NEWPORT CORP
Form 10-Q
August 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended July 1, 2006

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: 000-01649

NEWPORT CORPORATION

(Exact name of registrant as specified in its charter)

Nevada	**94-0849175**
(State or other jurisdiction of incorporation or organization)	***(IRS Employer Identification No.)***

1791 Deere Avenue, Irvine, California 92606

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (949) 863-3144

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

Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Yes ¨ No x

As of July 28, 2006, 40,789,655 shares of the registrant s sole class of common stock were outstanding.

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FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NEWPORT CORPORATION

Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	July 1, 2006	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Net sales	$ 112,369	$ 98,636	$ 215,555	$ 196,866
Cost of sales	62,609	57,470	122,351	115,381
Gross profit	49,760	41,166	93,204	81,485
Selling, general and administrative expense	28,589	25,127	55,133	50,238
Research and development expense	10,200	8,925	20,136	17,652
Operating income	10,971	7,114	17,935	13,595
Interest and other income (expense), net	408	(759)	(216)	(1,197)
Income from continuing operations before income taxes	11,379	6,355	17,719	12,398
Income tax provision	2,130	801	2,140	1,887
Income from continuing operations before extraordinary gain	9,249	5,554	15,579	10,511
Loss from discontinued operations, net of income tax benefits of $0, $37, $119 and $760, respectively		(2,695)	(652)	(6,054)
Extraordinary gain on settlement of litigation				2,891
Net income	$ 9,249	$ 2,859	$ 14,927	$ 7,348
Basic income (loss) per share:				
Income from continuing operations before extraordinary gain	$ 0.23	$ 0.13	$ 0.39	$ 0.24
Loss from discontinued operations, net of income taxes		(0.06)	(0.02)	(0.14)
Extraordinary gain on settlement of litigation				0.07
Net income	$ 0.23	$ 0.07	$ 0.37	$ 0.17
Diluted income (loss) per share:				
Income from continuing operations before extraordinary gain	$ 0.22	$ 0.13	$ 0.37	$ 0.24
Loss from discontinued operations, net of income taxes		(0.07)	(0.01)	(0.14)
Extraordinary gain on settlement of litigation				0.07
Net income	$ 0.22	$ 0.06	$ 0.36	$ 0.17
Shares used in the computation of income (loss) per share:				

Basic	40,606	42,727	40,445	42,808
Diluted	41,852	44,263	41,778	44,321

See accompanying notes.

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NEWPORT CORPORATION

Consolidated Balance Sheets

(In thousands, except share data)

(Unaudited)

	July 1, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 38,559	$ 30,112
Marketable securities	39,032	40,910
Accounts receivable, net of allowance for doubtful accounts of $2,142 and $1,402, respectively	78,510	75,222
Notes receivable, net	2,900	5,170
Inventories	80,027	75,504
Deferred income taxes	2,265	2,077
Prepaid expenses and other current assets	10,368	8,405
Total current assets	251,661	237,400
Property and equipment, net	54,180	50,424
Goodwill	173,440	173,440
Deferred income taxes	935	927
Intangible assets, net	48,892	50,840
Investments and other assets	15,904	16,375
	$ 545,012	$ 529,406
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term obligations	$ 7,279	$ 12,559
Accounts payable	26,740	24,604
Accrued payroll and related expenses	21,145	22,562
Accrued expenses and other current liabilities	25,288	26,158
Accrued restructuring costs	771	1,122
Obligations under capital leases	82	77
Total current liabilities	81,305	87,082
Long-term debt	50,381	49,996
Obligations under capital leases, less current portion	1,330	1,299
Accrued pension liabilities	12,105	11,311
Accrued restructuring costs and other liabilities	2,504	3,135
Commitments and contingencies		
Stockholders equity:		
Common stock, par value $0.1167 per share, 200,000,000 shares authorized; 40,777,885 and 40,035,738 shares issued and outstanding, respectively	4,759	4,672
Capital in excess of par value	456,983	449,921
Deferred stock compensation		(316)
Accumulated other comprehensive income (loss)	(325)	1,263
Accumulated deficit	(64,030)	(78,957)
Total stockholders equity	397,387	376,583

	$ 545,012	$ 529,406

See accompanying notes.

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Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended July 1, 2006	July 2, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 14,927	$ 7,348
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,621	10,137
Loss on disposal of business	803	
Provision for losses on inventories	1,467	384
Provision for doubtful accounts, net	319	(549)
Stock-based compensation expense	2,070	175
Investment write-down		458
Gain on disposal of property and equipment	(63)	(463)
Realized foreign exchange translation gain	(915)	
Extraordinary gain on settlement of litigation		(2,891)
Deferred income taxes, net	(121)	
Increase (decrease) in cash due to changes in:		
Accounts and notes receivable	(2,076)	(2,921)
Inventories	(2,695)	372
Prepaid expenses and other current assets	(1,880)	(202)
Other assets and liabilities	(268)	(55)
Accounts payable	800	4
Accrued payroll and related expenses	(2,555)	(4,401)
Accrued expenses and other current liabilities	(2,816)	(3,210)
Accrued restructuring costs	(780)	(1,300)
Net cash provided by operating activities	15,838	2,886
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(5,265)	(5,199)
Purchase of property and equipment related to information systems implementation	(4,611)	
Proceeds from the sale of property and equipment	187	318
Purchase of marketable securities	(22,605)	(235,878)
Proceeds from the sale of marketable securities	23,294	268,659
Proceeds from the sale of business and equity investments		952
Net cash provided by (used in) investing activities	(9,000)	28,852
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of long-term debt and obligations under capital leases	(42)	(97)
Short-term borrowings (repayments), net	(3,979)	(675)
Proceeds from the issuance of common stock under employee plans	6,214	3,227
Purchases of the Company s common stock	(1,039)	(46,081)
Net cash provided by (used in) financing activities	1,154	(43,626)
Impact of foreign exchange rate changes on cash balances	455	(2,217)

Net increase (decrease) in cash and cash equivalents	8,447	(14,105)
Cash and cash equivalents at beginning of period	30,112	41,443
Cash and cash equivalents at end of period	$ 38,559	$ 27,338
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 1,467	$ 1,494
Income taxes, net	$ 3,087	$ 1,549

See accompanying notes.

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NEWPORT CORPORATION

Notes to Consolidated Financial Statements

July 1, 2006

NOTE 1 BASIS OF PRESENTATION

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. These financial statements are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal and recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions and balances have been eliminated in consolidation.

The accompanying consolidated financial statements do not include certain footnotes and financial presentations normally required under generally accepted accounting principles (GAAP) and, therefore, should be read in conjunction with the consolidated financial statements and related notes contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The results for the interim periods are not necessarily indicative of results for the full year ending December 30, 2006. The December 31, 2005 balances reported herein are derived from the audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Certain prior period amounts have been reclassified to conform to the current period presentation.

NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS

In September 2005, the Emerging Issues Task Force (EITF) reached consensus on EITF Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty* (EITF No. 04-13). In certain situations, a company may enter into nonmonetary transactions to sell inventory to another company in the same line of business from which it also purchases inventory. Under EITF No. 04-13, in general, an entity is required to treat sales and purchases of inventory between the entity and the same counterparty as one transaction for purposes of applying Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, when such transactions are entered into in contemplation of each other. When such transactions are legally contingent on each other, they are considered to have been entered into in contemplation of each other. The EITF also agreed on other factors that should be considered in determining whether transactions have been entered into in contemplation of each other. EITF No. 04-13 is effective for all new arrangements entered into in reporting periods beginning after March 15, 2006. The Company adopted EITF No. 04-13 in the second quarter of 2006, and the provisions of EITF No. 04-13 did not have a material impact on the Company s financial position or results of operations.

In June 2006, the Financial Accounting Standards Board (FASB) ratified EITF Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* (EITF No. 06-03). Under EITF No. 06-03, a company must disclose its accounting policy regarding the gross or net presentation of certain taxes. If taxes included in net sales are significant, a company must disclose the amount of such taxes for each period for which an income statement is presented. Taxes within the scope of EITF No. 06-03 are those that are imposed on and concurrent with a specific revenue-producing transaction. Taxes assessed on a company s activities over a period of time, such as gross receipts taxes, are not within the scope of the EITF. EITF No. 06-03 will be effective for reporting periods beginning after December 15, 2006. The Company currently presents all taxes collected from customers and remitted to government authorities on a net basis (i.e. does not include such taxes in net sales), and expects to continue to do so following its adoption of EITF No. 06-03.

In July 2006, the FASB issued FASB Interpretation No.48, *Accounting For Uncertain Tax Positions* (FIN 48). FIN 48 clarifies how uncertainty in income taxes should be accounted for in a company s financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for the recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition and classification of tax positions, accounting for interest and penalties, accounting for tax positions in interim periods, and disclosure and transition requirements. FIN 48 will be effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the expected impact of the provisions of FIN 48 on its financial position and results of operations.

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Notes to Consolidated Financial Statements

July 1, 2006

NOTE 3 DISCONTINUED OPERATIONS

Following the Company s acquisition of Spectra-Physics, Inc. and certain related entities (Spectra-Physics), the Company conducted a strategic review of all of its businesses and concluded that its robotic systems operations in Richmond, California, which served the front-end semiconductor equipment industry with product lines including wafer-handling robots, load ports and equipment front-end modules, were no longer core to the Company s overall strategy. Consequently, in the first quarter of 2005, the Company s Board of Directors approved a plan to sell these operations, and the sale was completed in the fourth quarter of 2005.

These operations have been reflected in discontinued operations for all periods presented. In the first quarter of 2006, the Company adjusted the loss on the sale of these operations and recorded a loss of approximately $0.7 million, net of income taxes.

The net sales and loss before income taxes from the discontinued operations were as follows:

	Three Months Ended		Six Months Ended	
	July 1,	July 2,	July 1,	July 2,
(In thousands)	2006	2005	2006	2005
Net sales	$	$ 2,795	$	$ 5,516
Loss before income taxes		(2,732)	(771)	(6,814)

NOTE 4 DERIVATIVE INSTRUMENTS

The Company recognizes all derivative financial instruments in the consolidated financial statements at fair value regardless of the purpose or intent for holding the instrument. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. The Company does not engage in currency speculation; however, the Company uses forward exchange contracts to mitigate the risks associated with certain foreign currency transactions entered into in the ordinary course of business, primarily foreign currency denominated receivables and payables. Such contracts do not qualify for hedge accounting and, accordingly, changes in fair values are reported in the statements of operations. The forward exchange contracts generally require the Company to exchange U.S. dollars for foreign currencies at maturity, at rates agreed to at the inception of the contracts. If the counterparties to the exchange contracts (AA or A+ rated banks) do not fulfill their obligations to deliver the contracted currencies, the Company could be at risk for any currency-related fluctuations. Transaction gains and losses are included in *interest and other income (expense), net* in the accompanying consolidated statements of operations.

There were no foreign exchange contracts outstanding as of July 1, 2006 or December 31, 2005.

NOTE 5 ACCOUNTS AND NOTES RECEIVABLE

The Company records reserves for specific receivables deemed to be at risk for collection, as well as a reserve based on its historical collections experience. The Company estimates the collectibility of customer receivables on an ongoing basis by reviewing past due invoices and assessing the current creditworthiness of each customer. A considerable amount of judgment is required in assessing the ultimate realization of these receivables.

Certain of the Company s Japanese customers provide the Company with promissory notes on the due date of the receivable. The payment dates of the promissory notes range between 60 and 150 days from the original receivable due date. For balance sheet presentation purposes, amounts due to the Company under such promissory notes are reclassified from accounts receivable to current notes receivable. At July 1, 2006 and

December 31, 2005, *notes receivable, net* totaled $2.9 million and $5.2 million, respectively. Subsequently, certain of these promissory notes are sold with recourse under line of credit agreements to one of four banks in Japan with which the Company does

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Notes to Consolidated Financial Statements

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business. Such transactions are conducted in the ordinary course of business. The principal amount of promissory notes sold with recourse is included in both *notes receivable, net* and *short-term obligations* until the underlying note obligations are ultimately satisfied by payment by the customers to the banks. At July 1, 2006 and December 31, 2005, the principal amount of such promissory notes included in *notes receivable, net* and *short-term obligations* in the accompanying consolidated balance sheets totaled $1.4 million and $2.8 million, respectively.

NOTE 6 REVENUE RECOGNITION

The Company recognizes revenue after title to and risk of loss of products have passed to the customer (which typically occurs upon shipment from the Company s facilities), or delivery of the service has been completed, provided that persuasive evidence of an arrangement exists, the fee is fixed or determinable and collectibility is reasonably assured. The Company recognizes revenue and related costs for arrangements with multiple deliverables, such as equipment and installation, as each element is delivered or completed based upon its relative fair value, determined based upon the price that would be charged on a standalone basis. If a portion of the total contract price is not payable until installation is complete, the Company does not recognize such portion as revenue until completion of installation; however, the Company does record the full cost of the product at the time of shipment. Revenue for training is deferred until the service is completed. Revenue for extended service contracts is recognized over the related contract periods.

Customers generally have 30 days from the original invoice date (generally 60 days for international customers) to return a standard catalog product purchase for exchange or credit. Catalog products must be returned in the original condition and meet certain other criteria. Product returns of catalog items have historically been insignificant and are charged against revenue in the period returned. Custom, option-configured and certain other products as defined in the terms and conditions of sale cannot be returned without the Company s consent. For certain of these products, the Company establishes a sales return reserve based on the historical product returns.

NOTE 7 STOCK-BASED COMPENSATION

Stock-Based Benefit Plans

In March 2006, the Company s Board of Directors adopted the 2006 Performance-Based Stock Incentive Plan (2006 Plan), which was approved by the Company s stockholders in May 2006. The purposes of the 2006 Plan are to enhance the Company s ability to attract, motivate and retain the services of qualified employees, officers and directors, consultants and other service providers upon whose judgment, initiative and efforts the successful conduct and development of the Company s business largely depends.

The 2006 Plan authorizes the Company to grant up to 6,000,000 shares of common stock, which includes the number of shares previously available for future grant under the Company s 2001 Stock Incentive Plan (2001 Plan), subject to adjustments as to the number and kind of shares in the event of stock splits, stock dividends or certain other similar changes in the capital structure of the Company. Upon approval of the 2006 Plan by the Company s stockholders, the 2001 Plan was terminated for purposes of future grants.

The 2006 Plan permits the grant of stock appreciation rights, restricted stock, restricted stock units, incentive stock options and non-qualified stock options. The vesting of substantially all awards granted to officers and employees under the 2006 Plan will occur over a period of three years, conditioned on the achievement of annual performance goals established by the Compensation Committee of the Company s Board of Directors, and all awards will be subject to forfeiture if employment or other service terminates prior to the vesting of the awards. Any stock options or stock appreciation rights granted under the 2006 Plan will have exercise prices or base values not less than the fair market value of the Company s common stock on the date of grant and terms of not more than seven years.

The Company maintains an Employee Stock Purchase Plan (Purchase Plan) to provide employees of the Company with an opportunity to purchase common stock through payroll deductions. Prior to January 1, 2006, the Purchase Plan provided that the purchase price for the purchase of common stock in any offering period was 85% of the fair market value of the stock on the first day of the offering period or the last day of the offering period, whichever was lower. The Company amended the Purchase Plan effective January 1, 2006. As amended, the Purchase Plan

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provides that the purchase price for the purchase of common stock in any offering period is 95% of the fair market value of the stock on the last day of the offering period. The purpose of the amendment was to eliminate the compensation expense which the Company would be required to recognize in connection with future purchases under the Purchase Plan following the adoption of SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R) on January 1, 2006.

Adoption of SFAS No. 123R

Prior to January 1, 2006, the Company applied the intrinsic value based method of accounting prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* and related Interpretations in accounting for its stock-based compensation and complied with the disclosure provisions of SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* and SFAS No. 123, *Accounting for Stock-Based Compensation.* Accordingly, no compensation expense was recognized for employee stock options with exercise prices greater than or equal to the Company s stock price at the date of grant, and no compensation expense was recognized for purchases under the Purchase Plan. Costs related to restricted stock awards, determined based on the fair market value of the shares at the date of grant, net of estimated forfeitures, were recognized as compensation expense ratably over the vesting period.

Effective January 1, 2006, the Company adopted SFAS No. 123R, which requires the Company to recognize compensation expense related to the fair value of the Company s stock-based compensation awards. The Company elected to use the modified prospective transition method as permitted by SFAS No. 123R, and therefore has not retrospectively recognized expense in its financial results for prior periods. Under this transition method, stock-based compensation expense for the three and six months ended July 1, 2006 included compensation expense for all stock-based awards, including restricted stock awards, granted prior to, but not yet vested as of, December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, as adjusted for estimated forfeitures. Stock-based compensation expense for all awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. The Company recognizes compensation expense for all stock-based awards, net of estimated forfeitures, on a straight-line basis over the requisite service period of the awards. Under SFAS No. 123R, the Purchase Plan, as amended, is considered a non-compensatory plan, and the Company is not required to recognize compensation expense for purchases made under the Purchase Plan.

As a result of adopting SFAS No. 123R on January 1, 2006, the Company s income from continuing operations, income before income taxes and net income for the three and six months ended July 1, 2006 were approximately $0.8 million and $1.8 million, respectively, lower than if it had continued to account for stock-based compensation under APB Opinion No. 25. For the three and six months ended July 1, 2006, basic and diluted net income per share were $0.02 per share and $0.04 per share, respectively, lower than if the Company had continued to account for stock-based compensation under APB Opinion No. 25.

Determining Fair Value

Valuation and Amortization Method The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option pricing model and a single option award approach. The fair value of restricted stock and restricted stock unit awards is based on the closing market price of the Company s common stock on the date of grant. The fair value of an award is amortized on a straight-line basis over the requisite service period of the award, which is generally the vesting period.

Expected Term The expected term represents the period of time that the Company s stock options and stock appreciation rights are expected to be outstanding and is determined based on its historical experience, giving consideration to the contractual terms of the stock-based awards, vesting schedules, the effects of expected employee exercises and post-vesting employee behavior after termination of employment.

Expected Volatility The Company computes expected volatility based on a combination of historical volatility and market-based implied volatility, as it believes that this combination provides a more accurate estimate of future

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NEWPORT CORPORATION

Notes to Consolidated Financial Statements

July 1, 2006

volatility. In making such computation, the Company has excluded historical periods prior to 2004 from its estimate of expected volatility as it believes such periods do not reflect the expected future volatility of the Company s common stock. The Company acquired Spectra-Physics on July 16, 2004, and it announced its intent to sell its robotics systems operations in the first quarter of 2005, which it completed in December 2005. The Company believes that these discrete events changed its business risk. In addition, the historical volatility of the Company s common stock excluding periods prior to 2004 is approximately equal to the current market-based implied volatility of the Company s common stock based on its exchange-traded options.

Risk-Free Interest Rate The risk-free interest rate used in the Black-Scholes-Merton valuation model is based upon the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the stock options.

Expected Dividend The expected dividend assumption is based on the Company s current expectations about its future dividend policy.

The fair value of the Company s stock options granted to employees was estimated as of the date of the grant using the following weighted-average assumptions:

	Three Months Ended		**Six Months Ended**	
	July 1, 2006	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Expected annual volatility	35.9%	60.1%	35.9%	60.1%
Risk-free interest rate	4.4%	3.9%	4.4%	3.9%
Expected turnover rate	12.4%	12.9%	12.4%	12.9%
Expected term (years)	5.4	5.0	5.4	5.0
Annualized dividend yield				

Based on guidance provided in SFAS No. 123R and Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment,* in the first quarter of 2006, the Company refined the assumptions it uses for input into the Black-Scholes-Merton model. Specifically, the Company changed its volatility assumption to be based on a combination of historical volatility and market-based implied volatility and changed its expected term assumption based on historical information that considered the contractual terms of its stock-based awards, vesting schedules, the effects of expected employee exercises and post-vesting employee behavior after termination of employment. The Company believes that its current assumptions are more representative of the expected future volatility of the Company s common stock and the expected term of the stock options and, therefore, generate a more accurate estimate of the fair value of the stock options.

Stock-Based Compensation Expense

The total stock-based compensation expense included in the Company s consolidated statements of operations is as follows:

	Three Months Ended		**Six Months Ended**	
(In thousands)	**July 1, 2006**	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Cost of sales	$ 97	$	$ 97	$
Selling, general and administrative expense	677	33	1,797	175
Research and development expense	116		176	

$ 890	$ 33	$ 2,070	$ 175

Stock-based compensation expense for the three and six months ended July 2, 2005 included amortization of restricted stock awards which were granted prior to the adoption of SFAS No. 123R and accounted for under APB Opinion No. 25.

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Approximately $0.2 million of stock-based compensation expense associated with personnel engaged in manufacturing was capitalized and is reflected in *inventory* in the accompanying consolidated balance sheet at July 1, 2006. No stock-based compensation expense was capitalized in 2005.

As required by SFAS No. 123R, the Company has estimated the expected future forfeitures of stock options and restricted stock and has recognized compensation expense only for those equity awards expected to vest.

At July 1, 2006, the total compensation cost related to unvested stock-based awards granted to employees, officers and directors under its stock-based benefit plans that had not yet been recognized was approximately $3.8 million, net of estimated forfeitures of $1.3 million. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 1.7 years and will be adjusted for subsequent changes in estimated forfeitures.

In accordance with SFAS No. 123R, the cash flows resulting from excess tax benefits (tax benefits related to the excess of proceeds from exercises of stock options over the stock-based compensation cost recognized for those stock options) are classified as financing cash flows. Prior to the adoption of SFAS No. 123R, tax benefits of deductions resulting from exercises of stock options were presented as operating cash flows in the statement of cash flows. However, the Company has recorded a valuation allowance against certain of its deferred tax assets pursuant to SFAS No. 109, due to the uncertainty as to the timing and ultimate realization of those assets. Accordingly, no excess tax benefits were included in the statement of cash flows and no income tax benefit has been recorded for the Company s stock-based compensation expense for the three and six months ended July 1, 2006.

Stock Options and Awards Activity

The following table summarizes stock option activity for the six months ended July 1, 2006:

	Number of Shares (In thousands)	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (Years)**	**Aggregate Intrinsic Value (In thousands)**
Outstanding at December 31, 2005	5,483	$ 15.97		
Granted	63	14.27		
Exercised	(758)	7.18		
Forfeitures and cancellations	(111)	26.27		
Outstanding at July 1, 2006	4,677	$ 17.13	5.4	$ 30,460
Vested and expected to vest at July 1, 2006	4,475	$ 17.32	5.7	$ 29,255
Exercisable at July 1, 2006	3,792	$ 18.12	5.2	$ 25,174

The aggregate intrinsic value of the stock options is equal to the difference between the quoted price of the Company s common stock for the 4.1 million stock options that were in-the-money at July 1, 2006 and the exercise price of such stock options. The aggregate intrinsic value of stock options exercised during the three and six months ended July 1, 2006, determined as of the dates of exercise of the stock options, was $1.8

million and $7.9 million, respectively.

At July 1, 2006, there were 55,612 shares of restricted stock outstanding with a weighted average grant date fair value of $13.03 and 52,500 restricted stock units outstanding with a weighted average grant date fair value of $16.58. All such restricted stock units were granted in the second quarter of 2006. In the three and six months ended July 1, 2006, 942 shares of restricted stock were forfeited.

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Pro Forma Disclosures

The following illustrates the effect on net income and net income per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three and six months ended July 2, 2005:

(In thousands, except per share data)	Three Months Ended July 2, 2005		Six Months Ended July 2, 2005	
Net income reported	$	2,859	$	7,348
Employee compensation expense under fair value method		(1,729)		(3,517)
Net income pro forma	$	1,130	$	3,831
Basic net income per share reported	$	0.07	$	0.17
Basic net income per share pro forma	$	0.03	$	0.09
Diluted net income per share reported	$	0.06	$	0.17
Diluted net income per share pro forma	$	0.03	$	0.09
Shares used in computation of income per share:				
Basic reported and pro forma		42,727		42,808
Diluted reported and pro forma		44,263		44,321

For purposes of pro forma disclosure, the value of the stock options and purchases under the Purchase Plan was estimated using the Black-Scholes-Merton option-pricing model and was amortized on a straight-line basis over the respective vesting periods of the awards.

NOTE 8 INCOME TAXES

The Company provides for income taxes in interim periods based on the estimated effective income tax rate for the complete fiscal year. The income tax provision is computed on the pretax income of the consolidated entities located within each taxing jurisdiction based on current tax law. Deferred tax assets and liabilities are determined based on the future tax consequences associated with temporary differences between income and expenses reported for financial accounting and tax reporting purposes. In accordance with the provisions of SFAS No. 109, a valuation allowance for deferred tax assets is recorded to the extent that the Company cannot determine that the ultimate realization of the net deferred tax assets is more likely than not.

Realization of deferred tax assets is principally dependent upon the achievement of future taxable income, the estimation of which requires significant management judgment. The Company s judgments regarding future profitability may change due to many factors, including future market conditions and the Company s ability to successfully execute its business plans and/or tax planning strategies. These changes, if any, may require material adjustments to these deferred tax asset balances. Due to uncertainties surrounding the realization of the Company s cumulative federal and state net operating losses, the Company has recorded a valuation allowance against a portion of its gross deferred tax assets. For the foreseeable future, the Federal tax provision related to future earnings will be substantially offset by a reduction in the valuation reserve, and any future pretax losses will not be offset by a tax benefit due to the uncertainty of the recoverability of the deferred tax assets. Accordingly, current and future tax expense will consist primarily of certain required state income taxes and taxes in certain foreign jurisdictions.

Acquired tax liabilities related to prior tax returns of acquired entities at the date of purchase are recognized based on the Company s estimate of the ultimate settlement that may be accepted by the tax authorities. The Company continually evaluates these tax-related matters. At the date of any material change in the Company s estimate of items relating to an acquired entity s prior tax returns, and at the date that the items are settled with the tax authorities, any liabilities previously recognized are adjusted to increase or decrease the remaining balance of goodwill attributable to that acquisition.

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The Company is subject to audit by federal, state and foreign tax authorities in the ordinary course of business. These audits often challenge the timing and amount of deductions, the apportionment of income among various tax jurisdictions, and compliance with federal, state and foreign tax laws. In evaluating the potential tax exposures associated with various tax filing positions taken, the Company will establish a tax reserve for probable exposures where necessary. In the first quarter of 2006, the Company determined that certain income tax contingency reserves were no longer necessary, and, accordingly, reduced its tax contingency reserve by approximately $1.2 million. At July 1, 2006, the Company believes that it has appropriately accrued for probable tax exposures. To the extent the Company subsequently prevails in matters for which tax reserves have been established or is required to pay amounts in excess of its reserves, the Company s effective tax rate in a given financial statement period could be materially affected.

NOTE 9 INVENTORIES

Inventories are stated at the lower of cost (determined on either a first-in, first-out (FIFO) or average cost basis) or fair market value and include materials, labor and manufacturing overhead. The Company writes down excess and obsolete inventory to net realizable value. In assessing the ultimate realization of inventories, the Company makes judgments as to future demand requirements and compares those requirements with the current or committed inventory levels. Amounts required to reduce the carrying value of inventory to net realizable value are recorded as a charge to cost of sales.

Inventories were as follows:

	July 1,	December 31,
(In thousands)	**2006**	**2005**
Raw materials and purchased parts	$ 34,675	$ 33,401
Work in process	20,255	20,148
Finished goods	25,097	21,955
	$ 80,027	$ 75,504

NOTE 10 ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities were as follows:

	July 1,	December 31,
(In thousands)	**2006**	**2005**
Deferred revenue	$ 10,217	$ 8,775
Accrued warranty obligations	5,058	5,255
Accrued income taxes	2,895	3,093
Other	7,118	9,035

	$ 25,288	$ 26,158

NOTE 11 ACCRUED WARRANTY OBLIGATIONS

Unless otherwise stated in the Company s product literature or in its agreements with customers, products sold by the Company s Photonics and Precision Technologies (PPT) Division generally carry a one-year warranty from the original invoice date on all product materials and workmanship. Products of such division sold to original equipment manufacturer (OEM) customers generally carry longer warranties, typically 15 to 24 months. Products sold by the Company s Lasers Division generally carry warranties that vary by product and product component, but generally range from 90 days to two years. In certain cases, such warranties for Lasers Division products are limited by either a set calendar period or a maximum amount of usage of the product, whichever occurs first. Defective products will be either repaired or replaced, generally at the Company s option, upon meeting certain criteria. The Company accrues a provision (based on historical experience) for the estimated costs that may be incurred for warranties relating to a product as a component of cost of sales at the time revenue for that product is recognized.

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The activity in accrued warranty obligations was as follows:

	Six Months Ended	
	July 1,	July 2,
(In thousands)	**2006**	**2005**
Balance at beginning of year	$ 5,255	$ 4,890
Additions charged to cost of sales	3,328	1,610
Warranty claims	(3,525)	(2,318)
Balance at end of period	$ 5,058	$ 4,182

Such amounts are included in *accrued expenses and other current liabilities* in the accompanying consolidated balance sheets.

NOTE 12 ACCRUED RESTRUCTURING COSTS

2004 Restructuring Plan

In connection with the acquisition of Spectra-Physics, the Company s Board of Directors approved a restructuring plan to consolidate certain locations. This plan included $3.3 million for employee relocation and employee severance and related termination costs and $2.2 million related to facility consolidation costs.

The following table summarizes the activity in the accrued restructuring costs related to the purchase of Spectra-Physics:

(In thousands)	**Employee Relocation and Severance**	**Facility Consolidation**	**Total**
Accrued restructuring at December 31, 2005	$ 591	$ 1,801	$ 2,392
Cash payments	(482)	(172)	(654)
Reclassifications	(27)	27	
Accrued restructuring at July 1, 2006	$ 82	$ 1,656	$ 1,738

The facility consolidation costs will be paid over the term of the lease for the closed facility, which expires in 2011. At July 1, 2006 and December 31, 2005, $0.5 million and $0.9 million, respectively, of these accrued restructuring costs were expected to be paid within one year and are included in current liabilities in *accrued restructuring costs*, and $1.2 million and $1.5 million, respectively, of accrued restructuring costs are included in long-term liabilities in *accrued restructuring costs and other liabilities,* in the accompanying consolidated balance sheets.

2002 Restructuring Plan

During 2002, in response to the continued severe downturn in the fiber optic communications market and the uncertainty with respect to the pace of recovery in the semiconductor equipment market, the Company s Board of Directors approved a restructuring and cost reduction plan designed to bring its operating costs in line with its business outlook at that time.

The following table summarizes the activity in accrued restructuring costs related to the 2002 restructuring plan:

(In thousands)	**Facility Consolidation**
Accrued restructuring at December 31, 2005	$ 571
Cash payments	(126)
Accrued restructuring at July 1, 2006	$ 445

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The facility consolidation costs will be paid over the term of the lease for the closed facility, which expires in 2008. At July 1, 2006 and December 31, 2005, $0.3 million and $0.2 million, respectively, of accrued restructuring costs were expected to be paid within one year and are included in current liabilities in *accrued restructuring costs,* and $0.1 million and $0.4 million, respectively, of accrued restructuring costs are included in long-term liabilities in *accrued restructuring costs and other liabilities*, in the accompanying consolidated balance sheets.

NOTE 13 DEBT AND LINES OF CREDIT

At July 1, 2006 and December 31, 2005, the Company had a note payable with a principal amount of $50.0 million issued in connection with the Company s acquisition of Spectra-Physics in July 2004. The note payable was valued at approximately $46.4 million on the date of acquisition, based upon the present value of cash flows, using a discount rate of 6.75% in order to reflect a market rate of interest for similar debt with similar characteristics. This discount is being amortized on a straight line basis until maturity.

At July 1, 2006 and December 31, 2005, the Company had a total of seven lines of credit, including one domestic revolving line of credit, two revolving lines of credit with Japanese banks, and four other lines of credit with Japanese banks, which are used to sell trade notes receivable with recourse to the banks.

The Company s domestic revolving line of credit has a total credit limit of $5.0 million and expires December 1, 2006. Certain of the marketable securities that are being managed by the lending institution collateralize this line of credit, which bears interest at either the prevailing prime rate, or the prevailing London Interbank Offered Rate (5.32% at July 1, 2006) plus 1.5%, at the Company s option, and carries an unused line fee of 0.25% per year. At July 1, 2006, there were no balances outstanding under this line of credit, with $3.9 million available, after considering outstanding letters of credit totaling $1.1 million.

The two revolving lines of credit with Japanese banks totaled 1.7 billion yen ($14.6 million at July 1, 2006) and expire as follows: $6.9 million on November 30, 2006, $5.1 million on March 31, 2007 and $2.6 million on June 30, 2008. These lines are not secured and bear interest at the prevailing bank rate. At July 1, 2006, the Company had $8.5 million outstanding and $6.1 million available for borrowing under these lines of credit. Approximately $5.9 million of the amount outstanding under these revolving lines of credit at July 1, 2006 is due prior to June 30, 2007 and is included in *short-term obligations* in the accompanying balance sheets, and approximately $2.6 million is included in *long-term debt* in the accompanying balance sheets, as the due date of this portion of the outstanding borrowings is June 30, 2008. The four other lines of credit with Japanese banks, which are used to sell trade notes receivable with recourse to the banks, totaled 800 million yen ($6.9 million at July 1, 2006), have no expiration dates and bear interest at the bank s prevailing rate. At July 1, 2006, the Company had $1.4 million outstanding and $5.5 million available for the sale of notes receivable under these lines of credit. Amounts outstanding under these lines of credit are included in *short-term obligations* in the accompanying consolidated balance sheets. The weighted average interest rate on all borrowings on all six Japanese lines of credit as of July 1, 2006 was 1.4%.

Total long-term debt is as follows:

(In thousands)	July 1, 2006	December 31, 2005
Line of credit due June 2008, interest at bank s prevailing rate (1.3% at July 1, 2006 and December 31, 2005)	$ 2,579	$ 2,556