

SIPEX CORP
Form 10-Q
August 17, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q**

(Mark One)

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

For the quarterly period ended July 2, 2005

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 0-27892

Sipex Corporation

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

04-6135748

(IRS Employer Identification No.)

**233 South Hillview Drive,
Milpitas, California 95035**

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code:

(408) 934-7500

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 in Rule 12b-2 of the Act). Yes No

Number of shares outstanding of the registrant's common stock, \$0.01 par value, as of the latest practicable date.

Class	Outstanding at August 15, 2006
Common Stock	35,550,378

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EXPLANATORY NOTE

On January 20, 2005, we announced that our audit committee had commenced an internal investigation over the possible improper recognition of revenue on sales for which price protection, stock rotation and return rights might have been granted. As a result of this investigation, we restated our previously reported results of operations for the fiscal year ended December 31, 2003 and restated quarterly information for all fiscal quarters in the year ended December 31, 2003 and the fiscal quarters ended April 3, 2004, July 3, 2004 and October 2, 2004 in our annual report on Form 10-K for the year ended January 1, 2005.

In addition, because of the internal investigation we delayed the timely filing of our Forms 10-K for the fiscal years ended January 1, 2005 and December 31, 2005, this quarterly report and our quarterly reports on Forms 10-Q for the periods ended April 2, 2005, October 1, 2005, April 1, 2006 and July 1, 2006.

We are also filing our annual reports on Form 10-K for the years ended January 1, 2005 and December 31, 2005 and our quarterly reports on Forms 10-Q for the periods ended April 2, 2005 and October 1, 2005 concurrently with this quarterly report.

SIPEX CORPORATION
FORM 10-Q
THREE MONTHS ENDED JULY 2, 2005
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SIPEX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)
(Unaudited)

	July 2, 2005	January 1, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 5,368	\$ 15,523
Restricted cash	735	613
Short-term investment securities		249
Accounts receivable, less allowances of \$757 and \$1,143, respectively	4,861	7,597
Accounts receivable, related party, less allowances of \$415 and \$271, respectively (Note 6)	4,190	2,311
Inventories	13,586	13,141
Prepaid expenses and other current assets	1,669	1,604
Total current assets	30,409	41,038
Property, plant, and equipment, net	33,386	45,318
Restricted cash noncurrent	1,103	1,225
Other assets	216	485
Total assets	\$ 65,114	\$ 88,066
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 8,211	\$ 10,863
Accrued expenses	6,251	5,855
Accrued restructuring costs	615	566
Deferred income, related party	6,104	5,874
Deferred income, other	3,600	3,534
Total current liabilities	24,781	26,692
Long-term accrued restructuring costs	983	1,281
Other long-term liabilities	40	13
Total liabilities	25,804	27,986
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 1,000 shares authorized and no shares issued or outstanding	355	354

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Common stock, \$0.01 par value, 60,000 shares authorized; 35,550 shares issued and outstanding at July 2, 2005 and 35,394 shares issued and outstanding at January 1, 2005

Additional paid-in capital	223,961	223,479
Accumulated deficit	(184,987)	(163,734)
Accumulated other comprehensive loss	(19)	(19)
Total stockholders' equity	39,310	60,080
Total liabilities and stockholders' equity	\$ 65,114	\$ 88,066

See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004 (Restated)	July 2, 2005	July 3, 2004 (Restated)
Net sales	\$ 10,567	\$ 8,409	\$ 22,374	\$ 19,341
Net sales, related party (Note 6)	7,765	8,100	15,685	15,319
Total net sales	18,332	16,509	38,059	34,660
Cost of sales	8,966	6,523	18,312	16,809
Cost of sales, related party	6,121	5,631	11,125	10,417
Total cost of sales	15,087	12,154	29,437	27,226
Gross profit	3,245	4,355	8,622	7,434
Operating expenses:				
Research and development	4,267	3,809	8,119	7,463
Marketing and selling	2,720	2,239	5,297	4,279
General and administrative	3,138	1,578	7,224	4,194
Restructuring	47	42	59	24
Impairment of fixed assets	9,377		9,377	
Total operating expenses	19,549	7,668	30,076	15,960
Loss from operations	(16,304)	(3,313)	(21,454)	(8,526)
Other income (expense):				
Interest income	61	37	146	82
Interest expense	(5)	(13)	(17)	(111)
Other income, net	47	52	94	107
Total other income, net	103	76	223	78
Loss before income tax expense (benefit)	(16,201)	(3,237)	(21,231)	(8,448)
Income tax expense (benefit)	10	(100)	22	(69)
Net loss	\$ (16,211)	\$ (3,137)	\$ (21,253)	\$ (8,379)

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Net loss per common share basic and diluted	\$ (0.46)	\$ (0.09)	\$ (0.60)	\$ (0.26)
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Weighted average common shares outstanding basic and diluted	35,550	33,089	35,538	31,849
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See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Six Months Ended	
	July 2,	July 3, 2004
	2005	(Restated)
Operating activities:		
Net loss	\$ (21,253)	\$ (8,379)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock compensation expense	4	44
Depreciation and amortization	2,856	3,427
Provision for inventories	2,979	1,029
Provision for restructuring charges	59	24
Impairment of fixed assets	9,377	
Amortization of discount and issuance costs on notes payable		57
Provision for uncollectible receivables and sales returns and allowances	829	693
Consulting services provided by related party	17	89
Changes in assets and liabilities:		
Accounts receivable	28	1,896
Inventories	(3,424)	(2,485)
Prepaid expenses and other current assets	(286)	321
Other assets	269	(276)
Accounts payable	(2,693)	347
Accrued expenses	396	(125)
Accrued restructuring costs	(308)	(224)
Deferred income	296	153
Other long-term liabilities	27	(6)
Net cash used in operating activities	(10,827)	(3,415)
Investing activities:		
Proceeds from maturity of short-term investment securities	850	4,000
Purchase of short-term investment securities	(601)	(3,998)
Restricted cash increase		(1,838)
Purchase of property, plant & equipment	(260)	(1,322)
Net cash used in investing activities	(11)	(3,158)
Financing activities:		
Proceeds from issuance of common stock under employee stock plans	683	345
Legal fees for conversion of note payable to common stock		(42)
Net cash provided by financing activities	683	303
Effect of foreign currency exchange rate changes on cash and cash equivalents		(12)

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Decrease in cash and cash equivalents	(10,155)	(6,282)
Cash and cash equivalents at beginning of period	15,523	18,338
Cash and cash equivalents at end of period	\$ 5,368	\$ 12,056
Supplemental cash flow information:		
Cash paid during the period for:		
Income taxes	\$ 29	\$ 13
Interest	\$	\$ 5
Supplemental disclosure of non-cash investing and financing activities:		
Purchase of property, plant and equipment not paid at end of period	\$ 154	\$ 444
Conversion of convertible debt to common stock	\$	\$ 21,177

See accompanying notes to condensed consolidated financial statements

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SIPEX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 Description of Business and Basis of Presentation**Description of Business**

Based in Milpitas, California, Sipex Corporation (Sipex or the Company) was incorporated in May 1965 under the laws of the State of Massachusetts. The state of incorporation from Massachusetts was changed to Delaware in October 2003. Sipex designs, manufactures and markets high performance, analog integrated circuits or ICs that primarily are used by original equipment manufacturers, or OEMs, operating in the computing, consumer electronics, communications and networking infrastructure markets. Some of the end product applications that contain Sipex s ICs are cellular phones, base stations, computers, DVD players, and digital cameras. Sipex s products are sold either directly or through an international network of manufacturers representatives and distributors.

The Company s wafer fabrication facility in Milpitas, California along with a number of third-party contractors fabricate, package and test its ICs. In an effort to achieve significant cost savings, in the third quarter of 2005 Sipex decided to close down the Milpitas wafer fabrication facility and transfer the IC manufacturing processes from there to a wafer fabrication facility operated by Hangzhou Silan Integrated Circuit Co., Ltd. (Silan) in Hangzhou, China and a wafer fabrication facility operated by Epasil Technologies, Inc. in Taiwan. Definitive agreements regarding this transfer were entered into in February 2006, and the transition is expected to be completed by the end of September 2006.

Basis of Presentation and Significant Accounting Policies

The accompanying interim unaudited condensed consolidated financial statements have been prepared by Sipex without audit and reflect all adjustments, consisting only of normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of the Company s financial position, results of operations and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. Accordingly, they do not include all information and footnotes required by generally accepted accounting principles for annual consolidated financial statements.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Sipex GmbH and Sipex Nippon. All significant inter-company accounts and transactions have been eliminated in consolidation.

Effective January 1, 2004, the Company s fiscal year was changed from a calendar year end to a 52 or 53-week fiscal year, which ends on the Saturday closest to December 31. As a result of the change in the fiscal reporting period, the six months ended July 3, 2004 included 185 days and the second quarter of 2004 covered 91 days from April 4, 2004 to July 3, 2004. The six months ended July 2, 2005 included 182 days and the second quarter of fiscal year 2005 covered 91 days from April 3, 2005 to July 2, 2005.

These unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended January 1, 2005. The results of operations for the three and six months ended July 2, 2005 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

Revenue Recognition

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) 104, Revenue Recognition. SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed or determinable; and (4) collectibility is reasonably assured.

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Through the year ended December 31, 2002, the Company recognized revenue from distributors other than Future Electronics Inc. (Future) upon title transfer and shipment because these customers had no price protection and had limited return rights. Distributors were permitted to return products limited to a percentage of their purchases over a specified period of time. The Company was able to estimate and establish appropriate reserves for future returns from these distributors, and historically the Company received stock rotation requests from its distributors that were within the amounts estimated and contractually allowed. Starting in the first fiscal quarter of 2003, the Company began entering into arrangements that were not within the original contractual distributor agreements in that the Company allowed return rights and other concessions beyond the levels provided in the distributor agreements. Due to this change in customer arrangements, Company management concluded it is unable to reasonably estimate sales returns for arrangements with its distributors. This change was accounted for as a change in estimate effective January 1, 2003, and resulted in sales and related cost of sales on shipments to distributors being deferred until the resale to the end customer.

Sales to Future are made under an agreement that provides protection against price reductions of Sipex's products in Future's inventory. In addition, Future has stock rotation rights. Pursuant to these stock rotation rights, Future is permitted on a quarterly basis to return for credit up to 10% of its total purchases during the most recent three-month period. This credit will be reduced to 5% applicable to all purchases made by Future from Sipex starting April 1, 2006. Additionally, the Company is providing Future with a 2% scrap allowance also effective April 1, 2006. As the price of products sold to Future is not fixed or determinable until resold by Future to the end customer, Sipex is using sell-through revenue recognition and deferring recognition of such sales and related cost of goods sold until the product is sold by Future to its customers.

Under sell-through revenue accounting, accounts receivable are recognized and inventory is relieved upon shipment to the distributor as title to the inventory is transferred upon shipment, at which point the Company has a legally enforceable right to collection under normal terms. The associated sales and cost of sales are deferred by recording deferred income (gross profit margin on these sales) as shown on the face of the consolidated balance sheet. When the related product is sold by the Company's distributors to their end customers, Sipex recognizes previously deferred income as sales and cost of sales.

For non-distributor customers, the Company recognizes revenue when title to the product is transferred to the customers, which occurs upon shipment or delivery, depending upon the terms of the customer order, provided that persuasive evidence of a sales arrangement exists, the price is fixed and determinable, title has transferred, collection of the resulting receivables is reasonably assured, there are no customer acceptance requirements, and there are no remaining significant obligations. Provisions for returns and allowances for non-distributor customers are provided for at the time product sales are recognized. An allowance for sales returns and allowances for customers is recorded based on historical experience or specific identification of an event necessitating an allowance.

From time to time, Sipex develops custom products for various customers under engineering service contracts culminating in delivery of known functional development samples. The Company recognizes revenue under these agreements upon delivery of known functional development samples as delivery of such represents the culmination of utility of the contract to the customer and agreed to milestones. Sipex recognizes the costs as incurred associated with these contracts and presents such costs as research and development expenses due to the uncertain nature of the development efforts until delivery of the known functional development samples. Certain of these engineering service contracts include payments in advance of delivery of known functional development samples. These payments are recorded in deferred income, other, until the time of delivery of the functional samples.

Note 2 Restatement

Subsequent to the issuance of the Company's condensed consolidated financial statements for the quarter ended July 3, 2004, management determined that such condensed consolidated financial statements should be restated to correct errors primarily related to revenue recognition. As a result, the Company's condensed consolidated financial statements for the three and six months ended July 3, 2004 have been restated.

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Previously, the Company's revenue recognition policy was to record revenue upon shipment to its distributors (the ship-to method) other than Future Electronics Inc. (Future). Subsequent to the issuance of the Company's July 3, 2004 quarterly financial statements, the Company's management became aware of certain sales return provisions that had been provided to distributors for arrangements entered into after January 1, 2003. The Audit Committee was informed by certain members of the management that these provisions were granted and an investigation was performed. Upon conclusion of the investigation, Company management determined that the sales returns provisions granted impacted their ability to reasonably estimate the sales returns reserve. As the Company could not estimate the sales returns reserve, the Company concluded that revenue for these transactions could not be recognized upon shipment to the distributors, and should have been deferred until the resale of the products to the end customers (the sell-through method). The impact on the financial statements for correcting these errors primarily resulted in deferring revenue that was previously recognized until later periods and in certain cases permanent reductions in revenue.

In addition, the Company identified and corrected various other errors related to the following revenue items: sales cut-off errors, reversal of revenue when collectibility was not reasonably assured, reversal of revenue related to an undocumented sale, and deferral of engineering service contract revenue. The Company also identified and corrected various other errors related to the following items: errors in the recording of manufacturing personnel costs, improperly capitalized fixed assets, errors in the calculation of depreciation, reclassification of foreign exchange gains to general and administrative expenses, improper presentation of accrued fixed asset additions, and certain other items.

The following are the restated operating results for the three and six months ended July 3, 2004 (in thousands, except net loss per share data):

	Three Months Ended July 3, 2004			Six Months Ended July 3, 2004		
	Previously Reported	Restated	Net Adjustment	Previously Reported	Restated	Net Adjustment
Net sales	\$ 7,847	\$ 8,409	\$ 562	\$ 18,374	\$ 19,341	\$ 967
Net sales, related party	7,889	8,100	211	15,459	15,319	(140)
Total net sales	15,736	16,509	773	33,833	34,660	827
Cost of sales	6,450	6,523	73	15,405	16,809	1,404
Cost of sales, related party	5,163	5,631	468	9,757	10,417	660
Total cost of sales	11,613	12,154	541	25,162	27,226	2,064
Gross profit	4,123	4,355	232	8,671	7,434	(1,237)
Research and development	4,039	3,809	(230)	7,599	7,463	(136)
Marketing and selling	2,178	2,239	61	4,153	4,279	126
General and administrative	1,711	1,578	(133)	4,439	4,194	(245)
Restructuring	59	42	(17)	59	24	(35)
Total operating expenses	7,987	7,668	(319)	16,250	15,960	(290)
Loss from operations	(3,864)	(3,313)	551	(7,579)	(8,526)	(947)
Total other income, net	79	76	(3)	84	78	(6)
Income tax benefit	(100)	(100)		(69)	(69)	

Net loss	\$ (3,685)	\$ (3,137)	\$ 548	\$ (7,426)	\$ (8,379)	\$ (953)
Net loss per common share basic and diluted	\$ (0.11)	\$ (0.09)	\$ 0.02	\$ (0.23)	\$ (0.26)	\$ (0.03)

Note 3 Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board (FASB) issued Emerging Issues Task Force (EITF) Issue No. 03-1, or EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments which provided new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. The disclosure requirements are effective for annual periods ending after June 15, 2004. The adoption of EITF 03-1 did not have a material impact on the Company's consolidated financial statements.

In October 2004, the FASB approved EITF Issue 04-10 Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds which addresses an issue in the application of paragraph 19 of Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and related information. EITF 04-10 is effective for fiscal years ending after September 15, 2005. The adoption of this issue did not have a material impact to the disclosures relating to the Company's consolidated financial statements.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4. The amendments made by SFAS No. 151 are intended to improve financial reporting by clarifying that abnormal amount of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred beginning on January 1, 2006. The adoption of SFAS No. 151 did not have a material impact on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS 123R (revised 2004), Share-Based Payment. SFAS 123R is a revision of FASB 123 and supersedes APB No. 25. SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments. SFAS 123R primarily focuses on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123R requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award over the period during which an employee is required to provide service for the award. The grant-date fair value of employee share options and similar instruments must be estimated using option-pricing models adjusted for the unique characteristics of those instruments unless observable market prices for the same or similar instruments are available. In addition, SFAS

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123R requires a public entity to measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value and that the fair value of that award will be re-measured subsequently at each reporting date through the settlement date. The effective date of SFAS 123R for us is January 1, 2006. Due to the anticipated increase in stock compensation costs, Sipex expects the adoption to have a significant impact on the Company's consolidated operating results.

In December 2004, the FASB staff issued FSP FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (the FSP) to provide guidance on the application of Statement 109 to the provision within the American Jobs Creation Act of 2004 (the Act) that provides tax relief to U.S. domestic manufacturers. The FSP states that the manufacturer's deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 and not as a tax rate reduction. A special deduction is accounted for by recording the benefit of the deduction in the year in which it can be taken in the Company's tax return, rather than by adjusting deferred tax assets and liabilities in the period of the Act's enactment (which would have been done if the deduction on qualified production activities were treated as a change in enacted tax rates). The FSP was effective upon issuance. The adoption of the FSP did not have a material impact on the Company's consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*, an amendment of Accounting Principles Board (APB) No. 29, *Accounting for Nonmonetary Transactions*. SFAS No. 153 requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits, or (2) the transactions lack commercial substance. SFAS No. 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of the standard did not have a material effect on the Company's consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS No. 154 establishes new standards on accounting for changes in accounting principles. Pursuant to the new rules, all such changes must be accounted for by retrospective application to the financial statements of prior periods unless it is impracticable to do so. The Statement is effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005, with early adoption permitted for changes and corrections made in years beginning after May 2005. Adoption of SFAS No. 154 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In November 2005, the FASB issued FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP 115-1)*, which replaces the measurement and recognition guidance set forth in the EITF Issue No. 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and codifies certain existing guidance on investment impairment. FSP 115-1 clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell the security has not been made, and also provides guidance on the subsequent accounting for an impaired debt security. FSP 115-1 also requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and is effective for reporting periods beginning after December 15, 2005. Sipex adopted the provisions of FSP 115-1 beginning on January 1, 2006, and the adoption did not have a material impact on the Company's financial condition or results of operations.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of FASB Statements No. 133 and 140. SFAS No. 155 will be effective for the Company beginning in the first quarter of 2007. The statement permits interests in hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation, to be accounted for as a single financial instrument at fair value, with changes in fair value recognized in earnings. This election is permitted on an instrument-by-instrument basis for all hybrid financial instruments held, obtained, or issued as of the adoption date. The Company is assessing the impact of the statement.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) as an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation clarifies the accounting for uncertainty in income taxes recognized by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken

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or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition of tax benefits previously recognized and additional disclosures for unrecognized tax benefits, interest and penalties. The evaluation of a tax position in accordance with this Interpretation begins with a determination as to whether it is more likely than not that a tax position will be sustained upon examination based on the technical merits of the position. A tax position that meets the more-likely-than-not recognition threshold is then measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement for recognition in the financial statements. FIN 48 is effective no later than fiscal years beginning after December 15, 2006, and is required to be adopted by the Company in the first quarter of fiscal year 2007. The Company is currently assessing the impact of the adoption of FIN 48.

Note 4 Stock-Based Compensation

The Company measures compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company applies the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-based Compensation Transition and Disclosure* as if the fair value-based method had been applied in measuring compensation expense.

Under APB Opinion No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized. In certain situations, under these plans, options to purchase shares of common stock may be granted at less than fair market value, which results in compensation expense equal to the difference between the market value on the date of grant and the purchase price. This expense is recognized over the vesting period of the options on a straight-line basis and included in the Company's results of operations.

As required under SFAS No. 123 and SFAS No. 148, the pro forma effects of stock-based compensation on net income (loss) and earnings per common share for employee stock options granted and employee stock purchase plan share purchases have been estimated at the date of grant and beginning of the period, respectively, as if the Company had accounted for such awards under the fair value method of SFAS No. 123 using the Black-Scholes option-pricing model. For purposes of pro forma disclosures, the estimated fair value of the options and shares is amortized to pro forma net income (loss) over the vesting period.

The Company's pro forma information for the three months and six months ended July 2, 2005 and July 3, 2004 is as follows (in thousands, except per share data):

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net loss, as reported	\$ (16,211)	\$ (3,137)	\$ (21,253)	\$ (8,379)
Add stock-based employee compensation included in reported net loss		44		44
Less stock-based employee compensation determined under the fair value method for all awards	(1,045)	(1,494)	(2,280)	(3,253)
Pro forma net loss	\$ (17,256)	\$ (4,587)	\$ (23,533)	\$ (11,588)
Net loss per share:				
Basic and diluted as reported	\$ (0.46)	\$ (0.09)	\$ (0.60)	\$ (0.26)
Basic and diluted pro forma	\$ (0.49)	\$ (0.14)	\$ (0.66)	\$ (0.36)

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For pro forma net loss computation, the fair value for each option grant was estimated at the date of grant using the Black-Scholes option-pricing model. The assumptions used to value the option grants are as follows:

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Expected life of options	4 years	5 years	4 years	5 years
Volatility	88%	61%	82%	62%
Risk-free interest rate	3.8%	3.7%	3.8%	3.4%
Dividend yield				

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The weighted average fair value of options granted for the three months ended July 2, 2005 and July 3, 2004 was \$1.10 and \$3.23, respectively.

There were no purchases of common stock under the Company's Employee Stock Purchase Plan (ESPP) in the second quarter of 2005. For the second quarter of 2004, the fair value of ESPP shares was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions: volatility of 61%, risk free rate of 1.39%, no dividend yield and an option life of six months. The weighted average fair value of ESPP shares for the second quarter of 2004 was \$1.37.

Note 5 Net Loss Per Share

Basic net loss per share is based upon the weighted average number of common shares outstanding. Diluted net loss per share is based upon the weighted average number of common and common equivalent shares outstanding assuming dilution. Common equivalent shares, consisting of outstanding stock options, convertible debt and warrants, are included in the per share calculations where the effect of their inclusion would be dilutive. As the Company had net a loss for the three and six months ended July 2, 2005 and July 3, 2004, the weighted average number of common shares outstanding equals the weighted average number of common and common equivalent shares assuming dilution.

Approximately 5,903,000 stock option shares were outstanding with an average exercise price of \$5.10 per share as of July 2, 2005 compared to approximately 6,679,000 stock option shares with an average exercise price \$5.52 per share at July 3, 2004.

Note 6 Related Party Transactions

Future is a related party as its affiliates own approximately 16.3 million shares or 46% of Sipex's outstanding common stock as of July 2, 2005. Sipex has a distribution agreement that provides for Future to act as the Company's sole distributor for certain products within North America and Europe. Sales to Future are made under an agreement that provides protection against price reduction for its inventory of Sipex's products. The Company recognizes revenue on sales to Future under the distribution agreement when Future sells the products to end customers. Future has historically accounted for a significant portion of the Company's revenues. It is the Company's largest distributor worldwide and accounted for 39% of its total net sales for the year ended January 1, 2005, and 42% and 49% of the Company's net sales during the three months ended July 2, 2005 and July 3, 2004, respectively. The Company anticipates that sales of its products to Future will continue to account for a significant portion of its revenues.

From time to time, Future provides services and/or incurs expenses on behalf of the Company. The fair value of the un-reimbursed expenses and uncompensated services rendered by Future has been recorded in the Company's consolidated financial statements as capital contributions for which none was recorded for the second quarter ended July 2, 2005 and \$17,000 was for the six months ended July 2, 2005, compared to \$64,000 and \$89,000 for the second quarter and six months ended July 3, 2004, respectively.

As discussed in Note 14, on January 19, 2006, Sipex announced the completion of a \$7.0 million private loan financing in which the Company issued a 9% secured note with convertible interest due January 19, 2008 to the affiliates of Future, which could provide these affiliates with the opportunity to obtain additional shares of Sipex common stock. The loan was repaid in March 2006 (See Note 14).

As discussed in Note 14, on May 16, 2006, Sipex placed \$30.0 million of its 5.5% Convertible Senior Notes (the 2006 Notes) due 2026 and related warrants in a private placement transaction to accredited investors in reliance on Regulation D under the Securities Act. Rodfre Holdings LLC (Rodfre), an affiliate of Alonim Investments Inc., Sipex's largest stockholder, and an affiliate of Future, purchased 50% of the 2006 Notes or \$15.0 million aggregate principal amount being placed in this offering. The 2006 Notes will mature on May 18, 2026 and bear interest at an annual rate of 5.5% payable semi-annually on May 15 and November 15 of each year, beginning on November 15, 2006.

For the second quarter and six months ended July 2, 2005, Sipex did not record any interest expense related to the debt with Future as both convertible notes were subsequently extinguished and converted into 4.6 million of the Company's common shares as of February 18, 2004. For the six months ended July 3, 2004, Sipex recorded interest expense for the debt with Future totaling \$58,000. There was no interest expense recorded for the second quarter ended July 3, 2004.

Table of Contents**Note 7 Restructuring and Impairment**

The Company has established a restructuring reserve relating to the unused portion of its leased facility in Billerica, Massachusetts. For the three and six months ended July 2, 2005, the Company utilized \$198,000 and \$371,000, respectively, of restructuring reserves which were primarily lease costs associated with the unused portion of the Billerica facility. The balance of the restructuring accrual as of July 2, 2005 consisted principally of facility lease costs.

Below is a summary of the activities related to restructuring and impairment charges for the six months ended July 2, 2005 (in thousands):

	Restructuring Costs	Fixed Asset Impairment
Accrual balance, January 1, 2005	\$ 1,847	\$
Incurring in 2005		
Charges utilized	(173)	
Sub-lease income received	44	
Adjustments to accrual	12	
Accrual balance, April 2, 2005	1,730	
Incurring in 2005		9,377
Charges utilized	(198)	(9,377)
Sub-lease income received	19	
Adjustments to accrual	47	
Accrual balance, July 2, 2005	\$ 1,598	

Impairment Charges

In the second quarter of 2005, Sipex recognized a \$9.4 million impairment charge for its long-lived assets. Based on changes in the planned use for its wafer fabrication assets, the Company performed an impairment evaluation in accordance with SFAS No. 144. Sipex determined that the appropriate grouping for this impairment evaluation was the wafer fabrication assets taken together and the associated cash flows for these assets. These assets were evaluated on a held-for-use basis as the Company was required to operate its wafer fabrication facility until the new wafer fabrication partner processes were qualified. As the carrying value exceeded the undiscounted cash flows of the wafer fabrication assets for the period of planned use by the Company, an impairment charge was recorded for the difference between the carrying value and the fair value of the wafer fabrication assets which management determined with the assistance of an independent appraisal firm. While the Company subsequently agreed to sell a substantial portion of its wafer fabrication machinery and equipment to Silan by the end of the third quarter of 2006, its wafer fabrication assets remain in use and Sipex will continue to record depreciation expense based on the estimated remaining useful life at the time of impairment.

Note 8 Comprehensive Loss

Comprehensive income (loss) is the total of net income (loss) and all other revenue, expenses, gains and losses recorded directly in equity. Sipex's other comprehensive loss consists of foreign currency translation adjustments. There were no foreign currency translation adjustments during the three and six month ended July 2, 2005, and no significant tax effect on the components of other comprehensive loss for the three and six months ended July 2, 2005 and July 3, 2004.

The following table provides the comprehensive loss information (in thousands):

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	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net loss	\$ (16,211)	\$ (3,137)	\$ (21,253)	\$ (8,379)
Other comprehensive loss:				
Foreign currency translation adjustment		(18)		(12)
Comprehensive loss	\$ (16,211)	\$ (3,155)	\$ (21,253)	\$ (8,391)

Note 9 Inventories

Inventories are as follows (in thousands):

	July 2, 2005	January 1, 2005
Raw materials	\$ 242	\$ 482
Work-in-process	9,550	9,512
Finished goods	3,794	3,147
Total	\$ 13,586	\$ 13,141

Note 10 Accrued Expenses

Accrued expenses are as follows (in thousands):

	July 2, 2005	January 1, 2005
Accrued compensation and benefits	\$ 2,436	\$ 2,177
Accrued audit fees	1,784	1,643
Accrued legal fees	475	158
Accrued royalties	344	711
Accrued commissions	323	318
Accrued warranty	189	228
Other	700	620
Total	\$ 6,251	\$ 5,855

Table of Contents**Note 11 Accrued Warranty**

Products are sold with warranties ranging from one to two years depending upon the customers. Reserve requirements are recorded in the period of sale and are based on an assessment of the products sold with warranty and historical warranty costs incurred. The Company also assesses its pre-existing warranty obligations and may adjust the amounts based on actual experience or changes in future expectations.

The following table summarizes the activity in the warranty reserve for the six months ended July 2, 2005 and July 3, 2004 (in thousands):

	July 2, 2005	July 3, 2004
Beginning accrued warranty	\$ 228	\$ 195
Warranty claims	(46)	(68)
Accruals for the period	7	169
Ending accrued warranty	\$ 189	\$ 296

Note 12 Segment Information and Major Customers

The Company's Chief Executive Officer (CEO) is considered to be the Company's chief operating decision maker. The Company has organized its operations based on a single operating segment: the development and delivery of high performance analog integrated circuits that are used primarily by original equipment manufacturers operating in the computing, communications and networking infrastructure markets. The CEO reviews financial information presented on a consolidated basis accompanied by disaggregated information about revenues by product family and geographic region for purposes of making operating decisions and assessing financial performance. The disaggregated revenue information reviewed on a product family basis by the CEO includes the interface, power management and optical storage families along with other legacy product families.

The disaggregated information reviewed on a product line basis by the CEO is as follows (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Interface	\$ 9,295	\$ 10,993	\$ 19,220	\$ 21,068
Power Management	4,626	4,780	9,327	10,556
Optical Storage	3,981	600	9,082	2,507
Other*	430	136	430	529
Total net sales	\$ 18,332	\$ 16,509	\$ 38,059	\$ 34,660

* Includes Legacy and other discontinued products.

Although Sipex has operations in Malaysia, China, Taiwan, Japan, Germany, Canada and Belgium, substantially all the Company's long-lived assets reside in the United States.

The Company markets its products primarily from its operations in the United States. International sales are made primarily to customers in Asia and Europe. Information regarding the Company's net sales derived from products shipped to different geographic regions is as follows (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Japan	\$ 4,769	\$ 2,241	\$ 10,347	\$ 5,410
United States	3,414	4,623	7,276	7,915
United Kingdom	2,766	2,482	5,670	4,841
China	2,403	1,843	3,925	3,103
Singapore	2,367	2,344	4,406	4,535
Taiwan	958	1,872	2,988	5,101
Asia, other than Japan, China, Taiwan, & Singapore	558	357	902	1,156
Rest of the world	1,097	747	2,545	2,599
Total net sales	\$ 18,332	\$ 16,509	\$ 38,059	\$ 34,660

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Information on major customers which accounted for 10% or more of the Company's total net sales and total gross accounts receivable is as follows:

	% of Total Net Sales				% of Total Gross	
	For the Three Months Ended		For the Six Months Ended		Accounts Receivable	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004	July 2, 2005	January 1, 2005
Future, a related party	42%	49%	41%	44%	45%	23%
Microtek, Inc.	13%	*	18%	*	*	23%
Komatsu	*	*	*	*	14%	*

* Less than 10%

Note 13 Commitments and Contingencies**Commitments**

On August 21, 2003, Sipex announced an exclusive sourcing agreement with PolarFab, a US-based semiconductor foundry. The Company is under obligation to make minimum purchase commitments based on quarterly rolling forecasts extending out to one year. The Company has also agreed to purchase no less than 50% of the rolling forecast on an ongoing basis through the term of this agreement. The initial term of the agreement is five years with renewals on a negotiated basis. As of July 2, 2005, the minimum purchase commitment with PolarFab was approximately \$2.6 million for the following twelve months.

On July 2, 2004, the Company entered into an agreement to use certain licensed tools for circuit design and development as well as maintenance support for a total future payment commitment of \$2.5 million over the next three and one-half years. The contract requires the Company to deposit 75% of the total commitment in a certificate of deposit account. As of July 2, 2005, restricted cash consisted of \$1.8 million held in a certificate of deposit as a guarantee of payment to fulfill the terms of a software license agreement which is included in the condensed consolidated balance sheet. The agreement expires on January 1, 2008.

Contingencies

Under the terms and conditions of the Company's sales agreements, Sipex has offered limited intellectual property indemnification to its customers. The indemnity limits the time within which an indemnification claim can be made and the amount of the claim. It is not possible to determine the maximum potential amount due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular situation. Historically, payments made by the Company for this type of claim have not had a material impact on its operating results or financial position, and the Company is not aware of any significant claims or potential claims under the agreements.

Pending Litigation

The Company is also subject to legal proceedings, claims, and litigation arising in the course of business. The Company defends itself vigorously against any such claims. The outcome of unresolved matters related to the Company's legal proceedings, claims and litigation is currently not determinable, and an unfavorable outcome could have a material adverse effect on the Company's consolidated financial position, results of operations, or cash flows.

Class Action Securities Litigation

Beginning on or about January 24, 2005, four securities class action suits were filed against Sipex and certain of its current and former officers and directors. All complaints were filed in the United States District Court for the Northern District of California, San Francisco. The captions of the cases were as follows: Keller v. Sipex Corporation, et al., (05-CV-00331) (WHA), Coil Partners LLC v. Sipex Corporation, et al., (05-CV-00392) (WHA), Levy v. Sipex Corporation, et al., (05-CV-00505) (WHA), and Jacobson v. Sipex Corporation, et al., (05-CV-00712) (WHA).

The securities class action suits were filed on behalf of the purchasers of Sipex's common stock in various class

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periods, beginning on or about April 10, 2003 and ending on January 20, 2005. The plaintiffs in these cases alleged, among other things, violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated there-under, and sought unspecified monetary damages and other relief against all defendants. Specifically, the complaints alleged that Sipex and the individual defendants made false or misleading public statements regarding its financial results during the class periods.

On March 25, 2005, four lead plaintiff motions were filed asking the Court to consolidate the class actions. Prior to the hearing on the lead plaintiff motions, the Levy and Keller plaintiffs voluntarily agreed to dismiss their complaints. On May 12, 2005, the Court consolidated the remaining cases under the caption In re Sipex Corporation Securities Litigation, Master File No. 05-CV-00392. Defendants Clyde Ray Wallin and Doug McBurnie were voluntarily dismissed from the action on August 16, 2005, and defendant Phil Kagel was granted a motion to dismiss on November 17, 2005.

On January 18, 2006, the Court preliminarily approved the settlement of the class action lawsuit. The settlement provides for a payment of \$6.0 million to the plaintiffs and will be entirely funded by proceeds from the Company's directors' and officers' insurance policy. The specific terms for distribution of the settlement fund to class members were disclosed in a notice which was sent to the class members. On April 6, 2006, the United States District Court for the Northern District of California, San Francisco, approved the final settlement of the securities class action lawsuit.

Stockholder Derivative Litigation

On February 8, 2005, a putative stockholder derivative suit was filed in the Superior Court of the State of California, County of San Mateo, on behalf of Sipex against certain of the Company's current and former officers and directors for alleged fiduciary duty violations, gross negligence, unjust enrichment and breach of contract (Lie v. McBurnie, et al., CIV444748). On March 25, 2005, a second putative stockholder derivative suit was filed in the Superior Court of the State of California, County of Santa Clara, on behalf of Sipex against certain of the Company's current and former officers and directors for alleged fiduciary duty violations, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment (Nagdev v. Maghribi, et al., 105CV038114).

The derivative complaints are based on similar facts and events as those alleged in the securities class actions complaints. Specifically, the complaints allege that the individual defendants deliberately damaged Sipex by, among other things, causing Sipex to improperly recognize and report revenue, causing the Company to issue false and misleading statements about its financial results, exposing Sipex to liability for securities fraud, and damaging its reputation.

On April 22, 2005, defendants in the Lie derivative action filed a petition with the Judicial Council of California to coordinate the cases in Santa Clara County Superior Court. The petition was granted on July 13, 2005 and the actions had since been coordinated and consolidated before Judge Komar in Santa Clara Superior Court, under the consolidated caption, Sipex Derivative Cases, Judicial Council Coordination Proceeding No. 4431, Lead Case No. 1-05-CV-038114.

On January 23, 2006, the Court approved the settlement of the stockholder derivative action. The settlement provided for a payment of \$300,000 to the plaintiffs, pursuant to the terms of the settlement agreement, and the adoption of certain corporate governance measures and the payment of attorneys' fees and expenses to the derivative plaintiff's counsel, all of which were funded entirely by proceeds from Sipex's directors' and officers' insurance policy.

Government Investigation

On February 18, 2005, Sipex announced that the Securities and Exchange Commission (the "SEC") had commenced a formal investigation into the same matters as those that were the subject of the Company's previously announced internal investigation into the Company's financial and transactional records with regard to revenue recognition for the years ended December 31, 2003 and January 1, 2005. The investigation is ongoing.

Table of Contents**DiPietro v. Sipex**

In April 2003, Plaintiff Frank DiPietro (former CFO of Sipex Corp.) brought an action against Sipex for his severance benefits. Sipex counterclaimed for approximately \$150,000 which was owed under a promissory note signed by Mr. DiPietro. In August 2004, Sipex filed two motions for summary judgment (one for Mr. DiPietro's claims against it and one for its counterclaim against Mr. DiPietro under the promissory note). In June 2005, the Middlesex Superior Court granted both Sipex's Motions for Summary Judgment. As a result, Mr. DiPietro was ordered to pay Sipex \$149,486 plus costs and interest which has now appreciated to approximately \$204,000 as of June 2006. Interest is added to this amount at twelve (12%) percent per year. Mr. DiPietro filed a notice of appeal on July 19, 2005. In addition, the court has required Mr. DiPietro to post a bond in the amount of \$150,000.

Note 14 Subsequent Events

On July 21, 2005, Sipex entered into a Loan and Security Agreement, with Silicon Valley Bank. The Loan and Security Agreement provides for a secured revolving line of credit with an aggregate principal amount of up to \$5.0 million, which may be used to borrow revolving loans or to issue lines of credit on the Company's behalf. The Company has granted to Silicon Valley Bank a security interest in all presently existing and later acquired collateral, including but not limited to goods, equipment, inventory, contract rights, and financial assets, in order to secure the obligations and duties of the Loan and Security Agreement. Advances accrue interest on the outstanding principal balance at an annual interest rate equal to Silicon Valley Bank's prime rate. The Loan and Security Agreement matured on July 20, 2006, (see Amendment No. 5 below) at which time all outstanding advances must be repaid, and all outstanding letters of credit must be cash collateralized. The Loan and Security Agreement requires the Company to comply with a minimum liquidity ratio and retain a minimum tangible net worth. The Loan and Security Agreement contains additional affirmative covenants, including, among others, covenants regarding the payment of taxes and other obligations, maintenance of insurance, reporting requirements and compliance with applicable laws and regulations. In addition, the Loan and Security Agreement contains negative covenants limiting the Company's ability to dispose of assets, change its business plans, be acquired or beneficially owned, merge or consolidate, incur indebtedness, grant liens, make investments, pay dividends, repurchase stock, and pay subordinated debt. The Loan and Security Agreement contains events of default that include, among others, non-payment of principal, interest or fees, inaccuracy of representations and warranties, violations of covenants, bankruptcy and insolvency events, any material adverse change, material judgments, cross defaults to certain other indebtedness and seizure of assets. The occurrence of an event of default will increase the applicable rate of interest by 5.0 % and would, unless waived by Silicon Valley Bank, result in the immediate payment of all of the Company's obligations under the Loan and Security Agreement.

On August 29, 2005, the board of directors of Sipex approved a plan to close its wafer fabrication operations located in Milpitas, California and transfer the fabrication to Silan in China to reduce costs and improve operating efficiencies. As a result, the Company recognized total restructuring charges of approximately \$871,000 in the second half of 2005 including severance and retention benefits totaling \$766,000 for approximately 70 employees and other exit costs of \$105,000. The Company currently anticipates that the facility closure activities will be substantially completed by the end of third quarter of 2006. In addition, during the third quarter of 2005, Sipex decided not to transfer the remaining operations in Billerica to Milpitas that was originally anticipated to be completed by the end of 2005.

On August 29, 2005, Sipex's board of directors approved the repricing of the employee stock options outstanding under its stock option plans, effective as of the close of business on September 6, 2005 with the exception that options granted pursuant to the Sipex Corporation 1999 Stock Plan and options granted to Sipex's current CEO and directors would not be repriced. In addition, outstanding options with current exercise prices below the fair market value of Sipex's common stock at the close of business on September 6, 2005 will also not be subject to the repricing. As such, approximately 2,456,000 options held by 235 employees, with a weighted-average exercise price of \$6.22 were modified on September 6, 2005 to lower the option exercise price to \$1.90 which equals to the fair market value of Sipex's common stock at the close of business as disclosed on the Pink Sheets on that date. No other changes were made to the terms of the repriced stock options. Compensation expense associated with the option repricing will be recorded until the options are exercised, cancelled, or otherwise expired and the expense or benefit for the increase or

decrease, respectively, in the fair market value of the Company's common stock in excess of the option's exercise price is recognized immediately for vested options and is recognized over the vesting period using an accelerated method for unvested employee options. Management anticipates that the variable accounting associated with the repriced options will cease upon the adoption of SFAS

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No. 123R, effective January 1, 2006.

On October 7, 2005, Sipex entered into an Amendment No. 1 to the Loan and Security Agreement with Silicon Valley Bank dated July 21, 2005. The Loan and Security Agreement was amended that the Bank would make advances not exceeding the lesser of (i) the borrowing base (as defined in the agreement) plus \$500,000, and (ii) the committed revolving line, minus the sublimit utilization amount. Amendment No. 1 also provided that the interest rate was amended at a per annum rate equal to the Prime Rate plus one percent (1.00%). In addition, the Loan and Security Agreement was amended to reflect a minimum liquidity ratio not less than 1.50:1.00 which is calculated as Sipex's consolidated accounts divided by the obligations, as well as a minimum amount of tangible net worth was required to be maintained for each quarter ended.

On November 10, 2005, Sipex entered into an Amendment No. 2 to the Loan and Security Agreement with Silicon Valley Bank dated July 21, 2005 (amended by Amendment No. 1 dated October 7, 2005). The Amendment No. 2 provided that the financial covenants section of the Loan and Security Agreement was amended to reflect the calculation of minimum liquidity ratio as the sum of (i) Sipex's unrestricted cash and cash equivalents and consolidated accounts divided by (ii) the obligations. Sipex was required to maintain a pre-determined tangible net worth as of the last day of each quarter. In addition, for purposes of such calculation, up to \$5,000,000 in non-cash charges relating to inventory write-downs might be added to the tangible net worth.

In November 2005, based on the previous decision to close the Company's wafer fabrication operation located at its Milpitas, California headquarters facility, the Company decided to sell this facility. As a result of this decision, the Company reduced the remaining estimated depreciation life for its headquarters building and related improvements from 25 years to approximately four months.

On January 19, 2006, Sipex announced the completion of a \$7.0 million private loan financing in which Sipex issued a 9% secured note with convertible interest due January 19, 2008 to an affiliate of Future. The Note was secured by a deed of trust on the Company's headquarters property located in Milpitas, California. Accrued interest on the Note was convertible into Sipex's common stock at the option of the holder on January 19, 2007 and January 19, 2008. The conversion price would be the volume weighted average price for sales of the common stock during the 20 trading days prior to the date of conversion. The holder of the note can require repayment of the note in the event of a change of control of Sipex or the sale of the property subject to the deed of trust. The note was subject to customary events of default. Interest on the note accrued at 9% compounded quarterly and payable at maturity. This loan was subsequently terminated and paid off in cash during March 2006 as described below.

On January 19, 2006, Sipex entered into an Amendment No. 3 to the Loan and Security Agreement with Silicon Valley Bank dated July 21, 2005 (amended by Amendment No. 1 dated October 7, 2005 and Amendment No. 2 dated November 10, 2005). In connection with the \$7.0 million private loan financing transaction mentioned above, Amendment No. 3 modified the Loan and Security Agreement to permit the granting of a lien on Sipex's headquarters property in Milpitas, California, the sale of the property and to make additional conforming changes. Amendment No. 3 also raises the interest rate to the prime rate plus 2% from the prime rate plus 1%. The note holder and Silicon Valley Bank also entered into a subordination agreement that sets out the inter-creditor arrangements between the two lenders.

On February 27, 2006, Sipex entered into a definitive Master Agreement with Silan. This transaction is related to the transaction Sipex announced in its Form 8-K filed on September 2, 2005, which reported that the board of directors of Sipex had approved a plan to close its wafer fabrication operations located in Milpitas, California and that Sipex and Silan would work together to enable Silan to manufacture semiconductor wafers using Sipex's process technology. The Master Agreement includes a Production Equipment Sale Agreement, Process Technology Transfer and License Agreement, Wafer Supply Agreement and Product License Agreement covering fabrication equipment sales, process technology transfers and related licensing, foundry manufacturing and product licenses, respectively. The initial term of the agreement is five years with renewals on a negotiated basis. As part of this arrangement, Sipex will receive a payment of \$1.2 million by letter of credit upon delivery of certain manufacturing equipment to Silan. In addition, Silan will pay Sipex a Process Technology Transfer Fee of \$0.3 million.

The Process Technology Transfer and License Agreement contemplates the transfer of eight (8) of Sipex's processes to Silan. After this transfer, Silan will commence the implementation of these processes. Silan will deliver

process qualification wafers to Sipex. Process qualification shall be deemed to have occurred when Sipex confirms to Silan that the process qualification wafers conform to Sipex's specifications. Once Sipex confirms to Silan that the process qualification wafers conform to Sipex's specifications, Silan shall manufacture and deliver product qualification wafers to Sipex. If such product qualification wafers achieve product qualification, Sipex

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shall notify Silan thereof and the relevant Sipex product shall be deemed to be qualified and Silan shall commence the commercial manufacture and supply of such Sipex product. Subject to Sipex's option to suspend in whole or in part its purchase commitment if Silan fails to meet any requirements under the wafer supply agreement, Sipex shall order an average of at least one thousand (1000) equivalent wafers per week, calculated on a quarterly basis, for two years.

On March 9, 2006, Sipex entered into an Agreement for Purchase and Sale of Real Property with Mission West Properties L.P. The agreement provides for the sale of Sipex's headquarters facility, located at 233 South Hillview Drive in Milpitas, California, (the Hillview facility) to Mission West Properties L.P. for a price of \$13.4 million in cash. The Hillview facility primarily consists of two buildings with approximately 95,690 total square feet (which includes 20,000 square feet of Class 10 clean room), approximately 293 on-site surface parking spaces, and the underlying land with improvements and all fixtures attached thereto. Simultaneously, Sipex entered into a Standard Form Lease agreement to lease back the Hillview facility from Mission West Properties L.P. The lease term is 60 months with average lease payments of approximately \$1.4 million per year. In addition, Sipex has provided a security deposit of \$1,265,000 in the form of an irrevocable standby letter of credit issued to Mission West Properties, L.P. under its \$5.0 million line of credit with Silicon Valley Bank. The security deposit is held as security for the faithful performance by Sipex for all of the terms, covenants, and conditions prescribed under the lease agreement. Further, Sipex will have an option to extend the lease for an additional five years when the current term lease expires.

This sale and leaseback arrangement is expected to be accounted for as a financing obligation as a result of the Company's continuing involvement in the arrangement.

The proceeds from the sale of the Company's Hillview facility were used to pay off and terminate the \$7.0 million private loan entered into on January 19, 2006, pursuant to a loan financing (noted above) with an affiliate of Future in which it issued a 9% Secured Note With Convertible Interest due January 19, 2008.

On May 16, 2006, the Company placed \$30.0 million of 5.5% Convertible Senior Notes due 2026 in a private placement. Rodfre, an affiliate of Future, purchased 50% of the 2006 Notes or \$15,000,000 aggregate principal amount being sold in this offering. The remainder of the 2006 Notes were purchased by other accredited investors. The Company intends to use the net proceeds from the private placement for general corporate purposes. The 2006 Notes bear interest of 5.5% per year, payable semi-annually on May 15 and November 15 of each year, commencing on November 15, 2006, and mature on May 18, 2026. The 2006 Notes are convertible into common stock at any time at a fixed conversion price of \$2.68 per share. If fully converted, the principal amount of the 2006 Notes would convert into approximately 11,194,030 shares of the Company's common stock. At any time following the effectiveness of a registration statement related to the resale of the common stock issuable upon the conversion of the 2006 Notes, the Company may, subject to certain conditions, elect to automatically convert the 2006 Notes into common stock if the average price of the Company's common stock exceeds 150% of the conversion price for at least 20 trading days during any consecutive 30 trading-day period, ending within 5 days of the notice of automatic conversion. The Company has the right to redeem the 2006 Notes at par plus accrued interest at anytime after May 15, 2009 and the purchasers have the right to require us to repurchase the 2006 Notes at par plus accrued interest on May 15 in 2011, 2016 and 2021.

The Company also issued to the purchasers of the 2006 Notes, warrants to purchase an aggregate of 1,679,104 shares of common stock of the Company at a rate of 55.97 warrants per \$1,000 of principal amount of 2006 Notes purchased. The warrants are exercisable at \$3.216 per share and expire in 2011. The Company has also agreed to file, by August 15, 2006, a registration statement with the Securities and Exchange Commission covering the resale of the 2006 Notes, the warrants and the common stock issuable upon conversion of the 2006 Notes and exercise of the warrants.

Upon issuance of the 2006 Notes, it is expected that a beneficial conversion feature will be recorded which will result in an increase in additional paid-in capital with a corresponding increase to debt discount to be amortized as interest expense. The Company is in the process of estimating the value of the beneficial conversion feature.

In connection with the issuance of the \$30.0 million 2006 Notes, on May 18, 2006, Sipex entered into Amendment No. 4 to the Loan and Security Agreement with Silicon Valley Bank dated July 21, 2005 (as amended by Amendment No. 1 dated October 7, 2005, Amendment No. 2 dated November 10, 2005 and Amendment No. 3 dated January 19, 2006). Amendment No. 4 modifies the Loan and Security Agreement to permit the 2006 Note transaction and the

scheduled cash interest payments.

On August 1, 2006, Sipex entered into Amendment No. 5 to the Loan and Security Agreement with Silicon Valley Bank dated July 21, 2005 (as amended by Amendment No. 1 dated October 7, 2005, Amendment No. 2 dated November 10, 2005, Amendment No. 3 dated January 19, 2006 and Amendment No. 4 dated May 18, 2006).

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Amendment No. 5 modifies the Loan and Security Agreement to: (1) extend the maturity date from July 20, 2006 to September 30, 2006, (2) delete entirely the Tangible Net Worth covenant contained in Section 6.7(b) and waive Sipex's non-compliance with such covenant for the periods ended April 1, 2006 and July 1, 2006 and (3) lower the interest rate to the prime rate from the prime rate plus 2%.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. The statements that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Form 10-Q are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, intends, estimates, predicts, potential, or continue or the negative or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot offer any assurance of future results, levels of activity, performance or achievements. Moreover, neither any other person nor we assume responsibility for the accuracy and completeness of such statements. Important factors that may cause actual results to differ from expectations include those discussed in Risk Factors beginning on Item 1A of Part II in this document. The terms Sipex, the Company, we, us, its and its used in this Form 10-Q refer to Sipex Corporation and its subsidiaries and its predecessors as a combined entity, except where the context requires otherwise.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, are available on its website at www.sipex.com/investor when such reports are available on the SEC website. The public may read and copy any materials filed by us with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. The contents of these websites are not incorporated into this filing. Further, our references to the Uniform Resource Locators (URLs) for these websites are intended to be inactive textual references only.

As discussed in Note 2 to the condensed consolidated financial statements, our financial statements for the three months ended April 3, 2004 and six months ended July 3, 2004 have been restated. The accompanying management's discussion and analysis gives effect to that restatement.

Overview

On June 21, 2005, a Nasdaq Listings Qualification Panel, the Panel, notified us that the Panel had denied our request for continued inclusion on the Nasdaq Global Market. Our common stock was delisted from the Nasdaq Global Market effective with the beginning of trading on June 23, 2005.

We design, manufacture and market, high performance, analog ICs that are used primarily by OEMs, operating in the computing, consumer, communications and networking infrastructure markets. Some of the end product applications that contain our ICs are cellular phones, base stations, computers, DVD players, and digital cameras. Our products fall into three major product families: power management, interface and optical storage.

We focus on several key areas to drive operating and financial performance, including product mix, new product introductions, capacity utilization, cost reductions and productivity. All of these key areas are interrelated and important in achieving improved gross margin.

Product mix between our three product families and the sale of new products within each of our product families can significantly impact overall gross margin. Power management product gross margins have a wide

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range depending on the mix of sales within this product family. The very high volume commodity products sold into the Asian market, such as power regulators, have generally lower margins. By contrast, our advanced power management product offerings, such as white LED (light emitting diode) drivers, and our Power Blox™ family, are newer products, and contribute typically higher margins. Interface products typically have more moderate margins, due to the multi-protocol family and the new low voltage interface products. Optical storage product gross margins are typically within range of our average margin. The products in this line are typically proprietary, but alternative suppliers often introduce competitive solutions.

Capacity utilization of our wafer fabrication facility in Milpitas, California was historically an important factor in driving gross margin improvement. In the past, a large portion of our fabrication cost structure was fixed, such as depreciation and payroll expense for process engineering and manufacturing support, and this structure provided for lower per unit costs as the volume of completed wafers increased. In the third quarter of 2005, we decided to outsource all of our wafer fabrication operations and to begin shutting down the Milpitas, California facility. We expect this transition to be completed by the third quarter of 2006. We believe that this transition will improve the margins of our interface products and certain of our commodity market power management products which we historically manufactured at the Milpitas facility; however, because of this transition away from the fixed cost structure, we will not recognize the same decrease in per unit manufacturing costs as production volumes increase.

Cost reductions and productivity improvements are required in order to remain competitive in our marketplace. Cost reductions are achieved in several ways, such as re-designing the products to shrink the size of the die providing more individual products per wafer produced. This generates increased output without adding significant incremental cost. Other cost reductions and productivity improvements come through product assembly and test yield improvement and test time reduction.

Net sales during the quarter ended July 2, 2005 were \$18.3 million, an increase of \$1.8 million or approximately 11% compared to the same period of 2004. The increase in sales for the three month period was due primarily to a \$3.4 million increase in sales of optical storage products, partly offset by a \$1.7 million and \$154,000 decrease in sales of interface and power management products, respectively. The demand for our optical storage products was driven by continuing high volume production of DVD drives using our products. Geographically, in the United States we experienced a sales decline of 26% for the second quarter compared to the same period in 2004. Net sales in Japan grew by 113% for the second quarter of 2005 compared to the same period last year. This growth was driven by the strong demand for our optical storage products.

Gross profit of \$3.2 million in the second quarter of 2005 decreased by \$1.1 million, or 25% from \$4.4 million, in the corresponding period of 2004. The decrease in gross profit for the second quarter was due primarily to a 24% increase in cost of sales. Our gross profit on sales of interface products declined due to lower sales, partly offset by an increase in the gross profit attributable to the higher sale of optical storage products.

As of July 2, 2005, we had cash and cash equivalents of \$5.4 million compared to cash and cash equivalents and short-term investments of \$15.8 million at January 1, 2005. The decrease of \$10.4 million was used principally to fund our ongoing operations. Net cash used in operations was \$10.8 million for the six months ended July 2, 2005, resulting primarily from the \$21.3 million net loss, partially offset by \$16.1 million non-cash expenses that were included in net loss, and the \$5.7 million use of cash from the change in assets and liabilities.

Restructuring and Impairment

During the fourth quarter of 2003, we established a \$1.0 million restructuring reserve for our facility in Billerica, Massachusetts. This followed our 2002 restructuring initiative in which we transferred our back end test operations to Asia in the first quarter of 2003 and began to integrate other support activities to Milpitas, California. By the fourth quarter of 2003 we had vacated and segregated approximately 75% of the Billerica, Massachusetts facility and are seeking a lessee for this unoccupied space. The restructuring reserve represents the present value of future lease payments subsequent to abandonment less any estimated sublease income net of associated costs. To estimate future sublease income, we worked with an independent broker to estimate the length of time to sublease the facility and the total amount to be received. However, our estimates of expected sublease income could change in the future based on factors that affect our ability to sublease this facility such as general economic conditions and the real estate market,

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among others. During the third quarter of 2004, we entered into a sublease arrangement for a portion of the facility and decided to relocate additional personnel to Milpitas, California. This resulted in additional restructuring costs of \$1.9 million for future lease payments, severance payments and write-off of leasehold improvements in Billerica. For the three and six months ended July 2, 2005, we respectively utilized \$198,000 and \$371,000 of restructuring reserves, which was primarily the lease cost associated with the unused portion of our Billerica facility.

In the second quarter of 2005, we recognized a \$9.4 million impairment charge for our long-lived assets. Based on changes in the planned use for our wafer fabrication assets, we performed an impairment evaluation in accordance with SFAS No. 144. We determined that the appropriate grouping for this impairment evaluation was the wafer fabrication assets taken together and the associated cash flows for these assets. These assets were evaluated on a held-for-use basis as we were required to operate our wafer fabrication facility until the new wafer fabrication partner processes were qualified. As the carrying value exceeded the undiscounted cash flows of the wafer fabrication assets for the period of planned use by us, an impairment charge was recorded for the difference between the carrying value and the fair value of the wafer fabrication assets which our management determined with the assistance of an independent appraisal firm. While we subsequently agreed to sell a substantial portion of our wafer fabrication machinery and equipment to Silan by the end of the third quarter of 2006, our wafer fabrication assets remain in use and we will continue to record depreciation expense based on the estimated remaining useful life at the time of impairment.

Results of Operations

The table below presents the statements of operations for the three months and six months ended July 2, 2005 and July 3, 2004, as a percentage of net sales:

	For the Three Months Ended		For the Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	82.3	73.6	77.3	78.6
Gross profit	17.7	26.4	22.7	21.4
Operating expenses:				
Research and development	23.3	23.1	21.4	21.5
Marketing and selling	14.8	13.5	13.9	12.3
General and administrative	17.1	9.5	19.0	12.1
Restructuring	0.3	0.3	0.2	0.1
Impairment of fixed assets	51.2	0.0	24.6	0.0
Total operating expenses	106.7	46.4	79.1	46.0
Loss from operations	(89.0)	(20.0)	(56.4)	(24.6)
Other income, net	0.6	0.4	0.6	0.2
Loss before income taxes	(88.4)%	(19.6)%	(55.8)%	(24.4)%

Net Sales

Net sales during the quarter ended July 2, 2005 were \$18.3 million, an increase of \$1.8 million or approximately 11% compared to the same period of 2004. The increase in sales for the three month period was due primarily to a \$3.4 million increase in sales of optical storage products, partly offset by a \$1.7 million and \$0.2 million decrease in sales of interface and power management products, respectively. For the six months ended July 2, 2005, net sales also increased 9.8% to \$38.1 million compared to \$34.7 million for the six months ended July 3, 2004. Sales of optical

storage products for the six months ended July 2, 2005 increased by \$6.6 million, but was partly offset by the \$1.8 million and \$1.2 million decreases in sales of interface and power management products, respectively. The demand for our optical storage products was driven by continuing high volume production of DVD drives using our products.

Geographically, in the United States we experienced a sales decline of 26% for the second quarter and 8.1% for the first six months of 2005 compared to the same period in 2004. Our international net sales made up 81% and 72% of the total net sales for the second quarter of 2005 and 2004, respectively, and 81% and 77% for the six months ended July 2, 2005 and July 3, 2004, respectively. In dollar terms, the international net sales were \$14.9 million and \$11.9 million for the second quarter of 2005 and 2004, respectively. For the six months ended July 2,

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2005 and July 3, 2004, international sales were \$30.8 million and \$26.7 million, respectively. Net sales in Japan grew by 113% for the second quarter and 91% during the first six months of 2005 compared to the same period last year. This growth was driven by the strong demand for our optical storage products. Net sales in Asia other than Japan declined by 2% and 12% in the second quarter and first six months of 2005, respectively, as compared to the same period in 2004 primarily as a result of lower sales of power management and interface products in Taiwan.

Gross Profit

Gross profit of \$3.2 million in the second quarter of 2005 decreased by \$1.1 million, or 25% from \$4.4 million, in the corresponding period of 2004. For the six months ended July 2, 2005, gross profit increased by 16% to \$8.6 million compared to \$7.4 million for the six months ended July 3, 2004. For the second quarter of 2005, our gross profit on sales of interface products declined due to lower sales, partly offset by an increase in the gross profit attributable to the higher sale of higher margin optical storage products. The overall increase in gross profit for the six months ended July 2, 2005 was primarily due to higher sales of optical storage products.

Research and Development

Research and development expenses were \$4.3 million and \$8.1 million for the second quarter and six months ended July 2, 2005, respectively, compared to \$3.8 million and \$7.5 million for the second quarter and six months ended July 3, 2004, respectively. The increase in expense for the three and six months ended July 2, 2005 as compared to the three and six months ended July 3, 2004, resulted primarily from an increase in spending for outside engineering design services, prototype wafers and new wafer mask sets, for new product development programs, partly offset by decreases in salaries and benefits, rent and maintenance expenses. The increase of \$0.7 million in research and development expense for the six-month period was due primarily to an increase in product development and consulting services, partly offset by lower spending in salaries, depreciation, building rent and maintenance expenses.

Marketing and Selling

Marketing and selling expenses were \$2.7 million and \$2.2 million for the second quarters of 2005 and 2004, respectively. The increase was primarily attributable to an increase in salaries and benefits for additional sales and marketing personnel compared to the corresponding period of 2004, as well as an increase in consulting fees in our Company's German sales subsidiary. For the six-month period, expenses were \$1.0 million higher than prior year due primarily to higher salaries, travel and consulting expenses.

As a percentage of net sales, marketing and sales were approximately 15% during the second quarter of 2005 compared to approximately 14% during the corresponding period of 2004, and 14% and 12% of net sales during the first six months of 2005 and 2004, respectively. These percentage and absolute dollar increases were primarily driven by higher spending on personnel in marketing and sales as well as higher consulting expenses incurred during the second quarter of 2005.

General and Administrative

General and administrative expenses were \$3.1 million and \$1.6 million for the second quarter of 2005 and 2004, respectively. The increase of \$1.5 million for the quarter was primarily driven by higher legal and accounting fees incurred related to our internal investigations relating to the restatement of our prior years' financial statements and fees for litigation. Expenses of \$7.2 million during the six months ended July 2, 2005 were \$3.0 million higher than the prior year's comparable period due primarily to higher legal and professional services fees for audits, litigation and investigation related expenses. This was partly offset by decreases in bad debt expense, depreciation, telephone and salaries expense.

As a percentage of net sales, general and administrative expense for the second quarter of 2005 increased from 10% in the second quarter of 2004 to 17% in the second quarter of 2005, and from 12% during the first half of 2004 to approximately 19% during the same period in 2005 for the same reasons as noted above.

Restructuring and Impairment

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In 2005, the restructuring charges of \$47,000 and \$59,000 to the three and six months ended July 2, 2005, respectively related to accruals for estimated expenses and adjustments to facility lease costs relating to our Billerica, Massachusetts facility, net of sublease income. In 2004, the charges of \$42,000 and \$24,000 to the three and six months ended July 3, 2004, respectively, related to accruals for estimated expenses and adjustments to facility lease costs relating to our Billerica, Massachusetts facility, net of sublease income and income from sale of excess equipment.

In the second quarter of 2005, we recognized a \$9.4 million impairment charge for our long-lived assets. Based on changes in the planned use for our wafer fabrication assets, we performed an impairment evaluation in accordance with SFAS No. 144. We determined that the appropriate grouping for this impairment evaluation was the wafer fabrication assets taken together and the associated cash flows for these assets. These assets were evaluated on a held-for-use basis as we were required to operate our wafer fabrication facility until the new wafer fabrication partner processes were qualified. As the carrying value exceeded the undiscounted cash flows of the wafer fabrication assets for the period of planned use by us, an impairment charge was recorded for the difference between the carrying value and the fair value of the wafer fabrication assets which our management determined with the assistance of an independent appraisal firm. While we subsequently agreed to sell a substantial portion of our wafer fabrication machinery and equipment to Silan by the end of the third quarter of 2006, our wafer fabrication assets remain in use and we will continue to record depreciation expense based on the estimated remaining useful life at the time of impairment.

Other Income, Net

Other income (expense), net, was \$103,000 and \$76,000 in the second quarter of 2005 and 2004, respectively, and \$223,000 and \$78,000 during six months ended July 2, 2005 and July 3, 2004. The increase was due primarily to an increase in interest income resulting from rising interest rates and decrease in interest expense related to the convertible debt issued to the affiliates of Future which was converted to our common stock in February of 2004.

Income Tax Expense (Benefit)

Income tax expense consisted principally of accruals for income taxes relating to our international locations. Income tax expense for the second quarter of 2005 was \$10,000 compared to a net tax benefit of \$100,000 in the same quarter last year. Income tax expense for the six months ended July 2, 2005 was \$22,000 compared to a net tax benefit of \$69,000 for the same period in 2004. For the prior year, the income tax benefit resulted from the favorable resolution of certain prior year foreign taxes at less than estimated amounts.

Liquidity and Capital Resources

As of July 2, 2005, we had cash and cash equivalents of \$5.4 million compared to cash and cash equivalents and short-term investments of \$15.8 million at January 1, 2005. The decrease of \$10.4 million was used principally to fund our ongoing operations.

Net cash used in operations was \$10.8 million for the six months ended July 2, 2005, resulting primarily from the \$21.3 million net loss, partially offset by \$16.1 million non-cash expenses that were included in net loss. Non-cash expense items primarily included \$9.4 million impairment charge relating to the planned closure of our wafer fabrication facility in Milpitas, California, \$3.0 million in provision for inventories, depreciation and amortization of \$2.9 million and \$0.8 million provision for uncollectible receivables and sales returns and allowances. The cash used in the change in assets and liabilities of \$5.7 million included \$3.4 million increase in inventories and \$2.7 million decrease in accounts payable. In comparison, net cash used in operating activities for the six months ended July 3, 2004 was \$3.4 million, resulting primarily from the \$8.4 million net loss, partially offset by \$5.4 million in non-cash items. Non-cash items during the first half of 2004 included \$3.4 million in depreciation and amortization, an increase in provision for uncollectible receivables and sales returns and allowances of \$0.7 million, and an increase in provision for inventories of \$1.0 million. The cash used in the change in assets and liabilities of \$0.4 million included a \$1.9 million decrease in accounts receivable, partially offset by a \$2.5 million increase in inventories.

Net cash used in investing activities was \$11,000 for the six months ended July 2, 2005. The change was made up primarily of \$0.6 million purchase of short-term investment securities and \$0.3 million purchase of property, plant and equipment, reduced by \$0.9 million proceeds from maturity of short-term investment securities. For the

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six months ended July 3, 2004, we used \$3.2 million cash in investing activities primarily to purchase \$4.0 million in short-term investment securities, \$1.8 million deposited in a restricted cash account to guarantee payment of contractual obligations with a supplier and the purchase of \$1.3 million in property, plant and equipment.

Net cash received from financing activities for the six months ended July 2, 2005 was \$0.7 million derived from the issuance of stock under the employee stock option plan. Net cash provided by financing activities during the same period in 2004 was \$0.3 million and included \$0.3 million from issuance of common stock under employee stock plans, partly offset by legal fees of \$42,000 incurred on conversion of convertible debt to common stock.

On July 21, 2005, we entered into a Loan and Security Agreement, with Silicon Valley Bank, and this agreement was subsequently amended on October 7, 2005, November 10, 2005, January 19, 2006, May 18, 2006, and August 1, 2006. The agreement currently provides for a secured revolving line of credit with an aggregate principal amount of up to \$5,000,000, which may be used to borrow revolving loans or to issue lines of credit on our behalf. We have granted to Silicon Valley Bank a security interest in all presently existing and later acquired collateral, including but not limited to goods, equipment, inventory, contract rights, and financial assets, in order to secure the obligations and duties under such loan and security agreement. Advances accrue interest on the outstanding principal balance at an annual rate equal to Silicon Valley Bank's prime rate. The agreement matures on September 30, 2006 at which time all outstanding advances must be repaid, and all outstanding letters of credit must be cash collateralized. The agreement requires us to comply with a minimum liquidity ratio. It also required us to retain a minimum tangible net worth. However, the latest amendment dated August 1, 2006, has modified the agreement to delete the requirement for a minimum tangible net worth and waive our non-compliance with the financial covenant on tangible net worth for the periods ended April 1, 2006 and July 1, 2006. The agreement contains additional affirmative covenants, including, among others, covenants regarding the payment of taxes and other obligations, maintenance of insurance, reporting requirements and compliance with applicable laws and regulations. In addition, the agreement contains negative covenants limiting our ability to dispose of assets, change our business plans, be acquired or beneficially owned, merge or consolidate, incur indebtedness, grant liens, make investments, pay dividends, repurchase stock, and pay subordinated debt. The agreement contains events of default that include, among others, non-payment of principal, interest or fees, inaccuracy of representations and warranties, violations of covenants, bankruptcy and insolvency events, any material adverse change, material judgments, cross defaults to certain other indebtedness and seizure of assets. The occurrence of an event of default will increase the applicable rate of interest by 5.0 % and would, unless waived by Silicon Valley Bank, result in the immediate payment of all of our obligations under the agreement.

On January 19, 2006, we announced the completion of a \$7.0 million private loan financing in which we issued a 9% secured note with convertible interest due January 19, 2008 to Rodfre, an affiliate of Future. The note was secured by a deed of trust on our headquarters property located in Milpitas, California. The holder of the note could require repayment of the loan in the event of, among other things, the sale of the property subject to the deed of trust. On March 9, 2006, we entered into an Agreement for Purchase and Sale of Real Property with Mission West Properties L.P. The agreement provides for the sale of Sipex's Hillview facility to Mission West Properties L.P. for a price of \$13.4 million in cash. We used the proceeds from the sale of our Hillview facility to pay off and terminate this loan. The remaining balance of \$6.4 million from the sale of the property will be used for operating activities.

Simultaneously with the sale of the Hillview property (See Note 14 of condensed consolidated financial statements), we entered into a Standard Form Lease agreement to lease back the facility from Mission West Properties L.P. The lease term is 60 months. In addition, we have provided a security deposit of \$1,265,000 in the form of an irrevocable standby letter of credit issued to Mission West Properties, L.P. under our line of credit with Silicon Valley Bank. The security deposit is held as security for our faithful performance of the terms, covenants, and conditions prescribed under the lease agreement.

On May 16, 2006 we sold \$30.0 million of 5.5% Convertible Senior Notes due 2026, or the 2006 Notes, in a private placement. The 2006 Notes bear interest of 5.5% per year, payable semi-annually on May 15 and November 15 of each year, commencing on November 15, 2006, and mature on May 16, 2026. The 2006 Notes are convertible into common stock at any time at a fixed conversion price of \$2.68 per share. If fully converted, the principal amount of the Notes would convert into approximately 11,194,030 shares of our common stock. At any time following the effectiveness of a registration statement related to the resale of the common stock issuable upon the

conversion of the 2006 Notes, we may, subject to certain conditions, elect to automatically convert the 2006 Notes into common stock if the average price of our common stock exceeds 150% of the conversion price for at least 20 trading days during any consecutive 30 trading-day period, ending within 5 days of the notice of automatic conversion. We have the right to

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redeem the 2006 Notes at par plus accrued interest at anytime after May 15, 2009 and the purchasers have the right to require us to repurchase the 2006 Notes at par plus accrued interest on May 15 in 2011, 2016 and 2021.

The 2006 Notes provide that since we were not current in our SEC filings by August 15, 2006, we will pay additional interest on the 2006 Notes at an annual rate of 1.5% for the period beginning August 15, 2006 through the date that our filings become current. In addition, if our common stock is not listed on the Nasdaq Global Market, the New York Stock Exchange or another national exchange or automated quotation system by December 31, 2006, we will pay additional interest on the 2006 Notes at an annual rate of 1.5% for the period beginning December 31, 2006 through the date that our common stock becomes listed for trading on one of the national exchanges. Likewise, the Registration Rights Agreement entered into in connection with the 2006 Notes provides that since we have not filed a registration statement for the shares of our common stock issuable upon conversion of the 2006 Notes or exercise of the warrants issued in connection with the 2006 Notes as of August 15, 2006, we will pay additional payments to the noteholders equal to a per annum rate of 0.8% times the principal amount of the Notes for the period beginning on August 15, 2006 through the date that the registration statement is filed; provided, however, that we may face increased payments if the filing of the registration statement is delayed by over 60 days, or if the registration statement is not declared effective by December 31, 2006.

A more detailed description of the terms of the 2006 Notes is presented in Note 14 to our condensed consolidated financial statements included in this 10-Q filing and in our Form 8-K filing with the Securities and Exchange Commission on May 22, 2006.

We believe that our existing cash and cash equivalents are adequate to fund operations, capital expenditures and research and development efforts for the next twelve months. We also believe that our management has taken and will continue to take appropriate actions to improve operations and obtain the necessary funds to finance our operations, capital expenditures and research and development efforts. However, in the event that we need to secure additional funds for operations, there is no guarantee that financing will be available or that it will be on terms that we will accept. In the long-term, management believes that the results of its recent years restructuring activities, cost control actions and revised product line focus will eventually result in a return to positive cash flow from operations at which time it anticipates that additional equity or debt financing would become available for financing working capital requirements and capital expenditure plans. However, there is no guarantee that we will return to positive cash flow from operations or that financing, if required, will be available or that it will be on terms that we will accept.

Critical Accounting Estimates and Policies

Our condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such statements requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reporting period and the reported amounts of assets and liabilities as of the date of the financial statements. Our estimates are based on historical experience and other assumptions that we consider to be appropriate in the circumstances. However, actual future results may vary from our estimates.

We believe that the following accounting policies are critical as defined by the Securities and Exchange Commission, in that they are both highly important to the portrayal of our financial condition and results, and require difficult management judgments and assumptions about matters that are inherently uncertain. We also have other important policies, including those related to derivative instruments and concentration of credit risk. However, these policies do not meet the definition of critical accounting policies because they do not generally require us to make significant estimates or judgments that are difficult or subjective. These policies are discussed in the Notes to the consolidated financial statements, which are included in our annual report on Form 10-K for the year ended January 1, 2005.

We believe the accounting policies below are the ones that most frequently require us to make estimates and judgments, and therefore are critical to the understanding of our results of operations:

1. revenue recognition;
2. valuation of inventories;

3. restructuring and fixed asset impairment; and,
4. income taxes.

There have been no significant changes to these policies from the disclosure noted in our annual report on Form 10-K for the year ended January 1, 2005.

Recent Accounting Pronouncements

Please refer to Note 3 of Notes to condensed financial statements included in Item 1 of Part I for a discussion of the expected impact of recently issued accounting standards.

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Contractual Obligations and Commitments

As of July 2, 2005, there have been no significant changes to our contractual obligations as provided in Management Discussion and Analysis of Financial Condition and Result of Operations of our Form 10-K for the year ended January 1, 2005.

As of July 2, 2005, we have no off-balance sheet arrangements as defined in Item 303(a) (4) of the SEC's Regulation S-K.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market Risk

We invest excess cash in financial investments that are sensitive to market risks as part of our investment strategy. None of these market-sensitive instruments are held for trading purposes. We do not own derivative financial instruments in our portfolio. The investment portfolio contains instruments that are subject to the risk of a decline in interest rates. As required by our investment policy, available funds are invested in a manner that assures maximum safety and liquidity and, secondarily, maximizes yield within such constraints.

Interest Rate Risk

Our financial investments consist primarily of high quality commercial paper and money market funds. We believe we have no material exposure to interest rate risk.

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio and interest expense we are charged on borrowings. We do not use derivative financial instruments or engage in hedging activities in our investment portfolio. We ensure the safety and preservation of our invested principal funds by limiting default risks, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities.

We had no investment in short term securities at July 2, 2005.

In 2005 we entered into a Loan and Security Agreement, as amended, with Silicon Valley Bank which provides us with a line of credit up to \$5,000,000 and charges interest at the prime rate. However, we do not believe that a hypothetical increase in market interest rates by 10% from current levels would result in a material increase in our overall expenses.

On May 16, 2006 we placed \$30.0 million of 5.5% Convertible Senior Notes due 2026. Although the rate may be increased if we do not meet certain conditions, the 2006 Notes provide for a fixed interest rate. A more detailed description of the terms of our 2006 Notes is provided in our annual report on Form 10-K for the year ended January 1, 2005 and in our Form 8-K filed with the Securities and Exchange Commission on May 22, 2006. Because the interest rates of the 2006 Notes were fixed, a hypothetical 10% increase in interest rates will not have a material effect on our financials.

Since we were not current in our SEC filings by August 15, 2006, we will pay additional interest on the 2006 Notes at an annual rate of 1.5% for the period beginning August 15, 2006 through the date that our filings become current. In addition, if our common stock is not listed on the Nasdaq Global Market, the New York Stock Exchange or another national exchange or automated quotation system by December 31, 2006, we will pay additional interest on the 2006 Notes at an annual rate of 1.5% for the period beginning December 31, 2006 through the date that our common stock becomes listed for trading on one of the national exchanges.

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Foreign Currency Exchange Risk

The majority of our sales, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of sales activities outside of the U.S., we enter into transactions in other currencies. We are primarily exposed to changes in exchange rates for the euro, Japanese yen, and British pound. Currently, we have no plan to enter into any foreign currency hedging program since the amounts involved have not been material. Foreign currency fluctuations did not have a material impact on our consolidated financial position, results of operations or cash flows for the quarters ended July 2, 2005 and July 3, 2004.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We evaluated the design and operating effectiveness of our disclosure controls and procedures as of July 2, 2005, under the supervision and with the participation of our management, pursuant to Rule 13a-15(b) of the Exchange Act. Based on this evaluation, our Chief Executive Officer (CEO) and Chief Financial Officer (CFO) concluded that our disclosure controls and procedures as defined in Rule 13a-15(e) were not effective in ensuring that information required to be included in our periodic SEC filings is recorded, processed, summarized, and reported within the time periods specified in the Commission's rules and forms and is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure, due to certain material weaknesses in our internal controls over financial reporting described in Management's Report On Internal Control Over Financial Reporting in Item 9A of our annual report on Form 10-K for the year ended January 1, 2005 that have not been remediated. Notwithstanding management's assessment that our disclosure controls and procedures as of July 2, 2005 were ineffective due to the material weaknesses that existed as of January 1, 2005, as described in our annual report on Form 10-K for the year then ended, we believe that the condensed consolidated financial statements contained in this report present fairly our financial condition, results of operations and cash flows for the periods covered thereby in all material respects in accordance with generally accepted accounting principles.

The material weaknesses in our internal control over financial reporting as of January 1, 2005 identified by our management related to the design and operation of controls in the following areas: (i) entity level controls, (ii) revenue accounting, and (iii) financial closing process - use of estimates.

Changes in Internal Control over Financial Reporting

Our management has committed considerable resources to the design, implementation, documentation, and testing of our internal controls. Additional efforts were also required to address certain internal control deficiencies. Our management believes that these efforts have or are reasonably likely to have, once implemented, a material effect on our internal control over financial reporting.

For the quarter ended July 2, 2005, our management took the following steps to address the material weaknesses that existed as of January 1, 2005:

Our new CEO, Ralph Schmitt, was hired in June 2005;

As part of our adoption of sell-through revenue accounting, noted in our Quarterly Report on Form 10-Q for the period ended April 2, 2005, we engaged an outside company to conduct inventory cycle counts on a rotating basis at all of our distributors' warehouses to verify quantities;

Our key financial managers began making periodic visits to our distributors by to emphasize the terms of the distribution agreements and the revenue reporting requirements of Sipex as a public company;

We implemented a process for conducting formal revenue recognition training sessions for key finance, sales and marketing personnel;

We implemented annual ethics training for all employees and we engaged a compliance firm to ensure that all employees read, understand and confirm critical accounting and ethics policies. All employees must now annually reaffirm our Code of Conduct, legal compliance policy and whistleblower procedures;

We increased management oversight by expanding our disclosure process to include all senior managers and sales and marketing personnel with responsibility for responding to issues raised during the financial reporting process and we require certifications from all executive management and key sales and marketing personnel;

We improved the documentation, communication and periodic review of our accounting policies throughout our domestic and international locations for consistency and compliance with generally accepted accounting principles;

We enhanced the training and education for our international finance and accounting personnel and new hire additions to the worldwide finance team;

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During the first fiscal quarter of 2005, our management took the following additional steps to address the material weaknesses that existed as of January 1, 2005:

We adopted sell-through revenue recognition for our sales to distributors other than Future. As part of this adoption, we advised our distributors that the terms of the distribution agreement are binding and any changes to those terms must be approved in writing by both our CEO and CFO. Additionally, we implemented more stringent policies and procedures regarding revenue accounting and oversight of contractual arrangements by requiring the review and approval from our CEO and CFO on non-standard sales terms and conditions of a significant nature;

During the remainder of 2005, our management took the following additional steps to address the material weaknesses that existed as of January 1, 2005:

We re-engineered the sales administration function so that all finance-related activities are performed by the finance staff. The finance department assumed responsibility for the customer credit issuance and tracking process and the external sales representative commission calculation;

During 2006, our management took the following additional steps to address the material weaknesses that existed as of January 1, 2005:

We conducted a formal review of the foreign locations in which we are doing business, evaluated the appropriate and necessary legal and tax structure for these foreign locations and then implemented such structure and the related internal controls to ensure compliance with local laws and regulations.

Our management is dedicated to improving our internal controls over financial reporting and intends to continue monitoring and upgrading our internal controls as necessary or appropriate for our business.

The nature and significance of the material weaknesses may prevent successful remediation of all the material weaknesses during fiscal year 2005.

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Part II: OTHER INFORMATION

Item 1. Legal Proceedings

The information included in Note 13 of Notes to condensed consolidated financial statements under the caption Pending Litigation in Item 1 is incorporated herein by reference.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth under Item 1A. Risk Factors included in our annual report on Form 10-K for the year ended January 1, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit Number

Title

31.1	Certification of Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of 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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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.

SIPEX CORPORATION

DATE: August 17, 2006

/s/ Clyde R. Wallin
Clyde R. Wallin
Chief Financial Officer and
Senior Vice President, Finance
(Duly Authorized Officer &
Principal Financial Officer)
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