



Interlink Electronics, Inc. and Subsidiaries

Quarterly Report
for the Three Months Ended
March 31, 2020

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About Our Company

Interlink Electronics Inc. (“we”, “us”, “our”, “Interlink” or the “Company”) designs, develops, manufactures and sells a range of force-sensing technologies that incorporate our proprietary materials technology, firmware and software into a portfolio of standard products and custom solutions. These include sensor components, subassemblies, modules and products that support effective, efficient cursor control and novel three-dimensional user inputs. Our Human Machine Interface (“HMI”) technology platforms are deployed in a wide range of markets including consumer electronics, automotive, industrial, and medical. The application of our HMI technology platforms includes vehicle entry, vehicle multi-media control interface, rugged touch controls, presence detection, collision detection, speed and torque controls, biological monitoring and others.

Interlink has been a leader in the printed electronics industry for over 30 years with the commercialization of our patented Force-Sensing Resistor (“FSR®”) technology that has enabled rugged and reliable HMI solutions. Our solutions have focused on handheld user input, menu navigation, cursor control, and other intuitive interface technologies for the world’s top electronics manufacturers.

We invented FSR® technology and pioneered commercialization of printed electronics manufacturing, paving the way for industry-wide adoption of force sensing technology. Our extensive knowledge and experience with this technology, along with the firmware we incorporate in our HMI solutions, differentiates us from other providers of HMI solutions. We, along with our customers, incorporate our FSR and force sensing sensors and modules into end user products. Our sensors and modules are used in electronics devices and systems where user input must be converted into electronics and software data. Our force sensing technology solution platforms enabled industry-first implementations in gaming, smartphone, rugged notebook, automotive cockpit and automotive entry applications. Consumer and end-user demand for enhanced user experience is driving the need for innovative multi-modal HMI technologies and applications. Force sensing input provides a critical novel modality that drives a paradigm shift in HMI.

Market requirements for innovative solutions that enable smaller, thinner devices, lower power consumption, highly refined designs, better navigation and more intuitive usability in all environments, are also driving increased demand for our products. Consumers expect to use multi-modal HMI in the home, industrial and medical environments, automotive spaces (both inside and outside the vehicle), and in all technology interactions where they formerly used switches and knobs. Interlink delivers cutting edge, high performance solutions for all of these environments.

Significant market opportunities are rapidly emerging for us to improve upon the functionality of standard capacitive sensors which are widely available and competitively priced. Inadvertent activation, where users unintentionally activate a control, is a common problem with capacitive technology. In contrast, force sensing solutions require a deliberate application of force to operate. We have had recent success in using our force sensing solutions in combination with capacitive technologies to minimize the latter’s performance issues, enabling force sensing solutions to complement competitive technologies and provide us with new opportunities for growth. We continue to simultaneously expand our standard product portfolio and develop new technology platforms to grow existing markets and capture emerging markets.

Interlink serves our world-wide customer base from our corporate headquarters in Camarillo, California (greater Los Angeles area), where we also maintain engineering, assembly and prototyping capabilities, our global research and development (“R&D”) and engineering center in Singapore, our printed electronics manufacturing facility in Shenzhen, China, our global distribution and logistics center in Hong Kong and our technical and sales offices in Japan. We sell our products in a wide range of markets, including consumer electronics, automotive, industrial and medical, to some of the world’s largest companies and most recognizable brands.

We were incorporated in California on February 27, 1985. On July 10, 1996, we re-incorporated into a Delaware corporation and, on July 20, 2012, we again changed our domicile from Delaware to Nevada by completing a merger with a newly formed Nevada corporation named Interlink Electronics Inc.

Our principal executive office is located at 1267 Flynn Road, Camarillo, California 93012 and our telephone number is (805) 484-8855. Our website address is www.interlinkelectronics.com. Interlink makes available its annual financial

statements, quarterly financial statements, and other significant reports and amendments to such reports, free of charge, on its website as soon as reasonably practicable after such reports are prepared.

Results of Operations – Three Months ended March 31, 2020

The following table sets forth certain unaudited condensed consolidated statements of income data for the periods indicated. The percentages in the table are based on net revenues.

	Three months ended March 31,			
	2020		2019	
	\$	%	\$	%
(in thousands, except percentages)				
Revenue, net	\$ 1,691	100.0 %	\$ 1,450	100.0 %
Cost of revenue	732	43.3 %	750	51.7 %
Gross profit	959	56.7 %	700	48.3 %
Operating expenses:				
Engineering, research and development	285	16.9 %	252	17.4 %
Selling, general and administrative	746	44.1 %	791	54.5 %
Total operating expenses	1,031	61.0 %	1,043	71.9 %
Income (loss) from operations	(72)	(4.3) %	(343)	(23.6) %
Other income (expense):				
Other income (expense), net	6	0.4 %	(33)	(2.3) %
Income (loss) before income tax expense	(66)	(3.9) %	(376)	(25.9) %
Income tax expense (benefit)	(48)	(2.8) %	(62)	(4.3) %
Net income (loss)	\$ (18)	(1.1) %	\$ (314)	(21.6) %

Other comprehensive income, net of tax:

Foreign currency translation adjustments	(20)	(1.2) %	50	3.4 %
Comprehensive income (loss)	\$ (38)	(2.3) %	\$ (264)	(18.2) %

Revenue, net by Market is as follows:

	Three months ended March 31,					
	2020		2019		Change	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
(in thousands, except percentages)						(8.6241/1450)
Industrial	392	23.2 %	429	29.6 %	(37)) %
Medical	404	23.9 %	402	27.7 %	2	0.5%
Consumer	187	11.1 %	33	2.3 %	154	466.3%
Standard	708	41.8 %	586	40.4 %	122	20.8%
Revenue, net	\$ 1,691	100.0 %	\$ 1,450	100.0 %	\$ 241	16.6%

We sell our custom products into the industrial, medical and consumer markets. We previously sold custom products in the automotive market and continue to peruse opportunities in that sector. We sell our standard products through various distribution networks. The ultimate customer for standards products may come from different markets which are often unknown to us at the time of sale. Each market has different product design cycles. Products with longer design cycles often have much longer product life-cycles. Automotive, industrial, and medical products generally have longer design and life-cycles than consumer products. We currently have products with life-cycles that have exceeded twenty years and are ongoing.

Overall revenues increased 16.6% due to consumer customer higher demand and timing of a standard product order from a longtime customer. In the normal cycle, some of our larger customers purchase in bulk quantities and absorption of these products can straddle several financial reporting periods. The timing of orders from our customers is not always predictable and can be concentrated in varying periods during the year to coincide with their project and building plans.

Many of our products are currently subject to import tariffs imposed on goods manufactured in China, increasing the cost to our customers by up to 25%. We believe many of our existing customers have reduced orders until the uncertainty passes, hoping to avoid tariffs. In the worst case, some of them may be seeking alternative domestic suppliers.

Some of our more recent custom product success for new product lines in the medical market is making its way into the pipeline as part of a long design cycle and revenues are just starting to be realized in 2019. Overall, we expect revenues to stabilize for the remainder of the year.

	Three months ended March 31,		2019		Change	% Change
	2020	% of Net Revenue	Amount	% of Net Revenue		
	Amount		Amount			
	(in thousands, except percentages)					
Cost of revenue	\$ 732	43.3 %	\$ 750	51.7 %	\$ (18)	(2.4)%

Our cost of revenue is impacted by various factors including product mix, volume, material costs, manufacturing efficiencies, facilities costs, compensation costs and any provisions for excess and obsolete inventories. Cost of revenues decreased compared with the prior year even though revenues increased due to efficiencies derived from relocation of our medical manufacturing to China from United States.

	Three months ended March 31,		2019		Change	% Change
	2020	% of Net Revenue	Amount	% of Net Revenue		
	Amount		Amount			
	(in thousands, except percentages)					
Engineering, research and development	\$ 285	16.9 %	\$ 252	17.4 %	\$ 33	13.1%

Engineering and R&D expenses consist primarily of compensation expenses for employees engaged in research, design and development activities. Our R&D team focuses both on internal design development, as well as design development aimed at addressing customer design challenges, in order to develop our HMI solutions.

Our engineering and R&D costs were higher as compared with the same period in the prior year primarily due to the increase engineering staffing of our Singapore R&D center.

	Three months ended March 31,					
	2020		2019		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
	(in thousands, except percentages)					
Selling, general and administrative	\$ 746	44.0 %	\$ 791	54.6 %	\$ (45)	(5.7)%

Selling, general and administrative expenses consist primarily of compensation expenses, legal and other professional fees, facilities expenses and communication expenses. G&A expenses decreased as compared with the same period in the prior year driven by internal efficiencies and reduced reliance of third-party consultants. Sales and marketing costs increased as a result of the Company building out the sales and marketing team.

	Three months ended March 31,					
	2020		2019		Change	% Change
	Amount	% of Pre-tax Income	Amount	% of Pre-tax Income		
	(in thousands, except percentages)					
Income tax expense (benefit)	\$ (48)	(72.7) %	\$ (62)	(16.5) %	\$ 14	(22.6)%

Tax expense reflects statutory tax rates in the jurisdictions that we operate adjusted for normal book/tax differences. The tax benefit for the three months ended March 31, 2020 was a result of the operating loss for the quarter.

Our effective tax rate is directly affected by the relative proportions of revenue and income before taxes in the jurisdictions in which we operate. Based on the expected mix of domestic and foreign earnings, we anticipate our effective tax rate to remain lower than the newly stated U.S. statutory rate primarily due to a significant portion of our earnings originating in lower rate foreign jurisdictions. Discrete tax events may cause our effective rate to fluctuate on a quarterly basis. Certain events, including, for example, acquisitions and other business changes, which are difficult to predict, may also cause our effective tax rate to fluctuate. We are subject to changing tax laws, regulations, and interpretations in multiple jurisdictions. Continued corporate tax reform continues to be a priority in the U.S. and other jurisdictions. Additional changes to the tax system in the U.S. could have significant effects, positive and negative, on our effective tax rate, and on our deferred tax assets and liabilities.

Liquidity and Capital Resources

Cash requirements for working capital and capital expenditures have been funded from cash balances on hand and cash generated from operations. As of March 31, 2020, we had cash and cash equivalents of \$6.1 million, working capital of \$7.2 million and no indebtedness. Cash and cash equivalents consist of cash and money market funds. We did not have any short-term or long-term investments as of March 31, 2020. Of the \$6.1 million of cash balances on hand, \$1.3 million was held by foreign subsidiaries. If these funds are needed for our operations in the U.S., we have several methods to repatriate without significant tax effects, including repayment of intercompany loans or distributions of previously taxed income. Other distributions may require us to incur U.S. or foreign taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside the U.S. and our current plans do not demonstrate a need to repatriate cash to fund our U.S. operations.

Subsequent to March 31, 2020, we applied for and received a loan from Silicon Valley Bank in the aggregate principal amount of \$185,530 pursuant to the Paycheck Protection Program (the "PPP") under the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which was enacted March 27, 2020. The loan is evidenced by a promissory note, dated April 21, 2020, issued by us to the lender, which note matures on April 20, 2022, and bears interest at a rate of 1.00% per annum, payable monthly commencing on November 21, 2020, following an initial deferral period as specified

under the PPP. We may prepay the note at any time prior to maturity with no prepayment penalties. Proceeds from the loan will be used to fund designated expenses, including certain payroll costs, group health care benefits and other permitted expenses, in accordance with the PPP. Under the terms of the PPP, up to the entire amount of principal and accrued interest may be forgiven to the extent loan proceeds are used for qualifying expenses as described in the CARES Act and applicable implementing guidance issued by the U.S. Small Business Administration under the PPP. We intend to use all or a substantial portion of the loan for designated qualifying expenses and to apply for forgiveness of all or a substantial portion of the loan in accordance with the terms of the PPP. No assurance can be given that we will obtain forgiveness of the loan in whole or in part. With respect to any portion of the loan that is not forgiven, the loan will be subject to customary provisions for a loan of this type, including customary events of default relating to, among other things, payment defaults and breaches of the note's provisions.

We believe that our existing cash and cash equivalents balance will be sufficient to maintain our current operations considering our current financial condition, obligations, the proceeds of the PPP loan and other expected cash flows. If our circumstances change, however, we may require additional cash. If we require additional cash, we may attempt to raise additional capital through equity, equity-linked or debt financing arrangements. If we raise additional funds by issuing equity or equity-linked securities, the ownership of our existing stockholders will be diluted. If we raise additional financing by the incurrence of indebtedness, we could be subject to fixed payment obligations and could also be subject to restrictive covenants, such as limitations on our ability to incur additional debt, and other operating restrictions that could adversely impact our ability to conduct our business. If we are unable to raise additional needed funds, we may also take measures to reduce expenses to offset any shortfall.

Stock Repurchases

On August 21, 2019, we repurchased 2,788 shares of our common stock at a purchase price of \$1.95 per share from an existing stockholder in a private transaction approved by our Board of Directors. The repurchased shares were immediately retired and restored to the status of authorized and unissued shares.

At March 31, we had 6,563,050 shares of common stock issued and outstanding.

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

INTERLINK ELECTRONICS, INC.
Condensed Consolidated Balance Sheets
(unaudited)

	March 31, 2020	December 31, 2019
(in thousands, except par value)		
ASSETS		
Current assets		
Cash and cash equivalents	\$ 6,021	\$ 5,812
Restricted cash	32	32
Accounts receivable, net	719	730
Inventories	826	927
Prepaid expenses and other current assets	277	330
Total current assets	7,875	7,831
Property, plant and equipment, net	573	633
Intangibles, net	192	171
Right-of-use	153	203
Deferred income taxes	435	435
Other assets	52	59
Total assets	<u>\$ 9,280</u>	<u>\$ 9,332</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 263	\$ 218
Accrued liabilities	282	302
Lease liabilities, current	130	154
Accrued income taxes	7	—
Deferred revenue, current	—	13
Total current liabilities	682	687
Long term liabilities		
Lease liabilities, long term	38	66
Deferred tax liability, long term	8	8
Total long-term liabilities	46	74
Total liabilities	728	761
Commitments and contingencies (see note 9)	—	—
Stockholders' equity		
Preferred stock, \$0.01 par value: 1,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$0.001 par value: 30,000 shares authorized, 6,563 and 6,563 shares issued and outstanding at March 31, 2020 and December 31, 2019, respectively	7	7
Additional paid-in-capital	57,959	57,940
Accumulated other comprehensive income	(113)	(93)
Accumulated deficit	(49,301)	(49,283)
Total stockholders' equity	8,552	8,571
Total liabilities and stockholders' equity	<u>\$ 9,280</u>	<u>\$ 9,332</u>

See accompanying notes to these condensed consolidated financial statements.

INTERLINK ELECTRONICS, INC.

Condensed Consolidated Statements of Income and Comprehensive Income
(unaudited)

	Three Months Ended 31,	
	2020	2019
	(in thousands, except per share data)	
Revenue, net	\$ 1,691	\$ 1,450
Cost of revenue	732	750
Gross profit	959	700
Operating expenses:		
Engineering, research and development	285	252
Selling, general and administrative	746	791
Total operating expenses	1,031	1,043
Income(loss) from operations	(72)	(343)
Other income (expense):		
Other income (expense), net	6	(33)
Income(loss) before income tax expense	(66)	(376)
Income tax expense	(48)	(62)
Net income(loss)	(18)	(314)
Other comprehensive income(loss), net of tax:		
Foreign currency translation adjustments	(20)	50
Comprehensive income(loss)	\$ (38)	\$ (264)
Earnings(loss) per share, basic and diluted	\$ (0.00)	\$ (0.05)
Weighted average common shares outstanding - basic	6,563	6,503
Weighted average common shares outstanding - diluted	6,598	6,581

See accompanying notes to these condensed consolidated financial statements.

INTERLINK ELECTRONICS, INC.
Statement of Changes in Stockholders Equity
(unaudited)

(in thousands)	Common Stock		Additional Paid-in- Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
Balance at January 1, 2020	6,563	\$ 7	\$ 57,940	\$ (93)	\$ (49,283)	\$ 8,571
Net income (loss)	—	—	—	—	(18)	(18)
Foreign currency translation adjustment	—	—	—	(20)	—	(20)
Stock Repurchase	—	—	—	—	—	—
Compensation expense related to equity awards, net of cancellations	—	—	19	—	—	19
Balance at March 31, 2020	<u>6,563</u>	<u>\$ 7</u>	<u>\$ 57,959</u>	<u>\$ (113)</u>	<u>\$ (49,301)</u>	<u>\$ 8,552</u>

(in thousands)	Common Stock		Additional Paid-in- Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
Balance at January 1, 2019	6,483	\$ 7	\$ 57,871	\$ (67)	\$ (48,826)	\$ 8,985
Net income (loss)	—	—	—	—	(314)	(314)
Foreign currency translation adjustment	—	—	—	50	—	50
Stock Repurchase	—	—	—	—	—	—
Compensation expense related to equity awards, net of cancellations	40	—	23	—	—	23
Balance at March 31, 2019	<u>6,523</u>	<u>\$ 7</u>	<u>\$ 57,894</u>	<u>\$ (17)</u>	<u>\$ (49,140)</u>	<u>\$ 8,744</u>

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

INTERLINK ELECTRONICS, INC.

Condensed Consolidated Statements of Cash Flows
(unaudited)

	<u>Three months ended March 31,</u>	
	<u>2020</u>	<u>2019</u>
	(in thousands)	
Cash flows from operating activities:		
Net income (loss)	\$ (18)	\$ (314)
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Depreciation and amortization	73	78
Stock based compensation	19	23
Amortization of right of use	50	45
Changes in operating assets and liabilities:		
Accounts receivable	11	269
Inventories	101	(58)
Prepaid expenses and other current assets	53	(8)
Other assets	7	—
Accounts payable	45	(71)
Accrued liabilities	(20)	(20)
Accrued income taxes	7	(29)
Deferred income taxes	—	—
Lease liabilities	(52)	(45)
Deferred other	(13)	(33)
Net cash provided (used) by operating activities	<u>263</u>	<u>(163)</u>
Cash flows from investing activities:		
Property, plant and equipment	—	(57)
Share repurchase	—	—
Intangibles	(34)	(17)
Net cash used in investing activities	<u>(34)</u>	<u>(74)</u>
Cash flows from financing activities:		
Proceeds from exercise of stock options	—	—
Net cash provided by financing activities	<u>—</u>	<u>—</u>
Effect of exchange rate changes on cash and cash equivalents	(20)	50
Net increase (decrease) in cash and cash equivalents	209	(187)
Cash, cash equivalents and restricted cash, beginning of period	5,844	6,107
Cash, cash equivalents and restricted cash, end of period	<u>\$ 6,053</u>	<u>\$ 5,920</u>
Supplemental disclosure of cash flow information:		
Income taxes paid	\$ —	\$ 27
Interest paid	—	—

See accompanying notes to these condensed consolidated financial statements.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements (unaudited)

NOTE 1-THE COMPANY AND ITS SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Interlink Electronics, Inc. (“we,” “us,” “our,” “Interlink” or the “Company”) designs, develops, manufactures and sells a range of force-sensing technologies that incorporate our proprietary materials technology, firmware and software into a portfolio of standard sensor based products and custom sensor system solutions. These include sensor components, subassemblies, modules and products that support effective, efficient cursor control and novel three-dimensional user inputs. Our Human Machine Interface (“HMI”) technology platforms are deployed in a wide range of markets including consumer electronics, automotive, industrial, and medical.

Interlink serves our world-wide customer base from our corporate headquarters in Camarillo, California (greater Los Angeles area), our global research and development (“R&D”) and engineering center in Singapore, our printed-electronics manufacturing facility in Shenzhen, China and our global distribution and logistics center in Hong Kong. We also maintain engineering, assembly and prototyping capabilities in Camarillo, California along with technical and sales offices in Japan and at multiple locations in the United States. Our principal executive office is located at 1267 Flynn Road, Camarillo, California 93012 and our telephone number is (805) 484-8855. Our website address is www.interlinkelectronics.com.

Fiscal Year

Our fiscal year is the calendar year reporting cycle beginning January 1 and ending December 31.

Basis of Presentation

The accompanying unaudited interim consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intra-entity transactions and balances have been eliminated in consolidation.

The accompanying unaudited interim consolidated financial statements for the Company and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial reporting. Accordingly, certain information and footnote disclosures normally included in annual consolidated financial statements have been condensed or omitted. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments and the elimination of intra-entity accounts) considered necessary for a fair presentation of all periods presented. The results of the Company’s operations for any interim periods are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year. These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes included in our Annual Report for the year ended December 31, 2019, which was posted to the OTC Markets website on May 15, 2020, and are included in the registration statement on Form 10.

Foreign Currency Translation

The functional currency of our Chinese subsidiary is the Chinese Yuan Renminbi. The functional currency for our Hong Kong and Singapore subsidiaries is the United States dollar. However, our Hong Kong and Singapore subsidiaries also transact business in their local currency. Therefore, assets and liabilities are translated into United States dollars at the exchange rate in effect on the balance sheet date. Revenues and expenses are translated at the average exchange rate prevailing during the respective periods. Foreign currency transaction and translation gains and losses are included in results of operations.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Segment Reporting

We operate in one reportable segment: the manufacture and sale of force sensing technology solutions.

Use of Estimates

The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and disclosures made in the accompanying notes to the consolidated financial statements. Management regularly evaluates estimates and assumptions related to revenue recognition, allowances for doubtful accounts, warranty reserves, inventory valuation reserves, stock-based compensation, purchased intangible asset valuations and useful lives, asset retirement obligations, and deferred income tax asset valuation allowances. These estimates and assumptions are based on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about carrying values of assets and liabilities that are not readily apparent from other sources. The actual results we experience may differ materially and adversely from our original estimates. To the extent there are material differences between the estimates and the actual results, our future results of operations will be affected.

Revenue Recognition

The Company recognizes revenue in accordance with Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers* (ASC 606), when its customer obtains control of promised goods or services, in an amount that reflects the consideration which we expect to receive in exchange for those goods or services. We recognize product revenues when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price to the customer is fixed or determinable; and (iv) collection of the sales price is reasonably assured. Delivery occurs when goods are shipped and title and risk of loss transfer to the customer, in accordance with the terms specified in the arrangement with the customer. Revenue recognition is deferred until the earnings process is complete.

We (i) input orders based upon receipt of a customer purchase order, (ii) confirm pricing through the customer purchase order record, (iii) validate creditworthiness through past payment history, credit agency reports and other financial data, and (iv) recognize revenue upon shipment of goods or when risk of loss and title transfer to the buyer. All customers have warranty rights, and some customers also have explicit or implicit rights of return. We establish reserves for potential customer returns or warranty repairs based on historical experience and other factors that enable us to reasonably estimate the obligation.

A portion of our product sales is made through distributors under agreements allowing for right of return. Our past history with these sell-through right of return provisions allow us to reasonably estimate the amount of inventory that could be returned pursuant to these agreements, and revenue is recognized accordingly.

We recognize revenue for non-recurring engineering or non-recurring tooling fees when there is persuasive evidence of an arrangement, performance obligations are identified, fees are fixed or determinable, delivery has occurred, and collectability is reasonably assured.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Warranty

We establish reserves for future product warranty costs that are expected to be incurred pursuant to specific warranty provisions with our customers. We generally warrant our products against defects for one year from date of shipment, with certain exceptions in which the warranty period can extend to more than one year based on contractual agreements. A warranty reserve is recorded against revenues when products are shipped. At each reporting period, we adjust our reserve for warranty claims based on our actual warranty claims experience as a percentage of net revenue for the preceding 12 months and also consider the effect of known operations issues that may have an impact that differs from historical trends. Historically, our warranty returns have not been material.

Shipping and Handling Fees and Costs

Amounts billed to customers for shipping and handling fees are presented in product revenues. Costs incurred for shipping and handling are included in cost of revenues.

Engineering, Research and Development Costs

Engineering, research and development (“R&D”) costs are expensed when incurred. R&D expenses consist primarily of compensation expenses for employees engaged in research, design and development activities. R&D expenses also include depreciation and amortization, and overhead, including facilities expenses.

Marketing Costs

All of the costs related to marketing and advertising our products are expensed as incurred or at the time the marketing takes place.

Stock-based Compensation

All stock-based payments to employees, including grants of employee stock options and employee stock purchase rights, are recognized in the financial statements based on their respective grant date (measurement date) fair values. We calculate the compensation cost of full-value awards such as restricted stock based on the market value of the underlying stock at the date of the grant. We estimate the expected life of a stock award as the period of time that the award is expected to be outstanding. We are required to estimate the fair value of stock-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense ratably over the requisite service periods. We estimate the fair value of each option award as of the date of grant using the Black-Scholes option pricing model, which was developed for use in estimating the value of traded options that have no vesting restrictions and that are freely transferable. The Black-Scholes option pricing model considers, among other factors, the expected life of the award and the expected volatility of our stock price. Although the Black-Scholes option pricing model meets the accounting guidance requirements, the fair values generated by the Black-Scholes option pricing model may not be indicative of the actual fair values of our awards, as it does not consider other factors important to those stock-based payment awards, such as continued employment, periodic vesting requirements, and limited transferability.

We have elected to recognize compensation expense for all stock-based awards on a straight-line basis over the requisite service period for the entire award. The amount of compensation expense recognized through the end of each reporting period is equal to the portion of the grant-date value of the awards that have vested, or for partially vested awards, the value of the portion of the award that is ultimately expected to vest for which the requisite services have been provided. The benefits of tax deductions in excess of recognized compensation cost are reported as a financing cash flow.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Other Income, Net

Other income, net, consists of interest income, foreign exchange gains and losses and other non-operating gains and losses.

Income Taxes

We account for income taxes under the asset and liability method, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis and operating loss and tax credit carryforwards. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not determinable beyond a “more likely than not” standard, we establish a valuation allowance. To the extent we establish a valuation allowance or increase or decrease this allowance in a period, we include an expense or benefit within the tax provision in the statement of operations. We also utilize a “more likely than not” recognition threshold and measurement analysis for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We recognize potential accrued interest and penalties related to unrecognized tax benefits within the consolidated statements of operations as income tax expense.

We operate within multiple tax jurisdictions and are subject to audit in these jurisdictions. Our foreign subsidiaries are subject to foreign income taxes on earnings in their respective jurisdictions. Earnings of our foreign subsidiaries are not included in our U.S. federal income tax return until earnings are repatriated. We are generally eligible to receive tax credits on repatriated earnings on our U.S. federal income tax return for foreign taxes paid by our subsidiaries.

Comprehensive Income

Comprehensive income includes all components of comprehensive income, including net income and any changes in equity during the period from transactions and other events and circumstances generated by non-owner sources.

Earnings per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of diluted common shares, which is inclusive of common stock equivalents from unexercised stock options and restricted stock units. Unexercised stock options and restricted stock units are considered to be common stock equivalents if, using the treasury stock method, they are determined to be dilutive.

Under the two-class method of determining earnings for each class of stock, we consider the dividend rights and participating rights in undistributed earnings for each class of stock.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Leases

Effective January 1, 2019, the Company accounts for its leases under ASC 842. Under this guidance, arrangements meeting the definition of a lease are classified as operating or financing leases, and are recorded on the consolidated balance sheet as both a right of use asset and lease liability, calculated by discounting fixed lease payments over the lease term at the rate implicit in the lease or the Company's incremental borrowing rate. Lease liabilities are increased by interest and reduced by payments each period, and the right of use asset is amortized over the lease term. For finance leases, interest on the lease liability and the amortization of the right of use asset results in front-loaded expense over the lease term. Variable lease expenses are recorded when incurred.

In calculating the right of use and lease liability, the Company has elected to combine lease and non-lease components. The Company excludes short-term leases having initial term of 12 months or less from the new guidance as an accounting policy election, and recognizes rent expense on a straight-line basis over the lease term.

Risk and Uncertainties

Our future results of operations involve a number of risks and uncertainties. Factors that could affect our business or future results and cause actual results to vary materially from historical results include, but are not limited to, the rapid change in our industry; problems with the performance, reliability or quality of our products; loss of customers; impacts of doing business internationally, including foreign currency fluctuations; potential shortages of the supplies we use to manufacture our products; disruptions in our manufacturing facilities; changes in environmental directives impacting our manufacturing process or product lines; the development of new proprietary technology and the enforcement of intellectual property rights by or against us; our ability to attract and retain qualified employees; and our ability to raise additional capital.

Public health threats could have an adverse effect on our operations and financial results.

Public health threats could adversely affect our ongoing or planned business operations. In particular, the outbreak in December 2019 of a novel coronavirus (COVID-19) in China has resulted in quarantines, restrictions on travel and other business and economic disruptions. We cannot presently predict the scope and severity of any potential business shutdowns or disruptions, but if we or any of the third parties with whom we engage, including the suppliers, distributors, resellers and other third parties with whom we conduct business, were to experience shutdowns or other business disruptions, our ability to conduct our business in the manner and on the timelines presently planned could be materially and adversely impacted.

Fair Value Measurements

We determine fair value measurements based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, we follow the following fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) our own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs):

Level 1: Observable inputs such as quoted prices for identical assets or liabilities in active markets;

Level 2: Other inputs observable directly or indirectly, such as quoted prices for similar assets or liabilities or market-corroborate inputs; and

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Level 3: Unobservable inputs for which there is little or no market data and which requires the owner of the assets or liabilities to develop its own assumptions about how market participants would price these assets or liabilities.

Our assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of assets and liabilities and their placement within the fair value hierarchy.

Recently Issued Accounting Pronouncements

In January 2016, the FASB issued ASU No. 2016-01, “*Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*”, that amends existing guidance around classification and measurement of certain financial assets and liabilities. Changes to the current GAAP model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. Under the new guidance, all equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. For equity investments without readily determinable fair values, the cost method is also eliminated. However, most entities will be able to elect to record equity investments without readily determinable fair values at cost, less impairment, and plus or minus subsequent adjustments for observable price changes. The standard also requires that financial assets and liabilities be disclosed separately in the notes to the financial statements based on measurement principle and form of financial asset. The amendments in this guidance are effective for financial statements issued for interim and annual periods beginning after December 15, 2017. This standard did not have a significant impact on our consolidated financial statements or disclosures.

In February 2016, the FASB issued ASU No. 2016-02, “*Leases (Topic 842)*”, which replaces the existing guidance in ASC Topic 840, “Leases”. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years and requires retrospective application. The Company adopted ASU 2016-02 as of January 1, 2019, which resulted in reclassifications to our balance sheet but an overall immaterial impact to our consolidated income or loss.

In June 2016, the FASB issued ASU No. 2016-13, “*Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*”, that significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income, including trade receivables. The standard requires an entity to estimate its lifetime “expected credit loss” for such assets at inception, and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The standard is effective for annual periods beginning after December 15, 2019, and interim periods therein. Early adoption is permitted for annual periods beginning after December 15, 2018, and interim periods therein. This standard is not expected to have a significant impact on our consolidated financial statements or disclosures.

In October 2016, the FASB issued ASU No. 2016-16, “*Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*,” which reduces the complexity in the accounting standards by allowing the recognition of current and deferred income taxes for an intra-entity asset transfer, other than inventory, when the transfer occurs. Historically, recognition of the income tax consequence was not recognized until the asset was sold to an outside party. This amendment should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. ASU 2016-16 is effective for annual periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. The Company

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Notes to Condensed Consolidated Financial Statements - continued (unaudited)

adopted ASU 2016-16 effective January 1, 2018 and it did not have a significant impact on our consolidated financial statements or disclosures.

In January 2017, the FASB issued ASU 2017-01, “*Business Combinations (Topic 805): Clarifying the Definition of a Business*”, clarifying the definition of a business, reducing the number of transactions that need to be further evaluated and providing a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in the ASU specify that when the fair value of the gross assets acquired or disposed of is concentrated in a single identifiable asset or a group of similar identifiable assets, the integrated set of assets and activities is not a business. The guidance also requires that an integrated set of assets and activities must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output to be considered a business, and removes the evaluation of whether a market participant could replace the missing elements. The ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019, with early adoption permitted. The Company will apply this standard to future transactions within the scope of the ASU.

In May 2017, the FASB issued ASU No. 2017-09, *Modification Accounting for Share-Based Payment Arrangements*, which amends the scope of modification accounting for share-based payment arrangements. The ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under ASC 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification. The ASU is effective for annual reporting periods, including interim periods within those annual reporting periods, beginning after December 15, 2017. The Company adopted ASU 2017-09 effective January 1, 2018 and it did not have a significant impact on our consolidated financial statements or disclosures.

We reviewed all other recently issued accounting pronouncements and concluded they are not applicable or not expected to be material to our financial statements.

NOTE 2-INVENTORIES

Inventories, stated at the lower of cost or net realizable value, consist of the following:

	March 31, 2019	December 31, 2019
Inventories	(in thousands)	
Raw materials	\$ 512	\$ 540
Work-in-process	215	253
Finished goods	99	134
Total inventories	<u>\$ 826</u>	<u>\$ 927</u>

NOTE 3-STOCK BASED COMPENSATION

Under the terms of our 2016 Omnibus Incentive Plan (the “2016 Plan”), officers and key employees could be granted restricted stock units, as well as non-qualified or incentive stock options, at the discretion of the Compensation Committee of the Board of Directors. The Plan replaces the 1996 Stock Incentive Plan (the “1996 Plan”) which was terminated in December 2015; however, all grants issued under the 1996 Plan prior to its termination will continue to vest, expire or terminate in accordance with the 1996 Plan document and the terms of each award.

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Notes to Condensed Consolidated Financial Statements - continued
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Restricted Stock Units

Our outstanding restricted stock unit grants vest over five years in installments of 50% on the fourth anniversary of the grant date and the remaining 50% on the fifth anniversary of the grant date. Unvested restricted shares are forfeited if the recipient's employment terminates for any reason other than death, disability or special circumstances as determined by the Compensation Committee of the Board of Directors.

Activity for our restricted stock units is as follows:

	<u>Restricted Stock Units</u> (in thousands)	<u>Weighted-Average Grant Date Fair Value</u>	<u>Weighted Average Remaining Contractual Life</u> (years)	<u>Aggregate Intrinsic Value</u> (in thousands)
Restricted stock units, December 31, 2019	37	\$ 5.23	0.38	\$ 178
Awarded	—	\$		
Issued	—	\$		
Forfeited	—	\$		
Restricted stock units, March 31, 2020	37	\$ 5.23	0.13	\$ 114

The aggregate intrinsic values in the preceding table for the restricted stock units outstanding represent the total pretax intrinsic value, based on our closing stock price of \$3.04 and \$4.75 as of March 31, 2020 and December 31, 2019, respectively.

Stock based compensation incurred for the three months ended March 31, 2020 was \$19 thousand as compared to \$23 thousand for the comparable periods ended March 31, 2019.

Stock Options

The exercise price of our stock options is the closing price on the date the options are granted. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. Options generally expire 10 years from the date of grant. The following table summarizes the activity for the remaining options outstanding under the Plan:

	<u>Shares</u> (in thousands)	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life</u> (years)	<u>Aggregate Intrinsic Value</u> (in thousands)
Options outstanding, December 31, 2019	3	\$ 7.40	7.84	\$ —
Granted	—			
Exercised	—			
Cancelled or expired	—			
Options outstanding, March 31, 2020	3	\$ 7.40	7.59	\$ —
Options exercisable, March 31, 2020	3	\$ 7.40	7.59	\$ —

This intrinsic value represents the excess of the fair market value of our common stock on the date of exercise over the exercise price of such options. The aggregate intrinsic values in the preceding table for the options outstanding represent the total pretax intrinsic value, based on our closing stock price of \$3.04 and \$4.75 as of March 31, 2020 and December 31, 2019, respectively, which would have been received by the option holders had those option holders exercised their in-the-money options as of those dates.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued
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The fair value of stock-based option awards is estimated at the date of grant using the Black-Scholes option pricing model; however, the value calculated using an option pricing model may not be indicative of the fair value observed in a willing buyer/willing seller market transaction, or actually realized by the employee upon exercise. Expected volatility used to estimate the fair value of options granted is based on the historical volatility of our common stock. The risk-free interest rate is based on the United States Treasury constant maturity rate for the expected life of the stock option. The expected life of a stock award is the period of time that the award is expected to be outstanding.

The following table provides additional information in regards to options outstanding as of March 31, 2020:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding (in thousands)	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number Exercisable (in thousands)	Weighted Average Exercise Price
\$ 7.40	3	7.59	\$ 7.40	3	\$ 7.40
	<u>3</u>	<u>7.59</u>		<u>3</u>	<u>7.40</u>

NOTE 4-EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period, plus the dilutive effect of outstanding stock options and restricted stock-based awards using the treasury stock method.

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

	Three Months Ended March 31,	
	2020	2019
	(in thousands, except per share data)	
Net income (loss)	\$ (18)	\$ (314)
Comprehensive income (loss)	\$ (38)	\$ (264)
Weighted average outstanding shares of common stock	6,563	6,503
Dilutive potential common shares from stock options and restricted stock units	35	78
Common stock and common stock equivalents	<u>6,598</u>	<u>6,581</u>
Earnings (loss) per share, basic and diluted	<u>\$ (0.00)</u>	<u>\$ (0.05)</u>
Comprehensive income (loss) per share: basic and diluted	<u>\$ (0.01)</u>	<u>\$ (0.05)</u>
Shares subject to anti-dilutive stock options and restricted stock-based awards excluded from calculation	<u>6</u>	<u>5</u>

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Notes to Condensed Consolidated Financial Statements - continued
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NOTE 5-EQUITY TRANSACTIONS

On August 21, 2019, we repurchased 2,788 shares of our common stock at a purchase price of \$1.95 per share from an existing stockholder in a private transaction approved by our Board of Directors. The repurchased shares were immediately retired and restored to the status of authorized and unissued shares.

At March 31, 2020 we had 6,563,050 shares of common stock issued and outstanding.

NOTE 6-SIGNIFICANT CUSTOMERS, CONCENTRATION OF CREDIT RISK AND GEOGRAPHIC INFORMATION

We manage and operate our business through one operating segment.

Net revenues from customers equal to or greater than 10% of total net revenues are as follows:

	<u>Three months ended March 31,</u>	
	<u>2020</u>	<u>2019</u>
Customer A	24 %	28 %
Customer B	11 %	* %
Customer C	* %	10 %
Customer D	* %	10 %

* Less than 10% of total net revenues

Net revenues by geographic area are as follows:

	<u>Three months ended March 31,</u>	
	<u>2020</u>	<u>2019</u>
	<u>(in thousands)</u>	
United States	\$ 742	\$ 672
Asia and Middle East	771	580
Europe and other	178	198
Revenue, net	<u>\$ 1,691</u>	<u>\$ 1,450</u>

Revenues by geographic area are based on the country of shipment destination. The geographic location of distributors and third-party manufacturing service providers may be different from the geographic location of the purchasers and/or ultimate end users.

We provide credit only to creditworthy third parties who are subject to our credit verification procedures. Accounts receivable balances are monitored on an ongoing basis, and accounts deemed to have credit risk are fully reserved. At March 31, 2020, three customers accounted for 26%, 15% and 11% of total accounts receivable, respectively. At December 31, 2019, four customers accounted for 29%, 20%, 11% and 11% of total accounts receivable, respectively. Our allowance for doubtful accounts was \$0 thousand at March 31, 2020 and December 31, 2019, respectively.

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Notes to Condensed Consolidated Financial Statements - continued (unaudited)

Our long-lived assets (property, plant and equipment plus intangibles, net) were geographically located as follows:

	March 31, 2020	December 31, 2019
	(in thousands)	
United States	\$ 217	\$ 200
Asia	548	604
Total long-lived assets	<u>\$ 765</u>	<u>\$ 804</u>

NOTE 7-RELATED PARTY TRANSACTIONS

BKF Capital Group (OTC:BKFG)

We entered into an agreement, dated March 1, 2017 with BKF Capital Group, Inc. (“BKF”). Pursuant to the agreement, BKF occupies and uses one furnished office, telephone and other services, located at our corporate offices, for a fee of \$1,000 per month. The agreement was amended effective February 1, 2017 reducing the fee to \$250 per month. In addition, we will occasionally pay administrative expenses on behalf of BKF, and BKF will reimburse the Company. On March 1, 2018, BKF leased executive office space in Charleston, SC. Interlink used a portion of this office space for a proportionate fee. BKF still utilized a portion of the Interlink offices in California for the \$250 per month fee. Effective March 1, 2018 we modified the existing agreement and entered into a cost-sharing agreement with Interlink that calls for a monthly net settlement of all shared costs between the use of the California and the South Carolina offices, including rent, administrative expenses and similar costs.

In February 2019, BKF chose not to renew the lease for executive office space in Charleston, SC. BKF still paid for office space located at Interlink’s corporate offices in Westlake Village, CA, for a fee of \$250 per month until June 2019, when Interlink moved its corporate headquarters to Camarillo, CA in a facility shared with Qualstar Corporation. Beginning in June 2019 and going forward, BKF Capital pays Qualstar directly for the \$250 per month fee.

For the three ended March 31, 2020 and 2019, BKF paid \$0 and \$750, respectively to the Company. Steven N. Bronson, our Chairman of the Board, President and Chief Executive Officer, is also the Chairman of the Board, Chief Executive Officer and majority shareholder of BKF. At March 31, 2020 and December 31, 2019, there were no amounts owed between the companies.

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Notes to Condensed Consolidated Financial Statements - continued
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Qualstar Corporation (NASDAQ:QBAK)

The Company agreed to reimburse, or be reimbursed by, Qualstar Corporation (“Qualstar”) for our occupation and use of a portion of their Camarillo manufacturing location and other expenses paid by one company on behalf of the other. In addition, the Company and Qualstar have entered into shared services agreements for marketing, executive and finance support services. Steven N. Bronson, our Chairman of the Board, President and Chief Executive Officer, is also the President and Chief Executive Officer of Qualstar. Transactions with Qualstar are as follows:

	Three months ended March 31,			
	2020		2019	
	Due from Qualstar	Due to Qualstar	Due from Qualstar	Due to Qualstar
	(in thousands)			
Balance at January 1,	\$ 24	\$ 12	\$ 3	\$ 2
Billed to Qualstar by Interlink	128	—	54	—
Paid by Qualstar to Interlink	(151)	—	(22)	—
Billed to Interlink by Qualstar	—	33	—	6
Paid by Interlink to Qualstar	—	(38)	—	(6)
Balance at March 31,	\$ 1	\$ 7	\$ 35	\$ 2

NOTE 8-INCOME TAXES

Income tax benefit as a percentage of income before income taxes was (72.7%) for the three months ended March 31, 2020 versus tax benefit of (16.5) % for the comparable period in the prior year. Our income tax expense is primarily impacted by the mix of domestic and foreign pre-tax earnings, as well as our ability to utilize prior net operating loss carryovers (“NOLs”).

The Company experienced an ownership change under IRC Section 382 in February 2010. In general, a Section 382 ownership change occurs if there is a cumulative change in our ownership by “5% shareholders” (as defined in the Internal Revenue Code of 1986, as amended) that exceeds 50 percentage points over a rolling three-year period. An ownership change generally affects the rate at which NOLs and potential other deferred tax assets are permitted to offset future taxable income. Certain state jurisdictions within which we operate contain similar provisions and limitations. All of the remaining federal and state NOLs as of March 31, 2020 are subject to annual limitations due to the February 2010 ownership change.

Management assesses the available positive and negative evidence to estimate if sufficient future taxable income will be generated to utilize the existing deferred tax assets. We analyzed our need to maintain the valuation allowance against our otherwise recognizable deferred tax assets in the federal, state and foreign jurisdictions and had previously recorded a full valuation allowance. During the fourth quarter of 2016, we determined, given our current earnings and anticipated future earnings, that sufficient evidence existed to reach a conclusion that the valuation allowance was no longer warranted.

INTERLINK ELECTRONICS, INC.

Notes to Condensed Consolidated Financial Statements - continued (unaudited)

NOTE 9-COMMITMENTS AND CONTINGENCIES

Lease Agreements

We lease facilities under non-cancellable operating leases. The leases expire at various dates through fiscal 2021 and frequently include renewal provisions for varying periods of time, provisions which require us to pay taxes, insurance and maintenance costs, and provisions for minimum rent increases. Minimum lease payments, including scheduled rent increases are recognized as rent expenses on a straight-line basis over the term of the lease.

The rate implicit in each lease is not readily determinable, and we therefore use our incremental borrowing rate to determine the present value of the lease payments. The weighted average incremental borrowing rate used to determine the initial value of right of use (ROU) assets and lease liabilities during the three months ended March 31, 2020 was 6.75%.

Right of use assets for operating leases are periodically reduce by impairment losses. We use the long-lived assets impairment guidance in ASC Subtopic 360-10, Property, Plant and Equipment – Overall, to determine whether a ROU asset is impaired, and if so, the amount of the impairment loss to recognize. As of March 31, 2020, we have not recognized any impairment losses for our ROU assets.

We monitor for events or changes in circumstances that require a reassessment of one of our leases. When a reassessment results in the remeasurement of a lease liability, a corresponding adjustment is made to the carrying amount of the corresponding ROU asset unless doing so would reduce the carrying amount of the ROU asset to an amount less than zero. In that case, the amount of the adjustment that would result in a negative ROU asset balance is recorded in profit or loss.

Right of Use Assets

We have various operating leases for office space that expire through 2021. Below is a summary of our right of use assets and liabilities as of March 31, 2020 (in thousands).

Right-of-use assets	\$	153
Lease liability obligations	\$	168
Lease liability obligations, less current portion		(130)
Total lease liability obligations, long term	\$	38
Weighted-average remaining lease term		1.45 years
Weighted-average discount rate		6.75%

During the three months ended March 31, 2020, we recognized approximately \$59 thousand in operating lease costs. Operating lease costs of \$24 thousand are included in cost of revenue, and \$35 thousand are included in operating expenses in our consolidated statement of operations. During the three months ended March 31, 2020, cash paid for operating leases was approximately \$72 thousand.

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During the three months ended March 31, 2019, we recognized approximately \$78 thousand in operating lease costs. Operating lease costs of \$30 thousand are included in cost of revenue, and \$48 thousand are included in operating expenses in our consolidated statement of operations. During the three months ended March 31, 2019, cash paid for operating leases was approximately \$82 thousand.

Approximate future minimum lease payments for our right of use assets over the remaining lease periods as of March 31, 2020, are as follows (in thousands):

Remainder of 2020	\$	107
2021		68
Total minimum payments		175
Less: amount representing interest		(7)
Total	\$	168

Litigation

We are not party to any legal proceedings at March 31, 2020. We are occasionally involved in legal proceedings in the ordinary course of business, including actions against us which assert or may assert claims or seek to impose fines and penalties in substantial amounts. Related legal defense costs are expensed as incurred.

Warranties

We establish reserves for future product warranty costs that are expected to be incurred pursuant to specific warranty provisions with our customers. We generally warrant our products against defects for one year from date of shipment, with certain exceptions in which the warranty period can extend to more than one year based on contractual agreements. Our warranty reserves are established at the time of sale and updated throughout the warranty period based upon numerous factors including historical warranty return rates and expenses over various warranty periods. Historically, our warranty returns have not been material.

Intellectual Property Indemnities

We indemnify certain customers and our contract manufacturers against liability arising from third-party claims of intellectual property rights infringement related to our products. These indemnities appear in development and supply agreements with our customers as well as manufacturing service agreements with our contract manufacturers, are not limited in amount or duration and generally survive the expiration of the contract. Given that the amount of any potential liabilities related to such indemnities cannot be determined until an infringement claim has been made, we are unable to determine the maximum amount of losses that we could incur related to such indemnifications.

Director and Officer Indemnities and Contractual Guarantees

We have entered into indemnification agreements with our directors and executive officers, which require us to indemnify such individuals to the fullest extent permitted by Nevada law. Our indemnification obligations under such agreements are not limited in amount or duration. Certain costs incurred in connection with such indemnifications may be recovered under certain circumstances under various insurance policies. Given that the amount of any potential

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Notes to Condensed Consolidated Financial Statements - continued (unaudited)

liabilities related to such indemnities cannot be determined until a lawsuit has been filed, we are unable to determine the maximum amount of losses that we could incur relating to such indemnities.

We have also entered into an employment agreement with Steven N. Bronson, our Chairman of the Board, President and Chief Executive Officer. This agreement contains certain severance and change in control obligations. Under the agreement, if Mr. Bronson's employment is terminated due to his death or disability (as such terms are defined in the agreement), Mr. Bronson or his beneficiaries will be entitled to receive: (i) his base compensation to the end of the monthly pay period immediately following the date of termination; (ii) accrued bonus payments; and (iii) all unvested equity and/or options issued by the Company shall immediately fully vest. If Mr. Bronson's employment is terminated by him for good reason (as such term is defined in the agreement), or by us without cause, then Mr. Bronson will be entitled to receive: (i) his base compensation to the date of termination; (ii) a severance payment equal to twelve months of his base compensation; (iii) any earned bonus compensation; (iv) employee benefits for twelve months following the date of termination; (v) any vested company match 401k or other retirement contribution; and (vi) all unvested equity and/or options issued by the Company shall immediately fully vest.

In the event of a change in control of the Company (as such term is defined in the agreement), Mr. Bronson is entitled to receive: (i) a change in control payment in an amount equal to twelve months of his base compensation, payable as of the date the change in control occurs; and (ii) all unvested equity and/or options issued by the Company shall immediately fully vest.

Guarantees and Indemnities

In the normal course of business, we are occasionally required to undertake indemnification for which we may be required to make future payments under specific circumstances. We review our exposure under such obligations no less than annually, or more frequently as required. The amount of any potential liabilities related to such obligations cannot be accurately determined until a formal claim is filed. Historically, any such amounts that become payable have not had a material negative effect our business, financial condition or results of operations. We maintain general and product liability insurance which may provide a source of recovery to us in the event of an indemnification claim.

Subsequent events

Subsequent to March 31, 2020, we applied for and received a loan from Silicon Valley Bank in the aggregate principal amount of \$185,530 pursuant to the Paycheck Protection Program (the "PPP") under the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which was enacted March 27, 2020. The loan is evidenced by a promissory note, dated April 21, 2020, issued by us to the lender, which note matures on April 20, 2022, and bears interest at a rate of 1.00% per annum, payable monthly commencing on November 21, 2020, following an initial deferral period as specified under the PPP. We may prepay the note at any time prior to maturity with no prepayment penalties. Proceeds from the loan will be used to fund designated expenses, including certain payroll costs, group health care benefits and other permitted expenses, in accordance with the PPP. Under the terms of the PPP, up to the entire amount of principal and accrued interest may be forgiven to the extent loan proceeds are used for qualifying expenses as described in the CARES Act and applicable implementing guidance issued by the U.S. Small Business Administration under the PPP. We intend to use all or a substantial portion of the loan for designated qualifying expenses and to apply for forgiveness of all or a substantial portion of the loan in accordance with the terms of the PPP. No assurance can be given that we will obtain forgiveness of the loan in whole or in part. With respect to any portion of the loan that is not forgiven, the loan will be subject to customary provisions for a loan of this type, including customary events of default relating to, among other things, payment defaults and breaches of the note's provisions.

