

AEHR TEST SYSTEMS
Form 10-Q
April 12, 2019

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

FORM 10-Q

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

For the quarterly period ended February 28, 2019

OR

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

For the transition period from _____ to _____

Commission file number: 000-22893

AEHR TEST SYSTEMS
(Exact name of Registrant as specified in its charter)

California 94-2424084
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

400 Kato Terrace 94539
Fremont, CA
(Address of principal executive offices) (Zip Code)

(510) 623-9400
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 as the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer

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Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Number of shares of the registrant's common stock, \$0.01 par value, outstanding as of March 31, 2019 was 22,562,044.

AEHR TEST SYSTEMS

FORM 10-Q

FOR THE QUARTER ENDED FEBRUARY 28, 2019

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS (Unaudited)

AEHR TEST SYSTEMS
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (in thousands, except per share data)
 (unaudited)

	February 28, May 31,	
	2019	2018
		(1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$12,300	\$16,848
Accounts receivable, net	1,944	2,856
Inventories	9,189	9,049
Prepaid expenses and other current assets	787	703
Total current assets	24,220	29,456
Property and equipment, net	975	1,203
Other assets	256	296
Total assets	\$25,451	\$30,955
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$557	\$1,762
Accrued expenses	2,085	1,646
Customer deposits and deferred revenue, short-term	1,267	1,630
Current portion of long-term debt	6,110	6,110
Total current liabilities	10,019	11,148
Deferred rent	151	63
Deferred revenue, long-term	240	459
Total liabilities	10,410	11,670
Aehr Test Systems shareholders' equity:	226	221

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Common stock, \$0.01 par value: Authorized: 75,000 shares; Issued and outstanding: 22,562 shares and 22,143 shares at February 28, 2019 and May 31, 2018, respectively

Additional paid-in capital	84,176	83,041
Accumulated other comprehensive income	2,252	2,292
Accumulated deficit	(71,594)	(66,249)
 Total Aehr Test Systems shareholders' equity	 15,060	 19,305
Noncontrolling interest	(19)	(20)
 Total shareholders' equity	 15,041	 19,285
 Total liabilities and shareholders' equity	 \$25,451	 \$30,955

(1) The condensed consolidated balance sheet at May 31, 2018 has been derived from the audited consolidated financial statements at that date.

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

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018
Net sales	\$3,163	\$7,393	\$13,814	\$22,286
Cost of sales	2,891	4,217	9,591	13,061
Gross profit	272	3,176	4,223	9,225
Operating expenses:				
Selling, general and administrative	1,850	1,829	5,706	5,474
Research and development	931	1,040	3,033	3,085
Restructuring	607	--	607	--
Total operating expenses	3,388	2,869	9,346	8,559
(Loss) income from operations	(3,116)	307	(5,123)	666
Interest expense, net	(76)	(98)	(228)	(310)
Other (expense) income, net	(11)	(33)	27	(100)
(Loss) income before income tax benefit (expense)	(3,203)	176	(5,324)	256
Income tax benefit (expense)	2	91	(21)	81
Net (loss) income	(3,201)	267	(5,345)	337
Less: Net income attributable to the noncontrolling interest	--	--	--	--
Net (loss) income attributable to Aehr Test Systems common shareholders	\$(3,201)	\$267	\$(5,345)	\$337
Net (loss) income per share				
Basic	\$(0.14)	\$0.01	\$(0.24)	\$0.02
Diluted	\$(0.14)	\$0.01	\$(0.24)	\$0.01

Shares used in per share calculations:

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Basic	22,459	21,832	22,314	21,631
Diluted	22,459	22,641	22,314	22,838

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

AEHR TEST SYSTEMS
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
 (in thousands, unaudited)

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018
Net (loss) income	\$(3,201)	\$267	\$(5,345)	\$337
Other comprehensive (loss) income, net of tax:				
Net change in unrealized loss on investments	--	--	--	(3)
Net change in cumulative translation adjustments	10	37	(39)	97
Total comprehensive (loss) income	(3,191)	304	(5,384)	431
Less: Comprehensive (loss) income attributable to the noncontrolling interest	(1)	(1)	1	(1)
Comprehensive (loss) income, attributable to Aehr Test Systems common shareholders	\$(3,190)	\$305	\$(5,385)	\$432

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

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended	
	February 28,	
	2019	2018
Cash flows from operating activities:		
Net (loss) income	\$(5,345)	\$337
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Stock-based compensation expense	705	822
Recovery of doubtful accounts	(3)	(3)
Depreciation and amortization	333	300
Accretion of investment discount	--	(24)
Changes in operating assets and liabilities:		
Accounts receivable	871	(527)
Inventories	(121)	(2,392)
Prepaid expenses and other current assets	(47)	(603)
Accounts payable	(1,132)	(268)
Accrued expenses	431	31
Customer deposits and deferred revenue	(582)	(764)
Deferred rent	88	--
Income taxes payable	9	(5)
Net cash used in operating activities	(4,793)	(3,096)
Cash flows from investing activities:		
Purchases of investments	--	(5,965)
Purchases of property and equipment	(124)	(458)
Net cash used in investing activities	(124)	(6,423)
Cash flows from financing activities:		
Proceeds from issuance of common stock under employee plans, net of taxes paid related to share settlement of equity awards	435	727
Net cash provided by financing activities	435	727
Effect of exchange rates on cash and cash equivalents	(66)	66
Net decrease in cash and cash equivalents	(4,548)	(8,726)

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Cash and cash equivalents, beginning of period	16,848	17,803
Cash and cash equivalents, end of period	\$12,300	\$9,077
Supplemental disclosure of non-cash flow information:		
Transfers of property and equipment to inventories	\$20	\$372

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

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AEHR TEST SYSTEMS
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCCOUNTING POLICIES

The accompanying financial information has been prepared by Aehr Test Systems, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations.

In the opinion of management, the unaudited condensed consolidated financial statements for the interim periods presented have been prepared on a basis consistent with the May 31, 2018 audited consolidated financial statements and reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the condensed consolidated financial position and results of operations as of and for such periods indicated. These unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2018. Results for the interim periods presented herein are not necessarily indicative of results which may be reported for any other interim period or for the entire fiscal year.

PRINCIPLES OF CONSOLIDATION. The condensed consolidated financial statements include the accounts of Aehr Test Systems and its subsidiaries (collectively, the "Company"). All significant intercompany balances have been eliminated in consolidation. For the Company's majority owned subsidiary, Aehr Test Systems Japan K.K., the noncontrolling interest of the portion the Company does not own was reflected on the Condensed Consolidated Balance Sheets in Shareholders' Equity and in the Condensed Consolidated Statements of Operations.

ACCOUNTING ESTIMATES. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used to account for sales and revenue allowances, the allowance for doubtful accounts, inventory valuations, income taxes, stock-based compensation expenses, and product warranties, among others. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances. Actual results could differ materially from those estimates.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES. The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K for the year ended May 31, 2018. There have been no significant changes in the Company's significant accounting policies during the three and nine months ended February 28, 2019 except for revenue recognition.

2. RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Adopted

Revenue Recognition

In May 2014, the FASB issued Accounting Standards Codification (“ASC”) Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), which has been subsequently updated (collectively “ASC 606”). The core principle of the standard is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. The new standard defines a five-step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price, and allocating the transaction price to each distinct performance obligation. The standard permits the use of either the retrospective or modified retrospective transition methods. It also requires expanded disclosures including the nature, amount, timing, and uncertainty of revenues and cash flows related to contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract.

The Company adopted ASC 606 on June 1, 2018, the first day of fiscal 2019, using the modified retrospective method. The Company applied ASC 606 to all contracts not completed as of the date of adoption in order to determine any adjustment to the opening balance of retained earnings. Under the modified retrospective adoption method, the comparative financial information has not been restated and continues to be reported under the accounting standards in effect for those periods, ASC 605, "Revenue Recognition", which is also referred to herein as "legacy GAAP."

The adoption of ASC 606 did not have a material impact on the Company’s consolidated financial statements as of June 1, 2018. No adjustment was recorded to accumulated deficit as of the adoption date and reported revenue would not have been different under legacy GAAP. Additionally, the Company does not expect the adoption of the revenue standard to have a material impact to the Company’s net income on an ongoing basis.

Classification of Certain Cash Receipts and Cash Payments

In August 2016, the FASB issued authoritative guidance related to the classification of certain cash receipts and cash payments on the statement of cash flows. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company’s consolidated financial statements.

Intra-Entity Asset Transfers

In October 2016, the FASB issued an accounting standard update that requires recognition of the income tax consequences of intra-entity transfers of assets (other than inventory) at the transaction date. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company’s consolidated financial statements.

Restricted Cash

In November 2016, the FASB issued authoritative guidance related to statements of cash flows. This guidance clarifies that amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of period total amounts shown on the statement of cash flows. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company’s consolidated financial statements.

Income Taxes

On December 22, 2017, the US government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act makes broad and complex changes to the US tax code including but not

limited to (1) reducing the US federal corporate tax rate from 34% to 21%; (2) requiring companies to pay a one-time transition tax on certain repatriated earnings of foreign subsidiaries; (3) generally eliminating US federal income taxes on dividends from foreign subsidiaries; (4) requiring a current inclusion in US federal income of certain earnings of controlled foreign corporations; (5) creating a new limitation on deductible interest expense; (6) changing rules related to the uses and limitations of net operating loss carryforwards created in tax years beginning after December 31, 2017, and (7) repeals the corporate alternative minimum tax regime, or AMT, effective December 31, 2017 and permits existing minimum tax credits to offset the regular tax liability for any tax year. Consequently, the Company has accounted for the reduction of \$6.4 million of deferred tax assets with an offsetting adjustment to the valuation allowance for the fiscal year ended 2018, and recorded a benefit of \$90,000 for the Company's Federal refundable AMT credit.

On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”) which provides guidance on accounting for the tax effects of the Tax act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income taxes. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. There are also certain transitional impacts of the Tax Act. As part of the transition to the new territorial tax system, the Tax Act imposes a one-time repatriation tax on deemed repatriation of historical earnings of foreign subsidiaries. The Company is not subject to the transition tax. The one-time transition tax is based on post-1986 earnings and profits that were previously deferred from U.S. income tax. The Company has finalized its calculation of the total post-1986 earnings and profits for its foreign corporations. Based on the Company’s net operating loss carryovers and valuation allowance, there is no impact to its consolidated financial statements as a result of the completion of the analysis.

Accounting Standards Not Yet Adopted

Financial Instruments

In January 2016, the FASB issued an accounting standard update related to recognition and measurement of financial assets and financial liabilities. This standard changes accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements for financial instruments. In addition, it clarifies guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. This standard is effective for us in fiscal year 2020. Early adoption is permitted. The Company does not expect a material impact of this new guidance on its consolidated financial statements.

In June 2016, the FASB issued an accounting standard update that requires measurement and recognition of expected credit losses for financial assets held based on historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. The accounting standard update will be effective for the Company beginning in the first quarter of fiscal 2021 on a modified retrospective basis, and early adoption in fiscal 2020 is permitted. The Company does not expect a material impact of this accounting standard update on its consolidated financial statements.

Leases

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) (“ASU 2016-02”), which modifies lease accounting for lessees to increase transparency and comparability by recording lease assets and liabilities for operating leases and disclosing key information about leasing arrangements. The Company will adopt ASU 2016-02 utilizing the modified retrospective transition method through a cumulative-effect adjustment at the beginning of its first quarter of 2020. We are currently assessing the impact on our Consolidated Financial Statements and expect that the primary impact upon adoption will be the recognition of right-of-use assets and lease liabilities on the Company’s Condensed Consolidated Balance Sheets for those leases currently classified as operating leases.

3. REVENUE

Revenue recognition

The Company recognizes revenue when promised goods or services are transferred to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services by following a five-step process, (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price, and (5) recognize revenue when or as the Company satisfies a performance obligation, as further described below.

Performance obligations include sales of systems, contactors, spare parts, and services, as well as, installation and training services included in customer contracts.

A contract's transaction price is allocated to each distinct performance obligation. In determining the transaction price, the Company evaluates whether the price is subject to refund or adjustment to determine the net consideration to which the Company expects to be entitled. The Company generally does not grant return privileges, except for defective products during the warranty period.

For contracts that contain multiple performance obligations, the Company allocates the transaction price to the performance obligations on a relative standalone selling price basis. Standalone selling prices are based on multiple factors including, but not limited to historical discounting trends for products and services and pricing practices in different geographies.

Revenue for systems and spares are recognized at a point in time, which is generally upon shipment or delivery. Revenue from services is recognized over time as services are completed or ratably over the contractual period of generally one year or less.

The Company has elected the practical expedient under ASC 606 to not assess whether a contract has a significant financing component as the Company's standard payment terms are less than one year.

Disaggregation of revenue

The following tables show revenues by major product categories. Within each product category, contract terms, conditions and economic factors affecting the nature, amount, timing and uncertainty around revenue recognition and cash flow are substantially similar.

The Company's revenues by product category are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018

Type of good / service:

Systems	\$404	\$4,345	\$5,922	\$12,851
Contactors	1,445	747	3,541	5,291
Services	1,314	2,301	4,351	4,144
	\$3,163	\$7,393	\$13,814	\$22,286

Product lines:

Wafer-level	\$2,046	\$2,934	\$8,240	\$9,898
Test During Burn-In	1,117	4,459	5,574	12,388
	\$3,163	\$7,393	\$13,814	\$22,286

The following presents information about the Company's operations in different geographic areas. Net sales are based upon ship-to location (in thousands):

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018

Geographic region:

United States	\$2,203	\$1,493	\$9,407	\$4,747
Asia	746	4,974	3,814	16,543
Europe	214	926	593	996
	\$3,163	\$7,393	\$13,814	\$22,286

With the exception of the amount of service contracts and extended warranties, the Company's product category revenues are recognized at point in time when control transfers to customers.

Three Months Ended		Nine Months Ended	
February 28,		February 28,	
2019	2018	2019	2018

Timing of revenue recognition:

Products and services transferred at a point in time	\$2,507	\$6,805	\$11,897	\$20,692
Services transferred over time	656	588	1,917	1,594
	\$3,163	\$7,393	\$13,814	\$22,286

Contract balances

A receivable is recognized in the period the Company delivers goods or provides services or when the Company's right to consideration is unconditional. The Company usually does not record contract assets because the Company has an unconditional right to payment upon satisfaction of the performance obligation, and therefore, a receivable is more commonly recorded than a contract asset.

Contract liabilities include payments received in advance of performance under a contract and are satisfied as the associated revenue is recognized. Contract liabilities are reported on the Condensed Consolidated Balance Sheets at the end of each reporting period as a component of deferred revenue. Contract liabilities as of February 28, 2019 and May 31, 2018 were \$1,507,000 and \$2,089,000, respectively. During the three and nine months ended February 28, 2019, the Company recognized \$185,000 and \$1,179,000, respectively, of revenues that were included in contract liabilities as of May 31, 2018.

Remaining performance obligations

On February 28, 2019, the Company had \$833,000 of remaining performance obligations, which were comprised of deferred service contracts and extended warranty contracts not yet delivered. The Company expects to recognize approximately 18% of its remaining performance obligations as revenue in fiscal 2019, and an additional 82% in fiscal 2020 and thereafter. The foregoing excludes the value of other remaining performance obligations as they have original durations of one year or less, and also excludes information about variable consideration allocated entirely to a wholly unsatisfied performance obligation.

Costs to obtain or fulfill a contract

The Company generally expenses sales commissions when incurred as a component of selling, general and administrative expense as the amortization period is typically less than one year. Additionally, the majority of the Company's cost of fulfillment as a manufacturer of products is classified as inventory and fixed assets, which are accounted for under the respective guidance for those asset types. Other costs of contract fulfillment are immaterial due to the nature of the Company's products and their respective manufacturing process.

4. EARNINGS PER SHARE

Basic earnings per share is determined using the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined using the weighted average number of common shares and potential common shares (representing the dilutive effect of stock options, RSUs and ESPP shares) outstanding during the period using the treasury stock method.

The following table presents the computation of basic and diluted net (loss) income per share attributable to AeHR Test Systems common shareholders (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018
Numerator: Net (loss) income	\$(3,201)	\$267	\$(5,345)	\$337
Denominator for basic net (loss) income per share: Weighted average shares outstanding	22,459	21,832	22,314	21,631
Shares used in basic net (loss) income per share calculation	22,459	21,832	22,314	21,631
Effect of dilutive securities	--	809	--	1,207
Denominator for diluted net (loss) income per share	22,459	22,641	22,314	22,838
Basic net (loss) income per share	\$(0.14)	\$0.01	\$(0.24)	\$0.02
Diluted net (loss) income per share	\$(0.14)	\$0.01	\$(0.24)	\$0.01

For the purpose of computing diluted earnings per share, the weighted average number of potential common shares does not include stock options with an exercise price greater than the average fair value of the Company's common stock for the period, as the effect would be anti-dilutive. In the three and nine months ended February 28, 2019 potential common shares have not been included in the calculation of diluted net loss per share as the effect would be anti-dilutive. As such, the numerator and the denominator used in computing both basic and diluted net loss per share for these periods are the same. Stock options to purchase 3,220,000 shares of common stock, RSUs for 34,000 shares and ESPP rights to purchase 327,000 ESPP shares were outstanding as of February 28, 2019, but were not included in the computation of diluted net loss per share, because the inclusion of such shares would be anti-dilutive. Stock options to purchase 983,000 shares of common stock were outstanding as of February 28, 2018 but were not included in the computation of diluted net income per share, because the inclusion of such shares would be anti-dilutive. The 2,657,000 shares convertible under the convertible notes outstanding at February 28, 2019 and 2018 were not included in the computation of diluted net income (loss) per share, because the inclusion of such shares would be anti-dilutive.

5. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company's financial instruments are measured at fair value consistent with authoritative guidance. This authoritative guidance defines fair value, establishes a framework for using fair value to measure assets and liabilities, and disclosures required related to fair value measurements.

The guidance establishes a fair value hierarchy based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions. The fair value hierarchy consists of the

following three levels:

Level 1 - instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets.

Level 2 - instrument valuations are obtained from readily-available pricing sources for comparable instruments.

Level 3 - instrument valuations are obtained without observable market values and require a high level of judgment to determine the fair value.

The following table summarizes the Company's financial assets measured at fair value on a recurring basis as of February 28, 2019 (in thousands):

	Balance as of			
	February 28, 2019	Level 1	Level 2	Level 3
Money market funds	\$10,581	\$10,581	\$--	\$--
Assets	\$10,581	\$10,581	\$--	\$--

The following table summarizes the Company's financial assets measured at fair value on a recurring basis as of May 31, 2018 (in thousands):

	Balance as of			
	May 31, 2018	Level 1	Level 2	Level 3
Money market funds	\$7,813	\$7,813	\$--	\$--
U.S. Treasury securities	5,983	5,983	--	--
Assets	\$13,796	\$13,796	\$--	\$--

The U.S. Treasury securities as of May 31, 2018 have maturities of three months and have no unrealized gain or loss.

Included in Money market funds as of February 28, 2019 and May 31, 2018 is \$80,000 restricted cash for Letter of Credit.

There were no financial liabilities measured at fair value as of February 28, 2019 and May 31, 2018.

There were no transfers between Level 1 and Level 2 fair value measurements during the three and nine months ended February 28, 2019.

The carrying amounts of financial instruments including cash, cash equivalents, receivables, accounts payable and certain other accrued liabilities, approximate fair value due to their short maturities. Based on the borrowing rates currently available to the Company for loans with similar terms, the carrying value of the debt approximates the fair value.

The Company has, at times, invested in debt and equity of private companies, and may do so again in the future, as part of its business strategy.

6. ACCOUNTS RECEIVABLE, NET

Accounts receivable represent customer trade receivables and is presented net of allowance for doubtful accounts of \$0 at February 28, 2019 and \$4,000 at May 31, 2018. Accounts receivable are derived from the sale of products throughout the world to semiconductor manufacturers, semiconductor contract assemblers, electronics manufacturers and burn-in and test service companies. The Company's allowance for doubtful accounts is based upon historical experience and review of trade receivables by aging category to identify specific customers with known disputes or collection issues. Uncollectible receivables are recorded as bad debt expense when all efforts to collect have been

exhausted and recoveries are recognized when they are received.

7. INVENTORIES

Inventories are comprised of the following (in thousands):

	February 28,	May 31,
	2019	2018
Raw materials and sub-assemblies	\$5,276	\$5,747
Work in process	3,678	3,068
Finished goods	235	234
	\$9,189	\$9,049

During the three and nine months ended February 28, 2019, the Company wrote down \$795,000 and \$802,000 of inventory, respectively. During the three and nine months ended February 28, 2018, the Company wrote down \$7,000 and \$91,000 of inventory, respectively.

8. PRODUCT WARRANTIES

The Company provides for the estimated cost of product warranties at the time revenues are recognized on the products shipped. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company's warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from the Company's estimates, revisions to the estimated warranty liability would be required.

The standard warranty period is one year for systems and ninety days for parts and service.

The following is a summary of changes in the Company's liability for product warranties during the three and nine months ended February 28, 2019 and 2018 (in thousands):

	Three Months Ended		Nine Months Ended	
	February 28,	February 28,	February 28,	February 28,
	2019	2018	2019	2018
Balance at the beginning of the period	\$163	\$133	\$135	\$113
Accruals for warranties issued during the period	30	5	176	251
Consumption of reserves	(30)	(22)	(148)	(248)

10. INCOME TAXES

Income taxes have been provided using the liability method whereby deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and net operating loss and tax credit carryforwards measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse or the carryforwards are utilized. Valuation allowances are established when it is determined that it is more likely than not that such assets will not be realized.

Since fiscal 2009, a full valuation allowance was established against all deferred tax assets as management determined that it is more likely than not that certain deferred tax assets will not be realized.

The Company accounts for uncertain tax positions consistent with authoritative guidance. The guidance prescribes a “more likely than not” recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company does not expect any material change in its unrecognized tax benefits over the next twelve months. The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income taxes.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income taxes. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements.

As part of the transition to the new territorial tax system, the Tax Act imposes a one-time repatriation tax on deemed repatriation of historical earnings of foreign subsidiaries. The company is not subject to the transition tax. The one-time transition tax is based on post-1986 earnings and profits that were previously deferred from U.S. income tax. The Company has finalized its calculation of the total post-1986 earnings and profits for its foreign corporations. Based on the Company’s net operating loss carryovers and valuation allowance, there is no impact to its consolidated financial statements as a result of the completion of the analysis.

The new law effective December 31, 2017 repeals the corporate alternative minimum tax, or AMT, regime and permits existing minimum tax credits to offset the regular tax liability for any tax year. Further, the credit is refundable for any tax year beginning after December 31, 2017 and before December 31, 2020 in an amount equal to 50% of the excess of the minimum tax credit over the allowable credit for the year against the regular tax liability. Any unused minimum tax credit carryforward is refundable in the following year. As result, the company recorded a benefit of \$90,000 in the third quarter of fiscal 2018 for its Federal refundable AMT credit.

In addition, the reduction of the U.S. federal corporate tax rate reduces the corporate tax rate to 21%, effective January 1, 2018. Consequently, the Company has accounted for the reduction of \$6.4 million of deferred tax assets with an offsetting adjustment to the valuation allowance.

Although the Company files U.S. federal, various state, and foreign tax returns, the Company’s only major tax jurisdictions are the United States, California, Germany and Japan. Fiscal years 1997 through 2018 remain subject to examination by the appropriate governmental agencies due to tax loss carryovers, research and development tax credits, or other tax attributes from those years.

11. LONG-TERM DEBT

On April 10, 2015, the Company entered into a Convertible Note Purchase and Credit Facility Agreement (the “Purchase Agreement”) with QVT Fund LP and Quintessence Fund L.P. (the “Purchasers”) providing for (a) the Company’s sale to the Purchasers of \$4,110,000 in aggregate principal amount of 9.0% Convertible Secured Notes due 2017 (the “Convertible Notes”) and (b) a secured revolving loan facility (the “Credit Facility”) in an aggregate principal amount of up to \$2,000,000. On August 22, 2016 the Purchase Agreement was amended to extend the maturity date of the Convertible Notes to April 10, 2019, decrease the conversion price from \$2.65 per share to \$2.30 per share, decrease the forced conversion price from \$7.50 per share to \$6.51 per share, and allow for additional equity awards.

The Convertible Notes bear interest at an annual rate of 9.0% and will mature on April 10, 2019 unless repurchased or converted prior to that date. Interest is payable quarterly on March 1, June 1, September 1 and December 1 of each year. Debt issuance costs of \$356,000, which were accreted over the term of the original loan using the effective interest rate method, were offset against the loan balance.

The conversion price for the Convertible Notes is \$2.30 per share and is subject to adjustment upon the occurrence of certain specified events. Holders may convert all or any part of the principal amount of their Convertible Notes in integrals of \$10,000 at any time prior to the maturity date. Upon conversion, the Company will deliver shares of its common stock to the holder of Convertible Notes electing such conversion. The Company may not redeem the Convertible Notes prior to maturity.

The maximum amount of \$2,000,000 drawn against the Credit Facility has been converted to Convertible Notes, and at February 28, 2019 there was no remaining balance available to be drawn on the Credit Facility.

The Company’s obligations under the Purchase Agreement are secured by substantially all of the assets of the Company.

At the maturity date of April 10, 2019, the Company repaid the debt in an aggregate principal amount of \$6,110,000 under the Purchase Agreement with QVT Fund LP and Quintessence Fund L.P.

12. STOCKHOLDERS’ EQUITY, COMPREHENSIVE INCOME AND STOCK-BASED COMPENSATION

ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in the components of AOCI, net of tax, were as follows (in thousands):

	Cumulative Translation Adjustments	Unrealized Loss on Investments, Net	Total
Balance at May 31, 2018	\$2,292	\$--	\$2,292
Other comprehensive (loss) income before reclassifications	(40)	--	(40)
Amounts reclassified out of AOCI	--	--	--
Other comprehensive (loss) income, net of tax	(40)	--	(40)
Balance at February 28, 2019	\$2,252	\$--	\$2,252

STOCK-BASED COMPENSATION

Stock-based compensation expense consists of expenses for stock options, restricted stock units, or RSUs, and employee stock purchase plan, or ESPP, purchase rights. Stock-based compensation expense for stock options and ESPP purchase rights is measured at each grant date, based on the fair value of the award using the Black-Scholes option valuation model, and is recognized as expense over the employee's requisite service period. This model was developed for use in estimating the value of publicly traded options that have no vesting restrictions and are fully transferable. The Company's employee stock options have characteristics significantly different from those of publicly traded options. For RSUs, stock-based compensation cost is based on the fair value of the Company's common stock at the grant date. All of the Company's stock-based compensation is accounted for as an equity instrument. See Note 10 in the Company's Annual Report on Form 10-K for fiscal 2018 filed on August 28, 2018 for further information regarding the 2016 Equity Incentive Plan and the Amended and Restated 2006 ESPP.

The following table summarizes the stock-based compensation expense for the three and nine months ended February 28, 2019 and 2018 (in thousands):

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018
Stock-based compensation in the form of employee stock options, RSUs and ESPP purchase rights, included in:				
Cost of sales	\$24	\$28	\$83	\$107
Selling, general and administrative	137	162	421	530
Research and development	64	52	201	185
Total stock-based compensation	\$225	\$242	\$705	\$822

As of February 28, 2019 and 2018, there were no stock-based compensation expenses capitalized as part of inventory.

During the three months ended February 28, 2019 and 2018, the Company recorded stock-based compensation expense related to stock options and RSUs of \$166,000 and \$206,000, respectively. During the nine months ended February 28, 2019 and 2018, the Company recorded stock-based compensation expense related to stock options and RSUs of \$505,000 and \$614,000, respectively.

As of February 28, 2019, the total compensation expense related to unvested stock-based awards under the Company's 2016 Equity Incentive Plan, but not yet recognized, was approximately \$1,466,000, which is net of estimated forfeitures of \$4,000. This expense will be amortized on a straight-line basis over a weighted average period of approximately 3.1 years.

During the three months ended February 28, 2019 and 2018, the Company recorded stock-based compensation expense related to the ESPP of \$59,000 and \$36,000, respectively. During the nine months ended February 28, 2019 and 2018, the Company recorded stock-based compensation expense related to the ESPP of \$200,000 and \$208,000,

respectively.

As of February 28, 2019, the total compensation expense related to purchase rights under the ESPP but not yet recognized was approximately \$174,000. This expense will be amortized on a straight-line basis over a weighted average period of approximately 1.2 years.

Valuation Assumptions

Valuation and Amortization Method. The Company estimates the fair value of stock options granted using the Black-Scholes option valuation model and a single option award approach. The fair value under the single option approach is amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

Expected Term. The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding and was determined based on historical experience, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as evidenced by changes to the terms of its stock-based awards.

Volatility. Volatility is a measure of the amounts by which a financial variable such as stock price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company uses the historical volatility for the past four or five years, which matches the expected term of most of the option grants, to estimate expected volatility. Volatility for each of the ESPP's four time periods of six months, twelve months, eighteen months, and twenty-four months is calculated separately and included in the overall stock-based compensation expense recorded.

Risk-Free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the stock awards including the ESPP.

Fair Value. The fair value of the Company's stock options granted to employees for the three and nine months ended February 28, 2019 and 2018 were estimated using the following weighted average assumptions in the Black-Scholes option valuation model:

	Three Months Ended		Nine Months Ended	
	February 28,		February 28,	
	2019	2018	2019	2018
Expected term (in years)	5	4	5	4
Volatility	0.69	0.73	0.72	0.77
Risk-free interest rate	2.77%	2.31%	2.83%	1.81%
Weighted average grant date fair value	\$1.01	\$1.53	\$1.34	\$2.17

The fair values of the ESPP purchase rights granted for the nine months ended February 28, 2019 were estimated using the following weighted-average assumptions:

	Nine Months Ended
	February 28, 2019
Expected term (in years)	0.5-2.0
Volatility	0.48-0.64
Expected dividend	\$0.00
Risk-free interest rates	2.40% -2.82%
Estimated forfeiture rate	0%
Weighted average grant date fair value	\$1.15

There were no ESPP purchase rights granted to employees for the three months ended February 28, 2019 and 2018, and nine months ended February 28, 2018. During the nine months ended February 28, 2019, ESPP purchase rights of 327,000 were granted. Total ESPP shares issued during the nine months ended February 28, 2019 and 2018 were 64,000 and 116,000 shares, respectively. As of February 28, 2019, there were 430,000 ESPP shares available for issuance.

The following tables summarize the Company's stock option and RSU transactions during three and nine months ended February 28, 2019 (in thousands):

Available

Shares

Balance, May 31, 2018	1,812
Options granted	(441)
Shares cancelled	13
Shares expired	(11)
Balance, August 31, 2018	1,373
Options granted	(248)
Shares cancelled	45
Shares expired	(33)
Balance, November 30, 2018	1,137
Options granted	(100)
Shares cancelled	51
Shares expired	(1)
Balance, February 28, 2019	1,087

The following table summarizes the stock option transactions during the three and nine months ended February 28, 2019 (in thousands, except per share data):

	Outstanding Options		
	Weighted		
	Number	Average	Aggregate
	of	Exercise	Intrinsic
	Shares	Price	Value
Balances, May 31, 2018	2,859	\$2.04	\$1,987
Options granted	441	\$2.40	
Options cancelled	(13)	\$1.64	
Options exercised	(98)	\$1.12	
Balances, August 31, 2018	3,189	\$2.12	\$1,757
Options granted	248	\$2.03	
Options cancelled	(45)	\$2.70	
Options exercised	(19)	\$1.09	
Balances, November 30, 2018	3,373	\$2.11	\$679
Options granted	100	\$1.71	
Options cancelled	(51)	\$1.72	
Options exercised	(202)	\$0.61	
Balances, February 28, 2019	3,220	\$2.20	