GSI GROUP INC
Form 10-Q
October 01, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended July 3, 2009

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 No. 000-25705

GSI Group Inc.

(Exact name of registrant as specified in its charter)

New Brunswick, Canada	**98-0110412**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
125 Middlesex Turnpike	
Bedford, Massachusetts, USA	**01730**
(Address of principal executive offices)	**(Zip Code)**

(781) 266-5700

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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 x

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12 , 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨ No þ

As of August 31, 2010, there were 100,026,395 of the Registrant s common shares, no par value, issued and outstanding.

GSI GROUP INC.

TABLE OF CONTENTS

Item No.		Page No.
	EXPLANATORY NOTE	
PART I FINANCIAL INFORMATION		1
ITEM 1.	FINANCIAL STATEMENTS	1
	CONSOLIDATED BALANCE SHEETS (unaudited)	1
	CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)	2
	CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)	3
	NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)	4
ITEM 2.	MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	48
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	68
ITEM 4.	CONTROLS AND PROCEDURES	69
PART II OTHER INFORMATION		70
ITEM 1.	LEGAL PROCEEDINGS	70
ITEM 1A.	RISK FACTORS	70
ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	86
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	86
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	87
ITEM 5.	OTHER INFORMATION	87
ITEM 6.	EXHIBITS	88
SIGNATURES		89

Table of Contents

EXPLANATORY NOTE

In August 2008, GSI Group Inc. (the Company) closed its acquisition of Excel Technology, Inc. (Excel). Delays in the integration of the financial accounting systems of the Company and Excel following the acquisition initially led to a delay of several weeks in the preparation of the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 26, 2008 (the 2008 Q3 Report). Shortly thereafter and prior to filing the 2008 Q3 Report, the Company initiated an internal review of certain potential errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Company s Semiconductor Systems segment, which were brought to the attention of the Audit Committee of the Company s Board of Directors (the Audit Committee) by Company management. Following this initial internal review, the Audit Committee, in consultation with the Company s outside legal counsel determined that it was appropriate to undertake an independent review of the potential revenue recognition issues brought to its attention.

On or about November 25, 2008, the Audit Committee initiated a broader independent review of sales transactions in the Semiconductor Systems segment that contain arrangements with multiple deliverables for fiscal years 2007 and 2008. The review was subsequently expanded to include sales transactions in the Semiconductor Systems segment, along with certain other sales transactions for fiscal years 2006, 2007 and 2008. To assist in its review, the Audit Committee retained independent legal counsel and forensic accounting experts.

On December 4, 2008, the Company announced that it identified errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Semiconductor Systems segment and that the previously issued financial statements contained in the Company s Quarterly Reports on Form 10-Q for the periods ended March 28, 2008 and June 27, 2008 should no longer be relied upon.

Subsequently, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems segment customers during fiscal year 2007. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2007 should no longer be relied upon. The Audit Committee thereafter expanded the scope of its investigation to include fiscal year 2006.

On March 30, 2009, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems segment customers during fiscal year 2006. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2006 should no longer be relied upon.

The Audit Committee s advisors reported the results of the investigation to the Audit Committee on April 24, 2009. The Company voluntarily reported the investigation results to the Securities and Exchange Commission (SEC) on April 30, 2009. The Company later announced in May 2009 that it was reviewing sales transactions of its Semiconductor Systems segment during fiscal years 2004 and 2005 to determine if adjustments needed to be made to those periods. Thereafter, on June 30, 2009, the Company announced that it was undertaking a preliminary review of the timing of revenue recognized in connection with multiple element arrangements in its Precision Technology segment from 2004 through 2008 to determine if adjustments need to be made to those periods (collectively with the Audit Committee s review of transactions in the Semiconductor Systems segment and any other related Company reviews of transactions in the Semiconductor Systems segment and Precision Technology segment, the Revenue Review). As is further explained in Note 2 to Consolidated Financial Statements, in connection with the Revenue Review, the Company concluded that there were a number of adjustments required that primarily relate to revenue recognition and the corresponding adjustments to deferred revenue, cost of goods sold and other assets. Adjustments to revenue resulted in revenue and their related costs being deferred and recognized in subsequent periods once all revenue recognition criteria have been met. In addition, these adjustments did not affect the Company s cash balances. The transactions that are being restated as a result of the Revenue Review include transactions for which the complete facts required to make the appropriate assessment with respect to the timing of the revenue recognition were not communicated to the finance department at the time the initial revenue was booked. As of September 26, 2008, a substantial portion of the revenue deferred through the restatement remains deferred, pending the finalization of all deliverables under the terms of the arrangements with customers. The revenue adjustments, in aggregate for both the Semiconductor Systems and the Precision Technology segments, primarily relate to:

- multiple-element arrangements for which objective and reliable evidence of fair value does not exist for one or more of the undelivered elements;

for those arrangements whereby it was determined that customer acceptance was required in order to record revenue in accordance with the Company s policy, the correction of the timing of revenue for instances where customer acceptance could not be demonstrated until a period subsequent to the period of original revenue recognition;

Table of Contents

contractual terms that resulted in arrangements being deemed to not be fixed or determinable at the outset of the arrangement (including extended payment terms and contracts whereby product quantity mix was subject to adjustment during the term of the arrangement); and

certain other revenue adjustments which were not individually, or in the aggregate, significant. These adjustments have been reflected in the restated consolidated financial statements and primarily relate to the accounting for separately priced extended warranty contracts.

In addition to adjustments from the Revenue Review, the Company has also identified and recorded the impact of certain adjustments which, due to their materiality, were not previously recorded. Certain of these adjustments affect revenue, cost of goods sold and operating expenses, as well as offsetting balance sheet accounts. These adjustments have been reflected in the accompanying consolidated financial statements.

In connection with its restatement, the Company and Ernst & Young LLP, its independent auditors, identified and reported to the Company s Audit Committee significant internal control matters that collectively constitute material weaknesses . Please see Item 4. Controls and Procedures below for a description of these matters, and of certain of the measures that have been implemented to date, as well as additional steps the Company plans to take to strengthen its controls.

The Company did not amend its previously filed annual reports on Form 10-K or any quarterly reports on Form 10-Q. The consolidated financial statements and related consolidated financial information contained in previously filed reports, including for the years ended December 31, 2007 and 2006 and for the first two quarterly reports during 2008 and the first three quarters of 2007, should no longer be relied upon.

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

GSI GROUP INC.

CONSOLIDATED BALANCE SHEETS

(In thousands of U.S. dollars, except share data)

	July 3, 2009 (Unaudited)	December 31, 2008
ASSETS		
Current Assets		
Cash and cash equivalents	$ 61,035	$ 69,001
Accounts receivable, net of allowance of $1,719 and $1,687, respectively	38,988	50,494
Income taxes receivable	24,944	30,038
Inventories	74,816	78,508
Deferred tax assets	11,126	11,106
Deferred cost of goods sold	31,768	20,507
Deferred debt financing costs	5,345	5,999
Prepaid expenses and other current assets	7,511	9,569
Total current assets	255,533	275,222
Property, plant and equipment, net of accumulated depreciation and amortization of $48,067 and $45,309, respectively	52,275	54,439
Deferred tax assets	23,937	23,802
Deferred cost of goods sold		23,133
Investments in auction rate securities	14,316	25,065
Other assets	4,378	2,133
Intangible assets, net	66,690	71,460
Goodwill	45,063	45,063
Total Assets	$ 462,192	$ 520,317
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Debt (Note 8)	$ 187,030	$ 185,115
Accounts payable	12,484	20,286
Accrued compensation and benefits (Note 3)	6,877	8,452
Deferred revenue	59,171	45,061
Deferred tax liabilities	486	486
Other accrued expenses (Note 3)	20,773	23,892
Total current liabilities	286,821	283,292
Deferred revenue		39,164
Deferred tax liabilities	30,109	30,131
Accrued restructuring, net of current portion	868	1,072
Income taxes payable	5,298	5,166
Accrued pension liability (Note 3)	4,131	4,026
Other liabilities (Note 3)	5,593	4,569

Total liabilities	332,820	367,420
Commitments and contingencies (Note 14)		
Stockholders Equity:		
Common shares, no par value; Authorized shares: unlimited; Issued and outstanding: 47,733,255 and 47,567,874, respectively	330,896	330,896
Additional paid-in capital	12,059	10,733
Accumulated deficit	(211,316)	(184,716)
Accumulated other comprehensive loss	(2,482)	(4,236)
Total GSI Group Inc. stockholders equity	129,157	152,677
Noncontrolling interest	215	220
Total stockholders equity	129,372	152,897
Total Liabilities and Stockholders Equity	$ 462,192	$ 520,317

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

Table of Contents

GSI GROUP INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands of U.S. dollars, except per share amounts)

	Three Months Ended		Six Months Ended	
	July 3, 2009 (Unaudited)	June 27, 2008 (Unaudited, as Restated)	July 3, 2009 (Unaudited)	June 27, 2008 (Unaudited, as Restated)
Sales	$ 62,904	$ 59,469	$ 126,812	$ 120,694
Cost of goods sold	38,451	36,861	78,760	75,529
Gross profit	24,453	22,608	48,052	45,165
Operating expenses:				
Research and development and engineering	6,870	7,167	15,001	14,955
Selling, general and administrative	14,601	14,363	29,439	30,237
Amortization of purchased intangible assets	1,600	551	3,220	1,103
Restructuring, restatement related costs and other	3,090	1,456	11,390	1,133
Pre-petition professional fees	1,280		1,950	
Total operating expenses	27,441	23,537	61,000	47,428
Loss from operations	(2,988)	(929)	(12,948)	(2,263)
Interest income	89	1,002	229	2,168
Interest expense	(7,055)	(18)	(14,231)	(35)
Foreign exchange transaction gains (losses)	(1,382)	133	(1,341)	271
Other income	889	21	162	142
Income (loss) from continuing operations before income taxes	(10,447)	209	(28,129)	283
Income tax provision (benefit)	(734)	259	(1,656)	519
Loss from continuing operations	(9,713)	(50)	(26,473)	(236)
Income (loss) from discontinued operations, net of tax	(132)	110	(132)	329
Consolidated net income (loss)	(9,845)	60	(26,605)	93
Less: Net (income) loss attributable to noncontrolling interest	(14)		5	
Net income (loss) attributable to GSI Group Inc.	(9,859)	60	(26,600)	93
Loss from continuing operations attributable to GSI Group Inc. per common share:				
Basic	$ (0.20)	$	$ (0.56)	$ (0.01)
Diluted	$ (0.20)	$	$ (0.56)	$ (0.01)
Income (loss) from discontinued operations attributable to GSI Group, Inc. per common share:				
Basic	$	$	$	$ 0.01
Diluted	$	$	$	$ 0.01
Net income (loss) attributable to GSI Group Inc. per common share:				
Basic	$ (0.21)	$	$ (0.56)	$
Diluted	$ (0.21)	$	$ (0.56)	$

Weighted average common shares outstanding basic	47,733	41,736	47,662	41,831
Weighted average common shares outstanding diluted	47,733	41,853	47,662	42,112
Amounts attributable to GSI Group Inc.:				
Loss from continuing operations	(9,727)	(50)	(26,468)	(236)
Income (loss) from discontinued operations	(132)	110	(132)	329
Net income (loss)	$ (9,859)	$ 60	(26,600)	$ 93

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

Table of Contents

GSI GROUP INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of U.S. dollars)

	Six Months Ended	
	July 3, 2009 (Unaudited)	**June 27, 2008 (Unaudited, as Restated)**
Cash flows from operating activities:		
Consolidated net income (loss)	$ (26,605)	$ 93
Adjustments to reconcile net income (loss) to net cash from operating activities:		
(Income) loss from operations of discontinued operations	132	(329)
Depreciation and amortization	9,265	6,739
Provision for uncollectible receivables	240	(40)
Provision for inventory obsolescence	847	2,535
Step-up value of acquired inventory sold	139	
Share based compensation	1,326	1,579
Deferred income taxes	(177)	(30)
Earnings from equity investment	(235)	(142)
Gain on sale of property and assets	(207)	(1,562)
Gain on sale of auction rate securities	(1,749)	
Non-cash interest expense	2,569	
Non-cash restructuring charges	25	
Changes in operating assets and liabilities:		
Accounts receivable	8,721	16,736
Inventories	1,752	1,283
Deferred costs	11,105	(8,559)
Prepaid expenses and other current assets	2,100	431
Deferred revenue	(23,436)	10,923
Deferred rent	(160)	3,217
Accounts payable, accruals and taxes receivable and payable	(5,189)	(3,168)
Changes in other non-current assets and liabilities	(1,555)	(46)
Cash used in operating activities of discontinued operations	(132)	(1,113)
Cash provided by (used in) operating activities	(21,224)	28,547
Cash flows from investing activities:		
Purchases of property, plant and equipment	(536)	(16,097)
Proceeds from the sale of auction rate securities	13,264	
Proceeds from the sale of property, plant and equipment	492	3,211
Cash provided by (used in) investing activities	13,220	(12,886)
Cash flows from financing activities:		
Purchases of the Company s common shares		(6,439)
Net proceeds from the issuance of share capital		38
Excess tax benefit of stock options		23
Cash used in financing activities		(6,378)
Effect of exchange rates on cash and cash equivalents	38	1,601
Increase (decrease) in cash and cash equivalents	(7,966)	10,884
Cash and cash equivalents, beginning of period (1)	69,001	172,387

Cash and cash equivalents, end of period (1)	$ 61,035	183,271
Supplemental disclosure of non cash investing activity:		
Auction rate securities	$ 764	$

(1) The Consolidated Statements of Cash Flows include cash and cash equivalent balances (in thousands) of $0, and $1 of discontinued operations for the six months ended July 3, 2009, and June 27, 2008, respectively.

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

3

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization, Presentation and Significant Events

GSI Group Inc. (GSIG) and its subsidiaries (collectively the Company) designs, develops, manufactures and sells photonics-based solutions (consisting of lasers, laser systems and electro-optical components), precision motion devices, associated precision motion control technology and systems. Its customers incorporate its technology into their products or manufacturing processes, for a wide range of applications in a variety of markets, including: industrial, scientific, electronics, semiconductor, medical and aerospace. The Company operates in three segments: Precision Technology, Semiconductor Systems, and Excel Technology, Inc. (Excel). The Company s principal markets are in North America, Europe, Japan and Asia-Pacific. The Company exists under the laws of New Brunswick, Canada.

Acquisition of Excel Technology, Inc.

In August 2008, the Company acquired Excel, a designer, manufacturer and marketer of photonics-based solutions consisting of lasers, laser-based systems, precision motion devices and electro-optical components, primarily for industrial and scientific applications. Excel, which was headquartered in East Setauket, New York, manufactures its products in plants located in the United States and Germany, and sells its products to customers worldwide, both directly and indirectly through resellers and distributors. The Company acquired Excel in exchange for a cash payment of $368.7 million, including transaction costs, a portion of which was financed with proceeds received from the issuance of $210.0 million of 11% Senior Notes due 2013 (the 2008 Senior Notes). This loan is discussed further in Notes 8 and 17 to Consolidated Financial Statements. Subsequent to the acquisition of Excel, the Company established a third segment which was comprised solely of the operations of the newly acquired entity. In 2009, the Company changed the structure of its internal organization in a manner that caused the composition of its reportable segments to change. More specifically, certain portions of a specific product line within the Precision Technology segment were transferred to the Excel segment. The Company s reportable segment financial information has been restated to reflect the updated reportable segment structure for all periods presented. See Note 4 to Consolidated Financial Statements for further details regarding the Excel transaction.

Divestiture of U.S. General Optics Business

On October 8, 2008, the Company completed the sale of its General Optics business (the U.S. Optics Business), located in Moorpark, California, for $21.6 million, which represented a gain of $8.7 million, net of tax. The sale of the U.S. Optics Business is reported as Gain on Disposal of Discontinued Operations in the Company s consolidated statements of operations for the year ended December 31, 2008. This business was part of the Company s Precision Technology segment. The results of operations of the U.S. Optics Business have been reclassified and reported as income from discontinued operations in the Company s consolidated statements of operations. See Note 5 to Consolidated Financial Statements for further details regarding the sale of the U.S. Optics Business.

Chapter 11 Bankruptcy Filing

On December 12, 2008, the Company announced that it had received four letters from certain holders of the 2008 Senior Notes issued in connection with the acquisition of Excel, alleging that the Company had failed to comply with the covenant in the governing Senior Notes Indenture (the 2008 Senior Note Indenture), that required it to file its Quarterly Reports on Form 10-Q and Annual Reports on Form 10-K within the time frames set forth in the SEC s rules and regulations. Specifically, the letters alleged that the Company failed to file its Quarterly Report on Form 10-Q for the quarterly period ended September 26, 2008 (the 2008 Q3 Report) within the time period specified by the rules and regulations of the SEC and that if such failure continued for 60 days from the date that the Company received notices of such failure from holders comprising at least 25% of the aggregate principal amount of the 2008 Senior Notes then outstanding, such failure would constitute an event of default. The Company notified the trustee under the 2008 Senior Note Indenture that the letters did not constitute proper notice as required by the terms of the 2008 Senior Note Indenture, and continued working diligently to complete the review by its Audit Committee and to file its 2008 Q3 Report to avoid any claim of an Event of Default from occurring under the 2008 Senior Note Indenture. Upon receipt of the letters from the note holders, the Company commenced discussions with certain of the noteholders and, on June 30, 2009, announced that the Company had reached an agreement with certain beneficial owners holding greater than 75% of the outstanding aggregate principal amount of the 2008 Senior Notes on a non-binding term sheet to consensually restructure its outstanding obligations under the 2008 Senior Notes.

As discussed below and in further detail in Note 17 to Consolidated Financial Statements, on November 20, 2009 (the Petition Date), GSIG and two of its United States subsidiaries, GSI Group Corporation (GSI US) and MES International, Inc. (MES and, collectively with GSIG and GSI US, the Debtors), filed voluntary petitions for relief (the Chapter 11 Petitions) under Chapter 11 of the United States Bankruptcy Code (the Bankruptcy Code) in the United States Bankruptcy Court for the District of Delaware (the Bankruptcy Court) (the Chapter 11 Cases).

Following the Petition Date, the Debtors continued to operate their business as debtors-in-possession under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. In late December 2009, the United States Trustee overseeing the Chapter 11 Cases appointed an Official Committee of Equity Security Holders (the Equity Committee) to represent the interests of the Company s equity holders.

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

On May 14, 2010, the Debtors entered into a Restructuring Plan Support Agreement (the May Plan Support Agreement) with the Equity Committee, the individual members of the Equity Committee (the Committee Members) and eight of ten beneficial holders (the Consenting Noteholders) of the 2008 Senior Notes. The Consenting Noteholders held 88.1% of the outstanding principal amount of the 2008 Senior Notes. Pursuant to the May Plan Support Agreement which superseded the previous plan support agreement, the Equity Committee, the Committee Members and the Consenting Noteholders agreed to support a modified plan, in the form of the Fourth Modified Joint Chapter 11 Plan of Reorganization for the Debtors (the May Plan).

On May 24, 2010, the Debtors filed with the Bankruptcy Court a modified joint Chapter 11 plan of reorganization for the Debtors, which was further supplemented on May 27, 2010 to provide for minor modifications to the May Plan (as supplemented, the Final Chapter 11 Plan). On May 27, 2010, the Bankruptcy Court entered an order confirming and approving the Final Chapter 11 Plan and the plan documents.

On July 23, 2010 (the Effective Date) the Debtors consummated their reorganization through a series of transactions contemplated by the Final Chapter 11 Plan, and the Final Chapter 11 Plan became effective pursuant to its terms. Refer to Note 17 to Consolidated Financial Statements for additional information concerning the Chapter 11 Cases including a description of material agreements the Company entered into on the Effective Date pursuant to the terms of the Final Chapter 11 Plan.

NASDAQ Delisting Determination

On November 3, 2009, the NASDAQ Hearing Panel (the Panel) of the NASDAQ Stock Market (NASDAQ) notified the Company that it had determined to delist the Company s common shares from the NASDAQ Global Select Market and to suspend trading in the Company s common shares effective at the open of market on November 5, 2009. The Panel s determination was made in connection with the Company s non-compliance with the filing requirements set forth in Listing Rule 5250(c)(1) due to the delayed filing of certain of the Company s periodic reports. As permitted by NASDAQ rules, the Company timely appealed the Panel s determination to the NASDAQ Listing and Hearing Review Council (the Listing Council). On January 15, 2010, the Listing Council notified the Company that it affirmed the Panel s decision to delist the Company s securities. On March 15, 2010, the Company received notification from the NASDAQ Stock Market, LLC Board of Directors (the NASDAQ Board) that the NASDAQ Board had declined to call for review the January 15, 2010 decision of the Listing Council. Accordingly, pursuant to Listing Rule 5825, the Listing Council s decision represents the final decision of NASDAQ. In accordance with Listing Rule 5830 and Rule 12d2-2 under the Securities Exchange Act of 1934, NASDAQ filed an application on Form 25 with the SEC on April 5, 2010, to delist the Company s securities from NASDAQ. The application became effective on April 15, 2010.

Prior to November 4, 2009, the Company s common shares were traded on The NASDAQ Global Select Market under the symbol GSIG . From November 5, 2009 through November 19, 2009, the Company s common shares were quoted on Pink OTC Markets, Inc., under the trading symbol GSIG . Following the Company s filing of the Chapter 11 Petitions on November 20, 2009, its common shares were quoted on Pink OTC Markets, Inc. under the trading symbol GSIGQ . Following the Company s emergence from bankruptcy on July 23, 2010, its common shares have been quoted on Pink OTC Markets Inc., under the trading symbol LASR.PK .

Going Concern

On November 20, 2009, GSIG, together with two of its subsidiaries, voluntarily filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. Under the Bankruptcy Code, the Company s status as a bankruptcy debtor automatically accelerated the payment of the debt arising under the 2008 Senior Notes. Accordingly, this debt has been classified as current as of December 31, 2008 and July 3, 2009 in the Company s accompanying consolidated balance sheets. Operating in bankruptcy imposed significant risks and uncertainties on the Company s business.

However, the Company emerged from bankruptcy on July 23, 2010 and in connection therewith completed a rights offering pursuant to which it sold common shares for approximately $85 million (the Rights Offering). The proceeds from the Rights Offering were used to pay down a portion of the obligations due with respect to the 2008 Senior Notes. The remaining obligations due with respect to the 2008 Senior Notes for unpaid principal and accrued interest were satisfied through the issuance of the Company s common shares, the payment of cash and the issuance of new 12.25% Senior Secured PIK Election Notes (the New Notes) which mature in July 2014. As a result of the Company s emergence from bankruptcy and the associated restructuring of its debt obligations, the Company believes it has sufficient liquidity to fund its operations through at least December 31, 2010.

2. Restatement of Previously Issued Financial Statements

In August 2008, the Company completed its acquisition of Excel. Delays in the integration of the financial accounting systems of the Company and Excel following the acquisition initially led to a delay of several weeks in the preparation of the

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Company s Quarterly Report on Form 10-Q for the quarterly period ended September 26, 2008 (the 2008 Q3 Report). Shortly thereafter and prior to filing the 2008 Q3 Report, the Company initiated an internal review of certain potential errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Company s Semiconductor Systems segment, which were brought to the attention of the Audit Committee of the Company s Board of Directors (the Audit Committee) by Company management. Following this initial internal review, the Audit Committee, in consultation with the Company s outside legal counsel, determined that it was appropriate to undertake an independent review of the potential revenue recognition issues brought to its attention.

On or about November 25, 2008, the Audit Committee initiated a broader independent review of sales transactions in the Semiconductor Systems segment, along with certain other sales transactions that contain arrangements with multiple deliverables for fiscal years 2007 and 2008. The review was subsequently expanded to include fiscal year 2006. To assist in its review, the Audit Committee retained independent legal counsel and forensic accounting experts.

On December 4, 2008, the Company announced that it had identified errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Semiconductor Systems segment and that the previously issued financial statements contained in the Company s Quarterly Reports on Form 10-Q for the periods ended March 28, 2008 and June 27, 2008 should no longer be relied upon.

Subsequently, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems segment customers during fiscal year 2007. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2007 should no longer be relied upon. The Audit Committee thereafter expanded the scope of its investigation to include fiscal year 2006.

On March 30, 2009, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems segment customers during fiscal year 2006. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2006 should no longer be relied upon.

The Audit Committee s advisors reported the results of the investigation to the Audit Committee on April 24, 2009. The Company voluntarily reported the investigation results to the SEC on April 30, 2009. Thereafter, on June 30, 2009, the Company announced that it was undertaking a preliminary review of the timing of revenue recognized in connection with multiple element arrangements in its Precision Technology segment from 2004 through 2008 to determine if adjustments need to be made to those periods (collectively with the Audit Committee s review of transactions in the Semiconductor Systems segment and any other related Company reviews of transactions in the Semiconductor Systems segment and Precision Technology segment, the Revenue Review).

As part of its Revenue Review procedures, the Company assessed historic revenue transactions back to 2002. Transactions prior to 2004 were reviewed to the extent that the Company had reason to believe such transactions could materially affect the consolidated financial statements for 2004, or any period after 2004. The restated consolidated financial statements include a number of adjustments primarily related to the timing of revenue recognition which impacts revenue, cost of goods sold, deferred revenue, and deferred cost of goods sold.

Adjustments arising from the Revenue Review resulted in sales and their related costs being deferred and recognized in subsequent periods, once all revenue recognition criteria have been met. In addition, these adjustments did not affect the Company s cash balances. As of July 3, 2009, a substantial portion of the revenue identified in the Revenue Review remains deferred, pending the finalization of all deliverables under the terms of the customer arrangements. The corresponding costs have also been deferred and are included as deferred cost of goods sold as a component of other deferred assets in the accompanying financial statements. All the deferred revenue and the deferred cost of goods sold have been classified as current or long-term, based on the Company s assessment of when each particular transaction is anticipated to be recognized into revenue.

As discussed further below, the majority of adjustments from the Revenue Review were derived from the Company s incorrect accounting for multiple element arrangements, the determination of fixed and determinable consideration, and the determination of customer acceptance. The Company found inconsistent and incorrect application of its policies. The transactions that are being restated as a result of the Revenue Review include transactions for which the complete facts required to make the appropriate assessment with respect to the timing of the revenue recognition were not communicated to the finance department at the time the initial revenue was booked. Refer to Note 3 to Consolidated Financial Statements for discussion of the Company s revenue recognition policy.

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

In addition to adjustments from the Revenue Review, the Company has also recorded the impact of certain adjustments which, due to their materiality, were not previously recorded. Certain of these adjustments affect revenue, cost of goods sold, the provision for income taxes, and, to a lesser extent, operating expenses.

The net effects of all of the restatement adjustments on the statements of operations for the three months ended June 27, 2008 and March 28, 2008 are as follows (in thousands, except per share data):

	Three Month Period Ended June 27, 2008			Three Month Period Ended March 28, 2008		
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Sales	$ 62,772	$ (3,303)	$ 59,469	$ 69,028	$ (7,803)	$ 61,225
Cost of goods sold	38,340	(1,479)	36,861	42,456	(3,788)	38,668
Gross profit	24,432	(1,824)	22,608	26,572	(4,015)	22,557
Operating expenses	24,520	(983)	23,537	24,795	(904)	23,891
Income (loss) from operations	(88)	(841)	(929)	1,777	(3,111)	(1,334)
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	1,138		1,138	1,329	79	1,408
Income (loss) from continuing operations, before income taxes	1,050	(841)	209	3,106	(3,032)	74
Income tax provision (benefit)	94	165	259	997	(737)	260
Income (loss) from continuing operations	956	(1,006)	(50)	2,109	(2,295)	(186)
Income (loss) from discontinued operations, net of tax	138	(28)	110	(2)	221	219
Net income (loss)	$ 1,094	$ (1,034)	$ 60	$ 2,107	$ (2,074)	$ 33
Net income (loss) attributable to GSI Group Inc. per common share basic	$ 0.03	$ (0.02)	$	$ 0.05	$ (0.05)	$
Net income (loss) attributable to GSI Group Inc. per common share diluted	$ 0.03	$ (0.02)	$	$ 0.05	$ (0.05)	$

The net effects of all of the restatement adjustments on the statements of operations for the six months ended June 27, 2008 are as follows (in thousands, except per share data):

	Six Month Period Ended June 27, 2008		
	As Reported	Adjustments	As Restated
Sales	$ 131,800	$ (11,106)	$ 120,694
Cost of goods sold	80,796	(5,267)	75,529

Gross profit		51,004		(5,839)		45,165
Operating expenses		49,315		(1,887)		47,428
Income (loss) from operations		1,689		(3,952)		(2,263)
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net		2,467		79		2,546
Income (loss) from continuing operations, before income taxes		4,156		(3,873)		283
Income tax provision (benefit)		1,091		(572)		519
Income (loss) from continuing operations		3,065		(3,301)		(236)
Income (loss) from discontinued operations, net of tax		136		193		329
Net income (loss)	$	3,201	$	(3,108)	$	93
Net income (loss) attributable to GSI Group Inc. per common share basic	$	0.08	$	(0.07)	$	
Net income (loss) attributable to GSI Group Inc. per common share diluted	$	0.08	$	(0.07)	$	

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

The net effects of all of the restatement adjustments on the statement of stockholders equity as of December 31, 2007 are as follows (in thousands):

	Year Ended December 31, 2007		
	As Reported	Adjustments	As Restated
Decrease in stockholders equity	$ 374,118	$ (28,440)	$ 345,678

The following table presents the impact of the restatement adjustments to the Company s beginning retained earnings balance, cumulatively to reflect adjustments booked to all periods prior to January 1, 2008 (in thousands):

	Amount
Retained earnings, December 31, 2007 (as previously reported)	$ 48,329
Adjustments from:	
Semiconductor Systems Segment Revenue Review, before income tax effect	(38,160)
Precision Technology Segment Revenue Review, before income tax effect	(4,226)
All other non-income tax adjustments	(390)
Income tax adjustments	13,578
Total adjustments	(29,198)
Retained earnings, December 31, 2007 (as restated)	$ 19,131

The net effects of all of the restatement adjustments on the condensed cash flow statements for the six months ended June 27, 2008 are as follows (in thousands):

	Six Months Ended June 27, 2008		
	As Reported(1)	Adjustments	As Restated
Consolidated net income (loss)	$ 3,201	$ (3,108)	$ 93
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	6,304	2,446	8,750
Changes in assets and liabilities	16,753	2,950	19,703
Cash flows provided by operating activities	26,258	2,288	28,546
Cash flows used in investing activities	(9,924)	(2,962)	(12,886)
Cash flows used in financing activities	(6,378)		(6,378)
Effect of exchange rates on cash and cash equivalents	1,602		1,602
Net increase (decrease) to cash and cash equivalents	11,558	(674)	10,884
Cash and cash equivalents, beginning of year (2)	171,713	674	172,387
Cash and cash equivalents, end of year (2)	$ 183,271		$ 183,271

(1) Amounts as reported reflect operating activities associated with discontinued operations as changes in assets and liabilities.
(2) The Consolidated Statements of Cash Flows include cash and cash equivalent balances (in thousands) of $1 and $1 of the discontinued operations for the year ended December 31, 2007 and the six months ended June 27, 2008, respectively.

The following discussion provides additional information regarding the adjustments that were identified during the Revenue Review. Certain transactions may have been restated for multiple reasons but have been included in the most applicable category.

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Semiconductor Systems Segment

The Company s product sales to customers of its Semiconductor Systems segment are typically multiple element arrangements. These arrangements generally include: hardware components, software components, installation services, an initial warranty period and training on the use of the product. Certain of these arrangements may also include other elements including specified product or software upgrades, product performance commitments and may also include separately priced extended warranty services.

Multiple Element Arrangements without Objective and Reliable Evidence of Fair Value for Undelivered Elements

The Revenue Review identified certain arrangements whereby there were undelivered elements for which objective and reliable evidence of fair value did not exist at the time that the revenue was initially recorded. The Company has deferred the revenue under these arrangements, and recognizes the revenue at the point in time when such undelivered elements are resolved. These undelivered elements include undelivered hardware, delivered hardware not functioning to specifications, and undelivered future software features or functionality committed as part of the arrangement. Additionally, the Company evaluated the unit of accounting for certain transactions based on the guidance in AICPA s Technical Practice Aid (TPA) 5100.39, Software Revenue Recognition for Multiple Element Arrangements. As a result, certain multiple customer orders that were originally accounted for as separate transactions are accounted for as one transaction in the restatement.

The Determination of Customer Acceptance

Under the Company s policy, sales to customers in Japan, sales to new customers, and sales of new products to existing customers, as defined in its policy, are required to be recorded upon the customer having installed, tested and accepted the product at the customer s site. Without acceptance for these types of sales, the Company is unable to conclude that the delivery has been achieved in accordance with the criteria in the SEC s Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. The Revenue Review noted instances whereby the criteria required under its policy to record revenue at the time of shipment had not been achieved; therefore revenue was improperly recognized in an earlier period. In such cases, the Company has deferred revenue recognition until the appropriate customer acceptance was received. Additionally, the Company noted instances where there were two documents representing customer acceptance; one form on a format provided by the Company, and another on a customer-specific form. Often these forms were provided from the customer on separate dates. In these cases of dual acceptance , the Company has performed procedures to assess when all deliverables were made, and then reviewed that against the multiple customer acceptance forms. As a result of these procedures, revenue has been generally recorded on the later of the two acceptance forms dates.

Determination that the Fees are not Fixed or Determinable

Under the Company s policy, arrangements with extended payment terms are not considered to be fixed or determinable. Accordingly, revenue is recognized as the payments become due. The Revenue Review noted instances whereby the arrangements with extended payment terms were not properly identified and revenue was improperly recognized in an earlier period. The revenue, as restated, reflects revenue being recorded as the payments have become due.

Other

The Revenue Review also identified certain other revenue adjustments which were not individually, nor in the aggregate, significant. These adjustments have been reflected in the restated consolidated financial statements and primarily relate to the accounting for separately priced extended warranty contracts. In certain arrangements, the amount deferred for extended warranty contracts differed from the stated price of the extended warranty contracts. In such cases, the Company has adjusted the amount of deferred revenue to equal the stated price of the extended warranty contracts, with the recognition of the adjusted amount recorded over the appropriate period of the extended warranty.

Precision Technology Segment

The Company s product sales to customers of its Precision Technology segment generally represent customer orders for a large volume of one or more types of components and occasionally include services such as installation, training and preventative maintenance plans. In order to meet customer production and inventory requirements, these arrangements frequently provide for the delivery of the components over several quarters.

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Multiple Element Arrangements without Objective and Reliable Evidence of Fair Value for Undelivered Elements

The Revenue Review identified certain arrangements whereby there were undelivered elements for which objective and reliable evidence of fair value did not exist at the time that the revenue was initially recorded. Additionally, the Company evaluated the unit of accounting for certain transactions based on the guidance in TPA 5100.39. As a result, certain multiple customer orders that were originally accounted for as separate transactions are accounted for as one transaction in the restatement.

A typical order includes a variety of products shipped over several reporting periods. These transactions were historically recognized based on the invoice price of each product shipped. The restated revenue is recognized under the multiple units shipped methodology, whereby revenue is recognized in each period based upon the lowest common percentage of the products shipped in the period. This approximates a proportional performance model of revenue recognition. This generally results in a partial deferral of revenue to a later reporting period. No revenue is recognized unless one or more units of each product has been delivered.

Determination that the Fees are not Fixed or Determinable

The Revenue Review identified certain customer arrangements that included customer rights to adjust the product quantity mix or otherwise involved uncertainty regarding the terms of the arrangement. In such cases, the Company has determined that the arrangement fees are not fixed or determinable and revenue is recognized when the order is completely fulfilled.

Summary of Sales Adjustments

The following tables reflect the adjustments identified during the Company s Revenue Review, as well as from the recording of previously unrecorded immaterial adjustments. The tables present a reconciliation of sales as previously reported to amounts as restated for the periods indicated (in thousands):

	Three Months Ended		**Six Months Ended**
	March 28, 2008	**June 27, 2008**	**June 27, 2008**
Sales, as previously reported	$ 69,028	$ 62,772	$ 131,800
Revenue Restatement Adjustments:			
Semiconductor Systems Segment:			
Multiple element arrangements	(5,981)	(6,078)	(12,059)
Customer acceptance not assured	1,108	325	1,433
Price not fixed or determinable	(691)		(691)
Other	(351)	(215)	(566)
Subtotal Semiconductor Systems Segment	(5,915)	(5,968)	(11,883)
Precision Technology Segment:			
Multiple element arrangements	(2,121)	197	(1,924)
Price not fixed or determinable	224	2,388	2,612
Other	9	80	89

Subtotal Precision Technology Segment	(1,888)	2,665	777
Total revenue restatement adjustments	(7,803)	(3,303)	(11,106)
Sales, as restated	$ 61,225	$ 59,469	$ 120,694

Expense Adjustments

In connection with its Revenue Review, the Company has deferred the corresponding direct costs associated with the deferred revenue. These deferred costs have been recorded as deferred cost of goods sold, in the current and long-term sections of the accompanying balance sheets, as appropriate, and are reflected in the statements of operations as cost of goods sold when the related revenue is recognized. These costs represent the direct and incremental costs that are attributable to the product whose revenue is being deferred.

The following tables reflect the adjustments to cost of goods sold and operating expenses that were identified as a result of the Company s Revenue Review, as well as from the recording of previously unrecorded immaterial adjustments. The tables present a reconciliation of previously reported amounts to amounts as restated for the periods indicated (in thousands):

10

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

	Three Months Ended March 28, 2008	Three Months Ended June 27, 2008	Six Months Ended June 27, 2008
Cost of goods sold, as previously reported	$ 42,456	$ 38,340	$ 80,796
Semiconductor Systems segment adjustments	(3,507)	(3,815)	(7,322)
Precision Technology segment adjustments	(1,155)	1,538	383
Reclassification of amortization of intangible assets (core technology)	874	798	1,672
Cost of goods sold, as restated	$ 38,668	$ 36,861	$ 75,529
Operating expenses, as previously reported	$ 24,795	$ 24,520	$ 49,315
Reclassification of amortization of intangible assets (core technology)	(874)	(798)	(1,672)
All other operating expense adjustments	(30)	(185)	(215)
Operating expenses, as restated	$ 23,891	$ 23,537	$ 47,428

Income Taxes

In connection with its Revenue Review, the Company has reassessed it provision for income taxes. As part of its assessment of its provision for income taxes, the Company has recorded two primary adjustments.

In connection with the Revenue Review, the Company reassessed the probability of realization of deferred tax assets in certain jurisdictions taking into account the effect of the restatement. This assessment, while conducted currently in connection with the restatement activities, was performed using only those facts that were known or expected to be knowable at the time in which each accounting period would have been initially closed. Pursuant to SFAS No. 109 the Company only recognizes a deferred tax asset when it is more likely than not of recovery, considering future reversal of deferred tax liabilities, available taxable income in carryback periods, the probability of future taxable income after a pattern of generating income in the jurisdiction or tax planning strategies that the Company can implement. Accordingly, adjustments have been reflected to the beginning balance sheet to reduce the deferred tax assets, and the corresponding beginning retained earnings balance.

The provision for income taxes has been further adjusted to reflect the statutory rate, adjusted by timing items and other appropriate current period tax credits, as applied against the as adjusted income and loss of the Company in various periods. See Note 12 to Consolidated Financial Statements for further disclosure.

3. Summary of Significant Accounting Policies

Basis of Presentation

These consolidated financial statements have been prepared by the Company in U.S. dollars and in accordance with U.S. generally accepted accounting principles, applied on a consistent basis.

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC), and the instructions to Form 10-Q and the provisions of Regulation S-X pertaining to interim financial statements. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations.

The interim consolidated financial statements include the accounts of the Company. Intercompany transactions and balances have been eliminated. In the opinion of management, all adjustments and accruals necessary for a fair presentation have been made and include only normal recurring adjustments and accruals. The results for interim periods are not necessarily indicative of results to be expected for the year or for any future periods.

Basis of Consolidation

The consolidated financial statements include the accounts of GSI Group Inc. and its wholly owned subsidiaries, including the accounts of Excel since August 20, 2008. The accounts of Excel include its 50% owned joint venture, Excel Laser Technology Private Limited (Excel SouthAsia JV), since it is a variable interest entity and the Company is the primary beneficiary of the joint

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

venture. The accompanying consolidated financial statements of the Company include the assets, liabilities, revenue, and expenses of Excel SouthAsia JV over which the Company exercises control. The Company records noncontrolling interest in its consolidated statements of operations for the ownership interest of the minority owners of Excel SouthAsiaJV. Financial information related to the joint venture is not considered material to the consolidated financial statements. Intercompany accounts and transactions have been eliminated.

Comparative Amounts and Other

Certain prior period amounts have been reclassified to conform to the current period presentation in the financial statements and notes thereto as of and for the three and six months ended July 3, 2009. These reclassifications had no effect on the Company s previously reported results of operations, financial position and cash flows.

Additionally, the Company has corrected the presentation of certain items in the accompanying consolidated balance sheet as of December 31, 2008. These corrections relate to the following: (i) Correction of $0.1 million previously reported within accrued pension liability to other accrued expenses and (ii) Correction of $0.6 million previously reported within other liabilities to accrued compensation and benefits. These corrections had no effect on the Company s previously reported results of operations, financial position and cash flows.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of sales and expenses during the reporting periods. On an ongoing basis, the Company evaluates its estimates, assumptions and judgments, including those related to revenue recognition; allowance for doubtful accounts; inventory costing and reserves; the assessment of warranty reserves; the valuation of goodwill, intangible assets and other long-lived assets; accounting for business combinations; share-based payments; employee benefit plans; accounting for restructuring activities; accounting for income taxes and related valuation allowances; and, accounting for loss contingencies. Actual results could differ significantly from those estimates.

Cash and Cash Equivalents

Cash equivalents consist principally of money market funds invested in U.S. Treasury Securities and repurchase agreements of U.S. Treasury Securities that have original maturities of 90 days or less. The Company does not believe it is exposed to any significant credit risk related to its cash equivalents.

Financial Instruments and Fair Value Measurements

Financial instruments with remaining maturities within one year from the balance sheet date are classified as current. Financial instruments with remaining maturities more than one year from the balance sheet date are classified as long-term.

Long-Term Investments

As of July 3, 2009, the Company held auction rate securities, recorded at a fair value of $14.3 million, and with a par value of $17.1 million. As of December 31, 2008, the Company held auction rate securities, recorded at a fair value of $25.1 million, and with a par value of $32.3 million. These securities were acquired as part of the Company s purchase of Excel in 2008. These auction rate notes are student loans backed by the federal government and are privately insured. Current capital market conditions have impacted the Company s ability to liquidate certain auction rate securities. Liquidity for these auction rate securities is typically provided by an auction process that resets the applicable interest rate at pre-determined intervals, usually every 7, 28, 35 or 90 days. In the past, the auction process has allowed investors to roll over their holdings or obtain immediate liquidity by selling the securities at par. Due to the current capital market conditions, an investor s ability to sell auction rate securities at par has been adversely affected. Due to the uncertainty in the market as to when these auction rate notes will be refinanced or the auctions will resume, the Company has classified these instruments as long-term assets available for sale. If the credit ratings of the issuer, the bond insurers or the collateral deteriorates further, or if the issuers of these auction rate securities are unable to successfully close further auctions, the Company may further reduce the carrying value of these investments and may in the future be required to record impairment charges against these investments, some of which may be considered other-than-temporary impairment charges. From January 1, 2009 through July 3, 2009, the Company recorded $0.8 million of other comprehensive income attributable to the change in unrealized gains relating to assets still held at July 3, 2009. From the date of the Company s acquisition of Excel through December 31, 2008, the Company recorded $0.1 million of other comprehensive income attributable to the change in unrealized gains relating to assets still held at December 31, 2008.

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

During the three months ended July 3, 2009, the Company sold $14.9 million in par value of its auction rate securities valued at $11.3 million for $13.0 million in proceeds which resulted in the recognition of realized gains of approximately $1.7 million. During the six months ended July 3, 2009, the Company sold $15.2 million in par value of its auction rate securities valued at $11.5 million for $13.3 million in proceeds which resulted in the recognition of realized gains of approximately $1.8 million related to the sale of these securities. The gains realized upon the sale of the auction rate securities are recorded in other income (expense), net in the accompanying consolidated statements of operations for the three and six months ended July 3, 2009. No losses were realized upon the sale of any auction rate securities during the three or six months ended July 3, 2009. The Company determines the cost of a security sold and the amount to be reclassified out of accumulated other comprehensive income (loss) into earnings based on the specific identification method. During the three and six months ended July 3, 2009, no amounts were reclassified out of accumulated other comprehensive income (loss) into earnings related to the sale of the Company s auction rate securities. See Note 17 to Consolidated Financial Statements for discussion of sales of auction rate securities after July 3, 2009.

At July 3, 2009 and December 31, 2008, the Company had a 25.1% equity investment in a privately held company located in the United Kingdom, valued at $1.2 million and $0.8 million at July 3, 2009 and December 31, 2008, respectively, and included in other assets in the accompanying consolidated balance sheets. The Company uses the equity method to record the results of this entity. In relation to this investment, the Company recognized income of $235,000 and $142,000 for the six months ended July 3, 2009 and June 27, 2008, respectively, which are shown in other income (expense), net in the accompanying consolidated statements of operations. In relation to this investment, the Company recognized income of $163,000 and $36,000 for the three months ended July 3, 2009 and June 27, 2008, respectively, which are shown in other income (expense), net in the accompanying consolidated statements of operations.

Fair Value Measurements

On January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements, with no impact to its consolidated results and financial position. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and enhances disclosures about fair value measurements. Fair value is defined as the price that would be received for an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. Valuation techniques must maximize the use of observable inputs and minimize the use of unobservable inputs.

SFAS No. 157 establishes a value hierarchy based on three levels of inputs, of which the first two are considered observable and the third is considered unobservable:

Level 1. Quoted prices for identical assets or liabilities in active markets which the Company can access.

Level 2. Observable inputs other than those described in Level 1.

Level 3. Unobservable inputs.

On January 1, 2009, the Company implemented the guidance in SFAS No. 157 related to all nonrecurring fair value measurements of nonfinancial assets and nonfinancial liabilities in accordance with FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 . However, no significant nonrecurring fair value measurements were conducted during the six months ended July 3, 2009.

The following table summarizes the Company s assets and liabilities, as of July 3, 2009, that are measured at fair value on a recurring basis (in thousands):

	July 3, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Cash equivalents (1)	$ 5,284	$ 5,284	$	$
Auction rate securities (2)	14,316			14,316
Total	$ 19,600	$ 5,284	$	$ 14,316

(1) Cash equivalents are valued at quoted market prices in active markets.

(2) Auction rate securities are valued based on assumptions that market participants might use in their estimates of fair value (including, among other factors, underlying collateral and lack of liquidity).

Table of Contents

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

The following table summarizes the Company s assets and liabilities, as of December 31, 2008, that are measured at fair value on a recurring basis (in thousands):

	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Cash equivalents (1)	$ 36,324	$ 36,324	$	$
Auction rate securities (2)	25,065			25,065
Total	$ 61,389	$ 36,324		

Deferred income taxes, net	903	1,982
Deferred credits and other	1,244	1,123
	2,147	3,105
Commitments and contingencies		
Shareholders' equity:		
Preferred stock: no par value per share, 1,000,000 shares authorized, no shares issued	—	—
Common stock: no par value, $.10 stated value per share, 12,500,000 shares authorized, 6,502,928 and 6,471,710 shares issued; and 6,447,210 and 6,440,851 shares outstanding, as of October 31, 2012 and October 31, 2011, respectively	645	644
Additional paid-in capital	53,415	52,614
Retained earnings	90,586	74,948
Accumulated other comprehensive loss	(853)	(1,994)
Total shareholders' equity	143,793	126,212
	$ 195,312	$ 186,545

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

30

HURCO COMPANIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended October 31,		
	2012	2011	2010
	(In thousands)		
Cash flows from operating activities:			
Net income (loss)	$15,638	$11,124	$(5,744)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:			
Provision for doubtful accounts	(224)	111	(312)
Deferred income taxes	1,846	1,372	(216)
Equity in (income) loss of affiliates	(276)	(53)	149
Foreign currency (gain) loss	3,003	311	1,927
Unrealized (gain) loss on derivatives	522	(720)	(624)
Depreciation and amortization	4,126	4,300	3,804
Stock-based compensation	870	470	141
Change in assets and liabilities:			
(Increase) decrease in accounts receivable and refundable taxes	(8,662)	(3,395)	(4,047)
(Increase) decrease in inventories	(10,152)	(25,702)	4,154
Increase (decrease) in accounts payable	(9,594)	8,085	21,114
Increase (decrease) in accrued expenses	343	5,922	(398)
Net change in derivative assets and liabilities	68	(330)	(174)
Other	(4,495)	(2,690)	1,978
Net cash provided by (used for) operating activities	(6,987)	(1,195)	21,752
Cash flows from investing activities:			
Proceeds from sale of property and equipment	1	—	40
Purchase of property and equipment	(2,755)	(1,745)	(632)
Software development costs	(977)	(1,097)	(1,216)
Other proceeds (investments)	(42)	(34)	50
Net cash used for investing activities	(3,773)	(2,876)	(1,758)
Cash flows from financing activities:			
Proceeds from exercise of common stock options	1	—	—
Borrowings on short-term debt	2,293	844	—
Net cash provided by financing activities	2,294	844	—
Effect of exchange rate changes on cash	(725)	(67)	(521)
Net increase (decrease) in cash	(9,191)	(3,294)	19,473
Cash and cash equivalents at beginning of year	44,961	48,255	28,782
Cash and cash equivalents at end of year	$35,770	$44,961	$48,255

Supplemental disclosures:			
Cash paid for (refunds of):			
Interest	$127	$23	$18
Income taxes, net	$10,679	$1,381	$(6,211)

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

31

HURCO COMPANIES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in thousands)	Common Stock Shares Outstanding	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balances, October 31, 2009	6,440,851	$ 644	$ 52,003	$ 69,568	$ (1,839)	$ 120,376
Net loss	—	—	—	(5,744)	—	(5,744)
Translation of foreign currency financial statements	—	—	—	—	(50)	(50)
Realized loss on derivative instruments reclassified into operations, net of tax of $11	—	—	—	—	19	19
Unrealized loss of derivative instruments,	—	—	—	—	(2)	(2)
Comprehensive loss						(5,777)
Stock-based compensation expense	—	—	141	—	—	141
Balances, October 31, 2010	6,440,851	$ 644	$ 52,144	$ 63,824	$ (1,872)	$ 114,740
Net income	—	—	—	11,124	—	11,124
Translation of foreign currency financial statements	—	—	—	—	363	363
Realized loss on derivative instruments reclassified into operations, net of tax of $3	—	—	—	—	7	7
Unrealized loss of derivative instruments, net of tax of $(283)	—	—	—	—	(492)	(492)
Comprehensive income						11,002
Stock-based compensation expense	—	—	470	—	—	470
Balances, October 31, 2011	6,440,851	$ 644	$ 52,614	$ 74,948	$ (1,994)	$ 126,212
Net income	—	—	—	15,638	—	15,638
Translation of foreign currency financial statements	—	—	—	—	(838)	(838)

Realized loss on derivative instruments reclassified into operations, net of tax of $63	—	—	—	—	109	109
Unrealized gain of derivative instruments, net of tax of $1,076	—	—	—	—	1,870	1,870
Comprehensive income						16,779
Exercise of common stock options	500	—	1	—	—	1
Restricted shares vested	5,859	1	(1)	—	—	—
Tax benefit from exercise of stock options	—	—	(69)	—	—	(69)
Stock-based compensation expense	—	—	870	—	—	870
Balances, October 31, 2012	6,447,210	$ 645	$53,415	$90,586	$ (853)	$143,793

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

32

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation. The consolidated financial statements include the accounts of Hurco Companies, Inc. (an Indiana corporation) and its wholly-owned subsidiaries. We have a 35% ownership interest in a Taiwan affiliate that is accounted for using the equity method. Our investment in that affiliate was approximately $2.4 million and $2.1 million as of October 31, 2012 and 2011, respectively. That investment is included in Investments and Other Assets, Net on the accompanying Consolidated Balance Sheets. Intercompany accounts and transactions have been eliminated.

Statements of Cash Flows. We consider all highly liquid investments with a stated maturity at the date of purchase of three months or less to be cash equivalents. Cash flows from hedges are classified consistent with the items being hedged.

Translation of Foreign Currencies. All balance sheet accounts of non-U.S. subsidiaries are translated at the exchange rate as of the end of the year and translation adjustments of foreign currency balance sheets are recorded as a component of Accumulated Other Comprehensive Loss in shareholders' equity. Income and expenses are translated at the average exchange rates during the year. Cumulative foreign currency translation adjustments as of October 31, 2012 were a net loss of $2.2 million and are included in Accumulated Other Comprehensive Loss. Foreign currency transaction gains and losses are recorded as income or expense as incurred and are recorded in other (income) expense.

Hedging. We account for derivative instruments as either assets or liabilities and carry them at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. For derivative instruments designated as a fair value hedge, the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributed to the risk being hedged. For a derivative instrument designated as a cash flow hedge, the effective portion of the derivative’s gain or loss is initially reported as a component of Accumulated Other Comprehensive Loss in shareholders’ equity and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately. For derivative instruments that are not designated as accounting hedges under the Derivatives and Hedging Topic of the Financial Accounting Standards Board (FASB guidance), changes in fair value are recognized in earnings in the period of change. The Company does not hold or issue derivative financial instruments for speculative trading purposes. We only enter into derivatives with one counterparty which is among one of the largest U.S. banks ranked by assets, in order to minimize its credit risk and to date, no such counterparty has failed to meet its financial obligations under such contracts. We are exposed to certain market risks relating to our ongoing business operations, including foreign currency risk, interest rate risk and credit risk. We manage our exposure to these and other market risks through regular operating and financing activities. Currently, the only risk that we manage through the use of derivative instruments is foreign currency risk.

We operate on a global basis and are exposed to the risk that our financial condition, results of operations and cash flows could be adversely affected by changes in foreign currency exchange rates. To reduce the potential effects of foreign exchange rate movements on our net equity investment in one of our foreign subsidiaries, gross profit and net earnings, we enter into derivative financial instruments in the form of foreign exchange forward contracts with a major financial institution. We are primarily exposed to foreign currency exchange rate risk with respect to transactions and net assets denominated in Euros, Pounds Sterling, Canadian Dollars, Indian Rupee, South African Rand, Singapore Dollars, Chinese Yuan, Polish Zloty, South Korean Won and New Taiwan Dollars.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

We account for derivative instruments designated as hedging instruments in accordance with FASB guidance related to accounting for derivative instruments and report all derivative instruments as assets or liabilities at fair value on our consolidated balance sheet.

Derivatives Designated as Hedging Instruments

We enter into foreign currency forward exchange contracts periodically to hedge certain forecasted inter-company sales and purchases denominated in foreign currencies (the Pound Sterling, Euro and New Taiwan Dollar). The purpose of these instruments is to mitigate the risk that the U.S. Dollar net cash inflows and outflows resulting from sales and purchases denominated in foreign currencies will be adversely affected by changes in exchange rates. These forward contracts have been designated as cash flow hedge instruments, and are recorded in the Consolidated Balance Sheets at fair value in Derivative Assets and Derivative Liabilities. The effective portion of the gains and losses resulting from the changes in the fair value of these hedge contracts are deferred in Accumulated Other Comprehensive Loss and recognized as an adjustment to Cost of Sales and Service in the period that the corresponding inventory sold that is the subject of the related hedge contract is recognized, thereby providing an offsetting economic impact against the corresponding change in the U.S. Dollar value of the inter-company sale or purchase being hedged. The ineffective portion of gains and losses resulting from the changes in the fair value of these hedge contracts is reported in Other (Income) Expense immediately. We perform quarterly assessments of hedge effectiveness by verifying and documenting the critical terms of the hedge instrument and determining that forecasted transactions have not changed significantly. We also assess on a quarterly basis whether there have been adverse developments regarding the risk of a counterparty default.

We had forward contracts outstanding as of October 31, 2012, in Euros, Pounds Sterling and New Taiwan Dollars with set maturity dates ranging from November 2012 through October 2013. The contract amount at forward rates in U.S. Dollars at October 31, 2012 for Euros and Pounds Sterling was $36.2 million and $9.8 million, respectively. The contract amount at forward rates in U.S. Dollars for New Taiwan Dollars was $26.3 million at October 31, 2012. At October 31, 2012, we had approximately $1.1 million of gains, net of tax, related to cash flow hedges deferred in Accumulated Other Comprehensive Loss. Of this amount, $30,000 represents unrealized gains, net of tax, related to cash flow hedge instruments that remain subject to currency fluctuation risk. The majority of these deferred gains will be recorded as an adjustment to Cost of Sales and Service in periods through October 2013, in which the corresponding inventory that is the subject of the related hedge contract is sold, as described above.

We are exposed to foreign currency exchange risk related to our investment in net assets in foreign countries. To manage this risk, we entered into a forward contract with a notional amount of €3.0 million. We designated this forward contract as a hedge of our net investment in Euro denominated assets. We selected the forward method under the FASB guidance related to the accounting for derivatives instruments and hedging activities. The forward method requires all changes in the fair value of the contract to be reported as a cumulative translation adjustment in Accumulated Other Comprehensive Loss, net of tax, in the same manner as the underlying hedged net assets This forward contract matured in November 2012 and we entered into a new forward contract for the same notional amount that is set to mature in November 2013. As of October 31, 2012, we had a realized gain of $227,000 and an unrealized gain of $106,000, net of tax, recorded as cumulative translation adjustments in Accumulated Other Comprehensive Loss, related to these forward contracts.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Derivatives Not Designated as Hedging Instruments

We enter into foreign currency forward exchange contracts to protect against the effects of foreign currency fluctuations on receivables and payables denominated in foreign currencies. These derivative instruments are not designated as hedges under FASB guidance and, as a result, changes in their fair value are reported currently as Other (Income) Expense, Net in the Consolidated Statements of Operations consistent with the transaction gain or loss on the related receivables and payables denominated in foreign currencies.

We had forward contracts outstanding as of October 31, 2012, in Euros, Pounds Sterling, Canadian Dollars, South African Rand, and New Taiwan Dollars with set maturity dates ranging from November 2012 through April 2013. The contract amounts at forward rates in U.S. Dollars at October 31, 2012 for Euros, Pounds Sterling, Canadian Dollars, South African Rand and Singapore Dollars totaled $20.5 million. The contract amount at forward rates in U.S. Dollars for New Taiwan Dollars was $10.8 million at October 31, 2012.

Fair Value of Derivative Instruments

We recognize the fair value of derivative instruments as assets and liabilities on a gross basis on our Consolidated Balance Sheets. As of October 31, 2012 and October 31, 2011, all derivative instruments were recorded at fair value on the balance sheets as follows (in thousands):

Derivatives	2012 Balance Sheet Location	Fair Value	2011 Balance Sheet Location	Fair Value
Designated as Hedging Instruments:				
Foreign exchange forward contracts	Derivative assets	$ 705	Derivative assets	$ 634
Foreign exchange forward contracts	Derivative liabilities	$ 492	Derivative liabilities	$ 1,492
Not Designated as Hedging Instruments:				
Foreign exchange forward contracts	Derivative assets	$ 3	Derivative assets	$ 563
Foreign exchange forward contracts	Derivative liabilities	$ 77	Derivative liabilities	$ 117

Effect of Derivative Instruments on the Consolidated Balance Sheets, Statements of Changes in Shareholders' Equity and Statements of Operations

Derivative instruments had the following effects on our Consolidated Balance Sheets, Statements of Changes in Shareholders' Equity and Statements of Operations, net of tax during the year ended October31, 2012 and 2011 (in thousands):

Derivatives	Amount of Gain (Loss) Recognized in Other Comprehensive Income		Location of Gain (Loss) Reclassified from Other Comprehensive Income	Amount of Gain (Loss) Reclassified from Other Comprehensive Income	
	2012	2011		2012	2011
Designated as Hedging Instruments: (Effective Portion)					
Foreign exchange forward contracts – Intercompany sales/purchases	$ 2,946	$ (775)	Cost of sales and service	$ (172)	$ (10)
Foreign exchange forward contract – Net Investment	$ 292	$ (32)			

35

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

We recognized a gain of $482,000 during the year ended October 31, 2012 and a loss of $3,000 during the year ended October 31, 2011 as a result of contracts closed early that were deemed ineffective for financial reporting purposes and did not qualify as cash flow hedges.

Derivatives	Location of Gain (Loss) Recognized in Operations	Amount of Gain (Loss) Recognized in Operations (in thousands)	
		2012	2011
Not Designated as Hedging Instruments:			
Foreign exchange forward contracts	Other income (expense)	$ 1,013	$ (368)

Inventories. Inventories are stated at the lower of cost or market, with cost determined using the first-in, first-out method. Provisions are made to reduce excess or obsolete inventories to their estimated realizable value.

Property and Equipment. Property and equipment are carried at cost. Depreciation and amortization of assets are provided primarily under the straight-line method over the shorter of the estimated useful lives or the lease terms as follows:

	Number of Years
Land	Indefinite
Building	40
Machines	7 – 10
Shop and office equipment	3 – 7
Leasehold improvements	3 – 40

Total depreciation and amortization expense recognized for property and equipment for the years ended October 31, 2012, 2011 and 2010 was $2.2 million, $2.1 million, and $2.1 million, respectively.

Revenue Recognition - We recognize revenue from sales of our machine tool systems upon delivery of the product to the customer, which is normally at the time of shipment, because persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed and determinable and collectability is reasonably assured. In certain foreign locations, we retain title after shipment under a “retention of title” clause solely to protect collectability. The retention of title is similar to Uniform Commercial Code ("UCC") filings in the United States and provides the creditor with additional rights to the machine if the customer fails to pay. Revenue recognition at the time of shipment is appropriate in this instance as long as all risks of ownership have passed to the buyer. Our computerized machine tools are general-purpose computer controlled machine tools that are typically used in stand-alone operations. Transfer of ownership and risk of loss are not contingent upon contractual customer acceptance. Prior to shipment, we test each machine to ensure the machine's compliance with standard operating specifications as listed in our sales literature.

Depending upon geographic location, after shipment, a machine may be installed at the customer's facilities by a distributor, independent contractor or by one of our service technicians. In most instances where a machine is sold through a distributor, we have no installation involvement. If sales are direct or through sales agents, we will typically complete the machine installation, which consists of the reassembly of certain parts that were removed for shipping and the re-testing of the machine to ensure that it is performing within the standard specifications. We consider the machine installation process to be inconsequential and perfunctory.

Service fees from maintenance contracts are deferred and recognized in earnings on a pro rata basis over the term of the contract.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Allowance for Doubtful Accounts. The allowance for doubtful accounts is based on our best estimate of probable credit issues and historical experience. We perform credit evaluations of the financial condition of our customers. No collateral is required for sales made on open account terms. Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers comprising our customer base. We consider trade accounts receivable to be past due when payment is not made by the due date as specified on the customer invoice, and charge off uncollectible balances when all collection efforts have been exhausted.

Software Revenue Recognition. Sales related to software products are recognized when shipped in conformity with FASB guidance related to software revenue recognition that requires at the time of shipment, persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed and determinable and collectability is reasonably assured. The software does not require production, modification or customization.

Product Warranty. Expected future product warranty claims are recorded to expense when the product is sold. Product warranty estimates are established using historical information about the nature, frequency, and average cost of warranty claims. Warranty claims are influenced by factors such as new product introductions, technological developments, the competitive environment, and the costs of component parts. Actual payments for warranty claims could differ from the amounts estimated requiring adjustments to the liabilities in future periods. See Note 11 of Notes to Consolidated Financial Statements for further discussion of warranties.

Research and Development Costs. The costs associated with research and development programs for new products and significant product improvements, other than software development costs which are eligible for capitalization per FASB guidance, are expensed as incurred and are included in Selling, General and Administrative Expenses. Research and development expenses totaled $2.6 million, $2.5 million, and $2.2 million, in fiscal 2012, 2011, and 2010, respectively.

Costs incurred to develop computer software products and significant enhancements to software features of existing products to be sold or otherwise marketed are capitalized, after technological feasibility is established. Software development costs are amortized on a straight-line basis over the estimated product life of the related software, which ranges from three to five years. We capitalized costs of $1.0 million in 2012, $1.1 million in 2011, and $1.2 million in 2010 related to software development projects. Amortization expense for software development costs was $1.9 million, $2.2 million, and $1.7 million, for the years ended October 31, 2012, 2011, and 2010, respectively. Accumulated amortization at October 31, 2012 and 2011 was $11.9 million and $10.0 million, respectively. Estimated amortization expense for the existing amortizable intangible assets for the years ending October 31, is as follows (in thousands):

Fiscal Year	Amortization Expense
2013	$ 1,008
2014	750
2015	353
2016	—
2017	—

Impairment of Long-Lived Assets. We periodically evaluates the carrying value of long-lived assets to be held and used, including property and equipment and software development costs, when events or circumstances warrant such a review. The carrying value of a long-lived asset (or group of assets) to be held and used is considered impaired when the anticipated separately identifiable undiscounted cash flows from such an asset (or group of assets) are less than the carrying value of the asset (or group of assets) in accordance with FASB guidance related to accounting for the impairment or disposal of long-lived assets.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – Continued

Earnings (Loss) Per Share. Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of common shares actually outstanding during the period. Diluted earnings (loss) per share assumes the issuance of additional shares of common stock upon exercise of all outstanding stock options and contingently issuable securities if the effect is dilutive, in accordance with the treasury stock method discussed in FASB issued guidance on "Earnings Per Share". The following table presents a reconciliation of our basic and diluted earnings (loss) per share computation:

	Fiscal Year Ended October 31,					
(in thousands, except per share amount)	2012		2011		2010	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
Net income (loss)	$15,638	$15,638	$11,124	$11,124	$(5,744)	$(5,744)
Undistributed earnings allocated to participating shares	(134)	(134)	(53)	(53)	—	—
Net income (loss) applicable to common shareholders	$15,504	$15,504	$11,071	$11,071	$(5,744)	$(5,744)
Weighted average shares outstanding	6,445	6,445	6,441	6,441	6,441	6,441
Stock options	—	25	—	31	—	—
	6,445	6,470	6,441	6,472	6,441	6,441
Income (loss) per share	$2.41	$2.40	$1.72	$1.71	$(0.89)	$(0.89)

Income Taxes – We account for income taxes and the related accounts under the liability method. Deferred tax assets and liabilities are measured using enacted income tax rates in each jurisdiction in effect for the year in which the temporary differences are expected to be recovered or settled. These deferred tax assets are reduced by a valuation allowance, which is established when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Our judgment regarding the realization of deferred tax assets may change due to future profitability and market conditions, changes in U.S. or foreign tax laws and other factors. These changes, if any, may require material adjustments to these deferred tax assets and an accompanying reduction or increase in net income in the period when such determinations are made.

The determination of our provision for income taxes requires judgment, the use of estimates and the interpretation and application of complex tax laws. Our provision for income taxes reflects a combination of income earned and taxed at the federal and state level in the U.S., as well as in various foreign jurisdictions. We have not provided for any U.S. income taxes on the undistributed earnings of our foreign subsidiaries based upon our determination that such earnings will be indefinitely reinvested abroad.

In addition to the risks to the effective tax rate described above, the future effective tax rate reflected in forward-looking statements is based on currently effective tax laws. Significant changes in those laws could materially affect these estimates.

We recognize uncertain tax positions when it is more likely than not that the tax position will be sustained upon examination by relevant taxing authorities, based on the technical merits of the position. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Stock Compensation – We account for share-based compensation according to FASB guidance relating to share based payments, which requires the measurement and recognition of compensation expense for all share-based awards made to employees and directors based on estimated fair values on the grant date. This guidance requires that we estimate the fair value of share-based awards on the date of grant and recognize as expense the value of the portion of the award that is ultimately expected to vest over the requisite service period.

Estimates. The preparation of financial statements in conformity with U.S. Generally Accepted Accounting Principles requires us to make estimates and assumptions that affect the reported amounts presented and disclosed in our consolidated financial statements. Significant estimates and assumptions in these consolidated financial statements require the exercise of judgment and are used for, but not limited to, allowance for doubtful accounts, estimates of future cash flows and other assumptions associated with intangible and long-lived asset impairment tests, useful lives for depreciation and amortization, warranty programs, stock compensation, income taxes and deferred tax valuation allowances, lease classification, and contingencies. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be different from these estimates.

2. BUSINESS OPERATIONS

Nature of Business. We design and manufacture computer control systems, software and computerized machine tools for sale to the worldwide machine tool industry. The machine tool industry is highly cyclical and declines in demand can and will occur abruptly in the geographic markets we serve. As a result of the recent global recession, we experienced a significant decline in our sales and orders during fiscal 2009 and 2010 that adversely affected our results of operations. We reported growth in sales during fiscal 2011 and 2012, but have not yet returned to pre-recession levels.

The end market for our products consists primarily of precision tool, die and mold manufacturers, independent job shops, and specialized short-run production applications within large manufacturing operations. Industries served include: aerospace, defense, medical equipment, energy, automotive/transportation, electronics and computer industries. Our products are sold through independent agents and distributors throughout North America, Europe and Asia. We also have our own direct sales and service organizations in China, France, Germany, India, Italy, Poland, Singapore, South Africa, South Korea, the United Kingdom, and certain areas of the United States.

Credit Risk. We sell products to customers located throughout the world. We perform ongoing credit evaluations of customers and generally do not require collateral. Allowances are maintained for potential credit losses. Concentration of credit risk with respect to trade accounts receivable is limited due to the large number of customers and their dispersion across many geographic areas. Although a significant amount of trade receivables are with distributors primarily located in the United States, no single distributor or region represents a significant concentration of credit risk.

Manufacturing Risk. At present, our wholly-owned subsidiaries in Taiwan and China, Hurco Manufacturing Ltd. (HML) and Ningbo Hurco Manufacturing Limited (NHML), produce all of our machine tools. Any interruption in manufacturing at either of these locations would have an adverse effect on our financial operating results. Interruption in manufacturing at one of these locations could result from a change in the political environment or a natural disaster, such as an earthquake, typhoon, or tsunami. Any interruption with one of our key suppliers may also have an adverse effect on our operating results and our financial condition.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – Continued

3. INVENTORIES

Inventories as of October 31, 2012 and 2011 are summarized below (in thousands):

	2012	2011
Purchased parts and sub-assemblies	$18,780	$20,925
Work-in-process	14,256	15,440
Finished goods	58,284	44,762
	$91,320	$81,127

Finished goods inventory consigned to our distributors and agents throughout North America, Europe and Asia was $4.7 million and $3.9 million as of October 31, 2012 and 2011, respectively.

4. DEBT AGREEMENTS

At October 31, 2012, we were party to a credit agreement that provided us with a $15.0 million revolving credit facility and maximum outstanding letters of credit of $3.0 million. Borrowings under this agreement may be used for general corporate purposes and bear interest at a floating rate, based either on LIBOR or the prime rate, plus an applicable margin. The agreement contained financial covenants, including restrictions on incurring additional debt, making acquisitions, or paying dividends if we report a cumulative net loss for four consecutive quarters.

On December 7, 2012, we entered into a new credit agreement to replace our prior credit agreement. Under the prior credit agreement, we had a $15.0 million unsecured revolving credit facility, a letter of credit facility with a maximum amount for outstanding letters of credit of $3.0 million and a backup letter of credit facility in the amount of 100 million New Taiwan Dollars or approximately $3.5 million. Pursuant to the new credit agreement, the lenders will provide us with a $12.5 million unsecured revolving credit and letter of credit facility, with a $3.0 million maximum amount for outstanding letters of credit. The scheduled maturity date of the new credit agreement is December 7, 2014. Given our current cash position, management determined that a $12.5 million revolving credit facility was sufficient to meet our needs during the term of the new credit agreement; moreover, the reduction in the size of the line from the prior credit agreement facilitated more favorable pricing and covenants.

Borrowings under the new credit agreement will bear interest at a LIBOR-based rate or a floating rate of 1% above the prevailing prime rate. The floating rate will not be less than the greatest of (a) a one month LIBOR-based rate plus 1.00% per annum, (b) the federal funds effective rate plus 0.50% per annum, and (c) the prevailing prime rate. The rate we must pay for that portion of the new credit agreement which is not utilized is 0.05% per annum.

The new credit agreement permits us to make investments in subsidiaries of up to $5.0 million, an increase from the amount permitted in the prior credit agreement. Further, the new credit agreement replaces the financial covenants that were in the prior credit agreement with a minimum working capital requirement of $90.0 million and a minimum tangible net worth requirement of $120.0 million. The new credit agreement will permit us to pay cash dividends in an amount not to exceed $1.0 million per calendar year so long as we are not in default before and after giving effect to such dividends. The remaining covenants in the new credit agreement are substantially the same as those that were in the prior credit agreement.

We also have an uncommitted credit facility in Taiwan in the amount of 100.0 million New Taiwan Dollars (approximately $3.4 million), a £1.0 million revolving credit facility in the United Kingdom and a €1.5 million revolving credit facility in Germany.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – Continued

On March 7, 2011 we entered into an uncommitted credit facility in China in the amount of 20.0 million Chinese Yuan (approximately $3.2 million) and amended our domestic credit agreement to accommodate the new facility. As of February 24, 2012, the maturity date of the China credit facility was extended for another twelve months and on July 2, 2012 the facility was increased to 40.0 million Chinese Yuan (approximately $6.4 million).

All of our credit facilities are unsecured.

At October 31, 2012, we had $3.2 million of borrowings outstanding under our credit facility in China, but had no other debt or borrowings under any of our other credit facilities. At October 31, 2011, we had $865,000 of borrowings outstanding under our credit facility in China, but had no other debt or borrowings under any of our other credit facilities. At October 31, 2012, we were in compliance with all covenants contained in the related credit agreements and, as of that date, we had unutilized credit facilities of $25.2 million.

5. FAIR VALUE MEASUREMENTS

The carrying amounts for cash and cash equivalents approximate their fair values due to the short maturity of these instruments and meet the Level 1 criteria of the three-tier fair value hierarchy discussed below. The carrying amount of short-term debt approximates fair value due to the variable rate of the interest and the short term nature of the instrument. Accordingly, the fair value is based on an internally developed model using current interest rate data for similar issues and there is no active markets for this type of facility and meets the Level 2 criteria of the three-tier fair value hierarchy discussed below.

Derivative instruments are reported in the accompanying consolidated financial statements at fair value. We have derivative financial instruments in the form of foreign currency forward exchange contracts as described in Note 1 of Notes to Consolidated Financial Statements in which the U.S. Dollar equivalent notional amount of these contracts was $107.3 million and $126.4 million at October 31, 2012 and 2011, respectively. The fair value of Derivative Assets recorded on our Consolidated Balance Sheets at October 31, 2012 and 2011 was $708,000 and $1.2 million, respectively. The fair value of Derivative Liabilities recorded on our Consolidated Balance Sheets at October 31, 2012 and 2011 was $569,000 and $1.6 million, respectively.

The fair value of the foreign currency forward exchange contracts and the related currency positions are subject to offsetting market risk resulting from foreign currency exchange rate volatility. The counterparty to the forward exchange contract is a substantial and creditworthy financial institution. We do not consider either the risk of counterparty non-performance or the economic consequences of counterparty non-performance as material risks.

FASB fair value guidance established a three-tier fair value hierarchy, which categorizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs, such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exist, therefore requiring an entity to develop its own assumptions.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – Continued

In accordance with this guidance, the following table represents the fair value hierarchy for our financial assets and liabilities measured at fair value as of October 31, 2012 (in thousands):

	Assets		Liabilities	
	October 31, 2012	October 31, 2011	October 31, 2012	October 31, 2011
Level 1				
Deferred compensation	$861	$ 741	$-	$ -
Level 2				
Derivatives	$708	$ 1,197	$569	$ 1,609

Included in Level 1 assets are mutual fund investments under a nonqualified deferred compensation plan. We estimate the fair value of these investments on a recurring basis using market prices which are readily available. Included as Level 2 fair value measurements are derivative assets and liabilities related to gains and losses on foreign currency forward exchange contracts entered into with a third party. We estimate the fair value of these derivatives on a recurring basis using foreign currency exchange rates obtained from active markets.

During fiscal 2012, we did not have any significant non-recurring measurements of nonfinancial assets and nonfinancial liabilities.

42

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

6. INCOME TAXES

In the fiscal years set forth below, the provision (benefit) for income taxes consisted of the following:

(in thousands)	Year Ended October 31,		
	2012	2011	2010
Current:			
U.S. taxes	$5,460	$3,272	$(4,410)
Foreign taxes	2,612	2,595	1,079
	8,072	5,867	(3,331)
Deferred:			
U.S. taxes	(1,931)	(1,452)	189
Foreign taxes	85	80	27
	(1,846)	(1,372)	216
	$6,226	$4,495	$(3,115)

A comparison of income tax expense at the U.S. statutory rate of 35% in 2012, 2011 and 2010, to the Company's effective tax rate is as follows:

Income (Loss) before income taxes (in thousands):	Year Ended October 31,		
	2012	2011	2010
Domestic	$12,432	$6,098	$(12,504)
Foreign	9,432	9,521	3,645
Earnings (Loss) before taxes on income	$21,864	$15,619	$(8,859)
Tax rates: U.S. statutory rate	35.0%	35.0%	35.0%
Effect of tax rate of international jurisdictions different than U.S. statutory rates	(5.5)%	(4.9)%	2.6%
Valuation allowance.	0.7%	(0.9)%	(9.5)%
State taxes	1.0%	0.9%	3.3%
Uncertain tax position statute expiration	—	—	5.6%
Other	(2.7)%	(1.3)%	(1.8)%
Effective tax rate	28.5%	28.8%	35.2%

We have not provided any U.S. income taxes on the undistributed earnings of our wholly-owned foreign subsidiaries based upon our determination that such earnings will be indefinitely reinvested. Undistributed earnings of our wholly-owned foreign subsidiaries at October 31, 2012 are approximately $48.7 million. In the event these earnings are later distributed to the U.S., such distributions would likely result in additional U.S. tax that may be offset, at least in part by associated foreign tax credits.

Deferred income taxes are determined based on the difference between the amounts used for financial reporting purposes and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred taxes are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

As of October 31, 2012, we have deferred tax assets established for accumulated net operating loss carryforwards of $764,000, primarily related to state and foreign jurisdictions. The Company has established a valuation allowance against some of these carryforwards due to the uncertainty of their full realization. As of October 31, 2012 and 2011, the balance of this valuation allowance was $460,000 and $487,000, respectively.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Significant components of our deferred tax assets and liabilities at October 31, 2012 and 2011 were as follows (in thousands):

	October 31, 2012	2011
Deferred Tax Assets:		
Net derivative instruments	$-	$448
Accrued inventory reserves	907	761
Accrued warranty expenses	171	205
Deferred compensation	282	265
Other accrued expenses	1,119	879
Net operating loss and credit carryforwards	764	750
Other	446	196
	3,689	3,504
Less: Valuation allowance on net operating loss carryforwards	(460)	(487)
Deferred tax assets	3,229	3,017
Deferred Tax Liabilities:		
Net derivative instruments	(799)	-
Property and equipment and capitalized software development costs	(2,025)	(2,298)
Other	(126)	(9)
Net deferred tax assets	$279	$710

As of October 31, 2012, we had deferred tax assets relating to net operating losses and credit carryforwards for international and U.S. income tax purposes of $764,000, of which $460,000 will expire within 5 years and $304,000 will expire between 5 and 20 years.

A reconciliation of the beginning and ending amount of unrecognized tax benefits, excluding the related accrual for interest or penalties, is as follows (in thousands):

	2012	2011	2010
Balance, beginning of year	$244	$178	$574
Additions based on tax positions related to the current year	5	66	1

Additions (reductions) related to prior years tax positions	(131)	—	—
Reductions due to statute expiration	—	—	(397)
Balance, end of year	$118	$244	$178

The entire balance of the unrecognized tax benefits and related interest at October 31, 2012, if recognized, would favorably affect the effective tax rate in future periods.

We recognize accrued interest and penalties related to unrecognized tax benefits as components of our income tax provision. We believe there is substantial support for taking these tax benefits and therefore have estimated no tax penalties. As of October 31, 2012, the gross amount of interest accrued, reported in other liabilities, was approximately $14,000, which did not include the federal tax benefit of interest deductions.

The statute of limitations with respect to unrecognized tax benefits will expire between July 2014 and July 2016.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Due to the uncertain and complex application of tax regulations, it is possible that the ultimate resolution of future audits may result in liabilities that could be different from this estimate. In such case, we will record additional tax expense or tax benefit in the tax provision (benefit) or reclassify amounts on the consolidated balance sheets in the period in which such the matter is effectively settled with the taxing authority.

We file income tax returns in the U.S. federal jurisdiction and various states, local, and non-U.S. jurisdictions. The Internal Revenue Service (IRS) has concluded their examination during the current fiscal year of our federal income tax returns for the years 2006, 2007 and 2010. The IRS did not examine tax returns for the tax years 2008 and 2009. The IRS examination resulted in no adjustments.

We or one of our subsidiaries files U.S. federal and/or state income tax returns as well as tax returns in one or more foreign jurisdictions. A summary of open tax years by major jurisdiction is presented below:

United States federal	Fiscal 2006 through the current period
Indiana	Fiscal 2007 through the current period
California	Fiscal 2007 through the current period
Germany[1]	Fiscal 2009 through the current period
Taiwan	Fiscal 2007 through the current period

[1] Includes federal as well as state, provincial or similar local jurisdictions, as applicable.

7. EMPLOYEE BENEFITS

We have defined contribution plans that include a majority of our employees, under which our matching contributions are primarily discretionary. The purpose of these plans is generally to provide additional financial security during retirement by providing employees with an incentive to save throughout their employment. Our contributions and related expense totaled $459,000, $274,000, and $144,000, for the fiscal years ended October 31, 2012, 2011 and 2010, respectively.

8. STOCK-BASED COMPENSATION

In March 2008, we adopted the Hurco Companies, Inc. 2008 Equity Incentive Plan (the “2008 Plan”), which allows us to grant awards of stock options, Stock Appreciation Rights settled in stock (SARs), restricted shares, performance shares and performance units. The 2008 Plan replaced the 1997 Stock Option and Incentive Plan, which expired in March 2007. The Compensation Committee of the Board of Directors has authority to determine the officers, directors and key employees who will be granted awards; designate the number of shares subject to each award; determine the terms and conditions upon which awards will be granted; and prescribe the form and terms of award agreements. We have granted stock options under both plans which are currently outstanding and restricted shares under the 2008 Plan. No stock option may be exercised more than ten years after the date of grant or such shorter period as the Compensation Committee may determine at the date of grant. The total number of shares of our common stock that may be issued as awards under the 2008 Plan is 750,000. The market value of a share of our common stock, for purposes of the 2008 Plan, is the closing sale price as reported by the Nasdaq Global Select Market on the date in question or, if not a trading day, on the last preceding trading date.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – Continued

During fiscal 2012, 2011 and 2010, we recorded approximately $870,000, $470,000 and $141,000, respectively, of stock-based compensation expense related to grants under the plans. As of October 31, 2012, there was approximately $1.1 million of total unrecognized stock-based compensation cost that we expect to recognize by the end of the first quarter of fiscal 2015.

On March 15, 2012, the Compensation Committee granted a total of 6,475 shares of restricted stock to our non-employee directors. The restricted stock vests in full one year from the date of grant provided the recipient remains on the board of directors through that date. The grant date fair value of the restricted stock is based on the closing sales price of our common stock on the grant date which was $27.00 per share.

On December 14, 2011, the Compensation Committee granted a total of 45,236 stock options under the 2008 Plan to our executive officers. The fair value of the options was estimated on the date of grant using a Black-Scholes valuation model with assumptions for expected volatility based on the historical volatility of our common stock of 64%, expected term of the options of five years, dividend yield rate of 0% and a risk-free interest rate of .86% based upon the five-year U.S. Treasury yield as of the date of grant. The options vest over a three-year period beginning one year from the date of grant. Based upon the foregoing factors, the grant date fair value of the stock options was determined to be $11.50 per share.

On December 14, 2011, the Compensation Committee granted a total of 24,243 shares of restricted stock to our executive officers. The restricted stock vests in full three years from the date of grant provided the recipient remains employed by us through that date. The grant date fair value of the restricted stock is based on the closing sales price of our common stock on the grant date which was $21.45 per share.

During fiscal 2012, options to purchase 500 shares were exercised, resulting in cash proceeds of approximately $1,000.

On March 17, 2011, the Compensation Committee granted a total of 5,859 shares of restricted stock under the 2008 Plan to our non-employee directors. The restricted stock vests one year from the date of grant provided the recipient remains on the board of directors through that date. The grant date fair value of the restricted stock is based on the closing sales price of our common stock on the grant date which was $29.86 per share.

On December 22, 2010, the Compensation Committee granted a total of 25,000 shares of restricted stock under the 2008 Plan to our executive officers. The restricted stock vests in full three years from the date of grant provided the recipient remains employed by us through that date. The grant date fair value of the restricted stock is based on the closing sales price of our common stock on the grant date which was $23.10 per share.

On May 13, 2010, the Compensation Committee granted a total of 20,000 stock options under the 2008 Plan to four executive employees. The fair value of the options was estimated on the date of grant using a Black-Scholes valuation model with assumptions for expected volatility based on the historical volatility of our common stock of 63%, expected term of the options, dividend yield rate of 0% and a risk-free interest rate of 2.3% based upon the five-year U.S. Treasury yield as of the date of grant. The options vest over a three-year period beginning one year from the date of grant. Based upon the foregoing factors, the grant date fair value of the stock options was determined to be $9.90 per share.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

A reconciliation of the Company's restricted stock activity and related information is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at October 31, 2011	30,859	$ 24.38
Shares granted	30,718	22.62
Shares vested	(5,859)	29.86
Shares cancelled	—	—
Unvested at October 31, 2012	55,718	$ 22.84

A summary of the status of the options as of October 31, 2012, 2011 and 2010 and the related activity for the year is as follows:

	Shares Under Option	Weighted Average Exercise Price Per Share
Balance October 31, 2009	65,369	$ 24.11
Granted	50,000	16.14
Cancelled	—	—
Expired	—	—
Exercised	—	—
Balance October 31, 2010	115,369	$ 20.66
Granted	—	—
Cancelled	—	—
Expired	—	—
Exercised	—	—
Balance October 31, 2011	115,369	$ 20.66
Granted	45,236	21.45
Cancelled	(5,000)	26.69
Expired	—	—
Exercised	(500)	2.15
Balance October 31, 2012	155,105	$ 20.75

The total intrinsic value of stock options exercised during the twelve months ended October 31, 2012, 2011 and 2010 was approximately $10,000, $0 and $0, respectively.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

As of October 31, 2012, the total intrinsic value of outstanding stock options already vested and expected to vest and the intrinsic value of options that are outstanding and exercisable was $581,000. Stock options outstanding and exercisable on October 31, 2012, are as follows:

Range of Exercise Prices Per Share	Shares Under Option	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life in Years
Outstanding			
$ 14.82	30,000	$ 14.82	7.1
14.88	21,000	14.88	6.5
18.13	20,000	18.13	7.5
21.45	45,236	21.45	9.1
26.69	28,869	26.69	4.0
35.83	10,000	35.83	5.6
$ 14.82 – 35.83	155,105	$ 20.75	7.0
Exercisable			
$ 14.82	20,000	$ 14.82	4.8
14.88	14,000	14.88	4.3
18.13	13,333	18.13	5.0
26.69	28,869	26.69	4.0
35.83	10,000	35.83	5.6
$ 14.82 – 35.83	86,202	$ 21.75	4.6

9. RELATED PARTY TRANSACTIONS

As of October 31, 2012, we owned approximately 35% of the outstanding shares of a Taiwanese-based contract manufacturer, Hurco Automation, Ltd. (HAL). HAL’s scope of activities includes the design, manufacture, sales and distribution of industrial automation products, software systems and related components, including control systems and components produced under contract for sale exclusively to us. We are accounting for this investment using the equity method. The investment of $2.4 million and $2.1 million at October 31, 2012 and 2011 is included in Investments and Other Assets, Net on the Consolidated Balance Sheets. Purchases of product from HAL amounted to $10.2 million, $9.1 million and $5.8 million in 2012, 2011 and 2010, respectively. Sales of product to HAL were $1.8 million, $1.9 million and $1.2 million for the years ended October 31, 2012, 2011 and 2010, respectively. Trade payables to HAL were $1.2 million and $2.7 million at October 31, 2012 and 2011, respectively. Trade receivables from HAL were $146,000 and $373,000 at October 31, 2012 and 2011, respectively.

Summary unaudited financial information for HAL’s operations and financial conditions is as follows:

(in thousands)	2012	2011	2010
Net Sales	$12,252	$10,938	$7,057
Gross Profit	1,735	1,284	816
Operating Income (Loss)	340	(97)	(399)
Net Income (Loss)	882	202	(337)
Current Assets	$7,091	$8,201	$7,439
Non-current Assets	2,610	2,133	1,846
Current Liabilities	1,702	3,298	2,529

48

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

10. CONTINGENCIES AND LITIGATION

We are involved in various claims and lawsuits arising in the normal course of business. We do not expect any of these claims, individually or in the aggregate, to have a material adverse effect on our consolidated financial position or results of operations.

11. GUARANTEES AND PRODUCT WARRANTIES

We follow FASB guidance for accounting for contingencies relating to the guarantor's accounting for, and disclosures of, the issuance of certain types of guarantees.

From time to time, our subsidiaries guarantee third party payment obligations in connection with the sale of machines to customers that use financing. We follow FASB guidance for accounting for contingencies with respect to these guarantees. As of October 31, 2012, we had 19 outstanding third party payment guarantees totaling approximately $1.1 million. The terms of these guarantees are consistent with the underlying customer financing terms. Upon shipment of a machine, the customer has the risk of ownership. The customer does not obtain title, however, until it has paid for the machine. A retention of title clause allows us to recover the machine if the customer defaults on the financing. We accrue for potential liabilities under these guarantees when we believe a loss is probable and can be estimated.

We provide warranties on our products with respect to defects in material and workmanship. The terms of these warranties are generally one year for machines and shorter periods for service parts. We recognize a reserve with respect to this obligation at the time of product sale, with subsequent warranty claims recorded against the reserve. The amount of the warranty reserve is determined based on historical trend experience and any known warranty issues that could cause future warranty costs to differ from historical experience. A reconciliation of the changes in our warranty reserve is as follows (in thousands):

	2012	2011	2010
Balance, beginning of year	$1,725	$1,591	$1,286
Provision for warranties during the year	3,473	3,142	2,170
Charges to the accrual	(3,567)	(2,993)	(1,875)
Impact of foreign currency translation	(8)	(15)	10

Balance, end of year	$1,623	$1,725	$1,591

The increase in warranty charges from fiscal 2011 to 2012 is in line with the increased volume of computerized machine tool sales. The warranty accrual decreased year-over-year as actual claims for specific warranties accrued in the prior year were less than anticipated resulting in an adjustment to the provision for warranties during the year.

The factor primarily responsible for the increase in the warranty accrual and provision from fiscal 2010 to fiscal 2011 is the increase in sales. In addition, during fiscal 2010 we introduced several new products and our product mix included a greater percentage of our higher-performance machines, which due to their complexity tend to have both a higher rate of warranty claim and a higher cost per claim. These factors, coupled with our increased production activity within a relatively short period of time, were considered when increasing the accrual and provision during fiscal 2010 and 2011.

49

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

12. OPERATING LEASES

We lease facilities, certain equipment and vehicles under operating leases that expire at various dates through 2017. Future payments required under operating leases as of October 31, 2012, are summarized as follows (in thousands):

2013	$3,037
2014	2,019
2015	1,106
2016	663
2017 and thereafter	153
Total	$6,978

Lease expense for the years ended October 31, 2012, 2011, and 2010 was $3.3 million, $3.0 million, and $2.7 million, respectively.

We recorded approximately $160,000 of lease income during fiscal 2012 from leasing 50,000 square feet of our Indianapolis facility. The lease expires on March 31, 2013.

50

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

13. QUARTERLY HIGHLIGHTS (Unaudited)

2012 (In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Sales and service fees	$51,126	$45,965	$49,959	$56,067
Gross profit	16,484	13,393	16,084	17,220
Gross profit margin	32.2 %	29.1 %	32.2 %	30.7 %
Selling, general and administrative expenses	9,730	9,288	10,272	11,870
Operating income	6,754	4,105	5,812	5,350
Provision for income taxes	2,263	1,103	1,641	1,219
Net income	4,633	2,962	3,957	4,086
Income per common share – basic	$0.71	$0.46	$0.61	$0.63
Income per common share – diluted	$0.71	$0.45	$0.61	$0.63

2011 (In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Sales and service fees	$39,680	$41,576	$50,573	$48,571
Gross profit	11,691	12,651	15,850	15,682
Gross profit margin	29.5 %	30.4 %	31.3 %	32.3 %
Selling, general and administrative expenses	8,830	9,254	9,317	11,092
Operating income	2,861	3,397	6,533	4,590
Provision for income taxes	899	1,050	1,706	840
Net income	1,546	2,349	4,575	2,654
Income per common share – basic	$0.24	$0.36	$0.71	$0.41
Income per common share – diluted	$0.24	$0.36	$0.70	$0.41

14. SEGMENT INFORMATION

We operate in a single segment: industrial automation equipment. We design and produce interactive computer control systems and software and computerized machine tools for sale to the worldwide metal working market. We also provide software options, control upgrades, accessories and replacement parts for our products, as well as customer service and training support.

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

We sell our products through more than 100 independent agents and distributors throughout North America, Europe and Asia. Our line is the primary line for the majority of our distributors globally even though some may carry competitive products. We also have our own direct sales and service organizations in China, France, Germany, India, Italy, Poland, Singapore, South Africa, South Korea, the United Kingdom, and certain areas of the United States, which are among the world's principal machine tool consuming countries. During fiscal 2012, no distributor accounted for more than 5% of our sales and service fees. In fiscal 2012, approximately 70% of our revenues were from overseas customers and no single end-user of our products accounted for more than 5% of our total sales and service fees.

The following table sets forth the contribution of each of our product groups to our total sales and service fees during each of the past three fiscal years (in thousands):

Net Sales and Service Fees by Product Category	Year ended October 31,		
	2012	2011	2010
Computerized Machine Tools	$179,337	$156,736	$88,184
Computer Control Systems and Software *	2,947	3,322	2,347
Service Parts	15,299	14,836	10,798
Service Fees	5,534	5,506	4,564
Total	$203,117	$180,400	$105,893

*Amounts shown do not include computer control systems and software sold as an integrated component of computerized machine systems.

The following table sets forth revenues by geographic area, based on customer location, for each of the past three fiscal years (in thousands):

Revenues by Geographic Area	Year Ended October 31,		
	2012	2011	2010
North America	$60,500	$47,599	$26,079
Germany	49,979	47,162	25,887
United Kingdom	28,914	22,463	13,703

Italy	6,038	5,192	5,863
France	9,970	10,227	6,061
Other Europe	23,145	23,205	12,185
Total Europe	118,046	108,249	63,699
Asia	23,216	21,552	13,697
Other Foreign	1,355	3,000	2,418
Total Foreign	142,617	132,801	79,814
	$203,117	$180,400	$105,893

Long-lived tangible assets, net by geographic area were (in thousands):

	As of October 31,	
	2012	2011
United States	$6,633	$6,773
Foreign countries	6,677	6,375
	$13,310	$13,148

52

HURCO COMPANIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Net assets by geographic area were (in thousands):

	As of October 31,	
	2012	2011
North America	$73,449	$60,235
Europe	48,571	45,613
Asia	21,773	20,364
	$143,793	$126,212

15. NEW ACCOUNTING PRONOUNCEMENTS

In June 2011, the FASB amended Accounting Standards Update (ASU 2011-05), *Comprehensive Income, Presentation of Comprehensive Income*, which will require companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity. The guidance in ASU 2011-05 does not change the items which must be reported in other comprehensive income, how such items are measured, or when they must be reclassified to net income. The guidance in ASU 2011-05 is effective for fiscal years and interim periods within those years beginning after December 15, 2011, and should be applied retrospectively. Since the provisions of ASU 2011-05 are presentation related only, we do not expect the adoption of ASU 2011-05 to have a material effect on our consolidated financial statements.

In December 2011, The FASB issued Accounting Standards Update 2011-12 (ASU 2011-12), *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05.* ASU 2011-12 defers the requirement that companies present reclassification adjustments for each component of AOCI in both net income and OCI on the face of the financial statements. The effective dates for ASU 2011-12 are consistent with the effective dates for ASU 2011-05 and, similar to our expectations for the adoption of ASU 2011-05, we do not expect that the adoption of ASU 2011-12 will have a material effect on our consolidated financial statements.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. CONTROLS AND PROCEDURES

Under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of October 31, 2012, pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of the evaluation date.

There have been no changes in our internal controls over financial reporting that occurred during the fourth quarter of the fiscal year ended October 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Item 9B. OTHER INFORMATION

During the fourth quarter of fiscal 2012, the Audit Committee of the Board of Directors did not engage our independent registered public accounting firm to perform any new non-audit services. This disclosure is made pursuant to Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002.

The following graph illustrates the cumulative total shareholder return on our common stock for the five-year period ended October 31, 2012, as compared to the Russell 2000 and a peer group consisting of traded securities for U.S. companies in the same three digit Standard Industrial Classification group as Hurco (SIC 3540-3549 – Metal Working Machinery and Equipment). The comparisons in this table are required by the SEC and are not intended to forecast or be indicative of possible future performance of our common stock.

	10/07	10/08	10/09	10/10	10/11	10/12
Hurco Companies, Inc.	100.00	39.40	27.85	32.22	45.74	40.25
Russell 2000	100.00	65.84	70.09	88.72	94.67	106.11
Peer Group - SIC Codes 3540-3549	100.00	50.55	63.57	87.27	91.54	100.46

54

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is incorporated herein by reference to the definitive proxy statement for our 2013 annual meeting of shareholders except that the information required by Item 10 regarding our executive officers is included herein under a separate caption at the end of Part I.

Item 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the definitive proxy statement for our 2013 annual meeting of shareholders.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the definitive proxy statement for our 2013 annual meeting of shareholders.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the definitive proxy statement for our 2013 annual meeting of shareholders.

Item 14. PRINCIPal ACCOUNTING FEES AND SERVICES

The information required by this item is incorporated herein by reference to the definitive proxy statement for our 2013 annual meeting of shareholders.

PART IV

Item 15. Exhibits AND Financial Statement Schedules

(a) 1. Financial Statements. The following consolidated financial statements of Registrant are included herein under Item 8 of Part II:

	Page
Report of Independent Registered Public Accounting Firm	27
Consolidated Statements of Operations – years ended October 31, 2012, 2011 and 2010	29
Consolidated Balance Sheets – as of October 31, 2012 and 2011	30
Consolidated Statements of Cash Flows – years ended October 31, 2012, 2011 and 2010	31
Consolidated Statements of Changes in Shareholders' Equity – years ended October 31, 2012, 2011 and 2010	32
Notes to Consolidated Financial Statements	33

2. Financial Statement Schedule. The following financial statement schedule is included in this Item.

	Page
Schedule II - Valuation and Qualifying Accounts and Reserves	57

All other financial statement schedules are omitted because they are not applicable or the required information is included in the consolidated financial statements or notes thereto.

(b) Exhibits

Exhibits being filed with this Form 10-K or incorporated herein by reference are listed on page 58.

Schedule II - Valuation and Qualifying Accounts and Reserves

for the years ended October 31, 2012, 2011, and 2010

(Dollars in thousands)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions		Balance at End of Period
Allowance for doubtful accounts for the year ended:						
October 31, 2012	$ 608	$ 88	—	$ 312	(1)	$ 384
October 31, 2011	$ 497	$ 315	—	$ 204	(2)	$ 608
October 31, 2010	$ 809	$ (301)	—	$ 11	(3)	$ 497
Accrued warranty expenses for the year ended:						
October 31, 2012	$ 1,725	$ 3,465	—	$ 3,567		$ 1,623
October 31, 2011	$ 1,591	$ 3,127	—	$ 2,993		$ 1,725
October 31, 2010	$ 1,286	$ 2,180	—	$ 1,875		$ 1,591
Income tax valuation allowance for the year ended:						
October 31, 2012	$ 487	$ 360	—	$ (387)		$ 460
October 31, 2011	$ 961	$ 72	—	$ (546)		$ 487
October 31, 2010	$ 163	$ 826	—	$ (28)		$ 961

(1) Receivable write-offs of $312,000.

2) Receivable write-offs of $204,000.

(3) Receivable write-offs of $13,000, net of cash recoveries on accounts previously written off of $2,000.

57

EXHIBITS INDEX

Exhibits Filed. The following exhibits are filed with this report:

10.1*	Summary compensation sheet.
21	Subsidiaries of the Registrant.
23	Consent of Independent Registered Public Accounting Firm, Ernst & Young LLP
31.1	Certification by the Chief Executive Officer, pursuant to Rule 13a-15(b) under the Securities and Exchange Act of 1934, as amended.
31.2	Certification by the Chief Financial Officer, pursuant to Rule 13a-15(b) under the Securities and Exchange Act of 1934, as amended.
32.1	Certification by the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Exhibits Incorporated by Reference. The following exhibits are incorporated into this report:

3.1	Amended and Restated Articles of Incorporation of the Registrant, incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended July 31, 2000.
3.2	Amended and Restated By-Laws of the Registrant as amended through July 8, 2009, incorporated by reference to Exhibit 3.1 to the Registrant’s Quarterly Report on Form 10-Q for the quarter ended July 31, 2009.
10.2	Credit Agreement dated as of December 7, 2012 between Hurco Companies, Inc. and JP Morgan Chase Bank, N.A., incorporated by reference to Exhibit 10.1 to the Registrant’s Current Report on Form 8-K filed December 10, 2012.
10.3*	Employment Agreement dated March 15, 2012, between Hurco Companies, Inc. and Michael Doar, incorporated by reference to Exhibit 10.1 to the Registrant’s Current Report on Form 8-K filed March 16, 2012.
10.4*	Employment Agreement dated March 15, 2012, between Hurco Companies, Inc. and John G. Oblazney, incorporated by reference to Exhibit 10.2 to the Registrant’s Current Report on Form 8-K filed March 16, 2012.
10.5*	Employment Agreement dated March 15, 2012, between Hurco Companies, Inc. and John P. Donlon, incorporated by reference to Exhibit 10.3 to the Registrant’s Current Report on Form 8-K filed March 16, 2012.
10.6*	Employment Agreement dated March 15, 2012, between Hurco Companies, Inc. and Gregory S. Volovic, incorporated by reference to Exhibit 10.4 to the Registrant’s Current Report on Form 8-K filed March 16, 2012.
10.7*	Employment Agreement dated March 15, 2012, between Hurco Companies, Inc. and Sonja McClelland, incorporated by reference to Exhibit 10.5 to the Registrant’s Current Report on Form 8-K filed March 16, 2012.
10.8*	Amended 1997 Stock Option and Incentive Plan, incorporated by reference as Exhibit 10 to the Registrant’s Quarterly Report on Form 10-Q filed for the quarter ended July 31, 2005.
10.9	Hurco Companies, Inc. 2008 Equity Incentive Plan, incorporated by reference to Appendix A of the Registrant’s definitive Proxy Statement on Schedule 14A filed January 28, 2008.
10.10*	Form of restated split-dollar insurance agreement, incorporated by reference to Exhibit 10.2 to the Registrant’s Annual Report on Form 10-K for the year ended October 31, 2008.
10.11*	Form of Restricted Stock Award Agreement – Employee, incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended January 31, 2011.

10.12	Form of Restricted Stock Award Agreement – Director, incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended January 31, 2011.

* The indicated exhibit is a management contract, compensatory plan or arrangement required to be listed by Item 601 of Regulation S-K.

58

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, this 11th day of January, 2013.

HURCO COMPANIES, INC.

By: /s/ John G. Oblazney
John G. Oblazney
Vice-President, Secretary,
Treasurer and
Chief Financial Officer

59

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature and Title(s)	Date
/s/ Michael Doar Michael Doar, Chairman of the Board, Chief Executive Officer and President of Hurco Companies, Inc. (Principal Executive Officer)	January 11, 2013
/s/ John G. Oblazney John G. Oblazney Vice-President, Secretary, Treasurer and Chief Financial Officer of Hurco Companies, Inc. (Principal Financial Officer)	January 11, 2013
/s/ Sonja K. McClelland Sonja K. McClelland Corporate Controller, Assistant Secretary of Hurco Companies, Inc. (Principal Accounting Officer)	January 11, 2013
/s/ Robert W. Cruickshank Robert W. Cruickshank, Director	January 11, 2013
/s/ Philip James Philip James, Director	January 11, 2013
/s/ Michael P. Mazza Michael P. Mazza, Director	January 11, 2013
/s/ Andrew Niner Andrew Niner, Director	January 11, 2013
/s/ Richard Porter Richard Porter, Director	January 11, 2013
/s/ Janaki Sivanesan Janaki Sivanesan, Director	January 11, 2013
/s/ Ronald Strackbein Ronald Strackbein, Director	January 11, 2013

60