KOPIN CORP
Form 10-Q
March 17, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2006

OR

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

Commission file number 0-19882

KOPIN CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**04-2833935**
State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization	**Identification No.)**
200 John Hancock Rd., Taunton, MA	**02780-1042**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (508) 824-6696

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 filing requirements for the past 90 days. Yes ¨ No x

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

Large Accelerated Filer ¨ Accelerated Filer x 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 x

Indicate the number of shares outstanding of each issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding as of March 14, 2008**
Common Stock, par value $.01	71,043,391

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EXPLANATORY NOTE REGARDING RESTATEMENTS

In this Quarterly Report on Form 10-Q (Form 10-Q), we are restating our condensed consolidated financial statements as of December 31, 2005 and for the three and nine months ended September 24, 2005. Contemporaneous with the filing of this Form 10-Q, we are filing an Annual Report on Form 10-K (Form 10-K) for the year ended December 30, 2006 and Quarterly Reports on Form 10-Q for the quarters ended March 31, 2007, June 30, 2007 and September 29, 2007. In our Form 10-K, we are restating our consolidated financial statements as of December 31, 2005 and for each of the years ended December 31, 2005 and December 25, 2004 and each of the quarters in 2005 and the three month periods ended April 1, 2006 and July 1, 2006.

The restatement of our consolidated financial statements reflects the correction of the following errors, in accordance with Financial Accounting Standards Board (FASB) No. 154 *Accounting Changes and Error Corrections* :

1. stock-based compensation expense not previously recorded for certain stock-based awards for which the original accounting was deemed incorrect;

2. tax-related adjustments resulting from the above errors in stock option accounting; and

3. the recording of previously unrecorded adjustments not related to accounting for stock options that were previously deemed to be immaterial to our consolidated financial statements.

On November 1, 2006, in response to a derivative lawsuit filed against the Company related to the Company s employee stock option granting practices and accounting (see Part II Item I Legal Proceedings), our Board of Directors appointed a Special Investigation Committee of the Board of Directors, referred to as the Special Committee, composed solely of an independent director who was not on the Company s Board of Directors and who had no affiliation with the Company during the period between 1995 and 2005, to conduct a comprehensive investigation of our historical stock option practices.

Responding to the findings of the Special Committee, filed in a Form 8-K on May 9, 2007, we reviewed the measurement dates for stock option and nonvested restricted common share grants (collectively, stock-based awards) used in our historical financial reporting. We reviewed the measurement dates for all 19.8 million of our historical stock-based award grants and reviewed all available evidence for each grant during the period from January 1, 1995 through December 30, 2006, referred to as the Investigation Period.

Stock-based awards granted during the Investigation Period can be categorized as follows:

New Hire Employee Stock-Based Awards. Total awards made to new hire employees during the Investigation Period totaled 3.8 million.

All Other Stock-Based Awards to Non Officer Employees. Total awards made to non-officers excluding new hires during the Investigation Period totaled 6.4 million.

All Other Stock-Based Awards to Officers. Total awards made to officers excluding new hires during the Investigation Period totaled 7.9 million.

Director Stock-Based Awards. Total awards made to members of the Board of Directors during the Investigation Period totaled 1.4 million.

Consultant Awards. Total awards made to consultants during the Investigation Period totaled 265,000.

Certain of the stock-based awards granted during the Investigation Period had exercise prices that tended to be at a price towards the lower end of range of common stock prices over a 90 day period from the original grant date.

Impact of Restatement

For stock-based awards granted during the period January 1, 1995 through December 31, 2005 of the Investigation Period, the accounting principle applied under United States Generally Accepted Accounting Principles (US GAAP) was Accounting Principles Board Opinion No. 25

(APB 25), *Accounting for Stock Issued to Employees*. For stock-based awards granted during the period January 1, 2006 through December 30, 2006, of the Investigation Period we applied Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). APB 25 prescribed that there was a compensation element in a stock option award to an employee if the option exercise price was below the fair market value of the company s stock on the measurement date. The measurement date is the date that the number of options the employee was to receive and the option exercise price were known. We typically accounted for all stock-based awards to new hires, employees, officers and directors, through December 31, 2005 under APB 25 using the stated grant date as the measurement date. We typically issued stock options with an exercise price equal to the fair market value of our common stock on the recorded

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grant date, and therefore recorded no stock-based compensation expense. We recorded compensation expense for awards of restricted common shares for the fair value of the common shares on the grant date over the vesting period. We refer to the measurement date used when the stock-based award was granted during the Investigation Period as the Original Measurement Date. If, as a result of our option review, we used a different measurement date than the Original Measurement Date to determine if there was an element of compensation expense in a stock-based award, we referred to the new measurement date as the Revised Measurement Date.

We reviewed 14.3 million stock-based awards granted to officers and non-officers (excluding new hires, consultants and Board of Directors awards which are addressed below) to verify that the terms of the awards were approved and known with finality on the Original Measurement Date. We determined that for 11.5 million stock-based awards the number of shares was not known with finality on the Original Measurement Date. In those situations where we had either not completed the process of determining the number of stock options a particular employee was to receive or the administrative process was not finished on the Original Measurement Date, a compensation charge is required to reflect the difference between the exercise price of the stock-based award and the stock price (when it exceeds the exercise price) on the date the determination or process was completed. We recorded compensation expense of $33.6 million, excluding income tax effects, in connection with the restatement described above.

We reviewed 3.8 million stock-based awards granted to new hires to verify that the grant date was the same date as the date that the individual met the definition of an employee, generally the employee start date. We identified instances where employees did not start on their anticipated start date per their offer letter but commenced employment at a later date; however the option was granted based on the anticipated start date included in their offer letter. Compensation expense is required to reflect the difference between the exercise price of the stock option and the stock price on the employee start date. We identified 718,000 options following this pattern and recorded compensation expense of $0.6 million, excluding income tax effects, in connection with the restatement described above. We identified one situation where an offer letter gave the employee an option to purchase 120,000 shares of our common stock with an exercise price equal to our common stock price on the date he commenced employment but we incorrectly granted the option with an exercise price equal to our common stock price on the date we made the offer of employment. We recorded compensation expense of $1.0 million, excluding income tax effects, in connection with the restatement described above. We identified one situation where the employment offer letter gave the prospective employee an option to purchase 400,000 shares of our common stock at an exercise price equal to our common stock price on the date the employment offer letter was accepted. In this situation, compensation expense should have been recorded to reflect the difference between the exercise price and our common stock price on the date employment commenced. We recorded compensation expense of $0.4 million, excluding income tax effects, in connection with the restatement described above.

We reviewed 265,000 stock option awards granted to consultants. We identified five grants to consultants totaling 205,000 options, which we accounted for incorrectly and we recorded compensation expense of $1.8 million, excluding income tax effects, in connection with the restatement described above. Of the $1.8 million of compensation expense, $1.6 million related to two grants made in January of 1996. We originally accounted for these consultant awards under APB 25 and recorded no compensation expense for these awards.

We also reviewed 1.4 million stock-based awards to members of the Board of Directors. We identified two awards of 300,000 options for which we recorded compensation expense of approximately $30,000, excluding income tax effects, as the result of an inconsistent pricing practice.

All financial information contained in this quarterly report gives effect to the restatements of our consolidated financial statements as described above. We have not amended, and we do not intend to amend, our previously filed annual reports or quarterly reports for each of the fiscal years and fiscal quarters of 1995 through 2005, and for the first two fiscal quarters of the fiscal year ended December 30, 2006. Financial information included in reports previously filed or furnished by us for the periods from fiscal 1995 through July 1, 2006 should not be relied upon and are superseded by the information in this quarterly report.

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Part 1: FINANCIAL INFORMATION

Item 1: Condensed Consolidated Financial Statements

KOPIN CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2006	December 31, 2005 (As restated - See Note 2)
ASSETS		
Current assets:		
Cash and equivalents	$ 24,456,852	$ 31,502,645
Marketable securities, at fair value	84,236,308	88,254,220
Accounts receivable, net of allowance of $345,000 and $281,000 in 2006 and 2005	7,899,075	7,937,397
Accounts receivable from unconsolidated affiliates	2,462,799	3,040,012
Unbilled receivables	2,221,364	2,037,406
Inventory	9,550,303	9,258,232
Prepaid taxes	143,023	433,744
Prepaid expenses and other current assets	1,944,472	1,466,735
Total current assets	132,914,196	143,930,391
Property, plant and equipment, net	16,217,262	11,250,453
Deferred tax asset		370,000
Other assets	12,630,883	10,782,666
Total assets	$ 161,762,341	$ 166,333,510
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,739,051	$ 7,299,695
Accounts payable to unconsolidated affiliates	635,550	1,034,586
Accrued payroll and expenses	2,515,775	2,944,109
Accrued warranty	1,030,000	1,030,000
Billings in excess of revenue earned	1,006,966	1,080,810
Accrued tax	249,000	457,000
Other accrued liabilities	1,563,235	1,134,051
Total current liabilities	13,739,577	14,980,251
Asset retirement obligations	764,148	740,000
Minority interest in subsidiary	4,263,825	4,337,925
Commitments and contingencies		
Stockholders equity:		
Preferred stock, par value $.01 per share: authorized, 3,000 shares; none issued		
Common stock, par value $.01 per share: authorized, 120,000,000 shares; issued 71,272,811 shares in 2006 and 71,235,036 shares in 2005 outstanding 67,428,611 in 2006 and 68,874,086 in 2005	712,728	712,350
Additional paid-in capital	304,885,791	305,166,998
Deferred compensation		(2,689,048)
Treasury stock (3,455,480 and 1,893,200 shares in 2006 and 2005, respectively, at cost)	(14,005,965)	(7,398,868)

Accumulated other comprehensive income	2,308,040	2,122,241
Accumulated deficit	(150,905,803)	(151,638,339)
Total stockholders equity	142,994,791	146,275,334
Total liabilities and stockholders equity	$ 161,762,341	$ 166,333,510

See notes to consolidated financial statements

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KOPIN CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 24, 2005 (As Restated See Note 2)	September 30, 2006	September 24, 2005 (As Restated See Note 2)
Revenues:				
Product revenues	$ 13,744,041	$ 24,006,807	$ 48,746,405	$ 61,754,067
Research and development revenues	1,960,151	1,409,084	4,512,837	3,603,334
	15,704,192	25,415,891	53,259,242	65,357,401
Expenses:				
Cost of product revenues	10,733,895	15,651,523	36,460,789	39,823,827
Research and development	2,676,931	2,533,883	8,132,489	8,811,602
Selling, general and administrative	4,018,942	2,965,826	11,767,381	10,316,279
Asset impairment				517,902
	17,429,768	21,151,232	56,360,659	59,469,610
(Loss) income from operations	(1,725,576)	4,264,659	(3,101,417)	5,887,791
Other income and (expense):				
Interest income	1,211,360	931,121	3,580,073	2,531,807
Other income	287,773	17,741	319,814	23,067
Gain on sale of Micrel common stock			1,208,000	
Foreign currency transaction (losses) gains	(143,442)	130,458	(624,367)	(32,038)
Interest and other expense	(10,155)	(70,053)	(45,063)	(105,020)
	1,345,536	1,009,267	4,438,457	2,417,816
(Loss) income before income taxes; minority interest in loss (income) of subsidiary and equity loss in unconsolidated affiliate	(380,040)	5,273,926	1,337,040	8,305,607
(Provision) benefit for income taxes	(551,073)	44,262	(523,141)	(63,966)
(Loss) income before minority interest in loss (income) subsidiary and equity loss in unconsolidated affiliate	(931,113)	5,318,188	813,899	8,241,641
Minority interest in loss (income) of subsidiary	144,817	(267,687)	394,479	(425,692)
Equity loss in unconsolidated affiliate	(97,740)	(18,515)	(475,843)	(168,023)
Net (loss) income	$ (884,036)	$ 5,031,986	$ 732,535	$ 7,647,926
(Loss) income per share:				
Basic	$ (0.01)	$ 0.07	$ 0.01	$ 0.11
Diluted	$ (0.01)	$ 0.07	$ 0.01	$ 0.11
Weighted average number of common shares outstanding:				
Basic	67,798,463	68,917,786	68,283,179	69,492,341

Diluted	67,798,463	69,810,168	68,305,531	69,852,326

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	**September 24, 2005 (As Restated See Note 2)**	**September 30, 2006**	**September 24, 2005 (As Restated See Note 2)**
Net (loss) income	$ (884,036)	$ 5,031,986	$ 732,535	$ 7,647,926
Foreign currency translation adjustments	169,186	(247,050)	875,066	(68,198)
Unrealized holding gain (loss) on marketable securities	618,961	(427,760)	(689,267)	(346,868)
Comprehensive (loss) income	$ (95,889)	$ 4,357,176	$ 918,334	$ 7,232,860

See notes to consolidated financial statements

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KOPIN CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Nine Months Ended September 30, 2006	Nine Months Ended September 24, 2005 (As restated See Note 2)
Cash flows from operating activities:		
Net income	$ 732,535	$ 7,647,926
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,270,271	2,784,779
Amortization of interest premium or discount	192,170	170,533
Minority interest in (loss) income of subsidiary	(394,480)	425,693
Equity loss in unconsolidated affiliate	475,843	168,023
Net (gain) loss on investment activity	(1,208,000)	68,111
Loss on equipment disposal		12,510
Stock-based compensation	2,130,455	1,217,173
Change in other non-cash items	(360,739)	(140,000)
Impairment charge		517,902
Changes in assets and liabilities:		
Accounts receivable	775,224	(6,213,042)
Inventory	(62,439)	(621,445)
Deferred tax asset	370,000	
Prepaid expenses and other current assets	(251,959)	(1,648,184)
Accounts payable and accrued expenses	(2,842,414)	1,709,033
Billings in excess of revenue earned	(73,844)	(249,102)
Net cash provided by operating activities	1,752,623	5,849,910
Cash flows from investing activities:		
Proceeds from sale of marketable securities	34,602,518	18,389,037
Purchases of marketable securities	(30,537,938)	(14,593,432)
Other assets	14,586	(68,673)
Investment in KoBrite and other equity investments	(4,952,063)	(3,000,000)
Proceeds from sale of equipment		4,500,000
Proceeds from sale of investments	3,002,000	
Capital expenditures	(5,450,936)	(1,490,244)
Net cash (used in) provided by investing activities	(3,321,833)	3,736,688
Cash flows from financing activities:		
Treasury stock purchases	(6,607,097)	(6,358,889)
Proceeds from exercise of stock options	277,762	618,200
Net cash used in financing activities	(6,329,335)	(5,740,689)
Effect of exchange rate changes on cash	852,752	(68,272)
Net (decrease) increase in cash and equivalents	(7,045,793)	3,777,637
Cash and equivalents:		

Beginning of period	31,502,645	17,816,498
End of period	$ 24,456,852	$ 21,594,135
Supplemental disclosure of cash flow information:		
Cash paid during the period for income taxes	$ 472,000	$
Supplemental schedule of noncash investing activities:		
Construction in progress included in accrued expenses	$ 1,572,000	$

See notes to consolidated financial statements.

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KOPIN CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The consolidated financial statements for the three and nine months ended September 30, 2006 and September 24, 2005 are unaudited and include all adjustments, which, in the opinion of management, are necessary to present fairly the results of operations for the periods then ended. All such adjustments are of a normal recurring nature.

These consolidated financial statements should be read in conjunction with the Company s annual consolidated financial statements and notes thereto.

The results of the Company s operations for any interim period are not necessarily indicative of the results of the Company s operations for any other interim period or for a full fiscal year.

The consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and Kowon Technology Co., Ltd. (Kowon), a majority owned (73%) subsidiary located in Korea. All intercompany transactions and balances have been eliminated.

2. RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

On November 1, 2006, in response to a derivative lawsuit filed against the Company, the Board of Directors established a Special Investigation Committee (the Special Committee) to review its historical stock-based awards granting practices (the Internal Review) and accounting.

As a result of the Internal Review, the Company determined that during the period from January 1, 1995 through December 30, 2006 (the Investigation Period), the Company i) applied incorrect measurement dates in the accounting for certain stock-based awards and ii) incorrectly accounted for certain stock options that should have been recorded under Emerging Issues Task Force (EITF) 96-18: *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* . Accordingly, the Company has restated the accompanying consolidated financial statements as of December 31, 2005 and for the periods ended September 24, 2005 to record additional stock-based compensation to correctly account for its stock-based awards and related payroll tax adjustments. The Company has also corrected other previously unrecorded misstatements not related to the accounting for stock-based awards previously deemed to be immaterial.

Stock-Based Compensation Adjustments

For stock-based awards granted during the period January 1, 1995 through December 31, 2005, the accounting principle applied under United States Generally Accepted Accounting Principles (US GAAP) was Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. For stock-based awards granted during the period January 1, 2006 through December 30, 2006, the Company applied Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). APB 25 prescribed that there was a compensation element in a stock option award to an employee if the option exercise price was below the fair market value of the Company s stock on the measurement date. The measurement date is the date that the number of options the employee was to receive and the option price were known. The Company typically accounted for all stock-based awards to new hires, employees, officers and directors, through December 31, 2005 under APB 25 using the grant date as the measurement date. The Company typically issued stock options with an exercise price equal to the fair market value of its common stock on the recorded grant date, and therefore recorded no stock-based compensation expense. The Company recorded compensation expense for awards of restricted common shares for the intrinsic value of the award on the grant date over the vesting period. The measurement date used when the stock-based award was granted during the Investigation Period is referred to as the Original Measurement Date. If, as a result of its option review, the Company used a different measurement date other than the Original Measurement Date to determine if there was an element of compensation expense in a stock-based award, the new measurement date is referred to as the Revised Measurement Date.

As a result of the Special Committee s findings and the Company s own further review of its stock-based award granting practices, it was determined that the measurement dates for certain stock-based awards differed from the recorded grant dates for such grants. In some instances, the Company was only able to locate sufficient evidence to identify the measurement date described in APB 25, the first date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known, within a range of possible dates. As a result, the Company developed a framework to determine the Revised Measurement Date using the best available evidence of the date on which both the number of shares that an individual employee was entitled to receive and the exercise price were known with finality. The information used to identify the Revised Measurement Dates for new hire stock-based awards was available in the respective offer letters and personnel files. For all other awards the Company used the minutes of the Board of Director meetings, minutes of the Compensation Committee meetings, written consents of the Board of Directors and Compensation Committee, emails, spreadsheets, Form 4 filings with the SEC, and other accounting records to identify the Revised Measurement dates.

The methodology the Company used to determine the Revised Measurement Dates associated with prior stock-based awards was as follows:

New Hire Employee Stock Based Awards. The Company determined that the Original Measurement Date was actually the anticipated employment commencement date documented in the employment offer letter and not the actual commencement date for 718,000 options granted to new hire employees. The Company determined the Revised Measurement Date for each of these grants to be the date the employee actually commenced employment with the company. The Company recorded compensation expense of $0.6 million, excluding income tax effects, in connection with the restatement described above. The Company identified one situation where an offer letter gave the employee an option to purchase 120,000 shares of our common stock with an exercise price equal to our common stock price on the date he commenced employment but the Company incorrectly granted the option with an exercise price equal to our common stock price on the date we made the offer of employment. The Company recorded compensation expense of $1.0 million, excluding income tax effects, in connection with the restatement described above. The Company identified one situation where the employment offer letter gave the prospective employee an option to purchase 400,000 shares of our common stock at an exercise price equal to its common stock price on the date the employment offer letter was accepted. In this situation, compensation expense should have been recorded to reflect the difference between the exercise price and our common stock price on the date employment commenced. The Company recorded compensation expense of $0.4 million, excluding income tax effects, in connection with the restatement described above.

All Other Stock-Based Awards to Non Officers. The Company determined that the Original Measurement Date could not be relied on for 6.2 million of the 6.4 million stock-based awards options granted to non-officer employees because the criteria for measurement date for the awards had not been met under US GAAP then applicable at the Original Measurement Date. The Company determined the Revised Measurement Date for each stock-based award to non officer employees, other than grants of new hire employee stock-based awards, based upon the following decision matrix which factored in all available evidence. The decision matrix contemplates the strength of the available evidence in supporting the finality of the granting process. If the criteria described below in a particular bullet point was satisfied then the date derived from the information reviewed under that bullet point was the date chosen as the Revised Measurement Date; if not, the Company proceeded to the next bullet point criteria.

- If the fully executed minutes of the Board of Director or Compensation Committee meetings documented the grantee, the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was the date of the fully executed minutes, which was the same as the Original Measurement Date. 137,000 stock-based awards met this criteria and accordingly no compensation expense was recorded.

- If a fully executed written consent of the Board of Directors or Compensation Committee documented the grantee, the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was the date of the last signature from a Board member or Compensation Committee member on the fully executed consent. The Company used this criteria to determine the Revised Measurement Date for 420,000 stock-based awards and to record compensation expense of approximately $413,000 as part of the restatement.

- If documentation from the Company s third party stock option plan administrator documented the grantee, the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was the date of such documentation. The Company used this criteria to determine the Revised Measurement Date for 207,000 stock-based awards and as the Company s common stock price on the Revised Measurement Date was lower than on the Original Measurement Date, no compensation expense was recorded.

- If documentation in the form of a final accounting spreadsheet contained the grantee, the number of stock option awards they were to receive and the exercise price for a significant percentage of employees, the Revised Measurement Date was the date of such documentation. The Company used this criteria to determine the Revised Measurement Date for 1.0 million stock-based awards and to record compensation expense of approximately $5.1 million.

- If documentation from one of the Company s product line general managers contained the grantee, the number of stock-based awards they were to receive and the exercise price for a significant percentage of the pool for that division and the total pool was approved by the Board of Directors or the Compensation Committee, the Revised Measurement Date was the date of such documentation. The Company was unable to locate concurrent documentation of the allocation of the pool for both of its product line divisions. Therefore, the Company evaluated whether the evidence of the allocation of the pool for one of the product line divisions was substantially complete, as based on the Company s process both divisions would have been finalizing their allocation at the same time. The Company defined substantially complete as approximately 90% or more of the total awards for the product line division were finalized. If the evidence supporting the allocation of the pool for one of the product line divisions was substantially complete, the Company assumed the Revised Measurement Date was the same for both product line divisions. The Company used this criteria to determine the Revised Measurement Date for 2.6 million stock-based awards and to record compensation expense of approximately $10.6 million as part of the restatement.

- If documentation in the form of Company records used to support the annual Form 10-K filings documented the grantee, the number of stock-based awards they were to receive and the exercise price the Revised Measurement Date was the date of the filing of the Form 10-K. The Company used this criteria to determine the Revised Measurement Date for 1.9 million stock-based awards and to record compensation expense of approximately $361,000 as part of the restatement.

All Other Stock-Based Awards to Officers. The Company determined that, for 5.3 million of the 7.9 million stock-based awards to Officers, the Original Measurement Date could not be relied on because the criteria for a measurement date had not been met under US GAAP then applicable at the Original Measurement Date. The Company determined the Revised Measurement Date for each stock-based award to officers, other than grants of new hire employee stock-based awards, based upon the following decision matrix which factored in all available evidence.

The Company assumed that the Revised Measurement Date for stock-based awards granted to Group B officers was the same as for Group A officers unless the evidence indicated otherwise. The decision matrix contemplates the strength of the available evidence in supporting the finality of the granting process. If the criteria described below in a particular bullet point was satisfied then the date derived from the information reviewed under that bullet point was the date chosen as the Revised Measurement Date, if not, Company proceeded to the next bullet point criteria.

If the fully executed minutes of the Board of Director or Compensation Committee meetings documented the grantee, the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was the date of the fully executed minutes, which was the same as the Original Measurement Date. 2.6 million stock-based awards met this criteria and accordingly no compensation expense was recorded.

If a fully executed consent of the Board of Directors or Compensation Committee documented the grantee, the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was

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the date of the last signature from a Board member or Compensation Committee member on the fully executed consent. The Company used this criteria to determine the Revised Measurement Date for 460,000 stock-based awards and to recorded compensation expense of approximately $445,000 as part of the restatement.

If the fully executed minutes of the Board of Director or Compensation Committee meetings subsequently documented or clarified the grantee and the number of stock-based awards they were to receive and the exercise price which were discussed in Compensation Committee minutes of a prior date, the Revised Measurement Date was the date of the clarifying Board of Director meeting. The Company used this criteria to determine the Revised Measurement Date for 2.8 million stock-based awards and to recorded compensation expense of approximately $10.5 million as part of the restatement.

If documentation in the form of a final accounting spreadsheet contained the grantee, the number of stock option awards they were to receive and the exercise price for a significant percentage (defined as containing approximately 90% or more of the awards to employees and officers) of employees, the Revised Measurement Date was the date of such documentation. The Company used this criteria to determine the Revised Measurement Date for 500,000 stock-based awards and to record compensation expense of approximately $3.4 million.

If a Form 4 was filed with the Securities and Exchange Commission documented the grantee and the number of stock-based awards they were to receive and the exercise price, the Revised Measurement Date was generally the filing date of the Form 4. The Company used this criteria to determine the Revised Measurement Date for 1.5 million stock-based awards and to record compensation expense of approximately $2.8 million as part of the restatement.

Director Stock-Based Awards. The 1997 Directors Stock Option Plan (the Directors Plan), which terminated in 2002, provided for the automatic grant of stock options to the Company s outside directors, such that the grants require no independent action of the Board of Directors or any committee of the Board of Directors. The Directors Plan permits the issuance of stock options with an exercise price of either the closing price of the Company s stock on the day before the grant or the closing price of the Company s stock on the day of grant. The Company identified two awards totaling 300,000 options where the exercise price of the award was the previous day s closing price. We recorded compensation expense of $30,000 for the difference between the previous days closing price and the closing price on the date of grant.

The Compensation Committee also made one award to a Director as an incentive to assist management in increasing the value of the Company. The Company could not locate documents which described the specific services the Director was to perform and accordingly this grant was treated as a non employee grant. The compensation charge for this grant was $27,000.

Applying the methodology described above, the Company calculated stock-based compensation expense for periods prior to fiscal 2006 under APB 25 based upon the intrinsic value on the Revised Measurement Dates of stock-based awards to new hires, officers, non-officers and directors and the vesting provisions of the underlying stock-based award. The Company calculated the intrinsic value on the Revised Measurement Date as the closing price of the Company s common stock on such date as reported on the Nasdaq National Market, now the Nasdaq Global Market (NASDAQ), less the exercise price per share of common stock, multiplied by the number of shares subject to such stock-based award. These amounts are recognized as compensation expense over the vesting period of the underlying stock-based award (generally four years). The Company also determined that EITF Issue 96-18: *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* should have been applied for certain stock-based awards to consultants in 1996. Under EITF 96-18, the Company remeasures, and reports in its consolidated statement of operations, the intrinsic value of the options at the end of each reporting period until the measurement date which is the date the options vest.

In applying the methodologies above, if the Company s stock price on the Revised Measurement Date was lower than the original grant price no compensation expense adjustment was recorded. The equity award plans under which the stock based awards discussed above were granted allow for the Board of Directors or its designee to issue stock options of the Company with an exercise price they choose, however, for a stock option to qualify as an incentive stock option the plan contains certain rules which are believed to be consistent with the requirements of the Internal Revenue Service. These rules essentially require that the equity awards be made at fair value on the date of grant, which is interpreted to be the previous day s closing price or the current day s closing price of the Company s common stock on NASDAQ. The Company has primarily used the current day s close price in determining the exercise price of stock options. When applying the methodologies above if an option was granted at the previous day s closing price the Company recorded compensation expense for the difference between the previous day s closing price and the closing price on the date of grant.

Tax Adjustments

Withholding Taxes

In addition to the stock-based compensation charges, amounts have also been recorded for tax-related expense related to the stock-based awards. The Company has determined that numerous stock options previously classified as incentive stock options (ISO) did not meet the criteria to qualify as ISOs since they were issued in the money based on the Revised Measurement Dates. As the Company mistakenly believed those options were ISOs, the Company did not withhold and pay certain employee income and payroll taxes on their exercise. Consequently, the Company has recorded additional expense,

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along with penalties and interest, in the periods of exercise. These expenses have been reversed in the period when the statute of limitations expires. Tax-related liabilities related to the disqualification of the ISO status of stock options and withholding taxes were approximately $80,000 at September 30, 2006.

Section 409A

Under Section 409A of the Internal Revenue Code (Section 409A), individuals who received option grants with an exercise price below the fair market value of the underlying stock at the Revised Measurement Date may be subject to additional taxes and interest with respect to options that vest after December 25, 2004. Absent corrective action by December 31, 2008 (or exercise, if earlier) holders of these stock options will be required to recognize ordinary income for federal income tax purposes as those options vest. Pursuant to interim Internal Revenue Service guidance, applicable to 2005 and 2006, the income is calculated as the difference between the fair market value of the underlying stock and the exercise price as of December 31 of the year of vesting. The individual must also recognize, in each subsequent year until the option is fully exercised or expires, ordinary income equal to the excess of the fair market value of the underlying stock over the sum of the exercise price and any previously recorded income. In addition to ordinary income taxes, an additional 20% penalty tax on the resulting ordinary income is levied on the individual, plus in certain instances interest on any tax to be paid. Certain states (e.g. California) take or may take the position that some or all of the same consequences, including the 20% penalty tax, will also apply for state purposes.

The Company intends to reimburse its employees and former employees the additional taxes arising under Section 409A due to the exercise of certain stock options in 2006. As a result, the Company anticipates incurring expenses of approximately $10,000. In order to avoid future tax consequences of 409A, the Company anticipates executing a tender offer to repurchase options which will give rise to taxes under 409A following the filing of this Form 10-Q. The Company estimates the aggregate cash payments to option holders under the program to be in the range of $200,000 to $500,000.

Income Taxes

Due to the Company s net operating loss position and full valuation against deferred tax assets there was no income tax impact related to this restatement.

Other Adjustments

The restatement of prior year financial statements includes adjustments in 2005 and 2004 of $372,000 and $303,000, respectively, for other errors identified in the period. However, such errors were not previously recorded as the Company concluded the amount of such errors, both individually and in the aggregate, were not material to the consolidated financial statements of any period. These errors related to inventory reserves and incentive and other miscellaneous accruals. We corrected certain interim period statements of cash flows to reflect construction in process accrued but not paid at the end of the period as a non-cash item. The Company also determined it has two reportable segments. Accordingly, the Company has corrected its disclosures in the notes to these Condensed Consolidated Financial Statements.

The following reflects the additional stock-based compensation expense, payroll tax expense and other adjustments recorded by the Company for the restatement described above (in thousands):

	Change in Stock-Based Compensation Expense Related to Restatement	Payroll Taxes	Change in Net Loss (Income) Related to Restatement of Stock-Based Compensation	Other Adjustments	Change in Net Loss (Income) Related to Restatement	Stock-Based Compensation Expense, Net of Tax, as Previously Reported	Stock-Based Compensation Expense, Net of Tax, As Restated
1995	$	$	$	$	$	$ 131	$ 131
1996	197		197		197	67	264
1997	1,666	103	1,769		1,769	76	1,742
1998	1,860	37	1,897		1,897	67	1,927
1999	4,646	631	5,277		5,277	55	4,701
2000	5,834	2,442	8,276		8,276	55	5,889
2001	8,209	582	8,791		8,791	55	8,264

2002	6,489	(609)	5,880	5,880		6,489
2003	5,263	(2,502)	2,761	2,761	20	5,283

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	Change in Stock-Based Compensation Expense Related to Restatement	Payroll Taxes	Change in Net Loss (Income) Related to Restatement of Stock-Based Compensation	Other Adjustments	Change in Net Loss (Income) Related to Restatement	Stock-Based Compensation Expense, Net of Tax, as Previously Reported	Stock-Based Compensation Expense, Net of Tax, As Restated
2004	2,458	(614)	1,844	(303)	1,541	505	2,963
Cumulative Expense	36,622	70	36,692	(303)	36,389		
2005	749	46	795	372	1,167	1,298	2,047
January 1, 2006 to July 1, 2006	41	4	45		45		
	$ 37,412	$ 120	$ 37,532	$ 69	$ 37,601		

The cumulative impact to net (loss) income for the years ended December 31, 1995 through 2004 is reflected as an increase to additional paid-in-capital of $37.5 million, an increase of deferred compensation of $0.9 million, a decrease in other accrued liabilities of $0.2 million, and an increase to accumulated deficit of $36.4 million as of December 26, 2004. The payroll tax adjustment in 2002 includes $383,000 of additional taxes resulting from the failure to withhold taxes upon the exercise of non-qualified option.

Statement of Operations Adjustments

The following table reconciles the amounts previously reported in the Company s consolidated statement of operations for the three month period ended September 24, 2005 to the corresponding restated amounts, which reflect the restatement adjustments previously described:

Three months ended September 24, 2005

	As previously reported	Adjustments	As restated
	(In thousands, except per share data)		
Statement of operations			
Revenues:			
Net product revenue	$ 24,007	$	$ 24,007
Research and development revenues	1,409		1,409

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	As previously reported	Adjustments	As restated
	(In thousands, except per share data)		
Total revenues	$ 25,416	$	$ 25,416
Expenses:			
Cost of product revenues	15,611	41	15,652
Research and development	2,488	46	2,534
Selling, general, and administration	2,699	267	2,966
Total operating expenses	20,798	353	21,151
Income from operations	4,618	(353)	4,265
Other income and (expense):			
Interest income	931		931
Other income	18		18
Foreign currency transaction gains	130		130
Interest and other expense	(70)		(70)

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