

OSI SYSTEMS INC  
Form 10-Q  
May 08, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark one)

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

For the quarterly period ended March 31, 2007

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 0-23125

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**OSI SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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**California**  
(State or other jurisdiction of  
incorporation or organization)

12525 Chadron Avenue

Hawthorne, California 90250

**33-0238801**  
(I.R.S. Employer

Identification Number)

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(Address of principal executive offices)

(310) 978-0516

(Registrant's telephone number, including area code)

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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 Exchange Act). Yes  No

As of May 4, 2007, there were 16,980,202 shares of the registrant's common stock outstanding.

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****OSI SYSTEMS, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(in thousands, except share amounts)****(Unaudited)**

|  | <b>June 30,<br/>2006</b> | <b>March 31,<br/>2007</b> |
|--|--------------------------|---------------------------|
| <b>ASSETS</b>                                  |                          |                           |
| Current Assets:                                |                          |                           |
| Cash and cash equivalents                      | \$ 13,799                | \$ 18,787                 |
| Accounts receivable, net                       | 119,419                  | 120,134                   |
| Other receivables                              | 4,495                    | 4,811                     |
| Inventories                                    | 120,604                  | 121,702                   |
| Deferred income taxes                          | 13,752                   | 24,475                    |
| Prepaid expenses and other current assets      | 11,230                   | 16,176                    |
| <b>Total current assets</b>                    | <b>283,299</b>           | <b>306,085</b>            |
| Property and equipment, net                    | 42,521                   | 47,524                    |
| Goodwill                                       | 29,066                   | 45,927                    |
| Intangible assets, net                         | 44,046                   | 28,826                    |
| Other assets                                   | 4,141                    | 4,427                     |
| <b>Total assets</b>                            | <b>\$ 403,073</b>        | <b>\$ 432,789</b>         |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>     |                          |                           |
| Current Liabilities:                           |                          |                           |
| Bank lines of credit                           | \$ 10,857                | \$ 16,358                 |
| Current portion of long-term debt              | 1,251                    | 5,578                     |
| Accounts payable                               | 54,282                   | 57,102                    |
| Accrued payroll and related expenses           | 14,244                   | 14,808                    |
| Deferred income taxes                          | 2,186                    | 2,530                     |
| Advances from customers                        | 2,961                    | 7,416                     |
| Accrued warranties                             | 7,224                    | 7,239                     |
| Deferred revenue                               | 9,314                    | 8,306                     |
| Other accrued expenses and current liabilities | 18,824                   | 17,821                    |
| <b>Total current liabilities</b>               | <b>121,143</b>           | <b>137,158</b>            |
| Long-term debt                                 | 5,483                    | 26,965                    |
| Deferred rent                                  | 5,379                    | 5,240                     |
| Accrued pension                                | 2,280                    | 2,006                     |
| Deferred income taxes                          | 7,504                    | 8,148                     |
| Other long-term liabilities                    | 2,606                    | 4,955                     |
| <b>Total liabilities</b>                       | <b>144,395</b>           | <b>184,472</b>            |

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|   |            |            |
|---|------------|------------|
| Minority interest   | 9,731      | 9,723      |
| Commitments and Contingencies (Note 10)   |            |            |
| Shareholders' Equity:   |            |            |
| Preferred stock, no par value authorized, 10,000,000 shares; no shares issued or outstanding  |            |            |
| Common stock, no par value authorized, 100,000,000 shares; issued and outstanding, 16,598,361 and 16,973,202 shares at June 30, 2006 and March 31, 2007, respectively | 193,698    | 203,450    |
| Retained earnings   | 50,208     | 27,019     |
| Accumulated other comprehensive income  | 5,041      | 8,125      |
| Total shareholders' equity  | 248,947    | 238,594    |
| Total liabilities and shareholders' equity  | \$ 403,073 | \$ 432,789 |

See accompanying notes to consolidated financial statements.

**Table of Contents****OSI SYSTEMS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(Unaudited)**

|   | <b>Three Months Ended<br/>March 31,</b> |             | <b>Nine Months Ended<br/>March 31,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2006</b>                             | <b>2007</b> | <b>2006</b>                            | <b>2007</b> |
| Revenues  | \$ 108,092                              | \$ 126,498  | \$ 327,100                             | \$ 379,485  |
| Cost of goods sold  | 65,019                                  | 82,562      | 201,932                                | 257,772     |
| Gross profit  | 43,073                                  | 43,936      | 125,168                                | 121,713     |
| Operating expenses:   |   |             |  |             |
| Selling, general and administrative                                   | 33,805                                  | 36,199      | 100,738                                | 110,531     |
| Research and development  | 8,851                                   | 11,390      | 26,281                                 | 33,424      |
| Impairment, restructuring, and other charges                          |   | 2,226       | 800                                    | 23,769      |
| Other operating expenses  | 51                                      | 110         | 624                                    | 658         |
| Total operating expenses  | 42,707                                  | 49,925      | 128,443                                | 168,382     |
| Income (loss) from operations   | 366                                     | (5,989)     | (3,275)                                | (46,669)    |
| Other income (expense):   |   |             |  |             |
| Interest expense  | (236)                                   | (1,239)     | (1,186)                                | (3,520)     |
| Interest income   | 91                                      | 85          | 180                                    | 322         |
| Other   |   | 15,772      | 349                                    | 15,772      |
| Income (loss) before provision for income taxes and minority interest | 221                                     | 8,629       | (3,932)                                | (34,095)    |
| Provision (benefit) for income taxes                                  | (820)                                   | 3,678       | (1,816)                                | (11,607)    |
| Income (loss) before minority interest                                | 1,041                                   | 4,951       | (2,116)                                | (22,488)    |
| Minority interest   | (30)                                    | (1,338)     | (976)                                  | (553)       |
| Net income (loss)   | \$ 1,011                                | \$ 3,613    | \$ (3,092)                             | \$ (23,041) |
| Earnings (loss) per share:  |   |             |  |             |
| Basic   | \$ 0.06                                 | \$ 0.21     | \$ (0.19)                              | \$ (1.37)   |
| Diluted   | \$ 0.06                                 | \$ 0.21     | \$ (0.20)                              | \$ (1.37)   |
| Shares used in per share calculation:                                 |   |             |  |             |
| Basic   | 16,438                                  | 16,920      | 16,326                                 | 16,779      |
| Diluted   | 16,766                                  | 17,237      | 16,326                                 | 16,779      |

See accompanying notes to consolidated financial statements.

**Table of Contents****OSI SYSTEMS, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(amounts in thousands)****(Unaudited)**

|  | <b>Nine Months Ended<br/>March 31,</b> |                 |
|--|--|-----------------|
|  | <b>2006</b>                            | <b>2007</b>     |
| <b>Cash flows from operating activities:</b>                                       |  |                 |
| Net loss   | \$ (3,092)                             | \$ (23,041)     |
| <b>Adjustments to reconcile net loss to net cash used in operating activities:</b> |  |                 |
| Depreciation and amortization  | 9,985                                  | 13,960          |
| Settlement of Spacelabs purchase price dispute                                     |  | (15,000)        |
| Stock based compensation expense   | 4,083                                  | 4,187           |
| Minority interest in net income of subsidiary                                      | 976                                    | 553             |
| Equity in undistributed earnings (losses) of unconsolidated affiliates             | (288)                                  | 499             |
| Deferred income taxes  | (2,124)                                | (13,245)        |
| Impairment of long-lived assets  | 447                                    | 21,543          |
| In-process research and development  |  | 561             |
| Other  | (287)                                  | 156             |
| <b>Changes in operating assets and liabilities net of business acquisitions:</b>   |  |                 |
| Accounts receivable  | (12,001)                               | 5,831           |
| Other receivables  | (3,681)                                | 257             |
| Inventories  | (10,417)                               | 2,627           |
| Prepaid expenses and other current assets  | (1,036)                                | (2,778)         |
| Accounts payable   | 2,174                                  | (583)           |
| Accrued payroll and related expenses   | 257                                    | 427             |
| Advances from customers  | 7,068                                  | 4,491           |
| Accrued warranties   | 279                                    | (68)            |
| Deferred revenue   | 650                                    | (2,101)         |
| Other accrued expenses and current liabilities                                     | (4,405)                                | (6,505)         |
| <b>Net cash used in operating activities</b>                                       | <b>(11,412)</b>                        | <b>(8,229)</b>  |
| <b>Cash flows from investing activities:</b>                                       |  |                 |
| Proceeds from sale of property and equipment                                       |  | 205             |
| Acquisition of property and equipment  | (10,672)                               | (10,825)        |
| Proceeds from sale of marketable securities  | 921                                    | 147             |
| Purchase of investments and marketable securities                                  | (599)                                  | 27              |
| Cash paid for business acquisitions, net of cash acquired                          | (311)                                  | (23,432)        |
| Settlement of Spacelabs purchase price dispute                                     |  | 15,000          |
| Intangible and other assets  | (310)                                  | (1,675)         |
| <b>Net cash used in investing activities</b>                                       | <b>(10,971)</b>                        | <b>(20,553)</b> |
| <b>Cash flows from financing activities:</b>                                       |  |                 |
| Net proceeds (payments) from bank lines of credit                                  | (11,866)                               | 5,478           |
| Net proceeds from long-term debt   | 1,434                                  | 22,159          |
| Net proceeds (payments) on capital lease obligations                               | (229)                                  | 1,583           |
| Proceeds from exercise of stock options, warrants and employee stock purchase plan | 3,786                                  | 5,404           |
| Proceeds from issuance of subsidiary stock   | 26,270                                 |                 |

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|  |           |           |
|--|-----------|-----------|
| Net cash provided by financing activities            | 19,395    | 34,624    |
| Effect of exchange rate changes on cash              | 1,462     | (854)     |
| Net increase (decrease) in cash and cash equivalents | (1,526)   | 4,988     |
| Cash and cash equivalents-beginning of year          | 14,623    | 13,799    |
| Cash and cash equivalents-end of year                | \$ 13,097 | \$ 18,787 |
| Supplemental disclosure of cash flow information:    |           |           |
| Cash paid for interest                               | \$ 1,155  | \$ 3,513  |
| Cash paid for income taxes                           | \$ 2,370  | \$ 3,212  |

See accompanying notes to consolidated financial statements.



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**OSI SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

*Description of Business*

OSI Systems, Inc. (the Company) is a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. The Company sells its products in diversified markets, including homeland security, healthcare, defense and aerospace.

The Company has three operating divisions: (a) Security, providing security inspection systems; (b) Healthcare, providing medical monitoring and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for affiliated end-products divisions, as well as for external clients in the defense and aerospace markets, among others.

The Company's Security division designs, manufactures and markets security and inspection systems worldwide to end users primarily under the Rapiscan Systems trade name. Rapiscan Systems products are used for the non-intrusive inspection of baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband and to screen people. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold (checked) baggage screening and people screening.

The Company's Healthcare division designs, manufactures and markets medical monitoring and anesthesia systems worldwide to end users, primarily under the Spacelabs Healthcare trade name. The products and services of this division include network and connectivity solutions, ambulatory blood pressure monitors and related services as well as cardiac monitoring and diagnostic services.

The Company's Optoelectronics and Manufacturing division designs, manufactures and markets optoelectronic devices and value-added manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, computed tomography (CT), toll and traffic management systems, fiber optics, telecommunications, weapons simulation systems, gaming, office automation, computer peripherals and industrial automation. The Company sells optoelectronic devices under the OSI Optoelectronics trade name and performs value-added manufacturing services under the OSI Electronics trade name. This division provides products and services to original equipment manufacturers, as well as to the Company's own Security and Healthcare divisions.

*Basis of Presentation*

The consolidated financial statements include the accounts of OSI Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The consolidated financial statements have been prepared by the Company, without audit, pursuant to Financial Accounting Principles Board (FASB) Opinion No. 28, Interim Financial Reporting and the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company's management, all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the financial position and the results of operations for the periods presented have been included. These consolidated financial statements and the accompanying notes 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 fiscal year ended June 30, 2006, filed with the Securities and Exchange Commission on September 22, 2006. The results of operations for the three and nine months ended March 31, 2007 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future periods.

*Reclassifications*

Certain reclassifications have been made to prior period amounts to conform to the current year's presentation.

*Spacelabs Healthcare Public Offering*

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In October 2005, Spacelabs Healthcare, Inc., a subsidiary comprising the business operations of the Company's Healthcare division, completed an initial public offering of approximately 20% of its total issued and outstanding common stock. The Spacelabs Healthcare shares trade under the ticker symbol SLAB on the AIM (formerly known as the Alternative Investment Market), a stock

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market administered by the London Stock Exchange. As a result of the initial public offering, the Company recorded minority interest in Spacelabs Healthcare of \$7.6 million, representing approximately 20% of Spacelabs Healthcare's issued and outstanding shares. The Company treated the initial public offering as a capital transaction in accordance with Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 51 Accounting for Sales of Stock of a Subsidiary. The offering resulted in \$26.3 million in proceeds, net of expenses.

During the third quarter of fiscal year 2007, the Company repurchased 575,000 shares of common stock of Spacelabs Healthcare in the open market for \$1.1 million. The repurchase of shares of Spacelabs Healthcare resulted in an increase in goodwill in the amount of \$0.7 million, representing the excess cost over the underlying book value of the shares, and in a decrease in the Company's minority interest from approximately 20% to approximately 19%.

### *Impairment of Long-Lived Assets*

The Company tests goodwill for impairment in accordance with SFAS 142, Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 requires that goodwill be tested for impairment at the reporting unit level at least annually and more frequently upon the occurrence of certain events. For purposes of SFAS 142, the Company has determined that it has five reporting units, consisting of the Security division, Optoelectronics and Manufacturing division and three reporting units within the Healthcare division. The Company tests goodwill for impairment annually in its second fiscal quarter using a two-step process. First, the Company determines if the carrying amount of any of the reporting units within each of its divisions exceeds its fair value. It uses a discounted cash flows method to make this determination for its Security and Optoelectronics and Manufacturing divisions and it uses a market value method for the reporting units within its Healthcare division (based on the market price of Spacelabs Healthcare common stock on the AIM). If these methods indicate a potential impairment of goodwill associated with any reporting unit, the Company then compares the implied fair value of the goodwill associated with the respective reporting unit to its carrying amount to determine if there is an impairment loss. The Company performed its annual impairment test for goodwill during the second quarter of fiscal year 2007 and found no impairment of goodwill.

In accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets, the Company evaluates long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment is considered to exist if the total estimated future cash flows on an undiscounted basis are less than the carrying amount of the assets. If an impairment does exist, the Company measures the impairment loss and records it based on the discounted estimate of future cash flows. In estimating future cash flows, the Company groups assets at the lowest level for which there are identifiable cash flows that are largely independent of cash flows from other asset groups. The Company's estimate of future cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors.

During the second quarter ended December 31, 2006, the Company recognized non-cash impairment charges totaling \$21.5 million relating to software development costs, core technology, developed technology, customer relationships/backlog and fixed assets. Of the \$21.5 million impairment charge, the Company recognized \$21.3 million within the Security division and \$0.2 million within the Optoelectronics and Manufacturing division. See Note 5 for additional information about these impairment charges.

### *Derivative Instruments*

The Company may, from time to time, purchase foreign exchange contracts in order to attempt to reduce foreign exchange transaction gains and losses, or enter into interest rate swaps. As of June 30, 2006, the Company had a \$25.4 million foreign currency forward contract outstanding to buy British pounds in anticipation of the acquisition by Spacelabs Healthcare of the Del Mar Reynolds cardiac division of Ferraris Group PLC. Transaction gains during the year ended June 30, 2006, included a \$0.5 million gain related to this contract. In July 2006, the Company completed the Del Mar Reynolds acquisition and the foreign currency forward contract settled, resulting in a loss related to this contract of \$24,000 for the nine months ended March 31, 2007.

### *Per Share Computations*

The Company computes basic earnings per share by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. The Company computes diluted earnings per share by dividing net income available to common shareholders by the sum of the weighted average number of common and dilutive potential common shares outstanding. Potential common shares consist of the shares issuable upon the exercise of stock options or warrants under the treasury stock method. The Company excludes from the calculation of diluted earnings per share stock options and warrants with exercise prices greater than the average market price of the Company's common stock because their effect would otherwise be anti-dilutive. Stock options and warrants to purchase a total of 337,500 and 1,472,705 shares of common stock for the three and nine months ended March 31, 2007, respectively, were not included in diluted earnings per share calculations because to do so would have been



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antidilutive. Stock options and warrants to purchase a total of 958,500 and 2,140,365 shares of common stock for the three and nine months ended March 31, 2006, were not included in diluted earnings per share calculations because to do so would have been antidilutive. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

|   | Three months Ended<br>March 31, |          | Nine months Ended<br>March 31, |             |
|---|---------------------------------|----------|--------------------------------|-------------|
|   | 2006                            | 2007     | 2006                           | 2007        |
| Net income (loss)                               | \$ 1,011                        | \$ 3,613 | \$ (3,092)                     | \$ (23,041) |
| Effect of dilutive interest in subsidiary stock | (33)                            | (64)     | (198)                          | (27)        |
| Income (loss) available to common shareholders  | \$ 978                          | \$ 3,549 | \$ (3,290)                     | \$ (23,068) |
| Weighted average shares outstanding basic       | 16,438                          | 16,920   | 16,326                         | 16,779      |
| Dilutive effect of stock options and warrants   | 328                             | 317      |                                |             |
| Weighted average of shares outstanding diluted  | 16,766                          | 17,237   | 16,326                         | 16,779      |
| Basic earnings (loss) per share                 | \$ 0.06                         | \$ 0.21  | \$ (0.19)                      | \$ (1.37)   |
| Diluted earnings (loss) per share               | \$ 0.06                         | \$ 0.21  | \$ (0.20)                      | \$ (1.37)   |

*Comprehensive Income*

Comprehensive income (loss) is computed as follows (in thousands):

|  | Three months Ended<br>March 31, |          | Nine months Ended<br>March 31, |             |
|--|---------------------------------|----------|--------------------------------|-------------|
|  | 2006                            | 2007     | 2006                           | 2007        |
| Net income (loss)                        | \$ 1,011                        | \$ 3,613 | \$ (3,092)                     | \$ (23,041) |
| Foreign currency translation adjustments | 1,693                           | 1,030    | 708                            | 3,159       |
| Minimum pension liability adjustment     |                                 | (2)      |                                | (57)        |
| Other                                    | 27                              |          | (81)                           | (26)        |
| Comprehensive income (loss)              | \$ 2,731                        | \$ 4,641 | \$ (2,465)                     | \$ (19,965) |

*Recent Accounting Pronouncements*

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes. This interpretation clarifies how companies should account for uncertainty in income taxes that they recognize in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company has not yet determined the impact that this interpretation will have on its consolidated financial statements.

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the impact that this statement will have on its consolidated financial statements.

In September 2006, FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). This statement requires that an employer recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability, as applicable, in its statement of financial position and that it recognize, in comprehensive income of a business entity, any changes in such status in the year in which the changes occur. This statement also requires that an employer measure the funded status of a plan as of the date of its year-end

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statement of financial position, with limited exceptions. This statement is effective for fiscal years ending after December 15, 2006. The Company has not yet determined the impact that this statement will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities- including an amendment of SFAS No. 115, ( SFAS 159 ). SFAS No. 159 allows companies to elect to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been chosen are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the impact, that this statement will have on its consolidated financial statements.

**Table of Contents****2. Business Acquisitions***Del Mar Reynolds*

In July 2006, the Company's majority-owned subsidiary, Spacelabs Healthcare, completed the acquisition of the Del Mar Reynolds Cardiac division of Ferraris Group PLC. Pursuant to the terms of the acquisition agreement, Spacelabs Healthcare made an initial cash payment of \$25.9 million, subject to a working capital adjustment and to an adjustment of plus or minus \$1.9 million based upon revenue and earnings results for Del Mar Reynolds for the 13-month period ending September 30, 2006. In September 2006, Ferraris Group PLC paid \$1.7 million in connection with the working capital adjustment and in November 2006 it paid an additional \$1.9 million as a result of the failure of Del Mar Reynolds to meet certain revenue and earnings results for the 13-month period ending September 30, 2006.

Contingent consideration of up to £5 million (\$9.8 million at March 31, 2007) will be payable if Del Mar Reynolds achieves certain revenue targets during fiscal year 2007. The additional earn-out, if any, may be satisfied, at Spacelabs Healthcare's discretion, either in cash or by the issuance of Spacelabs Healthcare common stock. As of March 31, 2007, no contingent consideration has been earned. This acquisition expands the portfolio of products that the Company's Healthcare division offers to the hospital market with the addition of cardiac monitoring systems. Del Mar Reynolds also offers a core laboratory business that provides clinical trial services to pharmaceutical companies and to clinical research organizations.

The results of operations for Del Mar Reynolds have been included in the consolidated financial statements as of the date of acquisition. The total cost of the acquisition, excluding the potential earn-out, was as follows (in thousands):

|  |                  |
|--|------------------|
| Cash paid for common stock   | \$ 25,879        |
| Less refund pursuant to working capital adjustment                   | (1,694)          |
| Less receivable pursuant to 13-month revenue and earnings adjustment | (1,872)          |
| Direct costs   | 814              |
| <b>Total purchase price</b>  | <b>\$ 23,127</b> |

The Company has based the preliminary allocation of the purchase price on an estimate of fair values of the assets acquired and the liabilities assumed. The final determination of the allocation of the purchase price is pending the final assessment of a third party's valuation of the assets acquired and liabilities assumed. The finalization of the purchase price allocation may result in asset fair values and liabilities assumed that differ from the preliminary estimates of these amounts. As of March 31, 2007, the preliminary purchase price allocation was as follows (in thousands):

|  |                  |
|--|------------------|
| In-process research and development costs acquired | \$ 561           |
| Identifiable intangible assets acquired            | 7,567            |
| Goodwill   | 15,222           |
| Net liabilities acquired                           | (223)            |
|  | <b>\$ 23,127</b> |

A history of operating margins and profitability, a strong scientific employee base and operations in an attractive market niche were among the factors that contributed to a purchase price resulting in the recognition of goodwill. In-process research and development costs acquired were expensed during the nine months ended March 31, 2007, and are included in other operating expenses. Projects that qualify as in-process research and development represent those that have not yet reached technological feasibility and which have no alternative future use.

As part of the integration of these business operations, for the three months and the nine months ended March 31, 2007, the Company established reserves of \$0.8 million and \$2.4 million, respectively, for the termination and relocation of certain employees to other sites as well as legal and accounting fees (in thousands):

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|                            |          |
|----------------------------|----------|
| Employee severance         | \$ 670   |
| Relocation costs           | 230      |
| Legal and accounting fees  | 29       |
| Rent and lease obligations | 1,490    |
|                            | \$ 2,419 |



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During the nine months ended March 31, 2007, the Company paid \$0.8 million in connection with severance charges, relocation costs and rent obligations. At March 31, 2007, the remaining reserve amounted to \$1.6 million and is included in accrued expenses and other current liabilities in the Consolidated Balance Sheets.

**3. Balance Sheet Details**

The following tables provide details of selected balance sheet accounts (in thousands):

|  | June 30,<br>2006 | March 31,<br>2007 |
|--|------------------|-------------------|
| <b>Accounts receivable</b>   |                  |                   |
| Trade receivables  | \$ 118,129       | \$ 121,131        |
| Receivables related to long term contracts unbilled costs and accrued profit on progress completed | 4,286            | 2,233             |
| <b>Total</b>   | 122,415          | 123,364           |
| Less: allowance for doubtful accounts  | (2,996)          | (3,230)           |
| <b>Accounts receivable, net</b>  | \$ 119,419       | \$ 120,134        |
| <b>Inventories, net</b>  |                  |                   |
| Raw materials  | \$ 63,785        | \$ 76,735         |
| Work-in-process  | 29,961           | 22,999            |
| Finished goods   | 26,858           | 21,968            |
| <b>Total</b>   | \$ 120,604       | \$ 121,702        |
| <b>Property and equipment, net</b>   |                  |                   |
| Land   | \$ 5,899         | \$ 6,172          |
| Buildings and leasehold improvements   | 14,436           | 15,963            |
| Equipment and tooling  | 40,437           | 43,885            |
| Furniture and fixtures   | 4,140            | 5,054             |
| Computer equipment   | 15,619           | 22,102            |
| ERP software   | 2,455            | 2,433             |
| <b>Total</b>   | 82,986           | 95,609            |
| Less: accumulated depreciation and amortization  | (40,465)         | (48,085)          |
| <b>Property and equipment, net</b>   | \$ 42,521        | \$ 47,524         |

The Company expects to bill and collect the receivables for unbilled costs and accrued profits at March 31, 2007 during the next twelve months.

**4. Goodwill and Intangible Assets**

The changes in the carrying value of goodwill for the nine month period ended March 31, 2007 are as follows (in thousands):

|  | Security<br>Group | Healthcare<br>Group | Optoelectronics | Consolidated |
|--|-------------------|---------------------|-----------------|--------------|
|--|-------------------|---------------------|-----------------|--------------|

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|   | and<br>Manufacturing Group |           |          |           |
|---|----------------------------|-----------|----------|-----------|
| Balance as of June 30, 2006             | \$ 16,732                  | \$ 5,990  | \$ 6,344 | \$ 29,066 |
| Goodwill acquired during the period     |                            | 16,177    | 236      | 16,413    |
| Foreign currency translation adjustment | 189                        | 259       |          | 448       |
| Balance as of March 31, 2007            | \$ 16,921                  | \$ 22,426 | \$ 6,580 | \$ 45,927 |

Intangible assets consisted of the following (in thousands):

|                                | Weighted<br>Average<br>Lives | June 30, 2006              |                             |                    | March 31, 2007             |                             |                    |
|--------------------------------|------------------------------|----------------------------|-----------------------------|--------------------|----------------------------|-----------------------------|--------------------|
|                                |                              | Gross<br>Carrying<br>Value | Accumulated<br>Amortization | Intangibles<br>Net | Gross<br>Carrying<br>Value | Accumulated<br>Amortization | Intangibles<br>Net |
| Amortizable assets:            |                              |                            |                             |                    |                            |                             |                    |
| Software development costs     | 3 years                      | \$ 3,271                   | \$ 1,480                    | \$ 1,791           | \$ 3,610                   | \$ 1,749                    | \$ 1,861           |
| Patents                        | 10 years                     | 420                        | 215                         | 205                | 422                        | 248                         | 174                |
| Core technology                | 10 years                     | 9,289                      | 1,159                       | 8,130              | 2,642                      | 567                         | 2,075              |
| Developed technology           | 12 years                     | 27,573                     | 4,589                       | 22,984             | 14,854                     | 3,328                       | 11,526             |
| Customer relationships/backlog | 5 years                      | 5,462                      | 1,646                       | 3,816              | 8,128                      | 2,131                       | 5,997              |
| Total amortizable assets       |                              | 46,015                     | 9,089                       | 36,926             | 29,656                     | 8,023                       | 21,633             |
| Non-amortizable assets:        |                              |                            |                             |                    |                            |                             |                    |
| Trademarks                     |                              | 7,120                      |                             | 7,120              | 7,193                      |                             | 7,193              |
| Total intangible assets        |                              | \$ 53,135                  | \$ 9,089                    | \$ 44,046          | \$ 36,849                  | \$ 8,023                    | \$ 28,826          |

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Amortization expense related to intangibles assets was \$2.7 million and \$3.3 million for the nine months ended March 31, 2006 and 2007 respectively. During the nine months ended March 31, 2007, the Company recorded an impairment charge for core technology of \$5.9 million, developed technology of \$14.5 million and customer relationships/backlog of \$0.3 million. See Note 5 for additional information about these impairment charges. At March 31, 2007, the estimated future amortization expense was as follows (in thousands):

|                           |           |
|---------------------------|-----------|
| 2007 (remaining 3 months) | \$ 893    |
| 2008                      | 3,486     |
| 2009                      | 3,114     |
| 2010                      | 2,759     |
| 2011                      | 2,678     |
| 2012                      | 2,596     |
| 2013 and thereafter       | 6,107     |
| Total                     | \$ 21,633 |

**5. Impairment, Restructuring and Other Charges**

During the second quarter ended December 31, 2006, as part of a global review of its operations, the Company assessed the value of certain technologies and product lines. As a result of this assessment, the Company recorded total charges of \$31.8 million. These charges consist of \$21.5 million of asset impairment of certain identifiable intangible and fixed assets, and \$10.3 of inventory charges, primarily related to finished goods inventory. Of the \$21.5 million of impairment charges, \$21.3 million was recorded within the Company's Security division and \$0.2 million was recorded within the Optoelectronics and Manufacturing division. Of the \$10.3 million of inventory charges, \$9.9 million was recorded within the Company's Security division and \$0.4 million was recorded within the Optoelectronics and Manufacturing division. Such inventory charges are reflected in cost of goods sold in the consolidated financial statements. Asset impairments were calculated in accordance with SFAS No. 144 as discussed in Note 1.

During the first quarter of fiscal 2006 and the third quarter of fiscal 2007, the Company consolidated manufacturing processes and facilities of certain businesses. These consolidations resulted in pre-tax restructuring charges of \$0.8 million and \$2.2 million, respectively.

The following table summarizes the aforementioned impairment, restructuring and other charges (in thousands):

|  | Nine months Ended  |       |           |           |
|--|--------------------|-------|-----------|-----------|
|  | Three months Ended |       | March 31, |           |
|  | March 31,<br>2006  | 2007  | 2006      | 2007      |
| Impairment of intangible assets:           |                    |       |           |           |
| Software development costs                 | \$                 | \$    | \$        | \$ 169    |
| Core technology                            |                    |       |           | 5,874     |
| Developed technology                       |                    |       |           | 14,463    |
| Customer relationships/backlog             |                    |       |           | 280       |
| Impairment of fixed assets                 |                    |       |           | 757       |
| Restructuring charges                      |                    | 2,226 | 800       | 2,226     |
| Total impairment and restructuring charges |                    | 2,226 | 800       | 23,769    |
| Inventory charges                          |                    |       |           | 10,301    |
| Total charges                              | \$                 | \$    | 2,226     | \$ 800    |
|  |                    |       |           | \$ 34,070 |



**Table of Contents****6. Lines of Credit**

In May 2005, the Company entered into a second amended and restated credit agreement with Bank of the West. The agreement provided for a \$50 million senior revolving line-of-credit, including a letter-of-credit, foreign exchange facility and an acquisition credit facility, each of which were secured by substantially all of the assets of the Company's U.S. subsidiaries and its stock ownership in two significant foreign subsidiaries. In October 2005, the Company entered into a first amendment to the second amended and restated credit agreement. As amended, the agreement included an asset based credit facility of up to \$50 million with revised financial covenants. In July 2006, in order to provide the Company's Spacelabs Healthcare subsidiary with a separate line of credit, the Company bifurcated its arrangement with Bank of the West. In doing so, the Company entered into a third amended and restated credit agreement with Bank of the West. As amended, the agreement currently provides the Company a \$35 million senior revolving line-of-credit, including a letter-of-credit and foreign exchange facility, each of which are secured by substantially all of the Company's U.S. assets, including its ownership interest in Spacelabs Healthcare. Interest on the revolving loans is based, at the Company's option, on either the bank's prime rate plus up to 0.5%, or on the British Bankers Association Interest Settlement Rate for deposits in U.S. dollars, plus up to 2.5%. The agreement contains various representations, warranties, affirmative, negative and financial covenants, and conditions of default customary for financing of this type. The agreement expires in July 2009. As of March 31, 2007, \$10.5 million was outstanding under the revolving line-of-credit and \$10.2 million was issued and outstanding under the letter-of-credit facility.

In connection with bifurcating the Company's line-of-credit, Spacelabs Healthcare also entered into a credit agreement with Bank of the West. The agreement provides for a \$10 million senior revolving line-of-credit, including a letter-of-credit and foreign exchange facility, and a \$27.4 million term loan to fund the purchase of the Del Mar Reynolds cardiology division of Ferraris Group PLC. The agreement is secured by substantially all of the assets of the U.S. subsidiaries of the Company's Healthcare division. Interest on the revolving loans is based, at Spacelabs Healthcare's option, on either the bank's prime rate, plus up to 0.5%, or on the British Bankers Association Interest Settlement Rate for deposits in U.S. dollars plus up to 2.5%. The agreement contains various representations, warranties, affirmative, negative and financial covenants, and conditions of default customary for financing of this type. The agreement expires in July 2009. As of March 31, 2007, \$5.8 million was outstanding under the revolving line-of-credit and \$22.7 million was outstanding under the term loan.

As of March 31, 2007, several of the Company's foreign subsidiaries maintained bank lines-of-credit, denominated in local currencies, to meet short-term working capital requirements and for the issuance of letters of credit. The total amount of these credit facilities was \$36.2 million with a total cash borrowing sub limit of \$11.6 million, of which nothing was outstanding at March 31, 2007. The weighted average interest rate of these facilities was 6.8% at March 31, 2007. The Company has guaranteed these credit facilities.

**7. Long-Term Debt**

Long-term debt consisted of the following (in thousands):

|   | June 30,<br>2006 | March 31,<br>2007 |
|---|------------------|-------------------|
| Five-year term loan payable in quarterly installments of \$908,000 with a balloon payment of \$7.3 million on July 18, 2011 to pay the remaining balance. Interest is variable based on either one to three-month LIBOR plus 2.5% (7.88% at March 31, 2007) or the prime rate plus up to 0.5% | \$               | \$ 22,690         |
| Twenty-year term loan payable in quarterly installments of £34,500 (approximately \$68,000 at March 31, 2007) until paid in full on December 1, 2024. Interest is due quarterly at a rate of three-month LIBOR plus 1.2% (6.82% at March 31, 2007)  | 4,721            | 4,808             |
| Capital leases  | 248              | 3,453             |
| Other   | 1,765            | 1,592             |
|   | 6,734            | 32,543            |
| Less current portion of long-term debt  | 1,251            | 5,578             |
| Long-term portion of debt   | \$ 5,483         | \$ 26,965         |

**Table of Contents****8. Stock-based Compensation**

As of March 31, 2007, the Company maintained the following three significant stock option plans: (a) the 2006 Equity Participation Plan of OSI Systems, Inc. (the OSI Plan ), (b) the 2005 Equity Participation Plan of Spacelabs Healthcare (the Spacelabs Healthcare Plan ) and (c) the 2006 Equity Participation Plan of Rapiscan Systems Holdings, Inc. (the Rapiscan Systems Plan ).

The Company recorded stock-based-compensation expense in accordance with SFAS No. 123(R) Share-Based Payment for the three months ended March 31, 2006 and 2007 of approximately \$1.1 million and \$1.0 million, respectively, net of tax and for the nine months ended March 31, 2006 and 2007 of approximately \$3.0 million and \$3.0 million, respectively, net of tax. The income tax benefit related to such compensation for the three months ended March 31, 2006 and 2007 was approximately \$0.4 million and \$0.4 million, respectively and for the nine months ended March 31, 2006 and 2007 was approximately \$1.1 million and \$1.1 million, respectively. The Company recorded stock-based compensation expense in the consolidated statement of operations as follows (in thousands):

|                                     | Three Months Ended |          | Nine Months Ended |          |
|-------------------------------------|--------------------|----------|-------------------|----------|
|                                     | March 31,          |          | March 31,         |          |
|                                     | 2006               | 2007     | 2006              | 2007     |
| Cost of goods sold                  | \$ 221             | \$ 88    | \$ 330            | \$ 270   |
| Selling, general and administrative | 1,155              | 1,183    | 3,373             | 3,649    |
| Research and development            | 165                | 91       | 380               | 268      |
|                                     | \$ 1,541           | \$ 1,362 | \$ 4,083          | \$ 4,187 |

As of March 31, 2007, total unrecognized compensation cost related to non-vested share-based compensation arrangements granted amounted to: \$2.5 million under the OSI Plan, \$1.2 million under the Spacelabs Healthcare Plan and \$2.1 million under the Rapiscan Systems Plan. The Company expects to recognize these costs over a weighted-average period of 1.7 years with respect to the OSI Plan, 1.9 years with respect to the Spacelabs Healthcare Plan and 2.3 years with respect to the Rapiscan Systems Plan.

*Employee Stock Purchase Plan*

The Company maintains and administers an employee stock purchase plan under which it has reserved for issuance 500,000 shares of its common stock. Eligible employees may purchase a limited number of shares of common stock at a discount of up to 15% of the market value of such stock at pre-determined, plan-defined dates. The compensation expense associated with the this plan, included in the consolidated statement of operations for the nine month period ended March 31, 2007, was not material.

**Table of Contents***Stock Option Plans*

*OSI Plan* Under the OSI Plan, the Company is authorized to grant up to 3,350,000 shares of common stock in the form of incentive and nonqualified options or restricted stock to its directors and employees, including those of its subsidiaries. Under the plan, the exercise price of nonqualified options may not be less than 85% of the fair market value of the Company's common stock on the date of grant. The exercise price of incentive stock options may not be less than the fair market value of the Company's common stock at the date of grant. The exercise price of incentive stock options granted to individuals who own more than 10% of the Company's voting stock may not be less than 110% of the fair market value of the Company's common stock on the date of grant. Restricted stock may be issued at such price, if any, and may be made subject to such conditions (including time vesting or satisfaction of performance milestones) as may be determined by the administrator of the OSI Plan. Restricted stock may be repurchased and/or cancelled by the Company if such conditions do not materialize. In general, restricted stock may not be sold, or otherwise hypothecated or transferred, until the vesting restrictions applicable to such shares are removed or expire.

As of March 31, 2007, the Company had not made any grants of restricted stock under the OSI Plan. The Company estimates the fair value of each option award under the OSI Plan as of the date of grant using the Black-Scholes options pricing model utilizing assumptions detailed in the table below. The Company bases expected volatilities on a blend of historical volatilities of the Company's common stock and implied volatilities of its publicly traded options, as more fully explained below. The expected-life-utilized represents the weighted-average period of time that options granted are expected to be outstanding, giving consideration to vesting periods and historical exercise patterns. The risk-free rate utilized is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding to the expected life of the option.

The Company determined the fair value of options issued under the OSI Plan as of the date of the grant, using the Black-Scholes option pricing model, with the following weighted average assumptions:

|                          | Nine Months Ended  |      |           |       |
|--------------------------|--------------------|------|-----------|-------|
|                          | Three Months Ended |      | March 31, |       |
|                          | 2006               | 2007 | 2006      | 2007  |
| Expected dividend        | 0%                 |      | 0%        | 0%    |
| Risk-free interest rate  | 4.4%               |      | 4.5%      | 4.9%  |
| Expected volatility      | 39.4%              |      | 43.0%     | 42.3% |
| Expected life (in years) | 3.7                |      | 3.7       | 3.9   |

The following table summarizes stock option activity under the OSI Plan during the nine months ended March 31, 2007:

|                               | Number<br>of<br><br>Options | Weighted-Average<br><br>Exercise Price | Weighted-Average      |                 |
|-------------------------------|-----------------------------|--|-----------------------|-----------------|
|                               |                             |  | Remaining Contractual | Aggregate       |
|                               |                             |  | Term                  | Intrinsic Value |
|                               |                             |  | (in years)            | (\$000)         |
| Outstanding at June 30, 2006  | 1,778,678                   | \$ 17.93                               |                       |                 |
| Granted                       | 149,500                     | 18.28                                  |                       |                 |
| Exercised                     | (297,371)                   | 14.23                                  |                       |                 |
| Expired or cancelled          | (178,713)                   | 19.13                                  |                       |                 |
| Outstanding at March 31, 2007 | 1,452,094                   | \$ 18.57                               | 2.5                   | \$ 11,418       |
| Exercisable at March 31, 2007 | 821,148                     | \$ 18.42                               | 1.8                   | \$ 6,583        |

The Company did not grant any stock options under the OSI Plan during the three months ended March 31, 2007. The weighted-average fair-value of stock options granted under the OSI Plan was \$7.13 for the nine months ended March 31, 2007. It was \$6.90 for the three months ended March 31, 2006 and \$7.02 for the nine months ended March 31, 2006. The total intrinsic value of options exercised during the three months ended March 31, 2007 was \$1.0 million and \$2.3 million for the nine months ended March 31, 2007. The total intrinsic value of options

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exercised was \$0.8 million for the three months ended March 31, 2006 and \$1.4 million for the nine months ended March 31, 2006.

Additional information relating to the OSI Plan at March 31, 2007 is as follows:

|  |           |
|--|-----------|
| Options exercisable                              | 821,148   |
| Options and restricted stock available for grant | 546,784   |
| Total shares reserved for stock option plan      | 3,350,000 |



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*Spacelabs Healthcare Plan* The Company established the Spacelabs Healthcare Plan in October 2005 and authorized the grant of options to purchase up to 10,000,000 shares of Spacelabs Healthcare common stock. Under the Spacelabs Healthcare Plan, Spacelabs Healthcare may grant to employees, including those of its subsidiaries, consultants and to the non-employee directors of Spacelabs Healthcare, nonqualified options to purchase shares of the Spacelabs Healthcare common stock.

The Company estimates the fair value of each option award under the Spacelabs Healthcare Plan as of the date of grant using a Black-Scholes option pricing model utilizing assumptions detailed in the table below. The Company bases expected volatilities on the historical volatilities of the publicly traded common stock of a select peer group of companies that are similar to Spacelabs Healthcare. The Company has determined the expected term assumption under the Simplified Method as defined in SAB No. 107 Share-Based Payment, ( SAB 107 ) as it lacks historical data and is unable to make reasonable estimates regarding future exercise patterns. The risk-free rate utilized is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

The Company has determined the fair value of options issued under the Spacelabs Healthcare Plan as of the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

|                          | Three Months Ended |      | Nine Months Ended |       |
|--------------------------|--------------------|------|-------------------|-------|
|                          | March 31,          |      | March 31,         |       |
|                          | 2006               | 2007 | 2006              | 2007  |
| Expected dividend        | 0%                 |      | 0%                | 0%    |
| Risk-free interest rate  | 4.6%               |      | 4.5%              | 4.5%  |
| Expected volatility      | 40.3%              |      | 46.3%             | 37.8% |
| Expected life (in years) | 3.6                |      | 3.6               | 3.6   |

The following table summarizes stock option activity under the Spacelabs Healthcare Plan during the nine months ended March 31, 2007:

|                               | Number<br>of<br>Options | Weighted-<br>Average<br>Exercise<br>Price | Weighted-Average      |                            |
|-------------------------------|-------------------------|---|-----------------------|----------------------------|
|                               |                         |   | Remaining Contractual | Aggregate                  |
|                               |                         |   | Term<br>(in years)    | Intrinsic Value<br>(\$000) |
| Outstanding June 30, 2006     | 5,474,119               | \$ 1.37                                   |                       |                            |
| Granted                       | 997,200                 | 2.11                                      |                       |                            |
| Exercised                     | (196,116)               | 1.12                                      |                       |                            |
| Canceled                      | (300,315)               | 1.40                                      |                       |                            |
| Outstanding at March 31, 2007 | 5,974,888               | \$ 1.50                                   | 2.9                   | \$ 1,128                   |
| Exercisable at March 31, 2007 | 2,083,000               | \$ 1.26                                   | 2.4                   | \$ 1,128                   |

The Company did not grant any stock options under the 2005 Spacelabs Healthcare Plan during the three months ended March 31, 2007. The per-share weighted-average grant-date fair value of stock options granted under the 2005 Spacelabs Healthcare Plan was \$0.72 for nine months ended March 31, 2007. It was \$0.88 for the three months ended March 31, 2006 and \$1.04 for the nine months ended March 31, 2006. The total intrinsic value of options exercised was \$2,680 for the three months ended March 31, 2007 and \$243,540 for the nine months ended March 31, 2007. No option holders under the 2005 Spacelabs Healthcare Plan exercised their options during the three months ended March 31, 2006.

Additional information relating to the Spacelabs Healthcare Plan at March 31, 2007 is as follows:

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|   |            |
|---|------------|
| Options exercisable                         | 2,083,000  |
| Options available for grant                 | 3,933,998  |
| Total shares reserved for stock option plan | 10,000,000 |

*Rapiscan Systems Plan* The Company established the Rapiscan Systems Plan in January 2006 and authorized the grant of options to purchase up to 10,000,000 shares of Rapiscan Systems Holdings common stock. Under the Rapiscan Systems Plan, Rapiscan Systems Holdings may grant to employees, including those of its subsidiaries, consultants and to the non-employee directors of Rapiscan Systems Holdings, incentive or nonqualified options to purchase shares of the Rapiscan Systems Holdings common stock.

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The Company estimates the fair value of each option award under the Rapiscan Systems Plan as of the date of grant using a Black-Scholes option pricing model utilizing assumptions detailed in the table below. The Company bases expected volatilities on the historical volatilities of the publicly traded common stock of a select peer group of companies that are similar to Rapiscan Systems Holdings. The Company has determined the expected term assumption under the Simplified Method as defined in SAB 107, as it lacks historical data and is unable to make reasonable estimates regarding future exercise patterns. The risk-free rate utilized is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

The Company has determined the fair value of the options issued under the Rapiscan Systems Plan as of the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

|                          | Three Months Ended |       | Nine Months Ended |       |
|--------------------------|--------------------|-------|-------------------|-------|
|                          | March 31,          |       | March 31,         |       |
|                          | 2006               | 2007  | 2006              | 2007  |
| Expected dividend        | 0%                 | 0%    | 0%                | 0%    |
| Risk-free interest rate  | 4.6%               | 4.8%  | 4.6%              | 4.7%  |
| Expected volatility      | 43.4%              | 37.2% | 43.4%             | 37.3% |
| Expected life (in years) | 3.6                | 3.6   | 3.6               | 3.6   |

The following table summarizes stock option activity under the Rapiscan Systems Plan during the nine months ended March 31, 2007:

|                               | Number of Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (\$000) |
|-------------------------------|-------------------|---------------------------------|--|-----------------------------------|
| Outstanding at June 30, 2006  | 5,048,000         | \$ 1.42                         |  |                                   |
| Granted                       | 2,602,500         | 1.53                            |  |                                   |
| Exercised                     |                   |                                 |  |                                   |
| Expired or cancelled          | (55,000)          | 1.40                            |  |                                   |
| Outstanding at March 31, 2007 | 7,595,500         | \$ 1.46                         | 4.2  | \$ 0.00                           |
| Exercisable at March 31, 2007 | 950,750           | \$ 1.40                         | 3.9  | \$ 0.00                           |

The per-share weighted-average grant-date fair value of stock options granted under the 2006 Rapiscan Systems Plan was \$0.35 for the three months ended March 31, 2007 and \$0.43 for the nine months ended March 31, 2007. It was \$0.39 for the three months ended March 31, 2006. The Company made no grants under this plan prior to such periods. There were no options exercises under the 2006 Rapiscan Systems Plan during the three months ended March 31, 2007.

Additional information relating to the Rapiscan Systems Plan at March 31, 2007 is as follows:

|  |            |
|--|------------|
| Options exercisable                                      | 950,750    |
| Options available for grant                              | 2,404,500  |
| Total reserved common stock shares for stock option plan | 10,000,000 |

**9. Retirement Benefit Plans**

The Company has a defined benefit plan for certain employees located in the United Kingdom. The benefits under this plan are based on years of service and an employee's highest twelve months compensation during the last five years of employment. The components of net periodic pension expense are as follows (in thousands):

|                                     | Nine Months Ended  |              |               |               |
|-------------------------------------|--------------------|--------------|---------------|---------------|
|                                     | Three Months Ended |              | March 31,     |               |
|                                     | 2006               | 2007         | 2006          | 2007          |
| Service cost                        | \$ 9               | \$ 9         | \$ 32         | \$ 26         |
| Interest cost                       | 41                 | 55           | 133           | 164           |
| Expected return on plan assets      | (29)               | (47)         | (91)          | (141)         |
| Amortization of net loss            | 26                 | 26           | 89            | 79            |
| <b>Net periodic pension expense</b> | <b>\$ 47</b>       | <b>\$ 43</b> | <b>\$ 163</b> | <b>\$ 128</b> |

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For the nine months ended March 31, 2007, the Company made contributions of \$119,000 to this pension plan.

### **10. Commitments and Contingencies**

#### *Legal Proceedings*

In March 2004, the Company completed the acquisition from Instrumentarium Corporation, now a subsidiary of General Electric Company ( GE ), of certain capital stock and assets constituting substantially all of the business operations of Spacelabs Medical. The acquisition price was approximately \$47.9 million in cash (net of cash acquired), including acquisition costs. In June 2004, the Company notified GE of a working capital and retention bonus adjustment resulting in what the Company believed to be a downward adjustment of the purchase price. In September 2004, GE responded that it disagreed with the Company's calculation of the purchase price adjustment. In March 2007, the dispute was resolved and the Company received \$15 million from GE which has been recorded as other income in the Consolidated Statements of Operations for the three and nine months ended March 31, 2007.

In November 2002, L-3 Communications Corporation ( L-3 ) brought suit against the Company seeking a declaratory judgment that L-3 had not breached its obligations to the Company concerning the acquisition of PerkinElmer's Security Detection Systems Business. The Company asserted counterclaims against L-3 for, among other things, fraud and breach of fiduciary duty. On May 24, 2006, the jury in the case returned a verdict in the Company's favor and awarded \$125 million in damages. The jury found that L-3 had breached its fiduciary duty to the Company and had committed fraud. L-3 has filed a notice of its appeal of the judgment.

In February 2005, Electromedica, a Greek distribution company, filed an action in the courts of Greece claiming that Spacelabs Medical orally agreed to appoint Electromedica as Spacelabs' exclusive Greek distributor, but failed to do so. Electromedica claims that it incurred significant expenses as a result of Spacelabs' actions. In March 2007, the matter settled and the Company paid approximately \$0.1 million to Electromedica.

The Company is also involved in various other claims and legal proceedings arising out of the ordinary course of business which have not been previously disclosed in its quarterly and annual reports. In the opinion of the Company's management, after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on the Company's financial statements.

In accordance with SFAS No. 5, Accounting for Contingencies, the Company has not accrued for loss contingencies relating to legal proceedings that have been previously disclosed in its quarterly and annual reports because it believes that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.

#### *Contingent Acquisition Obligations*

Under the terms and conditions of the purchase agreements associated with the following acquisitions, the Company may be obligated to make additional payments.

In August 2002, the Company purchased a minority equity interest in CXR Limited, a United Kingdom-based research and development company that develops real time tomography systems. In June 2004, the Company increased its equity interest in CXR to approximately 75% and in December 2004, the Company acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest, the Company agreed to make certain royalty payments based on sales of CXR's products. As of March 31, 2007, no royalty payments have been earned.

In November 2002, the Company acquired all the outstanding capital stock of Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company, for its advanced inspection systems for aviation security, port and border inspection and counter-terrorism. Consideration paid for the acquisition consisted of a combination of the Company's common stock and cash of approximately \$10.4 million, including professional fees associated with the acquisition. In addition, during the five years following the close, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at \$34.0 million. As of March 31, 2007, no contingent consideration has been earned.

In January 2004, the Company acquired Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately-held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17.6 million (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at

\$30.0 million. As of March 31, 2007, no contingent consideration has been earned.

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In February 2005, the Company acquired Blease Medical Holdings Limited and certain affiliated companies for approximately \$9.3 million in cash (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$12.3 million as of March 31, 2007). As of March 31, 2007, no contingent consideration has been earned.

*Environmental Contingencies*

The Company is subject to various environmental laws. The Company's practice is to ensure that Phase I environmental site assessments are conducted for each of its properties in the United States at which the Company manufactures products in order to identify, as of the date of such report, potential sources of contamination of the property. In certain cases, the Company has conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants.

During one investigation, the Company discovered soil and groundwater contamination at its Hawthorne, California facility. The Company filed reports concerning this problem with the appropriate environmental authorities in fiscal year 2001. The Company has not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. The Company's site was previously used for semiconductor manufacturing similar to that presently conducted on the site by the Company, and it is not presently known who is responsible for the contamination and the remediation. The groundwater contamination is a known regional problem, not limited to the Company's premises or its immediate surroundings.

The Company has also been informed of soil and groundwater remediation efforts at a facility that its Ferson Technologies, Inc. subsidiary previously leased in Ocean Springs, Mississippi. Ferson Technologies occupied the facility until October 2003. The Company believes that the owner and previous occupants of the facility have primary responsibility for such remediation and have an agreement with the facility's owner under which the owner is responsible for remediation of pre-existing conditions. However, the Company is unable at this time to ascertain whether Ferson Technologies bears any exposure for remediation costs under applicable environmental regulations.

In accordance with SFAS No. 5, Accounting for Contingencies, the Company has not accrued for loss contingencies relating to the above environmental matters because it believes that, although unfavorable outcomes may be possible, they are not considered by the Company's management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.

*Product Warranties*

The Company offers its customers warranties on many of the products that it sells. These warranties typically provide for repairs and maintenance of the products if problems arise during a specified time period after original shipment. Concurrent with the sale of products, the Company records a provision for estimated warranty expenses with a corresponding increase in cost of goods sold. The Company periodically adjusts this provision based on historical and anticipated experience. The Company charges actual expenses of repairs under warranty, including parts and labor, to this provision when incurred.

The following table presents changes in warranty provisions (in thousands):

|                                      | Three months ended March 31, |          | Nine months ended March 31, |          |
|--------------------------------------|------------------------------|----------|-----------------------------|----------|
|                                      | 2006                         | 2007     | 2006                        | 2007     |
| Balance at beginning of period       | \$ 6,761                     | \$ 7,380 | \$ 6,641                    | \$ 7,224 |
| Additions                            | 1,798                        | 652      | 4,566                       | 2,585    |
| Increase as a result of acquisitions |                              |          |                             | 439      |
| Reductions for warranty repair costs | (1,653)                      | (793)    | (4,301)                     | (3,009)  |
| Balance at end of period             | \$ 6,906                     | \$ 7,239 | \$ 6,906                    | \$ 7,239 |

**11. Segment Information**

The Company operates in three identifiable industry segments: (a) Security, providing security and inspection systems; (b) Healthcare, providing medical monitoring and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for

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affiliated end-products divisions, as well as for applications in the defense and aerospace markets, among others. The Company also has a Corporate segment that includes executive compensation and certain other general



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and administrative expenses, interest expense, expenses related to stock issuances and legal, audit and other professional service fees not allocated to industry segments. Both the Security and Healthcare divisions comprise primarily end-product businesses whereas the Optoelectronics and Manufacturing division comprises businesses that primarily supply components and subsystems to original equipment manufacturers, including to the businesses of the Security and Healthcare divisions. All intersegment sales are eliminated in consolidation.

The following table presents segment information (in thousands):

|   | <b>Three months ended<br/>March 31,</b> |                   | <b>Nine months ended<br/>March 31,</b> |                    |
|---|---|-------------------|--|--------------------|
|   | <b>2006</b>                             | <b>2007</b>       | <b>2006</b>                            | <b>2007</b>        |
| <b>Revenues - by Segment:</b>   |   |                   |  |                    |
| Security division   | \$ 36,446                               | \$ 45,044         | \$ 93,787                              | \$ 130,479         |
| Healthcare division   | 49,429                                  | 53,671            | 161,799                                | 164,639            |
| Optoelectronics and Manufacturing division, including intersegment revenues | 29,689                                  | 37,200            | 88,593                                 | 111,068            |
| Intersegment revenues elimination   | (7,472)                                 | (9,417)           | (17,079)                               | (26,701)           |
| <b>Total</b>  | <b>\$ 108,092</b>                       | <b>\$ 126,498</b> | <b>\$ 327,100</b>                      | <b>\$ 379,485</b>  |
| <b>Revenues - by Geography:</b>   |   |                   |  |                    |
| North America   | \$ 83,803                               | \$ 87,181         | \$ 248,001                             | \$ 250,708         |
| Europe  | 23,795                                  | 32,351            | 69,273                                 | 109,650            |
| Asia  | 7,966                                   | 16,383            | 26,905                                 | 45,828             |
| Intersegment revenues elimination   | (7,472)                                 | (9,417)           | (17,079)                               | (26,701)           |
| <b>Total</b>  | <b>\$ 108,092</b>                       | <b>\$ 126,498</b> | <b>\$ 327,100</b>                      | <b>\$ 379,485</b>  |
| <b>Operating income (loss) - by Segment:</b>                                |   |                   |  |                    |
| Security division (1)   | \$ 1,230                                | \$ 527            | \$ (2,614)                             | \$ (31,284)        |
| Healthcare division (2)   | 1,063                                   | (3,381)           | 8,159                                  | (8,994)            |
| Optoelectronics and Manufacturing division (3)                              | 3,608                                   | 547               | 7,391                                  | 7,279              |
| Corporate   | (5,293)                                 | (3,291)           | (16,002)                               | (13,436)           |
| Eliminations  | (242)                                   | (391)             | (209)                                  | (234)              |
| <b>Total</b>  | <b>\$ 366</b>                           | <b>\$ (5,989)</b> | <b>\$ (3,275)</b>                      | <b>\$ (46,669)</b> |
| <b>Assets - by Segment:</b>   |   |                   |  |                    |
| Security division   |   |                   | \$ 168,987                             | \$ 152,414         |
| Healthcare division   |   |                   | 148,858                                | 165,528            |
| Optoelectronics and Manufacturing division                                  |   |                   | 73,793                                 | 83,586             |
| Corporate   |   |                   | 15,124                                 | 33,854             |
| Eliminations (4)  |   |                   | (3,689)                                | (2,593)            |
| <b>Total</b>  |   |                   | <b>\$ 403,073</b>                      | <b>\$ 432,789</b>  |

- (1) Operating losses for the nine months ended March 31, 2007, include \$21.3 million of impairment charges and \$9.9 million of inventory charges related to the Company's global review of its operations and the value of certain product lines. In addition, for the three months and nine months ended March 31, 2007, operating results include \$0.5 million of restructuring charges.
- (2) Operating losses for the three months and nine months ended March 31, 2007, include \$1.3 million of restructuring charges.

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- (3) Operating income for the nine months ended March 31, 2007, includes \$0.2 million of impairment charges and \$0.4 million of inventory charges related to the Company's global review of its operations and the value of certain product lines. In addition, for the three months and nine months ended March 31, 2007, operating income includes \$0.4 million of restructuring charges.

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- (4) Eliminations primarily reflect the elimination of intercompany inventory profit not-yet-realized. This profit will be realized when inventory is shipped to the Security and Healthcare divisions' external customers.

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

*Certain statements contained in this quarterly report on Form 10-Q that are not related to historical results, including, without limitation, statements regarding our business strategy, objectives and future financial position, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and involve risks and uncertainties. These forward-looking statements may be identified by the use of forward-looking terms such as anticipate, believe, expect, may, could, likely to, should, or will, or by discussions of strategy that involve predictions which are based upon a number of future conditions that ultimately may prove to be inaccurate. Statements in this quarterly report on Form 10-Q that are forward-looking are based on current expectations and actual results may differ materially. Forward-looking statements involve numerous risks and uncertainties described in this quarterly report on Form 10-Q, our Annual Report on Form 10-K and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. Such factors, of course, do not include all factors that might affect our business and financial condition. Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, such assumptions could prove to be inaccurate and actual results could differ materially from those expressed in or implied by the forward-looking statements. All forward-looking statements contained in this quarterly report on Form 10-Q are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Our critical accounting policies are detailed in our Annual Report on Form 10-K for the year ended June 30, 2006. As of March 31, 2007, our critical accounting policies had not changed from those at June 30, 2006, other than the addition of Impairment of Long-Lives Assets as described below.

*Impairment of Long-Lived Assets.* We test goodwill for impairment at the reporting unit level at least annually and more frequently upon the occurrence of certain events. For purposes of testing for goodwill impairment, we have determined that we have five reporting units, consisting of the Security division, Optoelectronics and Manufacturing division and three reporting units within the Healthcare division. We test goodwill for impairment annually during the second fiscal quarter using a two-step process. First, we determine if the carrying amount of any of the reporting units exceeds its fair value. We use a discounted cash flows method to make this determination for our Security and Optoelectronics and Manufacturing divisions and we use a market value method for our Healthcare division (based on the market price of the Healthcare division's publicly traded stock). If these methods indicate a potential impairment of goodwill associated with that the respective reporting unit, we then compare the implied fair value of the goodwill associated with the respective reporting unit to its carrying amount to determine if there is an impairment loss. We performed this annual impairment test for goodwill during the second quarter of fiscal year 2007 and concluded that there was no impairment of goodwill.

We evaluate long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment is considered to exist if the total estimated future cash flows on an undiscounted basis are less than the carrying amount of the assets. If an impairment does exist, we measure the impairment loss and record it based on discounted estimated future cash flows. In estimating future cash flows, we group assets at the lowest level for which there are identifiable cash flows that are largely independent of cash flows from other asset groups. Our estimate of future cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors.

During the second quarter ended December 31, 2006, we recognized non-cash impairment charges totaling \$21.5 million relating to software development costs, core technology, developed technology, customer relationships/backlog and fixed assets. Of the \$21.5 million impairment charge, we recognized \$21.3 million within the Security division and \$0.2 million within the Optoelectronics and Manufacturing division. See Note 5 to the consolidated financial statements for additional information about these impairment charges.



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### **Recent Accounting Pronouncements**

We describe recent accounting pronouncements in Item 1 Condensed Consolidated Financial Statements Notes to Consolidated Financial Statements.

### **Executive Summary**

We are a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. We sell our products in diversified markets, including homeland security, healthcare, defense and aerospace. We have three operating divisions: (a) Security, providing security and inspection systems; (b) Healthcare, providing medical monitoring and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for affiliated end-products divisions, as well as for applications in the defense and aerospace markets, among others.

*Security Division.* Through our Security division, we design, manufacture and market security and inspection systems worldwide for sale primarily to U.S. federal, state and local government agencies as well as to foreign governments. These products are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband as well as to screen people. Revenues from our Security division accounted for 35% of our total consolidated revenues for the nine months ended March 31, 2007 and 29% for the nine months ended March 31, 2006.

Following the September 11, 2001 terrorist attacks, U.S. Government spending for the development and acquisition of security and inspection systems increased in response to the attacks and has continued at high levels during its global war on terrorism. This spending has had a favorable impact on our business. However, future levels of such spending could decrease as a result of changing budgetary priorities or could shift to products that we do not provide. Additionally, competition for contracts with the U.S. Government has become more intense in recent years as new competitors and technologies have entered this market.

*Healthcare Division.* Through our Healthcare division, we design, manufacture and market medical monitoring and anesthesia systems for sale primarily to hospitals and medical centers. Our products monitor patients in critical, emergency and perioperative care areas of the hospital and provide such information, through wired and wireless networks, to physicians and nurses who may be at the patient's bedside, in another area of the hospital or even outside the hospital. Revenues from our Healthcare division accounted for 43% our total consolidated revenues for the nine months ended March 31, 2007 and 49% for the nine months ended March 31, 2006.

The healthcare markets in which we operate are highly competitive. We believe that our customers choose among competing medical monitoring and anesthesia products on the basis of product performance, functionality, value and service. We also believe that price has become an important factor in hospital purchasing decisions because of pressures they are facing to cut costs.

*Optoelectronics and Manufacturing Division.* Through our Optoelectronics and Manufacturing division, we design, manufacture and market optoelectronic devices and value-added manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, computed tomography (CT), fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We also provide our optoelectronic devices and value-added manufacturing services to our own Security and Healthcare divisions. Revenues from our Optoelectronics and Manufacturing division accounted for approximately 22% of our total consolidated revenues for the nine months ended March 31, 2007 and 2006.

Despite the overall growth in revenues that we experienced, our operating losses for the nine months ended March 31, 2007, grew in comparison to the prior year period, primarily as a result of: (i) lower sales of patient monitors in North America by our Healthcare division (such monitors generally carry a higher gross margin than many of our other products), (ii) a \$21.5 million charge associated with the impairment of certain intangible and fixed assets, (iii) the recordation of \$10.3 million of inventory charges following a review of our product portfolio, (iv) \$2.2 million of restructuring charges related to the consolidation of several manufacturing processes and facilities among each of our three operating divisions, (v) a \$0.6 million charge for in-process research and development related to our acquisition of Del Mar Reynolds, and (vi) cost overruns in certain long-term contracts for weapons simulation systems sold by our Optoelectronics and Manufacturing division.

During the second quarter of fiscal year 2007, we undertook a review of our global operations as part of our on-going efforts to integrate recent acquisitions and rationalize our overall cost structure. The review resulted in plans to achieve approximately \$15-\$17 million of pre-tax annualized cost savings, including a reduction of approximately 8% of the global workforce and the consolidation of multiple facilities. We have initiated these cost cutting measures, with the goal of implementing them by the end of the current fiscal year.



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*Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006.*

**Net Revenues**

The table below and the discussion that follows are based upon the way we analyze our business. See Note 11 to the Consolidated Financial Statements for additional information about our business segments.

| (in millions)                              | Q3<br>2006      | % of<br>Net Sales | Q3<br>2007      | % of<br>Net Sales | \$ Change      | % Change   |
|--|-----------------|-------------------|-----------------|-------------------|----------------|------------|
| Security division                          | \$ 36.4         | 34%               | \$ 45.0         | 35%               | \$ 8.6         | 24%        |
| Healthcare division                        | 49.4            | 46%               | 53.7            | 42%               | 4.3            | 9%         |
| Optoelectronics and Manufacturing division | 29.7            | 27%               | 37.2            | 30%               | 7.5            | 25%        |
| Intersegment revenues                      | (7.4)           | (7)%              | (9.4)           | (7)%              | (2.0)          | 27%        |
| <b>Total revenues</b>                      | <b>\$ 108.1</b> |                   | <b>\$ 126.5</b> |                   | <b>\$ 18.4</b> | <b>17%</b> |

Net revenues for the three months ended March 31, 2007, increased \$18.4 million, or 17%, to \$126.5 million from \$108.1 million for the comparable prior-year period.

Revenues for the Security division for the three months ended March 31, 2007, increased \$8.6 million, or 24%, to \$45.0 million, from \$36.4 million for the comparable prior-year period. The increase was primarily attributable to a \$6.3 million, or 23%, increase in sales of baggage and parcel inspection and people screening systems, and a \$2.3 million, or 25%, increase in sales of cargo and vehicle inspection systems.

Revenues for the Healthcare division for the three months ended March 31, 2007, increased \$4.3 million, or 9%, to \$53.7 million, from \$49.4 million for the comparable prior-year period. The increase was primarily attributable to the inclusion of revenues from Del Mar Reynolds totaling approximately \$8.0 million, a business that we acquired in July 2006, partially offset by reduced patient monitoring sales of \$1.4 million, primarily in North America as well as lower anesthesia delivery sales of approximately \$1.0 million.

Revenues for the Optoelectronics and Manufacturing division for the three months ended March 31, 2007, increased \$7.5 million, or 25%, to \$37.2 million, from \$29.7 million for the comparable prior-year period. The increase was primarily attributable to higher commercial optoelectronic and contract manufacturing sales. In addition, for the three months ended March 31, 2007, the division recorded intersegment sales of \$9.4 million, compared to \$7.4 million in the comparable prior-year period. Such sales are eliminated in consolidation.

**Gross Profit**

| (in millions) | Q3<br>2006 | % of Net<br>Sales | Q3<br>2007 | % of Net<br>Sales |
|---------------|------------|-------------------|------------|-------------------|
| Gross profit  | \$ 43.1    | 39.9%             | \$ 43.9    | 34.7%             |

Gross profit increased \$0.8 million, or 2%, to \$43.9 million for the three months ended March 31, 2007, from \$43.1 million for the comparable prior-year period. The gross profit margin decreased to 34.7%, from 39.9% over the same period. The decline in gross margin was attributable to: (i) lower gross margins within our Security division due primarily to product mix; (ii) reduced patient monitoring systems sales by our Healthcare division (such monitors generally carry higher gross margins than many of our other products); (iii) growth in sales of commercial optoelectronic products and contract manufacturing services by our Optoelectronic and Manufacturing division (such products and services generally carry lower gross margins than the products and services of the other divisions); and (iv) cost overruns on certain long-term contracts for weapons simulation systems sold by our Optoelectronics and Manufacturing division.

**Operating Expenses**

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| (in millions)                                | Q3<br>2006 | % of Net<br>Sales | Q3<br>2007 | % of Net<br>Sales | \$ Change | %<br>Change |
|--|------------|-------------------|------------|-------------------|-----------|-------------|
| Selling, general and administrative          | \$ 33.8    | 31.3%             | \$ 36.2    | 28.6%             | \$ 2.4    | 7%          |
| Research and development                     | 8.9        | 8.2%              | 11.4       | 9.0%              | 2.5       | 28%         |
| Impairment, restructuring, and other charges |            | %                 | 2.2        | 1.7%              | 2.2       | NM          |
| Other  |            | %                 | 0.1        | 0.1%              | 0.1       | NM          |
| Total operating expenses                     | \$ 42.7    | 39.5%             | \$ 49.9    | 39.4%             | \$ 7.2    | 17%         |



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**Selling, general and administrative expenses.** Selling, general and administrative ( SG&A ) expenses consist primarily of compensation paid to sales, marketing and administrative personnel, professional service fees and marketing expenses. For the three months ended March 31, 2007, SG&A expenses increased by \$2.4 million, or 7%, to \$36.2 million, from \$33.8 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses for the three months ended March 31, 2007 decreased to 28.6%, from 31.3% for the comparable prior-year period. The increase in SG&A expenses during the three months ended March 31, 2007, was primarily attributable to: (i) approximately \$2.0 million in support of Del Mar Reynolds, a business that we acquired in July 2006 and (ii) an increase of \$1.8 million in general sales and administrative support costs to support the growth in the Optoelectronic and Manufacturing divisions, partially offset by a \$2.1 million reduction in legal expenses due to lower litigation activities.

**Research and development.** Research and development expenses include research related to new product development and product enhancement expenditures. For the three months ended March 31, 2007, such expenses increased \$2.5 million, or 28%, to \$11.4 million, from \$8.9 million for the comparable prior-year period. As a percentage of revenues, research and development expenses were 9.0% for the three months ended March 31, 2007, compared to 8.2% for the comparable prior-year period. The increase in research and development expenses for the three month period ended March 31, 2007 was primarily attributable to: (i) \$1.0 million in support of Del Mar Reynolds, a business that we acquired in July 2006, (ii) \$0.8 million in support of next generation products in our Healthcare division, and (iii) increased investment by our Security division of \$0.8 million, primarily to support new hold (checked) baggage screening products.

**Impairment, restructuring, and other charges.** During the three months ended March 31, 2007, in connection with our company-wide review of our global operations, we incurred \$2.2 million in restructuring charges. These charges related to the recording of \$0.5 million of charges in the Security division for severance, lease and manufacturing relocation costs, \$1.3 million of charges in our Healthcare division for the restructuring of certain operations in the U.S. and Europe, including severance costs and the closure of certain facilities, and \$0.4 million of charges in our Optoelectronics and Manufacturing division for severance, lease and manufacturing relocation costs.

**Other Income and Expenses**

| (in millions)                  | Q3<br>2006 | % of Net<br>Sales | Q3<br>2007 | % of Net<br>Sales | \$ Change | %<br>Change |
|--------------------------------|------------|-------------------|------------|-------------------|-----------|-------------|
| Interest expense               | \$ 0.3     | 0.3%              | \$ 1.3     | 1.0%              | \$ 1.0    | 333%        |
| Interest (income)              | (0.1)      | (0.1)%            | (0.1)      | (0.1)%            |           | %           |
| Other (income) / expense       |            | %                 | (15.8)     | (12.4)%           | (15.8)    | NM          |
| Total other income and expense | \$ 0.2     | 0.2 %             | \$ (14.6)  | (11.5)%           | \$ (14.8) | NM          |

**Interest expense.** For the three months ended March 31, 2007, we incurred interest expense of \$1.3 million, compared to \$0.3 million for the comparable prior-year period. The increase in interest expense was primarily attributable to increased borrowings associated with the acquisition of Del Mar Reynolds in July 2006 and working capital requirements.

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**Other (income) / expense.** During the three months ended March 31, 2007, other income includes the receipt of a \$15 million payment from General Electric Corporation in settlement of a dispute regarding an adjustment of the purchase price associated with our acquisition Spacelabs Medical in March 2004, and a \$0.8 million payment in settlement of a dispute with a competitor of our Optoelectronics and Manufacturing division.

**Income taxes.** For the three months ended March 31, 2007, our income tax expense was \$3.7 million compared to a benefit \$0.8 million for the comparable prior-year period. Our effective tax rate for the three months ended March 31, 2007 was 42.6%, compared to a benefit in the comparable prior-year period. Our provision for income taxes is dependent on the mix of income from U.S. and foreign locations due to tax rate differences among such countries as well as due to the impact of permanent taxable differences.

*Nine Months Ended March 31, 2007 Compared to Nine Months Ended March 31, 2006.*

**Net Revenues**

| (in millions)                   | Q3 YTD<br>2006  | % of<br>Net<br>Sales | Q3 YTD<br>2007  | % of<br>Net<br>Sales | \$ Change      | % Change   |
|---------------------------------|-----------------|----------------------|-----------------|----------------------|----------------|------------|
| Security                        | \$ 93.8         | 29%                  | \$ 130.5        | 35%                  | \$ 36.7        | 39%        |
| Healthcare                      | 161.8           | 49%                  | 164.6           | 43%                  | 2.8            | 2%         |
| Optoelectronics / Manufacturing | 88.6            | 27%                  | 111.1           | 29%                  | 22.5           | 25%        |
| Intersegment Revenues           | (17.1)          | (5)%                 | (26.7)          | (7)%                 | (9.6)          | 56%        |
| <b>Total Revenues</b>           | <b>\$ 327.1</b> |                      | <b>\$ 379.5</b> |                      | <b>\$ 52.4</b> | <b>16%</b> |

Net revenues for the nine months ended March 31, 2007, increased \$52.4 million, or 16%, to \$379.5 million from \$327.1 million for the comparable prior-year period.

Revenues for the Security division for the nine months ended March 31, 2007, increased \$36.7 million, or 39%, to \$130.5 million, from \$93.8 million for the comparable prior-year period. The increase was primarily attributable to a \$23.6 million, or 31%, increase in sales of baggage and parcel inspection and people screening systems, and a \$13.1 million, or 74%, increase in sales of cargo and vehicle inspection systems.

Revenues for the Healthcare division for the nine months ended March 31, 2007, increased \$2.8 million, or 2%, to \$164.6 million, from \$161.8 million for the comparable prior-year period. The increase was primarily attributable to the inclusion of \$21.2 million of revenues from Del Mar Reynolds, a business that we acquired in July 2006, partially offset by lower patient monitoring sales of \$13.4 million and lower anesthesia delivery sales of approximately \$2.7 million.

Revenues for the Optoelectronics and Manufacturing division for the nine months ended March 31, 2006, increased \$22.5 million, or 25%, to \$111.1 million, from \$88.6 million for the comparable prior-year period. The increase was primarily attributable to higher commercial optoelectronic sales, as well as to higher levels of contract manufacturing sales. In addition, for the nine months ended March 31, 2007, the division recorded intersegment sales of \$26.7 million, compared to \$17.1 million in the comparable prior-year period. Such sales are eliminated in consolidation.

**Gross Profit**

| (in millions) | Q3 YTD<br>2006 | % of Net<br>Sales | Q3 YTD<br>2007 | % of Net<br>Sales |
|---------------|----------------|-------------------|----------------|-------------------|
| Gross profit  | \$ 125.2       | 38.3%             | \$ 121.7       | 32.1%             |

Gross profit decreased \$3.5 million, or 3%, to \$121.7 million for the nine months ended March 31, 2007, from \$125.2 million for the comparable prior-year period. The gross profit margin decreased to 32.1%, from 38.3% over the same periods. This decrease was partially attributable to the recording of \$10.3 million of inventory charges in the three months ended December 31, 2006, following a global review of operations during which we determined that certain finished goods inventory values primarily associated with cargo and vehicle inspection products developed by our Security division were impaired. These inventory charges reduced our gross margin by 2.7%. The decline in gross

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profit margin was also attributable to: (i) lower gross margins within in our Security division resulting from a change in the product mix in sales of baggage and parcel inspection and people screening systems; (ii) lower gross margins within our Security division resulting from sales of new types of cargo and vehicle inspection products that were sold at low gross

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margins, but which we expect to sell at higher gross margins when future repeat sales result in greater operating efficiencies; (iii) reduced patient monitoring systems sales by our Healthcare division (such sales generally carry higher gross margins than many of our other products); (v) growth in sales of commercial optoelectronic products and contract manufacturing services by our Optoelectronic and Manufacturing division (such products and services generally carry lower gross margins than the products and services of the other divisions); and (vi) cost overruns incurred during the performance of certain long-term contracts for the development and manufacture of weapons simulation systems by our Optoelectronics and Manufacturing division.

**Operating Expenses**

| (in millions)                                | Q3 YTD<br>2006  | % of Net<br>Sales | Q3 YTD<br>2007  | % of Net<br>Sales | \$ Change      | %<br>Change |
|--|-----------------|-------------------|-----------------|-------------------|----------------|-------------|
| Selling, general and administrative          | \$ 100.8        | 30.8%             | \$ 110.6        | 29.1%             | \$ 9.8         | 10%         |
| Research and development                     | 26.3            | 8.0%              | 32.8            | 8.7%              | 6.5            | 25%         |
| Impairment, restructuring, and other charges | 0.8             | 0.3%              | 23.8            | 6.3%              | 23.0           | NM          |
| Other  | 0.6             | 0.2%              | 1.2             | 0.3%              | 0.6            | 100%        |
| <b>Total operating expenses</b>              | <b>\$ 128.5</b> | <b>39.2%</b>      | <b>\$ 168.4</b> | <b>44.4%</b>      | <b>\$ 39.9</b> | <b>31%</b>  |

**Selling, general and administrative expenses.** For the nine months ended March 31, 2007, SG&A expenses increased by \$9.8 million, or 10%, to \$110.6 million from \$100.8 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses for the nine months ended March 31, 2007 decreased to 29.1%, from 30.8% in the comparable prior-year period. The increase in SG&A expenses in the nine months ended March 31, 2007, over the comparable prior-year period, was primarily attributable to: (i) approximately \$10.2 million in increased Healthcare division spending primarily due to spending in support of Del Mar Reynolds, a business that we acquired in July 2006 and (ii) an increase of \$2.9 million to support growth in the Optoelectronic and Manufacturing division. This increase in SG&A expenses was partially offset by (i) a \$1.6 million net reduction due to a favorable foreign exchange gain of \$0.3 in the nine months ended March 31, 2007, as compared to a foreign exchange loss of \$1.3 million exchange loss in the comparable prior year period and (ii) a \$2.2 million reduction in legal expenses.

**Research and development.** Research and development expenses include research related to new product development and product enhancement expenditures. For the nine months ended March 31, 2007, such expenses increased \$6.5 million, or 25%, to \$32.8 million, from \$26.3 million for the comparable prior-year period. As a percentage of revenues, research and development expenses were 8.7% for the nine months ended March 31, 2007, compared to 8.0% for the comparable prior-year period. The increase in research and development expenses for the nine month period ended March 31, 2007 was primarily attributable to: (i) \$4.4 million in increased Healthcare division spending, primarily due to costs incurred in support of Del Mar Reynolds (a business acquired in July 2006) and in support of next generation products and (ii) increased investment by our Security division of \$2.9 million, primarily to support new hold baggage screening products; partially offset by a \$0.7 million reduction in Optoelectronic and Manufacturing division spending.

**Impairment, restructuring, and other charges.** During the nine months ended March 31, 2007, as part of a global review of our operations, we assessed the value of certain technologies and product lines. As a result of this assessment, to date we have recorded charges of \$34.0 million. This amount consists of (i) \$21.5 million of asset impairment of certain identifiable intangible and fixed assets, (ii) \$10.3 of inventory charges, primarily related to finished goods inventory, and (iii) \$2.2 million for severance associated with headcount reductions, charges associated with office closures, early lease terminations and other charges associated with eliminating and consolidating manufacturing facilities.

Of the \$21.5 million of impairment charges of intangible and fixed assets, \$21.3 million was recorded within our Security division and \$0.2 million was recorded within our Optoelectronics and Manufacturing division. Of the \$10.3 million of inventory charges, \$9.9 million was recorded within our Security division and \$0.4 million was recorded within our Optoelectronics and Manufacturing division. Such inventory charges are reflected in cost of goods sold in our consolidated financial statements. Of the \$2.2 million, \$1.3 million was recorded within our Healthcare division, \$0.5 million within our Security division and \$0.4 within our Optoelectronics and Manufacturing division.

During the nine months ended March 31, 2006, we consolidated manufacturing processes and facilities of certain businesses. These consolidations resulted in a pre-tax restructuring charge of \$0.8 million.



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| (in millions)                  | Q3 YTD<br>2006 | % of Net<br>Sales | Q3 YTD<br>2007 | % of Net<br>Sales | \$ Change | %<br>Change |
|--------------------------------|----------------|-------------------|----------------|-------------------|-----------|-------------|
| Interest expense               | \$ 1.1         | 0.4%              | \$ 3.5         | 0.9%              | \$ 2.4    | 218%        |
| Interest (income)              | (0.2)          | (0.1)%            | (0.3)          | (0.1)%            | (0.1)     | 50%         |
| Other (income) / expense       | (0.3)          | (0.1)%            | (15.8)         | (4.1)%            | (15.5)    | NM          |
| Total other income and expense | \$ 0.6         | 0.2%              | \$ (12.6)      | (3.3)%            | \$ (13.2) | NM          |

**Interest expense.** For the nine months ended March 31, 2006, we incurred interest expense of \$3.5 million, as compared to \$1.1 million incurred for the comparable prior-year period. The increase in interest expense was primarily attributable to increases in our borrowings used to support our acquisition of Del Mar Reynolds in July 2006 and for working capital requirements.

**Other (income) / expense.** During the nine months ended March 31, 2007, other income includes the receipt of a \$15 million payment from General Electric Corporation in settlement of a dispute regarding an adjustment of the purchase price associated with our acquisition of Spacelabs Medical in March 2004 and a \$0.8 million payment in settlement of a dispute with a competitor of our Optoelectronics and Manufacturing division.

**Income Taxes.** For the nine months ended March 31, 2007, our income tax benefit was \$11.6 million, compared to a tax benefit of \$1.8 million for the comparable prior-year period. Our effective tax rate for the nine months ended March 31, 2007 was a benefit of 34.0%, compared to a benefit of 46.2% in the comparable prior-year period. Our benefit for income taxes depends on the mix of income (losses) from U.S. and foreign locations due to tax rate differences among such countries as well as due to the impact of permanent taxable differences.

**Liquidity and Capital Resources**

To date, we have financed our operations primarily through cash flow from operations, proceeds from equity issuances and our credit facilities. Cash and cash equivalents totaled \$18.8 million at March 31, 2007, an increase of \$5.0 million from \$13.8 million at June 30, 2006.

**Cash Used in Operating Activities.** Cash flows from operating activities can fluctuate significantly from period to period, as net income (loss), tax timing differences, and other items can significantly impact cash flows. Net cash used in operations for the nine months ended March 31, 2007 was \$8.2 million, which was a \$3.2 million improvement from the \$11.4 million used in the comparable prior-year period. The \$3.2 million improvement was due to better working capital management driven by management's efforts to collect receivables on a more timely basis, reduce inventory levels and more consistently pay vendors within payment terms. These efforts resulted in a net change in operating assets and liabilities of \$22.7 million during the current nine month-ended period. These improvements in working capital management were partially offset by an increase in net loss of \$19.5 million during the nine months ended March 31, 2007 after giving consideration to various adjustments to the net losses for non-operating cash items including depreciation and amortization, stock-based compensation and deferred taxes for both periods, and charges for impairment of long-lived assets and the litigation settlements in the current period.

**Cash Used in Investing Activities.** Net cash used in investing activities was \$20.6 million for the nine months ended March 31, 2007 compared to \$11.0 million for the nine months ended March 31, 2006. Of this amount, \$22.1 million was used to fund the acquisition of Del Mar Reynolds and \$10.8 million was used for capital expenditures. We used \$10.7 million for capital expenditures during the comparable prior-year period. In addition, during the nine months ended March 31, 2007, we settled a legal dispute related to the purchase price of Spacelabs Medical and received a cash settlement payment of \$15.0 million.

**Cash Provided by Financing Activities.** Net cash provided by financing activities of \$34.6 million primarily consisted of \$26.0 million from increases in long-term debt used to fund the acquisition of Del Mar Reynolds, \$5.5 million from our revolving lines-of-credit to fund operations and capital expenditures, and \$5.4 million from the exercise of stock options and purchases of stock under our employee stock purchase plan. In the comparable prior-year period, net cash provided by financing activities of \$19.4 million primarily consisted of \$26.3 million from an initial public offering of approximately 20% of the total issued and outstanding common stock of our Spacelabs Healthcare, Inc. subsidiary on the AIM (formerly known as the Alternative Investment Market), a stock market administered by the London Stock Exchange. We used approximately \$13.8 million of these proceeds to pay down our credit line with a U.S. bank.

**Borrowings**

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Outstanding lines of credit and long-term debt totaled \$48.9 million at March 31, 2007, an increase of \$31.3 million from \$17.6 million at June 30, 2006.

We maintain two revolving credit lines with a U.S. bank totaling \$45 million, including letter-of-credit and foreign exchange facilities. Loans under these credit lines bear interest at either LIBOR plus up to 2.5% or at the bank's prime rate plus up to 0.5%.

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The credit lines are collateralized by substantially all of our U.S. assets. As of March 31, 2007, \$16.3 million was outstanding under these credit lines and \$10.2 million was outstanding under the letter-of-credit facilities. Our credit lines contain covenants limiting our ability to, among other things, incur additional debt, pay cash dividends, make investments or repurchase our stock, enter into transactions with affiliates, merge or consolidate with others and dispose of assets or create liens on assets. In addition, they contain certain financial covenants. In addition, in July 2006 we secured a \$27.4 million term loan with the same U.S. bank to fund the acquisition of Del Mar Reynolds. As of March 31, 2007, \$22.7 million was outstanding under this term loan.

As of March 31, 2007, several of our foreign subsidiaries maintained bank lines-of-credit, denominated in local currencies, to meet short-term working capital requirements and for the issuance of letters of credit. The total amount of these credit facilities was \$36.2 million with a total cash borrowing sub limit of \$11.6 million, of which nothing was outstanding at March 31, 2007. The weighted average interest rate of these facilities was 6.8% at March 31, 2007. We have guaranteed these credit facilities.

Our long-term debt consisted of the following:

|  | June 30, | March 31, |
|--|----------|-----------|
|  | 2006     | 2007      |
| Five-year term loan, payable in quarterly installments of \$908,000, with a final balloon payment of \$7.3 million due on July 18, 2011. Interest is variable based on either one to three-month LIBOR plus 2.5% (7.88% at March 31, 2007) or the prime rate plus up to 0.5% | \$       | \$ 22,690 |
| Twenty-year term loan, payable in quarterly installments of £34,500 (approximately \$68,000 at March 31, 2007) until paid in full on December 1, 2024. Interest is due quarterly at a rate of three-month LIBOR plus 1.2% (6.82% at March 31, 2007)                          | 4,721    | 4,808     |
| Capital leases   | 248      | 3,453     |
| Other  | 1,765    | 1,592     |
|  | 6,734    | 32,543    |
| Less current portion of long-term debt   | 1,251    | 5,578     |
| Long-term portion of debt  | \$ 5,483 | \$ 26,965 |

We anticipate that existing cash borrowing arrangements and future access to capital markets should be sufficient to meet our cash requirements for the foreseeable future. However, our future capital requirements and the adequacy of available funds will depend on many factors, including future business acquisitions, litigation, stock repurchases and levels of research and development spending.

**Stock Repurchase Program**

Our Board of Directors has authorized a stock repurchase program under which we can repurchase up to 3,000,000 shares of our common stock. During the nine months ended March 31, 2007, we did not repurchase any shares under this program. As of March 31, 2007, 1,330,973 shares were available for additional repurchase under the program. We retire the treasury shares as they are repurchased and record them as a reduction in the number of shares of common stock issued and outstanding in our consolidated financial statements.

**Dividend Policy**

We have never paid cash dividends on our common stock and have no plans to do so in the foreseeable future.

**Contractual Obligations**

Under the terms and conditions of the purchase agreements associated with the following acquisitions, we may be obligated to make additional payments:

In August 2002, we purchased a minority equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems. In June 2004, we increased our equity interest in CXR to approximately 75%





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and in December 2004 we acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest, we have agreed to make certain royalty payments based on sales of CXR's products. As of March 31, 2007, no royalty payments had been earned.

In November 2002, we acquired all of the outstanding capital stock of Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company. During the five years following the close, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at \$34.0 million. As of March 31, 2007, no earn-out payments had been earned.

In January 2004, we acquired Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately-held company located in Sunnyvale, California. During the seven years following the close, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. As of March 31, 2007, no earn out payments had been earned.

In February 2005, we acquired Blease Medical Holdings Limited and certain affiliated companies. During the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$12.3 million as of March 31, 2007). As of March 31, 2007, no earn-out payments had been earned.

In July 2006, we acquired Del Mar Reynolds. If Del Mar Reynolds achieves certain revenue targets during fiscal year 2007, contingent consideration of up to £5 million (\$9.8 million at March 31, 2007) will be payable. The additional earn-out, if any, may be satisfied, at Spacelabs Healthcare's discretion, either in cash or by the issuance of Spacelabs Healthcare common stock. As of March 31, 2007 no earn-out payments had been earned.

### **Off Balance Sheet Arrangements**

As of March 31, 2007, we did not have any significant off balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

For the three months ended March 31, 2007, no material changes occurred with respect to market risk as disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

#### **Market Risk**

We are exposed to certain market risks, which are inherent in our financial instruments and arise from transactions entered into in the normal course of business. We may enter into derivative financial instrument transactions in order to manage or reduce market risk in connection with specific foreign-currency-denominated transactions. We do not enter into derivative financial instrument transactions for speculative purposes.

We are subject to interest rate risk on our short-term borrowings under our bank lines of credit. Borrowings under these lines of credit do not give rise to significant interest rate risk because these borrowings have short maturities and are borrowed at variable interest rates. Historically, we have not experienced material gains or losses due to interest rate changes.

#### **Foreign Currency**

We maintain the accounts of our operations in each of the following countries in the following currencies: Singapore (Singapore dollars), Malaysia (Malaysian ringgits), United Kingdom (U.K. pounds sterling), Norway (Norwegian kroners), India (Indian rupees), Indonesia (Indonesian rupiah), Hong Kong (Hong Kong dollars), China (Chinese renminbi), Canada (Canadian dollars) and Cyprus (Cypriot pounds). We maintain the accounts of our operations in each of the following countries in euros: Finland, France, Germany, Greece and Italy. We translate foreign currency financial statements into U.S. dollars at current rates, with the exception of revenues, costs and expenses, which we translate at average rates during the reporting period. We include gains and losses resulting from foreign currency transactions in income, and exclude those resulting from translation of financial statements from income and accumulate them as a component of shareholders' equity. A hypothetical 10% change in the relevant currency rates at March 31, 2007 would not have a material impact on our financial position or results of operations.

#### **Use of Derivatives**

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Our use of derivatives consists primarily of foreign exchange contracts and interest rate swaps. We purchase forward contracts to hedge foreign exchange exposure related to commitments to acquire inventory for sale and to reduce our exposure associated with

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acquisitions. We do not use the contracts for trading purposes. As of June 30, 2006, we had a \$25.4 million foreign currency forward contract outstanding to buy U.K. pounds sterling in anticipation of the Del Mar Reynolds acquisition. In July 2006, we completed the Del Mar Reynolds acquisition and the foreign currency forward contract settled, resulting in a fiscal year 2007 loss of approximately \$24,000 related to this contract. There were no foreign exchange contracts or interest rate swaps outstanding as of March 31, 2007.

### **Importance of International Markets**

International markets provide us with significant growth opportunities. However, the following events, among others, could adversely affect our financial results in subsequent periods: periodic economic downturns in different regions of the world, changes in trade policies or tariffs, wars and other forms of political instability. For the three and nine months ended March 31, 2007, overall foreign currency fluctuations relative to the U.S. dollar had an immaterial effect on our consolidated revenues and results of operations. Despite changes in monetary policy in Malaysia, including the de-pegging of the Malaysian ringgit to the U.S. dollar, we believe that our foreign currency exposure in Malaysia will not be significant in the foreseeable future. We continue to perform ongoing credit evaluations of our customers' financial condition and, if deemed necessary, we require advance payments for sales. We monitor economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future. Due to our overseas investments and the necessity of dealing in local currencies in many foreign business transactions, we are at risk with respect to foreign currency fluctuations.

### **Inflation**

We do not believe that inflation had a material impact on our results of operations during fiscal year 2007.

### **Interest Rate Risk**

We classify all highly liquid investments with maturity of three months or less as cash equivalents and record them in the balance sheet at fair value. Short-term investments comprise high-quality marketable securities.

## **Item 4. Controls and Procedures**

### *(a) Evaluation of Disclosure Controls and Procedures*

As of March 31, 2007, the end of the period covered by this Quarterly Report on Form 10-Q, our management, including our Chief Executive Officer and our Chief Financial Officer, reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934, Rule 13a-15(e) and 15d-15(e)). Such disclosure controls and procedures are designed to ensure that material information we must disclose in this report is recorded, processed, summarized, and filed or submitted on a timely basis. Based upon this evaluation and due to material weaknesses existing in our internal controls as of June 30, 2006 (described below), which have not been fully remediated as of March 31, 2007 we have concluded that, as of March 31, 2007, our disclosure controls and procedures were ineffective.

### *(b) Changes in Internal Control over Financial Reporting*

As reported in Item 9A of our Annual Report on Form 10-K filed with the Securities and Exchange Commission on September 22, 2006, we determined that the following material weaknesses in internal control over financial reporting existed as of June 30, 2006:

1) In our testing of information technology controls, we determined that controls over systems change management, program development, end-user computing, and systems access and related monitoring were inadequately designed and implemented. In assessing these control deficiencies, we determined that there was an incomplete adoption of recognized industry standards resulting in the lack of a comprehensive internal control framework over information technology; we determined that there was a lack of adequate oversight by experienced managers knowledgeable and fully engaged with the design and implementation of effective information technology controls; we determined there was a lack of a comprehensive training program related to information technology controls supporting our internal controls over financial reporting; and we determined that the evaluation and testing of information technology controls was insufficient and was conducted by personnel who lacked the competency needed to fully evaluate this area; and

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2) In our overall testing of internal controls, we determined that there was a weakness in the monitoring and oversight component of our control environment. We found that there was insufficient and inappropriate verification of the performance of certain review controls and inadequacies in the documentation supporting those controls. Although we did not identify an error in financial reporting as a result of these observations, we determined that a material weakness in our monitoring and oversight controls was evident. Therefore, we determined that the design and operation of our control environment did not sufficiently promote effective internal control over financial reporting.

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During the nine months ended March 31, 2007, we dedicated substantial resources to strengthen our internal controls, including upgrading the talent and technical capabilities of individuals within the finance and IT functions through the hiring of experienced professionals from outside of the Company. In addition, we took the actions described below to address such material weaknesses. Given that our remediation efforts are still ongoing, these actions also serve as additional procedures and analyses to ensure that our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. We implemented the following measures:

Evaluated the adequacy of our personnel overseeing information technology controls and the testing of those controls;

Developed a training program for our personnel overseeing information technology controls and the testing of those controls;

Adopted a widely-recognized standard for information technology controls to supplement our existing internal control framework and evaluated and enhanced our existing processes and controls in adopting that standard; and

Evaluated and improved our information technology policies and procedures, specifically with regard to systems change management, program development, end-user computing, and access controls and related monitoring.

We are currently in the process of developing and implementing a global information technology strategic plan.

We have dedicated substantial resources and made significant progress with respect to remediating the material weaknesses described above and currently plan to remediate such items by June 30, 2007. Our management will continue to evaluate the effectiveness of our overall control environment and will continue to refine existing controls as they, in conjunction with the Audit Committee of our Board of Directors, Chief Executive Officer and Chief Financial Officer, consider necessary.

Other than the changes discussed above, there have been no changes in our internal control over financial reporting that occurred that have materially affected or are reasonably likely to materially affect our internal control over financial reporting. Our management has discussed these issues and remediation efforts in detail with the Audit Committee of our Board of Directors.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In March 2004, we completed the acquisition from Instrumentarium Corporation, now a subsidiary of General Electric Company ( GE ), of Spacelabs Medical. The acquisition price was approximately \$47.9 million in cash (net of cash acquired), including acquisition costs. In June 2004, we notified GE of a working capital and retention bonus adjustment resulting in what we believed to be a downward adjustment of the purchase price. In September 2004, GE responded that it disagreed with our calculation of the purchase price adjustment. In March 2007, we settled this dispute. Under the terms of the settlement, we received a payment of \$15 million.

In November 2002, L-3 Communications Corporation ( L-3 ) brought suit against us in the District Court for the Southern District of New York seeking a declaratory judgment that L-3 had not breached its obligations to us concerning the acquisition of PerkinElmer's Security Detection Systems Business. We asserted counterclaims against L-3 for, among other things, fraud, breach of fiduciary duty, breach of contract and failure to negotiate in good faith. On May 24, 2006, the jury in the case returned a verdict in our favor and awarded us \$125 million in damages. The jury found that L-3 had breached its fiduciary duty to us and had committed fraud. The jury awarded us \$33 million in compensatory damages and \$92 million in punitive damages. In addition, the jury also found that we had breached a confidentiality agreement and awarded L-3 nominal damages of one dollar. In response to the verdict, L-3 Communications moved for judgment as a matter of law or, in the alternative, a new trial or a reduction in the amount of the verdict. On February 26, 2007, U.S. District Judge Paul A. Crotty denied L-3 Communications' motion, upholding the jury's verdict in full. L-3 has filed a notice of its appeal of the judgment.

In February 2005, Electromedica, a Greek distribution company, filed an action in the courts of Greece claiming that our Spacelabs Medical subsidiary orally agreed to appoint Electromedica as its exclusive Greek distributor, but failed to do so. Electromedica claims that it incurred significant expenses as a result of Spacelabs' actions and demanded Euro 872,414 (approximately \$1.2 million as of March 31, 2007) in

compensation. In March 2007, we settled the matter and paid approximately \$0.1 million to Electromedica.

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We are also involved in various claims and legal proceedings which have been previously disclosed in our quarterly and annual reports in accordance with Item 103 of Regulation S-K. The results of such legal proceedings cannot be predicted with certainty. Should we fail to prevail in any of these legal matters or should several of these legal matters be resolved against us in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

We are involved in various other claims and legal proceedings arising out of the ordinary course of business which have not been previously disclosed in our quarterly and annual reports. In our opinion, after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on our financial position, future results of operations or cash flows.

**Item 1A. Risk Factors**

The discussion of our business and operations in this Quarterly Report on form 10-Q should be read together with the risk factors contained in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, filed with the Securities and Exchange Commission, which describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner.

**Item 6. Exhibits**

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification 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, in the City of Hawthorne, State of California on the 7<sup>th</sup> day of May 2007.

**OSI SYSTEMS, INC.**

By: /s/ Deepak Chopra  
Deepak Chopra  
President and Chief Executive Officer

By: /s/ Alan Edrick  
Alan Edrick  
Executive Vice President and  
Chief Financial Officer