

MERCURY COMPUTER SYSTEMS INC  
Form 10-Q  
May 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**  
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 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 0-23599

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**MERCURY COMPUTER SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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MASSACHUSETTS  
(State or other jurisdiction of  
incorporation or organization)

199 RIVERNECK ROAD

04-2741391  
(I.R.S. Employer

Identification No.)

01824

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**CHELMSFORD, MA**  
(Address of principal executive offices)

**978-256-1300**

(Zip Code)

(Registrant's telephone number, including area code)

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

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

Number of shares outstanding of the issuer's classes of common stock as of April 30, 2006:

| Class                                   | Number of Shares Outstanding |
|---|------------------------------|
| Common Stock, par value \$.01 per share | 20,977,539                   |

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED BALANCE SHEETS**

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

|  | March 31,         | June 30,          |
|--|-------------------|-------------------|
|  | 2006              | 2005              |
| <b>Assets</b>  |                   |                   |
| Current assets:  |                   |                   |
| Cash and cash equivalents  | \$ 30,497         | \$ 43,143         |
| Marketable securities  | 105,891           | 131,702           |
| Accounts receivable, net of allowance of \$581 and \$500 at March 31, 2006 and June 30, 2005, respectively | 27,715            | 40,033            |
| Inventory  | 18,855            | 16,691            |
| Deferred tax assets, net   | 3,196             | 2,664             |
| Prepaid expenses and other current assets  | 10,742            | 7,737             |
| <b>Total current assets</b>  | <b>196,896</b>    | <b>241,970</b>    |
| Marketable securities  | 31,743            | 53,382            |
| Property and equipment, net  | 31,514            | 29,484            |
| Goodwill   | 90,199            | 37,080            |
| Acquired intangible assets, net  | 24,391            | 5,402             |
| Deferred tax assets, net   | 1,695             | 4,481             |
| Other non-current assets   | 5,068             | 5,327             |
| <b>Total assets</b>  | <b>\$ 381,506</b> | <b>\$ 377,126</b> |
| <b>Liabilities and Shareholders' Equity</b>  |                   |                   |
| Current liabilities:   |                   |                   |
| Accounts payable   | \$ 11,142         | \$ 8,627          |
| Accrued expenses   | 11,512            | 6,471             |
| Accrued compensation   | 11,440            | 13,965            |
| Accrued warranty expenses  | 2,919             | 1,620             |
| Notes payable  | 10,287            | 894               |
| Income taxes payable   |                   | 3,128             |
| Deferred revenues and customer advances  | 12,653            | 8,162             |
| <b>Total current liabilities</b>   | <b>59,953</b>     | <b>42,867</b>     |
| Notes payable  | 125,602           | 134,997           |
| Accrued compensation   | 1,581             | 1,281             |
| Other long-term liabilities  | 968               | 155               |
| <b>Total liabilities</b>   | <b>188,104</b>    | <b>179,300</b>    |
| Commitments and contingencies (Note J)   |                   |                   |
| Shareholders' equity:  |                   |                   |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; no shares issued or outstanding             |                   |                   |

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|  |            |            |
|--|------------|------------|
| Common stock, \$.01 par value; 85,000,000 shares authorized; 20,977,539 and 21,006,016 shares issued and outstanding at March 31, 2006 and June 30, 2005, respectively | 210        | 210        |
| Additional paid-in capital   | 74,445     | 58,674     |
| Retained earnings  | 120,149    | 139,785    |
| Accumulated other comprehensive loss   | (1,402)    | (843)      |
| Total shareholders' equity   | 193,402    | 197,826    |
| Total liabilities and shareholders' equity   | \$ 381,506 | \$ 377,126 |

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

**Table of Contents****MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

|  | Three months ended |           | Nine months ended |            |
|--|--------------------|-----------|-------------------|------------|
|  | March 31,<br>2006  | 2005      | March 31,<br>2006 | 2005       |
| Net revenues                               | \$ 44,478          | \$ 64,345 | \$ 173,879        | \$ 178,659 |
| Cost of revenues                           | 26,607             | 21,797    | 74,825            | 61,519     |
| Gross profit                               | 17,871             | 42,548    | 99,054            | 117,140    |
| Operating expenses:                        |                    |           |                   |            |
| Selling, general and administrative        | 22,286             | 17,353    | 63,660            | 50,719     |
| Research and development                   | 15,614             | 12,998    | 46,322            | 35,848     |
| Amortization of acquired intangible assets | 2,179              | 778       | 6,220             | 1,887      |
| In-process research and development        |                    |           | 548               |            |
| Restructuring .                            | 1,873              |           | 1,873             |            |
| Total operating expenses                   | 41,952             | 31,129    | 118,623           | 88,454     |
| (Loss) income from operations              | (24,081)           | 11,419    | (19,569)          | 28,686     |
| Interest income                            | 1,656              | 1,307     | 4,708             | 3,454      |
| Interest expense                           | (1,010)            | (1,053)   | (3,096)           | (3,163)    |
| Other income (expense), net                | 56                 | (22)      | 27                | (262)      |
| (Loss) income before income taxes          | (23,379)           | 11,651    | (17,930)          | 28,715     |
| Income tax (benefit) provision             | (9,247)            | 3,495     | (8,103)           | 8,615      |
| Net (loss) income                          | \$ (14,132)        | \$ 8,156  | \$ (9,827)        | \$ 20,100  |
| Net (loss) income per share:               |                    |           |                   |            |
| Basic                                      | \$ (0.67)          | \$ 0.39   | \$ (0.47)         | \$ 0.95    |
| Diluted                                    | \$ (0.67)          | \$ 0.34   | \$ (0.47)         | \$ 0.84    |
| Weighted-average shares outstanding:       |                    |           |                   |            |
| Basic                                      | 20,961             | 21,011    | 20,974            | 21,054     |
| Diluted                                    | 20,961             | 26,007    | 20,974            | 26,017     |

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

**Table of Contents****MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(IN THOUSANDS)

(unaudited)

|  | Nine Months Ended |                 |
|--|-------------------|-----------------|
|  | March 31,<br>2006 | 2005            |
| Cash flows from operating activities:  |                   |                 |
| Net (loss) income  | \$ (9,827)        | \$ 20,100       |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: |                   |                 |
| Depreciation and amortization  | 13,403            | 7,821           |
| Deferred income taxes  | (5,131)           | 1,480           |
| Non-cash interest expense  | 628               | 640             |
| Stock-based compensation expense   | 7,289             |                 |
| Tax benefit from stock options   | 673               | 1,350           |
| Gross tax windfall from stock-based compensation   | (303)             |                 |
| In-process research and development acquired in acquisitions                             | 550               |                 |
| Other  |                   | 127             |
| Changes in operating assets and liabilities, net of effects of businesses acquired:      |                   |                 |
| Accounts receivable  | 15,765            | 8,495           |
| Inventory  | (668)             | (5,756)         |
| Prepaid expenses and other current assets  | (2,313)           | 2,028           |
| Other non-current assets   | (382)             | (534)           |
| Accounts payable and accrued expenses  | 3,514             | (36)            |
| Income taxes payable   | (3,114)           | (6,602)         |
| Deferred revenues and customer advances  | 4,515             | 4,287           |
| Other long-term liabilities  | 1,114             | (327)           |
| <b>Net cash provided by operating activities</b>   | <b>25,713</b>     | <b>33,073</b>   |
| Cash flows from investing activities:  |                   |                 |
| Purchases of marketable securities   | (102,678)         | (166,837)       |
| Sales and maturities of marketable securities  | 149,783           | 189,545         |
| Purchases of property and equipment  | (8,369)           | (7,382)         |
| Acquisition of businesses, net of cash acquired  | (67,506)          | (16,184)        |
| Acquisition of intellectual property license   | (2,000)           |                 |
| <b>Net cash used in investing activities</b>   | <b>(30,770)</b>   | <b>(858)</b>    |
| Cash flows from financing activities:  |                   |                 |
| Proceeds from employee stock option and purchase plans                                   | 5,111             | 4,809           |
| Repurchases of common stock  | (12,284)          | (24,966)        |
| Payments of principal under notes payable  | (653)             | (1,241)         |
| Gross tax windfall from stock-based compensation   | 303               |                 |
| <b>Net cash used in financing activities</b>   | <b>(7,523)</b>    | <b>(21,398)</b> |
| Effect of exchange rate changes on cash and cash equivalents                             | (66)              | (247)           |

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|  |           |           |
|--|-----------|-----------|
| Net (decrease) increase in cash and cash equivalents | (12,646)  | 10,570    |
| Cash and cash equivalents at beginning of period     | 43,143    | 18,695    |
| Cash and cash equivalents at end of period           | \$ 30,497 | \$ 29,265 |
| Cash paid during the period for:                     |           |           |
| Interest   | \$ 3,620  | \$ 1,938  |
| Income taxes, net                                    | 4,297     | 12,505    |
| Supplemental disclosures non-cash activities:        |           |           |
| Issuance of restricted stock awards to employees     | \$ 6,832  | \$        |
| Supplemental disclosures purchase of businesses:     |           |           |
| Fair value of assets acquired                        | \$ 83,611 | \$ 15,800 |
| Cash paid, net of cash acquired                      | (67,506)  | (13,402)  |
| Common stock issued                                  | (5,173)   |           |
| Liabilities assumed                                  | \$ 10,932 | \$ 2,398  |

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



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**MERCURY COMPUTER SYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

(unaudited)

**A. Description of Business**

Mercury Computer Systems, Inc. (the Company or Mercury ) designs, manufactures and markets high-performance embedded computer systems and software. The primary areas of business for the Company are defense electronics, which includes radar, signals intelligence, sonar, smart weapons, and imagery applications; imaging and visualization solutions, which includes life sciences (medical diagnostic imaging and biotechnology), geosciences (oil and gas exploration), and simulation applications; and commercial OEM solutions, which includes semiconductor test inspection, reticle inspection, mask writing, and telecommunications test applications. These markets have computing needs that benefit from the unique system architecture developed by the Company.

**B. Basis of Presentation**

The accompanying financial data as of March 31, 2006 and for the three and nine months ended March 31, 2006 and 2005 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2005.

In the second quarter of fiscal 2006, the Company concluded that it was appropriate to classify a portion of the costs associated with the Company s retirement of treasury stock and common stock as a result of the enactment of the Massachusetts Business Corporation Act as a reduction of retained earnings. Previously, all such costs were classified as a reduction in additional paid-in capital. Accordingly, the Company has revised the classification to increase additional paid-in capital by \$48,309 at June 30, 2005, and to decrease retained earnings by \$48,309. This change in classification does not affect the previously reported consolidated statement of operations or consolidated statement of cash flows.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present a fair statement of financial position as of March 31, 2006 and June 30, 2005, results of operations for the three and nine months ended March 31, 2006 and 2005, and cash flows for the nine months ended March 31, 2006 and 2005 have been made. The results of operations for the three and nine months ended March 31, 2006 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

The preparation of financial statements in conformity with U.S. general accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets.

**C. Accounting for Stock-Based Compensation**

**STOCK OPTION PLANS**

The number of shares authorized for issuance under the Company s 2005 Stock Incentive Plan (the 2005 Plan ) is 1,942,264 shares as of the adoption of the 2005 Plan and will be increased by any future cancellations, forfeitures or terminations (other than by exercise) under the Company s 1997 Stock Option Plan. The 2005 Plan provides for the grant of non-qualified and incentive stock options, restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company s common stock at the date of grant and the options have a maximum term of 10 years. There were 1,536,741 shares available for future grant under the 2005 Plan at March 31, 2006.

The number of shares authorized for issuance under the Company s 1997 Stock Option Plan (the 1997 Plan ) is 8,650,000 shares, of which 100,000 shares may be issued pursuant to restricted stock grants. The 1997 Plan provides for the grant of non-qualified and incentive stock options and restricted stock to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the

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fair value of the Company's common stock at the date of grant. The options vest over periods of zero to six years and have a maximum term of 10 years. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company's Board of Directors directed that no further grants of stock options or other awards would be made under the 1997 Plan. The foregoing action does not affect any outstanding awards under the 1997 Plan, which remain in full force and effect in accordance with their terms.

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The following table summarizes activity of the Company's stock option plans since June 30, 2004:

|                                      | Number of Shares | Options Outstanding             |   |
|--------------------------------------|------------------|---------------------------------|---|
|                                      |                  | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) |
| <b>Outstanding at June 30, 2004</b>  | <b>4,533,495</b> | <b>\$ 24.18</b>                 | <b>7.11</b>   |
| Grants                               | 1,083,150        | 26.64                           |   |
| Exercises                            | (320,349)        | 14.80                           |   |
| Cancellations                        | (211,768)        | 27.45                           |   |
| <b>Outstanding at June 30, 2005</b>  | <b>5,084,528</b> | <b>25.16</b>                    | <b>6.83</b>   |
| Grants                               | 269,300          | 23.55                           |   |
| Exercises                            | (288,486)        | 15.42                           |   |
| Cancellations                        | (429,604)        | 28.78                           |   |
| <b>Outstanding at March 31, 2006</b> | <b>4,635,738</b> | <b>\$ 25.33</b>                 | <b>6.32</b>   |

Information related to the stock options outstanding as of March 31, 2006 is as follows:

| Range of Exercise Prices | Number of Shares | Weighted-Average Remaining Contractual Life (years) |                  | Weighted-Average Exercise Price | Exercisable Number of Shares | Exercisable Weighted-Average Exercise Price | Exercisable Weighted Average Remaining Contractual Term (years) |
|--------------------------|------------------|---|------------------|---------------------------------|------------------------------|---|---|
|                          |                  | Contractual   | Weighted-Average |                                 |                              |   |   |
| \$ 2.00 - \$19.01        | 975,562          | 4.70  | \$ 13.65         | 816,312                         | \$ 12.79                     |   |   |
| \$19.02 - \$23.44        | 821,683          | 6.90  | \$ 21.10         | 470,382                         | \$ 21.35                     |   |   |
| \$23.45 - \$26.88        | 892,218          | 7.65  | \$ 24.64         | 400,894                         | \$ 24.69                     |   |   |
| \$26.89 - \$30.06        | 854,152          | 6.42  | \$ 28.73         | 648,502                         | \$ 28.94                     |   |   |
| \$30.07 - \$39.63        | 794,473          | 6.69  | \$ 33.75         | 794,473                         | \$ 33.75                     |   |   |
| \$39.64 - \$52.00        | 297,650          | 4.81  | \$ 45.19         | 297,650                         | \$ 45.19                     |   |   |
| <b>\$ 2.00 - \$52.00</b> | <b>4,635,738</b> | <b>6.32</b>   | <b>\$ 25.33</b>  | <b>3,428,213</b>                | <b>\$ 26.08</b>              | <b>5.70</b>                                 |   |

Options for the purchase of 3,405,084 shares were exercisable at June 30, 2005, with a weighted-average exercise price of \$26.48.

The aggregate intrinsic value of the Company's in-the-money outstanding and exercisable options as of March 31, 2006 was a \$3,657. The intrinsic value of the options exercised during the three and nine months ended March 31, 2006 was \$330 and \$1,667, respectively. Nonvested common stock options are subject to the risk of forfeiture until the fulfillment of specified conditions. As of March 31, 2006, there was \$14,522 of total unrecognized compensation cost related to nonvested options granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 1.2 years.

The following table summarizes the status of the Company's nonvested restricted stock awards since June 30, 2005:

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|                                      | Nonvested Restricted Stock Awards |                  |
|--------------------------------------|-----------------------------------|------------------|
|                                      | Number of                         | Weighted Average |
|                                      |                                   | Grant Date       |
|                                      | Shares                            | Fair Value       |
| <b>Outstanding at June 30, 2005</b>  |                                   | \$               |
| Granted                              | 366,156                           | 18.66            |
| Vested                               |                                   |                  |
| Forfeited                            | (2,460)                           | 17.25            |
| <b>Outstanding at March 31, 2006</b> | <b>363,696</b>                    | <b>\$ 18.67</b>  |

Nonvested restricted stock awards are subject to the risk of forfeiture until the fulfillment of specified conditions. As of March 31, 2006, there was \$5,929 of total unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 2.0 years. The total fair value of nonvested restricted stock awards that vested during the three and nine months ended March 31, 2006 was \$0 and \$0, respectively.

**Table of Contents****EMPLOYEE STOCK PURCHASE PLAN**

During 1997, the Company adopted the 1997 Employee Stock Purchase Plan (ESPP) and authorized 500,000 shares for future issuance. Under the plan, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The plan permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the plan. The number of shares issued under the ESPP during the three and nine months ended March 31, 2006 was 0 and 37,767, respectively. Shares available for future purchase under the ESPP totaled 88,621 at March 31, 2006.

**STOCK-BASED COMPENSATION**

The Company has several stock-based employee compensation plans. On July 1, 2005, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS 123R), Accounting for Stock-Based Compensation, using the modified prospective method, which results in the provisions of SFAS 123R only being applied to the consolidated financial statements on a going-forward basis (that is, the prior period results were not restated). Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period. Stock-based employee compensation expense was \$3,210 and \$7,289 (before tax) for the three and nine months ended March 31, 2006, respectively. Previously, the Company had followed Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, which resulted in the accounting for employee share options at their intrinsic value in the consolidated financial statements.

The Company recognized the full impact of its share-based payment plans in the consolidated statements of operations for the three and nine months ended March 31, 2006 under SFAS 123R and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. The following table presents share-based compensation expenses included in the Company's consolidated statement of operations:

|   | <b>Three Months Ended</b> | <b>Nine Months Ended</b> |
|---|---------------------------|--------------------------|
|   | <b>March 31, 2006</b>     | <b>March 31, 2006</b>    |
| Cost of revenues                            | \$ 364                    | \$ 532                   |
| Selling, general and administrative         | 2,273                     | 5,249                    |
| Research and development                    | 573                       | 1,508                    |
| Share-based compensation expense before tax | 3,210                     | 7,289                    |
| Income tax benefit                          | (993)                     | (2,213)                  |
| Net compensation expense                    | \$ 2,217                  | \$ 5,076                 |

The Company had previously adopted the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, through disclosure only. The following table illustrates the effect on net income and earnings per share for the three and nine months ended March 31, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee awards.

|   | <b>Three Months Ended</b> | <b>Nine Months Ended</b> |
|---|---------------------------|--------------------------|
|   | <b>March 31, 2005</b>     | <b>March 31, 2005</b>    |
| Net income as reported  | \$ 8,156                  | \$ 20,100                |
| Add: Employee compensation expense for share options included in reported net income, net of income taxes               |                           |                          |
| Less: Total employee compensation expense for share options determined under the fair value method, net of income taxes | 2,861                     | 9,546                    |

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|                      |    |       |    |        |
|----------------------|----|-------|----|--------|
| Pro forma net income | \$ | 5,295 | \$ | 10,554 |
| Earnings per share:  |    |       |    |        |
| Basic as reported    | \$ | 0.39  | \$ | 0.95   |
| Basic pro forma      | \$ | 0.25  | \$ | 0.50   |
| Diluted as reported  | \$ | 0.34  | \$ | 0.84   |
| Diluted pro forma    | \$ | 0.23  | \$ | 0.47   |

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The weighted-average grant-date fair values of options granted during the three months ended March 31, 2006 and 2005 were \$9.94 and \$20.82, respectively, per option. The weighted-average grant-date fair values of options granted during the nine months ended March 31, 2006 and 2005 were \$12.43 and \$17.78, respectively, per option. The fair value of options at date of grant was estimated using the Black-Scholes option-pricing model with the following assumptions:

|                         | Three Months Ended |         | Nine Months Ended |         |
|-------------------------|--------------------|---------|-------------------|---------|
|                         | March 31,          |         | March 31,         |         |
|                         | 2006               | 2005    | 2006              | 2005    |
| Option life             | 6 years(1)         | 6 years | 6 years(1)        | 6 years |
| Risk-free interest rate | 4.5%(2)            | 3.81%   | 4.27%(2)          | 3.93%   |
| Stock volatility        | 55%(3)             | 72%     | 51%(3)            | 73%     |
| Dividend rate           | 0%                 | 0%      | 0%                | 0%      |

- (1) The option life was determined using the simplified method for estimating expected option life, which qualify as plain-vanilla options.
- (2) The risk-free interest rate for each grant is equal to the U.S. Treasury yield curve in effect at the time of grant for instruments with a similar expected life.
- (3) The stock volatility for each grant is measured using the weighted average of historical daily price changes of the Company's common stock over the most recent period equal to the expected option life of the grant, the historical short-term trend of the option and other factors, such as expected changes in volatility arising from planned changes in the Company's business operations.

The weighted-average fair value of stock purchase rights granted as part of the Company's Employee Stock Purchase Plan ( ESPP ) during the three months ended March 31, 2006 and 2005 were \$4.21 and \$6.53, respectively per right. The weighted-average fair value of stock purchase rights granted as part of the Company's ESPP during the nine months ended March 31, 2006 and 2005 were \$7.40 and \$6.30, respectively per right. The fair value of the employees' stock purchase rights were estimated using the Black-Scholes option-pricing model with the following assumptions:

|                         | Three Months Ended |          | Nine Months Ended |          |
|-------------------------|--------------------|----------|-------------------|----------|
|                         | March 31,          |          | March 31,         |          |
|                         | 2006               | 2005     | 2006              | 2005     |
| Option life             | 6 months           | 6 months | 6 months          | 6 months |
| Risk-free interest rate | 4.63%              | 3.13%    | 4.44%             | 2.76%    |
| Stock volatility        | 28%                | 35%      | 50%               | 34%      |
| Dividend rate           | 0%                 | 0%       | 0%                | 0%       |

During the nine months ended March 31, 2006, the Company granted 366,156 shares of restricted common stock to certain employees and officers as permitted under the 1997 and 2005 Stock Plans. These restricted stock grants either vest ratably over three years, four years or cliff vest after four years and are subject to forfeiture if employment terminates during the prescribed retention period. Compensation expense for the number of shares issued is recognized over the service period and is recorded in the consolidated statement of operations as a component of cost of revenues, selling, general and administrative and research and development expense. During the three and nine months ended March 31, 2006, \$260 and \$386, respectively, of compensation expense was recognized related to these restricted stock awards.

**Table of Contents****D. Inventory**

Inventory is stated at the lower of cost (first-in, first-out) or market value, and consists of materials, labor and overhead. There are no amounts in inventory relating to contracts having production cycles longer than one year. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. The Company records a provision for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. In the third quarter fiscal 2006, the Company recorded a significant inventory write-off which was the result of several factors including a decline in revenues of the Defense business and shifts in technology that resulted in inventory becoming obsolete.

Inventory was comprised of the following at March 31, 2006 and June 30, 2005:

|                 | March 31, | June 30,  |
|-----------------|-----------|-----------|
|                 | 2006      | 2005      |
| Raw materials   | \$ 6,285  | \$ 5,885  |
| Work in process | 9,559     | 7,471     |
| Finished goods  | 3,011     | 3,335     |
| Total           | \$ 18,855 | \$ 16,691 |

**E. Net Income (Loss) Per Share**

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

|   | Three Months Ended |           | Nine Months Ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | March 31,          | March 31, | March 31,         | March 31, |
|   | 2006               | 2005      | 2006              | 2005      |
| Net (loss) income basic   | \$ (14,132)        | \$ 8,156  | \$ (9,827)        | \$ 20,100 |
| Interest and amortization of deferred financing costs, net of tax, related to convertible notes |                    | 588       |                   | 1,765     |
| Adjusted net (loss) income for calculation of diluted earnings per share                        | \$ (14,132)        | \$ 8,744  | \$ (9,827)        | \$ 21,865 |
| Shares used in computation of net income (loss) per share basic                                 | 20,961             | 21,011    | 20,974            | 21,054    |
| Potential dilutive common shares:   |                    |           |                   |           |
| Shares issuable under Convertible Senior Notes  |                    | 4,135     |                   | 4,135     |
| Stock option, restricted common stock and employee stock purchase plans                         |                    | 861       |                   | 828       |
| Shares used in computation of net income (loss) per share diluted                               | 20,961             | 26,007    | 20,974            | 26,017    |
| Net (loss) income per share basic   | \$ (0.67)          | \$ 0.39   | \$ (0.47)         | \$ 0.95   |
| Net (loss) income per share diluted   | \$ (0.67)          | \$ 0.34   | \$ (0.47)         | \$ 0.84   |

Options to purchase 4,635,738 and 4,635,738 shares of common stock were not included in the calculation of diluted net income (loss) per share for the three and nine months ended March 31, 2006, respectively, because the sum of the option exercise proceeds, including the unrecognized compensation and unrecognized future tax benefit, divided by the aggregate number of shares under outstanding options exceeded the average stock price and therefore would be antidilutive. Options to purchase 1,553,249 and 1,671,437 shares of common stock were not included in the calculation of diluted net income per share for the three and nine months ended March 31, 2005, respectively, because the option exercise prices were greater than the average market price of the Company's common stock during the periods and therefore would be antidilutive. The change in methodology in determining antidilutive options was due to the implementation of SFAS 123R.



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During the year ended June 30, 2005, the Company adopted the guidance of Emerging Issue Task Force Issue No. 04-08 ( EITF 04-08 ), The Effect of Contingently Convertible Debt on Diluted Earnings Per Share. The guidance requires the inclusion in diluted earnings per share calculations of the effect of notes that are contingently convertible into shares of common stock, with restatement of reported amounts for periods prior to adoption. As a result of adoption, the calculations of diluted net income per share for the three and nine months ended March 31, 2005 both (i) include 4,135,000 shares, which represent the securities issuable under the Company's outstanding Convertible Senior Notes issued in fiscal year 2004 and (ii) reflect increases to reported net income of \$588 and \$1,765, respectively, representing the interest expense (including amortization of deferred financing costs) incurred, net of tax, related to the Convertible Senior Notes that would have not

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been incurred had the notes been converted into common stock, as assumed per the calculation. Further, for the three and nine months ended March 31, 2006, the effect of the convertible debt would be antidilutive, thus the convertible debt had no impact on the dilutive net income (loss) per share calculation.

**F. Recent Accounting Pronouncements**

In June 2005, The FASB issued FSP FAS 143-1 titled *Accounting for Electronic Waste Obligations*. The obligations addressed in the FSP relate to those which might be created under the operation of Directive 2002/96/EC on Electrical and Electronic Equipment adopted by the European Union in February 2003. The FSP provides guidance on proper accounting for costs associated with retiring electronic equipment classified as Historical held by commercial users on or before August 13, 2005. Commercial users in EU countries that have adopted the law may be required to record an asset retirement obligation and to capitalize a related increase in the carrying value of the equipment subject to the directive utilizing concepts outlined under FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, and the related FASB Interpretation No. 47, *Accounting for Conditions Asset Retirement Obligations*. The effective date of this FSP is the first reporting period after June 8, 2005 or the date of adoption of the law by the applicable EU-member country. The Company has evaluated whether the EU Directive is applicable to both its foreign subsidiaries and to shipments abroad from its U.S. subsidiaries. Management has assessed the impact of the adoption of this accounting pronouncement and there is no material affect on operating results.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board (APB) Opinion No. 20 and FASB Statement No. 3* ( SFAS 154 ). SFAS 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS 154 s retrospective-application requirement replaces APB Opinion No. 20 s requirement to recognize most voluntary changes in accounting principle by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. Under SFAS 154, correction of an error in previously issued financial statements will continue to be accounted for by restating the prior-period financial statements, and a change in accounting estimate will continue to be accounted for prospectively. The requirements of SFAS 154 are effective for accounting changes made in fiscal years beginning after December 15, 2005. The Company will determine the impact of this standard on the consolidated financial statements when an accounting change or error correction occurs.

**G. Comprehensive Income (Loss)**

Total comprehensive income (loss) was as follows:

|   | Three Months Ended |          | Nine Months Ended |           |
|---|--------------------|----------|-------------------|-----------|
|   | March 31,<br>2006  | 2005     | March 31,<br>2006 | 2005      |
| Net income  | \$ (14,132)        | \$ 8,156 | \$ (9,827)        | \$ 20,100 |
| Other comprehensive income (loss):                        |                    |          |                   |           |
| Foreign currency translation adjustments                  | 415                | 198      | (214)             | 154       |
| Change in unrealized gain (loss) on marketable securities | 9                  | (273)    | (345)             | (348)     |
| Other comprehensive income (loss)                         | 424                | (75)     | (559)             | (194)     |
| Total comprehensive income (loss)                         | \$ (13,708)        | \$ 8,081 | \$ (10,386)       | \$ 19,906 |

**H. Operating Segment Information**

Operating segments are defined as components of an enterprise evaluated regularly by the Company s senior management in deciding how to allocate resources and assess performance. The Company has four operating and reportable segments: Defense Business Unit (Defense), formerly Defense Electronics Group; Commercial Imaging and Visualization Business Unit (CIV), formerly Imaging and Visualization Solutions Group; Advanced Solutions Business Unit (Advanced Solutions), formerly OEM Solutions Group; and Modular Products and Services Business Unit (MPS), formerly Momentum Computer Group. These operating segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company s management structure.

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The accounting policies of the reportable segments are the same as those described in Note B: Summary of Significant Accounting Policies in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2005. The profitability measure employed by the Company and its chief operating decision maker for making decisions about allocating resources to segments and assessing segment performance is income (loss) from operations prior to stock compensation expense. As such, stock compensation expense has been excluded from each operating segments' income (loss) from

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operations below and reported separately to reconcile the reported segment income (loss) from operations to the consolidated operating income reported in the consolidated statements of operations. Additionally, asset information by reportable segment is not reported because the Company does not produce such information internally. The following is a summary of the performance of the Company's operations by reportable segment:

|  | Commercial  |               |                    |                      |         |                    | Total     |
|--|-------------|---------------|--------------------|----------------------|---------|--------------------|-----------|
|  | Imaging and |               | Advanced Solutions | Modular Products and |         | Stock Compensation |           |
|  | Defense     | Visualization |                    | Services             | Expense |                    |           |
| <b>THREE MONTHS ENDED MARCH 31, 2006</b> |             |               |                    |                      |         |                    |           |
| Net revenues to unaffiliated customers   | \$ 18,418   | \$ 11,185     | \$ 11,576          | \$ 3,299             | \$      | \$                 | \$ 44,478 |
| Intersegment revenues                    |             |               |                    | 161                  |         | (161)              |           |
| Net revenues                             | 18,418      | 11,185        | 11,576             | 3,460                |         | (161)              | 44,478    |
| Income (loss) from operations            | (17,603)    | (3,085)       | 288                | (471)                | (3,210) |                    | (24,081)  |
| Depreciation and amortization expense    | 3,268       | 812           | 441                | 139                  |         |                    | 4,660     |
| <b>THREE MONTHS ENDED MARCH 31, 2005</b> |             |               |                    |                      |         |                    |           |
| Net revenues to unaffiliated customers   | \$ 36,461   | \$ 11,437     | \$ 14,193          | \$ 2,254             | \$      | \$                 | \$ 64,345 |
| Intersegment revenues                    |             |               |                    | 304                  |         | (304)              |           |
| Net revenues                             | 36,461      | 11,437        | 14,193             | 2,558                |         | (304)              | 64,345    |
| Income (loss) from operations            | 9,683       | 517           | 2,216              | (875)                |         | (122)              | 11,419    |
| Depreciation and amortization expense    | 1,493       | 492           | 438                | 589                  |         |                    | 3,012     |

|   | Commercial  |               |                    |                      |         |                    | Total      |
|---|-------------|---------------|--------------------|----------------------|---------|--------------------|------------|
|   | Imaging and |               | Advanced Solutions | Modular Products and |         | Stock Compensation |            |
|   | Defense     | Visualization |                    | Services             | Expense |                    |            |
| <b>NINE MONTHS ENDED MARCH 31, 2006</b> |             |               |                    |                      |         |                    |            |
| Net revenues to unaffiliated customers  | \$ 93,322   | \$ 40,132     | \$ 31,627          | \$ 8,798             | \$      | \$                 | \$ 173,879 |
| Intersegment revenues                   |             |               |                    | 382                  |         | (382)              |            |
| Net revenues                            | 93,322      | 40,132        | 31,627             | 9,180                |         | (382)              | 173,879    |
| Income (loss) from operations           | (9,981)     | (2,430)       | 919                | (788)                | (7,289) |                    | (19,569)   |
| Depreciation and amortization expense   | 8,870       | 2,858         | 1,269              | 406                  |         |                    | 13,403     |
| <b>NINE MONTHS ENDED MARCH 31, 2005</b> |             |               |                    |                      |         |                    |            |
| Net revenues to unaffiliated customers  | \$ 100,715  | \$ 37,034     | \$ 38,149          | \$ 2,761             | \$      | \$                 | \$ 178,659 |
| Intersegment revenues                   |             |               |                    | 348                  |         | (348)              |            |
| Net revenues                            | 100,715     | 37,034        | 38,149             | 3,109                |         | (348)              | 178,659    |
| Income (loss) from operations           | 22,073      | 3,793         | 4,212              | (1,289)              |         | (103)              | 28,686     |
| Depreciation and amortization expense   | 4,337       | 1,602         | 1,117              | 765                  |         |                    | 7,821      |

**Table of Contents****I. Goodwill and Acquired Intangible Assets**

Acquired intangible assets result from the Company's acquisition of Myriad Logic, Inc., the TGS Group, Advanced Radio Corporation, Momentum Computer, Inc., SoHard AG and Echotek Corporation and consist of identifiable intangible assets, including completed technology, licensing agreements, customer backlog and customer relationships. Acquired intangible assets are reported at cost, net of accumulated amortization and are amortized on a straight-line basis over their estimated useful lives of one to six years. Goodwill is the amount by which the cost of the acquired net assets in a business acquisition exceeded the fair values of the identifiable assets on the date of purchase. In accordance with the requirements of SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized; rather goodwill is assessed for impairment at least annually, on a reporting unit basis, or more frequently when events and circumstances occur indicating that the recorded goodwill may be impaired. If the book value of a reporting unit exceeds its fair value, the implied fair value of goodwill is compared with the carrying amount of goodwill. If the carrying amount of goodwill exceeds the implied fair value, an impairment loss is recorded in an amount equal to that excess. The Company completed its annual goodwill impairment test in the third quarter of fiscal year 2006 and determined that no goodwill was impaired.

The changes in the carrying amount of goodwill for the nine months ended March 31, 2006 were as follows:

|                                 | Commercial<br>Imaging and<br>Defense | Modular<br>Products and<br>Visualization | Services | Total     |
|---------------------------------|--------------------------------------|--|----------|-----------|
| JUNE 30, 2005 balance           | \$ 9,848                             | \$ 18,180                                | \$ 9,052 | \$ 37,080 |
| Foreign currency translation    |                                      | (75)                                     |          | (75)      |
| Goodwill recorded during period | 36,037                               | 17,157                                   |          | 53,194    |
| MARCH 31, 2006 balance          | \$ 45,885                            | \$ 35,262                                | \$ 9,052 | \$ 90,199 |

The increase in goodwill during the nine months ended March 31, 2006 consisted of an increase of \$17,157 related to the acquisition by the Company of SoHard AG and an increase of \$36,037 related to the acquisition of Echotek Corporation. This increase was partially offset by the foreign currency translation adjustments.

Acquired intangible assets consisted of the following:

|  | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Average<br>Useful<br>Life |
|--|-----------------------------|-----------------------------|---------------------------|---------------------------|
| MARCH 31, 2006                               |                             |                             |                           |                           |
| Completed technology                         | \$ 17,213                   | \$ (6,333)                  | \$ 10,880                 | 3.3 years                 |
| Customer relationships                       | 12,023                      | (2,044)                     | 9,979                     | 5.4 years                 |
| Licensing agreements, trademarks and patents | 3,678                       | (243)                       | 3,435                     | 5.0 years                 |
| Customer backlog                             | 1,728                       | (1,728)                     | 0                         | 0.4 years                 |
| Non-compete agreements                       | 130                         | (33)                        | 97                        | 3.0 years                 |
|  | \$ 34,772                   | \$ (10,381)                 | \$ 24,391                 |                           |
| JUNE 30, 2005                                |                             |                             |                           |                           |
| Completed technology                         | \$ 5,208                    | \$ (2,991)                  | \$ 2,217                  | 4.4 years                 |
| Customer relationships                       | 3,489                       | (562)                       | 2,927                     | 5.6 years                 |
| Licensing agreement                          | 338                         | (80)                        | 258                       | 5.0 years                 |

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|                  |          |            |           |
|------------------|----------|------------|-----------|
| Customer backlog | 549      | (549)      | 0.4 years |
|                  | \$ 9,584 | \$ (4,182) | \$ 5,402  |

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In September 2005, the Company entered into an agreement to license certain technologies from a third party for \$2,000. The costs associated with the license agreement were capitalized as an intangible asset in accordance with FAS 142, *Goodwill and Other Intangible Assets* and will be amortized over the estimated period that the Company will receive an economic benefit from the intangible asset.

Amortization expense related to acquired intangible assets for the three months ended March 31, 2006 and 2005 was \$2,179 and \$895, respectively. Amortization expense related to acquired intangible assets for the nine months ended March 31, 2006 and 2005 was \$6,220 and \$1,882, respectively. Estimated future amortization expense for acquired intangible assets remaining at March 31, 2006 is \$1,854 for the remainder of fiscal 2006, \$7,484 for fiscal 2007, \$7,484 for fiscal 2008, \$3,882 for fiscal 2009, \$2,315 for fiscal 2010, and \$1,372 thereafter.

### **J. Commitments and Contingencies**

On January 31, 2006, the Company received a written notice and request for indemnification from Seismic Micro-Technology, Inc. ( SMT ), which had been named as a defendant in a patent infringement suit entitled *Landmark Graphics Corporation, et al. v. Paradigm Geophysical Corporation, et al.*, filed in the United States District Court for the Southern District of Texas. SMT based its request for indemnification on the terms of certain application developer agreements it entered into with the Company and certain of its subsidiaries. The complaint alleges infringement by SMT of U.S. patent number 6,765,570, and seeks injunctive relief, treble damages, costs and attorneys' fees. On February 22, 2006, SMT answered and filed counterclaims for declaratory judgment of non-infringement and invalidity. On February 28, 2006 the Company notified SMT that it would indemnify SMT from all costs and damages that may be awarded against SMT in the foregoing action, and would be responsible for attorneys' fees and expenses incurred by SMT in defense of the action, subject to certain conditions, including the Company's right to control and direct the defense of the action on behalf of SMT. The Company believes there are meritorious defenses to the complaint and the Company intends to contest it vigorously. However, an adverse resolution of this litigation could have an adverse effect on the Company's consolidated financial position, results of operations or cash flows in the period in which the litigation is resolved. No costs have been accrued for this loss contingency.

The Company's standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited.

The Company is also subject to legal proceedings and claims that arise in the ordinary course of business. The Company does not believe the outcome of these matters will not have a material adverse effect on its financial position, results of operations or cash flows.

### **K. Shareholders' Equity**

#### **PREFERRED STOCK**

The Company is authorized to issue 1,000,000 shares of preferred stock with a par value of \$0.01 per share.

**Table of Contents****SHAREHOLDER RIGHTS PLAN**

The Company has adopted a Shareholder Rights Plan, the purpose of which is, among other things, to enhance the Board's ability to protect the shareholder interests and to ensure that shareholders receive fair treatment in the event any coercive takeover attempt of the Company is made in the future. The Shareholder Rights Plan could make it more difficult for a third party to acquire, or could discourage a third party from acquiring, the Company or a large block of the Company's common stock. The following summary description of the Shareholder Rights Plan does not purport to be complete and is qualified in its entirety by reference to the Company's Shareholder Rights Plan, which has been previously filed with the Securities and Exchange Commission as an exhibit to a Registration Statement on Form 8-A.

In connection with the adoption of the Shareholder Rights Plan, the Board of Directors of the Company declared a dividend distribution of one preferred stock purchase right (a "Right") for each outstanding share of common stock to shareholders of record as of the close of business on December 23, 2005. The Rights currently are not exercisable and are attached to and trade with the outstanding shares of common stock. Under the Shareholder Rights Plan, the Rights become exercisable if a person becomes an "acquiring person" by acquiring 15% or more of the outstanding shares of common stock or if a person commences a tender offer that would result in that person owning 15% or more of the common stock. If a person becomes an "acquiring person," each holder of a Right (other than the acquiring person) would be entitled to purchase, at the then-current exercise price, such number of shares of the Company's preferred stock which are equivalent to shares of common stock having a value of twice the exercise price of the Right. If the Company is acquired in a merger or other business combination transaction after any such event, each holder of a Right would then be entitled to purchase, at the then-current exercise price, shares of the acquiring company's common stock having a value of twice the exercise price of the Right.

**STOCK REPURCHASE PROGRAM**

In July 2004, the Company's Board of Directors extended the share repurchase program through December 2005 and authorized an increase in the total authorized dollar amount for repurchase then available to approximately \$25,000. During fiscal year 2005, the Company repurchased 873,459 shares of its common stock, which completed the authorized purchase under this stock repurchase program. During the six months ended December 31, 2004, the Company repurchased 600,000 shares of common stock for a total cost of \$16,631.

In July 2005, the Company's Board of Directors authorized a second share repurchase program for up to \$20,000 of the Company's currently outstanding common stock. This program is intended to offset the potential dilutive impact of the issuance of shares in connection with the Company's employee stock option and purchase plans. Repurchases of the Company's common stock may be made from time to time at management's discretion on the open market at prevailing market prices or in privately negotiated transactions. During the nine months ended March 31, 2006, 531,824 shares of common stock were repurchased under this program for a total cost of \$12,284. As of March 31, 2006, there was \$7,716 available under this program to repurchase outstanding common stock.

**L. Product Warranty Liability**

All of the Company's product sales generally include a 12 or 18-month hardware warranty, with the exception of product sales in the MPS segment, which generally include a three-year hardware warranty. At the time of product shipment, the Company accrues the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar transactions. The following table presents the changes in the Company's product warranty liability for the nine months ended March 31, 2006 and 2005:

|  | Fiscal   | Fiscal   |
|--|----------|----------|
|  | 2006     | 2005     |
| Beginning balance at June 30,                    | \$ 1,620 | \$ 1,135 |
| Accruals for warranties issued during the period | 4,765    | 1,271    |
| Warranty liabilities assumed in acquisitions     | 101      |          |
| Settlements made during the period               | (3,567)  | (974)    |
| Ending balance at March 31,                      | \$ 2,919 | \$ 1,432 |

The Company recorded \$85 and \$16, respectively, for the fair value of product warranty liabilities assumed in connection with the acquisitions of Echotek Corporation and SoHard AG during the nine months ended March 31, 2006.



**M. Acquisitions**

As part of a continuing growth strategy, the Company, from time to time, may acquire interests, either partially or wholly, in businesses the Company deems to be at favorable market prices. The Company generally attempts to make acquisitions from which it can expand its breadth of product offerings, increase its market share and/or realize sales and marketing synergies.

**Table of Contents***Momentum Computer, Inc.*

On September 30, 2004, the Company acquired a 35% voting interest in Momentum Computer, Inc. (MCI), a manufacturer and developer of high-performance embedded processor and I/O boards, for \$3,087, which was recorded at that time as an investment in an unconsolidated entity. On December 7, 2004, the Company acquired the remaining 65% voting interest in MCI in a separately negotiated transaction, paying \$10,500 in cash and agreeing to pay up to \$12,000 of additional cash consideration if specified operating income and revenue targets are achieved by MCI over 24 months following the closing. Any such additional payments will be recorded as additional goodwill if and when incurred.

The acquisition of MCI has been accounted for in accordance with SFAS No. 141, Business Combinations. The total purchase price for the acquisition of MCI was \$13,790, consisting of cash payments of \$13,587, and transaction costs of \$203 directly related to the acquisition. The results of MCI's operations have been included in the Company's consolidated financial statements since December 7, 2004. Prior to that date, the Company recorded its pro rata share of MCI's net operating results under the equity method of accounting.

The purchase price as of December 7, 2004 was allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

|  |           |
|--|-----------|
| Cash   | \$ 388    |
| Accounts receivable  | 1,157     |
| Property and equipment   | 452       |
| Other assets   | 192       |
| Inventory  | 1,975     |
| Customer relationships   | 1,900     |
| Customer backlog   | 549       |
| Goodwill   | 9,575     |
| Current liabilities  | (1,759)   |
| Short-term notes payable (repaid subsequent to acquisition date) | (500)     |
| Deferred tax liabilities, net                                    | (139)     |
|  | \$ 13,790 |

This transaction resulted in an amount of purchase price that exceeded the estimated fair values of tangible and intangible assets, which was allocated to goodwill. The Company believes that the high amount of goodwill relative to identifiable intangible assets was the result of several factors including: (1) the Company's ability to gain protection against competition and to mitigate loss of market share at the low end of the market through expanded product and service offerings; (2) the Company's intentions to utilize its financial stability and market presence to attract new customers that were not then customers of MCI; and (3) buyer-related synergies resulting from the Company's leverage of its sales force and intellectual property to attract new contracts and revenue.

The acquired intangible assets, other than goodwill, will be amortized over their estimated useful lives of six years for customer relationships and four months for customer backlog. The goodwill and other intangible assets associated with the acquisition are not deductible for tax purposes.

Pro forma financial information reflecting the operating results of MCI and the Company as if MCI had been acquired as of July 1, 2003 would not differ materially from the operating results of the Company, as reported.

*SoHard AG*

On July 1, 2005, the Company acquired SoHard AG (SoHard) for a purchase price of \$23,294 (including transaction costs of \$1,003). SoHard is a market leader in the development of advanced software solutions for medical imaging systems, hardware and firmware for commercial embedded systems and software intelligence applications delivered via professional services. SoHard is headquartered in Fuerth, Germany. The results of SoHard's operations have been included in the Company's consolidated financial statements since July 1, 2005.

The acquisition of SoHard was accounted for in accordance with SFAS No. 141, Business Combinations. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at the date of acquisition. Fair values of intangible assets were determined via independent third-party appraisals. The tangible long-lived assets were valued using the cost approach, while the intangible long-lived assets were



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valued using a discounted cash flow method. The excess of the purchase price over the estimated fair values of the tangible and intangible assets and liabilities was allocated to goodwill. Goodwill and intangible assets recognized in this transaction are not expected to be deductible for tax purposes. The Company believes that the high amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) the Company's willingness to pay for potential buyer-specific synergies related to market opportunities for combined existing and future product offering; (2) the Company's ability to protect its existing competitive advantages within certain product lines of its Commercial Imaging and Visualization Business Unit; and (3) the potential to sell Mercury products to existing SoHard customers.

The purchase price as of July 1, 2005 was allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

|   |           |
|---|-----------|
| Cash  | \$ 888    |
| Accounts receivable   | 1,180     |
| Inventory   | 287       |
| Prepaid expenses and other current assets                                       | 570       |
| Property and equipment  | 418       |
| Customer relationships  | 3,300     |
| Other acquired intangible assets (customer backlog, non-compete and technology) | 2,350     |
| In-process research and development   | 450       |
| Goodwill  | 17,157    |
| Current liabilities   | (1,916)   |
| Current portion of long-term notes payable                                      | (36)      |
| Deferred tax liabilities, net   | (751)     |
| Long-term notes payable   | (603)     |
|   | \$ 23,294 |

The purchase price allocation was finalized during the three months ended December 31, 2005, upon completion of the fair-value appraisals of intangible assets and certain assumed assets and liabilities, and did not differ materially from the preliminary purchase price allocation recorded as of September 30, 2005.

As of March 31, 2006, there was approximately \$512 of unpaid purchase price related to the SoHard acquisition. This liability is accrued and recorded in the consolidated balance sheet in accrued expenses and is expected to be paid by July 2006.

In-process research and development (IPR&D) consisted of one project under development at the acquisition date. Because the technological feasibility of this project had not been established and no future alternative uses existed, the purchased IPR&D was expensed at the acquisition date in the consolidated statement of operations. The value of the purchased IPR&D was determined using the residual income approach, which discounts expected future cash flows from projects under development to their net present value. Each project was analyzed to determine the technological innovations included; the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion.

The amortization periods for the acquired intangible assets subject to amortization are as follows:

|   |                |
|---|----------------|
| Customer relationships  | 6 years        |
| Other acquired intangible assets (customer backlog, non-compete and technology) | 0.5 to 3 years |

The pro forma statements reflecting the operating results of SoHard as if SoHard had been acquired as of July 1, 2004 would not differ materially from the operating results of the Company as reported.

*Echotek Corporation*

On August 31, 2005, the Company purchased Echotek Corporation (Echotek) for a purchase price of \$50,274 (including transaction costs of \$368). The purchase price (excluding transaction costs) was paid in a combination of cash totaling \$44,734 and 177,132 shares of Mercury common stock. The 177,132 shares of common stock were valued at \$5,172 based on the average closing price of the Company's common stock

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for the five-day period including two days before and after July 12, 2005, the date the Company executed the related merger agreement and announced the transaction. Based in Huntsville, Alabama, Echotek is a market leader in the development of data acquisition products. The results of Echotek's operations have been included in the Company's consolidated financial statements since September 1, 2005.

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The acquisition of Echotek was accounted for in accordance with SFAS No. 141, Business Combinations. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at the date of acquisition. Fair values of intangible assets were determined via independent third-party appraisals. The tangible long-lived assets were valued using the cost approach, while the intangible long-lived assets were valued using a discounted cash flow method. The excess of the purchase price over the estimated fair value of the tangible and intangible assets and liabilities was allocated to goodwill. Goodwill and intangible assets recognized in this transaction are not expected to be deductible for tax purposes. The Company believes that the high amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) the Company's willingness to pay for potential buyer-specific synergies related to market opportunities for combined existing and future product offering; (2) the Company's intentions to utilize its financial stability and market presence to attract new customers that were not then customers of Echotek; and (3) the potential to continue developing next-generation technologies from the acquired workforce.

The purchase price as of August 31, 2005 was allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

|  |                  |
|--|------------------|
| Accounts receivable  | \$ 2,397         |
| Inventory  | 1,219            |
| Prepaid expenses and other current assets                          | 133              |
| Property and equipment   | 431              |
| Other assets   | 2                |
| Goodwill   | 36,037           |
| Completed technology   | 10,230           |
| Customer relationships   | 5,300            |
| Other acquired intangible assets (customer backlog and trademarks) | 2,050            |
| In-process research and development                                | 100              |
| Current liabilities  | (989)            |
| Deferred tax liabilities, net                                      | (6,636)          |
|  | <b>\$ 50,274</b> |

The purchase price allocation was finalized during the three months ended December 31, 2005, upon completion of the fair-value appraisals of intangible assets, and did not differ materially from the preliminary purchase price allocation recorded as of September 30, 2005.

In-process research and development (IPR&D) consisted of eight projects under development at the acquisition date. Because the technological feasibility of these projects had not been established and no future alternative uses existed, the purchased IPR&D was expensed at the acquisition date and recorded in selling, general and administrative expense in the consolidated statement of operations. The value of the purchased IPR&D was determined using the residual income approach, which discounts expected future cash flows from projects under development to their net present value. Each project was analyzed to determine the technological innovations included; the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion.

The amortization period for the acquired intangible assets subject to amortization is as follows:

|  |                |
|--|----------------|
| Completed technology   | 3 years        |
| Customer relationships   | 5 years        |
| Other acquired intangible assets (customer backlog and trademarks) | 0.5 to 8 years |

The following table presents the Company's unaudited pro forma results of operations for the nine months ended March 31, 2006 and 2005, as if the Echotek acquisition had occurred on July 1, 2004. These pro forma results include adjustments related to the amortization of intangible assets with finite useful lives (totaling \$78 and \$4,324 during the nine months ended March 31, 2006 and 2005, respectively), adjustments to eliminate inter-company transactions (totaling \$213 during the nine months ended March 31, 2005), adjustments to capitalize labor and overhead costs (totaling \$150 during the nine months ended December 31, 2005), adjustments for non-recurring items (totaling \$741 of bonuses directly related to the acquisition during the nine months ended March 31, 2006) and adjustments for income tax effects (totaling \$1,360 during the nine months ended March 31, 2006). The table has been prepared for comparative purposes only and does not purport to be indicative of what would have occurred had the acquisition been made at the beginning of the period noted or of results that may occur in the future.



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| <b>For the nine months ended March 31,</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| Net revenues                               | \$ 177,423  | \$ 192,301  |
| Net (loss) income                          | (4,020)     | 26,778      |
| Net (loss) income per share - basic        | (0.19)      | 1.26        |
| Net (loss) income per share - diluted      | (0.19)      | 1.09        |

**N. Mortgage Notes**

In November 1999, the Company completed a lending agreement with a commercial financing company, issuing two 7.30% senior secured financing notes (the Mortgage Notes) due November 2014. The original principal amount of the Mortgage Notes totaled \$14,500. The Mortgage Notes are collateralized by the Company's corporate headquarters, which consists of two buildings. The terms of the Mortgage Notes contained certain covenants, which, among other provisions, require the Company to maintain a specified minimum tangible net worth on November 2<sup>nd</sup> of each year. The Mortgage Notes also include significant prepayment penalties. The outstanding principal amount on the Mortgage Notes was \$10,210 at March 31, 2006 and \$10,828 at June 30, 2005.

On October 19, 2005, the Company obtained a temporary waiver from the holders of the Mortgage Notes, effective through December 31, 2005, for the Company's non-compliance with the minimum tangible net worth ratio covenant as of November 2, 2005. This non-compliance was largely the result of the intangible assets capitalized as a result of two businesses acquired by the Company during the nine months ended March 31, 2006.

On December 22, 2005, the Company amended certain financial covenants relating to the Mortgage Notes. Pursuant to the amendments, the minimum tangible net worth covenant was replaced with new financial covenants relating to the maintenance of an interest coverage ratio, certain leverage ratios and a minimum consolidated net worth. The amendments also permanently waived any non-compliance with the superseded minimum tangible net worth covenant as of November 2, 2005.

The Company was not in compliance with the consolidated interest expense to EBIT and consolidated indebtedness to EBITDA covenants as of March 31, 2006. This non-compliance was largely due to the impact of the third quarter 2006 losses on the covenants ratios. On April 21, 2006, the Company obtained a temporary waiver from the holders of the Mortgage Notes, effective through July 15, 2006, for the Company's non-compliance with these covenants, after which time the Company would be required to meet these covenants. Management expects, however, that the Company will not be in compliance with the covenant as currently structured after March 31, 2006. Accordingly, the Company has reclassified its Mortgage Notes from long-term to current as of March 31, 2006.

The holders of the Mortgage Notes and the Company have agreed to negotiate a mutually agreeable amendment to the covenants in the near future. Management believes that by June 30, 2006, it will be successful in its negotiations with the Mortgage Note holders to revise the financial covenants to levels that are attainable by the Company. However, there can be no assurance that an agreement will be reached. If an agreement cannot be reached or if an agreement is reached but the covenants are not attainable and the Mortgage Note holders were to exercise their rights, the Company would be required to repay the outstanding principal, accrued interest plus the prepayment penalty (which as of March 31, 2006 would be approximately \$767).

The Company was in compliance with all covenants of the Mortgage Notes as of June 30, 2005.

**O. Property and Equipment***Property and Equipment*

Property and equipment are the long-lived, physical assets of the Company acquired for use in the Company's normal business operations and are not intended for resale by the Company. These assets are recorded at cost. Renewals and betterments that increase the useful lives of the assets are capitalized. Repair and maintenance expenditures that increase the efficiency of the assets are expensed as incurred. The Company capitalizes interest costs associated with the development and construction of certain qualifying assets in accordance with SFAS No. 34, *Capitalization of Interest Costs*, over the period of construction. Equipment under capital lease is recorded at the present value of the minimum lease payments required during the lease period. Depreciation is based on the following estimated useful lives of the assets using the straight-line method:

|                                 |              |
|---------------------------------|--------------|
| Computer software and equipment | 2 to 5 years |
| Machinery and equipment         | 5 years      |



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|                        |                 |
|------------------------|-----------------|
| Furniture and fixtures | 5 years         |
| Buildings              | 15 and 30 years |
| Building improvements  | 10 years        |

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As assets are retired or sold, the related cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the results of operations.

*Software Development and Enhancements*

Expenditures for major software purchases and software developed for internal use are capitalized and depreciated using the straight-line method over the estimated useful lives of the related assets, which are generally 3 to 5 years. For software developed for internal use, all external direct costs for material and services and certain payroll and related fringe benefit costs are capitalized in accordance with Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

At March 31, 2006 and June 30, 2005, the Company had \$159 thousand and \$0, respectively, in construction in process (CIP) related to the Company's implementation of Oracle's enterprise risk system. The Company placed \$883 thousand in CIP related to Oracle's enterprise risk system into service during both the three and nine months ended March 31, 2006. The Company does not depreciate CIP until it is placed into service.

**P. Income Tax (Benefit) Provision**

The Company recorded a tax benefit during the nine months ended March 31, 2006 reflecting a 45% effective tax benefit rate, as compared to a 30% effective tax rate for the same period in fiscal 2005. The effective tax rate for the nine months ended March 31, 2006 was higher than the U.S. statutory tax rate of 35% primarily due to an additional benefit attributable to research and development tax credits, the extraterritorial income (ETI) benefit and other state tax benefits.

The Company recorded a tax benefit of \$9,247 in the three months ended March 31, 2006 in order to adjust the 21% effective tax benefit rate used in the three months ended December 31, 2005 to the 45% effective tax benefit rate currently expected for the full fiscal year. The forecasted full-year effective tax benefit rate was increased in the quarter as a result of lowering forecasted profitability without materially reducing the expected dollar amounts of tax benefits from research and development credits and other items.

**Q. Restructuring Provision**

In response to lower than expected demand in certain sectors of the Company's business, as well as the need to maintain a competitive cost structure and integrate the Company's previous acquisitions, the Company recorded a restructuring charge of \$1,873 related to the Company's 2006 restructuring plan (the 2006 Plan). The 2006 Plan included \$1,811 related to involuntary separation costs for 55 employees, \$25 for a facility closure and \$37 for other costs (primarily legal costs). The restructuring charges associated with the involuntary separation and facility closures are classified as operating expenses in the consolidated statements of operations and are expected to be paid within the next 12-months.

During the third quarter of fiscal 2006, the Company completed an analysis related to the defense markets and its previous acquisitions. To consolidate closely related facilities, one facility operating lease was terminated which resulted in a restructuring charge of \$25. A decision was also made to eliminate 55 positions in the areas of manufacturing, engineering and sales and overheads. All of these expenses were principally in the Defense Business Unit with a modest amount in the Commercial Imaging and Visualizations and Modular Products Solutions business units.

The following table presents the detail of expenses by operating segment for the 2006 Plan:

|  | Severance | Facilities | Other | Total    |
|--|-----------|------------|-------|----------|
| Restructuring Liability at June 30, 2005 | \$        | \$         | \$    | \$       |
| Defense Business Unit                    | \$ 1,212  |            | \$ 10 | \$ 1,222 |
| CIV Business Unit                        | 397       | 25         | 26    | 448      |
| Advanced Solutions Business Unit         | 190       |            | 1     | 191      |
| MPS Business Unit                        | 12        |            |       | 12       |
| Provision for 2006 Plan                  | \$ 1,811  | \$ 25      | \$ 37 | \$ 1,873 |
| Cash paid                                | 66        | 25         | 3     | 94       |
| Reversals                                |           |            |       |          |

|   |          |    |       |          |
|---|----------|----|-------|----------|
| Restructuring Liability at March 31, 2006 | \$ 1,745 | \$ | \$ 34 | \$ 1,779 |
|---|----------|----|-------|----------|

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

From time to time, information provided, statements made by our employees or information included in our filings with the Securities and Exchange Commission may contain statements that are not historical facts but that are forward-looking statements, which involve risks and uncertainties. The words may, will, expect, anticipate, continue, estimate, plan, project, intend and similar expressions are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. These statements are based on our current expectations and estimates as to prospective events and circumstances about which there can be no firm assurances given. Further, any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made. As it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. Actual results, performances or achievements may differ materially from the anticipated future results, performances or achievements expressed or implied by these forward-looking statements. Important factors that may cause our actual results to differ from these forward-looking statements include, but are not limited to, those referenced in the section below entitled **Factors that May Affect Future Results** in Part I Item 2 of this Form 10-Q.

**OVERVIEW**

We design, manufacture and market high-performance, real-time digital signal and image processing computer systems that transform sensor-generated data into information which can be displayed as images for human interpretation or be subjected to additional computer analysis. These multicomputer systems are heterogeneous and scalable, allowing them to accommodate several microprocessor types and to scale from a few to hundreds of microprocessors within a single system.

We are an OEM supplier to our commercial markets and conduct business with our defense customers via commercial off-the-shelf (COTS) distribution, which means that product requests by customers are a primary driver of revenue fluctuations from quarter to quarter. Customers specify delivery date requirements that coincide with their need for our product. Because these customers may use our products in connection with a variety of defense programs or other projects with different sizes and durations, a customer's orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns of one customer do not necessarily correlate with the order patterns of another customer and, therefore, we generally cannot identify sequential quarterly trends, even within our business units.

During the past several years, the majority of our revenue has been generated from sales of our products to the defense electronics market, generally for use in intelligence-gathering electronic warfare systems. Our activities in this area have focused on the proof of concept, development and deployment of advanced military applications in radar, sonar and airborne surveillance. Imaging and visualization solutions is another primary market that we currently serve. Our computer hardware and software are embedded in magnetic resonance imaging (MRI), positron emission tomography (PET), and digital X-ray machines. Our remaining revenues are derived from computer systems used in such commercial OEM solutions as semiconductor photomask generation, wafer inspection, baggage scanning, seismic analysis and development of new reticle inspection and wafer inspection systems.

During the first nine months of fiscal year 2006, revenues decreased by \$4.8 million compared to the same period in fiscal 2005, primarily as a result of a \$7.4 million decrease in revenues of our Defense Business Unit (Defense) and \$6.5 million decrease in revenues of our Advanced Solutions Business Unit (Advanced Solutions) offset by a \$3.1 million increase of our Commercial Imaging and Visualization Business Unit (CIV) and a \$6.0 million increase of our Modular Product Solutions Business Unit (MPS). Gross margins as a percentage of revenues decreased from 66% during the nine months ended March 31, 2005 to 57% during the nine months ended March 31, 2006 primarily due to a shift within our Defense business to lower margin business, increased competition of good enough products that resulted in lower prices, a significant third quarter 2006 inventory write-off and increased warranty provisions. Operating expenses increased by \$30 million during the nine months ended March 31, 2006 as compared to the same period in 2005 primarily due to several factors. First, we incurred \$11.2 million of incremental operating expenses associated with our acquisitions of Echotek Corporation and SoHard AG, which were completed in the first quarter of fiscal year 2006, and \$1.8 million of incremental operating expenses associated with the acquisition of Momentum Computer, Inc., which was completed in the second quarter of fiscal year 2005. Second, research and development expenses unrelated to these acquisitions increased by \$7.7 million during the nine months ended March 31, 2006 compared to the same period in 2005. Third, we incurred \$6.8 million of compensation costs classified as operating expenses associated with the stock-based awards provided to our employees. In prior periods, this compensation expense was reported on a pro forma basis in the financial statement footnotes; however, upon our adoption of SFAS 123R on July 1, 2005, these costs are now expensed in the consolidated statements of operations.

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In response to lower than expected demand in certain sectors of our business, as well as the need to maintain a competitive cost structure and integrate our previous acquisitions, we incurred \$1.9 million related to the Company's 2006 restructuring plan in order to save approximately \$6.1 million annually based on the reduction in workforce. The decision was difficult for us, however, we believe the restructuring was necessary given the state of our markets. Funding for several Defense programs have been delayed and our transition to computing for 3D imaging in the life sciences segment has delayed some revenue. We believe that this workforce reduction will enable us to remain competitive in the market and improve our long-term results.

On July 1, 2005, we acquired SoHard AG (SoHard) for \$23.3 million, consisting of cash payments of \$22.3 million and transaction costs of \$1.0 million directly related to the acquisition. SoHard is a market leader in the development of advanced software solutions for medical imaging systems, hardware and firmware for commercial embedded systems and software intelligence applications delivered via professional services. SoHard is headquartered in Fuerth, Germany. The results of SoHard's operations have been included in our consolidated financial statements since the acquisition date.

On August 31, 2005, we purchased Echotek Corporation (Echotek) for \$50.3 million, consisting of cash payments of \$44.7 million, 177,132 shares of Mercury common stock valued at \$5.2 million and transaction costs of \$0.4 million directly related to the acquisition. Based in Huntsville, Alabama, Echotek is a market leader in the development of data acquisition products. The results of Echotek's operations have been included in our consolidated financial statements since the acquisition date.

Going forward, business and market uncertainties may affect future results. For a discussion of key factors that could impact the future and must be managed by us, please refer to the discussion below.

**RESULTS OF OPERATIONS:**

The following tables set forth, for the periods indicated, certain financial data as a percentage of total revenues:

|  | Three months ended |       | Nine months ended |       |
|--|--------------------|-------|-------------------|-------|
|  | March 31,<br>2006  | 2005  | March 31,<br>2006 | 2005  |
| Revenues                                   | 100%               | 100%  | 100%              | 100%  |
| Cost of revenues                           | 59.8               | 33.9  | 43.0              | 34.4  |
| Gross profit                               | 40.2               | 66.1  | 57.0              | 65.6  |
| Operating expenses:                        |                    |       |                   |       |
| Selling, general and administrative        | 50.1               | 27.0  | 36.6              | 28.4  |
| Research and development                   | 35.1               | 20.2  | 26.6              | 20.1  |
| Amortization of acquired intangible assets | 4.9                | 1.2   | 3.6               | 1.0   |
| In-process research and development        |                    |       | 0.3               |       |
| Restructuring                              | 4.2                |       | 1.1               |       |
| Total operating expenses                   | 94.3               | 48.4  | 68.2              | 49.5  |
| Income from operations                     | (54.1)             | 17.7  | (11.2)            | 16.1  |
| Other income (expense), net                | 1.5                | 0.4   | 0.9               |       |
| Income (Loss) before income taxes          | (52.6)             | 18.1  | (10.3)            | 16.1  |
| (Benefit) provision for income taxes       | (20.8)             | 5.4   | (4.6)             | 4.8   |
| Net income (loss)                          | (31.8)%            | 12.7% | (5.7)%            | 11.3% |

**REVENUES**

Total revenues decreased by \$19.8 million or 31% to \$44.5 million for the three months ended March 31, 2006 compared to \$64.3 million during the same period in fiscal 2005. Total revenues decreased by \$4.8 million or 3% to \$173.9 million for the nine months ended March 31,

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2006 compared to \$178.7 million during the same period in fiscal 2005. Revenues by segment as a percentage of total revenues were as follows:

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|  | Three months ended |             | Nine months ended |             |
|--|--------------------|-------------|-------------------|-------------|
|  | March 31,          |             | March 31,         |             |
|  | 2006               | 2005        | 2006              | 2005        |
| Defense Business Unit (Defense)                          | 42%                | 57%         | 54%               | 56%         |
| Commercial Imaging and Visualization Business Unit (CIV) | 25                 | 18          | 23                | 21          |
| Advanced Solutions Business Unit (Advanced Solutions)    | 26                 | 22          | 18                | 21          |
| Modular Products and Services Business Unit (MPS)        | 7                  | 3           | 5                 | 2           |
| <b>Total revenues</b>                                    | <b>100%</b>        | <b>100%</b> | <b>100%</b>       | <b>100%</b> |

Defense revenues decreased by \$18.1 million or 50% to \$18.4 million for the three months ended March 31, 2006 compared to \$36.5 million during the same period in fiscal 2005. The decrease for the three months ended March 31, 2006 was primarily related to a \$12.3 million decrease in shipments serving signal intelligence applications and a \$3.8 million decrease in shipments serving radar applications. This decrease was partially offset by a \$1.9 million increase resulting from the acquisition of Echotek Corporation. The decline in Defense revenues was primarily the result of several large defense programs experiencing timing delays and the acceptance test failure of a multi-million dollar system. We anticipate all of the technical issues to be resolved and that the revenue will be recorded in the fourth quarter of fiscal year 2006 related to this system.

Defense revenues decreased by \$7.4 million or 7.3% to \$93.3 million for the nine months ended March 31, 2006 compared to \$100.7 million during the same period in fiscal 2005. The decrease for the nine months ended March 31, 2006 was primarily related to a \$9.8 million decrease in shipments serving signal intelligence applications, a \$4.9 million decrease in radar applications, and a \$2.4 million decrease in defense technology and applications; partially offset by a \$3.7 million increase in sales of radio frequency products and a \$5.7 million increase resulting from the acquisition of Echotek Corporation. The overall decrease in Defense revenues was primarily the result of timing delays and acceptance test failure as described above.

CIV revenues decreased \$0.2 million or 1.8% to \$11.2 million for the three months ended March 31, 2006 compared to \$11.4 million during the same period in fiscal 2005. The decrease for the three months ended March 31, 2006 compared to the same period in fiscal 2005 was primarily the result of an expected decline in most of our legacy business lines including MRI, digital X-ray and PET, offset by a \$2.1 million increase from the acquisition of SoHard. We are expecting that our 2D business with GE Healthcare, Motorola GmbH and Philips Medical Systems will continue to decrease significantly over the next 12 months as these customers transition to new platforms and new component manufacturers. We are starting to build a portfolio of new 3D image processing and visualization software applications for which we perceive significant customer interest in the medical and oil and gas discovery industries; however, these are not ramping up quickly enough to offset the decline in our existing programs. Despite this fact, the revenues associated with our 3D image processing and visualization software increased \$0.2 million comparatively over the prior fiscal year three-month period.

CIV revenues increased \$3.1 million or 8.4% to \$40.1 million for the nine months ended March 31, 2006 compared to \$37.0 million during the same period in fiscal 2005. The increase for the nine months ended March 31, 2006 compared to the same period in fiscal 2005 was primarily the result of revenues of \$6.2 million associated with the acquisition of SoHard, which was completed in the first quarter of 2006, and a \$1.1 million increase in revenues related to our 3D image processing and visualization software applications offset by an expected decline in most of our legacy business lines including MRI, digital X-ray, computed tomography (CT) and PET.

Advanced Solutions revenues decreased \$2.6 million or 18.3% to \$11.6 million for the three months ended March 31, 2006 compared to \$14.2 million during the same period in fiscal 2005. The decrease in revenues for the three months ended March 31, 2006 was primarily related to a \$4.3 million decrease in shipments of semiconductor imaging boards for developing and testing new semiconductors. These decreases in shipments were primarily attributable to overall softness in the semiconductor market. Shipments of semiconductor imaging boards represented 74.9% and 91.6% of Advanced Solutions revenues for the three months ended March 31, 2006 and 2005, respectively. The decrease in semiconductor sales was partially offset by an approximately \$1.6 million increase in sales of our Ensemble2 Application Platform system to several large telecommunication customers.

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Advanced Solutions revenues decreased \$6.5 million or 17.1% to \$31.6 million for the nine months ended March 31, 2006 compared to \$38.1 million during the same period in fiscal 2005. The decrease in revenues for the nine months ended December 31, 2005 was primarily related to a \$7.2 million decrease in shipments of semiconductor imaging boards for developing and testing new semiconductors. These decreases in shipments were primarily attributable to overall softness in the semiconductor market. Shipments of semiconductor imaging boards represented 79.6% and 86.8% of Advanced Solutions revenues for the nine months ended March 31, 2006 and 2005, respectively. The decrease in semiconductor sales was partially offset by an approximately \$1.6 million increase in sales of our Ensemble2 Application Platform system to several large telecommunication customers.

MPS revenues increased \$1.0 million or 43% to \$3.3 million for the three months ended March 31, 2006 compared to \$2.3 million during the same period in fiscal 2005. The increase in revenues for the three months ended March 31, 2006 was primarily related to heightened demand for new product introductions including a custom design board for a large telecommunications customer.

MPS revenues were \$8.8 million for the nine months ended March 31, 2006. MPS was formed as a result of the MCI acquisition on December 7, 2004; thus there were only 4 months of revenues included in our consolidated financial statements during the comparable periods in fiscal year 2005. Overall, MPS has seen an increase in revenue due to growing demand for its new high performance custom and off-the-shelf products.

**GROSS PROFIT**

Gross profit was 40.2% for the three months ended March 31, 2006, a decrease of 2,590 basis points from the 66.1% gross profit achieved in the same period of fiscal 2005. The decrease in the gross margin as a percentage of revenue for the three months ended March 31, 2006 compared to the same periods of fiscal 2005 is primarily due to a) a significant decline in the Defense business unit revenues which contains the products with the highest gross margin, b) increased competition of good enough products that resulted in lower prices c) our acquisition of SoHard in the first quarter of 2006, which carries a lower margin than other businesses and d) a significant third quarter 2006 inventory write-off of \$5.4 million. This inventory write-off was the result of several factors including a decline in revenue of the Defense business and shifts in technology that resulted in inventory becoming obsolete.

Gross profit was 57.0% for nine months ended March 31, 2006, a decrease of 860 basis points from the 65.6% gross profit achieved in the same period of fiscal 2005. The decrease in the gross margin as a percentage of revenue for the nine months ended March 31, 2006 compared to the same periods of fiscal 2005 is primarily due to a) a significant decline in the Defense business unit revenues which contains the products with the highest gross margin, b) increased competition of good enough products, c) our acquisition of SoHard in the first quarter of 2006, which carries a lower margin than other businesses, and d) a significant inventory write-off and increased warranty provisions. The inventory write-off was the result of several factors including a decline in revenues of the Defense business and shifts in technology that resulted in inventory becoming obsolete. The warranty provision increased significantly during the nine months ended March 31, 2006 primarily due to two commitments made with customers to perform on-site warranty work related to boards purchased from our contract manufacturers and other third party suppliers. These agreements resulted in an incremental warranty provision of approximately \$1.0 million during the nine months ended March 31, 2006.

**SELLING, GENERAL AND ADMINISTRATIVE**

Selling, general and administrative expenses increased 30% or \$5.1 million to \$22.3 million for the three months ended March 31, 2006 compared to \$17.2 million during the same period in fiscal 2005. The increase in selling, general and administrative expenses for the three months ended March 31, 2006 was primarily the result of \$2.3 million of expenses related to stock-based compensation recorded as a result of adopting SFAS 123R and \$1.5 million of incremental expenses relating to the operations of the SoHard and Echotek acquisitions, offset by a decrease in compensation expense due to a decrease in headcount of 14 employees unrelated to our recent acquisitions. Also impacting the increase was \$0.4 million of expenses related to our on-going enterprise resource procurement (ERP) system project. In July 2005, we began an ERP system upgrade to improve our ERP system capabilities and processes. During the three months ended March 31, 2006 \$0.6 million was spent on the ERP system upgrade, of which, \$0.2 million was capitalized during the same period.

Selling, general and administrative expenses increased 26% or \$13.0 million to \$63.7 million for the nine months ended March 31, 2006 compared to \$50.7 million during the same period in fiscal 2005. The increase in selling, general and administrative expenses for the nine months ended March 31, 2006 was primarily the result of \$5.2 million of expenses related to stock-based compensation recorded as a result of adopting SFAS 123R and a \$4.6 million of incremental expenses relating to the operations of the SoHard, Echotek and MCI acquisitions, offset by a decrease in compensation expense due to a decrease in headcount of 14 employees unrelated to our recent acquisitions. Also impacting the increase was \$1.2 million of expenses related to our on-going enterprise resource procurement (ERP) system project. In July 2005, we began an ERP system upgrade to improve our ERP system capabilities and processes. During the nine months ended March 31, 2006 \$2.2 million was spent on the ERP system upgrade, of which \$1.0 million of ERP costs were capitalized during the same period.





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RESEARCH AND DEVELOPMENT

Research and development expenses increased 20% or \$2.6 million to \$15.6 million for the three months ended March 31, 2006 compared to \$13.0 million during the same period in fiscal 2005. The increase in research and development expenses for the three months ended March 31, 2006 was primarily the result of \$0.6 million of expenses related to stock-based compensation recorded as a result of adopting SFAS 123R, \$0.6 million of expenses relating to the operations of the SoHard and Echotek acquisitions and \$1.4 million of expenses associated with a shift in contract mix and personnel allocation which resulted in fewer research and development employees working on customer contracts and spending more time on research and development initiatives.

Research and development expenses increased 29% or \$10.5 million to \$46.3 million for the nine months ended March 31, 2006 compared to \$35.8 million during the same period in fiscal 2005. The increase in research and development expenses for the nine months ended March 31, 2006 was primarily the result of a) \$1.5 million of expenses related to stock-based compensation recorded as a result of adopting SFAS 123R, b) \$3.6 million of expenses relating to the operations of the SoHard, Echotek and MCI acquisitions, c) \$1.2 million increase in prototype development expenses and d) \$3.3 million of expenses associated with a shift in contract mix and personnel allocation which resulted in fewer research and development employees working on customer contracts and spending more time on research and development initiatives.

AMORTIZATION OF ACQUIRED INTANGIBLE ASSETS

Amortization of acquired intangible assets increased 175% or \$1.4 million to \$2.2 million for the three months ended March 31, 2006 compared to \$0.8 million during the same period in fiscal 2005. The increase in amortization expenses for the three months ended March 31, 2006 was primarily the result of the SoHard and Echotek acquisitions, completed in the first quarter of fiscal 2006.

Amortization of acquired intangible assets increased 226% or \$4.3 million to \$6.2 million for the nine months ended March 31, 2006 compared to \$1.9 million during the same period in fiscal 2005. The increase in amortization expenses for the nine months ended March 31, 2006 was primarily the result of the SoHard and Echotek acquisitions which were completed in the first quarter of fiscal 2006 and the MCI acquisition which was completed in the second quarter of fiscal 2005.

RESTRUCTURING EXPENSE

In response to lower than expected demand in certain sectors of the Company's business, as well as the need to maintain a competitive cost structure and integrate the Company's previous acquisitions, the Company incurred \$1.9 million related to the Company's 2006 restructuring plan (the 2006 Plan) during the three and nine months ended March 31, 2006. The 2006 Plan included \$1.8 million related to involuntary separation costs for 55 employees and \$0.1 for other costs. The restructuring charges are classified as operating expenses in the consolidated statements of operations.

INTEREST INCOME

Interest income for the three months ended March 31, 2006 increased by \$0.3 million to \$1.7 million compared to the same period of fiscal 2005. Interest income for the nine months ended March 31, 2006 increased by \$1.3 million to \$4.7 million compared to the same period of fiscal 2005. The increases for both the three and nine months ended March 31, 2006 were primarily related to increased rates of return on our investments, partially offset by lower levels of cash and cash equivalents.

INTEREST EXPENSE

Interest expense for the three months ended March 31, 2006 decreased minimally to \$1.0 million compared to the same period of fiscal 2005. Interest expense for the nine months ended March 31, 2006 also decreased minimally to \$3.1 million compared to the same period of fiscal 2005. The interest rates on our outstanding notes payable are fixed in nature; thus, the fluctuations in interest expense are primarily related to lower principal balances on the debt and the impact of non-cash interest expense which relates to the amortization of our deferred financing costs.

**Table of Contents****OTHER INCOME (EXPENSE), NET**

Other income (expense), net for the three months ended March 31, 2006 increased by \$0.1 million compared to the same period of fiscal 2005. Other income (expense) for the nine months ended March 31, 2006 increased by \$0.3 million compared to the same period of fiscal 2005. The changes in other income (expense) for both the three and nine month periods were primarily due to gains and losses related to foreign currency transactions and the impact of our deferred compensation plan.

**INCOME TAX (BENEFIT) PROVISION**

We recorded a tax benefit during the three months ended March 31, 2006 reflecting a 40% benefit on income before taxes of \$23.4 million, as compared to tax provision of 30% for the same period in fiscal 2005. Our effective tax rate for the three months ended March 31, 2006 reflects a benefit due to a change in the full fiscal year 2006 effective rate from 21% to a tax benefit rate of 45% resulting from a decrease in estimated profits before tax for the fiscal year.

We recorded a tax benefit during the nine months ended March 31, 2006 reflecting a 45% effective tax rate, as compared to 30% for the same period in fiscal 2005. Our effective tax rate for the nine months ended March 31, 2006 was higher than the U.S. statutory tax rate of 35% primarily due to an additional benefit attributable to research and development tax credits, the extraterritorial income (ETI) benefit and other state tax benefits.

We expect our fiscal year 2006 effective tax rate to be approximately 45%.

**SEGMENT OPERATING RESULTS**

Losses from operations of the Defense segment increased \$27.3 million to \$17.6 million for the three months ended March 31, 2006 from income from operations of \$9.7 million for the same period of fiscal 2005. For the nine months ended March 31, 2006 results from operations decreased \$32.1 million to a loss of \$10.0 million as compared to income from operations of \$22.1 million for the same period of fiscal 2005. The decrease in income from operations of the Defense segment for the three and nine months ended March 31, 2006 was primarily related to a) a shift in product mix to lower-margin products, b) increased incremental operating expenses associated with the acquisition of Echotek, c) a significant third quarter 2006 inventory write-off and d) increased organic operating expenses, primarily associated with additional research and development. These increased operating expenses for the three and nine months ended March 31, 2006 primarily consisted of \$1.4 million and \$3.5 million, respectively, of additional amortization associated with the intangibles capitalized as a result of the Echotek acquisition and a charge of \$0.0 million and \$0.1 million, respectively, related to in-process research and development.

Losses from operations of the CIV segment increased \$3.6 million to \$3.1 million for the three months ended March 31, 2006 from income from operations of \$0.5 million for the same period of fiscal 2005. For the nine months ended March 31, 2006 losses from operations decreased \$6.2 million to \$2.4 million as compared to income from operations of \$3.8 million for the same period of fiscal 2005. The decrease in income from operations of the CIV segment for the three and nine months ended March 31, 2006 was primarily related to operating losses incurred by our SoHard subsidiary. These increased operating expenses for the three and nine months ended March 31, 2006 primarily consisted of \$0.3 million and \$1.3 million, respectively, of additional amortization associated with the intangibles capitalized as a result of the SoHard acquisition and a non-recurring charge of \$0.0 million and \$0.5 million, respectively, related to in-process research and development.

Income from operations of the Advanced Solutions segment decreased \$1.9 million to \$0.3 million for the three months ended March 31, 2006 from \$2.2 million for the same period of fiscal 2005, and decreased \$3.3 million to \$0.9 million for the nine months ended March 31, 2006 from \$4.2 million for the same period of fiscal 2005. The decrease in income from operations of the Advanced Solutions segment for the three months ended March 31, 2006 was primarily a result of the decrease in revenues of \$2.6 million primarily related to semiconductor market applications. This decrease was partially offset by the lower research and development spending. The decrease in income from operations of the Advanced Solutions segment for the nine months ended March 31, 2006 was primarily a result of the decrease in revenues of \$6.5 million primarily related to semiconductor market applications and the impact of a significant discrete warranty obligation. This decrease was partially offset by lower research and development spending, plus the impact of one high-margin contract relating to the sale of intellectual property licenses.

Losses from operations of the MPS segment decreased \$0.4 million to \$0.5 million for the three months ended March 31, 2006 from \$0.9 million for the same period of fiscal 2005. Losses from operations were \$0.8 million for the nine months ended March 31, 2006. MPS was formed as a result of the MCI acquisition on December 7, 2004; thus, there were no MPS operations included in our consolidated operations during the first quarter of fiscal 2005 and minimal operations included in our second quarter of fiscal 2005. The decrease in losses from operations for the three and nine months ended March 31, 2006 was primarily due to growing demand for MPS's new high performance custom and off-the-shelf products.



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See Note H to our consolidated financial statements included in this report for more information regarding our operating segments.

**LIQUIDITY AND CAPITAL RESOURCES**

Our cash and cash equivalents decreased by \$12.6 million to \$30.5 million as of March 31, 2006 as compared to \$43.1 million as of June 30, 2005 primarily as a result of cash outlays for acquisitions. During the nine months ended March 31, 2006, we generated \$25.7 million in cash from operations compared to \$33.1 million generated during the nine months ended March 31, 2005. The \$7.4 million decrease in the amount of cash generated from operations during the nine months ended March 31, 2006 compared to the nine months ended March 31, 2005 was largely driven by lower comparative net income and a \$6.6 million decrease in the deferred income taxes. The net loss was offset by several factors, including a \$7.3 million increase in stock compensation expense due to the adoption of SFAS 123R, a \$5.6 million increase in depreciation and amortization expense due largely to the amortization of intangible assets acquired in the SoHard and Echotek acquisitions, and a \$7.3 million decrease in accounts receivable due largely to the downturn in revenue.

We used \$30.8 million and \$0.9 million, respectively, of cash for investing activities during the nine months ended March 31, 2006 and March 31, 2005. During the nine months ended March 31, 2006, our net sales of marketable securities were \$47.1 million, which were partially offset by the acquisition of businesses and purchases of property and equipment of \$67.5 million and \$8.4 million, respectively. Also impacting the nine month March 31, 2006 investing cash flows was the purchase of certain licensed technologies for \$2.0 million. During the nine months ended March 31, 2005, our net sales of marketable securities were \$22.7 million, which were partially offset by the acquisition of businesses and purchases of property and equipment of \$16.2 million and \$7.4 million, respectively.

During the nine months ended March 31, 2006, our financing activities used cash of \$7.5 million, which primarily consisted of \$12.3 million used for purchases of our common stock. During the same period in 2005, financing activities used cash of \$21.4 million, which primarily consisted of \$25.0 million used for purchases of our common stock.

In July 2004, our Board of Directors extended the share repurchase program through December 2005 and authorized an increase in the total authorized dollar amount for repurchase then available to approximately \$25.0 million. During fiscal year 2005, we repurchased 873,459 shares of our common stock, which completed the authorized purchase under this stock repurchase program. During the nine months ended March 31, 2005, we repurchased 873,459 shares of common stock for a total cost of \$25.0 million.

In July 2005, our Board of Directors authorized a second share repurchase program for up to \$20.0 million of our currently outstanding common stock. This program is intended to offset the potential dilutive impact of the issuance of shares in connection with our employee stock option and purchase plans. Repurchases of our stock may be made from time to time at management's discretion on the open market at prevailing market prices or in privately negotiated transactions. During the nine months ended March 31, 2006, we repurchased 531,824 shares of common stock under this program for a total cost of \$12.3 million. As of March 31, 2006, there was \$7.7 million available under this program to repurchase outstanding common stock.

The terms of our mortgage note agreements contain certain covenants, which, among other provisions, require us to maintain a minimum tangible net worth. The mortgage note agreements also include significant prepayment penalties. We were not in compliance with the consolidated interest expense to EBIT and consolidated indebtedness to EBITDA covenants as of March 31, 2006. This non-compliance was largely due to the impact of the third quarter 2006 losses on the covenants ratios. On April 21, 2006, the Company obtained a temporary waiver from the holders of the mortgage notes, effective through July 15, 2006, for the Company's non-compliance with these covenants, after which time the Company would be required to meet these covenants. We expect, however, that we will not be in compliance with the covenant as currently structured after March 31, 2006. Accordingly, we have reclassified the mortgage notes from long-term to current as of March 31, 2006.

The holders of the mortgage notes and we have agreed to negotiate a mutually agreeable amendment to the covenants in the near future. We believe that by June 30, 2006, we will be successful in its negotiations with the mortgage note holders to revise the financial covenants to levels that are attainable by us. However, there can be no assurance that an agreement will be reached. If an agreement cannot be reached or if an agreement is reached but the covenants are not attainable and the mortgage note holders were to exercise their rights, we would be required to repay the outstanding principal, accrued interest plus the prepayment penalty (which as of March 31, 2006 would be approximately \$767).

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The terms of our convertible senior notes contain certain contingent conversion provisions. Under certain circumstances, the notes will be convertible into our common stock at a conversion rate of 33.0797 shares per \$1,000 principal amount of the notes, subject to adjustment in certain circumstances. The conversion rate is equal to an initial conversion price of approximately \$30.23 per share. The notes are convertible into shares of our common stock contingent upon the occurrence of specified events, including if, (a) on or prior to May 1, 2019, the closing price of our common stock is above the initial threshold price of \$36.28 for at least 20 trading days in a 30 consecutive trading-day period ending on the eleventh trading day of any fiscal quarter and (b) prior to May 1, 2019, the average trading price for the convertible senior notes is less than 98% of the average conversion value for the convertible senior notes during any five consecutive trading-day period. The convertible notes mature on May 1, 2024 and bear interest at 2% per year, payable semiannually in arrears in May and November. The convertible notes are unsecured, rank equally in right of payment to our existing and future senior debt, and do not subject us to any financial covenants. The holders may require us to repurchase the notes, in whole or in part, (a) on May 1, 2009, 2014 or 2019, (b) upon a change in control, or (c) if our common stock is neither listed nor approved for trading on specified markets. At our option, we may redeem any of the convertible notes on or after May 1, 2009 at a price equal to 100% of the principal amount of the convertible notes to be redeemed plus accrued and unpaid interest.

In June 2005, we entered into an alliance agreement with a third party to purchase certain computer equipment and services. This alliance agreement, as subsequently amended, is in effect until December 2011 and contains penalties for volume commitments and a variable early termination penalty that generally increases over time. Aggregate minimum purchase commitments over the six-year term of the agreement total approximately \$91.2 million. As of March 31, 2006, the total early termination fee was \$8.8 million. Further, this agreement requires payments of \$2.0 million related to the licensing of certain technology, \$3.8 million related to the development of certain technologies and royalty payments based on future purchases capped at a maximum of \$1.0 million (with a minimum of \$0.2 million). Payments of \$0 million and \$2.6 million, respectively, were made during the three and nine months ended March 31, 2006 in relation to this alliance agreement.

In September 2005, the Company entered into a software license agreement with a third party. This agreement provides the Company with a perpetual license to utilize and resell the software license subject to certain restrictions. The agreement requires \$0.4 million in cash payments plus a variable royalty fee related to any sublicenses sales. Payments of \$0.1 and \$0.2 million, respectively, were made during the three and nine months ended March 31, 2006 in relation to this agreement.

In July 2005, the Company began its ERP system upgrade to improve our ERP system capabilities and processes. In connection with the implementation of the ERP system upgrade, we entered into several agreements with a third-party relating to the initial phases of the implementation. As of March 31, 2006, there was \$2.2 million of funds authorized that have not been expended related to the ERP effort.

The Company from time to time enters into non-cancelable purchase commitments for certain inventory components used in its normal supply-chain operations. The purchase commitments covered by these agreements are generally for less than one year and aggregated approximately \$15.4 million at March 31, 2006.

The following is a schedule of our commitments and contractual obligations outstanding at March 31, 2006:

|                                |            | Less Than | 2-3       | 4-5        | More Than |
|--------------------------------|------------|-----------|-----------|------------|-----------|
| (in thousands)                 | Total      | 1 Year    | Years     | Years      | 5 Years   |
| Notes payable                  | \$ 135,889 | \$ 10,287 | \$ 95     | \$ 125,075 | \$ 432    |
| Interest due on notes payable  | 8,802      | 3,589     | 5,000     | 213        |           |
| Alliance agreement             | 95,275     | 2,650     | 20,660    | 56,340     | 15,625    |
| Inventory purchase obligations | 15,411     | 15,411    |           |            |           |
| License agreement              | 200        | 200       |           |            |           |
| ERP agreements                 | 2,232      | 2,232     |           |            |           |
| Operating leases               | 5,570      | 1,747     | 2,189     | 1,197      | 437       |
| Other long-term liabilities    | 135        |           | 135       |            |           |
| Deferred compensation          | 1,581      |           | 1,581     |            |           |
|                                | \$ 265,095 | \$ 36,116 | \$ 29,660 | \$ 182,825 | \$ 16,494 |

Currently, our prime source of liquidity comes from cash, marketable securities and cash generated from operations. We generated \$25.7 million and \$33.1 million from operating activities during the nine months ended March 31, 2006 and 2005, respectively. As of March 31, 2006, we had \$135.9 million of outstanding debt. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating

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leases, mortgage notes, an alliance purchase agreement and inventory purchase commitments, as well as interest payments on our long-term debt. We do not currently have any material commitments for capital expenditures.

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If cash generated from operations is insufficient to satisfy working capital requirements, we may need to access funds through bank loans, sales of securities or other means. There can be no assurance that we will be able to raise any such capital on terms acceptable to us, on a timely basis or at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to effectively operate our business.

Based on our current plans and business conditions, we believe that existing cash and marketable securities will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months.

**Additional Information on Stock Option Plans and Grants***Stock Option Program Description*

We currently have one active stock option plan under which we grant options: the 2005 Stock Incentive Plan (the 2005 Plan). We have 4,530,138 options outstanding as of March 31, 2006 that were issued under previously utilized plans.

Our stock option grants are designed to reward employees for their long-term contributions to our company and provide incentives for them to remain with our company. We consider our equity compensation program critical to our operation and productivity. Approximately 68% of our employees participate in our equity compensation program.

*Stock Option Accounting*

On July 1, 2005, we adopted Statement of Financial Accounting Standards No. 123R (SFAS 123R), Accounting for Stock-Based Compensation, using the modified prospective method, which results in the provisions of SFAS 123R only being applied to the consolidated financial statements on a going-forward basis (that is, the prior period results were not restated). Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the requisite service period. Stock-based employee compensation expense was \$3.2 million and \$7.3 million before tax for the three and nine months ended March 31, 2006, respectively, and the remaining unamortized compensation was \$20.5 million as of March 31, 2006.

Previously, we had followed Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, which resulted in the accounting for employee share options at the intrinsic value.

**Employee and Executive Option and Restricted Stock Grants**

Option and restricted stock grants for the period:

|   | Nine Months Ended |       | Year Ended |       |
|---|-------------------|-------|------------|-------|
|   | March 31,         |       | June 30,   |       |
|   | 2006              | 2005  | 2005       | 2004  |
| Grants during the period as a percentage of outstanding shares at the end of such period                                    | 3.0%              | 5.2%  |            | 4.7%  |
| Grants to Named Executive Officers* during the period as a percentage of total options granted during such period           | 16.7%             | 12.5% |            | 13.8% |
| Grants to Named Executive Officers* during the period as a percentage of outstanding shares at the end of such period       | 0.5%              | 0.6%  |            | 0.6%  |
| Cumulative options held by Named Executive Officers* as a percentage of total options outstanding at the end of such period | 22.8%             | 20.9% |            | 21.7% |

\* The term "Named Executive Officers" as used in these notes includes the Chief Executive Officer and the four other most highly compensated executive officers as of June 30, 2005. Due to the departure of Robert D. Becker on August 5, 2005, the next most highly compensated executive officer as of June 30, 2005 was used to replace Mr. Becker in the December 31, 2005 results.





**Table of Contents****Summary of Stock Option and Restricted Stock Activity**

|                                      | Options Outstanding |                  | Restricted Stock Awards Outstanding |                       |
|--------------------------------------|---------------------|------------------|-------------------------------------|-----------------------|
|                                      | Number of           | Weighted Average | Number of                           | Weighted Average      |
|                                      | Shares              | Exercise Price   | Shares                              | Grant Date Fair Value |
| <b>Outstanding at June 30, 2004</b>  | <b>4,533,495</b>    | <b>\$ 24.18</b>  |                                     | <b>\$</b>             |
| Grants                               | 1,083,150           | 26.64            |                                     |                       |
| Exercises                            | (320,349)           | 14.80            |                                     |                       |
| Cancellations                        | (211,768)           | 27.45            |                                     |                       |
| <b>Outstanding at June 30, 2005</b>  | <b>5,084,528</b>    | <b>\$ 25.16</b>  |                                     | <b>\$</b>             |
| Grants                               | 269,300             | 23.55            | 366,156                             | 18.66                 |
| Exercises                            | (288,486)           | 15.42            |                                     |                       |
| Cancellations                        | (429,604)           | 28.78            | (2,460)                             | 17.25                 |
| <b>Outstanding at March 31, 2006</b> | <b>4,635,738</b>    | <b>\$ 25.33</b>  | <b>363,696</b>                      | <b>\$ 18.67</b>       |

**Summary of In-the-Money and Out-of-the-Money Option Information**

|                                  | Exercisable      |                 | As of March 31, 2006<br>Unexercisable |                 | Total            |                 |
|----------------------------------|------------------|-----------------|---------------------------------------|-----------------|------------------|-----------------|
|                                  | Weighted         | Average         | Weighted                              | Average         | Weighted         | Average         |
|                                  | Shares           | Price           | Shares                                | Price           | Shares           | Price           |
| In-the-money                     | 460,669          | \$ 8.26         |                                       |                 | 460,669          | \$ 8.26         |
| Out-of-the-money (1)             | 2,967,544        | \$ 28.85        | 1,207,525                             | \$ 23.22        | 4,175,069        | \$ 27.22        |
| <b>Total options outstanding</b> | <b>3,428,213</b> | <b>\$ 26.08</b> | <b>1,207,525</b>                      | <b>\$ 23.22</b> | <b>4,635,738</b> | <b>\$ 25.33</b> |

(1) Out-of-the-money options are those options with an exercise price equal to or above the closing price of our common stock of \$16.20 as of March 31, 2006.

**Options Granted to Named Executive Officers during the Three Months ended March 31, 2006**

No options were granted to any of the Named Executive Officers during the nine months ended March 31, 2006.

**Option Exercises and Remaining Holdings of Named Executive Officers**

| During the nine | Value    | Number of Securities   | Values of Unexercised     |
|-----------------|----------|------------------------|---------------------------|
| months ended    | Realized | Underlying Unexercised | In-the-Money Options      |
| March 31, 2006: |          | Options as of          | as of March 31, 2006: (1) |

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| Name                | Shares Acquired on |            | March 31, 2006: |               | Exercisable  | Unexercisable | Exercisable | Unexercisable |
|---------------------|--------------------|------------|-----------------|---------------|--------------|---------------|-------------|---------------|
|                     | Exercise           |            | Exercisable     | Unexercisable |              |               |             |               |
| James R. Bertelli   | 101,957            | \$ 140,744 | 284,100         | 122,500       | \$ 1,173,822 | \$            |             |               |
| Robert E. Hult      |                    |            | 50,000          | 50,000        |              |               |             |               |
| Craig Lund          | 19,600             | 189,095    | 67,280          | 29,500        |              |               |             |               |
| Mark F. Skalabrin   |                    |            | 95,580          | 29,000        | 301,576      |               |             |               |
| Didier M.C. Thibaud |                    |            | 86,940          | 40,000        |              |               |             |               |

(1) Option values based on the closing price of our common stock of \$16.20 on March 31, 2006.

**Restricted Stock Holdings of Named Executive Officers**

|                     | Number of Restricted Shares Held | Value of Restricted Shares Held at March 31, 2006 (1) | Restricted Shares at March 31, 2006 Vesting in 4 years or less |           |                       |
|---------------------|----------------------------------|---|--|-----------|-----------------------|
|                     |                                  |   | Number Awarded   | Date      | Vesting Schedule      |
|                     |                                  |   |  |           |                       |
| James R. Bertelli   | 6,526                            | \$ 105,721  | 6,526  | 8/12/2005 | 25%/year              |
| James R. Bertelli   | 30,000                           | 486,000   | 30,000   | 2/22/2006 | 33%/year              |
| Robert E. Hult      | 2,497                            | 40,451  | 2,497  | 8/12/2005 | 25%/year              |
| Robert E. Hult      | 7,500                            | 121,500   | 7,500  | 8/12/2005 | Cliff vest in 4 years |
| Robert E. Hult      | 12,000                           | 194,400   | 12,000   | 2/20/2006 | 33%/year              |
| Craig Lund          | 1,953                            | 31,639  | 1,953  | 8/12/2005 | 25%/year              |
| Craig Lund          | 8,000                            | 129,600   | 8,000  | 2/20/2006 | 33%/year              |
| Mark F. Skalabrin   | 2,098                            | 33,988  | 2,098  | 8/12/2005 | 25%/year              |
| Mark F. Skalabrin   | 4,500                            | 72,900  | 4,500  | 8/12/2005 | Cliff vest in 4 years |
| Mark F. Skalabrin   | 8,000                            | 129,600   | 8,000  | 2/20/2006 | 33%/year              |
| Didier M.C. Thibaud | 2,098                            | 33,988  | 2,098  | 8/12/2005 | 25%/year              |
| Didier M.C. Thibaud | 7,500                            | 121,500   | 7,500  | 8/12/2005 | Cliff vest in 4 years |
| Didier M.C. Thibaud | 13,400                           | 217,080   | 13,400   | 2/20/2006 | 33%/year              |

(1) Share values based on the closing price of our common stock of \$16.20 on March 31, 2006.

**Table of Contents****Rule 10b5-1 Plans**

Four of our executive officers, Douglas F. Flood, Craig Lund, Barry S. Isenstein and Mark Skalabrin have adopted written trading plans in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, and our insider trading policy. A portion of the shares to be sold under these plans will be issued pursuant to the exercise of existing stock options. Sales made pursuant to these plans will be disclosed publicly through Form 4 and Form 144 filings with the Securities and Exchange Commission.

**Equity Compensation Plans**

The following table sets forth information as of March 31, 2006 with respect to compensation plans under which equity securities of the Company are authorized for issuance.

|  | (1)  | (2)  | (3)   |
|--|--|--|---|
| Plan category  | Number of securities to be issued upon exercise of outstanding options, warrants, and rights | Weighted-average exercise price of outstanding options, warrants, and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (1)) |
| Equity compensation plans approved by shareholders (a) | 4,635,738(b)   | \$ 25.33   | 1,625,362(c)  |
| Equity compensation plans not approved by shareholders |  |  |   |
| <b>TOTAL</b>   | <b>4,635,738</b>   | <b>\$ 25.33</b>  | <b>1,625,362</b>  |

- (a) Consists of the 1991, 1997, 1998 and 2005 equity plans and our 1997 Employee Stock Purchase Plan ( ESPP ).
- (b) Does not include purchase rights under the ESPP, as the purchase price and number of shares to be purchased is not determined until the end of the relevant purchase period.
- (c) Includes 88,621 shares available for future issuance under the ESPP and 1,536,741 shares available for future issuance under the Company's 2005 Plan. We are no longer permitted to grant options under our 1991, 1997 and 1998 plans.

**Related party transactions**

In July 2004, we entered into a consulting contract with David Bertelli, the brother of our Chief Executive Officer and former Senior Vice President of Organizational Development. We paid no monies to David Bertelli during the three and nine months ended March 31, 2006 and we owed no monies to him as of March 31, 2006. We paid David Bertelli \$30,000 for consulting services during fiscal year 2005 and owed no amounts under this agreement as of June 30, 2005. In addition, we paid \$2,000 and \$25,000 of life insurance premiums for the benefit of David Bertelli during the nine months ended March 31, 2006 and fiscal year 2005, respectively.

We have arrangements with other parties that do not meet the technical disclosure requirements of related parties and are not material in the aggregate. These individual arrangements either fall under reporting thresholds or are with non-immediate family members of our executive officers.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2005, The FASB issued FSP FAS 143-1 titled *Accounting for Electronic Waste Obligations*. The obligations addressed in the FSP relate to those which might be created under the operation of Directive 2002/96/EC on Electrical and Electronic Equipment adopted by the European Union in February 2003. The FSP provides guidance on proper accounting for costs associated with retiring electronic equipment classified as *Historical* held by commercial users on or before August 13, 2005. Commercial users in EU countries that have adopted the law

may be required to record an asset retirement obligation and to capitalize a related increase in the carrying value of the equipment subject to the directive utilizing concepts

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outlined under FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, and the related FASB Interpretation No. 47, *Accounting for Conditions Asset Retirement Obligations*. The effective date of this FSP is the first reporting period after June 8, 2005 or the date of adoption of the law by the applicable EU-member country. The Company has evaluated whether the EU Directive is applicable to both its foreign subsidiaries and to shipments abroad from its U.S. subsidiaries. Management has assessed the impact of the adoption of this accounting pronouncement and there is no material affect on operating results.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections: a Replacement of Accounting Principles Board (APB) Opinion No. 20 and FASB Statement No. 3* ( SFAS 154 ). SFAS 154 requires retrospective application for voluntary changes in accounting principle unless it is impracticable to do so. Retrospective application refers to the application of a different accounting principle to previously issued financial statements as if that principle had always been used. SFAS 154's retrospective-application requirement replaces APB Opinion No. 20's requirement to recognize most voluntary changes in accounting principle by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. Under SFAS 154, correction of an error in previously issued financial statements will continue to be accounted for by restating the prior-period financial statements, and a change in accounting estimate will continue to be accounted for prospectively. The requirements of SFAS 154 are effective for accounting changes made in fiscal years beginning after December 15, 2005. We will determine the impact of this standard on our consolidated financial statements when an accounting change or error correction occurs.

**FACTORS THAT MAY AFFECT FUTURE RESULTS**

**We depend heavily on defense electronics programs that incorporate our products, which may be only partially funded and are subject to potential termination and reductions and delays in government spending.**

Sales of our computer systems, primarily as an indirect subcontractor or team member with prime contractors and in some cases directly, to the U.S. Government and its agencies, as well as foreign governments and agencies, accounted for approximately 59%, 68% and 69% of our total revenues in fiscal 2005, 2004 and 2003, respectively, and approximately 53.7% of our total revenues for the nine months ended March 31, 2006. Our computer systems are included in many different domestic and international programs. Over the lifetime of a program, the award of many different individual contracts and subcontracts may implement our requirements. The funding of U.S. Government programs is subject to Congressional appropriations. Although multiple-year contracts may be planned in connection with major procurements, Congress generally appropriates funds on a fiscal year basis even though a program may continue for several years. Consequently, programs are often only partially funded initially, and additional funds are committed only as Congress makes further appropriations and prime contracts receive such funding. The reduction or delay in funding or termination of a government program in which we are involved would result in a loss of or delay in receiving anticipated future revenues attributable to that program and contracts or orders received. The U.S. Government could reduce or terminate a prime contract under which we are a subcontractor or team member irrespective of the quality of our products or services. The termination of a program or the reduction in or failure to commit additional funds to a program in which we are involved could negatively impact our revenues and have a material adverse effect on our financial condition and results of operations. In addition, delays in funding of a program, or of the defense appropriation generally, could negatively impact our revenues and have a material adverse effect on our financial condition and results of operations for the period in which such revenues were originally anticipated.

**We face other risks and uncertainties associated with defense-related contracts, which may have a material adverse effect on our business.**

Whether our contracts are directly with the U.S. Government, a foreign government or one of its respective agencies, or indirectly as a subcontractor or team member, our contracts and subcontracts are subject to special risks, including:

Changes in government administration and national and international priorities, including developments in the geo-political environment such as the current War on Terrorism, Operation Enduring Freedom, Operation Iraqi Freedom, and the threat of nuclear proliferation in North Korea and Iran, could have a significant impact on national or international defense spending priorities and the efficient handling of routine contractual matters. These changes could have a negative impact on our business in the future.

Our contracts with the U.S. and foreign governments and their prime contractors and subcontractors are subject to termination either upon default by us or at the convenience of the government or contractor if, among other reasons, the program itself has been terminated. Termination for convenience provisions generally entitle us to recover costs incurred, settlement expenses and profit on work completed prior to termination, but there can be no assurance in this regard.



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Because we contract to supply goods and services to the U.S. and foreign governments and their prime and subcontractors, we compete for contracts in a competitive bidding process and, in the event we are awarded a contract, we are subject to protests by disappointed bidders of contract awards that can result in the reopening of the bidding process and changes in governmental policies or regulations and other political factors.

Consolidation among defense industry contractors has resulted in a few large contractors with increased bargaining power relative to us. The increased bargaining power of these contractors may adversely affect our ability to compete for contracts and, as a result, may adversely affect our business or results of operations in the future.

Our customers include U.S. Government contractors who must comply with and are affected by laws and regulations relating to the formation, administration and performance of U.S. Government contracts. A violation of these laws and regulations could result in the imposition of fines and penalties to our customer or the termination of its contract with the U.S. Government. As a result, there could be a delay in our receipt of orders from our customer or a termination of such orders.

We sell products to U.S. and international defense contractors and also directly to the U.S. Government as a commercial supplier such that cost data is not supplied. To the extent that there are interpretations or changes in the Federal Acquisition Regulations (FARs) regarding the qualifications necessary to be a commercial supplier, there could be a material adverse effect on our business and operating results.

Defense Federal Acquisition Regulations require that certain specialty metals (as defined in the regulations) incorporated in articles delivered under Department of Defense contracts must be melted in the United States or a qualifying country, subject to certain exceptions. While these regulations generally do not apply to subcontractors such as the Company, they do apply to subcontractors in connection with certain types of military programs. Certain of the products we have historically sold to U.S. Government defense contractors may contain third-party components which incorporate specialty metals that are non-compliant with these regulations. Our customers may not accept certain of our products for the affected programs, which could have a material adverse effect on our business and operating results, if (a) our third-party vendors are not able to supply us with components that comply with these requirements, or (b) we are not able to procure compliant substitutes for these components, or (c) our products do not otherwise qualify for an exception to, or fall outside the scope of, these requirements.

**The loss of one or more of our largest customers could adversely affect our results of operations.**

We are dependent on a small number of customers for a large portion of our revenues. A significant decrease in the sales to or loss of any of our major customers would have a material adverse effect on our business and results of operations. For the nine months ended March 31, 2006, four customers, KLA-Tencor Corporation, GE Healthcare, Argon Engineering Associates and Northrop Grumman accounted for 11%, 10%, 14% and 13%, respectively, of our total revenues. In fiscal 2005, KLA-Tencor Corporation, Argon Engineering Associates, GE Medical Systems and Lockheed Martin accounted for 14%, 14%, 11% and 11% of our total revenues, respectively. Customers in the Defense market generally purchase our products in connection with government programs that have a limited duration, leading to fluctuating sales to any particular customer in this market from year to year. In addition, our revenues are largely dependent upon the ability of customers to develop and sell products that incorporate our products. No assurance can be given that our customers will not experience financial, technical or other difficulties that could adversely affect their operations and, in turn, our results of operations.

**Our CIV, Advanced Solutions and MPS revenues currently come from a small number of customers and modalities, and any significant decrease in revenue from one of these customers or modalities could adversely impact our operating results.**

If a major CIV, Advanced Solutions or MPS customer significantly reduces the amount of business it does with us, there would likely be an adverse impact on our operating results. GE Medical Systems, Philips Medical Systems and Force Computers GmbH accounted for substantially all of our CIV revenues for the fiscal years ended June 30, 2005, 2004 and 2003. In particular, GE Medical accounted for 56% of our aggregate CIV sales in fiscal 2005, 60% in fiscal 2004 and 59% in fiscal 2003. For the nine months ended March 31, 2006, GE Healthcare, Philips Medical Systems and Motorola GmbH accounted for 44%, 10% and 10%, respectively, of our aggregate CIV sales. Further, we are currently expecting that our 2D business with GE Healthcare, Motorola GmbH and Philips Medical Systems will significantly decrease over the next 12-months as these customers transition to new platforms and new component manufactures. We expect that this forecasted decline in our 2D business will be offset, either partially or fully, by an increase in our 3D business. KLA-Tencor accounted for 72% of our total sales in the Advanced Solutions market in fiscal 2005, 66% in fiscal 2004 and 44% in fiscal 2003. For the nine months ended March 31, 2006, KLA-Tencor and Micronic



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accounted for 62% and 10%, respectively, of our aggregate Advanced Solutions sales. Additionally, for the MPS segment, which was consolidated into our company starting in the second quarter of 2005, Motorola Computer Group, Continuous Computing Corporation and SS8 Networks accounted for 28%, 22% and 11%, respectively, of the aggregate MPS sales for the nine months ended March 31, 2006. Although we are seeking to broaden our commercial customer base, we expect to continue to depend on sales to a relatively small number of major customers in both the Advanced Solutions and MPS markets. Because it often takes significant time and added cost to replace lost business, it is likely that our operating results would be adversely affected if one or more of our major customers were to cancel, delay or reduce significant orders in the future. Our customer agreements typically permit the customer to discontinue future purchases without cause after timely notice.

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### **Our sales to the CIV market could be adversely affected by changes in technology, strength of the economy, and health care reforms.**

The economic and technological conditions affecting our industry in general or any major CIV OEM customer in particular, may adversely affect our operating results. CIV OEM customers provide products to markets that are subject to both economic and technological cycles. Any change in the demand for medical imaging devices that renders any of our products unnecessary or obsolete, or any change in the technology in these devices, could result in a decrease in our revenues. In addition to our CIV OEM customers, the end users of their products and the health care industry generally are subject to extensive federal, state and local regulation in the United States, as well as in other countries. Changes in applicable health care laws and regulations or new interpretations of existing laws and regulations could cause these customers or end users to demand fewer CIV products. There can be no assurance that future health care regulation or budgetary legislation or other changes in the administration or interpretation of governmental health care programs both in the United States and abroad will not have a material adverse effect on our business.

### **Competition from existing or new companies in the CIV business could cause us to experience downward pressure on prices, fewer customer orders, reduced margins, the inability to take advantage of new business opportunities and the loss of market share.**

CIV competes in highly competitive industries, and our CIV OEM customers generally extend the competitive pressures they face throughout their respective supply chains. We are subject to competition based upon product design, performance, pricing, quality and services. Our product performance, embedded systems engineering expertise, and product quality have been important factors in our growth. While we try to maintain competitive pricing on those products that are directly comparable to products manufactured by others, in many instances our products will conform to more exacting specifications and carry a higher price than analogous products. Many of our CIV OEM customers and potential CIV OEM customers have the capacity to design and internally manufacture products that are similar to our products. We face competition from research and product development groups and the manufacturing operations of current and potential customers, who continually evaluate the benefits of internal research and product development and manufacturing versus outsourcing. This competition could result in fewer customer orders and a loss of market share.

### **Our sales in the Defense market could be adversely affected by the emergence of commodity-type products as acceptable substitutes for certain of the Company's products and by uncertainty created by emerging changes in standards that may cause customers to delay purchases or seek alternative solutions.**

Our computing products for the Defense market are designed for operating under physical constraints such as limited volume, weight, and electrical power. Furthermore, these products are often designed to be rugged, that is, to withstand enhanced environmental stress such as extended temperature range, shock, vibration, and exposure to sand or salt spray. Historically these requirements have often precluded the use of less expensive, readily available commodity-type systems typically found in more benign non-military settings. Factors that may increase the acceptability of commodity-type products in some Defense platforms that we serve include improvements in the physical properties and durability of such alternative products, combined with the relaxation of physical and ruggedness requirements by the military due to either a reevaluation of those requirements or the installation of computing products in a more highly environmentally isolated setting. In addition, recent proposed changes in the VMEbus computer infrastructure standard, to which a majority of our Defense products adhere, may cause program managers with the U.S. Government and prime contractors to delay decisions on new program implementations in order to determine which emerging standards and configurations will be the dominant design in the market, and may result in program managers selecting new standards or configurations that we have not chosen to invest in. These developments could negatively impact our revenues and have a material adverse effect on our business and operating results.

### **If we are unable to respond adequately to our competition, we may lose existing customers and fail to win future business opportunities.**

The markets for our products are highly competitive and are characterized by rapidly changing technology, frequent product performance improvements and evolving industry standards. Competitors may be able to offer more attractive pricing or develop products that could offer performance features that are superior to our products, resulting in reduced demand for our products. Due to the rapidly changing nature of technology, we may not become aware in advance of the emergence of new competitors into our markets. The emergence of new competitors into markets historically targeted by us could result in the loss of existing customers and may have a negative impact on our ability to win future business opportunities. With continued microprocessor evolution, low-end systems could become adequate to meet the requirements of an increased number of the lesser-demanding applications within our target markets. Workstation manufacturers and other low-end single-board computer or merchant board computer companies, or new competitors, may attempt to penetrate the high-performance market for defense electronics systems, which could have a material adverse effect on our business.

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**We cannot predict the consequences of future terrorist activities, but they may adversely affect the markets in which we operate, our ability to insure against risks, and our operations or profitability.**

The terrorist attacks in the United States on September 11, 2001, as well as the U.S.-led response, including Operation Enduring Freedom and Operation Iraqi Freedom, the potential for future terrorist activities, and the development of a Homeland Security organization have created economic and political uncertainties that could have a material adverse effect on business and the price of our common stock. These matters have caused uncertainty in the world's financial and insurance markets and may increase significantly the political, economic and social instability in the geographic areas in which we operate. These developments may adversely affect business and profitability and the prices of our securities in ways that cannot be predicted at this time.

**Implementation of our growth strategy may not be successful, which could affect our ability to increase revenues.**

Our growth strategy includes developing new products and entering new markets, as well as identifying and integrating acquisitions. Our ability to compete in new markets will depend upon a number of factors including, among others:

our ability to create demand for products in new markets;

our ability to manage growth effectively;

our ability to successfully integrate any acquisitions that we make;

our ability to respond to changes in our customers' businesses by updating existing products and introducing, in a timely fashion, new products which meet the needs of our customers;

the quality of our new products; and

our ability to respond rapidly to technological change.

The failure to do any of the foregoing could have a material adverse effect on our business, financial condition and results of operations. In addition, we may face competition in these new markets from various companies that may have substantially greater research and development resources, marketing and financial resources, manufacturing capability and customer support organizations.

**We may be unable to successfully integrate acquisitions.**

We completed the acquisitions of SoHard and Echotek in fiscal year 2006, MCI in fiscal year 2005 and TGS Group and Advanced Radio Corporation in fiscal year 2004. We may in the future acquire or make investments in complementary companies, products or technologies. Acquisitions may pose risks to our operations, including:

problems and increased costs in connection with the integration of the personnel, operations, technologies or products of the acquired companies;

unanticipated costs;

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diversion of management's attention from our core business;

adverse effects on business relationships with suppliers and customers and those of the acquired company;

acquired assets becoming impaired as a result of technical advancements or worse-than-expected performance by the acquired company;

entering markets in which we have no, or limited, prior experience; and

potential loss of key employees, particularly those of the acquired organization.

In addition, in connection with any acquisitions or investments we could:

issue stock that would dilute our existing shareholders' percentage ownership;

incur debt and assume liabilities;

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obtain financing on unfavorable terms;

incur amortization expenses related to acquired intangible assets or incur large and immediate write-offs;

incur large expenditures related to office closures of the acquired companies, including costs relating to termination of employees and facility and leasehold improvement charges relating to vacating the acquired companies' premises; and

reduce the cash that would otherwise be available to fund operations or to use for other purposes.

The failure to successfully integrate any acquisition or for acquisitions to yield expected results may negatively impact our financial condition and operating results.

### **We may be unable to obtain critical components from suppliers, which could disrupt or delay our ability to deliver products to our customers.**

Several components used in our products are currently obtained from sole-source suppliers. We are dependent on key vendors like LSI Logic, Xilinx and Toshiba for custom-designed ASICs and FPGAs; Freescale and IBM for PowerPC microprocessors; IBM for a specific SRAM; and Arrow, Hybricon, and Motorola for chassis and chassis components. Generally, suppliers may terminate their contracts with us without cause upon 30 days' notice and may cease offering their products upon 180 days' notice. If any of our sole-source suppliers limits or reduces the sale of these components, we may be unable to fulfill customer orders in a timely manner or at all. In addition, if these or other component suppliers, some of which are small companies, experienced financial difficulties or other problems that prevented them from supplying us with the necessary components, we could experience a loss of revenues due to our inability to fulfill orders. These sole-source and other suppliers are each subject to quality and performance issues, materials shortages, excess demand, reduction in capacity and other factors that may disrupt the flow of goods to us or to our customers, which would adversely affect our business and customer relationships. We have no guaranteed supply arrangements with our suppliers and there can be no assurance that these suppliers will continue to meet our requirements. If supply arrangements are interrupted, we may not be able to find another supplier on a timely or satisfactory basis. We may incur significant set-up costs and delays in manufacturing should it become necessary to replace any key vendors due to work stoppages, shipping delays, financial difficulties or other factors.

### **We may not be able to effectively manage our relationships with contract manufacturers.**

We may not be able to effectively manage our relationship with contract manufacturers, and the contract manufacturers may not meet future requirements for timely delivery. We rely on contract manufacturers to build hardware sub-assemblies for our products in accordance with our specifications. During the normal course of business, we may provide demand forecasts to contract manufacturers up to five months prior to scheduled delivery of our products to customers. If we overestimate requirements, the contract manufacturers may assess cancellation penalties or we may be left with excess inventory, which may negatively impact our earnings. If we underestimate requirements, the contract manufacturers may have inadequate inventory, which could interrupt manufacturing of our products and result in delays in shipment to customers and revenue recognition. Contract manufacturers also build products for other companies, and they may not have sufficient quantities of inventory available or sufficient internal resources to fill our orders on a timely basis or at all.

In addition, there have been a number of major acquisitions within the contract manufacturing industry in recent periods. While there has been no significant impact on our contract manufacturers to date, future acquisitions could potentially have an adverse effect on our working relationships with contract manufacturers. Moreover, we currently rely primarily on two contract manufacturers. The failure of these contract manufacturers to fill our orders on a timely basis or in accordance with our customers' specifications could result in a loss of revenues and damage to our reputation. We may not be able to replace these contract manufacturers in a timely manner or without significantly increasing our costs if such contract manufacturers were to experience financial difficulties or other problems that prevented them from fulfilling our order requirements.

### **Our performance and stock price may decline if we are unable to retain and attract key personnel.**

We are largely dependent upon the skills and efforts of senior management including James R. Bertelli, our president and chief executive officer, as well as our senior managerial, sales and technical employees. None of our senior management or other key employees is subject to employment contracts. The loss of services of any executive or other key personnel could have a material adverse effect on our business, financial condition and results of operations and stock price. In addition, our future success will depend to a significant extent on the ability to

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attract, train, motivate and retain highly skilled technical professionals, particularly project managers, engineers and other senior technical personnel. There can be no assurance that we will be successful in retaining current or future employees.

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**We are exposed to risks associated with international operations and markets.**

We market and sell products in international markets, and have established offices and subsidiaries in the United Kingdom, Japan, the Netherlands, France, Germany and Italy. Revenues from international operations accounted for 9%, 9% and 7% of total revenues for fiscal years 2005, 2004 and 2003, respectively, and 14% for the nine months ended March 31, 2006. From our U.S. operations, we also ship directly to international customers, which shipments accounted for 13%, 10% and 12% of total revenues for fiscal years 2005, 2004 and 2003, respectively, and 5% for the nine months ended March 31, 2006. There are inherent risks in transacting business internationally, including:

changes in applicable laws and regulatory requirements;

export and import restrictions;

export controls relating to technology;

tariffs and other trade barriers;

less favorable intellectual property laws;

difficulties in staffing and managing foreign operations;

longer payment cycles;

problems in collecting accounts receivable;

political instability;

fluctuations in currency exchange rates;

expatriation controls; and

potential adverse tax consequences.

There can be no assurance that one or more of these factors will not have a material adverse effect on our future international activities and, consequently, on our business and results of operations.

**We may be exposed to unfavorable currency exchange rate fluctuations, which may lead to lower operating margins, or may cause us to raise prices which could result in reduced sales.**

Currency exchange rate fluctuations could have an adverse effect on our net sales and results of operations. Unfavorable currency fluctuations could require us to increase prices to foreign customers, which could result in lower net sales by us to such customers. Alternatively, if we do not

adjust the prices for our products in response to unfavorable currency fluctuations, our results of operations could be adversely affected. In addition, most sales made by our foreign subsidiaries are denominated in the currency of the country in which these products are sold, and the currency they receive in payment for such sales could be less valuable at the time of receipt as a result of exchange rate fluctuations. We do not currently hedge our foreign currency exchange rate exposure.

**If we are unable to respond to technological developments and changing customer needs on a timely and cost-effective basis, our results of operations may be adversely affected.**

Our future success will depend in part on our ability to enhance current products and to develop new products on a timely and cost-effective basis in order to respond to technological developments and changing customer needs. Defense customers, in particular, demand frequent technological improvements as a means of gaining military advantage. Military planners have historically funded significantly more design projects than actual deployments of new equipment, and those systems that are deployed tend to contain the components of the subcontractors selected to participate in the design process. In order to participate in the design of new defense electronics systems, we must demonstrate the ability to deliver superior technological performance on a timely and cost-effective basis. There can be no assurance that we will secure an adequate number of Defense design wins in the future, that the equipment in which our products are intended to function will eventually be deployed in the field, or that our products will be included in such equipment if it eventually is deployed.

Customers in our CIV and Advanced Solutions markets, including the semiconductor imaging market, also seek technological improvements through product enhancements and new generations of products. OEMs historically have selected certain suppliers whose products have been included in the OEMs' machines for a significant portion of the products' life cycles. We may not be selected to participate in the future design of any medical or semiconductor imaging equipment, or if selected, we may not generate any revenues for such design work.



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The design-in process is typically lengthy and expensive, and there can be no assurance that we will be able to continue to meet the product specifications of OEM customers in a timely and adequate manner. In addition, any failure to anticipate or respond adequately to changes in technology and customer preferences, or any significant delay in product developments or introductions, could negatively impact our financial condition and results of operations, including the risk of inventory obsolescence. Because of the complexity of our products, we have experienced delays from time to time in completing products on a timely basis. If we are unable to design, develop or introduce competitive new products on a timely basis, our future operating results may be adversely affected.

### **Our products are complex, and undetected defects may increase our costs, harm our reputation with customers or lead to costly litigation.**

Our products are extremely complex and must operate successfully with complex products of other vendors. Our products may contain undetected errors when first introduced or as we introduce product upgrades. The pressures we face to be the first to market new products or functionality increases the possibility that we will offer products in which we or our customers later discover problems. We have experienced new product and product upgrade errors in the past and expect similar problems in the future. These problems may cause us to incur significant costs to support our service contracts and other costs and divert the attention of personnel from our product development efforts. If we are unable to repair these problems in a timely manner, we may experience a loss of or delay in revenue and significant damage to our reputation and business prospects. Many of our customers rely upon our products for business-critical applications. Because of this reliance, errors, defects or other performance problems in our products could result in significant financial and other damage to our customers. Our customers could attempt to recover those losses by pursuing products liability claims against us which, even if unsuccessful, would likely be time-consuming and costly to defend and could adversely affect our reputation.

### **We may be unsuccessful in protecting our intellectual property rights.**

Our ability to compete effectively against other companies in our industry depends, in part, on our ability to protect our current and future proprietary technology under patent, copyright, trademark, trade secret and unfair competition laws. We cannot assure that our means of protecting our proprietary rights in the United States or abroad will be adequate, or that others will not develop technologies similar or superior to our technology or design around the proprietary rights we own. In addition, we may incur substantial costs in attempting to protect our proprietary rights.

Also, despite the steps taken by us to protect our proprietary rights, it may be possible for unauthorized third parties to copy or reverse-engineer aspects of our products, develop similar technology independently or otherwise obtain and use information that we regard as proprietary and we may be unable to successfully identify or prosecute unauthorized uses of our technology. Furthermore, with respect to our issued patents and patent applications, we cannot assure you that any patents from any pending patent applications (or from any future patent applications) will be issued, that the scope of any patent protection will exclude competitors or provide competitive advantages to us, that any of our patents will be held valid if subsequently challenged or that others will not claim rights in or ownership of the patents (and patent applications) and other proprietary rights held by us.

### **If we become subject to intellectual property infringement claims, we could incur significant expenses and could be prevented from selling specific products.**

We may become subject to claims that we infringe the intellectual property rights of others in the future. We cannot assure that, if made, these claims will not be successful. Any claim of infringement could cause us to incur substantial costs defending against the claim even if the claim is invalid, and could distract management from other business. Any judgment against us could require substantial payment in damages and could also include an injunction or other court order that could prevent us from offering certain products.

### **Our need for continued investment in research and development may increase expenses and reduce our profitability.**

Our industry is characterized by the need for continued investment in research and development. If we fail to invest sufficiently in research and development, our products could become less attractive to potential customers and our business and financial condition could be materially and adversely affected. As a result of the need to maintain or increase spending levels in this area and the difficulty in reducing costs associated with research and development, our operating results could be materially harmed if our research and development efforts fail to result in new products or if revenues fall below expectations. In addition, as a result of our commitment to invest in research and development, spending levels of research and development expenses as a percentage of revenues may fluctuate in the future.



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**Our results of operations are subject to fluctuation from period to period and may not be an accurate indication of future performance.**

We have experienced fluctuations in operating results in large part due to the sale of computer systems in relatively large dollar amounts to a relatively small number of customers. Customers specify delivery date requirements that coincide with their need for our products. Because these customers may use our products in connection with a variety of defense programs or other projects with different sizes and durations, a customer's orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns of one customer do not necessarily correlate with the order patterns of another customer. Thus, results of operations in any period should not be considered indicative of the results to be expected for any future period.

Our quarterly results may be subject to fluctuations resulting from a number of other factors, including:

delays in completion of internal product development projects;

delays in shipping computer systems and software programs;

delays in acceptance testing by customers;

a change in the mix of products sold to our served markets;

production delays due to quality problems with outsourced components;

shortages and costs of components;

the timing of product line transitions; and

declines in quarterly revenues from previous generations of products following announcement of replacement products containing more advanced technology.

In addition, from time to time, we have entered into contracts, referred to as development contracts, to engineer a specific solution based on modifications to standard products. Gross margins from development contract revenues are typically lower than gross margins from standard product revenues. We intend to continue to enter into development contracts and anticipate that the gross margins associated with development contract revenues will continue to be lower than gross margins from standard product sales.

Another factor contributing to fluctuations in our quarterly results is the fixed nature of expenditures on personnel, facilities and marketing programs. Expense levels for these programs are based, in significant part, on expectations of future revenues. If actual quarterly revenues are below management's expectations, our results of operations will likely be adversely affected.

**We have benefited from certain tax benefits that may expire or be repealed.**

In the past, we have benefited from certain tax provisions that have reduced our effective tax rate and the cash taxes paid. One of these benefits, the credit for increasing research activities, expired on December 31, 2005, and, as of the date of this report, had not been extended or reinstated by Congress. There are pending legislative proposals that would extend or make permanent this tax credit, including on a retrospective basis. However, there can be no assurance that the research credit will be made permanent or extended, or if so, for how long, and whether any such extension will be made retroactive.

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We have also utilized benefits under the extraterritorial income exclusion, or ETI tax regime. The ETI regime was ruled an illegal trade subsidy by the World Trade Organization and, as a result, the European Union imposed trade sanctions against the United States that would have increased substantially over time if the ETI regime were not repealed. On October 22, 2004, legislation was enacted to repeal the ETI regime for transactions entered into after December 31, 2004, subject to a phase-out to allow current beneficiaries to claim reduced ETI benefits for transactions entered into during calendar years 2005 and 2006. In addition to the repeal of ETI, this legislation created a deduction from taxable income that will apply to taxpayers with qualified production activities income, for which we believe we qualify. Our expenses for income taxes could be significantly higher or lower in the future if there are further changes in the tax law applicable to us or we fail to qualify for certain tax benefits.

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### **The trading price of our common stock may continue to be volatile, which may adversely affect business, and investors in our common stock may experience substantial losses.**

Our stock price, like that of other technology companies, has been volatile. The stock market in general and technology companies in particular may continue to experience volatility in their stock prices. This volatility may or may not be related to operating performance. Our operating results, from time to time, may be below the expectations of public market analysts and investors, which could have a material adverse effect on the market price of our common stock. In addition, the continued threat of terrorism in the United States and abroad, the resulting military action and heightened security measures undertaken in response to that threat may cause continued volatility in securities markets. When the market price of a stock has been volatile, holders of that stock will sometimes institute securities class action litigation against the company that issued the stock. If any shareholders were to institute a lawsuit, we could incur substantial costs defending the lawsuit. Also, the lawsuit could divert the time and attention of management.

### **We significantly increased our leverage as a result of the sale of convertible senior notes.**

In connection with our sale of convertible senior notes in April 2004, we incurred additional indebtedness of \$125 million. The degree to which we are leveraged could, among other things:

make it difficult for us to make payments on the convertible notes;

make it difficult for us to obtain financing for working capital, acquisitions or other purposes on favorable terms, if at all;

make us more vulnerable to industry downturns and competitive pressures; and

limit our flexibility in planning for, or reacting to changes in, our business.

Our ability to meet our debt service obligations will depend upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control. We may not have enough funds or be able to arrange for additional financing to pay the principal at maturity or to repurchase the notes when tendered in accordance with their terms, which would constitute an event of default under the related indenture.

### **Provisions in our organizational documents and Massachusetts law and other actions we have taken could make it more difficult for a third party to acquire us.**

Provisions of our charter and by-laws could have the effect of discouraging a third party from making a proposal to acquire our company and could prevent certain changes in control, even if some shareholders might consider the proposal to be in their best interest. These provisions include a classified board of directors, advance notice to our board of directors of shareholder proposals and director nominations, and limitations on the ability of shareholders to remove directors and to call shareholder meetings. In addition, we may issue shares of any class or series of preferred stock in the future without shareholder approval upon such terms as our board of directors may determine. The rights of holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any such class or series of preferred stock that may be issued.

We also are subject to the Massachusetts General Laws which, subject to certain exceptions, prohibit a Massachusetts corporation from engaging in a broad range of business combinations with any interested shareholder for a period of three years following the date that such shareholder becomes an interested shareholder. These provisions could discourage a third party from pursuing an acquisition of our company at a price considered attractive by many shareholders.

We have adopted a Shareholder Rights Plan that could make it more difficult for a third party to acquire, or could discourage a third party from acquiring, the Company or a large block of our common stock. A third party that acquires 15% or more of our common stock (an acquiring person) could suffer substantial dilution of its ownership interest under the terms of the Shareholder Rights Plan through the issuance of common stock or common stock equivalents to all shareholders other than the acquiring person.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There were no material changes in our exposure to market risk from June 30, 2005 to March 31, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

***Evaluation of Disclosure Controls and Procedures.*** Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective. We continue to review our disclosure controls and procedures and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our company's business.

***Changes in Internal Control over Financial Reporting.*** There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that occurred during the quarter ended March 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On January 31, 2006, we received a written notice and request for indemnification from Seismic Micro-Technology, Inc. ( SMT ), which had been named as a defendant in a patent infringement suit entitled *Landmark Graphics Corporation, et al. v. Paradigm Geophysical Corporation, et al.*, filed in the United States District Court for the Southern District of Texas. SMT based its request for indemnification on the terms of certain application developer agreements it entered into with us and certain of our subsidiaries. The complaint alleges infringement by SMT of U.S. patent number 6,765,570, and seeks injunctive relief, treble damages, costs and attorneys' fees. On February 22, 2006, SMT answered and filed counterclaims for declaratory judgment of non-infringement and invalidity. On February 28, 2006 we notified SMT that we would indemnify SMT from all costs and damages that may be awarded against SMT in the foregoing action, and would be responsible for attorneys' fees and expenses incurred by SMT in defense of the action, subject to certain conditions, including our right to control and direct the defense of the action on behalf of SMT. We believe there are meritorious defenses to the complaint and intend to contest it vigorously. However, an adverse resolution of this litigation could have an adverse effect on our consolidated financial position, results of operations or cash flows in the period in which the litigation is resolved. No costs have been accrued for this loss contingency.

We are also subject to legal proceedings and claims that arise in the ordinary course of business and in the opinion of management the outcome of these matters will not have a material adverse effect on our financial position, results of operations or cash flows.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

- (a) We acquired no common stock shares as of and for the quarter ended March 31, 2006 with respect to our share repurchase program.

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**ITEM 6. EXHIBITS**

The following Exhibits are filed or furnished, as applicable, herewith:

- 10.1 Form of Deferred Stock Award Agreement under the 2005 Stock Incentive Plan.
- 12.1 Ratio of Earnings to Fixed Charges.
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 32.1+ Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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+ Furnished herewith. This certificate shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.



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**MERCURY COMPUTER SYSTEMS, INC.**

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Chelmsford, Massachusetts, on May 9, 2006.

MERCURY COMPUTER SYSTEMS

By: **/s/ ROBERT E. HULT**  
**Robert E. Hult**

**Senior Vice President and**

**Chief Financial Officer**