered a separate element. These systems are standard products with published product specifications and are configurable with standard options. The evidence that these systems could be deemed as accepted was based upon having standardized factory production of the units, results from batteries of tests of product performance to our published specifications, quality inspections and installation standardization, as well as past product operation validation with the customer and the history provided by our installed base of products upon which the current versions were based.

The amount of revenue recognized is affected by our judgments as to the collectability of the transaction, the existence of an acceptance clause or whether an arrangement includes multiple elements and if so, whether specific objective evidence of selling price exists for those elements. Allocation between multiple elements is done based on objective evidence of selling price based on a selling price hierarchy, including discounts.

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

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

We recognize revenue when the price is fixed or determinable, the buyer has paid or is obligated to pay and the obligation is not contingent on resale of the product, the buyer's obligation would not be changed in the event of theft, physical destruction or damage to the product, the buyer acquiring the product for resale has economic substance apart from Data I/O and we do not have significant obligations for future performance to directly bring about the resale of the product by the buyer.

When we sell software separately, we recognize software revenue upon shipment provided that no significant obligations remain on our part, substantive acceptance conditions, if any, have been met and when the fee is fixed and determinable and when collection is deemed probable.

Certain fixed-price engineering services contracts that require significant production, modification, or customization of software, are accounted for using the percentage-of-completion method. We use the percentage-of-completion method of accounting because it is the most accurate method to recognize revenue based on the nature and scope of certain of our fixed-price engineering services contracts. It is a better measure of periodic income results than other methods and it better matches revenue recognized with the cost incurred. Percentage-of-completion is measured based primarily on input measures such as hours incurred to date compared to estimated total hours at completion, with consideration given to output measures, such as contract milestones, when applicable.

Significant judgment is required when estimating total hours and progress to completion on these arrangements which determines the amount of revenue we recognize as well as whether a loss is recognized if expected to be incurred upon project completion. Revisions to hour and cost estimates are incorporated in the period the amounts are recognized if the results of the period have not been reported; otherwise, the revision of estimates are recognized in the period in which the facts that give rise to the revision become known.

Data I/O transfers certain products out of service from their internal use and makes them available for sale. The products transferred are our standard products in one of the following areas: service loaners, rental or test units; engineering test units; or sales demonstration equipment. Once transferred, the equipment is sold by our regular sales channels as used equipment inventory. These product units often involve refurbishing and an equipment warranty, and are conducted as sales in our normal and ordinary course of business. The transfer amount is the product unit's net book value and the sale transaction is accounted for as revenue and cost of goods sold.

#### Stock-Based Compensation Expense

Data I/O measures and recognizes compensation expense as required for all share-based payment awards, including employee stock options and restricted stock awards, based on estimated fair values on the grant dates. Total share-based compensation for the three and six months ended June 30, 2012 was \$150,121 and \$281,475 respectively. Total shared based compensation for the three and six months ended June 30, 2011 was \$122,788 and \$209,900 respectively.

#### Income Tax

Historically when accounting for uncertainty in income taxes, Data I/O has not incurred any interest or penalties associated with tax matters and no interest or penalties were recognized during the three and six months ended June 30, 2012. However, the Company has adopted a policy whereby amounts related to penalties associated with tax matters are classified as general and administrative expense when incurred and amounts related to interest associated with tax matters are classified as interest income or interest expense.

Data I/O has incurred net operating losses in certain past years. We continue to maintain a valuation allowance for the full amount of the net deferred tax asset balance associated with our net operating losses and credit carryforwards, as sufficient uncertainty exists regarding our ability to realize such tax assets in the future. There was \$117,000 unrecognized tax benefits related to uncertain tax positions and related valuation allowance as of June 30, 2012.

Tax years that remain open for examination include 2008, 2009, 2010 and 2011 in the United States of America. In addition, tax years from 2000 to 2007 may be subject to examination in the event that the Company utilizes the net

operating losses and credit carryforwards from those years in its current or future year tax returns.

#### Recent Accounting Pronouncements

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (“ASU 2011-05”). This ASU amends requirements for the presentation of other comprehensive income (OCI), requiring presentation of comprehensive income in either, a single, continuous statement of comprehensive income or on separate but consecutive statements, the statement of operations and the statement of OCI. We have adopted this amendment effective for the year ended December 31, 2011. The adoption of this guidance did not impact our financial position, results of operations or cash flows and only impacts the presentation of OCI on the financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and International Reporting Standards* (“ASU No. 2011-04”) which amended the guidance regarding fair value measurement and disclosure. The amended guidance clarifies the application of existing fair value measurement and disclosure requirements. The amendment was effective for us at the beginning of January 2012, with early adoption prohibited. The adoption of this amendment did not materially affect our financial statements.

**NOTE 2 – INVENTORIES**

Inventories consisted of the following components:

|                 | June 30,<br>2012 | December 31,<br>2011 |
|-----------------|------------------|----------------------|
| (in thousands)  |                  |                      |
| Raw material    | \$2,602          | \$2,498              |
| Work-in-process | 1,321            | 985                  |
| Finished goods  | 712              | 481                  |
| Inventories     | \$4,635          | \$3,964              |

**NOTE 3 – PROPERTY, PLANT AND EQUIPMENT, NET**

Property and equipment consisted of the following components:

|                               | June 30,<br>2012 | December 31,<br>2011 |
|-------------------------------|------------------|----------------------|
| (in thousands)                |                  |                      |
| Leasehold improvements        | \$478            | \$479                |
| Equipment                     | 7,536            | 7,515                |
|                               | 8,014            | 7,994                |
| Less accumulated depreciation | 6,759            | 6,505                |
| Property and equipment, net   | \$1,255          | \$1,489              |

**NOTE 4 – INTANGIBLE SOFTWARE TECHNOLOGY, NET**

On April 29, 2011, Data I/O purchased software technology for \$2 million in cash and issuance of 163,934 shares of Data I/O common stock, valued at \$1 million on the date of purchase. Acquisition costs of \$89,000 were capitalized as part of the transaction. The transaction was accounted for as an asset purchase.

For a period of five years, Data I/O will pay the seller royalties of 4% of directly associated revenues relating to this acquired software technology. We will expense the royalty payments when they are incurred as we could not reasonably estimate the future royalty payment amount at the time of acquisition. For the first three years, Data I/O will pay an additional royalty of 2.5% of directly associated revenues relating to this acquired software technology to the original developer of the technology. No royalty expense has been recognized since the acquisition date.

The following is a summary of the Company's intangible software technology:

|                                     | June 30,<br>2012 | December 31,<br>2011 |
|-------------------------------------|------------------|----------------------|
| (in thousands)                      |                  |                      |
| Intangible software technology      | \$3,089          | \$3,089              |
| Less accumulated amortization       | 517              | 296                  |
| Intangible software technology, net | \$2,572          | \$2,793              |

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Future amortization expense related to this intangible asset is as follows:

|                  | Amortization |
|------------------|--------------|
| (in thousands)   |              |
| 2012 (remaining) | \$219        |
| 2013             | 438          |
| 2014             | 438          |
| 2015             | 438          |
| 2016             | 438          |
| Thereafter       | 601          |
| Total            | \$2,572      |

**NOTE 5 – OTHER ACCRUED LIABILITIES**

Other accrued liabilities consisted of the following components:

|                           | June 30,<br>2012 | December 31,<br>2011 |
|---------------------------|------------------|----------------------|
| (in thousands)            |                  |                      |
| Product warranty          | \$316            | \$396                |
| Sales return reserve      | 70               | 81                   |
| Other taxes               | 188              | 100                  |
| Other                     | 124              | 133                  |
| Other accrued liabilities | \$698            | \$710                |

The changes in Data I/O's product warranty liability for the six months ending June 30, 2012 are as follows:

|                              | June 30,<br>2012 |
|------------------------------|------------------|
| (in thousands)               |                  |
| Liability, beginning balance | \$396            |
| Net expenses                 | 350              |
| Warranty claims              | (350)            |
| Accrual revisions            | (80)             |
| Liability, ending balance    | \$316            |

**NOTE 6 – OPERATING LEASE COMMITMENTS**

Data I/O has commitments under non-cancelable operating leases and other agreements, primarily for factory and office space, with initial or remaining terms of one year or more as follows:

For the years ending December 31:

|                  | Operating<br>Leases |
|------------------|---------------------|
| (in thousands)   |                     |
| 2012 (remaining) | \$569               |
| 2013             | 972                 |
| 2014             | 848                 |
| 2015             | 800                 |
| 2016             | 505                 |
| Thereafter       | -                   |
| Total            | \$3,694             |

**NOTE 7 – OTHER COMMITMENTS**

Data I/O has purchase obligations for inventory and production costs as well as other obligations such as capital expenditures, service contracts, marketing, and development agreements. Arrangements are considered purchase obligations if a contract specifies all significant terms, including fixed or minimum quantities to be purchased, a pricing structure and approximate timing of the transaction. Most arrangements are cancelable without a significant

penalty, and with short notice, typically less than 90 days. At June 30, 2012, the purchase and other obligations totaled \$911,000 of which all but \$4,000 are 2012 commitments.

#### **NOTE 8 – CONTINGENCIES**

As of June 30, 2012, Data I/O was not a party to any legal proceedings, the adverse outcome of which in management's opinion, individually or in the aggregate, would have a material adverse effect on our results of operations or financial position.

**Indemnification Arrangements:** We may, from time to time in the ordinary course of our business enter into contractual arrangements with third parties that include indemnification obligations. Under these contractual arrangements, we have agreed to defend, indemnify and/or hold the third party harmless from and against certain liabilities. These arrangements include indemnities in favor of customers in the event that our programming system products infringe a third party's intellectual property and indemnities in favor of our lessors in connection with facility leasehold liabilities that we may cause. In addition, we have entered into indemnification agreements with our directors and certain of our officers, and our bylaws contain indemnification obligations in favor of our directors, officers and agents. These indemnity arrangements may limit the type of the claim, the total amount that we can be required to be paid in connection with the indemnification obligation and the time within which an indemnification claim can be made. The duration of the indemnification obligation may vary, and for most arrangements, survives the agreement term and is indefinite. We believe that substantially all of our indemnity arrangements provide either for limitations on the maximum potential future payments we could be obligated to make, or for limitations on the types of claims and damages we could be obligated to indemnify, or both. However, it is not possible to determine or reasonably estimate the maximum potential amount of future payments under these indemnification obligations due to the varying terms of such obligations, a lack of history of prior indemnification claims, the unique facts and circumstances involved in each particular contractual arrangement and in each potential future claim for indemnification, and the contingency of any potential liabilities upon the occurrence of events that are not reasonably determinable. We have not had any requests for indemnification under these arrangements. Our management believes that any liability for these indemnity arrangements would not be material to our accompanying consolidated financial statements. We have not recorded any liabilities for these indemnification arrangements on our consolidated balance sheet as of June 30, 2012.

## NOTE 9 – EARNINGS PER SHARE

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

The following table sets forth the computation of basic and diluted earnings per share:

|                                                     | Three Months Ended |                  | Six Months Ended |                  |
|-----------------------------------------------------|--------------------|------------------|------------------|------------------|
|                                                     | June 30,<br>2012   | June 30,<br>2011 | June 30,<br>2012 | June 30,<br>2011 |
| (in thousands except per share data)                |                    |                  |                  |                  |
| Numerator for basic and diluted earnings per share: |                    |                  |                  |                  |
| Net income (loss)                                   | (\$57)             | \$398            | (\$1,735)        | \$930            |
| Denominator for basic earnings per share-           |                    |                  |                  |                  |

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|                                                                                                                                       |          |        |          |        |
|---------------------------------------------------------------------------------------------------------------------------------------|----------|--------|----------|--------|
| weighted-average shares                                                                                                               | 7,734    | 9,176  | 8,250    | 9,103  |
| Employee stock options and awards                                                                                                     | -        | 167    | -        | 186    |
| Denominator for diluted earnings per share-<br>adjusted weighted-average shares<br>and<br>assumed conversions of stock<br><br>options | 7,734    | 9,343  | 8,250    | 9,289  |
| Basic and diluted earnings per share:                                                                                                 |          |        |          |        |
| Total basic earnings per share                                                                                                        | (\$0.01) | \$0.04 | (\$0.21) | \$0.10 |
| Total diluted earnings per share                                                                                                      | (\$0.01) | \$0.04 | (\$0.21) | \$0.10 |

The computation for the three and six months ended June 30, 2012 excludes 1,086,892 and 905,571 options, respectively, to purchase common stock as their effect is anti-dilutive. The computation for the three and six months ended June 30, 2011 excludes 310,209 and 223,362 options, respectively, to purchase common stock as their effect is anti-dilutive.

**NOTE 10 – SHARE-BASED COMPENSATION**

For share-based awards granted, we have recognized compensation expense based on the estimated grant date fair value method. For these awards we have recognized compensation expense using a straight-line amortization method and reduced for estimated forfeitures.

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The impact on our results of operations of recording share-based compensation for the three and six months ended June 30, 2012 and June 30, 2011, respectively, was as follows:

|                                     | Three Months Ended |                  | Six Months Ended |                  |
|-------------------------------------|--------------------|------------------|------------------|------------------|
|                                     | June 30,<br>2012   | June 30,<br>2011 | June 30,<br>2012 | June 30,<br>2011 |
| (in thousands)                      |                    |                  |                  |                  |
| Cost of goods sold                  | \$15               | \$12             | \$26             | \$21             |
| Research and development            | 34                 | 23               | 60               | 32               |
| Selling, general and administrative | 101                | 88               | 195              | 157              |
| Total share-based compensation      | \$150              | \$123            | \$281            | \$210            |
| Impact on net income per share:     |                    |                  |                  |                  |
| Basic and diluted                   | (\$0.02)           | (\$0.01)         | (\$0.03)         | (\$0.02)         |

The fair value of share-based awards for employee stock options was estimated using the Black-Scholes valuation model. The following weighted average assumptions were used to calculate the fair value of stock options granted during the three months and six months ended June 30, 2012 and 2011:

|                                      | Three Months Ended |                  | Six Months Ended |                  |
|--------------------------------------|--------------------|------------------|------------------|------------------|
|                                      | June 30,<br>2012   | June 30,<br>2011 | June 30,<br>2012 | June 30,<br>2011 |
| Risk-free interest rates             | 0.61%              | 1.41%            | 0.62%            | 1.40%            |
| Volatility factors                   | 0.53               | 0.55             | 0.53             | 0.55             |
| Expected life of the option in years | 4.00               | 4.00             | 4.00             | 4.00             |
| Expected dividend yield              | None               | None             | None             | None             |

Option grants during the three and six months ended June 30, 2012 was 175,000 and 190,000 respectively. Option grants during the three and six months ended June 30, 2011 was 0 and 322,000 respectively.

At June 30, 2012, there remained approximately \$1,182,586 of unamortized expected future compensation expense associated with unvested option grants and restricted stock awards, with a remaining weighted average amortization period of 2.59 years.

### NOTE 11- SHARE REPURCHASE PROGRAMS

On October 20, 2011, we announced a stock repurchase program to buy back up to \$1 million dollars of stock over four quarters. Through December 31, 2011, Data I/O repurchased 62,916 shares of stock at an average price of \$3.97 for a total repurchase amount of \$249,986 plus \$2,551 in commissions. For the quarter ended March 31, 2012 an additional 10,581 shares were repurchased under this plan at an average price of \$3.90 for a total repurchase amount

of \$41,274 plus \$432 in commissions. Since this program began, we have repurchased 73,497 shares of stock at an average price of \$3.96 for a total of \$291,260 plus \$2,983 in commissions. On January 13, 2012, this stock repurchase program was terminated.

On January 9, 2012, our board of directors approved a new and expanded 2012 share repurchase program with provisions to buy back up to \$6 million dollars of stock. The program included establishing a Rule 10b5-1 plan under the Exchange Act to provide flexibility to make purchases at any time. The 10b5-1 trading plan allows us to repurchase our common stock in the open market during periods in which stock trading is otherwise closed for us. For the quarter ended March 31, 2012, 1,472,208 shares of stock have been repurchased at an average price of \$4.03 for a total of \$5,927,937 plus \$56,938 in commissions, completing the program.

There has been no further share repurchase program activity during the quarter ended June 30, 2012.

The following is a summary of share repurchase activity under both plans through June 30, 2012:

|                                                    | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Repurchase<br>Program | Approximate<br>Dollar Value<br>of Shares that<br>May Yet Be<br>Purchased<br>under the<br>Program |
|----------------------------------------------------|-------------------------------------------|------------------------------------|-----------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|
| <u>\$1 million program dated October 20, 2011:</u> |                                           |                                    |                                                                                                     |                                                                                                  |
| November 2011                                      | 32,068                                    | \$3.88                             | 32,068                                                                                              | \$874,328                                                                                        |
| December 2011                                      | 30,848                                    | \$4.07                             | 30,848                                                                                              | \$747,463                                                                                        |
| January 2012                                       | 10,581                                    | \$3.90                             | 10,581                                                                                              | \$0(1)                                                                                           |
| <u>\$6 million program dated January 9, 2012:</u>  |                                           |                                    |                                                                                                     |                                                                                                  |
| January 2012                                       | 171,832                                   | \$4.18                             | 171,832                                                                                             | \$5,274,294                                                                                      |
| February 2012                                      | 243,862                                   | \$4.25                             | 243,862                                                                                             | \$4,228,920                                                                                      |
| March 2012                                         | 1,056,514                                 | \$3.95                             | 1,056,514                                                                                           | \$0(2)                                                                                           |
| Total                                              | 1,545,705                                 | \$4.02                             | 1,545,705                                                                                           |                                                                                                  |

(1) Program terminated January 13, 2012

(2) Program terminated March 26, 2012

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

**General**

**Forward-Looking Statements**

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. This Act provides a “safe harbor” for forward-looking statements to encourage companies to provide prospective information about themselves as long as they identify these statements as forward-looking and provide meaningful cautionary statements identifying important factors that could cause actual results to differ from the projected results. All statements other than statements of historical fact made in this Quarterly Report on Form 10-Q are forward-looking. In particular, statements herein regarding industry prospects or trends; expected revenues; expected level of expense; future results of operations, restructuring implications; breakeven point, or financial position; changes in gross margin; economic conditions and capital spending outlook; market acceptance of our newly introduced or upgraded products; the impact and integration of acquisitions; development, introduction and shipment of new products; and any other guidance on future periods are forward-looking statements. Forward-looking statements reflect management’s current expectations and are inherently uncertain. Although Data I/O believes that the expectations reflected in these forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, achievements, or other future events. Moreover, neither Data I/O nor anyone else assumes responsibility for the accuracy and completeness of these forward-looking statements. Data I/O is under no duty to update any of these forward-looking statements after the date of this report. The reader should not place undue reliance on these forward-looking statements. The discussions above and in the section in Item 1A., Risk Factors “Cautionary Factors That May Affect Future Results” in the Company’s Annual report on Form 10-K for the year ended December 31, 2011 describe some, but not all, of the factors that could cause these differences.

**OVERVIEW**

Starting during the second half of 2011 and continuing during the first half of 2012, we experienced a decrease in customer demand. We believe the decline in orders and revenue is due primarily to overcapacity in the installed base of programming equipment causing reduced capital spending. We believe the underlying decrease in demand is due to a downturn in Asia-based electronics manufacturing caused in part by the economic uncertainty related to the European sovereign debt situation. We continued to focus on our primary goal of profitably managing the business, while developing, launching and enhancing products to drive revenue and return to profitability.

Our challenge continues to be operating in a cyclical and rapidly evolving industry environment. Although our solutions address the growing flash and microcontroller markets and the resulting need for programming, our opportunity to experience significant growth occurs when there is increased capacity needed to address the

combination of growing file sizes and the growth in the flash and microcontroller markets. However, we compete for this capacity growth against alternative methods of loading data, such as programming after placement, or the increased efficiency of the installed base of equipment, which has and continues to constrain the programming equipment market. Additional factors impacting demand for our solutions other than capacity, include quality, process, technology and integration. We are continuing our efforts to balance market forces, business geography shifts, increasing costs and strategic investments in our business with the level of demand and mix of business we expect.

We continue to focus on extending the capabilities and support for our FlashCORE architecture, and the RoadRunner, FLX, PS and FlashPAK product lines. Our applications innovation strategy provides complete solutions to target customer's business problems. These solutions generally have a larger software element, may involve third-party components, and in many cases will be developed or customized to address the specific requirements of individual customers. We believe by adding these features to our strategic product platforms, we will continue to set ourselves apart from other product suppliers and elevate our relationships with our customers to a partner level. We consider the Azido technology, which we acquired in April 2011, to be a strategic platform for programmer and product development. During the quarter we completed enhancements for FLXHD, an automated duplication system for e-MMC flash memories, launched in the first quarter.

Our customer focus has been on strategic high volume manufacturers in key market segments like wireless, automotive, industrial controls and programming centers and supporting e-MMC, NAND Flash and microcontrollers on our newer products to gain new accounts. We also provide product solutions used by electronics design engineers. We continued to leverage our China operations to take advantage of the growth of manufacturing in China and to operate close to our customers. We continued to address the effectiveness of our sales and marketing organization and sales channels by adding and changing channels and providing our channel partners with extensive product, sales and service training. We recognized the need to diversify our customer base and are continuing to take steps to broaden our channels of distribution and representation to reach a greater number of customers. We believe these channel actions help us grow our business more rapidly, both by adding new customers and by increasing penetration of existing accounts.

## **cRITICAL aCCOUNTING pOLICY JUDGMENTS AND eSTIMATES**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires that we make estimates and judgments, which affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, Data I/O evaluates our estimates, including those related to revenue recognition, estimating the percentage-of-completion on fixed-price professional engineering service contracts, sales returns, bad debts, inventories, investments, intangible assets, income taxes, warranty obligations, restructuring charges, contingencies such as litigation, and contract terms that have multiple elements and other complexities typical in the capital equipment industry. We base our estimates on historical experience and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

Data I/O believes the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements:

**Revenue Recognition:** Data I/O generally recognizes revenue at the time products are shipped. We have determined that our programming equipment has reached a point of maturity and stability such that product acceptance can be assured by testing at the factory prior to shipment and that the installation meets the criteria to be considered a separate element. These systems are standard products with published product specifications and are configurable with standard options. The evidence that these systems could be deemed as accepted was based upon having standardized factory production of the units, results from batteries of tests of product performance to our published specifications, quality inspections and installation standardization, as well as past product operation validation with the customer and the history provided by our installed base of products upon which the current versions were based.

The amount of revenue recognized is affected by our judgments as to the collectability of the transaction, the existence of an acceptance clause or whether an arrangement includes multiple elements and if so, whether specific objective evidence of selling price exists for those elements. Allocation between multiple elements is done based on objective evidence of selling price based on a selling price hierarchy, including discounts.

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

We record revenue from the sale of service and update contracts as deferred revenue and we recognize it on a straight-line basis over the contractual period, which is typically one year. Service revenue from time and materials contracts and training services is recognized as services are performed. We recognize software revenue upon shipment provided that no significant obligations remain on our part, substantive acceptance conditions, if any, have been met and when the fee is fixed and determinable and when collection is deemed probable.

Certain fixed-price engineering service contracts that require significant production, modification, or customization of software, are accounted for using the percentage-of-completion method. We use the percentage-of-completion method of accounting because it is the most accurate method to recognize revenue based on the nature and scope of our fixed-price professional engineering service contracts; it is a better measure of periodic income results than other methods and it better matches revenue recognized with the costs incurred. Percentage of completion is measured based primarily on input measures such as hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. Significant judgment is required when estimating total hours and progress to completion on these arrangements, which determines the amount of revenue we recognize as well as whether a loss is recognized if one is expected to be incurred upon project completion. Revisions to hour and cost estimates are incorporated in the period the amounts are recognized if the results of the period have not been reported; otherwise, the revision of estimates are recognized in the period in which the facts that give rise to the revision become known.

We establish a reserve for sales returns based on historical trends in product returns and estimates for new items. Data I/O has a stated return policy that customers can return standard products for any reason within 30 days after delivery provided that the returned product is received in its original condition, including all packaging materials, for a refund of the price paid less a restocking charge of 30% of the total amount invoiced for the product returned, unless such restocking charge is waived in writing by Data I/O. For us to recognize revenue, the price is fixed or determinable at the date of the sale, the buyer has paid or is obligated to pay and the obligation is not contingent on resale of the product, the buyer's obligation would not be changed in the event of theft, physical destruction or damage to the product, the buyer acquiring the product for resale has economic substance apart from Data I/O and we have no contractual obligations for future performance to directly bring about the resale of the product by the buyer.

**Allowance for Doubtful Accounts:** We base the allowance for doubtful accounts receivable on our assessment of the collectability of specific customer accounts and the aging of accounts receivable. If there is deterioration of a major customer's credit worthiness or actual defaults are higher than historical experience, our estimates of the recoverability of amounts due to us could be adversely affected.

**Inventory:** Inventories are stated at the lower of cost or market. Adjustments are made to standard cost, which approximates actual cost on a first-in, first-out basis. We estimate reductions to inventory for obsolete, slow-moving, excess and non-salable inventory by reviewing current transactions and forecasted product demand. We evaluate our inventories on an item by item basis and record inventory adjustments accordingly. If there is a significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, Data I/O may be required to increase our inventory adjustments and our gross margin could be adversely affected.

**Warranty Accruals:** Data I/O accrues for warranty costs based on the expected material and labor costs to fulfill our warranty obligations. If we experience an increase in warranty claims, which are higher than our historical experience, our gross margin could be adversely affected.

**Tax Valuation Allowances:** Given the uncertainty created by our loss history, as well as the current uncertain economic outlook for our industry and capital spending, Data I/O expects to continue to limit the recognition of net deferred tax assets and accounting for uncertain tax positions and maintain the tax valuation allowances. We expect, therefore, that reversals of the tax valuation allowance will take place only as we are able to take advantage of the underlying tax loss or other attributes in carry forward. The transfer pricing and expense or cost sharing arrangements are complex areas where judgments, such as the determination of arms-length arrangements, can be subject to challenges by different tax jurisdictions.

**Share-based Compensation:** We account for share-based awards made to our employees and directors, including employee stock option awards and restricted and performance share awards, using the estimated grant date fair value method of accounting. We estimate the fair value using the Black-Scholes valuation model, which requires the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected stock price volatility assumption was determined using the historical volatility of the Company's common stock. Changes in the subjective assumptions required in the valuation model may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations. Beginning in the second quarter of 2006, restricted stock awards were granted. Employee Stock Purchase Plan ("ESPP") shares were issued under provisions that do not require us to record any equity compensation expense.

## Results of Operations

### **Net Sales**

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|                                             | Three Months Ended |         |                  | Six Months Ended |         |                  |
|---------------------------------------------|--------------------|---------|------------------|------------------|---------|------------------|
|                                             | June 30,<br>2012   | Change  | June 30,<br>2011 | June 30,<br>2012 | Change  | June 30,<br>2011 |
| Net sales by product line<br>(in thousands) |                    |         |                  |                  |         |                  |
| Automated programming<br>systems            | \$3,590            | (11.4%) | \$4,050          | \$5,620          | (36.4%) | \$8,832          |
| Non-automated programming<br>systems        | 1,770              | (36.8%) | 2,799            | 3,419            | (32.4%) | 5,060            |
| Total programming systems                   | \$5,360            | (21.7%) | \$6,849          | \$9,039          | (34.9%) | \$13,892         |

|                                         | Three Months Ended |         |                  | Six Months Ended |         |                  |
|-----------------------------------------|--------------------|---------|------------------|------------------|---------|------------------|
|                                         | June 30,<br>2012   | Change  | June 30,<br>2011 | June 30,<br>2012 | Change  | June 30,<br>2011 |
| Net sales by location<br>(in thousands) |                    |         |                  |                  |         |                  |
| United States                           | \$756              | 29.5%   | \$584            | \$1,226          | 10.1%   | \$1,114          |
| % of total                              | 14.1%              |         | 8.5%             | 13.6%            |         | 8.0%             |
| International                           | \$4,603            | (26.5%) | \$6,265          | \$7,812          | (38.9%) | \$12,778         |
| % of total                              | 85.9%              |         | 91.5%            | 86.4%            |         | 92.0%            |

Revenues for the second quarter of 2012 were \$5.4 million, down 22% compared with \$6.8 million in the second quarter of 2011, but up 46% sequentially from \$3.7 million in the first quarter of 2012. We believe the decline in revenue compared to last year relates primarily to reduced capital spending resulting from a downturn in Asia-based electronics manufacturing and economic uncertainty related to the European sovereign debt situation. Our revenues were impacted by the change in the Euro translation rate, compared to one year ago, with the Euro devaluation resulting in \$291,000 less revenue in the second quarter of 2012. Backlog at June 30, 2012 was \$1.1 million.

On a regional basis, Asia had the largest revenue decline of 59%, while Europe declined 4% and the Americas increased 13% compared to revenues in the second quarter of 2011. On a product basis, the revenue decrease was primarily from our automated PS and FLX families as well as FlashPak which was the most impacted by the drop in Asian demand compared to the second quarter of 2011.

For the first six months of 2012 compared to 2011, the decrease in revenues are primarily attributed to the same factors as the second quarter of 2012. However, revenues for the second quarter were sequentially up 46% from the first quarter of 2012.

## Gross Margin

|                         | Three Months Ended |         |                  | Six Months Ended |         |                  |
|-------------------------|--------------------|---------|------------------|------------------|---------|------------------|
|                         | June 30,<br>2012   | Change  | June 30,<br>2011 | June 30,<br>2012 | Change  | June 30,<br>2011 |
| (in thousands)          |                    |         |                  |                  |         |                  |
| Gross margin            | \$2,941            | (26.6%) | \$4,008          | \$4,882          | (40.3%) | \$8,172          |
| Percentage of net sales | 54.9%              |         | 58.5%            | 54.0%            |         | 58.8%            |

Gross margin as a percentage of sales in the second quarter of 2012 was 54.9%, compared with 58.5% in the second quarter of 2011. The decrease compared to the second quarter of 2011 was primarily due to the decreased sales volume in relation to fixed manufacturing costs, offset in part by favorable variances. Gross margin improved by 2 percentage points compared to 52.8% in the first quarter of 2012, primarily due to the sales volume increase.

Gross margin decreased in dollars for the first six months of 2012 primarily due to the decreased sales volume. The gross margin as a percentage of sales decline was primarily due to the decreased sales volume in relation to fixed manufacturing costs.

## Research and Development

|  | Three Months Ended |        |                  | Six Months Ended |        |                  |
|--|--------------------|--------|------------------|------------------|--------|------------------|
|  | June 30,<br>2012   | Change | June 30,<br>2011 | June 30,<br>2012 | Change | June 30,<br>2011 |

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(in thousands)

|                          |         |       |         |         |      |         |
|--------------------------|---------|-------|---------|---------|------|---------|
| Research and development | \$1,427 | 11.8% | \$1,276 | \$2,819 | 7.3% | \$2,627 |
| Percentage of net sales  | 26.6%   |       | 18.6%   | 31.2%   |      | 18.9%   |

Research and development (“R&D”) spending in the second quarter of 2012 increased by \$152,000 compared to the same period in 2011 primarily due to higher Azido related costs of \$120,000, \$73,000 less engineering charged to cost of goods sold, and \$52,000 higher patent related costs, offset in part by a reduction in consultant and contractor expense of \$150,000.

R&D expenses increased \$192,000 for the first six months of 2012 compared to the same period in 2011, primarily due to same factors as in the second quarter of 2012.

**Selling, General and Administrative**

|                                   | Three Months Ended |        |                  | Six Months Ended |        |                  |
|-----------------------------------|--------------------|--------|------------------|------------------|--------|------------------|
|                                   | June 30,<br>2012   | Change | June 30,<br>2011 | June 30,<br>2012 | Change | June 30,<br>2011 |
| (in thousands)                    |                    |        |                  |                  |        |                  |
| Selling, general & administrative | \$1,996            | (9.9%) | \$2,215          | \$4,245          | (3.3%) | \$4,388          |
| Percentage of net sales           | 37.2%              |        | 32.3%            | 47.0%            |        | 31.6%            |

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Selling, general and administrative (“SG&A”) expenses in the second quarter of 2012 decreased by \$219,000 compared to the same period in 2011 primarily attributable to \$158,000 lower professional fees and \$76,000 lower incentive compensation, offset in part by \$42,000 higher sales commissions primarily resulting from sales channel mix. The CEO search firm fees included in SG&A in the second quarter were \$38,000 and there are not expected to be any further fees to expense under this fixed fee engagement.

Excluding the non-recurring CEO search firm and separation pay of \$462,000 this year, SG&A expenses for the first six months of 2012 decreased by \$604,000 compared to the same period in 2011, primarily due to the same factors as the second quarter of 2012.

## Interest

|                 | Three Months Ended |        |                  | Six Months Ended |        |                  |
|-----------------|--------------------|--------|------------------|------------------|--------|------------------|
|                 | June 30,<br>2012   | Change | June 30,<br>2011 | June 30,<br>2012 | Change | June 30,<br>2011 |
| (in thousands)  |                    |        |                  |                  |        |                  |
| Interest income | \$174              | 815.8% | \$19             | \$207            | 546.9% | \$32             |

Interest income for the second quarter of 2012 increased by \$155,000 compared to the same period in 2011 primarily related to interest received related to a German tax refund and higher invested balances in foreign accounts.

Interest income for the first six months of 2012 increased by \$175,000 compared to the same period in 2011, primarily due to the same factors as in the second quarter of 2012.

## Income Taxes

|                              | Three Months Ended |          |                  | Six Months Ended |          |                  |
|------------------------------|--------------------|----------|------------------|------------------|----------|------------------|
|                              | June 30,<br>2012   | Change   | June 30,<br>2011 | June 30,<br>2012 | Change   | June 30,<br>2011 |
| (in thousands)               |                    |          |                  |                  |          |                  |
| Income tax (expense) benefit | \$296              | (381.9%) | (\$105)          | \$276            | (244.5%) | (\$191)          |

Income tax (expense) benefit recorded for the second quarter and first six months of 2012 and 2011 resulted primarily from foreign taxes on income and tax refunds in our foreign subsidiaries. During the second quarter of 2012, we prevailed in tax issues from the 1995-1998 years related to an acquisition and we received refunds from German tax authorities of approximately \$318,000.

The effective tax rate differed from the statutory tax rate primarily due to the effect of valuation allowances, as well as foreign taxes. Data I/O has a valuation allowance of \$9.7 million as of June 30, 2012. Our deferred tax assets and valuation allowance have been reduced by approximately \$117,000 associated with the requirements of accounting for uncertain tax positions as of June 30, 2012. Given the uncertainty created by our past loss history and the cyclical nature of the industry in which we operate, we expect to continue to limit the recognition of net deferred tax assets and maintain the tax valuation allowances.

## Financial Condition

### **Liquidity and Capital Resources**

|                 | June, 30<br>2012 | Change    | December 31,<br>2011 |
|-----------------|------------------|-----------|----------------------|
| (in thousands)  |                  |           |                      |
| Working capital | \$15,265         | (\$7,090) | \$22,355             |

The Company's cash position at June 30, 2012 decreased \$1.3 million during the second quarter to \$11.0 million. In the second quarter of 2012, cash was primarily used to fund a \$1.7 million increase in accounts receivable to \$3.6 million at June 30, 2012. Inventories were at \$4.6 million at June 30, 2012, up from \$4.5 million at March 31, 2012. Deferred revenue was \$1.4 million at June 30, 2012, compared to \$1.2 million at March 31, 2012. This increase was primarily due to a PS system shipped, but not yet recognizable as revenue. The Company remains debt free.

For the six months ending June 30, 2012, the decrease in working capital primarily relates to cash used in our share repurchase programs of \$6 million completed in the first quarter of 2012.

We expect that we will continue to make capital expenditures to support our business. Capital expenditures are expected to be funded by existing and internally generated funds or lease financing.

As a result of our significant product development, customer support, international expansion and selling and marketing efforts, we have required substantial working capital to fund our operations. Over the last few years, we restructured our operations to lower our costs and operating expenditures in some geographic regions, while investing in other regions, and to lower the level of revenue required for our net income breakeven point or offsetting in part costs rising over time, to preserve our cash position and to focus on profitable operations. We believe that we have sufficient working capital available under our operating plan to fund our operations and capital requirements through at least the next one-year period. Approximately \$9 million of our cash is located in foreign subsidiary accounts and, although we have no current repatriation plans, there may be tax and other impediments to repatriating the cash to the United States. Our working capital may be used to fund growth initiatives including acquisition, which could reduce our liquidity. Any substantial inability to achieve our current business plan could have a material adverse impact on our financial position, liquidity, or results of operations and may require us to reduce expenditures and/or seek additional financing.

### **Share Repurchase Programs**

The \$1 million dollar share repurchase plan announced in October of 2011 resulted in \$42,000 of stock buybacks during the first quarter of 2012. This program was cancelled in January 2012, after the new expanded \$6 million dollar repurchase program announced in January 2012 went into effect. Share repurchases for \$6 million were made during the first quarter of 2012, completing this program. These programs were made under 10b5-1 plans that allowed purchases to take place at any time. See accompanying consolidated financial statements Note 11, "Share Repurchase Programs".

### **OFF-Balance sheet arrangements**

Except as noted in the accompanying consolidated financial statements in Note 6, "Operating Lease Commitments" and Note 7, "Other Commitments", Data I/O had no off-balance sheet arrangements.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (“ASU 2011-05”). This ASU amends requirements for the presentation of other comprehensive income (OCI), requiring presentation of comprehensive income in either, a single, continuous statement of comprehensive income or on separate but consecutive statements, the statement of operations and the statement of OCI. We have adopted this amendment effective for the year ended December 31, 2011. The adoption of this guidance did not impact our financial position, results of operations or cash flows and only impacts the presentation of OCI on the financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and International Reporting Standards* (“ASU No. 2011-04”) which amended the guidance regarding fair value measurement and disclosure. The amended guidance clarifies the application of existing fair value measurement and disclosure requirements. The amendment was effective for us at the beginning of January 2012, with early adoption prohibited. The adoption of this amendment did not materially affect our financial statements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

**Item 4. Controls and Procedures**

**Evaluation of disclosure controls and procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, Data I/O evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act) as of the end of the period covered by this report (the “Evaluation Date”). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective at the reasonable level of assurance. Disclosure Controls are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed under the Exchange Act is recorded,

processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure Controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

#### **Changes in internal controls**

There were no changes made in our internal controls during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1.**                **Legal Proceedings**

From time to time, we may be involved in litigation relating to claims arising out of our operations in the normal course of business.

As of June 30, 2012, Data I/O was not a party to any material pending legal proceedings, other than ordinary routine litigation incidental to the business.

### **Item 1A.**            **Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. There are no material changes to the Risk Factors described in our Annual Report.

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

None

### **Item 3.**            **Defaults Upon Senior Securities**

None

### **Item 4.**            **Mine Safety Disclosures**

Not Applicable

**Item 5.**      **Other Information**

None

**Item 6.**      **Exhibits**

(a)    **Exhibits**

**10      Material Contracts:**

10.23              Amended and Restated 2000 Stock Compensation Incentive Plan dated January 25, 2012  
(Incorporated by reference to Appendix A of Data I/O's proxy statement filed on April 3, 2012)

**31      Certification pursuant to Section 302 of the Sarbanes Oxley Act of 2002:**

31.1              Chief Executive Officer Certification

31.2              Chief Financial Officer Certification

**32      Certification pursuant to Section 906 of the Sarbanes Oxley Act of 2002:**

32.1              Chief Executive Officer Certification

32.2              Chief Financial Officer Certification

**101    Interactive Data Files Pursuant to Rule 405 of Regulation S-T**

(To be provided on an amended 10-Q/A within 30 days.)



**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.

**CORPORATION**

**DATA I/O**

(REGISTRANT)

DATED: August 10, 2012

By: //S//Joel S. Hatlen

Joel S. Hatlen

Vice President - Finance

Chief Financial Officer

Secretary and Treasurer

(Principal Financial Officer and Duly

Authorized Officer)

By: //S//Frederick R. Hume

Frederick R. Hume

President

Chief Executive Officer

Authorized Officer)

(Principal Executive Officer and Duly

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Exhibit 31.1

CERTIFICATION

I, Frederick R. Hume, certify that:

- 1) I have reviewed this quarterly report on Form 10-Q of Data I/O Corporation;
- 2) Based on my knowledge, this report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- 3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f), for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - d) Disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

DATED: August 10, 2012

/s/ Frederick R. Hume

Frederick R. Hume

Chief Executive Officer

(Principal Executive Officer)

Exhibit 31.2

CERTIFICATION

I, Joel S. Hatlen, certify that:

- 1) I have reviewed this quarterly report on Form 10-Q of Data I/O Corporation;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- 3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f), for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
  - d) Disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

DATED: August 10, 2012

/s/ Joel S. Hatlen

Joel S. Hatlen

Chief Financial Officer

(Principal Financial Officer)

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Exhibit 32.1

Certification by Chief Executive Officer

Pursuant to 18 U.S.C. Section 1350

As Adopted Pursuant to

Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the quarterly report of Data I/O Corporation (the “Company”) on Form 10-Q for the period ended June 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Frederick R. Hume, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Frederick R. Hume

Frederick R. Hume

Chief Executive Officer

(Principal Executive Officer)

August 10, 2012



Exhibit 32.2

Certification by Chief Financial Officer

Pursuant to 18 U.S.C. Section 1350

As Adopted Pursuant to

Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the quarterly report of Data I/O Corporation (the “Company”) on Form 10-Q for the period ended June 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Joel S. Hatlen, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Joel S. Hatlen

Joel S. Hatlen

Chief Financial Officer

(Principal Financial Officer)

August 10, 2012

