

INTERLINK ELECTRONICS INC
Form 10-Q
November 14, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2003

or

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

For the transition period from _____ to _____

Commission File No. 0-21858

INTERLINK ELECTRONICS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

546 Flynn Road

Camarillo, California
(Address of principal executive offices)

77-0056625
(I.R.S. Employer

Identification Number)

93012
(Zip Code)

(805) 484-8855

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(Registrant's telephone number, including area code)

Not applicable.

(Former name, former address and former fiscal year

if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Shares of Common Stock Outstanding, at November 12, 2003: 11,146,030

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

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(IN THOUSANDS, EXCEPT PAR VALUE)

	December 31, 2002	September 30, 2003
	<u> </u>	<u> </u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 7,906	\$ 6,116
Accounts receivable, less allowance for doubtful accounts of \$497 and \$570 at 2002 and 2003, respectively	5,308	8,313
Inventories	7,006	8,647
Prepaid expenses and other current assets	259	245
	<u> </u>	<u> </u>
Total current assets	20,479	23,321
Property and equipment, net	1,211	966
Patents and trademarks, less accumulated amortization of \$1,100 and \$1,109 at 2002 and 2003, respectively	9	
Other assets	67	63
	<u> </u>	<u> </u>
Total assets	<u>\$ 21,766</u>	<u>\$ 24,350</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Current maturities of long-term debt	\$ 933	\$ 692
Accounts payable	2,201	2,164
Accrued payroll and related expenses	922	585
Other accrued expenses	176	169
	<u> </u>	<u> </u>
Total current liabilities	4,232	3,610
	<u> </u>	<u> </u>
Long-term debt, net of current portion	1,401	1,168
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$5.00 par value (100 shares authorized, none issued and outstanding)		
Common stock, \$0.00001 par value (50,000 shares authorized, 9,778 and 11,140 shares issued and outstanding at 2002 and 2003, respectively)	29,074	31,595
Due from stockholders	(797)	(518)
Accumulated other comprehensive loss	(837)	(857)
Accumulated deficit	(11,307)	(10,648)
	<u> </u>	<u> </u>
Total stockholders' equity	16,133	19,572
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	<u>\$ 21,766</u>	<u>\$ 24,350</u>

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

INTERLINK ELECTRONICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three Month Period Ended September 30,		Nine Month Period Ended September 30,	
	2002	2003	2002	2003
Revenues	\$ 6,629	\$ 7,848	\$ 18,065	\$ 22,326
Cost of revenues	3,928	4,563	10,623	12,985
Gross profit	2,701	3,285	7,442	9,341
Operating expense:				
Product development and research	748	828	2,481	2,564
Selling, general and administrative	1,923	2,177	5,653	6,241
Total operating expense	2,671	3,005	8,134	8,805
Operating income (loss)	30	280	(692)	536
Other income (expense):				
Interest income (expense), net	(7)	(6)	8	(18)
Minority interest	4		(7)	
Other income (expense)	13		(1)	195
Total other income (expense)	10	(6)		177
Income (loss) before provision for income taxes	40	274	(692)	713
Provision for income tax		36		54
Net income (loss)	\$ 40	\$ 238	\$ (692)	\$ 659
Earnings (loss) per share basic	\$.07	\$.02	\$ (.07)	\$.07
Earnings (loss) per share diluted	\$.06	\$.02	\$ (.07)	\$.06
Weighted average shares basic	9,770	10,599	9,764	10,062
Weighted average shares diluted	10,435	11,643	9,764	11,065

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

INTERLINK ELECTRONICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(IN THOUSANDS)

	Nine Month Period Ended September 30,	
	2002	2003
Cash flows from operating activities:		
Net income (loss)	\$ (692)	\$ 659
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Provision for bad debts	35	46
Depreciation and amortization	600	533
Minority interest	(7)	
Changes in operating assets and liabilities:		
Accounts receivable	68	(3,051)
Inventories	(1,370)	(1,641)
Prepaid expenses and other current assets	277	14
Other assets	22	4
Accounts payable	1,232	(37)
Accrued payroll and related expenses and other accrued expenses	260	(344)
Net cash provided by (used in) operating activities	425	(3,817)
Cash flows from investing activities:		
Sales of marketable securities	2,457	
Purchases of property and equipment	(286)	(279)
Costs of patents and trademarks	(15)	
Net cash provided by (used in) investing activities	2,156	(279)
Cash flows from financing activities:		
Principal payments on debt	(1,198)	(474)
Principal payments on capital lease obligation	(51)	
Due from stockholders	40	279
Proceeds from issuance of common stock, net	33	2,521
Net cash provided by (used in) financing activities	(1,176)	2,326
Effect of exchange rate changes on cash	(51)	(20)
Increase (decrease) in cash and cash equivalents	1,354	(1,790)
Cash and cash equivalents:		
Beginning of period	6,868	7,906
End of period	\$ 8,222	\$ 6,116
Supplemental disclosures of cash flow information:		
Interest paid	\$ 79	\$ 55
Income taxes paid	\$ 1	\$ 1

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

INTERLINK ELECTRONICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

*FOR THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2003 (UNAUDITED)***1. Basis of Presentation of Interim Financial Data**

The financial information as of September 30, 2003 and for the three and nine month periods ended September 30, 2002 and 2003 included in this report is unaudited. Such information, however, reflects all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of results for the interim periods. The interim statements should be read in conjunction with the financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

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

2. Earnings Per Share

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

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

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

	Three Months		Nine Months	
	Ended September 30,		Ended September 30	
	2002	2003	2002	2003
Weighted average shares outstanding - basic	9,770	10,599	9,764	10,062
Effect of dilutive securities (options)	665	1,044	(1)	1,003
Weighted average shares - diluted	10,435	11,643	9,764	11,065

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- (1) Due to the net loss in 2002, the diluted share calculation result was anti-dilutive. Thus, the basic weighted average shares were used. Shares of common stock equivalents of approximately 1.1 million and 866,000 for the three months ended September 30, 2002 and 2003, respectively and 1.1 million and 1.0 million for the nine months ended September 30, 2002 and 2003, respectively, were not included in the diluted calculations because they were anti-dilutive.

3. Comprehensive Income (Loss)

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

	Accumulated Other Comprehensive Loss	Comprehensive Income (Loss)
	<u> </u>	<u> </u>
Balance at December 31, 2001	\$ (843)	
Translation adjustment	(51)	\$ (51)
Net loss		(692)
	<u> </u>	<u> </u>
Balance at September 30, 2002	\$ (894)	\$ (743)
	<u> </u>	<u> </u>
Balance at December 31, 2002	\$ (837)	\$
Translation adjustment	(20)	(20)
Net income		659
	<u> </u>	<u> </u>
Balance at September 30, 2003	\$ (857)	\$ 639
	<u> </u>	<u> </u>

4. Segment Information

The Company has four business segments: (i) business communications; (ii) home entertainment; (iii) e-transactions; and (iv) specialty components. The accounting policies of the segments are the same as those described in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies. However, the Company evaluates performance based on revenue and gross profit. The Company does not allocate any other income, expenses or assets to these segments. Reportable segment information for the nine months ended September 30, 2002 and 2003 is as follows (in thousands):

Nine Months Ended:	Business Communications	Home Entertainment	E-Transactions	Specialty Components and Other	Total
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
September 30, 2002					
Revenue	\$ 11,191	\$ 1,759	\$ 1,371	\$ 3,744	\$ 18,065
Gross profit	4,183	788	666	1,805	7,442
September 30, 2003					
Revenue	\$ 14,789	\$ 1,898	\$ 2,145	\$ 3,494	\$ 22,326
Gross profit	4,983	886	1,184	2,288	9,341

5. Inventories

Inventories consisted of the following (in thousands):

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	December 31, 2002	September 30, 2003
	<u> </u>	<u> </u>
Raw material	\$ 3,661	\$ 4,522
Work in process	809	792
Finished goods	2,536	3,333
	<u> </u>	<u> </u>
Total inventories	<u>\$ 7,006</u>	<u>\$ 8,647</u>

6. Stock Options

Under the terms of the Company's stock option plans, officers and key employees may be granted non-qualified or incentive stock options and outside directors and independent contractors of the Company may be granted non-qualified stock options. The aggregate number of shares which may be issued under the plans is 8,026,225. Options are granted at fair market value on the date of grant and generally vest ratably over 36 months and have a five-year term but terminate earlier if employment is terminated. As of September 30, 2003 there were 563,000 options available for grant.

First nine months of 2003 activity under the stock option plans is summarized as follows (in thousands, except per share information):

	<u>Options</u>	<u>Wgt. avg. Exercise Price</u>
Outstanding beginning of period	3,617	\$ 3.72
Granted	730	3.21
Exercised	(1,361)	1.98
Forfeited or expired	(31)	6.13
	<u> </u>	
Outstanding end of period	2,955	4.37
	<u> </u>	
Exercisable end of period	2,261	4.45
	<u> </u>	

The following table summarizes information about stock options outstanding as of September 30, 2003 (in thousands, except per share information):

Exercise Price Per Share	# of Options Outstanding	Months Remaining On Contractual Life		
		Options Exercisable	Options Un-exercisable	Options
\$ 2.40	626	34	380	246
2.70	47	55	8	39
2.94	557	53	557	0
3.04	71	78	21	50
3.08	164	5	164	0
3.30	12	53	2	10
3.54	4	41	2	2
3.67	45	7	45	0
4.30	21	51	5	16
4.42	360	39	207	153
5.50	59	12	59	0
5.51	80	31	65	15

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5.65	13	57	1	12
6.87	865	29	745	120
7.54	31	60	0	31
	<u> </u>		<u> </u>	<u> </u>
Total	2,955		2,261	694
	<u> </u>		<u> </u>	<u> </u>

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The weighted average fair value at the date of grant for stock options granted during the nine months ended September 30, 2002 and 2003 was \$1.87 and \$1.65 per option, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes model with the following weighted average assumptions:

	Nine Months Ended September 30,	
	2002	2003
Expected life (years)	4	4
Interest rate	1.5%	3.0%
Volatility	75%	63%
Dividend yield	0%	0%

The Company applies Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and related interpretations in accounting for its stock option plans. Accordingly, no compensation cost has been recognized for these plans. Had compensation cost for the Company s plans been determined based on the fair value at the grant dates for awards under the plans consistent with the method of SFAS No. 123, Accounting for Stock-Based Compensation , the Company would have recorded stock-based compensation expense as follows (in thousands except per share information):

	Nine Months Ended September 30,	
	2002	2003
Net income (loss) as reported	\$ (692)	\$ 659
Stock-based compensation expense included in reported net income, net of related tax effects		
Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(4,204)	(4,179)
Net Loss pro forma	\$ (4,896)	\$ (3,520)
Basic earnings (loss) per share as reported	\$ (.07)	\$.07
pro forma	(.50)	(.35)
Diluted earnings (loss) per share as reported	\$ (.07)	\$.06
pro forma	(.50)	(.32)

7. Recent Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) issued Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables . This issue addresses determination of whether an arrangement involving more than one deliverable contains more than one unit of accounting and how arrangement consideration should be measured and allocated to the separate units of accounting. EITF Issue No. 00-21 will be effective for revenue arrangements entered into in fiscal quarters beginning after June 15, 2003, or the Company may elect to report the change in accounting as a cumulative-effect adjustment. We do not expect the adoption of this issue will have a material impact on our operating results or financial position.

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In May 2003, the FASB issued SFAS No.150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not expect the adoption of this statement to have a material impact on our financial condition or results of operations.

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

Critical Accounting Policies

Material accounting policies that we believe are the most critical to an investor's understanding of our financial results and condition and require complex management judgment are discussed below.

Revenue Recognition. We recognize revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements", as amended by SAB No. 101A and No. 101B. SAB No. 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) require management's judgments regarding the fixed nature of the fee charged for services rendered and products delivered and the collectibility of those fees. To satisfy the criteria, we: (1) input orders based upon receipt of a customer purchase order; (2) record revenue upon shipment of goods when risk of loss and title transfer under our arrangements with customers or otherwise complying with the terms of the purchase order; (3) confirm pricing through the customer purchase order; and (4) validate creditworthiness through past payment history, credit agency reports and other financial data. Other than through warranty rights, our customers do not have explicit or implicit rights of return. Should changes in conditions cause management to determine the revenue recognition criteria are not met for certain future transactions, such as a determination that an outstanding account receivable has become uncollectible, revenue recognized for any reporting period could be adversely affected.

Accounts Receivable and Allowance for Doubtful Accounts. Our accounts receivable are unsecured, and we are at risk to the extent such amounts become uncollectible. We continually monitor individual account receivable balances, and provide for an allowance of doubtful accounts at the time collection may become questionable based on payment performance or age of the receivable and other factors related to the customer's ability to pay.

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

Provision for Income Tax. We first achieved profitable operations in 1995. Because of net operating loss (NOL) carryforwards available both for our U.S.-based and Japan-based operations, we did not accrue income tax expense until 1999. In that year, due to the expiration or full utilization of NOL carryforwards in California and Japan, we began to record a provision for income tax expense in those jurisdictions. By the end of 2000, we also began to accrue an income tax benefit related to our federal NOL carryforwards to be used in future periods. However, in mid-2001, we began to record quarterly tax losses and suspended any further recognition of NOL carryforward tax benefits. In the fourth quarter of 2002, we recorded a full valuation allowance against the deferred tax asset balance as it appeared more likely than not that we would be unable to realize it in future periods.

Foreign Exchange Exposure. We have established relationships with most of the major original equipment manufacturers (OEMs) in the business communications market. Many of these OEM's are based in Japan and for the first nine months of 2002 and 2003, respectively, approximately 30% and 22% of revenues came from Japanese customers. Revenues from these customers are denominated in Japanese yen and as a result we are subject to foreign currency exchange rate fluctuations in the yen/dollar exchange rate. We use foreign currency forward contracts to hedge this exposure. The gain or loss from these contracts is recorded in business communications revenue. In addition, because our Japanese subsidiary's functional currency is the yen, the

translation of the net assets of that subsidiary into the consolidated results will fluctuate with the yen/dollar exchange rate. The following table illustrates the impact of foreign currency fluctuations on our yen-denominated revenues and the effectiveness of our foreign currency hedging activity (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2002	2003	2002	2003
Effect of foreign currency fluctuation on revenues	\$	\$ 189	\$ 112	\$ 187
Hedging gains (losses)	40	(170)	343	(133)
Net revenue impact	\$ 40	\$ 19	\$ 455	\$ 54

Historical Factors Affecting Financial Performance

We were incorporated in California in February 1985 and reincorporated in Delaware in July 1996. Our stock was first listed on the Nasdaq National Market in June 1993.

From the inception of the Company, we developed and refined our *Force Sensing Resistor*, or FSR, technology and sold it to customers for electronic, musical, medical, industrial and other applications, which we now refer to as the specialty components market. This business segment is characterized by customers who have long design cycles and who, once a technology is designed-in, retain that technology for a relatively long period of time. We expect this segment of our business to experience only limited growth due to the limited resources we can allocate to it.

In 1992, we introduced our first Interlink-branded computer-pointing device, *PortaPoint*, and in 1994, we introduced our first wireless pointing device. The device, called *RemotePoint*, established Interlink as a leading supplier of branded and OEM remote controls and other products for the computerized presentation system market. This business segment has been our primary growth driver over the last five years and, in the nine months of 2003, constituted 66% of our overall sales. Within the OEM element of this segment, we have key customers both in the U.S. and in Japan and thus we have been affected by the performance of each of these economies. Despite our sizable OEM market share, no one customer constitutes 10% or more of our consolidated sales in the first nine months of 2003. Beginning in 2001, we began a renewed effort to expand our branded products product line and our branded products distribution channel.

In 1999, we introduced the electronic signature capture product, *ePad*, for our customers in the e-transactions market. Since then, we introduced ePad-Point of Sale, ePad-Ink and ePad-ID. To date, much of the success in this segment has occurred with large corporate accounts in financial services, insurance and medical industries. Typically these accounts buy 3,000 to 5,000 units and purchase them all at the initial deployment; consequently, revenues in this segment have been relatively variable from quarter to quarter.

In 2000, we first demonstrated *IntuiTouch* technology for the home entertainment market. Due to the general economic decline, the home entertainment market suffered a downturn beginning in 2001. In mid-2001, we scaled back our efforts related to interactive television. In 2001, 2002 and the first nine months of 2003, the Microsoft Xbox program constituted a high percentage of our home entertainment revenues.

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Prior to 1999, operations was a net user of cash that we funded through existing cash balances, private placements of equity and to a lesser extent, bank and lease financing. In 1999, operations was a net provider of cash, generating \$2.9 million. In 2000, 2001 and 2002, operations was essentially cash flow break-even to marginally positive. In the first nine months of 2003, operations recorded a \$3.8 million negative cash flow due to the further penetration into the business communications-branded channel and the related working capital investment.

In response to the economic slowdown that began in mid-2001, we restructured our operations and increased our inventory and bad debt reserves by \$2 million and \$300,000, respectively. In the fourth quarter of 2002, we wrote-off \$2.3 million in obsolete and excess inventories related to our Japanese subsidiary.

In March 2000, we licensed certain technology related to the production of FSR sensors to International Electronics and Engineering (IEE), a former affiliate based in Luxembourg, for use in connection with sales of sensors to the automotive industry. We received significant payments under this license agreement commencing in 2000 (\$2.5 million) and continuing through the third quarter of 2001 (\$1.5 million). No further payments are due under this agreement. We have occasionally licensed other aspects of our technology in connection with the settlement of intellectual property disputes and expect to continue to do so in the future. However, there are no current contingencies under which we would earn significant licensing revenue.

Business Segment Overview Three and Nine Months Ended September 30, 2002 Compared To Three and Nine Months Ended September 30, 2003

Three and nine months ended September 30, 2002 and 2003 revenue and gross profit by market segment are shown in the following table:

Market Segment	Three Months Ended September 30, 2002		Three Months Ended September 30, 2003		Nine Months Ended September 30, 2002		Nine Months Ended September 30, 2003	
	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales	\$000 s	Percent of Total Sales
Business Communications:								
Revenue	\$ 4,183	63%	\$ 5,238	67%	\$ 11,191	62%	\$ 14,789	66%
Gross Profit	1,591		1,810		4,183		4,983	
Gross Profit % of Segment Revenue	38%		35%		37%		34%	
Home Entertainment:								
Revenue	\$ 409	6%	\$ 928	12%	\$ 1,759	10%	\$ 1,898	8%
Gross Profit	180		437		788		886	
Gross Profit % of Segment Revenue	44%		47%		45%		47%	
E-Transactions:								
Revenue	\$ 583	9%	\$ 591	7%	\$ 1,371	7%	\$ 2,145	10%
Gross Profit	196		328		666		1,184	
Gross Profit % of Segment Revenue	34%		55%		49%		55%	
Specialty Components:								
Revenue	\$ 1,454	22%	\$ 1,091	14%	\$ 3,744	21%	\$ 3,494	16%
Gross Profit	734		710		1,805		2,288	
Gross Profit % of Segment Revenue	51%		65%		48%		65%	
All Segments:								
Revenue	\$ 6,629	100%	\$ 7,848	100%	\$ 18,065	100%	\$ 22,326	100%
Gross Profit	2,701		3,285		7,442		9,341	
Gross Profit % of Segment Revenue	41%		42%		41%		42%	

Business Communications

Business communications segment revenues for the third quarter of 2003 increased 25% compared to the third quarter of 2002 and increased 32% for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002. This growth is due to an increase in our branded products sales from greater distribution and an expanded product line. Partly offsetting this growth was lower net foreign exchange

hedging gains (\$455,000 in the nine months ended September 30, 2002 as compared to \$54,000 the same period of 2003).

Gross profit margins as a percentage of sales for the business communications segment decreased from 38% in the third quarter of 2002 to 35% in the third quarter of 2003 and decreased from 37% in the nine months ended September 30, 2002 to 34% in the nine months ended September 30, 2003 due to a higher ratio of lower margin OEM sales versus branded product sales in the 2003 periods.

Home Entertainment

Home entertainment segment revenues for the third quarter of 2003 increased by 127% compared to the third quarter of 2002 and increased 8% for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002 due to fluctuations in orders related to the Microsoft Xbox program.

Gross profit margins as a percentage of sales for the home entertainment segment increased from 44% in the third quarter of 2002 to 47% in the third quarter of 2003 and increased from 45% in the nine months ended September 30, 2002 to 47% in the nine months ended September 30, 2003 due to a higher ratio of low volume, higher margin product sales in the 2003 periods.

E-Transactions

E-transactions segment revenues for the third quarter of 2003 increased 1% compared to the third quarter of 2002 and increased 56% for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002 due to an increase in the number of larger volume customers, a broadened product line and a slight improvement in the general economic climate for corporate capital expenditures for information technology products.

Gross profit margins as a percentage of sales for the E-transactions segment increased from 34% in the third quarter of 2002 to 55% in the third quarter of 2003 and from 49% in the nine months ended September 30, 2002 to 55% in the nine months ended September 30, 2003 due to a low gross profit margin software-related revenue transaction that occurred in the third quarter of 2002.

Specialty Components

Specialty components segment revenues for the third quarter of 2003 decreased 25% compared to the third quarter of 2002 and decreased 7% for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002 due to a particularly large order shipped in the third quarter of 2002 to a customer in the medical device industry.

Gross profit margins as a percentage of sales for the specialty components segment increased from 51% in the third quarter of 2002 to 65% in the third quarter of 2003 and increased from 48% in the nine months ended September 30, 2002 to 65% in the nine months ended September 30, 2003 primarily due to a greater proportion of sales of higher margin computer input applications as compared with sales of lower margin custom applications.

Results of Operations Three and Nine Months Ended September 30, 2002 Compared to Three and Nine Months Ended September 30, 2003

The following table presents our historical operating results for the periods indicated as a percentage of revenues:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>
Revenues	100%	100%	100%	100%
Gross profit	40.7	41.9	41.2	41.8
Operating expenses:				
Product development and research	11.3	10.6	13.7	11.5
Selling, general and administrative	29.0	27.8	31.3	27.9
Total operating expenses	40.3	38.4	45.0	39.4
Operating income (loss)	0.4	3.5	(3.8)	2.4
Other income (loss)	0.2			0.8
Income tax expense		0.5		0.2
Net income (loss)	0.6%	3.0%	(3.8)%	3.0%

Consolidated revenues increased 18% from \$6.6 million in the third quarter of 2002 to \$7.8 million in the third quarter of 2003 and increased 24% from \$18.1 million in the nine months ended September 30, 2002 to \$22.3 million in the nine months ended September 30, 2003 due to the reasons described in the business segment analysis above.

Gross profit as a percentage of sales increased from 40.7% in the three months ended September 30, 2002 to 41.9% in the three months ended September 30, 2003 and increased from 41.2% in the nine months ended September 30, 2002 to 41.8% for the nine months ended September 30, 2003 for the reasons described in the business segment analysis above. Additionally, \$330,000 and \$531,000 in inventory write downs were recorded in the three and six month periods ended June 30, 2003, respectively, in accordance with our inventory reserve methodology described in the *Critical Accounting Policies - Inventory Reserve* section of this report.

Product development and research expense increased 11% from \$748,000 in the three months ended September 30, 2002 to \$828,000 in the three months ended September 30, 2003 and increased 3% from \$2.5 million in the nine months ended September 30, 2002 to \$2.6 million for the nine months ended September 30, 2003. The increased costs in the 2003 periods are due to the further development of new products for the business communications-branded and e-transactions product lines.

Selling, general and administrative expense (SG&A) increased 13% from \$1.9 million in the three months ended September 30, 2002 to \$2.2 million in the three months ended September 30 2003, and increased 10% from \$5.7 million in the nine months ended September 30, 2002 to \$6.2 million in the nine months ended September 30, 2003. The dollar increase is the result of the marketing support related to the new Business Communication Branded products and the percentage decrease is the result of leveraging of fixed SG&A over a larger sales base.

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Other income in the first quarter of 2003 included a \$180,000 gain associated with the settlement of a lawsuit with one of our former component suppliers in Japan.

Due to net operating loss (NOL) carryforwards, no tax provision was necessary related to our U.S. and Japanese operations. However, our Hong Kong logistics operation did record an income tax provision in the 2003 periods presented.

Due to sales growth, improved gross margins, successful cost containment measures and other income described above, net income improved to \$238,000 for the third quarter of 2003 as compared to net income of \$40,000 in the third quarter of 2002 and improved to \$659,000 in the nine months ended September 30, 2003 as compared to a net loss of \$692,000 in the nine months ended September 30, 2002.

Liquidity and Capital Resources

Working capital at September 30, 2003 was \$19.7 million versus \$16.2 million at the end of 2002. The increase is a result primarily of the improvement in net income for the first nine months of 2003 plus the additional equity issued in the third quarter of 2003 related to the exercise of employee stock options.

Operations used \$3.8 million in cash in the first nine months of 2003 primarily due to investments in working capital designed to facilitate our further penetration into the business communications-branded channel. This compares to cash generated by operations of \$425,000 in the first nine months of 2002.

We spent \$279,000 in the first nine months of 2003 and \$286,000 in the first nine months of 2002 to purchase additional manufacturing equipment and computer equipment related to our internal computer network.

We made payments on long-term debt of \$474,000 in the first nine months of 2003 and \$1.2 million in the first nine months of 2002. Net proceeds from the exercise of stock options and stockholder loan repayments were \$2.8 million in the first nine months of 2003 and \$73,000 in the first nine months of 2002.

We believe we can fund operations for at least the next 12 months from our current cash and cash equivalents balance (\$6.1 million as of September 30, 2003). Additionally, in July 2003, we renegotiated our U.S. bank line of credit (unused at September 30, 2003) to provide \$3 million in availability and to eliminate the previous requirement of cash and investment collateral. Negotiated lines of credit in Japan and the further exercise of employee stock options are also potential sources of capital available to us. We require liquidity to fund capital expenditures and for working capital and other general corporate purposes.

Disclosure Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that involve substantial risks and uncertainties and which are intended to be covered by the safe harbors created thereby. These statements can be identified by the fact that they do not relate strictly to historical information and may include the words *expects*, *believes*, *anticipates*, *plans*, *may*, *will*, *intends*, *estimates*, *continue* or expressions. These forward-looking statements are subject to various risks and uncertainties that could cause actual results to differ materially from those currently anticipated. These risks and uncertainties include, but are not limited to, items discussed under the heading

Forward-looking Statements, Historical Factors Affecting Financial Performance and Business Segment Overview three and nine months ended September 30, 2002 compared to three and nine months ended September 30, 2003. Forward-looking statements speak only as of the date made. We undertake no obligation to publicly release or update forward-looking statements, whether as a result of new information, future events or otherwise.

Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) issued Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables . This issue addresses determination of whether an arrangement involving more than one deliverable contains more than one unit of accounting and how arrangement consideration should be measured and allocated to the separate units of accounting. EITF Issue No. 00-21 will be effective for revenue arrangements entered into in fiscal quarters beginning after June 15, 2003, or the Company may elect to report the change in accounting as a cumulative-effect adjustment. We

adopted this issue on July 1, 2003 and the adoption had no material impact on our operating results or financial position.

In May 2003, the FASB issued SFAS No.150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We adopted this statement on July 1, 2003 and the adoption had no material impact on our financial condition or results of operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We use six-month foreign exchange forward contracts to hedge certain revenue exposures against future movements in foreign exchange rates. Gains and losses on the forward contracts are largely offset by gains and losses on the underlying exposure and consequently we would not expect a sudden or significant change in foreign exchange rates to have a material impact on future net income or cash flows. However, a foreign exchange movement with a duration of over six months could materially impact financial performance.

Item 4. Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer along with our Chief Financial Officer, on the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon that evaluation, each of our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in alerting them in a timely manner to material information required to be included in the Company's SEC reports. In addition, there have been no significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to the date we carried out our evaluation.

PART II OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 3.1 Certificate of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 3.2 Bylaws (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000).
- 31.1 Certification of Chief Executive Officer of Registrant Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer of Registrant Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer of Registrant Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer of Registrant Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

On September 12, 2003, we filed a Current Report on Form 8-K under Item 4. Changes in Registrant's Certifying Accountants announcing our dismissal of KPMG LLP as our principal accountant effective September 12, 2003 and our engagement of BDO Siedman, LLP as our new principal accountant as of that date. A letter from KPMG LLP addressed to the Securities and Exchange Commission confirming statements made by us in the report was attached to the report as Exhibit 99.1.

On October 27, 2003, we filed a Current Report on Form 8-K under Item 12. Results of Operations and Financial Condition reporting that on October 27, 2003, we issued a press release announcing our financial results for the quarter ended September 30, 2003. Our press release was attached to the report as Exhibit 99.1.

SIGNATURES

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

INTERLINK ELECTRONICS, INC.

DATE: November 14, 2003

/s/ PAUL D. MEYER

Paul D. Meyer

Chief Financial Officer

EXHIBIT INDEX

The following exhibits are filed with or incorporated by reference into this Quarterly Report:

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