VEECO INSTRUMENTS INC
Form 10-Q
August 04, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006
OR

o	**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 0-16244

VEECO INSTRUMENTS INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**11-2989601** (I.R.S. Employer Identification Number)
100 Sunnyside Boulevard, Suite B **Woodbury, New York** (Address of Principal Executive Offices)	**11797-2902** (Zip Code)

Registrant s telephone number, including area code: **(516) 677-0200**

Website: **www.veeco.com**

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 x No o

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 o Accelerated filer x Non-accelerated filer o

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

30,728,321 shares of common stock, $0.01 par value per share, were outstanding as of the close of business on July 26, 2006.

SAFE HARBOR STATEMENT

This Quarterly Report on Form 10-Q (the Report) contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Discussions containing such forward-looking statements may be found in Items 2 and 3 hereof, as well as within this Report generally. In addition, when used in this Report, the words believes, anticipates, expects, estimates, plans, intends, and similar expressions are intended to identify forward-looking statements. All forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from projected results. These risks and uncertainties include, without limitation, the following:

- The cyclicality of the microelectronics industries we serve directly affects our business.
- We operate in an industry characterized by rapid technological change.
- We face significant competition.
- We depend on a limited number of customers that operate in highly concentrated industries.
- Our quarterly operating results fluctuate significantly.
- We face securities class action and shareholder derivative lawsuits which could result in substantial costs, diversion of management s attention and resources and negative publicity.
- Our acquisition strategy subjects us to risks associated with evaluating and pursuing these opportunities and integrating these businesses.
- Any difficulty or inability to attract, retain and motivate key employees could have a material adverse effect on our business.
- We are exposed to the risks of operating a global business and the requirement to comply with laws and regulations of various jurisdictions such as import/export controls, which may not apply to our non-U.S. competitors.
- We are subject to foreign currency exchange risks.
- Our success depends on protection of our intellectual property rights.
- We may be subject to claims of intellectual property infringement by others.
- We rely on a limited number of suppliers.
- Our outsourcing strategy could adversely affect our results of operations.
- Changes in accounting standards for stock-based compensation may adversely affect our stock price and our ability to attract, motivate and retain key employees.
- The implementation of a new information technology system may disrupt our operations.
- We may not obtain sufficient affordable funds to finance our future needs.

- We are subject to risks of non-compliance with environmental and safety regulations.

- We have adopted certain measures that may have anti-takeover effects which may make an acquisition of our company by another company more difficult.

- The other matters discussed under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this Report and in the Annual Report on Form 10-K for the year ended December 31, 2005 of Veeco Instruments Inc. (Veeco or the Company).

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Consequently, such forward-looking statements should be regarded solely as the Company s current plans, estimates and beliefs. The Company does not undertake any obligation to update any forward-looking statements to reflect future events or circumstances after the date of such statements.

Available Information

We file annual, quarterly and current reports, information statements and other information with the Securities and Exchange Commission (the SEC). The public may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is http://www.sec.gov.

Internet Address

We maintain a website where additional information concerning our business and various upcoming events can be found. The address of our website is www.veeco.com. We provide a link on our website, under Investors Financial Information SEC Filings, through which investors can access our filings with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to those reports. These filings are posted to our Internet site, as soon as reasonably practicable after we electronically file such material with the SEC.

VEECO INSTRUMENTS INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Three Months Ended June 30, 2006	2005
Net sales	$ 111,635	$ 103,415
Cost of sales	61,923	59,989
Gross profit	49,712	43,426
Costs and expenses:		
Selling, general and administrative expense	24,996	21,435
Research and development expense	15,252	15,863
Amortization expense	3,989	4,026
Other (income) expense, net	(132)	70
Total operating expenses	44,105	41,394
Operating income	5,607	2,032
Interest expense, net	1,149	1,959
Income before income taxes	4,458	73
Income tax provision	1,433	522
Net income (loss)	$ 3,025	$ (449)
Net income (loss) per common share	$ 0.10	$ (0.02)
Diluted net income (loss) per common share	$ 0.10	$ (0.02)
Weighted average shares outstanding	30,322	29,863
Diluted weighted average shares outstanding	31,254	29,863

See accompanying notes.

Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Six Months Ended June 30, 2006	2005
Net sales	$ 205,553	$ 197,265
Cost of sales	114,072	116,307
Gross profit	91,481	80,958
Costs and expenses:		
Selling, general and administrative expense	46,326	41,606
Research and development expense	29,838	30,687
Amortization expense	8,004	8,516
Other expense (income), net	67	(28)
Total operating expenses	84,235	80,781
Operating income	7,246	177
Interest expense, net	2,527	4,105
Gain on extinguishment of debt	(330)	
Income (loss) before income taxes	5,049	(3,928)
Income tax provision	2,266	1,223
Net income (loss)	$ 2,783	$ (5,151)
Net income (loss) per common share	$ 0.09	$ (0.17)
Diluted net income (loss) per common share	$ 0.09	$ (0.17)
Weighted average shares outstanding	30,208	29,859
Diluted weighted average shares outstanding	30,946	29,859

See accompanying notes.

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Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In thousands)

	June 30, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 116,029	$ 124,499
Accounts receivable, less allowance for doubtful accounts of $2,306 in 2006 and $1,860 in 2005	88,673	89,230
Inventories	96,144	88,904
Prepaid expenses and other current assets	12,002	9,640
Deferred income taxes	3,309	2,870
Total current assets	316,157	315,143
Property, plant and equipment at cost, less accumulated depreciation of $83,984 in 2006 and $77,954 in 2005	72,317	69,806
Goodwill	99,622	99,622
Purchased technology, less accumulated amortization of $58,341 in 2006 and $51,992 in 2005	49,235	55,776
Other intangible assets, less accumulated amortization of $24,199 in 2006 and $22,274 in 2005	20,670	22,413
Other assets	6,054	5,100
Total assets	$ 564,055	$ 567,860
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 38,129	$ 31,289
Accrued expenses	46,848	51,169
Deferred profit	685	537
Income taxes payable	2,145	2,123
Current portion of long-term debt	387	375
Total current liabilities	88,194	85,493
Deferred income taxes	1,671	1,048
Long-term debt	209,008	229,205
Other non-current liabilities	3,374	3,527
Shareholders equity	261,808	248,587
Total liabilities and shareholders equity	$ 564,055	$ 567,860

See accompanying notes.

Veeco Instruments Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2006	2005
Operating activities		
Net income (loss)	$ 2,783	$ (5,151)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	14,594	15,080
Deferred income taxes	303	(101)
Gain on extinguishment of debt	(330)	
Compensation expense for share-based payments	721	
(Gain) loss on sale of property plant and equipment	(16)	83
Other	21	
Changes in operating assets and liabilities:		
Accounts receivable	2,659	6,281
Inventories	(6,354)	8,975
Accounts payable	6,765	2,953
Accrued expenses, deferred profit and other current liabilities	(1,576)	(2,428)
Other, net	(2,827)	(1,598)
Net cash provided by operating activities	16,743	24,094
Investing activities		
Capital expenditures	(9,570)	(4,550)
Payments for net assets of businesses acquired	(3,161)	(15,038)
Proceeds from sale of property, plant and equipment and assets held for sale	35	2,178
Net maturities of investments	(80)	(41)
Other	(500)	
Net cash used in investing activities	(13,276)	(17,451)
Financing activities		
Proceeds from stock issuance	7,983	1,041
Repayments of long-term debt	(19,585)	(176)
Net cash (used in) provided by financing activities	(11,602)	865
Effect of exchange rates on cash and cash equivalents	(335)	1,572
Net change in cash and cash equivalents	(8,470)	9,080
Cash and cash equivalents at beginning of period	124,499	100,276
Cash and cash equivalents at end of period	$ 116,029	$ 109,356

See accompanying notes.

VEECO INSTRUMENTS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation (consisting of normal recurring accruals) have been included. Operating results for the three and six months ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

Earnings (Loss) Per Share

The following table sets forth the reconciliation of weighted average shares outstanding and diluted weighted average shares outstanding:

	Three months ended June 30,		Six months ended June 30,	
	2006	**2005**	**2006**	**2005**
	(In thousands)			
Weighted average shares outstanding	30,322	29,863	30,208	29,859
Dilutive effect of stock options and restricted stock awards	932		738	
Dilutive weighted average shares outstanding	31,254	29,863	30,946	29,859

Net income and diluted net income per common share are computed using the weighted average number of common and common equivalent shares outstanding during the period. The effect of approximately 140,000 and 158,000 common equivalent shares for the three and six months ended June 30, 2005, respectively, were anti-dilutive, and therefore are not included in the weighted average shares outstanding.

In addition, the effect of the assumed conversion of subordinated convertible notes into approximately 5.2 million and 5.3 million common equivalent shares is antidilutive, and therefore is not included in the weighted shares outstanding for the three and six months ended June 30, 2006, respectively. The effect of the assumed conversion of subordinated convertible notes into approximately 5.7 million common equivalent shares is antidilutive, and therefore is not included in the weighted average shares outstanding for the comparable prior year periods.

Share-Based Compensation

As of June 30, 2006, the Company has stock option and restricted stock plans, which are described more fully in Note 2. In addition, the Company assumed certain stock option plans and agreements in connection with various acquisitions, as also discussed in Note 2. Prior to 2006, the Company accounted for these stock option plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations and generally, no compensation expense was reflected in net income as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, supersedes APB No. 25 and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees and non-employee directors, including grants of stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS No. 123(R) was adopted using the modified prospective method of application, which requires

Veeco to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in the pro forma disclosures in prior periods. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous accounting literature, which has the effect of reducing consolidated cash flows from operations and increasing cash flows from financing activities in periods after adoption. For the three and six months ended June 30, 2006, the Company did not recognize any amount of consolidated financing cash flows for such excess tax deductions.

Total share-based compensation expense is attributable to the remaining requisite service periods of stock options and restricted common stock awards. For the three and six months ended June 30, 2006, the Company granted 146,200 stock options and 198,250 restricted common stock awards to its directors, officers and employees. As a result of adopting SFAS No. 123(R), the Company s net income for the three and six months ended June 30, 2006 was $0.2 million and $0.3 million lower, respectively, than if it had continued to account for share-based compensation under APB No. 25. Net income per common share and diluted net income per common share for the three and six months ended June 30, 2006, are less than $0.01 and $0.01 lower, respectively, than if the Company had continued to account for share-based compensation under APB No. 25. As of June 30, 2006, the total unrecognized compensation cost related to nonvested stock awards and option awards is $5.1 million and $1.8 million, respectively, and the related weighted average period over which it is expected that such unrecognized compensation costs will be recognized is approximately 2.5 years for the nonvested stock awards and 2.4 years for option awards. Future share-based compensation expense will depend on levels of share-based awards granted in the future and, therefore, cannot be predicted at this time.

Prior to the Company s adoption of SFAS No. 123(R), SFAS No. 123 required that the Company provide pro forma information regarding net loss and loss per share as if compensation cost for the Company s stock-based awards had been determined in accordance with the fair value method prescribed therein. In accordance with SFAS No. 123, the following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions, under which compensation expense would be recognized as incurred, to stock-based employee compensation.

	Three months ended June 30, 2005			**Six months ended June 30, 2005**		
	(In thousands, except per share amounts)					
Net loss, as reported	$	(449	)	$	(5,151	)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(21,192		)	(25,216		)
Pro forma net loss	$	(21,641	)	$	(30,367	)
Net loss per common share:						
Net loss and diluted net loss per common share, as reported	$	(0.02	)	$	(0.17	)
Net loss and diluted net loss per common share, pro forma	$	(0.72	)	$	(1.02	)

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, Accounting for Income Taxes.* FIN 48 clarifies the accounting and disclosure for income taxes by defining the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. It also provides guidance on derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the impact of FIN 48 on its consolidated financial position and results of operations.

Note 2 Share-Based Payments

Stock Option and Restricted Stock Plans

The Company has several stock option and restricted stock plans. The Veeco Instruments Inc. 2000 Stock Incentive Plan, as amended, (the 2000 Plan), was approved by the Board of Directors and shareholders in May 2000. The 2000 Plan provides for the grant to officers and key employees of up to 8,530,000 options (1,776,524 options are available for future grants as of June 30, 2006) to purchase shares of common stock of the Company. Stock options granted pursuant to the 2000 Plan expire after seven years and generally become exercisable over a three-year period following the grant date. However, grants made under the 2000 Plan between June 17, 2005 and December 23, 2005 became exercisable on or before December 31, 2005, and are subject to a resale restriction which provides that the shares issuable upon exercise of the option may not be transferred prior to the second anniversary of the option grant date. In addition, the 2000 Plan provides for automatic annual grants of 5,000 shares of restricted stock to each member of the Board of Directors of the Company who is not an employee of the Company. Up to 1,700,000 of the awards authorized under the 2000 Plan may be issued in the form of restricted stock (1,456,750 shares are available for future grants as of June 30, 2006). In June 2006, the Company granted 158,250 shares of restricted common stock to key employees, which vest over three years, and in May 2006, granted 40,000 shares of restricted common stock to the non-employee members of the Board of Directors, which vest over a period of one year.

A summary of the Company s restricted stock awards as of June 30, 2006, is presented below:

	Shares (000 s)	Weighted-Average Grant-Date Fair Value
Nonvested at beginning of year	45	$ 15.60
Granted	198	24.32
Vested		
Forfeited		
Nonvested at June 30, 2006	243	$ 22.71

The Veeco Instruments Inc. 2000 Stock Option Plan for Non-Officer Employees (the Non-Officer Plan) was approved by the Board of Directors in October 2000. The Non-Officer Plan provided for the grant of stock options to non-officer employees to purchase shares of common stock of the Company. Stock options granted pursuant to the Non-Officer Plan become exercisable over a three-year period following the grant date and expire after seven years.

The Veeco Instruments Inc. Amended and Restated 1992 Employees Stock Option Plan (the 1992 Plan) provided for the grant to officers and key employees of stock options to purchase shares of common stock of the Company. Stock options granted pursuant to the 1992 Plan become exercisable over a three-year period following the grant date and expire after ten years.

The Veeco Instruments Inc. 1994 Stock Option Plan for Outside Directors, as amended, (the Directors Option Plan), provided for automatic annual grants of stock options to each member of the Board of Directors of the Company who is not an employee of the Company. Such options are exercisable immediately and expire after ten years.

The Non-Officer Plan, the 1992 Plan and the Directors Option Plan have been frozen; and, thus, there are no options available for future grant as of June 30, 2006 under these plans.

In addition to the plans described above, the Company assumed certain stock option plans and agreements relating to the merger in September 2001 with Applied Epi, Inc. (Applied Epi). These stock option plans do not have options available for future grants and expire after ten years from the date of grant. Options granted under two of the plans vested over three years and options granted under one of the plans vested immediately. As of June 30, 2006, there are 200,477 options outstanding under the various Applied Epi plans. In addition, Veeco assumed certain warrants related to Applied Epi, which were in effect prior to the merger with Veeco. These warrants expired in February 2006.

In May 2000, the Company assumed certain stock option plans and agreements related to CVC, Inc. and Commonwealth Scientific Corporation, a subsidiary of CVC, Inc., which were in effect prior to the merger with Veeco.

These plans do not have options available for future grants, the options granted thereunder generally vested over a three to five year period and expire five to ten years from the date of grant. As of June 30, 2006, there are 7,251 options outstanding under the various CVC, Inc. and Commonwealth Scientific Corporation plans.

With the adoption of SFAS No. 123(R) on January 1, 2006, the Company is required to record the fair value of stock-based compensation awards as an expense. In order to determine the fair value of stock options on the date of grant, the Company applies the Black-Scholes option-pricing model. Inherent in the model are assumptions related to expected stock-price volatility, option life, risk-free interest rate and dividend yield. While the risk-free interest rate and dividend yield are less subjective assumptions, typically based on factual data derived from public sources, the expected stock-price volatility and option life assumptions require a level of judgment which make them critical accounting estimates.

Beginning in the fourth quarter of 2005, the Company used an expected stock-price volatility assumption that is a combination of both historical and implied volatilities of the underlying stock, which are obtained from public data sources. Prior to that time, the Company based this assumption solely on historical volatility.

With regard to the weighted-average option life assumption, the Company considers the exercise behavior of past grants and models the pattern of aggregate exercises.

The fair value of each option granted during the three and six months ended June 30, 2006, was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Weighted-average expected stock-price volatility	40%
Weighted-average expected option life	3 years
Average risk-free interest rate	4.99%
Average dividend yield	0%

The fair value of each option grant that was unvested as of January 1, 2006, was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Weighted-average expected stock-price volatility	60%
Weighted-average expected option life	4 years
Average risk-free interest rate	3.64%
Average dividend yield	0%

A summary of the Company s stock option plans as of and for the six months ended June 30, 2006, is presented below:

	Shares (000 s)		Weighted-Average Exercise Price		Aggregate Intrinsic Value (000s)		Weighted-Average Remaining Contractual Life (in years)
Outstanding at beginning of year	7,834		$	24.81			
Granted	146		23.61				
Exercised	(454	)	17.38				
Forfeited (including cancelled options)	(292	)	23.49				
Outstanding at June 30, 2006	7,234		$	25.30	$	21,035	3.5
Options exercisable at June 30, 2006	6,982		$	25.45	$	20,350	3.4

The weighted-average grant date fair value of stock options granted for the three and six months ended June 30, 2006 was $7.61. The weighted-average grant date fair value of stock options granted for the three and six months ended June 30, 2005 was $8.05 and $7.99, respectively. The total intrinsic value of stock options exercised during the three and six months ended June 30, 2006 was $2.8 million and $3.2 million, respectively. The total intrinsic value of stock options exercised during the three and six months ended June 30, 2005 was less than $0.1

million and $0.1 million, respectively.

The following table summarizes information about stock options outstanding at June 30, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at June 30, 2006 (000 s)	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number Outstanding at June 30, 2006 (000 s)	Weighted-Average Exercise Price
$0.27	97	4.5	$ 0.27	97	$ 0.27
10.25-15.35	223	4.8	14.62	180	14.62
15.45-23.11	3,823	4.3	19.48	3,760	19.48
23.61-35.00	2,197	2.8	29.59	2,051	30.02
35.75-50.60	834	1.3	44.19	834	44.19
54.35-72.00	60	2.9	55.91	60	55.91
	7,234	3.5	$ 25.30	6,982	$ 25.45

On April 12, 2005, the Compensation Committee (the Committee) of the Company s Board of Directors approved the acceleration of vesting for unvested, out-of-the-money stock options granted under the Company s stock option plans prior to September 1, 2004. An option was considered out-of-the-money if the option exercise price was greater than the closing price of the Company s common stock on the NASDAQ National Market on April 11, 2005 ($15.26), the last trading day before the Committee approved the acceleration. As a result of this action, options to purchase approximately 2,522,000 shares of the Company s common stock became immediately exercisable, including options held by the Company s executive officers to purchase approximately 852,000 shares of common stock. The weighted average exercise price of the options for which vesting was accelerated was $21.24.

The purpose of the accelerated vesting was to avoid future compensation expense of approximately $7.9 million in 2006 and $3.6 million in 2007 associated with these options that the Company would otherwise recognize in its Consolidated Statements of Operations upon the adoption of SFAS No. 123(R) (see Note 1). In addition, many of these options had exercise prices significantly in excess of current market values and were not providing an effective means of employee retention and incentive compensation.

Employee Stock Purchase Plan

Under the Veeco Instruments Inc. Amended and Restated Employee Stock Purchase Plan (the ESP Plan), the Company is authorized to issue up to 2,000,000 shares of common stock to its full-time U.S. employees, nearly all of whom are eligible to participate. Under the terms of the ESP Plan, employees can choose to have up to 10% of their annual base earnings withheld to purchase the Company s common stock. The purchase price of the stock as of June 30, 2006 was 95% of the end-of-offering period market price and qualifies as a noncompensatory employee stock purchase plan under Section 423 of the Internal Revenue Code.

Shares Reserved for Future Issuance

As of June 30, 2006, the Company has reserved the following shares for future issuance related to:

Issuance upon exercise of stock options and issuance of restricted stock	9,010,505
Issuance upon conversion of subordinated debt	5,193,456
Issuance of shares pursuant to the ESP Plan	1,453,582
Total shares reserved	15,657,543

Preferred Stock

The Board of Directors of the Company has authority under the Company s Certificate of Incorporation to issue shares of preferred stock with voting and economic rights to be determined by the Board or Directors.

Note 3 Balance Sheet Information

Inventories

Inventories have been determined by lower of cost (principally first-in, first-out) or market. Inventories consist of:

	June 30, 2006 (In thousands)	December 31, 2005
Raw materials	$ 51,932	$ 45,357
Work in progress	32,469	33,307
Finished goods	11,743	10,240
	$ 96,144	$ 88,904

Accrued Warranty

The Company estimates the costs that may be incurred under the warranty it provides and recognizes a liability in the amount of such costs at the time the related revenue is recognized. Factors that affect the Company s warranty liability include product failure rates, material usage and labor costs incurred in correcting product failures during the warranty period. The Company periodically assesses the adequacy of its recognized warranty liability and adjusts the amount as necessary. Changes in the Company s warranty liability during the period are as follows:

	Six Months Ended June 30, 2006 (In thousands)	2005
Balance as of January 1	$ 6,671	$ 6,771
Warranties issued during the period	3,353	2,833
Settlements made during the period	(3,264)	(3,160)
Balance as of June 30	$ 6,760	$ 6,444

Note 4 Segment Information

As of January 1, 2006, the Company changed its management structure in a manner that caused the composition of its reportable segments to change. The Company currently manages the business, reviews operating results and assesses performance, as well as allocates resources, based upon two separate reporting segments. The Company merged the former Ion Beam and Mechanical Process Equipment segment and the Epitaxial Process Equipment segment into one reporting segment. The new Process Equipment segment combines the etch, deposition, dicing and slicing products sold mostly to data storage customers and the molecular beam epitaxy and metal organic chemical vapor deposition products primarily sold to high brightness light emitting diode and wireless telecommunications customers. This segment includes production facilities in Plainview, New York, Ft. Collins, Colorado, Camarillo, California, St. Paul, Minnesota and Somerset, New Jersey. The Metrology segment remains unchanged and represents equipment that is used to provide critical surface measurements on products such as semiconductor devices and thin film magnetic heads and includes Veeco s broad line of atomic force microscopes, optical interferometers and stylus profilers sold to semiconductor customers, data storage customers and thousands of research facilities and scientific centers. This segment includes production facilities in Santa Barbara, California and Tucson, Arizona. Accordingly, the Company has restated segment information for the prior periods presented.

The Company evaluates the performance of its reportable segments based on income or loss from operations before interest, income taxes and amortization (EBITA). The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Items excluded from segment profit primarily consist of interest, amortization, income taxes, corporate expenses, as well as other unusual charges for purchased in-process technology, restructuring and asset impairment charges and merger-related costs. Corporate expenses are comprised primarily of general and administrative expenses.

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The following tables present certain data pertaining to the reportable product segments of the Company and a reconciliation of EBITA to income (loss) before income taxes for the three and six months ended June 30, 2006 and 2005, and goodwill and total assets as of June 30, 2006 and December 31, 2005 (in thousands):

	Process Equipment	Metrology	Unallocated Corporate Amount	Total
Three Months Ended June 30, 2006				
Net sales	$ 67,361	$ 44,274	$	$ 111,635
Income (loss) before interest, taxes, amortization and certain items (EBITA)	7,801	6,316	(4,521)	9,596
Interest expense, net			1,149	1,149
Amortization expense	3,288	441	260	3,989
Income (loss) before income taxes	4,513	5,875	(5,930)	4,458
Three Months Ended June 30, 2005				
Net sales	$ 61,157	$ 42,258	$	$ 103,415
Income (loss) before interest, taxes, amortization and certain items (EBITA)	2,269	6,517	(2,728)	6,058
Interest expense, net			1,959	1,959
Amortization expense	3,294	457	275	4,026
(Loss) income before income taxes	(1,025)	6,060	(4,962)	73
Six Months Ended June 30, 2006				
Net sales	$ 120,552	$ 85,001	$	$ 205,553
Income (loss) before interest, taxes, amortization and certain items (EBITA)	9,677	11,928	(6,355)	15,250
Interest expense, net			2,527	2,527
Amortization expense	6,576	895	533	8,004
Other items			(330)	(330)
Income (loss) before income taxes	3,101	11,033	(9,085)	5,049
Six Months Ended June 30, 2005				
Net sales	$ 111,519	$ 85,746	$	$ 197,265
(Loss) income before interest, taxes, amortization and certain items (EBITA)	(433)	14,279	(5,153)	8,693
Interest expense, net			4,105	4,105
Amortization expense	6,888	1,038	590	8,516
(Loss) income before income taxes	(7,321)	13,241	(9,848)	(3,928)

	Process Equipment	Metrology	Unallocated Corporate Amount	Total
As of June 30, 2006				
Goodwill	$ 70,254	$ 29,368	$	$ 99,622
Total assets	297,035	136,903	130,117	564,055
As of December 31, 2005				
Goodwill	$ 70,254	$ 29,368	$	$ 99,622
Total assets	300,617	132,928	134,315	567,860

Corporate total assets are comprised principally of cash at June 30, 2006 and December 31, 2005.

Note 5 Comprehensive Income (Loss)

Total comprehensive income (loss) was $4.0 million and $4.5 million for the three and six months ended June 30, 2006, and ($2.4) million and ($8.7) million for the three and six months ended 2005, respectively. The Company s comprehensive income (loss) is comprised of net income (loss) and foreign currency translation adjustments.

Note 6 Other Matters

As of June 30, 2006, the Company has outstanding $200.0 million of 4.125% convertible subordinated notes. During the first quarter of 2006, the Company repurchased $20.0 million of its notes, reducing the amount outstanding from $220.0 million to $200.0 million. The repurchase amount was $19.5 million in cash, of which $19.4 million related to principal and $0.1 million related to accrued interest. As a result of the repurchase, the Company recorded a gain from the early extinguishment of debt in the amount of $0.6 million, offset by a $0.3 million proportionate reduction in the related deferred financing costs for a net gain of $0.3 million.

In conjunction with a cost reduction plan announced by the Company in October 2005, the Company recognized a restructuring charge of approximately $1.2 million in the fourth quarter of 2005. The $1.2 million charge consisted of personnel severance costs for approximately 37 employees which included management, administration and manufacturing employees located at the Company s Plainview, New York, Camarillo, California and Somerset, New Jersey Process Equipment operations and the Santa Barbara, California Metrology operations. As of June 30, 2006, approximately $1.0 million has been paid and approximately $0.2 million remains in accrued expenses. The Company expects to pay the remainder by the fourth quarter of 2006.

A reconciliation of the liability for the 2005 restructuring charge for severance costs is as follows (in millions):

	Process Equipment	Metrology	Total
Charged to accrual	$ 0.8	$ 0.4	$ 1.2