

COHERENT INC
Form 10-Q
January 31, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2007

or

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

For the transition period from to

Commission File Number: 0-5255

COHERENT, INC.

Delaware
(State or other jurisdiction of
incorporation or organization)

94-1622541
(I.R.S. Employer
Identification No.)

5100 Patrick Henry Drive, Santa Clara, California 95054

Edgar Filing: COHERENT INC - Form 10-Q

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(408) 764-4000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of shares outstanding of registrant's common stock, par value \$.01 per share, on January 15, 2008 was 31,544,990 shares.

COHERENT, INC.

INDEX

| | Page |
|--|-------------|
| Part I. Financial Information | |
| Item 1. Financial Statements (unaudited) | |
| <u>Condensed Consolidated Statements of Operations</u> | |
| <u>Three and nine months ended June 30, 2007 and July 1, 2006 (Restated)</u> | 5 |
| <u>Condensed Consolidated Balance Sheets</u> | |
| <u>June 30, 2007 and September 30, 2006</u> | 6 |
| <u>Condensed Consolidated Statements of Cash Flows</u> | |
| <u>Nine months ended June 30, 2007 and July 1, 2006 (Restated)</u> | 7 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 9 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 31 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 53 |
| Item 4. <u>Controls and Procedures</u> | 54 |
| Part II. Other Information | |
| Item 1. <u>Legal Proceedings</u> | 56 |
| Item 1A. <u>Risk Factors</u> | 57 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 67 |
| Item 3. <u>Defaults upon Senior Securities</u> | 67 |
| Item 4. <u>Submission of Matters to Vote of Security Holders</u> | 67 |
| Item 5. <u>Other Information</u> | 67 |
| Item 6. <u>Exhibits</u> | 68 |
| <u>Signatures</u> | 69 |

EXPLANATORY NOTE REGARDING RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

This quarterly report contains the restatement of our condensed consolidated statements of operations for the three and nine months ended July 1, 2006 and condensed consolidated statements of cash flows for the nine months ended July 1, 2006.

As previously announced on November 1, 2006, a Special Committee was established by our Board of Directors to conduct an independent investigation relating to our historical stock option practices. We requested the independent review following an internal review of our historical stock option practices, which was a voluntary review initiated in light of news of the option practices of numerous companies across several industries. The Special Committee, comprised of three independent members of our Board of Directors, retained independent outside counsel and forensic accountants to assist in conducting the investigation. Together with its independent counsel, the Special Committee conducted an extensive review of historical stock option practices including all awards made by us between January 1, 1995 and September 30, 2006, (the Relevant Period) that included the review of over one million documents and interviews of over 30 current and former employees, directors and advisors.

As a result of the investigation, our management and the Special Committee, with the assistance of independent legal counsel and forensic accounting experts, determined that incorrect measurement dates for a significant number of stock option awards during the Relevant Period were used, resulting in errors in our accounting related to stock option compensation expenses during the Relevant Period. We determined that corrections to previously issued consolidated financial statements were required to reflect additional material charges for stock-based compensation expenses and related income and payroll tax effects.

Options granted during the Relevant Period to purchase an aggregate of approximately 8,735,590 shares were determined to have incorrect measurement dates. Accordingly, our consolidated retained earnings as of July 1, 2006 has been restated to incorporate an aggregate of approximately \$21.8 million in incremental stock-based compensation charges, including payroll taxes, net of a \$3.4 million tax benefit, during the period from January 1, 1995 through July 1, 2006. We determined that the revised measurement dates for accounting purposes differed from the originally recorded measurement dates due primarily to a number of factors, including (1) delays in the final determination or approval of the awards, (2) retroactive selection of grant dates, (3) the absence of definitive documentation regarding approval, and (4) other process-related issues. These included annual grants to existing employees and officers and option grants made to new hires or to employees recently promoted.

In those cases in which we previously used a measurement date that we determined was incorrect, we have developed and applied a methodology to remeasure those stock option grants and record the relevant stock-based compensation charges. For more information on our restatement, including the methodology we adopted, see Part I. Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations Restatement of Condensed Consolidated Financial Statements and Note 3 of Notes to Condensed Consolidated Financial Statements appearing in Part I. Item 1 of this quarterly report.

In addition to restatements for stock-based compensation, we recorded restatements to correct other errors that occurred in the fiscal 2006 periods which have been reflected in the restated condensed consolidated financial statements. These restatements, including the nature thereof, are further discussed in Note 3 of Notes to Condensed Consolidated Financial Statements appearing in Part I. Item 1 of this quarterly report.

Edgar Filing: COHERENT INC - Form 10-Q

All financial information contained in this quarterly report gives effect to the restatements of our consolidated financial statements as described above.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements included in or incorporated by reference in this quarterly report, other than statements of historical fact, are forward-looking statements. These statements are generally accompanied by words such as trend, may, will, could, would, should, expect, plan, anticipate, rely, believe, estimate, predict, intend, potential, continue, forecast or other comparable terminology, including without limitation statements made under Future Trends , Our Strategy , discussions regarding our bookings and in Management s Discussion and Analysis of Financial Condition and Results of Operations . Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Actual results of Coherent, Inc. (referred to herein as the Company, we, our or Coherent) may differ significantly from those anticipated in these forward-looking statements as a result of various factors, including those discussed in the sections captioned Future Trends, Risk Factors, Key Performance Indicators, as well as any other cautionary language in this quarterly report. All forward-looking statements included in the document are based on information available to us on the date hereof. We undertake no obligation to update these forward-looking statements as a result of events or circumstances or to reflect the occurrence of unanticipated events or non-occurrence of anticipated events.

PART I. FINANCIAL INFORMATION

Item I. FINANCIAL STATEMENTS

COHERENT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited; in thousands, except per share data)

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------|--------------------|-----------------------------------|-------------------|-----------------------------------|
| | June 30, 2007 | July 1, 2006 (As Restated) (1) | June 30, 2007 | July 1, 2006 (As Restated) (1) |
| Net sales | \$ 142,608 | \$ 149,524 | \$ 442,233 | \$ 426,506 |
| Cost of sales | 85,470 | 83,231 | 258,651 | 240,391 |
| Gross profit | 57,138 | 66,293 | 183,582 | 186,115 |
| Operating expenses: | | | | |
| Research and development | 19,337 | 18,844 | 56,543 | 52,788 |
| In-process research and development | 2,200 | | 2,200 | 690 |
| Selling, general and administrative | 39,095 | 33,325 | 109,718 | 95,333 |
| Restructuring and other charges | | 187 | 248 | 97 |
| Amortization of intangible assets | 2,085 | 2,344 | 5,978 | 7,262 |
| Total operating expenses | 62,717 | 54,700 | 174,687 | 156,170 |
| Income (loss) from operations | (5,579) | 11,593 | 8,895 | 29,945 |
| Other income (expense): | | | | |
| Interest and dividend income | 6,077 | 4,815 | 18,386 | 9,441 |
| Interest expense | (2,012) | (1,847) | (5,665) | (2,741) |
| Other net | 1,952 | 565 | 3,666 | 473 |
| Total other income, net | 6,017 | 3,533 | 16,387 | 7,173 |
| Income before income taxes | 438 | 15,126 | 25,282 | 37,118 |
| Provision for income taxes | 1,201 | 3,881 | 8,005 | 11,039 |
| Net income (loss) | \$ (763) | \$ 11,245 | \$ 17,277 | \$ 26,079 |
| Net income (loss) per share: | | | | |
| Basic | \$ (0.02) | \$ 0.36 | \$ 0.55 | \$ 0.84 |
| Diluted | \$ (0.02) | \$ 0.36 | \$ 0.54 | \$ 0.83 |
| Shares used in computation: | | | | |
| Basic | 31,417 | 30,868 | 31,391 | 30,915 |
| Diluted | 31,417 | 31,596 | 32,045 | 31,460 |

(1) See Note 3, Restatement of Condensed Consolidated Financial Statements of the accompanying Notes to Condensed Consolidated Financial Statements.

See Accompanying Notes to Condensed Consolidated Financial Statements

COHERENT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited; in thousands, except par value)

| | June 30, 2007 | September 30, 2006 |
|--|------------------|-----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 338,899 | \$ 445,231 |
| Short-term investments | 179,486 | 48,767 |
| Restricted cash, current | 2,460 | |
| Accounts receivable net of allowances of \$3,424 and \$3,275, respectively | 100,432 | 111,446 |
| Inventories | 115,079 | 101,494 |
| Prepaid expenses and other assets | 41,563 | 21,256 |
| Deferred tax assets | 48,151 | 29,201 |
| Total current assets | 826,070 | 757,395 |
| Property and equipment, net | 127,603 | 148,592 |
| Assets held for sale | 21,242 | |
| Restricted cash, non-current | 1,786 | 3,709 |
| Goodwill | 82,090 | 71,871 |
| Intangible assets, net | 36,924 | 38,863 |
| Other assets | 67,397 | 62,094 |
| Total assets | \$ 1,163,112 | \$ 1,082,524 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term obligations | \$ 8 | \$ 8 |
| Convertible subordinated notes | 199,790 | |
| Accounts payable | 33,082 | 29,498 |
| Income taxes payable | 25,395 | 17,720 |
| Other current liabilities | 94,869 | 79,352 |
| Total current liabilities | 353,144 | 126,578 |
| Long-term obligations | 1,151 | 1,276 |
| Other long-term liabilities | 46,753 | 37,419 |
| Convertible subordinated notes | | 199,747 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' equity: | | |
| Common stock, par value \$.01 per share: | | |
| Authorized 500,000 shares | | |
| Outstanding 31,553 shares and 31,412 shares, respectively | 313 | 311 |
| Additional paid-in capital | 379,594 | 367,290 |
| Notes receivable from stock sales | | (324) |
| Accumulated other comprehensive income | 61,346 | 46,693 |
| Retained earnings | 320,811 | 303,534 |
| Total stockholders' equity | 762,064 | 717,504 |
| Total liabilities and stockholders' equity | \$ 1,163,112 | \$ 1,082,524 |

See Accompanying Notes to Condensed Consolidated Financial Statements.

COHERENT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited; in thousands)

| | June 30, 2007 | Nine Months Ended July 1, 2006 (As Restated) (1) |
|---|------------------|---|
| Cash flows from operating activities: | | |
| Net income | \$ 17,277 | \$ 26,079 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Purchased in-process research and development | 2,200 | 690 |
| Depreciation and amortization | 19,225 | 19,868 |
| Amortization of intangible assets | 5,978 | 7,262 |
| Deferred income taxes | (9,985) | (2,784) |
| Stock-based compensation | 8,930 | 10,373 |
| Excess tax benefit from stock-based compensation arrangements | (77) | (712) |
| Tax benefit from employee stock options | | 1,624 |
| Non-cash restructuring and other charges (recoveries) | (128) | 97 |
| Amortization of bond issue costs | 874 | 373 |
| Other non-cash expense | 1,855 | 571 |
| Changes in assets and liabilities, net of effect of acquisitions: | | |
| Accounts receivable | 13,215 | (12,875) |
| Inventories | (9,956) | (446) |
| Prepaid expenses and other assets | (20,446) | (9,599) |
| Other assets | (5,337) | (2,009) |
| Accounts payable | 3,286 | 11,914 |
| Income taxes payable/receivable | 7,355 | (407) |
| Other current liabilities | 11,086 | (34) |
| Other long-term liabilities | 4,497 | 711 |
| Net cash provided by operating activities | 49,849 | 50,696 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (17,713) | (12,938) |
| Proceeds from dispositions of property and equipment | 203 | 1,167 |
| Purchases of available-for-sale securities | (624,150) | (186,553) |
| Proceeds from sales and maturities of available-for-sale securities | 493,431 | 277,533 |
| Acquisition of businesses, net of cash acquired | (14,175) | (5,214) |
| Change in restricted cash | (448) | 13,725 |
| Deferred business acquisition costs | | (2,303) |
| Premiums paid for life insurance contracts | (2,800) | |
| Other net | 22 | 158 |
| Net cash provided by (used in) investing activities | (165,630) | 85,575 |

(continued)

COHERENT, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(Unaudited; in thousands)

| Cash flows from financing activities: | | | |
|---|------------|----|----------|
| Long-term debt borrowings | | | 1,387 |
| Long-term debt repayments | (210) | | (12,741) |
| Repayment of capital lease obligation | (5) | | |
| Cash overdrafts decrease | (1,919) | | (474) |
| Issuance of common stock under employee stock option and purchase plans | 3,783 | | 19,025 |
| Repurchase of common stock | | | (22,250) |
| Collection of notes receivable from stock sales | 324 | | |
| Proceeds received from issuance of convertible subordinated notes | | | 200,000 |
| Debt issuance costs | | | (5,567) |
| Excess tax benefits from stock-based compensation arrangements | 77 | | 712 |
| Net cash provided by financing activities | 2,050 | | 180,092 |
| Effect of exchange rate changes on cash and cash equivalents | 7,399 | | 7,135 |
| Net increase (decrease) in cash and cash equivalents | (106,332) | | 323,498 |
| Cash and cash equivalents, beginning of period | 445,231 | | 97,507 |
| Cash and cash equivalents, end of period | \$ 338,899 | \$ | 421,005 |

Supplemental disclosure of cash flow information:

| | | | |
|--------------------------------------|-----------|----|--------|
| Cash paid during the period for: | | | |
| Interest | \$ 4,234 | \$ | 1,440 |
| Income taxes | \$ 11,974 | \$ | 11,283 |
| Cash received during the period for: | | | |
| Income taxes | \$ 1,731 | \$ | 886 |

Noncash investing and financing activities:

| | | | |
|--|----------|----|-----|
| Unpaid property and equipment | \$ 813 | \$ | 566 |
| Portion of deferred business acquisition costs included in other current liabilities | \$ 1,682 | \$ | |
| Net retirement of restricted stock awards | \$ 225 | \$ | |

(1) See Note 3, Restatement of Condensed Consolidated Financial Statements of the accompanying Notes to Condensed Consolidated Financial Statements.

(concluded)

See Accompanying Notes to Condensed Consolidated Financial Statements

COHERENT, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes thereto should be read in conjunction with the Coherent, Inc. (referred to herein as the Company, we, our or Coherent) consolidated financial statements and notes thereto filed on Form 10-K for the fiscal year ended September 30, 2006. In the opinion of management, all adjustments necessary for a fair presentation have been made and include only normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year. Our fiscal year ends on the Saturday closest to September 30. Fiscal years 2007 and 2006 include 52 weeks each.

2. BUSINESS COMBINATION AND TERMINATED ACQUISITION

Nuvonyx, Inc.

In April 2007, we acquired Nuvonyx, Inc., a technology leader in high-power laser diode components, arrays, and industrial laser systems for materials processing and defense applications for approximately \$14.0 million in cash, net of acquisition costs of \$0.3 million. Nuvonyx produces high power arrays with powers in excess of 50 Kilowatts through its proprietary cooling and stacking technologies. The industrial laser systems are used for cladding and hardening of metals, joining materials, and other materials processing applications. We have accounted for the acquisition of Nuvonyx's assets as a business combination and the operating results of Nuvonyx have been included in our condensed consolidated financial statements from the date of acquisition. Our preliminary allocation of the purchase price is as follows (in thousands):

| | | |
|---|----|---------|
| Tangible assets | \$ | 4,654 |
| Goodwill | | 7,674 |
| In-process research and development (IPR&D) | | 2,200 |
| Intangible assets: | | |
| Existing technology | | 1,800 |
| Customer lists | | 900 |
| Non-compete agreements | | 140 |
| Backlog | | 60 |
| Trade name | | 20 |
| Deferred tax liabilities | | (1,203) |
| Liabilities assumed | | (1,980) |
| Total | \$ | 14,265 |

The goodwill recognized from this acquisition resulted primarily from anticipated increases in market share and synergies of combining this entity and has been included in our Commercial Lasers and Components segment. None of the goodwill from this purchase is deductible for tax purposes. The identifiable intangible assets are being amortized over their respective useful lives of one to five years.

At the date of acquisition, we immediately charged \$2.2 million to expense, representing purchased IPR&D related to two development projects that had not yet reached technological feasibility and had, in management's opinion, no alternative future use. The assigned value was determined by estimating the costs to develop the acquired in-process technology into commercially viable products, estimating the net cash flows from each project, and discounting the net cash flows back to its present value. Separate projected cash flows were prepared for both the existing, as well as the in-process projects. The key assumptions used in the valuation include, among others, the expected completion date of the in-process project identified as of the acquisition date, the estimated costs to complete the project, revenue contribution and expense projection assuming the resulting products have entered the market, and the discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations was obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and

development, the expected profitability level of such technology, and the uncertainty of technological advances that could potentially impact the estimates. Projected net cash flows were based on estimates of revenue and operating profit (loss) of the project. One project is expected to become commercially viable in fiscal 2008 with approximately \$0.9 million of estimated expenditures to complete and the other is expected to become commercially viable in fiscal 2009 with approximately \$2.5 million of estimated expenditures to complete.

Unaudited pro forma results of operations had the acquisition taken place at the beginning of fiscal 2007 would have resulted in net sales of \$142.8 million, net income of \$2.2 million, and net income per basic and diluted share of \$0.07 for the three months ended June 30, 2007. Unaudited pro forma results of operations had the acquisition taken place at the beginning of fiscal 2007 would have resulted in net sales of \$447.2 million, net income of \$17.7 million, and net income per basic and diluted share of \$0.56 and \$0.55, respectively, for the nine months ended June 30, 2007. Unaudited pro forma results of operations had the acquisition taken place at the beginning of fiscal 2006 would have resulted in net sales of \$150.5 million, net income of \$10.6 million, and net income per basic and diluted share of \$0.34 for the three months ended July 1, 2006. Unaudited pro forma results of operations had the acquisition taken place at the beginning of fiscal 2006 would have resulted in net sales of \$429.8 million, net income of \$22.2 million, and net income per basic and diluted share of \$0.72 and \$0.71, respectively, for the nine months ended July 1, 2006.

Excel Technology, Inc.

On February 21, 2006, we entered into a definitive agreement to acquire Excel Technology, Inc. (Excel), a manufacturer of photonics-based solutions, consisting of laser systems and electro-optical components, primarily for industrial, commercial, and scientific applications. On October 25, 2006, we received a prohibition order from the German Federal Cartel Office (FCO) regarding our proposed acquisition. The acquisition had previously been approved by antitrust authorities in the United States. None of the multiple remedy proposals offered by Coherent to the FCO addressing the overlap in the low-power carbon-dioxide laser market were satisfactory to the FCO. On November 1, 2006, we received notice from Excel that it was terminating the merger agreement. As a result, our fourth quarter fiscal 2006 results included a pre-tax charge of \$5.9 million for previously capitalized costs related to the terminated merger agreement. In addition, our results for the first nine months of fiscal 2007 include a pretax charge of \$0.3 million for additional costs incurred during the period related to the terminated merger agreement.

3. RESTATEMENT OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Background

Based upon an investigation and determinations made by a Special Committee of the Board of Directors and management's undertaking of a separate review of historical stock option activity subsequent to the filing of our quarterly report for the quarter ended July 1, 2006, we identified errors in our accounting related to stock-based compensation expense in prior periods.

As previously announced on November 1, 2006, a Special Committee was established by our Board of Directors to conduct an independent investigation relating to our historical stock option practices. The Special Committee, comprised of three independent members of our Board of Directors, retained independent legal counsel and forensic accountants to assist in conducting the investigation. Together with its independent counsel, the Special Committee conducted an extensive review of historical stock option practices including all awards made by us between January 1, 1995 and September 30, 2006 (the Relevant Period).

On July 26, 2007, we announced that our management and the Special Committee, with the assistance of independent legal counsel and forensic accounting experts, had determined that incorrect measurement dates for a significant number of stock option awards during the Relevant Period were used. After receiving the Special Committee's conclusions, we subsequently reviewed stock option grants during the Relevant Period. On September 26, 2007, our Audit Committee, after consultation with management, determined that additional charges for stock-based compensation expense were required as a result of such incorrect measurement dates. As a result of the Special Committee's investigation and our management's subsequent reviews and analyses, options granted during the Relevant Period to purchase an aggregate of approximately 8,735,590 shares were determined to have incorrect measurement dates. We determined that the revised measurement dates for accounting purposes (Revised Measurement Date) differed from the originally recorded measurement dates due primarily to a number of factors, including (1) delays in the final determination or approval of the awards, (2) retroactive selection of grant dates, (3) the absence of definitive documentation regarding approval, and (4) other process-related issues. These included annual grants to existing employees and officers and option grants made to new hires or to employees recently promoted. In those cases in which we previously used a measurement date that we determined was incorrect, we developed and applied a methodology in determining the revised measurement dates for option grants during the Relevant Period.

In addition to restatements for stock-based compensation and the related income and payroll tax effects, we recorded adjustments to correct other errors that occurred prior to fiscal 2007, which have been reflected in the accompanying related condensed consolidated financial statements.

Restatement Adjustments

Our restated condensed consolidated financial statements for the three and nine months ended July 1, 2006 incorporate adjustments to correct for errors in stock-based compensation expense, payroll tax expense and other accounting matters, including the income tax impacts related to the restatement adjustments and other tax errors (collectively, the restatement adjustments). The table below presents the decrease to net income for the first three and nine months of fiscal 2006 of the individual restatement adjustments, which are explained in further detail following the table (in thousands, except per share data):

| | Three Months Ended July 1, 2006 | Nine Months Ended July 1, 2006 |
|---|---------------------------------------|--------------------------------------|
| Stock-based compensation | | |
| Annual grants to employees | \$ (60) | \$ 266 |
| Annual grants to officers | (142) | 1 |
| Non-annual grants to employees | (50) | (44) |
| Non-annual grants to officers | 1 | 4 |
| Total stock-based compensation expense | (251) | 227 |
| Payroll taxes, interest and penalties | | |
| Total stock-based compensation adjustments | (69) | 120 |
| | (320) | 347 |
| Other miscellaneous accounting adjustments | | |
| Correction of Lambda Physik purchase accounting | 139 | 416 |
| Correction of accounting for asset retirement obligations | 71 | 206 |
| Classification of unrealized foreign exchange losses on intercompany note | | 77 |
| Correction to inventory capitalization | 454 | 454 |
| | 664 | 1,153 |
| Total adjustments to income before income taxes | 344 | 1,500 |
| Income tax expense (benefit) | (738) | 761 |
| Total decrease (increase) to net income | \$ (394) | \$ 2,261 |
| Decrease (increase) in diluted earnings per share | \$ (0.02) | \$ 0.07 |

Stock-Based Compensation Summary These adjustments are from management's determination, based upon the Special Committee's investigation and our subsequent reviews and analyses that the initially recorded measurement dates for various categories of option grants during the Relevant Period were incorrect. These categories were:

- *Annual grants to employees.* We determined that the appropriate measurement date for annual grants to employees was the date on which evidence indicates the allocation of the options to the individual employees was substantially complete, as further described below. As a result, annual grants for an aggregate of 4,749,940 shares

through the first nine months of fiscal 2006 were remeasured and accounted for as fixed awards under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, or APB 25, for periods prior to fiscal 2006 and under Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment (SFAS 123(R)), effective October 2, 2005 and thereafter, using the methodologies described below under Accounting Considerations Stock-Based Compensation.

- *Annual grants to officers.* For annual grants to officers during fiscal years 1995, 1996, 1997, 1999, 2000 and 2002, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under *Accounting Considerations Stock-Based Compensation*, and accounted for these grants as fixed awards under APB 25 or SFAS 123(R), as applicable. The grants represented options to purchase an aggregate of 1,251,500 shares through the first nine months of fiscal 2006. For annual grants to officers during other fiscal years during the Relevant Period, management determined that the original measurement date was properly determined.
- *Non-annual grants to employees.* Non-annual grants to employees are initial grants to newly hired employees or incremental grants to existing employees upon their promotion. For non-annual grants to employees, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under *Accounting Considerations Stock-Based Compensation*, and accounted for these grants as fixed awards under APB 25 or SFAS 123(R), as applicable. The grants represented options to purchase an aggregate of 2,382,650 shares through the first nine months of fiscal 2006.
- *Non-annual grants to officers.* Non-annual grants to officers are initial grants to newly hired officers or incremental grants upon an existing employee's promotion to an officer position. For non-annual grants to officers, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under *Accounting Considerations Stock-Based Compensation*, and accounted for these grants, which represented options to purchase an aggregate of 351,500 shares through the first nine months of fiscal 2006, as fixed awards under APB 25 or SFAS 123(R), as applicable.

Payroll taxes, interest and penalties In connection with the stock-based compensation charges included in the restatement, certain options previously classified as Incentive Stock Options (ISO) were determined to have been granted with an exercise price below the fair market value of our stock on the revised measurement date. Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant, and therefore might not qualify for ISO tax treatment. We refer to these stock options as the Affected ISOs. The potential disqualification of ISO status exposes us to additional payroll related withholding taxes on the exercise of options granted to U.S. employees, and interest and penalties for failing to properly withhold taxes on the exercise of those options. Additionally, we recorded tax, interest, and penalty expenses with respect to certain options granted in the U.K. which were determined to have been granted with an exercise price below the fair market value of our common stock on the revised measurement date (U.K. Options). The tax, interest and penalty expenses were recorded in the periods in which the underlying stock options were exercised. Then, in periods in which the liabilities were legally extinguished due to statutes of limitations, the expenses were reversed and recognized as a reduction in the related functional expense in our consolidated statements of operations. The net U.S. and U.K. tax liabilities at June 30, 2007 for this potential disqualification of ISO tax treatment for the Affected ISO's and the U.K. Options totaled \$1.1 million.

Management and the Board are considering possible ways to address the impact that Section 409A of the Internal Revenue Code (IRC) may have as a result of the exercise price of stock options being less than the fair market value of our common stock on the revised measurement date. IRC Section 409A imposes significant additional taxes to our employees on stock options granted with an exercise price lower than the fair market value on the date of grant that vest after December 31, 2004. The Internal Revenue Service (IRS) has issued transition rules under IRC Section 409A that allows for a correction, or cure , for non-exercised, non-executive options subject to IRC Section 409A. We continue to

evaluate the potential corrections or cures in light of the additional time relief granted by the IRS through December 2008.

Other miscellaneous accounting adjustments In addition to stock-based compensation related charges, we recorded adjustments to correct errors in the condensed consolidated financial statements for the fiscal 2006 periods that had not been previously reflected in our condensed consolidated financial statements. These restatements relate to the correction of errors in the purchase accounting related to our acquisition of a 39.62% interest in Lambda Physik in fiscal 2003, the failure to adopt the provisions of SFAS No. 143 Accounting for Asset Retirement Obligations, the correction of the classification of unrealized foreign exchange gains and losses related to an intercompany note and the correction of an error in our inventory capitalization during the third quarter of fiscal 2006.

Income tax benefit We reviewed the income tax effect of the stock-based compensation charges, and we believe that the proper income tax accounting for U.S. stock options under GAAP depends, in part, on the tax distinction of the stock options as either ISOs or non-qualified stock options (NSOs). Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant. Because of the potential impact of the measurement date changes on the qualified status of Affected ISOs, we have determined that all Affected ISOs might not be qualified ISOs under the tax regulations, and therefore should be accounted for as if they were NSOs for income tax accounting purposes. The Company recorded a tax benefit with respect to the Affected ISOs. To the extent an ISO was not disqualified through a same day sale or sold before fulfilling the holding period requirements related to the Affected ISOs, the recorded tax asset was written off to earnings when the statute of limitations for the year of exercise closed.

We have recorded a net income tax benefit of approximately \$3.4 million in connection with the stock-based compensation related expense during the period from fiscal year 1995 through July 1, 2006. The recognized tax benefit related to affected stock options granted to officers was limited due to the potential non-deductibility of the related expenses under IRC Section 162(m). This IRS rule limits the amount of executive compensation that may be deducted for U.S. tax purposes under certain circumstances. We did not record a tax benefit or deferred tax asset for affected stock options granted to non-U.S., non-U.K. and certain non-German employees because we determined that we could not receive tax benefits outside of the U.S., U.K. and Germany. The net tax benefit has resulted in an increase of our deferred tax assets for all U.S. and UK affected stock options and certain German affected stock options prior to the exercise or forfeiture of the related options. Upon exercise or cancellation of the underlying options, the excess or deficiency in deferred tax assets are written-off to either expense or additional paid-in capital in the period of exercise or cancellation.

Further, we have recorded additional restatements to income taxes to record the effect of errors identified in the accounting for income tax contingencies resulting from the misapplication of information available at the date of the misstatement as well as the tax effects of the other miscellaneous accounting adjustments.

Accounting Considerations Stock-Based Compensation

Prior to the adoption of SFAS 123(R) in fiscal 2006, we originally accounted for all employee, officer and director stock option grants as fixed grants under APB 25, using the recorded grant date as the measurement date. We issued all grants with an exercise price equal to the fair market value of our common stock on the recorded grant date, and therefore originally recorded no stock-based compensation expense.

The Special Committee concluded that the measurement dates for certain stock option grants differed from the recorded grant dates for such grants. As described in APB 25, the measurement date is the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price are known with finality. Using the methodologies described below we revised the measurement dates for the indicated option grants during the Relevant Period, and we refer to these revised measurement dates as the Revised Measurement Dates. For periods prior to fiscal 2006, we calculated stock-based compensation expense under APB 25 based upon the intrinsic value as of the Revised Measurement Dates of stock option awards determined to be fixed awards under APB 25 and the vesting provisions of the underlying options through October 1, 2005. We calculated the intrinsic value on the Revised Measurement Date as the closing price of our common stock on such date as reported on the Nasdaq National Market, now the Nasdaq Global Market, less the exercise price per share of common stock as stated in the underlying stock option agreement, multiplied by the number of shares subject to such stock option award. We recognized these amounts as compensation expense on a straight-line basis over the vesting period of the underlying options. Effective October 2, 2005, we adopted the fair value recognition provisions of SFAS 123(R), requiring us to recognize expense related to the fair value of our stock-based compensation awards. Therefore, subsequent to fiscal 2005, we calculated stock-based compensation expense based upon the fair value as of the Revised Measurement Date in accordance with the provisions of SFAS 123(R).

The methodology we used to determine the Revised Measurement Dates associated with prior stock option grants was as follows:

Annual grants to employees For the majority of the annual grants to employees, the process of allocating stock option grants among individual employees continued beyond the recorded grant date. Based on available evidence, we have determined that the appropriate measurement date for annual grants to employees was the earliest date on which evidence indicates the allocation of the options to the individual employees was substantially complete. We defined substantially complete as the point at which evidence indicated that 96% or greater of the grant records had been determined with finality. Such determination was based on the earliest of the three following actions that could be

verified with available evidence: (1) on evidence of a substantially complete listing of options allocated to individual employees, (2) on evidence of communication stating that the process was complete supported by records being added into our stock option database application prior to, on or within two days of such communication or (3) on evidence of dates that the employee records of the grants of the stock option were added to the stock option database application (the record added date), where evidence of a substantially complete listing of options allocated to individual employees was not available.

After the date on which substantially all granting activities were completed, there were an insignificant number of changes to option awards attributable to circumstances such as the effective cancellation of a grant because of an employee's termination, or additions due to administrative error corrections, promotion or individual performance reassessment. Where option awards were added subsequent to the date the allocation process was substantially complete, we have determined that each award was a separate grant with its own measurement date and that this subsequent addition was not indicative that the broader granting process for such annual awards had failed to be completed by the Revised Measurement Date. Measurement dates for individual awards which were not substantially complete by the Revised Measurement Date were determined based on the earlier of (1) the date the additions were communicated to the stock administrator for addition to the annual grant pool, (2) the record added date or (3) for periods prior to the implementation of the current stock administration system, the print date of the Notice of Grant.

Annual grants to officers For annual grants to officers during fiscal years 1995, 1996, 1997, 1999, 2000 and 2002, the grants were awarded between Board meeting dates and in certain cases between committee meeting dates, and there is a lack of evidence that the price and number of shares were determined with finality as of the recorded grant date.

Based on available evidence, we have determined that the appropriate measurement date for annual grants to officers was the date on which evidence indicates that both the shares awarded to the officers and the exercise price of those shares was known with finality. Such determination was based on the earliest date of the three following actions that could be verified with available evidence: (1) the date that the specific number of shares for each officer was approved for grant by the Board as evidenced by the minutes of the Board of Directors meeting, providing that the approval occurred prior to the submission of the applicable Form 3 or Form 4 to the Securities and Exchange Commission (SEC); (2) the record added date, providing that the record was added prior to the submission of the applicable Form 3 or Form 4 to the SEC; or (3) the date of submission of the applicable Form 3 or Form 4 to the SEC.

Non-annual grants to employees Non-annual grants to employees are initial grants to newly hired employees or incremental grants to existing employees upon their promotion. For non-annual grants to employees prior to June 2003, our stated process was to select the grant date to be the Monday after the Human Resources department requested the award. On June 5, 2003, we strengthened our process to require the signature of the Executive Vice President of HR on all award requests with the grant date to be the Monday after receipt of such signature. Beginning on June 7, 2006, we changed our process to require three members of an equity grant committee, established by the Board and the Board's Compensation and H.R. Committee, to meet only on a fixed date once a month to consider any requested awards, with the award effective on such date or, in the event action was required by written consent, the action would be effective on the date the last consent signature was received.

Based on available evidence, we determined that the process was not consistently followed during the period from fiscal 1995 through June 4, 2003. As a result, we determined that the appropriate measurement date for non-annual employee grants during the period from fiscal 1995 through June 4, 2003 was the earliest date of the two following actions that could be verified with available evidence: (1) the record added date and (2) the date the specific grant was approved as evidenced by the minutes of a Board of Directors meeting.

For the period from June 5, 2003 through June 6, 2006, we determined that most of the measurement dates for non-annual grants to employees during this period followed the stated process and were appropriate. For two grants that we determined did not follow the process, we determined the appropriate measurement date based on the stated process.

Edgar Filing: COHERENT INC - Form 10-Q

For the period from June 7, 2006 through September 30, 2006, we determined that we followed the process consistently and that all of the measurement dates for non-annual grants to employees during this period were appropriate.

Non-annual grants to officers Non-annual grants to officers are initial grants to newly hired officers or incremental grants for existing employees upon their promotion to an officer position. For non-annual grants to officers, Board or Compensation and H.R. Committee approval was reflected in written actions. We determined that the original recorded grant dates lacked evidence supporting when such written actions were executed for ten of the twelve non-annual grants to officers during the period from fiscal 1995 through fiscal 2006.

Based on available evidence, we determined that the appropriate measurement date for each of the ten non-annual grants to officers was the earliest of the three following actions that could be verified with available evidence: (1) the date written actions reflecting approval by the Board or Compensation and H.R. Committee were executed; (2) the record added date, providing that the related notice of grant was printed by us prior to the submission of the applicable Form 3 or Form 4 to the SEC; and (3) the date the applicable Form 3 or Form 4 was submitted to the SEC.

Non-employee director automatic stock option grants Our 1990 and 1998 Directors' Option Plans provide for the automatic and non-discretionary grant of non-statutory stock options to our non-employee directors, such that the grants require no independent action of the Board of Directors. The 1998 Directors' Plan replaced the 1990 Directors' Plan which expired on December 8, 1999 and was approved by stockholders on March 17, 1999. From 1995 through March 27, 2003, under both Plans, each non-employee director was automatically granted a non-discretionary grant of a non-statutory stock option to purchase 20,000 shares of common stock upon appointment as a member of the Board, and each non-employee director was granted a non-discretionary grant of a non-statutory stock option to purchase 5,000 shares of our common stock on the date of each Annual Meeting of Stockholders. The 1998 Directors' Plan was amended by the Stockholders on March 23, 2003 to increase the automatic non-discretionary grant of a non-statutory stock option to purchase shares of common stock upon appointment as a member of the Board from 20,000 to 30,000 shares (Initial Grant) and to increase the non-discretionary grant of a non-statutory stock option to purchase shares of our common stock on the date of and immediately following each Annual Meeting of Stockholders from 5,000 shares to 12,000 shares (Subsequent Grant). The Plans provide that the exercise price shall be equal to the fair market value of the common stock on the date of the grant of the options. On March 30, 2006, the 1998 Directors' Plan was further amended to reduce the Initial Grant from 30,000 to 24,000 shares and the Subsequent Grant from 12,000 to 6,000 shares. In addition, non-employee directors receive a restricted stock unit of 2,000 shares upon first joining the Board of Directors and an award of restricted stock units of 2,000 shares on each Annual Meeting of Stockholders where such director is reelected.

We have determined that, as a result of administrative errors, a total of five automatic grants representing initial options to purchase a total of 140,000 shares under the 1998 Directors' Plan upon the appointment of five of our directors to the Board of Directors were documented as having been made on dates other than as set forth in the 1998 Directors' Option Plan. We have corrected the documentation of these grants to reflect the correct dates and exercise prices, as automatically established under the 1998 Directors' Option Plan. Because these actions were corrections of administrative errors in the documentation, rather than changing any of the terms of the stock option grants as automatically granted, we determined that there was no accounting charge to be recognized in connection with these corrections, as the correct measurement date was the date of grant as automatically established by the 1998 Directors' Option Plan, and the exercise price was the fair market value of our common stock on the correct measurement date.

Although we determined that there is no accounting charge resulting from the administrative correction, the administrative correction did result in an increase of the exercise price for each of the five grants. Four of such directors have expressly agreed to the correction to increase the exercise prices of certain of such grants to purchase 107,800 shares. The fifth director's option expired unexercised; therefore no such agreement was needed. Further, the three directors who exercised misdocumented grants have reimbursed us for the difference between the aggregate exercise price as misdocumented and as corrected, in the amounts of \$1,195, \$1,100 and \$1,272, respectively.

Impact of the Restatement Adjustments on our Condensed Consolidated Financial Statements

The following tables present the impact of the financial statement restatement adjustments on our previously reported condensed consolidated statements of operations for the three and nine months ended July 1, 2006 and the condensed consolidated statements of cash flows for the nine months ended July 1, 2006 (in thousands, except per share data):

| | Three Months Ended July 1, 2006 | | | | Nine Months Ended July 1, 2006 | | | |
|-------------------------------------|---------------------------------|-------------|-------|----------------|--------------------------------|-------------|-------|----------------|
| | As Previously Reported | Adjustments | | As Restated | As Previously Reported | Adjustments | | As Restated |
| Net sales | \$ 149,524 | \$ | | \$ 149,524 | \$ 426,506 | \$ | | \$ 426,506 |
| Cost of sales | 82,697 | 534 | A,C,E | 83,231 | 239,664 | 727 | A,C,E | 240,391 |
| Gross profit | 66,827 | (534) | | 66,293 | 186,842 | (727) | | 186,115 |
| Operating expenses: | | | | | | | | |
| Research and development | 18,714 | 130 | A | 18,844 | 52,595 | 193 | A | 52,788 |
| In-process research and development | | | | | 690 | | | 690 |
| Selling, general and administrative | 33,827 | (502) | A,C | 33,325 | 95,369 | (36) | A,C | 95,333 |
| Restructuring and other charges | 187 | | | 187 | 97 | | | 97 |
| Amortization of intangible assets | 2,205 | 139 | B | 2,344 | 6,846 | 416 | B | 7,262 |
| Total operating expenses | 54,933 | (233) | | 54,700 | 155,597 | 573 | | 156,170 |
| Income from operations | 11,894 | (301) | | 11,593 | 31,245 | (1,300) | | 29,945 |
| Other income (expense): | | | | | | | | |
| Interest and dividend income | 4,815 | | | 4,815 | 9,441 | | | 9,441 |
| Interest expense | (1,808) | (39) | C | (1,847) | (2,629) | (112) | C | (2,741) |
| Other net | 569 | (4) | A | 565 | 561 | (88) | A,D | 473 |
| Total other income, net | 3,576 | (43) | | 3,533 | 7,373 | (200) | | 7,173 |
| Income before income taxes | 15,470 | (344) | | 15,126 | 38,618 | (1,500) | | 37,118 |
| Provision for income taxes | 4,619 | (738) | A,F | 3,881 | 10,278 | 761 | A,F | 11,039 |
| Net income | \$ 10,851 | \$ 394 | | \$ 11,245 | \$ 28,340 | \$ (2,261) | | \$ 26,079 |
| Net income per share: | | | | | | | | |
| Basic | \$ 0.35 | \$ 0.01 | | \$ 0.36 | \$ 0.92 | \$ (0.08) | | \$ 0.84 |
| Diluted | \$ 0.34 | \$ 0.02 | | \$ 0.36 | \$ 0.90 | \$ (0.07) | | \$ 0.83 |
| Shares used in computation: | | | | | | | | |
| Basic | 30,868 | | | 30,868 | 30,915 | | | 30,915 |
| Diluted | 31,592 | 4 | G | 31,596 | 31,461 | (1) | G | 31,460 |

A. Adjustments for stock-based compensation expense and the associated payroll taxes, interest, penalties and income tax benefit.

B. Adjustment to correct errors in the amortization of intangibles related to the purchase accounting for our acquisition of a 39.62% interest in Lambda Physik in fiscal 2003.

C. Adjustments for errors in the accounting for asset retirement obligations.

D. Adjustment to correct the classification of unrealized foreign exchange gains and losses related to an intercompany note.

E. Adjustment to correct inventory capitalization.

F. Adjustments to correct for errors in income taxes, including the income tax effects of adjustments described in A, C, D and E above.

G. Adjustment to reflect the effect on diluted weighted average shares outstanding as a result of the restatements described in A above.

Edgar Filing: COHERENT INC - Form 10-Q

| | Nine Months Ended July 1, 2006 | | | |
|---|--------------------------------|--------------|-------|-------------------|
| | As Previously Reported | Adjustments | | As Restated |
| Cash flows from operating activities: | | | | |
| Net income | \$ 28,340 | \$ (2,261) | | \$ 26,079 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Purchased in-process research and development | 690 | | | 690 |
| Depreciation and amortization | 19,774 | 94 | C | 19,868 |
| Amortization of intangible assets | 6,846 | 416 | B | 7,262 |
| Deferred income taxes | (2,784) | | | (2,784) |
| Stock-based compensation | 10,146 | 227 | A | 10,373 |
| Excess tax benefit from stock-based compensation arrangements | (278) | (434) | A | (712) |
| Tax benefit from employee stock options | | 1,624 | H | 1,624 |
| Non-cash restructuring and other charges | 97 | | | 97 |
| Amortization of bond issue costs | | 373 | G | 373 |
| Other non-cash expense | 459 | 112 | C | 571 |
| Changes in assets and liabilities, net of effect of acquisitions: | | | | |
| Accounts receivable | (12,875) | | | (12,875) |
| Inventories | (901) | 455 | E | (446) |
| Prepaid expenses and other assets | (9,599) | | | (9,599) |
| Other assets | (2,009) | | | (2,009) |
| Accounts payable | 11,914 | | | 11,914 |
| Income taxes payable/receivable | 456 | (863) | A,F,H | (407) |
| Other current liabilities | (154) | 120 | A | (34) |
| Other long-term liabilities | 711 | | | 711 |
| Net cash provided by operating activities | 50,833 | (137) | | 50,696 |
| Cash flows from investing activities: | | | | |
| Purchases of property and equipment | (12,884) | (54) | C | (12,938) |
| Proceeds from dispositions of property and equipment | 1,167 | | | 1,167 |
| Purchases of available-for-sale securities | (186,553) | | | (186,553) |
| Proceeds from sales and maturities of available-for-sale securities | 277,533 | | | 277,533 |
| Acquisition of businesses, net of cash acquired | (5,214) | | | (5,214) |
| Change in restricted cash | 13,725 | | | 13,725 |
| Deferred business acquisition costs | (2,303) | | | (2,303) |
| Other-net | 477 | (319) | C,G | 158 |
| Net cash used in investing activities | 85,948 | (373) | | 85,575 |
| Cash flows from financing activities: | | | | |
| Long-term debt borrowings | 1,387 | | | 1,387 |
| Long-term debt repayments | (12,741) | | | (12,741) |
| Cash overdrafts decrease | (474) | | | (474) |
| Issuance of common stock under employee stock plans | 19,025 | | | 19,025 |
| Repurchase of common stock | (22,250) | | | (22,250) |
| Proceeds received from issuance of convertible subordinated notes | 200,000 | | | 200,000 |
| Debt issuance costs | (5,567) | | | (5,567) |
| Excess tax benefits from stock-based compensation arrangements | 278 | 434 | A | 712 |
| Net cash used in financing activities | 179,658 | 434 | | 180,092 |
| Effect of exchange rate changes on cash and cash equivalents | 7,059 | 76 | D | 7,135 |
| Net increase in cash and cash equivalents | 323,498 | | | 323,498 |
| Cash and cash equivalents, beginning of period | 97,507 | | | 97,507 |
| Cash and cash equivalents, end of period | \$ 421,005 | \$ | | \$ 421,005 |

-
- A. Adjustments for stock-based compensation expense and the associated payroll taxes, interest, penalties and income tax benefit.
 - B. Adjustment to correct errors in the amortization of intangibles related to the purchase accounting for our acquisition of a 39.62% interest in Lambda Physik in fiscal 2003.
 - C. Adjustments for errors in the accounting for asset retirement obligations.
 - D. Adjustment to correct the classification of unrealized foreign exchange gains and losses related to an intercompany note.
 - E. Adjustment to correct inventory capitalization.
 - F. Adjustments to correct for errors in income taxes, including the income tax effects of adjustments described in A, C, D and E above.
 - G. Reclassification of amortization of bond issue costs from investing to operating cash flows to conform to current period presentation.
 - H. Reclassification of tax benefit from employee stock options to conform to current period presentation.

4. RECENT ACCOUNTING STANDARDS

In June 2006, the FASB issued Financial Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In addition, in May 2007, the FASB issued FASB Staff Position No. FIN 48-1,

Definition of Settlement in FASB Interpretation No. 48, (FSP FIN 48-1) to amend FIN No. 48 by providing that previously unrecognized tax benefits can be recognized when the tax positions are effectively settled upon examination by a taxing authority. According to FSP FIN 48-1, an enterprise's tax position will be considered effectively settled if the taxing authority has completed its examination, the enterprise does not plan to appeal, and the possibility is remote that the taxing authority would reexamine the tax position in the future. The requirements of FIN 48 and FSP FIN 48-1 are effective for our fiscal year beginning September 30, 2007. As of the end of fiscal year 2007, we estimate that our tax contingencies could increase by approximately \$1 million to \$3 million as a result of the adoption of FIN 48 and FSP FIN 48-1. This amount would be an adjustment to our retained earnings for fiscal year beginning September 30, 2007.

In September 2006, the SEC issued Staff Accounting Bulletin 108 Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108) addressing how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC Staff believes that companies should quantify errors using both a balance sheet and an income statement approach and evaluate whether either of these approaches results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 also describes the circumstances where it would be appropriate for a registrant to record a one-time cumulative effect adjustment to correct errors existing in prior years that previously had been considered immaterial as well as the required disclosures to investors. SAB 108 is effective for us for fiscal year 2007. We adopted SAB 108 on October 1, 2006 and our adoption did not have an impact on our consolidated financial position and results of operations.

Edgar Filing: COHERENT INC - Form 10-Q

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis. If the fair value option is elected, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted. We have elected not to early adopt and are currently assessing the impact of SFAS 159 on our consolidated financial position and results of operations.

5. REVENUE RECOGNITION

We recognize revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists, the product has been delivered or the service has been rendered, the price is fixed or determinable and collection is probable. Revenue from product sales is recorded when all of the foregoing conditions are met and risk of loss and title passes to the customer. Our products typically include a one-year warranty and the estimated cost of product warranty claims (based on historical experience) is recorded at the time the sale is recognized. Sales to customers are generally not subject to any price protection or return rights.

The vast majority of our sales are made to original equipment manufacturers ("OEMs"), distributors, resellers and end-users in the non-scientific market. Sales made to these customers do not require installation of the products by us and are not subject to other post-delivery obligations, except in occasional instances where we have agreed to perform installation or provide training. In those instances, we defer revenue related to installation services or training until these services have been rendered. We allocate revenue from multiple element arrangements to the various elements based upon relative fair values, which is determined based on the price charged for each deliverable on a standalone basis.

Our sales to distributors, resellers and end-user customers typically do not have customer acceptance provisions and only certain of our sales to OEM customers have customer acceptance provisions. Customer acceptance is generally limited to performance under our published product specifications. For the few product sales that have customer acceptance provisions because of other than published specifications, (1) the products are tested and accepted by the customer at our site or by the customer's acceptance of the results of our testing program prior to shipment to the customer, or (2) the revenue is deferred until customer acceptance occurs.

Sales to end-users in the scientific market typically require installation and, thus, involve post-delivery obligations; however, our post-delivery installation obligations are not essential to the functionality of our products. We defer revenue related to installation services until completion of these services.

For most products, training is not provided; therefore, no post-delivery training obligation exists. However, when training is provided to our customers, it is typically priced separately and is recognized as revenue after these services have been provided.

6. SHORT-TERM INVESTMENTS

We consider all highly liquid investments with maturities of three months or less at the time of purchase to be cash equivalents. Marketable short-term investments in debt and equity securities are classified and accounted for as available-for-sale securities and are valued based on quoted market prices. Investments classified as available-for-sale are reported at fair value with unrealized gains and losses, net of related income taxes, recorded as a separate component of other comprehensive income (OCI) in stockholders' equity until realized. Interest and amortization of premiums and discounts for debt securities are included in interest income. Gains and losses on securities sold are determined based on the specific identification method and are included in other income (expense).

Cash, cash equivalents and short-term investments consist of the following (in thousands):

Edgar Filing: COHERENT INC - Form 10-Q

| | June 30, 2007 | | | | Fair Value |
|--|---------------|---------------------|----------------------|----|------------|
| | Cost Basis | Unrealized Gains | Unrealized Losses | | |
| Cash and cash equivalents | \$ 343,149 | \$ | \$ (4) | \$ | 343,145 |
| Less: restricted cash and cash equivalents | | | | | (4,246) |
| | | | | | \$ 338,899 |
| Short-term investments: | | | | | |
| Available-for-sale securities: | | | | | |
| U.S. government and agency obligations | \$ 92,477 | \$ 84 | \$ (8) | \$ | 92,553 |
| State and municipal obligations | 49,083 | 908 | (20) | | 49,971 |
| Corporate notes and obligations | 36,801 | 171 | (10) | | 36,962 |
| Total short-term investments | \$ 178,361 | \$ 1,163 | \$ (38) | \$ | 179,486 |

| | September 30, 2006 | | | | Fair Value |
|---|--------------------|---------------------|----------------------|----|------------|
| | Cost Basis | Unrealized Gains | Unrealized Losses | | |
| Cash and cash equivalents | \$ 448,940 | \$ | \$ | \$ | 448,940 |
| Less: restricted cash and cash equivalents, non-current | | | | | (3,709) |
| | | | | | \$ 445,231 |
| Short-term investments: | | | | | |
| Available-for-sale securities: | | | | | |
| U.S. government and agency obligations | \$ 18,125 | \$ 131 | \$ (87) | \$ | 18,169 |
| State and municipal obligations | 16,130 | 237 | (30) | | 16,337 |
| Corporate notes and obligations | 14,235 | 59 | (33) | | 14,261 |
| Total short-term investments | \$ 48,490 | \$ 427 | \$ (150) | \$ | 48,767 |

At June 30, 2007, \$2.5 million of cash and cash equivalents were restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik, \$1.2 million were restricted pursuant to an outstanding long-term debt arrangement at a subsidiary and \$0.6 million were restricted deposits related to the potential sale of facilities. At September 30, 2006, \$2.5 million of cash and cash equivalents were restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik and \$1.2 million were restricted pursuant to an outstanding long-term debt arrangement at a subsidiary.

7. INTANGIBLE ASSETS

The changes in the carrying amount of goodwill for the period from September 30, 2006 to June 30, 2007 are summarized as follows (in thousands):

| | Commercial Lasers and Components | Specialty Laser Systems | Total |
|-----------------------------------|--|----------------------------|-----------|
| Balance as of September 30, 2006 | \$ 16,813 | \$ 55,058 | \$ 71,871 |
| Acquisition related | 7,674 | | 7,674 |
| Translation adjustments and other | 216 | 2,329 | 2,545 |
| Balance as of June 30, 2007 | \$ 24,703 | \$ 57,387 | \$ 82,090 |

Components of our amortizable intangible assets are as follows (in thousands):

| | June 30, 2007 | | | September 30, 2006 | | |
|--------------------------|-----------------------------|-----------------------------|-----------|-----------------------------|-----------------------------|-----------|
| | Gross Carrying Amount | Accumulated Amortization | Net | Gross Carrying Amount | Accumulated Amortization | Net |
| Existing technology | \$ 53,267 | \$ (25,097) | \$ 28,170 | \$ 50,487 | \$ (20,602) | \$ 29,885 |
| Patents | 9,690 | (6,388) | 3,302 | 9,106 | (5,391) | 3,715 |
| Drawings | 1,323 | (1,323) | | 1,243 | (1,243) | |
| Order backlog | 4,675 | (4,620) | 55 | 4,344 | (4,344) | |
| Customer lists | 5,250 | (2,326) | 2,924 | 4,213 | (1,805) | 2,408 |
| Trade name | 3,584 | (1,577) | 2,007 | 3,365 | (1,217) | 2,148 |
| Non-compete agreement | 2,330 | (1,864) | 466 | 2,084 | (1,377) | 707 |
| Total | \$ 80,119 | \$ (43,195) | \$ 36,924 | \$ 74,842 | \$ (35,979) | \$ 38,863 |

Edgar Filing: COHERENT INC - Form 10-Q

Amortization expense for intangible assets for the nine months ended June 30, 2007 was \$6.0 million. At June 30, 2007, estimated amortization expense for the remainder of fiscal 2007, the next five succeeding fiscal years and all fiscal years thereafter are as follows (in thousands):

| | Estimated Amortization Expense |
|------------------|---|
| 2007 (remainder) | \$ 2,178 |
| 2008 | 8,244 |
| 2009 | 7,645 |
| 2010 | 6,304 |
| 2011 | 4,942 |
| 2012 | 3,263 |
| Thereafter | 4,348 |
| Total | \$ 36,924 |

8. BALANCE SHEET DETAILS

Inventories consist of the following (in thousands):

| | June 30, 2007 | September 30, 2006 |
|--------------------------------|--------------------------|-------------------------------|
| Purchased parts and assemblies | \$ 30,098 | \$ 17,365 |
| Work-in-process | 45,917 | 50,189 |
| Finished goods | 39,064 | 33,940 |
| Inventories | \$ 115,079 | \$ 101,494 |

Prepaid expenses and other assets consist of the following (in thousands):

| | June 30, 2007 | September 30, 2006 |
|---|--------------------------|-------------------------------|
| Prepaid expenses and other | \$ 35,340 | \$ 15,062 |
| Prepaid and refundable income taxes | 5,060 | 5,060 |
| Prepaid debt issuance costs | 1,163 | 1,134 |
| Total prepaid expenses and other assets | \$ 41,563 | \$ 21,256 |

Other assets consist of the following (in thousands):

| | June 30, 2007 | September 30, 2006 |
|--|--------------------------|-------------------------------|
| Assets related to deferred compensation arrangements | \$ 31,721 | \$ 23,069 |
| Deferred tax assets | 29,507 | 32,717 |
| Prepaid debt issuance costs | 3,103 | 3,875 |
| Other assets | 3,066 | 2,433 |

Edgar Filing: COHERENT INC - Form 10-Q

| | | | | |
|--------------------|----|--------|----|--------|
| Total other assets | \$ | 67,397 | \$ | 62,094 |
|--------------------|----|--------|----|--------|

In the third quarter of fiscal 2007, as part of a plan to consolidate facilities, we moved our operations from our Condensa building in Santa Clara, California to other existing facilities and classified the property as held for sale in the third fiscal quarter of 2007. The net book value of the land was approximately \$12.9 million and the net book value of the building and improvements was approximately \$8.3 million. In September 2007, we sold the building for approximately \$24.8 million, resulting in a capital gain of approximately \$3.6 million.

Edgar Filing: COHERENT INC - Form 10-Q

Other current liabilities consist of the following (in thousands):

| | June 30, 2007 | September 30, 2006 |
|---------------------------------|------------------|-----------------------|
| Accrued payroll and benefits | \$ 24,501 | \$ 30,661 |
| Accrued expenses and other | 24,778 | 21,106 |
| Other taxes payable | 23,948 | 3,935 |
| Reserve for warranty | 13,321 | 11,462 |
| Deferred income | 5,198 | 7,832 |
| Customer deposits | 2,563 | 2,740 |
| Accrued restructuring charges | 560 | 1,616 |
| Total other current liabilities | \$ 94,869 | \$ 79,352 |

In the first nine months of fiscal 2007, we recorded \$1.4 million of payments made against our accrued restructuring charges for remaining lease liabilities and received sublease income of \$0.3 million. In the first quarter of fiscal 2006, we exited our Fort Lauderdale, Florida facility, and as a result, we recorded a facility closure charge of \$0.6 million. The facility closure charge included the estimated contractual obligations for lease and other facility costs, net of estimated sublease income.

We provide warranties on certain of our product sales (generally one year) and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

Components of the reserve for warranty costs during the first nine months of fiscal 2007 and 2006 were as follows (in thousands):

| | Nine Months Ended | |
|---|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 |
| Beginning balance | \$ 11,462 | \$ 10,424 |
| Additions related to current period sales | 16,165 | 13,902 |
| Warranty costs incurred in the current period | (14,855) | (13,641) |
| Accruals resulting from acquisitions | 247 | |
| Adjustments to accruals related to prior period sales | 302 | 111 |
| Ending balance | \$ 13,321 | \$ 10,796 |

The following table reconciles changes in our asset retirement liability, which is reported in other long-term liabilities on our condensed consolidated balance sheets (in thousands):

| | Nine Months Ended | |
|---|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 |
| Beginning balance | \$ 1,765 | \$ 1,674 |
| Additional asset retirement obligations recognized | 46 | 54 |
| Adjustment to asset retirement obligations recognized | 5 | |

Edgar Filing: COHERENT INC - Form 10-Q

| | | | | |
|--|----|-------|----|-------|
| Accretion recognized | | 113 | | 112 |
| Changes due to foreign currency exchange | | 91 | | |
| Ending balance | \$ | 2,020 | \$ | 1,840 |

Other long-term liabilities consist of the following (in thousands):

| | | June 30, 2007 | | September 30, 2006 |
|-----------------------------------|----|--------------------------|----|-------------------------------|
| Deferred compensation | \$ | 32,727 | \$ | 28,017 |
| Deferred tax liabilities | | 4,036 | | 684 |
| Deferred income | | 4,942 | | 4,390 |
| Asset retirement liability | | 2,020 | | 1,765 |
| Other long-term liabilities | | 3,028 | | 2,563 |
| Total other long-term liabilities | \$ | 46,753 | \$ | 37,419 |

9. CONVERTIBLE SUBORDINATED NOTES

In March 2006, we issued \$200.0 million of 2.75% convertible subordinated notes due March 2011. The notes were unsecured and subordinate to all existing and future senior debt. The notes were scheduled to mature on March 1, 2011, unless earlier redeemed or converted. Interest on the notes is payable in cash semi-annually in arrears on March 1 and September 1 of each year.

The fair value of the convertible debt at June 30, 2007 was estimated at \$207.8 million, based on quoted market prices for the convertible notes. The carrying value of the convertible subordinated notes was \$199.8 million at June 30, 2007.

On December 15, 2006, we received a letter from U.S. Bank National Association (the trustee) for the holders of the outstanding principal amount of 2.75% convertible subordinated notes due 2011 stating that we had violated certain provisions in the indenture dated March 13, 2006 (the Indenture) as a result of our failure to file our annual report for fiscal 2006 with the SEC. The Indentures provided that such a default could be cured by making that filing with the SEC within 60 days after the receipt by us of the notice of default. The indentures also provided that such a default, if not cured by that date, would give certain holders and the trustee the right to accelerate the maturity of the notes. We did not cure the default within 60 days after the receipt by us of the notice of default. On August 17, 2007, as amended by an addendum delivered on August 20, 2007, we received a letter from the trustee under that Indenture declaring the principal amount and accrued and unpaid interest, plus additional interest under the Notes, to be immediately due and payable pursuant to the Indenture due to our failure to file reports required to be filed and delivered to the trustee under the Indenture and Sections 13 and 15(d) of the Securities Exchange Act of 1934, as amended. The aggregate amount due and payable under the Notes including interest was \$203.0 million, which we paid on August 21, 2007. In connection therewith, we also recorded a charge of \$2.6 million to write off unamortized capitalized deferred issuance costs.

As a result of the violation and subsequent repayment, the convertible subordinated notes have been classified as current liabilities as of June 30, 2007.

10. STOCK-BASED COMPENSATION

Stock-Based Benefit Plans

We have two Stock Option Plans for which all service providers are eligible participants and a Directors' Stock Option Plan for which only non-employee directors are eligible participants. The Directors' Stock Option Plan is designed to work automatically without administration, however to the extent administration is necessary, it will be performed by the Board of Directors or a committee thereof. Under these three plans, we may grant options to purchase up to an aggregate of 5,500,000, 6,300,000 and 681,000 shares of common stock, respectively of which no, 3,832,966 and 192,000, respectively, remain available for grant at June 30, 2007. Employee options are generally exercisable between two to four years from the grant date at a price equal to the fair market value of the common stock on the date of the grant and generally vest 25% to 50% annually. We settle stock option exercises with newly issued shares of common stock. Grants under employee plans expire six years from the original grant date, unless otherwise determined by the Board or a committee thereof, up to a maximum of ten years. Director options are automatically granted to our non-employee directors. Such directors initially receive a stock option for 24,000 shares exercisable over a three-year period and an award of restricted stock units of 2,000 shares. Additionally, the non-employee directors receive an annual grant of 6,000 shares exercisable as to 50% of the shares on the day prior to each of the next two annual stockholder meetings. Grants under director plans expire ten years from the original grant date. In addition, each non-employee director receives an annual grant of 2,000 shares of restricted stock units that vest on the day prior to the annual stockholder meeting held in the third calendar year following the date of grant.

Restricted stock awards granted under our Stock Option Plans are independent of option grants and are subject to restrictions. At June 30, 2007, we had 262,915 shares of restricted stock outstanding, including 99,500 performance-based restricted stock awards and stock units, all of which are subject to forfeiture if employment terminates prior to the release of restrictions. During this period, ownership of the shares cannot be transferred. The service-based restricted awards generally vest three years from the date of grant. The performance-based restricted stock grants are subject to annual vesting over three years depending upon the achievement of performance measurements tied to the Company's internal metrics for revenue growth and EBITDA percentage and is variable. For fiscal 2006 awards, 115% of the target shares, or 19,479 shares, were issued. The number of shares earned can range from 0% to 200% of the grant target for 2007 and 2008. Restricted stock (not including performance-based restricted stock) has the same cash dividend and voting rights as other common stock and is considered to be currently issued and

outstanding. The cost of the awards, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse.

We have an Employee Stock Purchase Plan (ESPP) whereby eligible employees may authorize payroll deductions of up to 10% of their regular base salary to purchase shares at the lower of 85% of the fair market value of the common stock on the date of commencement of the offering or on the last day of the six-month offering period. At June 30, 2007, 224,536 shares of our common stock were reserved for future issuance under the plan.

In the second quarter of fiscal 2007, the stock purchase plan was suspended and employee contributions made to date were returned while the Special Committee conducted a voluntary review of our historical stock option practices. See Note 3, Restatement of Condensed Consolidated Financial Statements. The remaining unamortized expense of \$0.5 million was recognized in the second quarter of fiscal 2007.

Adoption of SFAS 123(R)

Effective October 2, 2005, we adopted the fair value recognition provisions of SFAS No. 123 (Revised 2004), Share-Based Payment, (SFAS 123(R)), requiring us to recognize expense related to the fair value of our stock-based compensation awards. We recognize compensation expense for all share-based payment awards on a straight-line basis over the respective requisite service period of the awards.

Determining Fair Value

Valuation and amortization method We estimate the fair value of stock options granted using the Black-Scholes-Merton option-pricing formula and a single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

Expected Term The expected term represents the period that our stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards.

Expected Volatility Our computation of expected volatility is based on a combination of historical volatility and market-based implied volatility.

Risk-Free Interest Rate The risk-free interest rate used in the Black-Scholes-Merton valuation method is based on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term.

Expected Dividend The expected dividend assumption is based on our current expectations about our anticipated dividend policy.

There were no grants made under our stock option and stock purchase plans during the second or third quarters of fiscal 2007 due to the voluntary review of our historical stock option practices. For the other periods presented, the fair values of our stock options granted to employees and shares purchased under the stock purchase plan for the three months ended July 1, 2006 and nine months ended June 30, 2007 and July 1, 2006 were estimated using the following weighted-average assumptions:

| | Employee Stock Option Plans | | | | Employee Stock Purchase Plans | | | |
|-----------------------------|-----------------------------|-----------------|-------------------|-----------------|-------------------------------|-----------------|-------------------|-----------------|
| | Three Months Ended | | Nine Months Ended | | Three Months Ended | | Nine Months Ended | |
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Expected life in years | | 4.5 | 4.4 | 4.9 | | 0.5 | 0.5 | 0.5 |
| Expected volatility | % | 34.2% | 34.2% | 35.2% | % | 32.6% | 29.0% | 33.6% |
| Risk-free interest rate | % | 5.2% | 4.7% | 4.9% | % | 4.8% | 5.1% | 4.1% |
| Expected dividends | | none | none | none | | none | none | none |
| Weighted average fair value | \$ | \$ 11.93 | \$ 12.04 | \$ 12.92 | \$ | \$ 8.72 | \$ 8.43 | \$ 7.98 |

Stock Compensation Expense

The following table shows total stock-based compensation expense included in the Condensed Consolidated Statements of Operations for the three and nine months ended June 30, 2007 and July 1, 2006 (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------|--------------------|--------------|-------------------|--------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Cost of sales | \$ 406 | \$ 437 | \$ 1,509 | \$ 880 |
| Research and development | 408 | 485 | 1,707 | 1,703 |
| Selling, general and administrative | 1,224 | 2,253 | 6,068 | 7,790 |
| Income tax benefit | (479) | (1,597) | (3,052) | (1,788) |
| | \$ 1,559 | \$ 1,578 | \$ 6,232 | \$ 8,585 |

During the three and nine months ended June 30, 2007, \$0.2 million and \$1.1 million, respectively, for all stock plans was capitalized into inventory, \$0.4 million and \$1.3 million, respectively, was amortized into cost of sales and \$0.3 million remained in inventory at June 30, 2007. During the three and nine months ended July 1, 2006, \$0.3 million and \$1.3 million, respectively, for all stock plans was capitalized into inventory, \$0.5 million and \$0.9 million, respectively, was amortized into cost of sales and \$0.4 million remained in inventory at July 1, 2006. As required by SFAS 123(R), management made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest.

At June 30, 2007, the total compensation cost related to unvested stock-based awards granted to employees under the Company's stock option plans but not yet recognized was approximately \$5.9 million, net of estimated forfeitures of \$0.4 million. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 1.2 years and will be adjusted for subsequent changes in estimated forfeitures.

Prior to the adoption of SFAS 123(R), we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in our statement of cash flows. In accordance with SFAS 123(R), the cash flows resulting from excess tax benefits (tax benefits related to the excess of proceeds from employee's exercises of stock options over the stock-based compensation cost recognized for those options) are classified as financing cash flows. During the nine months ended June 30, 2007 and July 1, 2006, we recorded less than \$0.1 million and \$0.7 million, respectively, of excess tax benefits as cash flows from financing activities.

During the quarter ended March 31, 2007, our Board of Directors approved an extension of the exercise period to December 31, 2007 for 210,088 fully vested stock options previously granted by the Company to employees. As a result, we recorded approximately \$0.5 million in compensation expense related to the stock option modification during the second quarter of fiscal 2007.

Stock Options & Awards Activity

The following is a summary of option activity for our Stock Option Plans (in thousands, except per share amounts and remaining contractual term in years):

Edgar Filing: COHERENT INC - Form 10-Q

| | Number of Shares | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term in Years | Aggregate Intrinsic Value |
|--|---------------------|--|--|------------------------------|
| Outstanding at October 1, 2006 | 3,823 | \$ 29.15 | | |
| Granted | 25 | 33.87 | | |
| Exercised | (53) | 24.13 | | |
| Forfeitures | (97) | 31.25 | | |
| Expirations | (403) | 34.55 | | |
| Outstanding at June 30, 2007 | 3,295 | \$ 28.54 | 2.8 | \$ 10,295 |
| Vested and expected to vest at June 30, 2007 | 3,276 | \$ 28.52 | 2.8 | \$ 10,294 |
| Exercisable at June 30, 2007 | 2,958 | \$ 28.00 | 2.5 | \$ 10,263 |

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the 1.5 million options that were in-the-money at June 30, 2007. There were no exercises of Company stock during the three months ended June 30, 2007, resulting in no intrinsic value realized during the period. During the three months ended July 1, 2006, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$3.8 million, determined as of the date of option exercise. During the nine months ended June 30, 2007 and July 1, 2006, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$0.5 million and \$4.6 million, respectively, determined as of the date of option exercise.

The following table summarizes our restricted stock award activity for the nine months ended June 30, 2007 (in thousands, except per share amounts):

| | Number of Shares | Weighted Average Grant Date Fair Value |
|------------------------------------|---------------------|---|
| Nonvested stock at October 1, 2006 | 299 | \$ 33.06 |
| Granted | 8 | 32.23 |
| Vested | (19) | 33.20 |
| Forfeited | (25) | 33.26 |
| Nonvested stock at June 30, 2007 | 263 | \$ 33.02 |

11. COMMITMENTS AND CONTINGENCIES

We are subject to legal claims and litigation arising in the ordinary course of business, such as employment or intellectual property claims, including, but not limited to, the matters described below. The outcome of any such matters is currently not determinable. Although we do not expect that such legal claims and litigation will ultimately have a material adverse effect on our consolidated financial position or results of operations, an adverse result in one or more matters could negatively affect our results in the period in which they occur.

Derivative Lawsuits Between February 15, 2007 and March 2, 2007, three purported shareholder derivative lawsuits were filed in the United States District Court for the Northern District of California against certain of Coherent's current and former officers and directors. Coherent is named as a nominal defendant. The complaints generally allege that the defendants breached their fiduciary duties and violated the securities laws in connection with the granting of stock options, the accounting treatment for such grants, and the issuance of allegedly misleading public statements and stock sales by certain of the individual defendants. On May 29, 2007, these lawsuits were consolidated under the caption *In re Coherent, Inc. Shareholder Derivative Litigation*, Lead Case No. C-07-0955-JF (N.D. Cal.). On June 25, 2007, plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts causes of action for alleged violations of federal securities laws, violations of California securities laws, breaches of fiduciary duty and/or aiding and abetting breaches of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, insider selling and misappropriation of information. The consolidated complaint seeks, among other relief, disgorgement and damages in an unspecified amount, an accounting, rescission of allegedly improper stock option grants, punitive damages and attorneys' fees and costs.

The Company's Board of Directors has appointed a Special Litigation Committee (SLC) comprised of independent director Sandeep Vij to investigate and evaluate the claims asserted in the derivative litigation and to determine what action(s) should be taken with respect to the derivative litigation. The SLC's investigation is ongoing.

Securities and Exchange Commission Inquiry In 2006, the Company was advised that the San Francisco District Office of the Securities and Exchange Commission was conducting an informal inquiry relating to the Company's past granting of stock options. The Company is cooperating fully with the inquiry.

Income Tax Audits The Internal Revenue Service (IRS) is conducting an audit of our 2003 and 2004 tax returns. The IRS has issued a number of Notices of Proposed Adjustments to these returns. Among other items, the IRS has challenged our research and development credits and our extraterritorial income (ETI) exclusion. We have agreed to the various adjustments proposed by the IRS and we believe that we have adequate reserves for these exposures and any other items identified by the IRS as a result of the audit of these tax years. As part of its audit of our 2003 and 2004 years, the IRS has requested information related to our stock option investigation and we will comply with this request and address any issues that are raised in a timely manner. The IRS has also indicated that it may consider an audit of our 2005 and 2006 tax returns.

The IRS is also auditing the research and development credits generated in the years 1999 through 2001 and carried forward to future tax years. We believe that we have adequate reserves for any adjustments that may be proposed by the IRS related to these credits.

The German tax authorities are conducting an audit of our subsidiary in Göttingen for the tax years 1999 through 2005. We believe that we have adequate reserves for any adjustments that may be proposed by the German tax authorities.

12. STOCKHOLDERS EQUITY

In September 2005, our Board of Directors authorized a share repurchase program of up to 1.5 million shares of our common stock. Under the terms of the repurchase program, purchases may be made from time to time in both the open market and in private transactions, as conditions warrant. There were no repurchases during the first quarter of fiscal 2007. As of September 30, 2006, we had purchased and cancelled a total of 721,942 shares of our common stock for approximately \$22.3 million. The program was suspended during the first quarter of fiscal 2007 due to our internal stock option investigation and was terminated effective September 30, 2007.

13. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss), net of income taxes, are as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Net income (loss) | \$ (763) | \$ 11,245 | \$ 17,277 | \$ 26,079 |
| Other comprehensive income: | | | | |
| Translation adjustment | 3,393 | 12,171 | 14,499 | 14,833 |
| Net gain on derivative instruments, net of taxes | 14 | | 17 | 5 |
| Changes in unrealized gains on available-for-sale securities, net of taxes | 22 | 41 | 137 | 15 |
| Other comprehensive income, net of tax | 3,429 | 12,212 | 14,653 | 14,853 |
| Comprehensive income | \$ 2,666 | \$ 23,457 | \$ 31,930 | \$ 40,932 |

The following summarizes activity in accumulated other comprehensive income (loss) related to derivatives, net of income taxes, held by us (in thousands):

| | |
|--------------------------------------|----------|
| Balance, October 1, 2005 | \$ (114) |
| Changes in fair value of derivatives | |
| Net losses reclassified from OCI | 5 |
| Balance, July 1, 2006 | \$ (109) |
| Balance, October 1, 2006 | \$ (135) |
| Changes in fair value of derivatives | |
| Net losses reclassified from OCI | 17 |
| Balance, June 30, 2007 | \$ (118) |

Accumulated other comprehensive income (net of tax) at June 30, 2007 is comprised of accumulated translation adjustments of \$61.6 million, net loss on derivative instruments of \$0.1 million and unrealized loss on available-for-sale securities of \$0.2 million. Accumulated other comprehensive income (net of tax) at September 30, 2006 is comprised of accumulated translation adjustments of \$47.2 million, net loss on derivative instruments of \$0.1 million and unrealized loss on available-for-sale securities of \$0.4 million, respectively.

14. EARNINGS PER SHARE

Basic earnings per share is computed based on the weighted average number of shares outstanding during the period, excluding unvested restricted stock. Diluted earnings per share is computed based on the weighted average number of shares outstanding during the period increased by the effect of dilutive stock options, awards including restricted stock and stock purchase contracts using the treasury stock method.

Edgar Filing: COHERENT INC - Form 10-Q

The following table presents information necessary to calculate basic and diluted earnings per common share (in thousands, except per share data):

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------------|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Weighted average shares outstanding (1) basic | 31,417 | 30,868 | 31,391 | 30,915 |
| Dilutive effect of employee stock plans | | 728 | 654 | 545 |
| Weighted average shares outstanding diluted | 31,417 | 31,596 | 32,045 | 31,460 |
| Net income (loss) | \$ (763) | \$ 11,245 | \$ 17,277 | \$ 26,079 |
| Net income (loss) per basic share | \$ (0.02) | \$ 0.36 | \$ 0.55 | \$ 0.84 |
| Net income (loss) per diluted share | \$ (0.02) | \$ 0.36 | \$ 0.54 | \$ 0.83 |

(1) Net of restricted stock

A total of 1,249,128 and 1,121,759 potentially dilutive securities have been excluded from the dilutive share calculation for the three months ended June 30, 2007 and July 1, 2006, respectively, as their effect was anti-dilutive. A total of 1,419,491 and 1,901,299 potentially dilutive securities have been excluded from the dilutive share calculation for the nine months ended June 30, 2007 and July 1, 2006, respectively, as their effect was anti-dilutive.

In September 2004, the Emerging Issues Task Force (EITF) reached final consensus on EITF No. 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share , that contingently convertible debt should be treated as convertible debt and included in the calculation of diluted EPS. The assumed proceeds under the treasury stock method were calculated by subtracting the aggregate weighted-average conversion price from the average market price of the shares related to the contingently convertible debt. As the market price for our shares did not reach the conversion price at any point during the quarter ended June 30, 2007, there was no dilutive effect from our \$200.0 million 2.75% convertible subordinated notes in our diluted EPS calculation under the treasury stock method. Therefore we did not include any shares related to the convertible subordinated notes, in accordance with the provisions of EITF No. 90-19, Convertible Bonds With Issuer Option to Settle in Cash Upon Conversion and SFAS No. 128, Earnings Per Share .

15. INCOME TAXES

The Company accounts for income taxes under the provisions of SFAS No. 109, Accounting for Income Taxes (SFAS 109). Under the provisions of SFAS 109, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries. The Company's estimated effective tax rate for the three and nine months ended June 30, 2007 was 274% and 31.7%, respectively. The difference between the statutory rate of 35% and the Company's effective tax rate for the three months ended June 30, 2007 was due primarily to permanent differences related to deemed dividend inclusions under the Subpart F tax rules and the non-deductibility of IPR&D related to the Nuvoynx acquisition, partially offset by the benefit of foreign tax credits and research and development tax credits.

Edgar Filing: COHERENT INC - Form 10-Q

The difference between the statutory rate of 35% and the Company's effective tax rate for the nine months ended June 30, 2007 was due primarily to the benefit of foreign tax credits and research and development tax credits, partially offset by permanent differences related to deemed dividend inclusions under the Subpart F tax rules and the non-deductibility of IPR&D related to the Nuvonyx acquisition.

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

In June 2006, the FASB issued Financial Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In addition, in May 2007, the FASB issued FASB Staff Position No. FIN 48-1, Definition of Settlement in FASB Interpretation

No. 48, (FSP FIN 48-1) to amend FIN No. 48 by providing that previously unrecognized tax benefits can be recognized when the tax positions are effectively settled upon examination by a taxing authority. According to FSP FIN 48-1, an enterprise's tax position will be considered effectively settled if the taxing authority has completed its examination, the enterprise does not plan to appeal, and the possibility is remote that the taxing authority would reexamine the tax position in the future. The requirements of FIN 48 and FSP FIN 48-1 are effective for our fiscal year beginning September 30, 2007. As of the end of fiscal year 2007, we estimate that our tax contingencies could increase by approximately \$1 million to \$3 million as a result of the adoption of FIN 48 and FSP FIN 48-1. This amount would be an adjustment to our retained earnings for fiscal year beginning September 30, 2007.

16. SEGMENT INFORMATION

During the second quarter of fiscal 2007, we established a new organizational and reporting structure whereby our previously single reportable operating segment was separated into two operating segments: Commercial Lasers and Components (CLC) and Specialty Lasers and Systems (SLS). The new segmentation reflects the go-to-market strategies for various products and markets. While both segments work to deliver cost-effective photonics solutions, CLC focuses on higher volume products that are offered in set configurations. The product architectures are designed for easy exchange at the point of use such that product service and repairs are based upon advanced replacement and depot (i.e., factory) repair. CLC's primary markets include OEM components and instrumentation and materials processing. SLS develops and manufactures configurable, advanced-performance products largely serving the microelectronics and scientific research markets. The size and complexity of many of the SLS products require service to be performed at the customer site by factory-trained field service engineers.

We have identified CLC and SLS as operating segments for which discrete financial information was available. Both operating segments have engineering, marketing, product business management and product line management. Prior period financial information has been restated to conform to the current segment presentation. A small portion of our outside revenue is attributable to projects and recently developed products for which a segment has not yet been determined. The associated direct and indirect costs are presented in the category of Corporate and other, along with other corporate costs as described below.

Pursuant to SFAS 131, Disclosures about Segments of an Enterprise and Related Information, our Chief Executive Officer has been identified as the chief operating decision maker (CODM) as he assesses the performance of the segments and decides how to allocate resources to the segments. Income (loss) from operations is the measure of profit and loss that our CODM uses to assess performance and make decisions. Income (loss) from operations represents the sales less the cost of sales and direct operating expenses incurred within the operating segments as well as allocated expenses such as shared sales and manufacturing costs. We do not allocate to our operating segments certain operating expenses, which we manage separately at the corporate level. These unallocated costs include stock-based compensation, corporate functions (certain research and development, management, finance, legal and human resources) and are included in the results below under Corporate and Other in the reconciliation of operating results. Management does not consider unallocated Corporate and Other costs in its measurement of segment performance.

| | Three Months Ended | | Nine Months Ended | |
|---------------------------------------|--------------------|-----------------|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Net sales: | | | | |
| Commercial Lasers and Components | \$ 74,506 | \$ 72,177 | \$ 211,453 | \$ 197,446 |
| Specialty Laser Systems | 68,050 | 76,663 | 229,136 | 227,754 |
| Corporate and other | 52 | 684 | 1,644 | 1,306 |
| Total net sales | \$ 142,608 | \$ 149,524 | \$ 442,233 | \$ 426,506 |
| Income (loss) from operations: | | | | |
| Commercial Lasers and Components | \$ 3,333 | \$ 11,027 | \$ 19,198 | \$ 21,326 |
| Specialty Laser Systems | 4,003 | 10,491 | 28,904 | 39,351 |

Edgar Filing: COHERENT INC - Form 10-Q

| | | | | |
|-------------------------------------|------------|-----------|----------|-----------|
| Corporate and other | (12,915) | (9,925) | (39,207) | (30,732) |
| Total income (loss) from operations | \$ (5,579) | \$ 11,593 | \$ 8,895 | \$ 29,945 |

17. SUBSEQUENT EVENTS

In September 2007, we sold substantially all of the net assets of our U.K. subsidiary, Coherent Imaging Optics Limited (CIOL), to CVI Laser (CVI) for \$6.5 million, resulting in an after-tax gain on the sale of \$0.8 million. In September 2007, we sold our Condensa building in Santa Clara, California for approximately \$24.8 million, resulting in a capital gain of approximately \$3.6 million. In September 2007, we also sold our Auburn campus in Auburn, California, for approximately \$9.8 million, resulting in a capital loss of approximately \$12.6 million.

On December 18, 2007, we announced that the Securities and Exchange Commission (SEC) notified us that it had denied our motion to stay the decision of The NASDAQ Stock Market LLC (Nasdaq), to suspend and delist our common stock. Therefore, effective at the opening of business on Wednesday, December 19, 2007, our common stock was suspended from trading on the Nasdaq Global Market, and was subsequently delisted. Following our delisting from the Nasdaq Global Market, we began trading on the Pink Sheet Electronic Quotation Service under the symbol, COHR.PK .

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

COMPANY OVERVIEW

BUSINESS BACKGROUND

We are one of the world's leading suppliers of photonics-based solutions in a broad range of commercial and scientific research applications. We design, manufacture and market lasers, precision optics and related accessories for a diverse group of customers. Since inception in 1966, we have grown through internal expansion and through strategic acquisitions of complementary businesses, technologies, intellectual property, manufacturing processes and product offerings.

During the second quarter of fiscal 2007, we established a new organizational and reporting structure whereby our previously single reportable operating segment was separated into two operating segments: Commercial Lasers and Components (CLC) and Specialty Lasers and Systems (SLS). The new segmentation reflects the go-to-market strategies for various products and markets. While both segments work to deliver cost-effective photonics solutions, CLC focuses on higher volume products that are offered in set configurations. The product architectures are designed for easy exchange at the point of use such that product service and repairs are based upon advanced replacement and depot (i.e., factory) repair. CLC's primary markets include OEM components and instrumentation and materials processing. SLS develops and manufactures configurable, advanced-performance products largely serving the microelectronics and scientific research markets. The size and complexity of many of the SLS products require service to be performed at the customer site by factory-trained field service engineers. Prior period segment information has been restated to conform to the current presentation.

Income (loss) from operations is the measure of profit and loss that our CODM uses to assess performance and make decisions. Income (loss) from operations represents the sales less the cost of sales and direct operating expenses incurred within the operating segments as well as allocated expenses such as shared sales and manufacturing costs. We do not allocate to our operating segments certain operating expenses, which we manage separately at the corporate level. These unallocated costs include stock-based compensation, corporate functions (certain research and development, management, finance, legal and human resources) and are included in Corporate and Other. Management does not consider unallocated Corporate and Other costs in its measurement of segment performance.

OUR STRATEGY

We strive to develop innovative and proprietary products and solutions that meet the needs of our customers and that are based on our core expertise in lasers and optical technologies. In pursuit of our strategy, we intend to:

- **Leverage our technology portfolio and application engineering to lead the proliferation of photonics into broader markets** We will continue to identify opportunities in which our technology portfolio and application engineering can be used to offer innovative solutions and gain access to new markets.

- **Optimize our leadership position in existing markets** There are a number of markets where we have historically been at the forefront of technological development and product deployment and from which we have derived a substantial portion of our revenues. We plan to optimize our financial returns from these markets.
- **Maintain and develop additional strong collaborative customer and industry relationships** We believe that the Coherent brand name and reputation for product quality, technical performance and customer satisfaction will help us to further develop our loyal customer base. We plan to maintain our current customer relationships and develop new ones with customers who are industry leaders and work together with these customers to design and develop innovative product systems and solutions as they develop new technologies.
- **Develop and acquire new technologies and market share** We will continue to enhance our market position through our existing technologies and develop new technologies through our internal research and development efforts, as well as through the acquisition of additional complementary technologies, intellectual property, manufacturing processes and product offerings.
- **Focus on long-term improvement of adjusted EBITDA %** We define adjusted EBITDA % as earnings before interest, taxes, depreciation, amortization, stock compensation expenses and other non-operating income and expense items as a percent of net sales.

RESTATEMENT OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Background

As previously announced on November 1, 2006, a Special Committee was established by our Board of Directors to conduct an independent investigation relating to our historical stock option practices. We requested the independent review following an internal review of our historical stock option practices, which was a voluntary review initiated in light of news of the option practices of numerous companies across several industries. The Special Committee, comprised of three independent members of our Board of Directors, retained independent outside counsel and forensic accountants to assist in conducting the investigation. Together with its independent counsel, the Special Committee conducted an extensive review of historical stock option practices including all awards made by us between January 1, 1995 and September 30, 2006, (the Relevant Period) that included the review of over one million documents and interviews of over 30 current and former employees, directors and advisors.

On July 26, 2007, we announced that our management and the Special Committee, with the assistance of independent legal counsel and forensic accounting experts, had determined that incorrect measurement dates for a significant number of stock option awards during the Relevant Period were used.

On September 26, 2007, our Audit Committee, after consultation with management, determined that additional charges for stock-based compensation expense were required as a result of such incorrect measurement dates. As a result of the Special Committee's investigation and our management's subsequent reviews and analyses, options granted during the Relevant Period to purchase an aggregate of approximately 8,735,590 shares were determined to have incorrect measurement dates. We determined that the revised measurement dates for accounting purposes (Revised Measurement Dates) differed from the originally recorded measurement dates due primarily to a number of factors, including (1) delays in the final determination or approval of the awards, (2) retroactive selection of grant dates, (3) the absence of definitive documentation regarding approval, and (4) other process-related issues. These included annual grants to existing employees and officers and option grants made to new hires or to employees recently promoted.

The restated condensed consolidated financial statements for the periods ended July 1, 2006 contained in this quarterly report reflect corrections resulting from the reviews described above by the Special Committee and management, including the related payroll tax effects, as well as other reviews of other accounting matters by management. This restatement is more fully described in Note 3, Restatement of Condensed Consolidated Financial Statements, of Notes to Condensed Consolidated Financial Statements.

We have incurred substantial expenses related to our special investigation and subsequent internal investigation, which began in early fiscal 2007. In addition, we are the subject of several derivative actions filed against certain of our current and former directors and officers as well as an informal investigation launched by the staff of the SEC regarding our past stock option granting practices, as more fully described in Part II, Item 1, Legal Proceedings. We have incurred approximately \$11.7 million in pretax costs for outside legal counsel fees (including special counsel), external audit firm fees, audit committee fees, and external consulting fees in fiscal 2007 and expect to incur significant additional fees related to the stock option matters and financial statement restatements until we are current with all filings.

Restatement Adjustments

Our restated condensed consolidated financial statements for the three and nine months ended July 1, 2006 incorporate adjustments to correct for errors in stock-based compensation expense, payroll tax expense and other accounting matters, including the income tax impacts related to the restatement adjustments and other tax errors (collectively, the restatement adjustments). The table below presents the decrease to net income for the first three and nine months of fiscal 2006 of the individual restatement adjustments, which are explained in further detail following the table (in thousands, except per share data):

| | Three Months Ended July 1, 2006 | Nine Months Ended July 1, 2006 |
|---|--|---|
| Stock-based compensation | | |
| Annual grants to employees | \$ (60) | \$ 266 |
| Annual grants to officers | (142) | 1 |
| Non-annual grants to employees | (50) | (44) |
| Non-annual grants to officers | 1 | 4 |
| Total stock-based compensation expense | (251) | 227 |
| Payroll taxes, interest and penalties | | |
| Total stock-based compensation adjustments | (69) | 120 |
| | (320) | 347 |
| Other miscellaneous accounting adjustments | | |
| Correction of Lambda Physik purchase accounting | 139 | 416 |
| Correction of accounting for asset retirement obligations | 71 | 206 |
| Classification of unrealized foreign exchange losses on intercompany note | | 77 |
| Correction to inventory capitalization | 454 | 454 |
| | 664 | 1,153 |
| Total adjustments to income before income taxes | 344 | 1,500 |
| Income tax expense (benefit) | (738) | 761 |
| Total decrease(increase) to net income | \$ (394) | \$ 2,261 |
| Decrease(increase) in diluted earnings per share | \$ (0.01) | \$ 0.07 |

Stock-Based Compensation Summary These adjustments are from management's determination, based upon the Special Committee's investigation and our subsequent reviews and analyses that the initially recorded measurement dates for various categories of option grants during the Relevant Period were incorrect. These categories were:

- Annual grants to employees.* We determined that the appropriate measurement date for annual grants to employees was the date on which evidence indicates the allocation of the options to the individual employees was substantially complete, as further described below. As a result, annual grants for an aggregate of 4,749,940 shares through the first nine months of fiscal 2006 were remeasured and accounted for as fixed awards under Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, or APB 25, for periods prior to fiscal 2006 and under Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), Share-Based Payment (SFAS 123(R)), effective October 2, 2005 and thereafter, using the methodologies described below under Accounting Considerations Stock-Based Compensation.

Edgar Filing: COHERENT INC - Form 10-Q

- *Annual grants to officers.* For annual grants to officers during fiscal years 1995, 1996, 1997, 1999, 2000 and 2002, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under Accounting Considerations Stock-Based Compensation , and accounted for these grants as fixed awards under APB 25 or SFAS 123(R), as applicable. The grants represented options to purchase an aggregate of 1,251,500 shares through the first nine months of fiscal 2006. For annual grants to officers during other fiscal years during the Relevant Period, management determined that the original measurement date was properly determined.
- *Non-annual grants to employees.* Non-annual grants to employees are initial grants to newly hired employees or incremental grants to existing employees upon their promotion. For non-annual grants to employees, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under Accounting Considerations Stock-Based Compensation , and accounted for these grants as fixed awards under APB 25 or SFAS 123(R), as applicable. The grants represented options to purchase an aggregate of 2,382,650 shares through the first nine months of fiscal 2006.

- *Non-annual grants to officers.* Non-annual grants to officers are initial grants to newly hired officers or incremental grants upon an existing employee's promotion to an officer position. For non-annual grants to officers, we adopted a methodology to remeasure these option grants to a revised measurement date, as described below under Accounting Considerations Stock-Based Compensation, and accounted for these grants, which represented options to purchase an aggregate of 351,500 shares through the first nine months of fiscal 2006, as fixed awards under APB 25 or SFAS 123(R), as applicable.

Payroll taxes, interest and penalties In connection with the stock-based compensation charges included in the restatement, certain options previously classified as Incentive Stock Options (ISO) were determined to have been granted with an exercise price below the fair market value of our stock on the revised measurement date. Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant, and therefore might not qualify for ISO tax treatment. We refer to these stock options as the Affected ISOs. The potential disqualification of ISO status exposes us to additional payroll related withholding taxes on the exercise of options granted to U.S. employees, and interest and penalties for failing to properly withhold taxes on the exercise of those options. Additionally, we recorded tax, interest, and penalty expenses with respect to certain options granted in the U.K. which were determined to have been granted with an exercise price below the fair market value of our common stock on the revised measurement date (U.K. Options). The tax, interest and penalty expenses were recorded in the periods in which the underlying stock options were exercised. Then, in periods in which the liabilities were legally extinguished due to statutes of limitations, the expenses were reversed and recognized as a reduction in the related functional expense in our consolidated statements of operations. The net U.S. and U.K. tax liabilities at June 30, 2007 for this potential disqualification of ISO tax treatment for the Affected ISOs and the U.K. Options totaled \$1.1 million.

Management and the Board are considering possible ways to address the impact that Section 409A of the Internal Revenue Code (IRC) may have as a result of the exercise price of stock options being less than the fair market value of our common stock on the revised measurement date. IRC Section 409A imposes significant additional taxes to our employees on stock options granted with an exercise price lower than the fair market value on the date of grant that vest after December 31, 2004. The Internal Revenue Service (IRS) has issued transition rules under IRC Section 409A that allows for a correction, or cure, for non-exercised, non-executive options subject to IRC Section 409A. We continue to evaluate the potential corrections or cures in light of the additional time relief granted by the IRS through December 2008.

Other miscellaneous accounting adjustments In addition to stock-based compensation related charges, we recorded adjustments to correct errors in the condensed consolidated financial statements for the fiscal 2006 periods that had not been previously reflected in our condensed consolidated financial statements. These restatements relate to the correction of errors in the purchase accounting related to our acquisition of a 39.62% interest in Lambda Physik in fiscal 2003, the failure to adopt the provisions of SFAS 143, the correction of the classification of unrealized foreign exchange gains and losses related to an intercompany note and the correction of an error in our inventory capitalization during the third quarter of fiscal 2006.

Income tax benefit We reviewed the income tax effect of the stock-based compensation charges, and we believe that the proper income tax accounting for U.S. stock options under GAAP depends, in part, on the tax distinction of the stock options as either ISOs or non-qualified stock options (NSOs). Under U.S. tax regulations, ISOs may not be granted with an exercise price less than the fair market value on the date of grant. Because of the potential impact of the measurement date changes on the qualified status of Affected ISOs, we have determined that all Affected ISOs might not be qualified ISOs under the tax regulations, and therefore should be accounted for as if they were NSOs for income tax accounting purposes. The Company recorded a tax benefit with respect to the Affected ISOs. To the extent an ISO was not disqualified through a same day sale or sold before fulfilling the holding period requirements related to the Affected ISOs, the recorded tax asset was written off to earnings when the statute of limitations for the year of exercise closed.

We have recorded a net income tax benefit of approximately \$3.4 million in connection with the stock-based compensation related expense during the period from fiscal year 1995 through July 1, 2006. The recognized tax benefit related to affected stock options granted to officers was limited due to the potential non-deductibility of the related expenses under IRC Section 162(m). This IRS rule limits the amount of executive compensation that may be deducted for U.S. tax purposes under certain circumstances. We did not record a tax benefit or deferred tax asset for

Edgar Filing: COHERENT INC - Form 10-Q

affected stock options granted to non-U.S., non-U.K. and certain non-German employees because we determined that we could not receive tax benefits outside of the U.S., U.K. and Germany. The net tax benefit has resulted in an increase of our deferred tax assets for all U.S. and UK affected stock options and certain German affected stock options prior to the exercise or forfeiture of the related options. Upon exercise or cancellation of the underlying options, the excess or deficiency in deferred tax assets are written-off to either expense or additional paid-in capital in the period of exercise or cancellation.

Further, we have recorded additional restatements to income taxes to record the effect of errors identified in the accounting for income tax contingencies resulting from the misapplication of information available at the date of the misstatement as well as the tax effects of the other miscellaneous accounting adjustments.

Accounting Considerations Stock-Based Compensation

Prior to the adoption of SFAS 123(R) in fiscal 2006, we originally accounted for all employee, officer and director stock option grants as fixed grants under APB 25, using the recorded grant date as the measurement date. We issued all grants with an exercise price equal to the fair market value of our common stock on the recorded grant date, and therefore originally recorded no stock-based compensation expense.

The Special Committee concluded that the measurement dates for certain stock option grants differed from the recorded grant dates for such grants. As described in APB 25, the measurement date is the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price are known with finality. Using the methodologies described below we revised the measurement dates for the indicated option grants during the Relevant Period, and we refer to these revised measurement dates as the Revised Measurement Dates. For periods prior to fiscal 2006, we calculated stock-based compensation expense under APB 25 based upon the intrinsic value as of the Revised Measurement Dates of stock option awards determined to be fixed awards under APB 25 and the vesting provisions of the underlying options through October 1, 2005. We calculated the intrinsic value on the Revised Measurement Date as the closing price of our common stock on such date as reported on the Nasdaq National Market, now the Nasdaq Global Market, less the exercise price per share of common stock as stated in the underlying stock option agreement, multiplied by the number of shares subject to such stock option award. We recognized these amounts as compensation expense on a straight-line basis over the vesting period of the underlying options. Effective October 2, 2005, we adopted the fair value recognition provisions of SFAS 123(R), requiring us to recognize expense related to the fair value of our stock-based compensation awards. Therefore, subsequent to fiscal 2005, we calculated stock-based compensation expense based upon the fair value as of the Revised Measurement Date in accordance with the provisions of SFAS 123(R).

The methodology we used to determine the Revised Measurement Dates associated with prior stock option grants was as follows:

Annual grants to employees For the majority of the annual grants to employees, the process of allocating stock option grants among individual employees continued beyond the recorded grant date. Based on available evidence, we have determined that the appropriate measurement date for annual grants to employees was the earliest date on which evidence indicates the allocation of the options to the individual employees was substantially complete. We defined substantially complete as the point at which evidence indicated that 96% or greater of the grant records had been determined with finality. Such determination was based on the earliest of the three following actions that could be verified with available evidence: (1) on evidence of a substantially complete listing of options allocated to individual employees, (2) on evidence of communication stating that the process was complete supported by records being added into our stock option database application prior to, on or within two days of such communication or (3) on evidence of dates that the employee records of the grants of the stock option were added to the stock option database application (the record added date), where evidence of a substantially complete listing of options allocated to individual employees was not available.

After the date on which substantially all granting activities were completed, there were an insignificant number of changes to option awards attributable to circumstances such as the effective cancellation of a grant because of an employee's termination, or additions due to administrative error corrections, promotion or individual performance reassessment. Where option awards were added subsequent to the date the allocation process was substantially complete, we have determined that each award was a separate grant with its own measurement date and that this subsequent addition was not indicative that the broader granting process for such annual awards had failed to be completed by the Revised Measurement Date. Measurement dates for individual awards which were not substantially complete by the Revised Measurement Date were determined based on the earlier of (1) the date the additions were communicated to the stock administrator for addition to the annual grant pool,

Edgar Filing: COHERENT INC - Form 10-Q

(2) the record added date or (3) for periods prior to the implementation of the current stock administration system, the print date of the Notice of Grant.

Annual grants to officers For annual grants to officers during fiscal years 1995, 1996, 1997, 1999, 2000 and 2002, the grants were awarded between Board meeting dates and in certain cases between committee meeting dates, and there is a lack of evidence that the price and number of shares were determined with finality as of the recorded grant date.

Based on available evidence, we have determined that the appropriate measurement date for annual grants to officers was the date on which evidence indicates that both the shares awarded to the officers and the exercise price of those shares was known with finality. Such determination was based on the earliest date of the three following actions that could be verified with available

Edgar Filing: COHERENT INC - Form 10-Q

evidence: (1) the date that the specific number of shares for each officer was approved for grant by the Board as evidenced by the minutes of the Board of Directors meeting, providing that the approval occurred prior to the submission of the applicable Form 3 or Form 4 to the Securities and Exchange Commission (SEC); (2) the record added date, providing that the record was added prior to the submission of the applicable Form 3 or Form 4 to the SEC; or (3) the date of submission of the applicable Form 3 or Form 4 to the SEC.

Non-annual grants to employees Non-annual grants to employees are initial grants to newly hired employees or incremental grants to existing employees upon their promotion. For non-annual grants to employees prior to June 2003, our stated process was to select the grant date to be the Monday after the Human Resources department requested the award. On June 5, 2003, we strengthened our process to require the signature of the Executive Vice President of HR on all award requests with the grant date to be the Monday after receipt of such signature. Beginning on June 7, 2006, we changed our process to require three members of an equity grant committee, established by the Board and the Board's Compensation and H.R. Committee, to meet only on a fixed date once a month to consider any requested awards, with the award effective on such date or, in the event action was required by written consent, the action would be effective on the date the last consent signature was received.

Based on available evidence, we determined that the process was not consistently followed during the period from fiscal 1995 through June 4, 2003. As a result, we determined that the appropriate measurement date for non-annual employee grants during the period from fiscal 1995 through June 4, 2003 was the earliest date of the two following actions that could be verified with available evidence: (1) the record added date and (2) the date the specific grant was approved as evidenced by the minutes of a Board of Directors meeting.

For the period from June 5, 2003 through June 6, 2006, we determined that most of the measurement dates for non-annual grants to employees during this period followed the stated process and were appropriate. For two grants that we determined did not follow the process, we determined the appropriate measurement date based on the stated process.

For the period from June 7, 2006 through September 30, 2006, we determined that we followed the process consistently and that all of the measurement dates for non-annual grants to employees during this period were appropriate.

Non-annual grants to officers Non-annual grants to officers are initial grants to newly hired officers or incremental grants for existing employees upon their promotion to an officer position. For non-annual grants to officers, Board or Compensation and H.R. Committee approval was reflected in written actions. We determined that the original recorded grant dates lacked evidence supporting when such written actions were executed for ten of the twelve non-annual grants to officers during the period from fiscal 1995 through fiscal 2006.

Based on available evidence, we determined that the appropriate measurement date for each of the ten non-annual grants to officers was the earliest of the three following actions that could be verified with available evidence: (1) the date written actions reflecting approval by the Board or Compensation and H.R. Committee were executed; (2) the record added date, providing that the related notice of grant was printed by us prior to the submission of the applicable Form 3 or Form 4 to the SEC; and (3) the date the applicable Form 3 or Form 4 was submitted to the SEC.

Non-employee director automatic stock option grants Our 1990 and 1998 Directors' Option Plans provide for the automatic and non-discretionary grant of non-statutory stock options to our non-employee directors, such that the grants require no independent action of the Board of Directors. The 1998 Directors' Plan replaced the 1990 Directors' Plan which expired on December 8, 1999 and was approved by stockholders on March 17, 1999. From 1995 through March 27, 2003, under both Plans, each non-employee director was automatically granted a non-discretionary grant of a non-statutory stock option to purchase 20,000 shares of common stock upon appointment as a member of the Board, and each non-employee director was granted a non-discretionary grant of a non-statutory stock option to purchase 5,000 shares of our common stock on the date of and

Edgar Filing: COHERENT INC - Form 10-Q

immediately following each Annual Meeting of Stockholders. The 1998 Directors Plan was amended by the Stockholders on March 23, 2003 to increase the automatic non-discretionary grant of a non-statutory stock option to purchase shares of common stock upon appointment as a member of the Board from 20,000 to 30,000 shares (Initial Grant) and to increase the non-discretionary grant of a non-statutory stock option to purchase shares of our common stock on the date of each Annual Meeting of Stockholders from 5,000 shares to 12,000 shares (Subsequent Grant). The Plans provide that the exercise price shall be equal to the fair market value of the common stock on the date of the grant of the options. On March 30, 2006, the 1998 Directors Plan was further amended to reduce the Initial Grant from 30,000 to 24,000 shares and the Subsequent Grant from 12,000 to 6,000 shares. In addition, non-employee directors receive a RSU of 2,000 shares upon first joining the Board of Directors and an award of restricted stock units of 2,000 shares on each Annual Meeting of Stockholders where such director is reelected.

We have determined that, as a result of administrative errors, a total of five automatic grants representing initial options to purchase a total of 140,000 shares under the 1998 Directors' Plan upon the appointment of five of our directors to the Board of Directors were documented as having been made on dates other than as set forth in the 1998 Directors' Option Plan. We have corrected the documentation of these grants to reflect the correct dates and exercise prices, as automatically established under the 1998 Directors' Option Plan. Because these actions were corrections of administrative errors in the documentation, rather than changing any of the terms of the stock option grants as automatically granted, we determined that there was no accounting charge to be recognized in connection with these corrections, as the correct measurement date was the date of grant as automatically established by the 1998 Directors' Option Plan, and the exercise price was the fair market value of our common stock on the correct measurement date.

Although we determined that there is no accounting charge resulting from the administrative correction, the administrative correction did result in an increase of the exercise price for each of the five grants. Four of such directors have expressly agreed to the correction to increase the exercise prices of certain of such grants to purchase 107,800 shares. The fifth director's option expired unexercised; therefore no such agreement was needed. Further, the three directors who exercised misdocumented grants have reimbursed us for the difference between the aggregate exercise price as misdocumented and as corrected, in the amounts of \$1,195, \$1,100 and \$1,272, respectively.

Related Proceedings

Between February 15, 2007 and March 2, 2007, three purported shareholder derivative lawsuits were filed in the United States District Court for the Northern District of California against certain of Coherent's current and former officers and directors. Coherent is named as a nominal defendant. The complaints generally allege that the defendants breached their fiduciary duties and violated the securities laws in connection with the granting of stock options, the accounting treatment for such grants, the issuance of allegedly misleading public statements and stock sales by certain of the individual defendants. On May 29, 2007, these lawsuits were consolidated under the caption *In re Coherent, Inc. Shareholder Derivative Litigation*, Lead Case No. C-07-0955-JF (N.D. Cal.). On June 25, 2007, plaintiffs filed an amended, consolidated complaint. The consolidated complaint asserts causes of action for alleged violations of federal securities laws, violations of California securities laws, breaches of fiduciary duty and/or aiding and abetting breaches of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, insider selling and misappropriation of information. The consolidated complaint seeks, among other relief, disgorgement and damages in an unspecified amount, an accounting, rescission of allegedly improper stock option grants, punitive damages and attorneys' fees and costs.

Our Board of Directors has appointed a Special Litigation Committee (SLC) comprised of independent director Sandeep Vij to investigate and evaluate the claims asserted in the derivative litigation and to determine what action(s) should be taken with respect to the derivative litigation. The SLC's investigation is ongoing.

In 2006, we were advised that the San Francisco District Office of the SEC was conducting an informal inquiry relating to our past granting of stock options. We are cooperating fully with the inquiry.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the SEC. The preparation of these financial statements 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 date of the financial statements and the reported

Edgar Filing: COHERENT INC - Form 10-Q

amounts of revenues and expenses during the reporting period. We have identified the following as the items that require the most significant judgment and often involve complex estimation: revenue recognition, accounting for long-lived assets (including goodwill and intangible assets), inventory valuation, warranty reserves, stock-based compensation and accounting for income taxes.

Revenue Recognition

We recognize revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists, the product has been delivered or the service has been rendered, the price is fixed or determinable and collection is probable. Revenue from product sales is recorded when all of the foregoing conditions are met and risk of loss and title passes to the customer. Our products typically include a one-year warranty and the estimated cost of product warranty claims (based on historical experience) is recorded at the time the sale is recognized. Sales to customers are generally not subject to any price protection or return rights.

The vast majority of our sales are made to original equipment manufacturers (OEMs), distributors, resellers and end-users in the non-scientific market. Sales made to these customers do not require installation of the products by us and are not subject to other post-delivery obligations, except in occasional instances where we have agreed to perform installation or provide training. In those instances, we defer revenue related to installation services or training until these services have been rendered. We allocate revenue from multiple element arrangements to the various elements based upon relative fair values, which is determined based on the price charged for each deliverable on a standalone basis.

Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected. Failure to obtain anticipated orders due to delays or cancellations of orders could have a material adverse effect on our revenue. In addition, pressures from customers to reduce our prices or to modify our existing sales terms may result in material harm to our revenue in future periods.

Our sales to distributors, resellers and end-user customers typically do not have customer acceptance provisions and only certain of our sales to OEM customers have customer acceptance provisions. Customer acceptance is generally limited to performance under our published product specifications. For the few product sales that have customer acceptance provisions because of higher than published specifications, (1) the products are tested and accepted by the customer at our site or by the customer's acceptance of the results of our testing program prior to shipment to the customer, or (2) the revenue is deferred until customer acceptance occurs.

Sales to end-users in the scientific market typically require installation and, thus, involve post-delivery obligations; however our post-delivery installation obligations are not essential to the functionality of our products. We defer revenue related to installation services until completion of these services.

For most products, training is not provided; therefore, no post-delivery training obligation exists. However, when training is provided to our customers, it is typically priced separately and recognized as revenue after these services have been provided.

Long-Lived Assets

We evaluate long-lived assets whenever events or changes in business circumstances or our planned use of assets indicate that their carrying amounts may not be fully recoverable or that their useful lives are no longer appropriate. Reviews are performed to determine whether the carrying values of assets are impaired based on comparison to either the discounted expected future cash flows (in the case of goodwill) or to the undiscounted expected future cash flows (for all other long-lived assets). If the comparison indicates that impairment exists, the impaired asset is written down to its fair value. Significant management judgment is required in the forecast of future operating results that are used in the preparation of expected discounted and undiscounted cash flows.

At June 30, 2007, we had \$119.0 million of goodwill and purchased intangible assets on our consolidated balance sheet. At June 30, 2007, we had \$127.6 million of property and equipment on our consolidated balance sheet. As no impairment indicators were present during the first nine months of fiscal 2007 except for an indicator related to the Auburn facility, we believe these values remain recoverable. In the first nine months of fiscal 2007, we evaluated the Auburn facility for potential impairment and determined that no impairment existed.

Edgar Filing: COHERENT INC - Form 10-Q

It is reasonably possible that the estimates of anticipated future net revenue, the remaining estimated economic life of the products and technologies, or both, could differ from those used to assess the recoverability of these assets. In that event, additional impairment charges or shortened useful lives of certain long-lived assets may be required.

Inventory Valuation

We record our inventory at the lower of cost (computed on a first-in, first-out basis) or market. We write-down our inventory to its estimated market value based on assumptions about future demand and market conditions. Inventory write-downs are generally recorded within guidelines set by management when the inventory for a device exceeds 12 months of its demand and when individual parts have been in inventory for greater than 12 months. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required which could materially affect our future results of operations. Due to rapidly changing forecasts and orders, additional write-downs for excess or obsolete inventory, while not currently expected, could be required in the future. In the event that alternative future uses of fully written down inventories are identified, we may experience better than normal profit margins when such inventory is sold. Differences between actual results and previous estimates of excess and obsolete inventory could materially affect our future results of operations. We write-down our demo inventory by amortizing the cost of demo inventory over a twenty month period starting from the fourth month after such inventory is placed in service.

Warranty Reserves

We provide warranties on certain of our product sales (generally one year) and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

Stock-Based Compensation

Effective October 2, 2005, we adopted the fair value recognition provisions of SFAS 123(R), requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected to use the modified prospective transition method as permitted by SFAS 123(R). SFAS 123(R) requires the use of option pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption was determined using a combination of historical volatility and market-based implied volatility.

Prior to October 2, 2005, our stock-based employee compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). We had a restatement of our condensed consolidated financial statements as described in Restatement of Condensed Consolidated Financial Statements. See also the explanatory note in Part I of this Form 10-Q and Note 3, Restatement of Condensed Consolidated Financial Statements, of the Notes to Condensed Consolidated Financial Statements. In accordance with SFAS 123(R), as of October 1, 2005, previously recorded deferred compensation of \$3,699,000 has been eliminated with a corresponding reduction to additional paid-in capital.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income tax provision (benefit) in each of the jurisdictions in which we operate. This process involves us estimating our current income tax provision (benefit) together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheets.

We record a valuation allowance to reduce our deferred tax assets to an amount that more likely than not will be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the allowance for the deferred tax asset would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the valuation allowance for the deferred tax asset would be charged to income in the period such determination was made.

Edgar Filing: COHERENT INC - Form 10-Q

In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial position.

KEY PERFORMANCE INDICATORS

The following is a summary of some of the quantitative performance indicators (as defined below) that may be used to assess our results of operations and financial condition:

| | Three Months Ended | | Change | % Change |
|---|--------------------|--|-------------|----------|
| | June 30, 2007 | July 1, 2006 (As Restated) (Dollars in thousands) | | |
| Bookings | \$ 139,187 | \$ 153,020 | \$ (13,833) | (9.0)% |
| Net sales - CLC | \$ 74,506 | \$ 72,177 | \$ 2,329 | 3.2% |
| Net sales - SLS | \$ 68,050 | \$ 76,663 | \$ (8,613) | (11.2)% |
| Gross profit as a percentage of net sales - CLC | 41.3% | 45.3% | (4.0)% | (8.8)% |
| Gross profit as a percentage of net sales - SLS | 39.8% | 44.1% | (4.3)% | (9.7)% |
| Research and development as a percentage of net sales | 13.6% | 12.6% | 1.0% | 7.6% |
| Income before income taxes | \$ 438 | \$ 15,126 | \$ (14,688) | (97.1)% |
| Cash provided by operating activities | \$ 9,913 | \$ 17,617 | \$ (7,704) | (43.7)% |
| Days sales outstanding in receivables | 63.4 | 61.8 | 1.6 | 2.6% |
| Days sales outstanding in inventories | 72.6 | 63.6 | 9.0 | 14.2% |
| Capital spending as a percentage of net sales | 3.6% | 3.2% | 0.4% | 13.1% |

| | Nine Months Ended | | Change | % Change |
|---|-------------------|--|-------------|----------|
| | June 30, 2007 | July 1, 2006 (As Restated) (Dollars in thousands) | | |
| Bookings | \$ 427,260 | \$ 431,013 | \$ (3,753) | (0.9)% |
| Net sales - CLC | \$ 211,453 | \$ 197,446 | \$ 14,007 | 7.1% |
| Net sales - SLS | \$ 229,136 | \$ 227,754 | \$ 1,382 | 0.6% |
| Gross profit as a percentage of net sales - CLC | 43.1% | 42.0% | 1.1% | 2.6% |
| Gross profit as a percentage of net sales - SLS | 40.7% | 45.7% | (5.0)% | (10.9)% |
| Research and development as a percentage of net sales | 12.8% | 12.4% | 0.4% | 3.3% |
| Income before income taxes | \$ 25,282 | \$ 37,118 | \$ (11,836) | (31.9)% |
| Cash provided by operating activities | \$ 49,849 | \$ 50,696 | \$ (847) | (1.7)% |
| Capital spending as a percentage of net sales | 4.0% | 3.0% | 1.0% | 32.0% |

Definitions and analysis of these performance indicators are as follows:

Bookings

Bookings represent orders expected to be shipped within 12 months and services to be provided pursuant to service contracts. While we generally have not experienced a significant rate of cancellation, bookings are generally cancelable by our customers without substantial penalty and, therefore, we can not assure all bookings will be converted to net sales.

Third quarter bookings decreased 9.0% and bookings for the nine months ended June 30, 2007 decreased 0.9% from the same periods one year ago. For the quarter, increases in the materials processing, scientific and government programs and OEM components and instrumentation markets were partially offset by decreases in the microelectronics and graphic arts and display markets. Year-to-date, decreases in the microelectronics, graphic arts and display and scientific and government programs markets were partially offset by increases in the OEM components and instrumentation and materials processing markets.

Bookings in the OEM components and instrumentation market increased slightly in the third quarter and increased significantly year-to-date primarily due to strong bioinstrumentation orders. Flow cytometry customers are consolidating their supply chains which offer opportunities to increase market share. The market potential of DNA sequencing and genomics is attracting new customers for applications in diagnostics and drug discovery. Bookings from medical OEM s were also slower in the third quarter following high volumes in the second quarter. The news in this market is more consolidation including the recent acquisition of German-based WaveLight AG by Alcon, Inc. We believe consolidation will lead to lower costs for vision correction systems, which we believe translates into higher adoption. Ultimately, this could benefit laser sales including those provided by Coherent.

Bookings in the materials processing market increased from the same periods one year ago, with Asia leading the way on new orders. The adoption of laser marking for product identification and textile marking maintained its strength, which translated into increased

demand for our CO₂ products, which provide optimal material response. Our emphasis is to further improve the cost of ownership that is critical to increased adoption. We are also expanding our product portfolio with the Matrix UV laser, which has been specifically designed for high volume materials processing applications such as trimming and marking. The introduction of our Highlight direct diode system at Lasers 2007 in Munich was well received. In addition, we received our first Highlight order for use in an automotive application.

Microelectronics bookings decreased from the comparable prior year periods primarily due to weakness in the advanced packaging market as the via drilling market remains depressed as ample capacity is currently deployed. Third quarter semi cap orders were similar to the second quarter with service orders remaining strong. As in several other markets, customers are expressing a desire to aggregate suppliers. We believe we are in a good position to capitalize on this trend given the strength and diversity of our product portfolio. The advanced packaging market posted encouraging numbers for existing and emerging applications. There are signs of recovery in the micro via market especially for high power UV lasers. Our new 14W Avia laser has demonstrated outstanding processing capabilities, especially for ceramic substrates. A sustained recovery will require current capacities for flip-chip packages to be consumed, which is projected to occur into 2008, and for another surge in cell phone complexity. In the flat panel display business, we experienced a number of push-outs and delays in new orders as the industry struggles with margin and capital investment issues. Given the higher average selling prices of our products in this market, flat panel display push-outs constituted the majority of our order shortfall in the third quarter. While the short-term results were unfavorable, further progress was made in the market for active matrix organic light emitting diode (AMOLED) yields. In conjunction with a leading customer, our development team has helped improve yields for AMOLED annealing close to the level of low-temperature polysilicon. This was a significant achievement since yield is among the pacing items governing deployment. The silicon singulation market appears ready to improve. We have received our first volume order for Avia lasers for micro-SD singulation. The shape of a micro-SD is not well suited to continuous blade cutting. A laser-based tool can easily trace the contour of the package. We expect power scaling of the laser to increase market prospects.

Bookings in the scientific and government programs market increased slightly in the third quarter and decreased year-to-date. Third quarter bookings rebounded due to improved funding conditions in the U.S. and Europe as well as increases from emerging markets in South America and Asia, which have historically lagged behind the U.S., Europe and Japan. There appear to be two trends emerging in the scientific markets. First, funding for life science research is outpacing all other basic research. This is not surprising given the aging populations in the Western world and longer life expectancies globally. Second, the scientific market also continues to be bifurcated between plug and play demand from the life sciences and high end performance for physical sciences research. The breadth and depth of our product portfolio allows us to address both groups.

Bookings in the graphic arts and display market decreased primarily due to its transition to low cost diode laser solutions, an area in which we do not participate. The majority of our graphic arts business came from direct diode computer to plate applications, consistent with past quarters. On the display side, our Mini-G OPS laser is gaining traction within the lightshow market. This could become an opportunity over the next few years.

Net Sales

Net sales include sales of lasers, precision optics, related accessories and service contracts. Net sales for the third fiscal quarter increased 3.2% in our CLC segment and decreased 11.2% in our SLS segment from the same quarter one year ago. Net sales for the first nine months of fiscal 2007 increased 7.1% in our CLC segment and 0.6% in our SLS segment from the same period one year ago. For a more complete description of the reasons for changes in net sales refer to the Results of Operations section of this quarterly report.

Gross Profit as a Percentage of Net Sales

Edgar Filing: COHERENT INC - Form 10-Q

Gross profit as a percentage of net sales (gross profit percentage) is calculated as gross profit for the period divided by net sales for the period. Gross profit percentage in the third fiscal quarter decreased from 45.3% to 41.3% in our CLC segment and decreased from 44.1% to 39.8% in our SLS segment from the same quarter one year ago. Gross profit percentage in the first nine months of fiscal 2007 increased from 42.0% to 43.1% in our CLC segment and decreased from 45.7% to 40.7% in our SLS segment from the same period one year ago. For a more complete description of the reasons for changes in gross profit refer to the Results of Operations section of this quarterly report.

Research and Development as a Percentage of Net Sales

Research and development as a percentage of net sales (R&D percentage) is calculated as research and development expense for the period divided by net sales for the period. Management considers R&D percentage to be an important indicator in managing our business as investing in new technologies is a key to future growth. R&D percentage increased to 13.6% from 12.6% in the third fiscal quarter and increased to 12.8% from 12.4% for the nine months ended June 30, 2007 from the same periods one year ago, respectively. For a more complete description of the reasons for changes in R&D percentage refer to the Results of Operations section of this quarterly report.

Net Cash Provided by Operating Activities

Net cash provided by operating activities shown on our Condensed Consolidated Statements of Cash Flows primarily represents the excess of cash collected from billings to our customers and other receipts over cash paid to our vendors for expenses and inventory purchases to run our business. This amount represents cash generated by current operations to pay for equipment, technology, and other investing activities, to repay debt, fund acquisitions, repurchase our common stock and for other financing purposes. We believe this is an important performance indicator since cash generation over the long term is essential to maintaining a healthy business and providing funds to help fuel growth. We believe generating positive cash from operations is an indication that our products are achieving a high level of customer satisfaction and that we are appropriately monitoring our expenses, inventory levels and cash collection efforts. For a more complete description of the reasons for changes in Net Cash Provided by Operating Activities refer to the Liquidity and Capital Resources section of this quarterly report.

Days Sales Outstanding in Receivables

We calculate days sales outstanding (DSO) in receivables as net receivables at the end of the period divided by net sales during the period and then multiplied by the number of days in the period, using 90 days for quarters. DSO in receivables indicates how well we are managing our collection of receivables, with lower DSO in receivables resulting in more cash flow available. The more money we have tied up in receivables, the less money we have available for research and development, acquisitions, expansions, marketing and other activities to grow our business. Our DSO in receivables for the third quarter of fiscal 2007 increased 1.6 days from the same quarter one year ago primarily due to a higher concentration of sales later in the quarter and increased receivables in Asia, which typically have longer payment terms.

Days Sales Outstanding in Inventories

We calculate DSO in inventories as net inventories at the end of the period divided by net sales of the period and then multiplied by the number of days in the period, using 90 days for quarters. DSO in inventories indicates how well we are managing our inventory levels, with lower DSO in inventories resulting in more cash flow available. The more money we have tied up in inventory, the less money we have available for research and development, acquisitions, expansions, marketing and other activities to grow our business. Our DSO in inventories for the third quarter of fiscal 2007 increased 9.0 days from the same quarter one year ago primarily due to higher levels of excimer and semiconductor inventories and due to the impact of foreign exchange rates.

Capital Spending as a Percentage of Net Sales

Capital spending as a percentage of net sales (capital spending percentage) is calculated as capital expenditures for the period divided by net sales for the period. Capital spending percentage indicates the extent to which we are expanding or improving our operations, including investments in technology. Management monitors capital spending levels as this assists management in measuring our cash flows, net of capital expenditures. Our capital spending percentage increased to 3.6% and 4.0% for the third quarter and nine months from 3.2% and 3.0%, respectively, for the same periods one year ago. The increase was primarily due to higher investments in information technology, manufacturing equipment and building improvements. We anticipate that capital spending for fiscal 2007 will be approximately 4% of net sales.

SIGNIFICANT EVENTS

In September 2005, our Board of Directors authorized a share repurchase program of up to 1.5 million shares of our common stock. Under the terms of the repurchase program, purchases could be made from time to time in both the open market and in private transactions, as conditions warrant. During fiscal 2006, we purchased and cancelled a total of 721,942 shares of our common stock for approximately \$22.3 million. The program was suspended during the first quarter of fiscal 2007 due to our internal stock option investigation and expired on September 30, 2007.

On February 21, 2006, we entered into a definitive agreement to acquire Excel Technology, Inc. (Excel), a manufacturer of photonics-based solutions, consisting of laser systems and electro-optical components, primarily for industrial, commercial, and scientific applications. The acquisition was to be an all-cash transaction at a price of \$30.00 per share of Excel common stock, for a total approximate offer value of \$376 million before fees and transaction costs. The completion of the acquisition was subject to customary closing conditions, including regulatory approvals. On October 25, 2006 we received a prohibition order from the German Federal Cartel Office (FCO) regarding our proposed acquisition. The acquisition had previously been approved by antitrust authorities in the United States. None of the multiple remedy proposals offered by Coherent to the FCO addressing the overlap in the low-power

carbon-dioxide laser market were satisfactory to the FCO. On November 1, 2006, we received notice from Excel that it was terminating the merger agreement. As a result, our fourth quarter fiscal 2006 results included a pre-tax charge of \$5.9 million for previously capitalized costs related to the proposed Excel acquisition. In addition, our results for the first quarter of fiscal 2007 include a pretax charge of \$0.3 million for additional costs incurred during the period related to the terminated merger agreement.

On March 10, 2006 we issued \$200.0 million of 2.75% convertible subordinated notes due March 2011. The notes were unsecured and subordinate to all existing and future senior debt. The notes were scheduled to mature on March 1, 2011, unless earlier redeemed or converted. Interest on the notes was payable in cash semi-annually in arrears on March 1 and September 1 of each year.

On December 15, 2006, we received a letter from U.S. Bank National Association (the trustee) for the holders of the outstanding principal amount of 2.75% convertible subordinated notes due 2011 stating that we had violated certain provisions in the Indenture dated March 13, 2006 (the Indenture) as a result of our failure to file our annual report for fiscal 2006 with the SEC. The indentures provided that such a default could be cured by making that filing with the SEC within 60 days after the receipt by us of the notice of default. The indentures also provided that such a default, if not cured by that date, would give certain holders and the trustee the right to accelerate the maturity of the notes. We did not cure the default within 60 days after the receipt by us of the notice of default. On August 17, 2007, as amended by an addendum delivered on August 20, 2007, we received a letter from the trustee under the Indenture declaring the principal amount and accrued and unpaid interest, plus additional interest under the notes, to be immediately due and payable pursuant to the Indenture due to our failure to file reports required to be filed with the SEC and delivered to the trustee under the Indenture and Sections 13 and 15(d) of the Securities Exchange Act of 1934, as amended. The aggregate amount due and payable under the notes including interest was \$202,984,067, which we paid on August 21, 2007.

In April 2007, we acquired Nuvonyx, Inc., a technology leader in high-power laser diode components, arrays, and industrial laser systems for materials processing and defense applications for approximately \$14.0 million in cash, net of acquisition costs of \$0.3 million. Nuvonyx produces high power arrays with powers in excess of 50 Kilowatts through its proprietary cooling and stacking technologies. The industrial laser systems are used for cladding and hardening of metals, joining materials, and other materials processing applications.

In September 2007, we sold substantially all of the net assets of our U.K. subsidiary, Coherent Imaging Optics Limited (CIOL), to CVI Laser (CVI) for \$6.5 million, resulting in an after-tax gain on the sale of \$0.8 million. In September 2007, we sold our Condensa building in Santa Clara, California for approximately \$24.8 million, resulting in a capital gain of approximately \$3.6 million in the fourth quarter of fiscal 2007. In September 2007, we also sold our Auburn campus in Auburn, California, for approximately \$9.8 million, resulting in a capital loss of approximately \$12.6 million in the fourth quarter of fiscal 2007.

On December 18, 2007, we announced that the Securities and Exchange Commission (SEC) notified us that it had denied our motion to stay the decision of The NASDAQ Stock Market LLC (Nasdaq), to suspend and delist our common stock. Therefore, effective at the opening of business on Wednesday, December 19, 2007, our common stock was suspended from trading on the Nasdaq Global Market, and was subsequently delisted. Following our delisting from the Nasdaq Global Market, we began trading on the Pink Sheet Electronic Quotation Service.

RESULTS OF OPERATIONS**CONSOLIDATED SUMMARY**

The following table sets forth, for the periods indicated, the percentage of total net sales represented by the line items reflected in our condensed consolidated statements of operations:

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------|--------------------|-----------------|-------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 59.9% | 55.7% | 58.5% | 56.4% |
| Gross profit | 40.1% | 44.3% | 41.5% | 43.6% |
| Operating expenses: | | | | |
| Research and development | 13.6% | 12.6% | 12.8% | 12.4% |
| In-process research and development | 1.5% | % | 0.5% | 0.1% |
| Selling, general and administrative | 27.4% | 22.3% | 24.8% | 22.4% |
| Restructuring and other charges | % | 0.1% | 0.1% | % |
| Amortization of intangible assets | 1.5% | 1.6% | 1.3% | 1.7% |
| Total operating expenses | 44.0% | 36.6% | 39.5% | 36.6% |
| Income (loss) from operations | (3.9)% | 7.7% | 2.0% | 7.0% |
| Other income (expense): | | | | |
| Interest and dividend income | 4.2% | 3.2% | 4.2% | 2.2% |
| Interest expense | (1.4)% | (1.2)% | (1.3)% | (0.6)% |
| Other net | 1.4% | 0.4% | 0.8% | 0.1% |
| Total other income, net | 4.2% | 2.4% | 3.7% | 1.7% |
| Income before income taxes | 0.3% | 10.1% | 5.7% | 8.7% |
| Provision for income taxes | 0.8% | 2.6% | 1.8% | 2.6% |
| Net income (loss) | (0.5)% | 7.5% | 3.9% | 6.1% |

Net loss for the third quarter of fiscal 2007 was \$0.8 million (\$0.02 per diluted share) including an in-process research and development (IPR&D) charge of \$2.2 million associated with the purchase of Nuvonyx during the third quarter of fiscal 2007 and \$1.8 million of after-tax costs related to our internal stock option investigation and litigation. Third quarter fiscal 2007 results also included approximately \$1.6 million of after-tax stock-based compensation expense as required by SFAS 123(R). Net income for the third quarter of fiscal 2006 was \$11.2 million (\$0.36 per diluted share) including a \$0.6 million tax benefit from increased use of tax credits and \$0.4 million in after-tax Excel Technology pre-merger integration related costs. Third quarter fiscal 2006 results also included approximately \$1.6 million of after-tax stock-based compensation expense as required by SFAS 123(R). Net income for the first nine months of fiscal 2007 was \$17.3 million (\$0.54 per diluted share) including \$5.4 million of after-tax costs related to our internal stock option investigation, an in-process research and development (IPR&D) charge of \$2.2 million associated with the purchase of Nuvonyx during the third quarter of fiscal 2007 and \$0.2 million in after-tax Excel Technology integration related costs. Results for the first nine months of fiscal 2007 also included approximately \$6.2 million of after-tax stock-based compensation expense as required by SFAS 123(R). Net income for the first nine months of fiscal 2006 was \$26.1 million (\$0.83 per diluted share) including a \$2.4 million tax benefit from increased use of tax credits, \$0.5 million in after-tax Excel Technology pre-merger integration related costs, an after-tax facility closure charge of \$0.4 million and an IPR&D charge of \$0.4 million associated with the purchase of the assets of Iolon during the first quarter of fiscal 2006. Results for the first nine months of fiscal 2006 also included approximately \$8.6 million of after-tax stock-based compensation expense as required by SFAS 123(R).

NET SALES**Market Application**

The following tables set forth, for the periods indicated, the amount of net sales and their relative percentages of total net sales by market application (dollars in thousands):

| | Three Months Ended | | | |
|------------------------------------|--------------------|-------------------------------------|-------------------|-------------------------------------|
| | June 30, 2007 | | July 1, 2006 | |
| | Amount | Percentage of total net sales | Amount | Percentage of total net sales |
| Consolidated: | | | | |
| Microelectronics | \$ 47,582 | 33.4% | \$ 56,729 | 37.9% |
| OEM components and instrumentation | 40,082 | 28.1% | 34,341 | 23.0% |
| Materials processing | 25,298 | 17.7% | 19,831 | 13.3% |
| Scientific and government programs | 25,932 | 18.2% | 27,960 | 18.7% |
| Graphic arts and display | 3,714 | 2.6% | 10,663 | 7.1% |
| Total | \$ 142,608 | 100.0% | \$ 149,524 | 100.0% |

| | Nine Months Ended | | | |
|------------------------------------|-------------------|-------------------------------------|-------------------|-------------------------------------|
| | June 30, 2007 | | July 1, 2006 | |
| | Amount | Percentage of total net sales | Amount | Percentage of total net sales |
| Consolidated: | | | | |
| Microelectronics | \$ 157,080 | 35.5% | \$ 154,542 | 36.2% |
| OEM components and instrumentation | 111,109 | 25.1% | 97,849 | 22.9% |
| Materials processing | 69,864 | 15.8% | 57,377 | 13.5% |
| Scientific and government programs | 89,481 | 20.3% | 86,446 | 20.3% |
| Graphic arts and display | 14,699 | 3.3% | 30,292 | 7.1% |
| Total | \$ 442,233 | 100.0% | \$ 426,506 | 100.0% |

By market application, quarterly decreases in the microelectronics, graphic arts and display and scientific and government programs markets were partially offset by increases in the OEM components and instrumentation and materials processing markets. Year-to-date increases in the OEM components and instrumentation, materials processing, scientific and government programs and microelectronics markets were partially offset by decreases in the graphic arts and display market.

Quarterly

The quarterly decrease in the microelectronics market of \$9.1 million, or 16%, was primarily due to lower demand in via drilling applications. Graphic arts and display market sales for the quarter decreased \$6.9 million, or 65%, primarily due to lower shipments of individually addressable semiconductor bar for reprographics applications. The decrease in scientific and government program sales of \$2.0 million, or 7%,

Edgar Filing: COHERENT INC - Form 10-Q

was due to lower demand from one-off universities and research centers. OEM components and instrumentation sales increased \$5.7 million, or 17%, due primarily to increased bioinstrumentation and medical imaging sales. The increase in materials processing market sales of \$5.5 million, or 28%, was primarily due to higher commercial laser shipments for non-metal cutting and marking applications.

Year-to-date

The increase in OEM components and instrumentation sales of \$13.3 million, or 14%, in the nine months ended June 30, 2007 was due primarily to increased bioinstrumentation and other medical application sales. The year-to-date increase in the materials processing market of \$12.5 million, or 22%, was primarily due to higher commercial laser shipments for marking applications. The increase in scientific and government program sales of \$3.0 million, or 4%, for the nine months was due to higher demand for pumping, measuring and advanced research applications used by universities. The increase in the microelectronics market of \$2.6 million, or 2%, during the first nine months of fiscal 2007 was primarily due to higher sales in PCB direct writing applications and solar panel scribing applications. Graphic arts and display market sales for the nine months decreased \$15.6 million, or 52%, primarily due to lower shipments of individually addressable semiconductor bar for reprographics applications.

Although we continue to have a sizeable backlog of orders, current market conditions make it difficult to predict future orders.

Segments

The following tables set forth, for the periods indicated, the amount of net sales and their relative percentages of total net sales by segment (dollars in thousands):

| | Three Months Ended | | | |
|----------------------|--------------------|-------------------------------|--------------|-------------------------------|
| | June 30, 2007 | | July 1, 2006 | |
| | Amount | Percentage of total net sales | Amount | Percentage of total net sales |
| Consolidated: | | | | |
| CLC | \$ 74,506 | 52.3% | \$ 72,177 | 48.2% |
| SLS | 68,050 | 47.7% | 76,663 | 51.3% |
| Others | 52 | 0.0% | 684 | 0.5% |
| Total | \$ 142,608 | 100.0% | \$ 149,524 | 100.0% |

| | Nine Months Ended | | | |
|----------------------|-------------------|-------------------------------|--------------|-------------------------------|
| | June 30, 2007 | | July 1, 2006 | |
| | Amount | Percentage of total net sales | Amount | Percentage of total net sales |
| Consolidated: | | | | |
| CLC | \$ 211,453 | 47.8% | \$ 197,446 | 46.3% |
| SLS | 229,136 | 51.8% | 227,754 | 53.4% |
| Others | 1,644 | 0.4% | 1,306 | 0.3% |
| Total | \$ 442,233 | 100.0% | \$ 426,506 | 100.0% |

Net sales for the third quarter of fiscal 2007 decreased by \$6.9 million, or 5%, compared to the third quarter of fiscal 2006, with decreases of \$8.6 million, or 11%, in the SLS segment and increases of \$2.3 million, or 3%, in the CLC segment. Net sales for the nine months ended June 30, 2007 increased by \$15.7 million, or 4%, compared to the same period one year ago, with increases of \$14.0 million, or 7%, in the CLC segment and increases of \$1.4 million, or 1%, in the SLS segment.

Quarterly

The quarterly decrease in our SLS segment sales was primarily due to decreases in the microelectronics market for via drilling applications, lower scientific applications sales to universities and lower semiconductor applications sales as well as lower excimer shipments in the microelectronics and materials processing markets, partially offset by higher sales of Chameleon systems to the Scientific market. The quarterly increase in our CLC segment sales was primarily due to increased sales for PCB direct writing applications, semiconductor wafer inspection, flow cytometry and medical imaging as well as the acquisition of Nuvonyx in April 2007, partially offset by decreases in semiconductor applications.

Year-to-date

The year-to-date increase in our CLC segment sales was primarily due to increased bioinstrumentation sales in the OEM components and instrumentation market, higher service revenue, higher sales for PCBA applications, semiconductor wafer inspection, marking and cutting applications and higher thermal imaging sales as well as the acquisition of Nuvonyx in April 2007, partially offset by lower sales for via drilling applications. The year-to-date increase in our SLS segment sales was primarily due to increased scientific market sales, partially offset by decreases in the microelectronics market for via drilling applications.

GROSS PROFIT

Consolidated

Our gross profit rate decreased to 40.1% from 44.3% in the third fiscal quarter and decreased to 41.5% from 43.6% for the nine months ended June 30, 2007, compared to the same periods one year ago.

The third quarter 4.2% decrease in gross profit was primarily due to less favorable product and market mix (4.0%), higher warranty and installation (0.9%) costs, and higher other costs including freight and packaging (0.3%), partially offset by lower rework costs and improved yields (0.9%).

The gross profit decrease of 2.1% during the first nine months of fiscal 2007 was primarily due to less favorable product and market mix (2.6%) and higher warranty and installation (0.9%) costs, partially offset by improved yields and the results of reliability improvement efforts (1.4%).

Our gross profit rate has been and will continue to be affected by a variety of factors including market mix, manufacturing efficiencies, excess and obsolete inventory write-downs, warranty costs, pricing by competitors or suppliers, new product introductions, production volume, customization and reconfiguration of systems, commodity prices and foreign currency fluctuations.

CLC

The gross profit rate in our CLC segment decreased to 41.3% from 45.3% in the third fiscal quarter and increased to 43.1% from 42.0% for the nine months ended June 30, 2007, compared to the same periods one year ago.

The third quarter 4.0% decrease in our CLC segment was primarily due to less favorable product mix (4.7%) due to lower sales in the graphic arts and display market as well as the microelectronics market and higher warranty expenses (0.6%), partially offset by improved yields (1.2%) and lower other costs (0.2%) due to lower inventory provisions.

The year-to-date 1.1% increase in our CLC segment is primarily due to improved yields due to reliability efforts (2.6%) and lower other costs (0.6%) due to lower inventory provisions, partially offset by unfavorable product mix (1.3%) due to lower sales in the graphic arts and display and microelectronics markets and higher warranty costs (0.8%).

SLS

Edgar Filing: COHERENT INC - Form 10-Q

The gross profit rate in our SLS segment decreased to 39.8% from 44.1% in the third fiscal quarter and decreased to 40.7% from 45.7% for the nine months ended June 30, 2007, compared to the same periods one year ago.

The third quarter 4.3% decrease in our SLS segment was primarily due to less favorable product mix (3.2%) within the microelectronics market, higher other costs (0.8%) due to inventory provisions and higher warranty and installation costs (1.1%), partially offset by lower rework costs (0.8%).

The year-to-date 5.0% decrease in our SLS segment was primarily due to less favorable product mix (3.5%) within the microelectronics market, in particular the flat panel display market, higher warranty and installation costs (1.0%) due to increases in installations of custom systems and higher warranty costs associated with new products and higher other costs (0.6%) due to higher inventory provisions and freight costs.

OPERATING EXPENSES:

| | Three Months Ended | | July 1, 2006 | |
|-------------------------------------|------------------------|-----------------|--------------|-----------------|
| | June 30, 2007 | Percentage of | Amount | Percentage of |
| | Amount | total net sales | | total net sales |
| | (As Restated) | | | |
| | (Dollars in thousands) | | | |
| Research and development | \$ 19,337 | 13.6% | \$ 18,844 | 12.6% |
| In-process research and development | 2,200 | 1.5% | | % |
| Selling, general and administrative | 39,095 | 27.4% | 33,325 | 22.3% |
| Restructuring and other charges | | % | 187 | 0.1% |
| Amortization of intangible assets | 2,085 | 1.5% | 2,344 | 1.6% |
| Total operating expenses | \$ 62,717 | 44.0% | \$ 54,700 | 36.6% |

| | Nine Months Ended | | July 1, 2006 | |
|-------------------------------------|------------------------|-----------------|--------------|-----------------|
| | June 30, 2007 | Percentage of | Amount | Percentage of |
| | Amount | total net sales | | total net sales |
| | (As Restated) | | | |
| | (Dollars in thousands) | | | |
| Research and development | \$ 56,543 | 12.8% | \$ 52,788 | 12.4% |
| In-process research and development | 2,200 | 0.5% | 690 | 0.1% |
| Selling, general and administrative | 109,718 | 24.8% | 95,333 | 22.4% |
| Restructuring and other charges | 248 | 0.1% | 97 | 0.0% |
| Amortization of intangible assets | 5,978 | 1.3% | 7,262 | 1.7% |
| Total operating expenses | \$ 174,687 | 39.5% | \$ 156,170 | 36.6% |

Research and development (R&D) expenses increased \$0.5 million, or 3%, during the fiscal quarter ended June 30, 2007 and increased \$3.8 million, or 7%, during the nine months ended June 30, 2007 compared to the same periods one year ago. The third fiscal quarter increase is primarily due to higher project spending for tooling and supplies (\$1.0 million) and higher charges for deferred compensation plan liability gains (\$0.4 million) partially offset by higher net reimbursements from customers for development projects (\$0.9 million). The year-to-date increase is primarily due to higher headcount related spending (\$2.1 million), higher project spending for tooling and supplies (\$1.9 million) and higher charges for deferred compensation plan liability gains (\$0.5 million), partially offset by lower consulting spending for projects (\$0.5 million). On a quarterly segment basis, CLC project spending increases of \$1.4 million were partially offset by \$1.0 million lower project spending in SLS. On a year-to-date segment basis, CLC project spending increased \$3.5 million and SLS project spending was unchanged.

The in-process research and development (IPR&D) charge recognized in the three and nine months ended June 30, 2007, resulted from our acquisition of Nuvonyx. One Nuvonyx project is expected to become commercially viable in fiscal 2008 with approximately \$0.9 million of estimated expenditures to complete and the other is expected to become commercially viable in fiscal 2009 with approximately \$2.5 million of estimated expenditures to complete. The in-process research and development (IPR&D) charge recognized in the nine months ended July 1, 2006 resulted from our acquisition of Iolon.

Selling, general and administrative (SG&A) expenses increased \$5.8 million, or 17% during the third fiscal quarter of 2007 and increased \$14.4 million, or 15%, in the nine months ended June 30, 2007 compared to the comparable periods one year ago. The third quarter increase is primarily due to \$2.6 million of costs related to our internal stock option investigation, \$1.9 million higher information technology spending, including the write-off of previously capitalized software and facilities investments, \$1.6 million higher gains on deferred compensation plan liabilities, \$1.2 million higher headcount related spending and \$0.2 million higher other spending, partially offset by \$1.1 million lower stock compensation expense under SFAS 123R and \$0.6 million lower Excel integration. The year-to-date increase is primarily due to \$8.5 million of costs related to our internal stock option investigation, \$3.8 million higher headcount related spending, \$2.1 million higher charges due to higher

Edgar Filing: COHERENT INC - Form 10-Q

gains on deferred compensation plan liabilities, \$2.0 million higher information technology spending, including the write-off of previously capitalized software and facilities investments and \$0.8 million other spending, partially offset by \$1.9 million lower stock-based compensation expense under SFAS 123(R) and \$0.9 million lower Excel integration costs. On a quarterly segment basis, SG&A expenses increased by \$1.5 million for CLC and \$1.3 million for the SLS segment due to increased headcount related spending and higher information technology spending as well as increased \$3.0 million in corporate and other, primarily due to \$2.6 million of costs related to our internal stock option investigation. On a year-to-date segment basis, SG&A expenses increased by \$3.3 million for CLC and \$1.0 million for the SLS segment due to increased headcount related spending and higher information technology spending as well as increased \$10.1 million in corporate and other primarily due to \$8.5 million of costs related to our internal stock option investigation..

Restructuring and other charges decreased \$0.2 million during the three months ended June 30, 2007 and increased \$0.2 million during the nine months ended June 30, 2007 compared to the same prior year periods. The third quarter decrease is due to lower adjustments to the estimated contractual obligation for lease and other facility costs of a previously vacated building, net of estimated sublease income. The year-to-date increase is due to a \$0.4 million write-off of Excel acquisition-related costs partially offset by \$0.2 million lower adjustment of the estimated contractual obligation for lease and other facility costs of a previously vacated building, net of estimated sublease income.

Amortization of intangible assets decreased \$0.3 million, or 11%, and \$1.3 million, or 18%, during the three and nine months ended June 30, 2007, respectively, compared to the same prior year periods one year ago. The decreases were primarily due to lower amortization of intangibles related to our 2005 TuiLaser acquisition, partially offset by amortization of intangibles related to our April 2007 Nuvonyx acquisition.

OTHER INCOME (EXPENSE)

Other income, net of other expense, increased \$2.5 million and \$9.2 million during the three and nine months ended June 30, 2007 compared to the same periods one year ago. The third quarter increase was primarily due to higher investment gains, net of expenses, associated with our deferred compensation plans (\$1.9 million) and higher interest income (\$1.3 million) as a result of higher cash, cash equivalents and short-term investments balances and higher returns, partially offset by lower foreign currency exchange net losses (\$0.4 million) and lower sublease net income (\$0.2 million). The year-to-date increase was primarily due to higher interest income (\$8.9 million) as a result of higher cash, cash equivalents and short-term investments balances and higher returns, \$2.5 million higher investment gains, net of expenses, associated with our deferred compensation plans and lower foreign currency exchange net losses (\$1.2 million), partially offset by higher interest expense (\$2.9 million) primarily due to interest on the convertible subordinated notes and lower sublease net income (\$0.2 million).

INCOME TAXES

The effective tax rate on income before income taxes for the third quarter of fiscal 2007 of 274% was higher than the statutory rate of 35.0% primarily due to permanent differences related to deemed dividend inclusions under the Subpart F tax rules and the non-deductibility of IPR&D related to the Nuvonyx acquisition, partially offset by the benefit of foreign tax credits and research and development tax credits. The effective tax rate on income before income taxes for the nine months ended June 30, 2007 of 31.7% was lower than the statutory rate of 35.0% primarily due to the benefit of foreign tax credits and research and development tax credits, partially offset by permanent differences related to deemed dividend inclusions under the Subpart F tax rules and the non-deductibility of IPR&D related to the Nuvonyx acquisition.

The effective tax rate on income before income taxes for the third quarter of fiscal 2006 of 25.7% was lower than the statutory rate of 35.0% primarily due to the use of tax credits. The effective tax rate on income before income taxes for the nine months ended July 1, 2006 of 29.7% was lower than the statutory rate of 35.0% primarily due to the use of tax credits, as well as a benefit of \$1.8 million resulting from the consolidation of two wholly-owned subsidiaries in Japan, partially offset by the write-off of deferred tax assets. The income of one of the Japanese subsidiaries and a portion of the income of its German parent that were previously treated as permanently reinvested were deemed distributed to the United States and the income and associated tax credits of these entities were currently reported for U.S. tax purposes.

STOCK-BASED COMPENSATION

Edgar Filing: COHERENT INC - Form 10-Q

Effective October 2, 2005, we adopted the fair value recognition provisions of SFAS 123(R), requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected to use the modified prospective transition method as permitted by SFAS 123(R). Under this transition method, stock-based compensation expense for fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 1, 2005, based on the fair value at the applicable measurement date estimated in accordance with the original provisions of SFAS 123, as adjusted for estimated forfeitures. Stock-based compensation expense for all stock-based compensation awards granted subsequent to October 1, 2005 was based on the fair value at the applicable measurement date estimated in accordance with the provisions of SFAS 123(R).

Total pretax compensation cost for our option plan in the third quarter of fiscal 2007 was \$1.7 million. Total pretax compensation cost for our option and ESPP plans in the nine months ended June 30, 2007 was \$6.1 million and \$0.9 million, respectively. Total pretax compensation cost for our restricted stock plan and performance restricted stock plan in the third quarter of fiscal 2007 was \$0.5 million and (\$0.2) million, respectively. Total pretax compensation cost for our restricted stock plan and performance restricted stock plan in the nine months ended June 30, 2007 was \$1.4 million and \$0.1 million, respectively. Total pretax compensation cost for our option and ESPP plans in the third quarter of fiscal 2006 was \$2.2 million and \$0.4 million, respectively. Total pretax compensation cost for our option and ESPP plans in the nine months ended July 1, 2006 was \$8.3 million and \$1.0 million, respectively. Total pretax compensation cost for our restricted stock plan and performance restricted stock plan in the third quarter of fiscal 2006 was \$0.4 million and \$0.2 million, respectively. Total pretax compensation cost for our restricted stock plan and performance restricted stock plan in the nine months ended July 1, 2006 was \$0.9 million and \$0.2 million, respectively. During the third quarter of fiscal 2007, \$0.2 million for all stock plans was capitalized into inventory, \$0.4 million was amortized to cost of sales and \$0.3 million remained in inventory at June 30, 2007. At June 30, 2007, the total compensation cost related to unvested stock-based options and awards granted to employees under our stock option plans but not yet recognized was approximately \$6.4 million, net of estimated forfeitures of \$0.4 million. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 1.2 years and will be adjusted for subsequent changes in estimated forfeitures. At June 30, 2007, there was no compensation cost related to options to purchase common shares under the ESPP but not yet recognized; \$0.5 million was written off in the second quarter of

fiscal 2007 as the stock purchase plan was put on hold and employee contributions made to date were returned while the Special Committee conducted a voluntary review of our historical stock option practices. We had 262,915 shares of restricted stock outstanding at June 30, 2007 and 299,044 shares outstanding at September 30, 2006.

During the quarter ended June 30, 2007, our Board of Directors approved an extension of the exercise period to December 31, 2007 for 210,088 fully vested stock options previously granted by the Company to employees. As a result, we recorded approximately \$0.5 million in compensation expense related to the stock option modification during the second quarter of fiscal 2007. During the quarter and nine months ended June 30, 2007, we recorded less than \$0.1 million and \$0.1 million, respectively, in compensation expense for cash payments to former employees for options that were not able to be exercised due to the internal stock option investigation.

FINANCIAL CONDITION

LIQUIDITY AND CAPITAL RESOURCES

Sources and Uses of Cash

Historically, our primary source of cash has been provided through operations. Other recent sources of cash include proceeds from our convertible subordinated note offering, proceeds received from the sale of stock through employee stock option and purchase plans, as well as through debt borrowings. Our historical uses of cash have primarily been for capital expenditures, acquisitions of businesses and technologies, payments of principal and interest on outstanding debt obligations and the repurchase of our common stock. Supplemental information pertaining to our historical sources and uses of cash is presented as follows and should be read in conjunction with our condensed consolidated statements of cash flows and the notes to condensed consolidated financial statements:

| | Nine Months Ended | |
|--|--------------------------|---------------------|
| | June 30, 2007 | July 1, 2006 |
| | (As Restated) | |
| | (in thousands) | |
| Net cash provided by operating activities | \$ 49,849 | \$ 50,696 |
| Sales of shares under employee stock plans | 3,783 | 19,025 |
| Net proceeds from convertible subordinated notes | | 194,433 |
| Repurchase of common stock | | (22,250) |
| Capital expenditures | (17,713) | (12,938) |
| Acquisition of businesses, net of cash acquired | (14,175) | (5,214) |
| Net payments on debt borrowings | (215) | (12,741) |

Net cash provided by operating activities decreased by \$0.8 million for the nine months ended June 30, 2007 compared to the same period one year ago. The decrease was primarily due to lower net income, lower cash flows from prepaids and other current assets, inventories and accounts payable and higher deferred taxes partially offset by higher cash flows from accounts receivable, other current liabilities, income taxes payable and accounts receivable. We believe that cash provided by operating activities will be adequate to cover our working capital needs, debt service requirements and planned capital expenditures for at least the next 12 months to the extent such items are known or are reasonably determinable based on current business and market conditions. However, we may elect to finance certain of our capital expenditure requirements through borrowings under our bank credit facilities or other sources of capital. We continue to follow our strategy to further strengthen our financial position by using available cash flow to fund operations.

We intend to continue pursuing acquisition opportunities at valuations we believe are reasonable based upon market conditions. However, we cannot accurately predict the timing, size and success of our acquisition efforts or our associated potential capital commitments. Furthermore, we cannot assure you that we will be able to acquire businesses on terms acceptable to us. We expect to fund future acquisitions through unrestricted cash balances and cash flows from operations. If required, we will look for additional borrowings or consider the issuance of securities. The extent to which we will be willing or able to use our common stock to make acquisitions will depend on its market value at the time and the willingness of potential sellers to accept it as full or partial payment.

Additional sources of cash available to us included a multi-currency line of credit and bank credit facilities totaling \$10.8 million as of June 30, 2007, of which \$10.8 million was unused and available. These credit facilities were used in Europe during the nine months ended June 30, 2007.

Edgar Filing: COHERENT INC - Form 10-Q

Our ratio of current assets to current liabilities was 2.3:1 at June 30, 2007 compared to 6.0:1 at September 30, 2006. The decrease in our ratio from September 30, 2006 to June 30, 2007 is primarily due to the reclassification of our convertible subordinated notes from

noncurrent to current at June 30, 2007 and higher other current liabilities and taxes payable partially offset by increases in cash equivalents and short-term investments, prepaids and other assets, deferred tax assets and inventories. Our cash position, short-term investments, working capital and current debt obligations are as follows:

| | June 30, 2007 | September 30, 2006 |
|----------------------------------|------------------|-----------------------|
| | (in thousands) | |
| Cash and cash equivalents | \$ 338,899 | \$ 445,231 |
| Short-term investments | 179,486 | 48,767 |
| Restricted cash, current | 2,460 | |
| Working capital | 472,926 | 630,817 |
| Total debt obligations - current | 199,798 | 8 |

Current Debt Obligations and Restricted Cash

On March 10, 2006 we issued \$200.0 million of 2.75% convertible subordinated notes due March 2011. The notes were unsecured and subordinate to all existing and future senior debt. The notes were scheduled to mature on March 1, 2011, unless earlier redeemed or converted. Interest on the notes was payable in cash semi-annually in arrears on March 1 and September 1 of each year.

On December 15, 2006, we received a letter from U.S. Bank National Association (the trustee) for the holders of the outstanding principal amount of 2.75% convertible subordinated notes due 2011 stating that we had violated certain provisions in the Indenture dated March 13, 2006 (the Indenture) as a result of our failure to file our annual report for fiscal 2006 with the SEC. The indentures provided that such a default could be cured by making that filing with the SEC within 60 days after the receipt by us of the notice of default. The indentures also provided that such a default, if not cured by that date, would give certain holders and the trustee the right to accelerate the maturity of the notes. We did not cure the default within 60 days after the receipt by us of the notice of default. On August 17, 2007, as amended by an addendum delivered on August 20, 2007, we received a letter from the trustee under the Indenture declaring the principal amount and accrued and unpaid interest, plus additional interest under the notes, to be immediately due and payable pursuant to the Indenture due to our failure to file reports required to be filed with the SEC and delivered to the trustee under the Indenture and Sections 13 and 15(d) of the Securities Exchange Act of 1934, as amended. As a result of the violation, the convertible subordinated notes have been classified as current liabilities as of June 30, 2007. The aggregate amount due and payable under the notes including interest was \$202,984,067, which we paid on August 21, 2007.

As part of our tender offer to purchase the remaining outstanding shares of Lambda Physik, we were required by local regulations to have funds available for the offer in an account located in Germany. As of June 30, 2007, we had \$2.5 million restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik, which are included in current restricted cash on our consolidated balance sheets. As of September 30, 2006, we had \$2.5 million restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik, which are included in non-current restricted cash on our consolidated balance sheets. At June 30, 2007 and September 30, 2006, we also had \$1.2 million and \$1.2 million, respectively, in non-current restricted cash related to outstanding long-term debt at a subsidiary. At June 30, 2007, we had \$0.6 million cash deposits related to pending facility sales restricted.

Contractual Obligations and Off-Balance Sheet Arrangements

Edgar Filing: COHERENT INC - Form 10-Q

We have no off-balance sheet arrangements as defined under Regulation S-K of the Securities Act of 1933. Information regarding our long-term debt payments, operating lease payments, obligations under SFAS 143, purchase commitments with suppliers and purchase obligations is provided in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the fiscal year ended September 30, 2006. There have been no material changes in contractual obligations since September 30, 2006. Information regarding our other financial commitments at June 30, 2007 is provided in the notes to the condensed consolidated financial statements in this filing.

Changes in Financial Condition

Cash provided by operating activities during the nine months ended June 30, 2007 was \$49.8 million, which included net income of \$17.3 million, depreciation and amortization of \$25.2 million, stock-based compensation expense of \$8.9 million, cash provided by operating assets and liabilities of \$3.7 million, IPR&D of \$2.2 million and other items aggregating \$2.5 million, partially offset by increases in net deferred tax assets of \$10.0 million.

Cash used in investing activities during the nine months ended June 30, 2007 was \$165.6 million, which included \$130.7 million, net, purchases of available-for-sale securities, \$17.7 million used to acquire property and equipment, invest in information technology and improve buildings, \$14.2 million used for acquisitions, \$2.8 million premiums paid on life insurance in our deferred compensation plan and \$0.4 million other, partially offset by \$0.2 million proceeds from dispositions of property and equipment.

Cash provided by financing activities during the nine months ended June 30, 2007 was \$2.1 million, which included \$3.8 million generated from our employee stock purchase and stock option plans, \$0.3 million payments on stock notes receivable and \$0.1 million excess tax benefits from stock-based payment arrangements, partially offset by a decrease in cash overdraft of \$1.9 million and net debt repayments of \$0.2 million.

Changes in exchange rates during the nine months ended June 30, 2007 provided \$7.4 million, primarily due to the strengthening of the Euro, partially offset by the weakening of the Japanese Yen, in relation to the U.S. dollar.

RECENT ACCOUNTING STANDARDS

In June 2006, the FASB issued Financial Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In addition, in May 2007, the FASB issued FASB Staff Position No. FIN 48-1,

Definition of Settlement in FASB Interpretation No. 48, (FSP FIN 48-1) to amend FIN No. 48 by providing that previously unrecognized tax benefits can be recognized when the tax positions are effectively settled upon examination by a taxing authority. According to FSP FIN 48-1, an enterprise's tax position will be considered effectively settled if the taxing authority has completed its examination, the enterprise does not plan to appeal, and the possibility is remote that the taxing authority would reexamine the tax position in the future. The requirements of FIN 48 and FSP FIN 48-1 are effective for our fiscal year beginning September 30, 2007. As of the end of fiscal year 2007, we estimate that our tax contingencies could increase by approximately \$1 million to \$3 million as a result of the adoption of FIN 48 and FSP FIN 48-1. This amount would be an adjustment to our retained earnings for fiscal year beginning September 30, 2007.

In September 2006, the SEC issued Staff Accounting Bulletin 108 Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108) addressing how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC Staff believes that companies should quantify errors using both a balance sheet and an income statement approach and evaluate whether either of these approaches results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 also describes the circumstances where it would be appropriate for a registrant to record a one-time cumulative effect adjustment to correct errors existing in prior years that previously had been considered immaterial as well as the required disclosures to investors. SAB 108 is effective for us for fiscal year 2007. We adopted SAB 108 on October 1, 2006 and our adoption did not have a material impact on our consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis. If the fair value option is elected, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted. We have elected not to early adopt and are currently assessing the impact of SFAS 159 on our consolidated financial position and results of operations.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk disclosures

Edgar Filing: COHERENT INC - Form 10-Q

We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

Interest rate sensitivity

A portion of our investment portfolio is composed of fixed income securities. These securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels at June 30, 2007, the fair value of the portfolio, based on quoted market prices, would decline by an immaterial amount. We have the ability to generally hold our fixed income investments until maturity and therefore we would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest rates on our securities portfolio. If necessary, we may sell short-term investments prior to maturity to meet our liquidity needs.

At June 30, 2007, the fair value of our available-for-sale debt securities was \$179.5 million, all of which were classified as short-term investments. Gross unrealized gains and losses on available-for-sale debt securities were \$1,163,000 and (\$38,000), respectively, at June 30, 2007.

Interest rate fluctuations affect the fair market value of our 2.75% convertible subordinated notes, but, with respect to such fixed rate debt instruments, do not impact our earnings or cash flows.

Foreign currency exchange risk

We maintain operations in various countries outside of the United States and foreign subsidiaries that manufacture and sell our products in various global markets. A majority of our sales are transacted in U.S. dollars. However, we do generate revenues in other currencies, primarily the Euro and Yen. As a result, our earnings and cash flows are exposed to fluctuations in foreign currency exchange rates. We attempt to limit these exposures through financial market instruments. We utilize derivative instruments, primarily forward contracts with maturities of twelve months or less, to manage our exposure associated with anticipated cash flows and net asset and liability positions denominated in foreign currencies. Gains and losses on the forward contracts are mitigated by gains and losses on the underlying instruments. We do not use derivative financial instruments for trading purposes.

We do not anticipate any material adverse effect on our consolidated financial position, results of operations or cash flows resulting from the use of these instruments. There can be no assurance that these strategies will be effective or that transaction losses can be minimized or forecasted accurately.

A hypothetical 10% appreciation of the forward adjusted U.S. dollar to June 30, 2007 market rates would decrease the unrealized value of our forward contracts by \$13.9 million. Conversely, a hypothetical 10% depreciation of the forward adjusted U.S. dollar to June 30, 2007 market rates would increase the unrealized value of our forward contracts by \$14.1 million.

The following table provides information about our foreign exchange forward contracts at June 30, 2007. The table presents the weighted average contractual foreign currency exchange rates, the value of the contracts in U.S. dollars at the contract exchange rate as of the contract maturity date and fair value. The U.S. notional fair value represents the contracted amount valued at June 30, 2007 rates.

Edgar Filing: COHERENT INC - Form 10-Q

Forward contracts to sell (buy) foreign currencies for U.S. dollars (in thousands, except contract rates):

| | Average Contract Rate | U.S. Notional Contract Value | U.S. Notional Fair Value |
|------------------------|--------------------------|---------------------------------|-----------------------------|
| Fair Value Hedges: | | | |
| Euro | 1.3305 | \$ (123,200) | \$ (125,621) |
| British Pound Sterling | 1.9695 | \$ (2,186) | \$ (2,225) |
| Japanese Yen | 118.3619 | \$ 10,801 | \$ 10,456 |
| Canadian Dollar | 1.1431 | \$ 962 | \$ 1,037 |
| Korean Won | 930.7316 | \$ 494 | \$ 499 |

Item 4. CONTROLS AND PROCEDURES

Management's Evaluation of Disclosure Controls and Procedures

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as of June 30, 2007 (the Evaluation Date). This evaluation was performed under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date that our disclosure controls and procedures were not effective for the purpose for which they were designed as of the end of June 2007 because of the material weakness previously disclosed in our annual report on Form 10-K for the year ended September 30, 2006.

Material Weakness and Remedial Efforts

The aforementioned material weakness existed in the Company's internal control over financial reporting resulting from an operational deficiency in the review and evaluation of significant issues and positions within the Company's tax provision. This weakness resulted in incorrect accounting for tax issues and positions that resulted in errors in the recorded and disclosed tax amounts.

The Company has taken the following actions to address the material weakness in its tax function:

- During the second quarter of fiscal 2006, we retained new tax advisors and increased the level of involvement of external tax advisors to provide additional quality assurance;
- During the second quarter of fiscal 2006, we increased the level of review and discussion of significant tax matters and supporting documentation with senior finance management;
- During the third quarter of fiscal 2006, we initiated a review of all significant tax issues and positions;
- Additionally, in the second quarter of fiscal 2007, we further increased the use of special tax advisors to support compliance areas, tax accounting and reporting; and
- In the fourth quarter of fiscal 2007, the Company made staffing changes in the leadership of the tax department.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations Over Internal Control

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The Company's internal control over financial reporting includes those policies and procedures that:

- (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;

- (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the Company's receipts and expenditures are being made only in accordance with authorizations of the Company's management and directors; and

- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management, including the Company's Chief Executive Officer and Chief Financial Officer, does not expect that the Company's internal controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Also, any evaluation of the effectiveness of controls in future periods are subject to the risk that those internal controls may become inadequate because of changes in business conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to legal claims and litigation arising in the ordinary course of business, such as product liability, employment or intellectual property claims, including, but not limited to, the matters described below. The outcome of any such matters is currently not determinable. Although we do not expect that such legal claims and litigation will ultimately have a material adverse effect on our consolidated financial position or results of operations, an adverse result in one or more matters could negatively affect our results in the period in which they occur.

Derivative Lawsuits

Between February 15, 2007 and March 2, 2007, three purported shareholder derivative lawsuits were filed in the United States District Court for the Northern District of California against certain of our current and former officers and directors. We are named as a nominal defendant. The complaints generally allege that the defendants breached their fiduciary duties and violated the securities laws in connection with the granting of stock options, the accounting treatment for such grants, the issuance of allegedly misleading public statements and stock sales by certain of the individual defendants. On May 29, 2007, these lawsuits were consolidated under the caption *In re Coherent, Inc. Shareholder Derivative Litigation*, Lead Case No. C-07-0955-JF (N.D. Cal.). On June 25, 2007, plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts causes of action for alleged violations of federal securities laws, violations of California securities laws, breaches of fiduciary duty and/or aiding and abetting breaches of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, insider selling and misappropriation of information. The consolidated complaint seeks, among other relief, disgorgement and damages in an unspecified amount, an accounting, rescission of allegedly improper stock option grants, punitive damages and attorneys' fees and costs. To date, we have been paying the defense costs of the individual defendants.

In addition, our Board of Directors has appointed a Special Litigation Committee (SLC) comprised of independent director Sandeep Vij to investigate and evaluate the claims asserted in the derivative litigation and to determine what action(s) should be taken with respect to the derivative litigation. The SLC has retained legal counsel to assist it. The SLC's investigation is ongoing.

SEC Inquiry

In 2006, we were advised that the San Francisco District Office of the SEC is conducting an informal inquiry relating to our past granting of stock options. We are cooperating fully with the inquiry.

Income Tax Audits

The Internal Revenue Service (IRS) is conducting an audit of our 2003 and 2004 tax returns. The IRS has issued a number of Notices of Proposed Adjustments to these returns. Among other items, the IRS has challenged our research and development credits and our extraterritorial income, (ETI), exclusion. We have agreed to the various adjustments proposed by the IRS and we believe that we have adequate reserves for

Edgar Filing: COHERENT INC - Form 10-Q

these exposures and any other items identified by the IRS as a result of the audit of these tax years. As part of its audit of our 2003 and 2004 years, the IRS has requested information related to our stock option investigation and we will comply with this request and address any issues that are raised in a timely manner. The IRS has also indicated that it may consider an audit of our 2005 and 2006 tax returns.

The IRS is also auditing the research and development credits generated in the years 1999 through 2001 and carried forward to future tax years. We believe that we have adequate reserves for any adjustments that may be proposed by the IRS related to these credits.

The German tax authorities are conducting an audit of our subsidiary in Göttingen for the tax years 1999 through 2005. We believe that we have adequate reserves for any adjustments that may be proposed by the German tax authorities.

Other Matters

As previously disclosed, the Company's proposed acquisition of Excel Technology, Inc. was the subject of a prohibition decision issued by the German Federal Cartel Office (FCO) in October 2006. While the agreement under which the Company was to acquire Excel was terminated, the Company is currently appealing the FCO's prohibition order to the appellate court in Germany.

ITEM 1A. RISK FACTORS

BUSINESS ENVIRONMENT AND INDUSTRY TRENDS

Risks Associated with Our Industry, Our Business and Market Conditions

Our operating results, including net sales, and stock price have varied in the past, and our future operating results will continue to be subject to quarterly and annual fluctuations based upon numerous factors, including those listed in this section and throughout this annual report. Our stock price will continue to be subject to daily variations as well. In addition, our future operating results and stock price may not follow any past trends.

Our net sales and operating results may vary significantly from quarter to quarter and from year to year in the future. In particular we typically experience seasonality in our first fiscal quarter, resulting in lower net sales. We believe a number of factors, many of which are outside of our control, could cause these variations and make them difficult to predict, including:

- general economic uncertainties;
- fluctuations in demand for, and sales of, our products or prolonged downturns in the industries that we serve;
- ability of our suppliers, both internal and external, to produce and deliver components and parts, including sole or limited source components, in a timely manner, in the quantity and quality desired and at the prices we have budgeted;
- timing or cancellation of customer orders and shipment scheduling;
- fluctuations in our product mix;
- foreign currency fluctuations;
- commodity pricing, including increases in oil prices;
- introductions of new products and product enhancements by our competitors, entry of new competitors into our markets, pricing pressures and other competitive factors;
- our ability to develop, introduce, manufacture and ship new and enhanced products in a timely manner without defects;
- rate of market acceptance of our new products;
- delays or reductions in customer purchases of our products in anticipation of the introduction of new and enhanced products by us or our competitors;
- maintenance of supply relating to products to the government on terms which we would prefer not to accept;

Edgar Filing: COHERENT INC - Form 10-Q

- our ability to control expenses;
- level of capital spending of our customers;
- potential obsolescence of our inventory;
- costs and timing of adhering to developing governmental regulations on our products and business;
- SEC investigations and stockholder litigation related to our recent internal investigation of our practices related to historical stock option grants and the related restatement of our consolidated financial statements;
- the suspension of trading and subsequent delisting of our stock from trading on Nasdaq;
- costs related to acquisitions of technology or businesses; and
- distraction of management related to acquisition or divestment activities and the SEC and stock exchange listing processes.

In addition, we often recognize a substantial portion of our sales in the last month of the quarter. Our expenses for any given quarter are typically based on expected sales and if sales are below expectations in any given quarter, the adverse impact of the shortfall on our operating results may be magnified by our inability to adjust spending quickly enough to compensate for the shortfall. We also base our manufacturing on our forecasted product mix for the quarter. If the actual product mix varies significantly from our forecast, we may not be able to fill some orders during that quarter, which would result in delays in the shipment of our products. Accordingly, variations in timing of sales, particularly for our higher priced, higher margin products, can cause significant fluctuations in quarterly operating results.

Due to these and other factors, we believe that quarter-to-quarter and year-to-year comparisons of our historical operating results may not be meaningful. You should not rely on our results for any quarter or year as an indication of our future performance. Our operating results in future quarters and years may be below public market analysts' or investors' expectations, which would likely cause the price of our stock to fall. In addition, over the past several years, the stock market has experienced extreme price and volume fluctuations that have affected the stock prices of many technology companies. There has not always been a direct correlation between this volatility and the performance of particular companies subject to these stock price fluctuations. These factors, as well as general economic and political conditions or investors' concerns regarding the credibility of corporate financial statements, may have a material adverse affect on the market price of our stock in the future.

We are exposed to risks associated with worldwide economic slowdowns and related uncertainties.

Concerns about consumer and investor confidence, volatile corporate profits and reduced capital spending, international conflicts, terrorist and military activity, civil unrest and pandemic illness could cause a slowdown in customer orders or cause customer order cancellations. In addition, political and social turmoil related to international conflicts and terrorist acts may put further pressure on economic conditions in the United States and abroad. Unstable political, social and economic conditions make it difficult for our customers, our suppliers and us to accurately forecast and plan future business activities. In particular, it is difficult to develop and implement strategy, sustainable business models and efficient operations, as well as effectively manage supply chain relationships in the face of such conditions. If such conditions persist, our business, financial condition and results of operations could suffer.

We depend on sole source or limited source suppliers for some of our key components and materials, including exotic materials and crystals, in our products, which make us susceptible to supply shortages or price fluctuations that could adversely affect our business.

We currently purchase several key components and materials used in the manufacture of our products from sole source or limited source suppliers, both internal and external. Some of these suppliers are relatively small private companies that may discontinue their operations at any time. We typically purchase our components and materials through purchase orders and we have no guaranteed supply arrangement with any of these suppliers. We may fail to obtain these supplies in a timely manner in the future. We may experience difficulty identifying alternative sources of supply for certain components used in our products. We would experience further delays while identifying, evaluating and testing the products of these potential alternative suppliers. Furthermore, financial or other difficulties faced by these suppliers or significant changes in demand for these components or materials could limit their availability. Any interruption or delay in the supply of any of these components or materials, or the inability to obtain these components and materials from alternate sources at acceptable prices and within a reasonable amount of time, would impair our ability to meet scheduled product deliveries to our customers and could cause customers to cancel orders.

We rely exclusively on our own production capability to manufacture certain strategic components, optics and optical systems, crystals, semiconductor lasers, lasers and laser-based systems. Because we manufacture, package and test these components, products and systems at our own facilities, and such components, products and systems are not readily available from other sources, any interruption in manufacturing would adversely affect our business. In addition, our failure to achieve adequate manufacturing yields of these items at our manufacturing facilities may materially and adversely affect our operating results and financial condition.

Our future success depends on our ability to increase our sales volumes and decrease our costs to offset anticipated declines in the average selling prices of our products and, if we are unable to realize greater sales volumes and lower costs, our operating results may suffer.

Our future success depends on the continued growth of the markets for lasers, laser systems, precision optics and related accessories, as well as our ability to identify, in advance, emerging markets for laser-based systems. We cannot assure you that we will be able to successfully identify, on a timely basis, new high-growth markets in the future. Moreover, we cannot assure you that new markets will develop for our products or our customers' products, or that our technology or pricing will enable such markets to develop. Future demand for our products is uncertain and will depend to a great degree on continued technological development and the introduction of new or enhanced products. If this does not continue, sales of our products may decline and our business will be harmed.

Edgar Filing: COHERENT INC - Form 10-Q

We have historically been the industry's high quality supplier of laser systems. We have, in the past, experienced decreases in the average selling prices of some of our products. We anticipate that as competing products become more widely available, the average selling price of our products may decrease. If we are unable to offset the anticipated decrease in our average selling prices by increasing our sales volumes, our net sales will decline. In addition, to maintain our gross margins, we must continue to reduce the cost of manufacturing our products while maintaining their high quality. From time to time, our products, like many complex technological products, may fail in greater frequency than anticipated. This can lead to further charges, which can result in higher costs, lower gross margins and lower operating results. Furthermore, as average selling prices of our current products decline, we must develop and introduce new products and product enhancements with higher margins. If we cannot maintain our gross margins, our operating results could be seriously harmed, particularly if the average selling prices of our products decrease significantly.

Our future success depends on our ability to develop and successfully introduce new and enhanced products that meet the needs of our customers.

Our current products address a broad range of commercial and scientific research applications in the photonics markets. We cannot assure you that the market for these applications will continue to generate significant or consistent demand for our products. Demand for our products could be significantly diminished by disrupting technologies or products that replace them or render them obsolete. Furthermore, the new and enhanced products generally continue to be smaller in size and have lower average selling prices (ASPs), and therefore, we have to sell more units to maintain revenue levels.

Over the last three fiscal years, our research and development expenses have been in the range of 11% to 13% of net sales. Our future success depends on our ability to anticipate our customers' needs and develop products that address those needs. Introduction of new products and product enhancements will require that we effectively transfer production processes from research and development to manufacturing and coordinate our efforts with those of our suppliers to achieve volume production rapidly. If we fail to transfer production processes effectively, develop product enhancements or introduce new products in sufficient quantities to meet the needs of our customers as scheduled, our net sales may be reduced and our business may be harmed.

We face risks associated with our foreign sales that could harm our financial condition and results of operations.

For the three and nine months ended June 30, 2007, 67% and 68% of our net sales, respectively, were derived from customers outside of the United States. For fiscal years 2006, 2005, and 2004, 68%, 65% and 61%, respectively, of our net sales were derived from customers outside of the United States. We anticipate that foreign sales will continue to account for a significant portion of our revenues in the foreseeable future. A global economic slowdown could have a negative effect on various foreign markets in which we operate. Such a slowdown may cause us to reduce our presence in certain countries, which may negatively affect the overall level of business in such countries. The majority of our foreign sales occur through our foreign sales subsidiaries and the remainder of our foreign sales result from exports to foreign distributors, resellers and customers. Our foreign operations and sales are subject to a number of risks, including:

- longer accounts receivable collection periods;
- the impact of recessions and other economic conditions in economies outside the United States;
- unexpected changes in regulatory requirements;
- certification requirements;
- environmental regulations;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences;
- political and economic instability; and
- preference for locally produced products.

We are also subject to the risks of fluctuating foreign exchange rates, which could materially adversely affect the sales price of our products in foreign markets, as well as the costs and expenses of our foreign subsidiaries. While we use forward exchange contracts and other risk management techniques to hedge our foreign currency exposure, we remain exposed to the economic risks of foreign currency fluctuations.

We may not be able to protect our proprietary technology, which could adversely affect our competitive advantage.

Maintenance of intellectual property rights and the protection thereof is important to our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We cannot assure you that our patent applications will be approved, that any patents that may be issued will protect our intellectual property or that any issued patents will not be challenged by third parties. Other parties may independently develop similar or competing technology or design around any patents that may be issued to us. We cannot be certain that the steps we have taken will prevent the misappropriation of our intellectual property, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

We may, in the future, initiate claims or litigation against third parties for infringement of our proprietary rights to protect these rights or to determine the scope and validity of our proprietary rights or the proprietary rights of competitors. These claims could result in costly litigation and the diversion of our technical and management personnel. Adverse resolution of litigation may harm our operating results or financial condition.

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. From time to time, like many other technology companies, we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which such third parties believe may cover certain of

our products, processes, technologies or information. In the future, we may be a party to litigation to protect our intellectual property or as a result of an alleged infringement of others' intellectual property. These claims and any resulting lawsuit, if successful, could subject us to significant liability for damages or invalidation of our proprietary rights. These lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention. Any potential intellectual property litigation could also force us to do one or more of the following:

- stop manufacturing, selling or using our products that use the infringed intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, although such license may not be available on reasonable terms, or at all; or
- redesign the products that use the technology.

If we are forced to take any of these actions, our business may be seriously harmed. We do not have insurance to cover potential claims of this type.

We are exposed to lawsuits in the normal course of business which could have a material adverse effect on our business, operating results, or financial condition.

We are exposed to lawsuits in the normal course of our business, including product liability claims, if personal injury or death occurs from the use of our products. While we typically maintain customary levels of business insurance, including directors and officer's policies, litigation can be expensive, lengthy, and disruptive to normal business operations, including the potential impact of indemnification obligations for individuals named in any such lawsuits. We may not, however, be able to secure insurance coverage on terms acceptable to us in the future. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit, including a recall or redesign of products if ultimately determined to be defective, could have a material adverse effect on our business, operating results, or financial condition.

We depend on skilled personnel to operate our business effectively in a rapidly changing market, and if we are unable to retain existing or hire additional personnel when needed, our ability to develop and sell our products could be harmed.

Our ability to continue to attract and retain highly skilled personnel will be a critical factor in determining whether we will be successful in the future. Recruiting and retaining highly skilled personnel in certain functions continues to be difficult. At certain locations where we operate, the cost of living is extremely high and it may be difficult to retain key employees and management at a reasonable cost. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Our failure to attract additional employees and retain our existing employees could adversely affect our growth and our business.

Our future success depends upon the continued services of our executive officers and other key engineering, sales, marketing, manufacturing and support personnel, any of whom may leave, which could harm our business and our results of operations.

The long sales cycles for our products may cause us to incur significant expenses without offsetting revenues.

Customers often view the purchase of our products as a significant and strategic decision. As a result, customers typically expend significant effort in evaluating, testing and qualifying our products before making a decision to purchase them, resulting in a lengthy initial sales cycle. While our customers are evaluating our products and before they place an order with us, we may incur substantial sales and marketing and research and development expenses to customize our products to the customer's needs. We may also expend significant management efforts, increase manufacturing capacity and order long lead-time components or materials prior to receiving an order. Even after this evaluation process, a potential customer may not purchase our products. As a result, these long sales cycles may cause us to incur significant expenses without ever receiving revenue to offset such expenses.

The markets in which we sell our products are intensely competitive and increased competition could cause reduced sales levels, reduced gross margins or the loss of market share.

Competition in the various photonics markets in which we provide products is very intense. We compete against a number of large public and private companies, including Newport Corporation; Excel Technology, Inc.; JDS Uniphase Corporation; Rofin-Sinar Technologies, Inc.; Trumpf GmbH; IPG Photonics Corporation; and Cymer, Inc., as well as other smaller companies. Some of our competitors are large companies that have significant financial, technical, marketing and other resources. These competitors may be able to devote greater resources than we can to the development, promotion, sale and support of their products. Some of our competitors that have more cash reserves are much better positioned than we are to acquire other companies in order to gain new

technologies or products that may displace our product lines. Any of these acquisitions could give our competitors a strategic advantage. Any business combinations or mergers among our competitors, forming larger competitors with greater resources, could result in increased competition, price reductions, reduced margins or loss of market share, any of which could materially and adversely affect our business, results of operations and financial condition.

Additional competitors may enter the market and we are likely to compete with new companies in the future. We may encounter potential customers that, due to existing relationships with our competitors, are committed to the products offered by these competitors. As a result of the foregoing factors, we expect that competitive pressures may result in price reductions, reduced margins and loss of market share. For example, in markets where there are a limited number of customers, such as the microelectronics market, competition is particularly intense.

Some of our laser systems are complex in design and may contain defects that are not detected until deployed by our customers, which could increase our costs and reduce our revenues.

Laser systems are inherently complex in design and require ongoing regular maintenance. The manufacture of our lasers, laser products and systems involves a highly complex and precise process. As a result of the technological complexity of our products, changes in our or our suppliers' manufacturing processes or the inadvertent use of defective materials by us or our suppliers could result in a material adverse effect on our ability to achieve acceptable manufacturing yields and product reliability. To the extent that we do not achieve and maintain our projected yields or product reliability, our business, operating results, financial condition and customer relationships would be adversely affected. We provide warranties on certain of our product sales, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of failure rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

Our customers may discover defects in our products after the products have been fully deployed and operated under peak stress conditions. In addition, some of our products are combined with products from other vendors, which may contain defects. As a result, should problems occur, it may be difficult to identify the source of the problem. If we are unable to identify and fix defects or other problems, we could experience, among other things:

- loss of customers;
- increased costs of product returns and warranty expenses;
- damage to our brand reputation;
- failure to attract new customers or achieve market acceptance;
- diversion of development and engineering resources; and
- legal actions by our customers and/or their end users.

The occurrence of any one or more of the foregoing factors could seriously harm our business, financial condition and results of operations.

If we fail to accurately forecast component and material requirements for our products, we could incur additional costs and incur significant delays in shipments, which could result in loss of customers.

We use rolling forecasts based on anticipated product orders and material requirements planning systems to determine our product requirements. It is very important that we accurately predict both the demand for our products and the lead times required to obtain the necessary components and materials. We depend on our suppliers for most of our product components and materials. Lead times for components and materials that we order vary significantly and depend on factors including the specific supplier requirements, the size of the order, contract terms and current market demand for components. For substantial increases in our sales levels, some of our suppliers may need at least six months lead-time. If we overestimate our component and material requirements, we may have excess inventory, which would increase our costs. If we underestimate our component and material requirements, we may have inadequate inventory, which could interrupt and delay delivery of our products to our customers. Any of these occurrences would negatively impact our net sales, business or operating results.

Our increased reliance on contract manufacturing may adversely impact our financial results and operations.

Our manufacturing strategy includes partnering with contract manufacturers to outsource non-core subassemblies and less complex turnkey products, including some performed at international sites located in Asia and Eastern Europe. Our ability to resume internal

manufacturing operations for certain products in a timely manner may be eliminated. The cost, quality, performance and availability of contract manufacturing operations are and will be essential to the successful production and sale of many of our products. The inability of any contract manufacturer to meet our cost, quality, performance and availability standards could adversely impact our financial condition or results of operations. We may not be able to provide contract manufacturers with product volumes that are high enough to achieve sufficient cost savings. If shipments fall below forecasted levels, we may incur increased costs or be required to take ownership of the inventory. Also, our ability to control the quality of products produced by contract manufacturers may be limited and quality issues may not be resolved in a timely manner, which could adversely impact our financial condition or results of operations.

If we fail to manage our growth effectively, our business could be disrupted, which could harm our operating results.

Our ability to successfully offer our products and implement our business plan in evolving markets requires an effective planning and management process. We continue to expand the scope of our operations domestically and internationally. The growth in sales, combined with the challenges of managing geographically-dispersed operations, has placed a significant strain on our management systems and resources, and our anticipated growth in future operations could continue to place such a strain. The failure to effectively manage our growth could disrupt our business and harm our operating results.

Any acquisitions we make could disrupt our business and harm our financial condition.

We have in the past made strategic acquisitions of other corporations and entities, including asset purchases, and we continue to evaluate potential strategic acquisitions of complementary companies, products and technologies. In the event of any future acquisitions, we could:

- issue stock that would dilute our current stockholders' percentage ownership;
- pay cash;
- incur debt;
- assume liabilities; or
- incur expenses related to in-process research and development, impairment of goodwill and amortization.

These purchases also involve numerous risks, including:

- problems combining the acquired operations, technologies or products;
- unanticipated costs or liabilities, including the costs associated with improving the internal controls of the acquired company;

- diversion of management's attention from our core businesses;
- adverse effects on existing business relationships with suppliers and customers;
- potential loss of key employees, particularly those of the purchased organizations; and
- the failure to complete acquisitions even after signing definitive agreements which, among other things, would result in the expensing of potentially significant professional fees and other charges in the period in which the acquisition or negotiations are terminated.

We cannot assure you that we will be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future, which may harm our business.

We use standard laboratory and manufacturing materials that could be considered hazardous and we could be liable for any damage or liability resulting from accidental environmental contamination or injury.

Although most of our products do not incorporate hazardous or toxic materials and chemicals, some of the gases used in our excimer lasers and some of the liquid dyes used in some of our scientific laser products are highly toxic. In addition, our operations involve the use of standard laboratory and manufacturing materials that could be considered hazardous. Also, if a facility fire were to occur at our Tampere, Finland, site and were to spread to a reactor used to grow semiconductor wafers, it could release highly toxic emissions. We believe that our safety procedures for handling and disposing of such materials comply with all federal, state and offshore regulations and standards. However, the risk of accidental environmental contamination or injury from such materials cannot be entirely eliminated. In the event of such an accident involving such materials, we could be liable for damages and such liability could exceed the amount of our liability insurance coverage and the resources of our business.

Compliance or the failure to comply with current and future environmental regulations could cause us significant expense.

We are subject to a variety of federal, state, local and foreign environmental regulations relating to the use, storage, discharge and disposal of hazardous chemicals used during our manufacturing process or requiring design changes or recycling of products we manufacture. If we fail to comply with any present and future regulations, we could be subject to future liabilities, the suspension of production or a prohibition on the sale of products we manufacture. In addition, such regulations could restrict our ability to expand our facilities or could require us to acquire costly equipment, or to incur other significant expenses to comply with environmental regulations, including expenses associated with the recall of any non-compliant product and the management of historical waste.

From time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. We continue to evaluate the necessary steps for compliance with regulations as they are enacted. These regulations include, for example, the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS) and the Waste Electrical and Electronic Equipment Directive (WEEE) enacted in the European Union which regulate the use of certain hazardous substances in, and require the collection, reuse and recycling of waste from, certain products we manufacture. This and similar legislation that has been or is in the process of being enacted in Japan, China, Korea and various states of the United States may require us to re-design our products to ensure compliance with the applicable standards, for example by requiring the use of different types of materials. These re-designs or alternative materials may detrimentally impact the performance of our products, add greater testing lead-times for product introductions or have other similar effects. We believe we comply with all such legislation where our products are sold and we will continue to monitor these laws and the regulations being adopted under them to determine our responsibilities. In addition, we are monitoring legislation relating to the reduction of carbon emissions from industrial operations to determine whether we may be required to incur any additional material costs or expenses associated with our operations. We are not currently aware of any such material costs or expenses. Our failure to comply with any of the foregoing regulatory requirements or contractual obligations could result in our being directly or indirectly liable for costs, fines or penalties and third-party claims, and could jeopardize our ability to conduct business in the United States and foreign countries.

If our facilities were to experience catastrophic loss, our operations would be seriously harmed.

Our facilities could be subject to a catastrophic loss from fire, flood, earthquake or terrorist activity. A substantial portion of our research and development activities, manufacturing, our corporate headquarters and other critical business operations are located near major earthquake faults in Santa Clara, California, an area with a history of seismic events. Any such loss at any of our facilities could disrupt our operations, delay production, shipments and revenue and result in large expenses to repair or replace the facility. While we have obtained insurance to cover most potential losses, after reviewing the costs and limitations associated with earthquake insurance, we have decided not to procure such insurance. We believe that this decision is consistent with decisions reached by numerous other companies located nearby. We cannot assure you that our

existing insurance coverage will be adequate against all other possible losses.

Provisions of our charter documents, Delaware law, our Common Shares Rights Plan, and our Change-of-Control Severance Plan may have anti-takeover effects that could prevent or delay a change in control.

Provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition or make removal of incumbent directors or officers more difficult. These provisions may discourage takeover attempts and bids for our common stock at a premium over the market price. These provisions include:

- the ability of our board of directors to alter our bylaws without stockholder approval;
- limiting the ability of stockholders to call special meetings; and
- establishing advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

We are subject to Section 203 of the Delaware General Corporation Law, which prohibits a publicly held Delaware corporation from engaging in a merger, asset or stock sale or other transaction with an interested stockholder for a period of three years following the date such person became an interested stockholder, unless prior approval of our board of directors is obtained or as otherwise provided. These provisions of Delaware law also may discourage, delay or prevent someone from acquiring or merging with us without obtaining the prior approval of our board of directors, which may cause the market price of our common stock to decline. In addition, we have adopted a change of control severance plan, which provides for the payment of a cash severance benefit to each eligible employee based on the employee's position. If a change of control occurs, our successor or acquirer will be required to assume and agree to perform all of our obligations under the change of control severance plan.

Our common shares rights agreement permits the holders of rights to purchase shares of our common stock to exercise the stock purchase rights following an acquisition of or merger by us with another corporation or entity, following a sale of 50% or more of our consolidated assets or earning power, or the acquisition by an individual or entity of 20% or more of our common stock. Our successor or acquirer is required to assume all of our obligations and duties under the common shares rights agreement, including in certain circumstances the issuance of shares of its capital stock upon exercise of the stock purchase rights. The existence of our common shares rights agreement may have the effect of delaying, deferring or preventing a change of control and, as a consequence, may discourage potential acquirers from making tender offers for our shares.

Changes in tax rates, tax liabilities or tax accounting rules could affect future results.

As a global company, we are subject to taxation in the United States and various other countries and jurisdictions. Significant judgment is required to determine worldwide tax liabilities. Our future tax rates could be affected by changes in the composition of earnings in countries with differing tax rates, changes in the valuation of our deferred tax assets and liabilities, or changes in the tax laws. In addition, we are subject to regular examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of favorable or unfavorable outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. Although we believe our tax estimates are reasonable, there can be no assurance that any final determination will not be materially different than the treatment reflected in our historical income tax provisions and accruals, which could materially and adversely affect our operating results and financial condition.

Compliance with changing regulation of corporate governance and public disclosure may create uncertainty