DATA I/O CORP
Form 10-Q
November 14, 2007

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 quarter ended **September 30, 2007**

OR

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

Commission File No. 0-10394

DATA I/O CORPORATION

(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	91-0864123 (I.R.S. Employer Identification No.)

6464 185th 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___

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

Large accelerated filer __ Accelerated filer __ Non-accelerated filer X

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes___ NoX

8,694,672 shares of no par value of the Registrant s Common Stock were issued and outstanding as of November 8, 2007.

DATA I/O CORPORATION

FORM 10-Q

For the Quarter Ended September 30, 2007

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

DATA I/O CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)	Sept. 30, 2007 (unaudited)	Dec. 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$4,106	$2,478
Trade accounts receivable, less allowance for doubtful accounts of $160 and $199	7,110	8,496
Inventories	5,906	5,052
Other current assets	176	491
TOTAL CURRENT ASSETS	17,298	16,517
Property and equipment - net	2,202	2,852
Other assets	115	122
TOTAL ASSETS	$19,615	$19,491
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$1,217	$1,673
Accrued compensation	961	1,210
Deferred revenue	1,760	1,564
Other accrued liabilities	1,300	1,194
Accrued costs of business restructuring	150	2
Income taxes payable	3	7
Notes payable	117	112
TOTAL CURRENT LIABILITIES	5,508	5,762
Long-term other payables	19	-
Long-term debt	365	446
COMMITMENTS	-	-
STOCKHOLDERS EQUITY:		
Preferred stock -		
Authorized, 5,000,000 shares, including		
200,000 shares of Series A Junior Participating		
Issued and outstanding, none	-	-
Common stock, at stated value -		
Authorized, 30,000,000 shares		
Issued and outstanding, 8,617,336 and 8,481,563 shares	20,519	20,053
Accumulated deficit	(7,519)	(7,261)

Accumulated other comprehensive income	723	491
TOTAL STOCKHOLDERS EQUITY	13,723	13,283
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$19,615	$19,491

See accompanying notes to consolidated financial statements.

DATA I/O CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended		**Nine Months Ended**	
(in thousands, except per share data)	Sept. 30, 2007	Sept. 30, 2006	Sept. 30, 2007	Sept. 30, 2006
Net sales	$7,283	$6,837	$19,089	$20,413
Cost of goods sold	2,771	3,069	8,419	9,491
Gross margin	4,512	3,768	10,670	10,922
Operating expenses:				
Research and development	1,036	1,426	3,693	4,245
Selling, general and administrative	1,969	2,229	6,534	7,494
Net provision for business restructure	(107)	152	725	152
Total operating expenses	2,898	3,807	10,952	11,891
Operating income (loss)	1,614	(39)	(282)	(969)
Non-operating income (expense):				
Interest income	19	18	70	98
Interest expense	(8)	-	(28)	-
Gain on sale	-	3	-	8
Other	1	-	1	-
Foreign currency exchange	(21)	1	(11)	(9)
Total non-operating income (expense)	(9)	22	32	97
Income (loss) before income taxes	1,605	(17)	(250)	(872)
Income tax expense (benefit)	(1)	(64)	8	(9)
Net income (loss)	$1,606	$47	($258)	($863)
Basic earnings (loss) per share	$0.19	$0.01	($0.03)	($0.10)
Diluted earnings (loss) per share	$0.18	$0.01	($0.03)	($0.10)
Weighted average shares outstanding - basic	8,613	8,437	8,555	8,413
Weighted average and potential shares outstanding - diluted	8,815	8,672	8,555	8,413

See accompanying notes to consolidated financial statements.

DATA I/O CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

For the nine months ended (in thousands)	Sept. 30, 2007	Sept. 30, 2006
OPERATING ACTIVITIES:	($258)	($863)
Net income (loss)		
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	797	906
Write-off of assets	15	11
Gain on sale of fixed asset	-	(8)
Equipment transferred to cost of goods sold	736	190
Amortization of deferred gain on sale	-	(388)
Share-based compensation	216	283
Net change in:		
Deferred revenue	284	211
Trade accounts receivable	1,617	(42)
Inventories	(763)	(1,510)
Other current assets	322	(115)
Accrued costs of business restructuring	148	(10)
Accounts payable and accrued liabilities	(532)	(100)
Security deposits	3	(55)
Net cash provided by (used in) operating activities	2,585	(1,490)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(632)	(1,139)
Acquisition of intangibles	-	(25)
Proceeds from sales of marketable securities	-	804
Net cash provided by (used in) investing activities	(632)	(360)
FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	250	194
Payment of capital lease obligation	(76)	-
Net cash provided by (used in) financing activities	174	194
Increase/(decrease) in cash and cash equivalents	2,127	(1,656)
Effects of exchange rate changes on cash	(499)	(214)
Cash and cash equivalents at beginning of year	2,478	4,362
Cash and cash equivalents at end of quarter	$4,106	$2,492

See accompanying notes to consolidated financial statements.

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DATA I/O CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 - FINANCIAL STATEMENT PREPARATION

Data I/O prepared the financial statements as of September 30, 2007 and 2006, 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, 2006 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 and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. 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, 2006.

Revenue Recognition

Sales of Data I/O s semiconductor programming equipment products requiring installation by us that is other than perfunctory were previously recorded when installation was complete, or at the later of customer acceptance or installation, if an acceptance clause is specified in the sales terms. Beginning in the third quarter of 2005, Data I/O began recognizing revenue for these products at the time of shipment. We began recognizing revenue at the time of shipment after we determined that our programming equipment have 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. When arrangements include multiple elements, we use objective evidence of fair value to allocate revenue to the elements pursuant to EITF 00-21, Revenue Arrangements with Multiple Deliverables, and recognize revenue when the criteria for revenue recognition have been met for each element according to SAB 104, Revenue Recognition. The amount of revenue recognized is affected by our judgments as to the collectibility of the transaction or whether an arrangement includes multiple elements and if so, whether specific objective evidence of fair value exists for those elements.

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 collectibility is reasonably assured. We measure the standalone fair value of the product versus the service installation value component by the amount paid to independent representative service groups or the amount of additional discount given to independent distributors to provide the service installation.

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 in writing by Data I/O.

Data I/O s software products are not normally sold separately from sales of programming systems. However, on those occasions where we sell software separately, we recognize revenue when a sales agreement exists, when delivery has occurred, when the fee is fixed or determinable, and when collection is probable.

Stock-Based Compensation Expense

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) and the Securities and Exchange Commission issued Staff Accounting Bulleting No. 107 (SAB 107) requiring the measurement and recognition of compensation expense for all share-based payment awards, including employee stock options, stock awards, and employee stock purchases, based on estimated fair values on the grant dates. The Company adopted SFAS 123(R) using the modified prospective method, which required the application of the accounting standard as of January 1, 2006. Total share-based compensation for the three and nine months ended September 30, 2007 was $63,000 and $216,000, respectively. Total share-based compensation for the three and nine months ended September 30, 2006 was $88,000 and $283,000, respectively.

Income Tax

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and disclosure for uncertainty in income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, measurement, classification, interest and penalties, accounting for interim periods, disclosure and transition, and clearly scopes income taxes out of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*. The Company adopted FIN 48 on January 1, 2007. The adoption of FIN 48 had no impact on the Company s financial statements.

Historically, the Company has not incurred any interest or penalties associated with tax matters and no interest or penalties were recognized during the three months ended March 31, 2007. However, the Company has adopted a policy whereby amounts related to interest and penalties associated with tax matters are classified as general and administrative expense when incurred.

The Company has incurred net operating losses. The Company continues to maintain a valuation allowance for the full amount of the net deferred tax asset balance associated with its net operating losses as sufficient uncertainty exists regarding its ability to realize such tax assets in the future. There was $58,000 of unrecognized tax benefits related to uncertain tax positions as of January 1, and September 30, 2007. The Company expects the amount of the net deferred tax asset balance and full valuation allowance to increase in future periods if it incurs future net operating losses.

Tax years that remain open for examination include 2003, 2004, 2005, and 2006 in the United States of America. In addition, tax years from 1999 to 2002 may be subject to examination in the event that the Company utilizes the NOL s or other carry forwards from those years in its current or future year tax return.

Recent Accounting Pronouncements

In February 2007, the FASB issued Statement 159, The Fair Value Option for Financial Assets and Financial Liabilities. This Statement permits entities to elect to measure certain financial instruments and other items at fair value through earnings. The fair value option may be applied on an instrument by instrument basis, is irrevocable and is applied only to entire instruments. SFAS 159 requires additional financial statement presentation and disclosure requirements for those entities that elect to adopt the standard and is effective for fiscal years beginning after November 15, 2007. We have not yet evaluated the impact of the adoption of SFAS 159.

NOTE 2 - RECLASSIFICATIONS

Certain prior period balances may have been reclassified to conform to the presentation used in the current period.

NOTE 3 - INVENTORIES

Inventories consisted of the following components (in thousands):

	Sept. 30, 2007	December 31, 2006
Raw material	$3,165	$2,990
Work-in-process	1,277	1,048
Finished goods	1,464	1,014
Inventories	$5,906	$5,052

NOTE 4 PROPERTY AND EQUIPMENT, NET

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

	Sept. 30, 2007	December 31, 2006
Leasehold improvements	$421	$431
Equipment	8,907	8,941
	9,328	9,372
Less accumulated depreciation	7,126	6,520
Property and equipment - net	$2,202	$2,852

NOTE 5 BUSINESS RESTRUCTURING

During the second half of 2006, as part of our additional effort to reduce expenses, we incurred restructuring charges of approximately $152,000 in the third quarter of 2006 and $39,000 in the fourth quarter of 2006. The restructuring charges are primarily related to severance charges incurred at our Redmond, Germany and China offices. In view of our declining margins and operating results during the first and second quarters of 2006, actions were taken to reduce expenses and improve margins.

We continued our restructuring activities in view of the declining revenues and gross margins during the first and second quarters of 2007, to further improve our operating results and to improve the effectiveness of our sales and marketing organization and sales channels. During the first quarter of 2007, we recorded restructuring charges of approximately $200,000 primarily related to severance charges. During the second quarter of 2007, we recorded an additional $632,000 of restructuring charges. During the third quarter of 2007, we recorded a net expense reversal of $107,000 comprised of $54.000 of additional expense, primarily relating to facilities, and a reversal of $161,000 of previously accrued severance primarily due to certain employees who had been scheduled for termination had their termination notice rescinded. At September 30, 2007, $150,000 remains accrued and is expected to be paid out during mostly in the fourth quarter of 2007 with the balance in 2008.

An analysis of the restructuring is as follows (in thousands):

Description	Reserve Balance 12/31/06	Q1&Q2 2007 Expenses	Q1&Q2 Payments/ Write-offs	Reserve Balance 6/30/07	Q3 2007 Expenses	Q3 2007 Payments Write-offs	Reserve Balance 9/30/07
US Operations							
Severance related	$2	416	310	108	-5	103	-
Other Costs	-	2	2	0	3	3	-
Foreign Operations							
Severance related	-	363	86	277	-156	37	84
Facility & other costs	-	51	27	24	51	9	66
Total	$2	$832	$425	$409	$-107	$152	$150

NOTE 6 OTHER ACCRUED LIABILITIES

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

	Sept. 30, 2007	December 31, 2006
Product warranty liability	$424	$467
Sales return reserve	145	135
Accrued rent	192	202
Other taxes	82	158
Other	457	232
Other accrued liabilities	$1,300	$1,194

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

	Sept. 30, 2007
Liability, beginning balance	$467
Net expenses	574
Warranty claims	(574)
Accrual revisions	(43)
Liability, ending balance	$424

NOTE 7 LONG-TERM DEBT

In 2006, the Company entered into a five year capital lease agreement in the amount of $591,145. The lease was used to fund new equipment and installation associated with our move to the new facility in 2006. The interest rate is 7.69%.

Scheduled maturities of the capital lease obligation for the years ending December 31 are as follows (in thousands):

2007	$35
2008	140
2009	140
2010	140
2011	106
Thereafter	-
Total minimum lease payments	561
Less: Amount representing interest	(79)
Present value of capital lease obligation	482
Current portion long-term debt	(117)
Non-current portion long-term debt	$365

NOTE 8 EARNINGS (LOSS) PER SHARE

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

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	Sept. 30,		Sept. 30,	
	2007	2006	2007	2006
Numerator for basic and diluted earnings per share:				
Net income (loss)	$1,606	$47	($258)	($863)
Denominator:				
Denominator for basic earnings per share - weighted-average shares	8,613	8,437	8,555	8,413
Employee stock options	202	235	-	-
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions of stock options	8,815	8,672	8,555	8,413
Total basic earnings (loss) per share	$0.19	$0.01	($0.03)	($0.10)
Total diluted earnings (loss) per share	$0.18	$0.01	($0.03)	($0.10)

The computation for the three months ended September 30, 2007 and 2006 excludes 471,236 and 665,341 options, respectively, to purchase common stock as their effect is anitdilutive. For the nine months ended September 30, 2007 and 2006, 1,038,029 and 1,155,261 options, respectively, were antidilutive.

NOTE 9 SHARE-BASED COMPENSATION

The impact on our results of operations of recording share-based compensation for the three and nine month period ended September 30, 2007 and September 30, 2006 are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	Sept. 30,		Sept. 30,	
	2007	2006	2007	2006
Cost of goods sold	$2	$6	$9	$19
Research and development	6	20	26	64
Selling, general and administrative	55	62	181	200
Total share-based compensation	$63	$88	$216	$283
Impact on net income (loss) per share: Basic and diluted	$0.01	$0.01	($0.03)	($0.03)

The fair value of share-based awards for employee stock options is estimated using the Black-Scholes valuation model. The volatility and expected life of the option used in calculating the fair value of share-based awards excludes certain periods of historical data that we considered atypical and not likely or rare to occur in future periods.

NOTE 10 COMPREHENSIVE INCOME (LOSS)

During the third quarter of 2007 and 2006 total comprehensive income (loss) was comprised of the following (in thousands):

	Three Months Ended		Nine Months Ended	
	Sept. 30,		Sept. 30,	
	2007	2006	2007	2006
Net income (loss)	$1,606	$47	($258)	($863)
Foreign currency translation gain (loss)	131	(20)	232	191
Total comprehensive income gain (loss)	$1,737	$27	($26)	($672)

NOTE 11 FOREIGN CURRENCY TRANSLATION AND DERIVATIVES

Data I/O translates assets and liabilities of foreign subsidiaries at the exchange rate on the balance sheet date. We translate revenues, costs and expenses of foreign subsidiaries at average rates of exchange prevailing during the year. We charge our credit translation adjustments resulting from this process to other comprehensive income (a component of stockholders equity), net of taxes. Realized and unrealized gains and losses resulting from the effects of changes in exchange rates on assets and liabilities denominated in foreign currencies are included in non-operating expense as foreign currency transaction gains and losses.

Data I/O accounts for its hedging activities in accordance with SFAS No. 133, *Accounting for Derivatives and Hedging Activities*. This statement establishes accounting and reporting standards for derivative instruments and requires recognition of derivatives as assets or liabilities in the statement of financial position and measurement of those instruments at fair value.

Data I/O utilizes forward foreign exchange contracts to reduce the impact of foreign currency exchange rate risks where natural hedging strategies cannot be effectively employed. All hedging instruments held by us are fair value hedges. Generally, these contracts have maturities less than one year and require us to exchange foreign currencies for U.S. dollars at maturity. At September 30, 2007, we had a notional value of approximately $716,387 in four foreign exchange contracts outstanding. We recorded the estimated loss in fair value as a non-operating expense and a liability of approximately $16,000. The Euro rates range from 1.3450 to 1.4156, all scheduled to be due within the next quarter and the value at that date of $716,921.

Data I/O does not hold or issue derivative financial instruments for trading purposes. The purpose of our hedging activities is to reduce the risk that the valuation of the underlying assets, liabilities and firm commitments will be adversely affected by changes in exchange rates. Our derivative activities do not create foreign currency exchange rate risk because fluctuations in the value of the instruments used for hedging purposes are offset by fluctuations in the value of the underlying exposures being hedged.

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; integration of acquired products and operations; market acceptance of our newly introduced or upgraded products; 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, 2006 describe some, but not all, of the factors that could cause these differences.

OVERVIEW

Our primary goal is to manage the business to achieve profitable operations, while developing and enhancing products to drive revenue and earnings growth. Our challenge continues to be operating in a seasonal, cyclical, and challenging industry environment, while positioning Data I/O to take advantage of any growth in capital spending. We saw a downturn in capital spending during the first six months of 2007, but have seen in the third quarter and expect to see a continued recovery in capital spending during the fourth quarter of 2007.

Following our losses during the first two quarters of 2006, we launched an initiative during the third quarter of 2006 to lower the quarterly revenue breakeven point to below $7 million, as it had increased to a calculated $7.6 million during the second quarter of 2006. During the first six months of 2007 as we experienced declining revenues and gross margins, we decided to take additional expense reductions to lower our expected quarterly revenue breakeven point to below $5.3 million when fully implemented this year.

We are continuing our efforts to balance increasing costs and strategic investments in our business with the level of demand and mix of business we expect. We are focusing our research and development efforts in our strategic growth markets, namely new programming technology, and automated programming systems for the manufacturing environment, particularly the new FLX500 desktop automated programming system, and extending the capabilities and support for our FlashCORE architecture and the ProLINE-RoadRunner and PS families. We have also introduced our new applications innovation strategy. This strategy provides complete solutions to target customer s business problems. These solutions will expand beyond what we have considered as products in the past. These solutions will have a larger software element, may involve third-party components, and in many cases, will be developed to address a specific customer s requirements. We believe by adding these features to our strategic product platforms, we will be able to set ourselves apart from other product suppliers and elevate our relationships with our customers to a partner level.

Our customer focus has been on strategic high volume manufacturers in key market segments like wireless, automotive, industrial controls and programming centers and supporting NAND Flash and microcontrollers on our newer products to gain new accounts and to break into new markets, such as microcontrollers for the automotive market. We continue to address the effectiveness of our sales and marketing organization and sales channels. With the sales decline we experienced in the first half of 2007 in China, we recognized the need to diversify our customer base there and are taking steps to broaden our channels of distribution in China to reach a greater number of customers. This decision, made at the end of the first quarter, includes the elimination of some China direct selling expenses and increased the use of agents that have established relationships with the desired customers. We have also added additional Asian sales channel management to drive Asia sales and manage this important region. We believe this decision should help us more rapidly grow our business in China and convert some of our fixed selling expenses to variable. During the first quarter of 2007, we repositioned and made changes that are expected to result in more effectively supporting our customer centric application strategy for targeted segments. We continue our efforts to partner with the semiconductor manufacturers to better serve our mutual customers and members of Preferred Partnership Program. The Preferred Partnership Program formalizes our mutual support relationship and is designed to increase collaboration between the semi conductor vendor and Data I/O to better serve customers.

BUSINESS RESTRUCTURING

During the second half of 2006, as part of our additional effort to reduce expenses, we incurred restructuring charges of approximately $152,000 in the third quarter of 2006 and $39,000 in the fourth quarter of 2006. The restructuring charges are primarily related to severance charges incurred at our Redmond, Germany and China offices. In view of our declining margins and operating results during the first and second quarters of 2006, actions were taken to reduce expenses and improve margins.

We continued our restructuring activities in view of the declining revenues and gross margins during the first and second quarters of 2007, to further improve our operating results and our effectiveness of the sales and marketing organization and sales channels. During the first quarter of 2007, we recorded restructuring charges of approximately $200,000 primarily related to severance charges. During the second quarter of 2007, we recorded an additional $632,000 of restructuring charges. These actions included reengineering some internal processes, integration of some activities, transferring some activities to our lower cost base of operations in China, reducing resources applied to declining legacy products, moving some engineering positions to production, reducing the number of taxable entities, outsourcing some functions such as payroll, combining some positions, eliminating some functions, and shifting some responsibilities and resources to our channels. During the third quarter of 2007, we recorded a net expense reversal of $107,000 comprised of $54,000 of additional expense, primarily relating to facilities, and a reversal of $161,000 of previously accrued severance primarily due to certain employees who had been scheduled for termination had their termination notice rescinded. At September 30, 2007, $150,000 remains accrued and is expected to be paid out during mostly in the fourth quarter of 2007 with the balance in 2008.

CRITICAL ACCOUNTING POLICY JUDGMENTS AND ESTIMATES

The Company s critical accounting policies are disclosed in the Company s Form 10-K for the year ended December 31, 2006 and have not materially changed as of September 30, 2007.

Results of Operations

NET S