HENRY JACK & ASSOCIATES INC
Form 10-Q
February 08, 2018
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 December 31, 2017

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 0-14112

JACK HENRY & ASSOCIATES, INC.
(Exact name of registrant as specified in its charter)

Delaware	43-1128385
(State or Other Jurisdiction of Incorporation)	(I.R.S Employer Identification No.)

663 Highway 60, P.O. Box 807, Monett, MO 65708
(Address of Principle Executive Offices)
(Zip Code)

417-235-6652
(Registrant's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

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 [ ]

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

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

Large accelerated filer [X]	Accelerated filer	[ ]
Non-accelerated filer [ ]	(Do not check if a smaller reporting company)	
	Smaller reporting company	[ ]

Emerging growth company [ ]

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. [ ]

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

APPLICABLE ONLY TO CORPORATE ISSUERS

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

As of January 31, 2018, the Registrant had 77,261,505 shares of Common Stock outstanding ($0.01 par value).

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In this report, all references to “JHA”, the “Company”, “we”, “us”, and “our”, refer to Jack Henry & Associates, Inc., and its wholly owned subsidiaries.

FORWARD LOOKING STATEMENTS

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including without limitation, in Management's Discussion and Analysis of Financial Condition and Results of Operations. Forward-looking statements generally are identified by the words “believe,” “project,” “expect,” “anticipate,” “estimate,” and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. Risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements are identified at “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended June 30, 2017. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

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PART I. FINANCIAL INFORMATION
ITEM I. FINANCIAL STATEMENTS

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JACK HENRY & ASSOCIATES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share and Per Share Data)
(Unaudited)

	December 31, 2017	June 30, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 57,719	$ 114,765
Receivables, net	166,827	276,923
Income tax receivable	23,630	20,135
Prepaid expenses and other	71,427	66,894
Deferred costs	49,997	41,314
Total current assets	369,600	520,031
PROPERTY AND EQUIPMENT, net	272,086	282,934
OTHER ASSETS:		
Non-current deferred costs	94,438	96,847
Computer software, net of amortization	278,235	247,317
Other non-current assets	90,641	82,525
Customer relationships, net of amortization	119,925	90,433
Other intangible assets, net of amortization	39,822	36,393
Goodwill	652,329	552,465
Total other assets	1,275,390	1,105,980
Total assets	$ 1,917,076	$ 1,908,945
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 13,135	$ 6,841
Accrued expenses	75,397	81,574
Deferred revenues	265,222	382,777
Total current liabilities	353,754	471,192
LONG-TERM LIABILITIES:		
Non-current deferred revenues	110,466	128,607
Non-current deferred income tax liability	166,789	219,541
Debt, net of current maturities	100,000	50,000
Other long-term liabilities	12,067	7,554
Total long-term liabilities	389,322	405,702
Total liabilities	743,076	876,894
STOCKHOLDERS' EQUITY		
Preferred stock - $1 par value; 500,000 shares authorized, none issued	—	—
Common stock - $0.01 par value; 250,000,000 shares authorized; 103,218,206 shares issued at December 31, 2017; 103,083,299 shares issued at June 30, 2017	1,032	1,031
Additional paid-in capital	452,841	452,016
Retained earnings	1,756,419	1,585,278
Less treasury stock at cost 25,961,920 shares at December 31, 2017; 25,660,212 shares at June 30, 2017;	(1,036,292)	(1,006,274)
Total stockholders' equity	1,174,000	1,032,051
Total liabilities and equity	$ 1,917,076	$ 1,908,945

See notes to condensed consolidated financial statements

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JACK HENRY & ASSOCIATES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In Thousands, Except Per Share Data)
(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
REVENUE	$374,756	$348,553	$734,690	$693,581
EXPENSES				
Cost of Revenue	211,653	198,146	416,368	392,908
Research and Development	22,414	20,873	43,343	40,611
Selling, General, and Administrative	45,613	40,928	89,346	80,038
Gain on Disposal of a Business	(189)	—	(1,894)	—
Total Expenses	279,491	259,947	547,163	513,557
OPERATING INCOME	95,265	88,606	187,527	180,024
INTEREST INCOME (EXPENSE)				
Interest Income	146	60	293	167
Interest Expense	(250)	(184)	(439)	(326)
Total Interest Income (Expense)	(104)	(124)	(146)	(159)
INCOME BEFORE INCOME TAXES	95,161	88,482	187,381	179,865
PROVISION/ (BENEFIT) FOR INCOME TAXES	(60,413)	29,668	(31,604)	58,807
NET INCOME	$155,574	$58,814	$218,985	$121,058
Basic earnings per share	$2.01	$0.76	$2.83	$1.55
Basic weighted average shares outstanding	77,218	77,814	77,250	78,114
Diluted earnings per share	$2.01	$0.75	$2.82	$1.54
Diluted weighted average shares outstanding	77,565	78,180	77,606	78,512

See notes to condensed consolidated financial statements

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JACK HENRY & ASSOCIATES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Six Months Ended December 31, 2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$218,985	$121,058
Adjustments to reconcile net income from operations to net cash from operating activities:		
Depreciation	24,602	24,892
Amortization	48,711	44,568
Change in deferred income taxes	(72,721)	8,745
Expense for stock-based compensation	4,609	4,230
(Gain)/loss on disposal of assets and businesses	(1,841)	671
Changes in operating assets and liabilities:		
Change in receivables	115,572	107,667
Change in prepaid expenses, deferred costs and other	(17,105)	(22,241)
Change in accounts payable	5,371	1,221
Change in accrued expenses	(15,386)	(18,339)
Change in income taxes	2,317	5,007
Change in deferred revenues	(136,206)	(113,612)
Net cash from operating activities	176,908	163,867
CASH FLOWS FROM INVESTING ACTIVITIES:		
Payment for acquisitions, net of cash acquired	(137,654)	—
Capital expenditures	(12,249)	(17,405)
Proceeds from the sale of businesses	350	—
Proceeds from the sale of assets	205	830
Internal use software	(6,025)	(11,455)
Computer software developed	(46,936)	(41,673)
Net cash from investing activities	(202,309)	(69,703)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on credit facilities	100,000	50,000
Repayments on credit facilities	(50,000)	(200)
Purchase of treasury stock	(30,018)	(103,885)
Dividends paid	(47,844)	(43,582)
Proceeds from issuance of common stock upon exercise of stock options	1	1
Tax withholding payments related to share based compensation	(7,144)	(5,394)
Proceeds from sale of common stock	3,360	2,774
Net cash from financing activities	(31,645)	(100,286)
NET CHANGE IN CASH AND CASH EQUIVALENTS	$(57,046)	$(6,122)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	$114,765	$70,310
CASH AND CASH EQUIVALENTS, END OF PERIOD	$57,719	$64,188

See notes to condensed consolidated financial statements

JACK HENRY & ASSOCIATES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)
(Unaudited)

NOTE 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of the Company

Jack Henry & Associates, Inc. and subsidiaries (“JHA” or the “Company”) is a provider of integrated computer systems and services that has developed and acquired a number of banking and credit union software systems. The Company's revenues are predominately earned by marketing those systems to financial institutions nationwide together with computer equipment (hardware), by providing the conversion and implementation services for financial institutions to utilize JHA systems, and by providing other related services. JHA also provides continuing support and services to customers using in-house or outsourced systems.

Consolidation

The condensed consolidated financial statements include the accounts of JHA and all of its subsidiaries, which are wholly-owned, and all intercompany accounts and transactions have been eliminated.

Comprehensive Income

Comprehensive income for the three and six months ended December 31, 2017 and 2016 equals the Company’s net income.

Prior Period Reclassification

During the first quarter of fiscal 2018, the Company's management decided to change the presentation of its income statement, along with a change in the segment structure (see Note 9), in order to more clearly align with the way management manages the Company and evaluates performance. Amounts within the condensed consolidated statements of income for the three and six months ended December 31, 2016 have been reclassified to improve comparability with the three and six months ended December 31, 2017. Revenue was previously classified as license, support and service, and hardware, and has been reclassified into one "Revenue" caption. Cost of sales was previously presented under three captions to correspond with our three lines of revenue, and has now been condensed to one caption, "Cost of Revenue". We have elected to include all operating expenses, including cost of revenue, under one expenses heading. Previously, cost of revenue was presented separately from operating expenses in order to show gross profit. Gross profit has been removed from our current presentation due to management's focus on operating income. Additionally, within operating expenses, selling and marketing expense and general and administrative expense were previously presented under two captions, but are now condensed under one caption, labeled "Selling, General, and Administrative."

Property and Equipment

Property and equipment is stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Accumulated depreciation at December 31, 2017 totaled $368,599 and at June 30, 2017 totaled $345,014.

Intangible Assets

Intangible assets consist of goodwill, customer relationships, computer software, and trade names acquired in business acquisitions in addition to internally developed computer software. The amounts are amortized, with the exception of those with an indefinite life (such as goodwill), over an estimated economic benefit period, generally three to twenty years. Accumulated amortization of intangible assets totaled $552,340 and $503,653 at December 31, 2017 and June 30, 2017, respectively.

Common Stock

The Board of Directors has authorized the Company to repurchase shares of its common stock. Under this authorization, the Company may finance its share repurchases with available cash reserves or borrowings on its existing line-of-credit. The share repurchase program does not include specific price targets or timetables and may be suspended at any time. At December 31, 2017, there were 25,962 shares in treasury stock and the Company had the remaining authority to repurchase up to 4,029 additional shares. The total cost of treasury shares at December 31, 2017 is $1,036,292. During the first six months of fiscal 2018, the Company repurchased 302 treasury shares for $30,018. At June 30, 2017, there were 25,660 shares in treasury stock and the Company had authority to repurchase up to 4,330 additional shares.

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Dividends declared per share were $0.31 and $0.28, for the three months ended December 31, 2017 and 2016, respectively, and totaled $0.62 and $0.56 for the six months ended December 31, 2017 and 2016, respectively.

Interim Financial Statements

The accompanying condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q of the Securities and Exchange Commission and in accordance with accounting principles generally accepted in the United States of America applicable to interim condensed consolidated financial statements, and do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete consolidated financial statements. The condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and accompanying notes, which are included in its Annual Report on Form 10-K ("Form 10-K") for the fiscal year ended June 30, 2017. The accounting policies followed by the Company are set forth in Note 1 to the Company's consolidated financial statements included in its Form 10-K for the fiscal year ended June 30, 2017.

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements reflect all adjustments necessary (consisting of normal recurring adjustments) to state fairly the financial position of the Company as of December 31, 2017, the results of its operations for the three and six months ending December 31, 2017 and 2016, and its cash flows for the six months ending December 31, 2017 and 2016. The condensed consolidated balance sheet at June 30, 2017 was derived from audited annual financial statements, but does not contain all of the footnote disclosures from the annual financial statements.

The results of operations for the period ended December 31, 2017 are not necessarily indicative of the results to be expected for the entire year.

NOTE 2: RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers in May 2014. This standard is part of an effort to create a common revenue standard for U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). The new standard will supersede much of the existing authoritative literature for revenue recognition. The new model enacts a five-step process for achieving the core principle, which is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB also issued ASU No. 2015-14 which deferred the effective date of the new standard by one year, but allows early application as of the original effective date. We do not intend to adopt the provisions of the new standard early, so the standard and related amendments will be effective for the Company for its annual reporting period beginning July 1, 2018, including interim periods within that reporting period. In March 2016, the FASB issued ASU No. 2016-08, which addresses principal versus agent considerations under the new revenue standard. Additional guidance, including ASU No. 2016-10, ASU No. 2016-12, and ASU No. 2016-20, also addresses specific aspects of the new standard and are being considered. Entities are allowed to transition to the new standard by either recasting prior periods (full retrospective) or recognizing the cumulative effect as of the beginning of the period of adoption (modified retrospective).

The Company has taken the following steps in evaluating and planning for the implementation of the new standard:

- Organization of a cross-functional implementation team whose goals are to: assess the impact of the guidance on each of our revenue streams by applying the five step model; determine new processes and procedures necessary to ensure proper revenue and cost recognition; quantify the effects of the new standard on prior and current year revenue; determine opening balances for deferred revenues and costs as of the beginning of fiscal 2017; develop disclosures required upon the adoption of the new standard; and develop new internal controls to ensure compliance with the new standard.
- Continued implementation and testing of new revenue recognition software that will apply the five-step model to each of our customer contracts.
- Continued comparisons of revenue recognition under current accounting methods versus under ASC 606 for each of our revenue streams.

Determinations that have been made regarding the effect of the new standard are as follows:

- We expect the adoption of this standard to have a significant impact on our revenue recognition currently subject to Accounting Standards Codification (ASC) Topic 985. One of the most significant expected impacts relates to the recognition of license and implementation revenue on our multi-element arrangements. Under the current standard, license and implementation revenue on these arrangements is often recognized over

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the maintenance period of the software due to a lack of vendor-specific objective evidence of fair value ("VSOE") for these elements. Under ASC 606, revenue for license and implementation will no longer be deferred due solely to a lack of VSOE.

- This new model will require more use of judgments and estimates than the current standard, including identifying performance obligations, estimating variable consideration, and allocating the transaction price to each performance obligation. We will be required to estimate the total expected value of variable consideration, arising from items such as maintenance and transaction or item processing, at contract inception and include those estimates in the total transaction price of the contract to be allocated to each performance obligation. These estimates will be modified over the term of the contract, resulting in re-allocations of the transaction price and adjustments to revenue recognized on the contract.

Significant implementation matters yet to be addressed include:

- Which transition approach will be applied. While we plan to adopt the standard using the full retrospective method, our ability to achieve that depends on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior period consolidated financial statements.
- Determination of opening balances for deferred revenues and costs, and the quantitative effect of the new standard on prior and current year revenues and costs.
- Development of required disclosures under the new standard.
- Updates to our internal controls surrounding the new processes.

The FASB issued ASU No. 2016-02, Leases, in February 2016. This ASU aims to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and requiring disclosure of key information regarding leasing arrangements. Specifically, the standard requires operating lease commitments to be recorded on the balance sheet as operating lease liabilities and right-of-use assets, and the cost of those operating leases to be amortized on a straight-line basis. ASU No. 2016-02 will be effective for Jack Henry's annual reporting period beginning July 1, 2019 and early adoption is permitted. At transition, a modified retrospective approach must be utilized to measure leases as of the beginning of the earliest period presented, however, the FASB has provided certain practical expedients, which the Company is currently evaluating. The Company is currently assessing the impact this new standard will have on our consolidated financial statements and when we will adopt it.
ASU 2016-15 issued by the FASB in August 2016 clarifies cash flow classification of eight specific cash flow issues and is effective for our annual reporting period beginning July 1, 2018. Early adoption is permitted. We do not expect any significant impact to our financial statements as a result of this standard.

NOTE 3. FAIR VALUE OF FINANCIAL INSTRUMENTS

For cash equivalents, amounts receivable or payable and short-term borrowings, fair values approximate carrying value, based on the short-term nature of the assets and liabilities.
The Company's estimates of the fair value for financial assets and financial liabilities are based on the framework established in the fair value accounting guidance. The framework is based on the inputs used in valuation, gives the highest priority to quoted prices in active markets, and requires that observable inputs be used in the valuations when available. The three levels of the hierarchy are as follows:
Level 1: inputs to the valuation are quoted prices in an active market for identical assets
Level 2: inputs to the valuation include quoted prices for similar assets in active markets that are observable either directly or indirectly
Level 3: valuation is based on significant inputs that are unobservable in the market and the Company's own estimates of assumptions that we believe market participants would use in pricing the asset

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Fair value of financial assets, included in cash and cash equivalents, and financial liabilities is as follows:

	Estimated Fair Value Measurements			Total Fair
	Level 1	Level 2	Level 3	Value
December 31, 2017				
Financial Assets:				
Money market funds	$21,581	$—	$ —	$21,581
Certificate of Deposit	$—	$1,000	$ —	$1,000
Financial Liabilities:				
Revolving credit facility	$—	$100,000	$ —	$100,000
June 30, 2017				
Financial Assets:				
Money market funds	$68,474	$—	$ —	$68,474
Certificate of Deposit	$—	$2,001	$ —	$2,001
Financial Liabilities:				
Revolving credit facility	$—	$50,000	$ —	$50,000
Non-Recurring Fair Value Measurements				
June 30, 2017				
Long-lived assets held for sale [a]		$—	$1,300	$— $1,300

[a] In accordance with ASC Subtopic 360-10, long-lived assets held for sale with a carrying value of $4,575 were written down to their fair value of $1,300, resulting in an impairment totaling $3,275, which was included in earnings for the period ended June 30, 2017. These assets are expected to be disposed of by sale within twelve months of June 30, 2017.

NOTE 4. INTANGIBLE ASSETS

The estimated aggregate future amortization expense for the remainder of fiscal 2018 and each of the next four years for all intangible assets remaining as of December 31, 2017, is as follows:

Years Ending June 30,	Computer Software	Customer Relationships	Other Intangible Assets	Total
2018 (remainder)	$ 33,443	$ 8,182	$ 7,613	$49,238
2019	62,836	16,399	11,773	91,008
2020	52,282	13,906	6,279	72,467
2021	34,637	11,750	1,717	48,104
2022	19,464	10,689	1,121	31,274

NOTE 5. DEBT

Revolving credit facility

The revolving credit facility allows for borrowings of up to $300,000, which may be increased by the Company at any time until maturity to $600,000. The credit facility bears interest at a variable rate equal to (a) a rate based on LIBOR or (b) an alternate base rate (the highest of (i) the Prime Rate for such day, (ii) the sum of the Federal Funds Effective Rate for such day plus 0.50% and (iii) the Eurocurrency Rate for a one-month Interest Period on such day for dollars plus 1.0%), plus an applicable percentage in each case determined by the Company's leverage ratio. The credit facility is guaranteed by certain subsidiaries of the Company. The credit facility is subject to various financial covenants that require the Company to maintain certain financial ratios as defined in the agreement. As of December 31, 2017, the Company was in compliance with all such covenants. The revolving loan terminates February 20, 2020. At December 31, 2017, there was an outstanding revolving loan balance of $100,000. There was a $50,000 outstanding balance at June 30, 2017.

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Other lines of credit

The Company has an unsecured bank credit line which provides for funding of up to $5,000 and bears interest at the prime rate less 1%. The credit line was renewed in April 2017 and expires on April 30, 2019. At December 31, 2017, no amount was outstanding. There was also no balance outstanding at June 30, 2017.

Interest

The Company paid interest of $355 and $188 during the six months ended December 31, 2017 and 2016, respectively.

NOTE 6. INCOME TAXES

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was enacted into law, which includes numerous provisions that impact the Company, including reducing the U.S. federal tax rate, eliminating the Domestic Production Activities Deduction in future tax years, and providing expanded asset expensing. The TCJA reduces the U.S. federal statutory tax rate from 35% to 21%, effective January 1, 2018. For the Company's fiscal year 2018, a blended U.S. federal statutory tax rate of approximately 28% will apply to the Company.

The effective tax rate was (63.5)% of income before income taxes for the quarter ended December 31, 2017, compared to 33.5% for the same quarter in fiscal 2017. For the six months ended December 31, 2017 the effective tax rate was (16.9)%, compared to 32.7% for the six months ended December 31, 2016. The significant decrease to the Company's tax rate was primarily due to $96,766 of income tax benefits recorded as a result of the TCJA in the quarter ended December 31, 2017.

The staff of the US Securities and Exchange Commission (SEC) has recognized the complexity of reflecting the impacts of the TCJA, and on December 22, 2017, issued guidance in Staff Accounting Bulletin No. 118 (SAB 118) which clarifies accounting for income taxes under ASC 740 if information is not available or complete and provides for up to a one year period in which to complete the required analyses and accounting. The Company relied on SAB 118 in computing its accounting for income taxes during the period ended December 31, 2017. The computation of income taxes payable, deferred tax liability, and income tax expense for the period ended December 31, 2017 reflect provisional amounts for which the income tax effects of the TCJA have not been completed, but for which reasonable estimates are available. As a fiscal year taxpayer, the Company has utilized certain estimates and forecasts of future operations in estimating both the reversal of deferred tax assets and liabilities that existed on the enactment date, as well as the generation of additional deferred tax assets and liabilities for the remainder of the year ending June 30, 2018. The Company analyzed its deferred tax balances to estimate which of those balances are expected to reverse in fiscal 2018 (at a blended U.S. federal income tax rate of approximately 28.0%), or thereafter (at a 21.0% U.S. federal income tax rate). These estimates may change as we receive additional information about the timing of deferred tax reversals. It is anticipated that any additional income tax effects from the TCJA will be recorded in the periods ending March 31, 2018 and June 30, 2018 as the deferred tax activity becomes known as a result of actual operations.

The Company paid income taxes, net of refunds, of $38,163 and $44,539 in the six months ended December 31, 2017 and 2016, respectively.

At December 31, 2017, the Company had $9,607 of gross unrecognized tax benefits, $8,679 of which, if recognized, would affect our effective tax rate. This includes $3,391 of unrecognized tax benefits recorded in the period ending December 31, 2017 as a result of recent tax pronouncements. We had accrued interest and penalties of $1,318 and $1,284 related to uncertain tax positions at December 31, 2017 and 2016, respectively.

The U.S. federal and state income tax returns for fiscal year 2014 and all subsequent years remain subject to examination as of December 31, 2017 under statute of limitations rules. We anticipate potential changes due to lapsing statutes of limitations and examination closures could reduce the unrecognized tax benefits balance by $500 - $1,500 within twelve months of December 31, 2017.

NOTE 7. STOCK-BASED COMPENSATION

Our operating income for the three months ended December 31, 2017 and 2016 included $3,096 and $3,032 of stock-based compensation costs, respectively. For the six months ended December 31, 2017 and 2016, stock-based compensation costs included in operating income totaled $4,609 and $4,230, respectively.

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Stock Options

On November 10, 2015, the Company adopted the 2015 Equity Incentive Plan ("2015 EIP") for its employees and non-employee directors. The plan allows for grants of stock options, stock appreciation rights, restricted stock shares or units, and performance shares or units. The maximum number of shares authorized for issuance under the plan is 3,000. For stock options, terms and vesting periods of the options are determined by the Compensation Committee of the Board of Directors when granted. The option period must expire not more than ten years from the option grant date. The options granted under this plan are exercisable beginning three years after the grant date at an exercise price equal to 100% of the fair market value of the stock at the grant date. The options terminate upon surrender of the option, ninety days after termination of employment, upon the expiration of one year following notification of a deceased optionee, or ten years after grant.

The Company previously issued options to outside directors under the 2005 Non-Qualified Stock Option Plan (“2005 NSOP”). No additional stock options may be issued under this plan.

A summary of option plan activity under these plans is as follows:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding July 1, 2017	72	$ 50.04	
Granted	—	—	
Forfeited	—	—	
Exercised	—	—	
Outstanding December 31, 2017	72	$ 50.04	$ 4,797
Vested and Expected to Vest December 31, 2017	72	$ 50.04	$ 4,797
Exercisable December 31, 2017	40	$ 20.55	$ 3,856

At December 31, 2017, there was $250 of compensation cost yet to be recognized related to outstanding options. The weighted average remaining contractual term on options currently exercisable as of December 31, 2017 was 1.50 years.

Restricted Stock Awards

The Company issues both share awards and unit awards under the 2015 EIP, and previously issued these through the 2005 Restricted Stock Plan. The following table summarizes non-vested share awards as of December 31, 2017, as well as activity for the six months then ended:

Share awards	Shares	Weighted Average Grant Date Fair Value
Outstanding July 1, 2017	36	$ 73.66
Granted	—	—
Vested	(11)	57.88
Forfeited	—	64.96
Outstanding December 31, 2017	25	$ 80.30

At December 31, 2017, there was $614 of compensation expense that has yet to be recognized related to non-vested restricted stock share awards, which will be recognized over a weighted average period of 0.78 years.

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The following table summarizes non-vested unit awards as of December 31, 2017, as well as activity for the six months then ended:

Unit awards	Units	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding July 1, 2017	386	$ 67.84	
Granted	103	93.94	
Vested	(151)	56.04	
Forfeited	(3)	78.13	
Outstanding December 31, 2017	335	$ 81.12	$ 39,118

The Company utilized a Monte Carlo pricing model customized to the specific provisions of the Company's plan design to value unit awards subject to performance targets on the grant dates. The weighted average assumptions used in this model to estimate fair value at the measurement date and resulting values for 81 unit awards granted in fiscal 2018 are as follows:

Volatility	15.60 %
Risk free interest rate	1.55 %
Dividend yield	1.20 %
Stock Beta	0.687

The remaining 22 unit awards granted are not subject to performance targets, and therefore the estimated fair value at measurement date is valued in the same manner as restricted stock share award grants.

At December 31, 2017, there was $14,788 of compensation expense that has yet to be recognized related to non-vested restricted stock unit awards, which will be recognized over a weighted average period of 1.58 years.

NOTE 8. EARNINGS PER SHARE

The following table reflects the reconciliation between basic and diluted earnings per share.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Net Income	$155,574	$58,814	$218,985	$121,058
Common share information:				
Weighted average shares outstanding for basic earnings per share	77,218	77,814	77,250	78,114
Dilutive effect of stock options and restricted stock	347	366	356	398
Weighted average shares outstanding for diluted earnings per share	77,565	78,180	77,606	78,512
Basic earnings per share	$2.01	$0.76	$2.83	$1.55
Diluted earnings per share	$2.01	$0.75	$2.82	$1.54

Per share information is based on the weighted average number of common shares outstanding for the three and six months ended December 31, 2017 and 2016. Stock options and restricted stock have been included in the calculation of earnings per share to the extent they are dilutive. There were no anti-dilutive stock options or restricted stock shares excluded for the quarter ended December 31, 2017, compared to 32 shares excluded for the quarter ended December 31, 2016. For the six months ended December 31, 2017 and 2016, respectively, there were 0 and 32 anti-dilutive securities excluded.

NOTE 9. BUSINESS ACQUISITION

Ensenta Corporation

On December 21, 2017, the Company acquired all of the equity interest of EST Holdings, Inc. and its wholly-owned subsidiary, EST Interco, Inc., for $134,472 paid in cash. EST Holdings, Inc. and EST Interco, Inc. jointly own all of the outstanding equity of Ensenta Corporation, a California-based provider of real-time, cloud-based solutions for mobile and online payments and deposits. This acquisition was partially funded by a draw on the Company's revolving credit facility, with the remaining amount funded by existing operating cash. The addition of Ensenta Corporation to the JHA Payment Solutions Group expands the Company’s ability to conduct real-time transactions with third-party platforms, extending its presence in the credit union market through shared branching technology.

Management has completed a preliminary purchase price allocation of Ensenta Corporation and its assessment of the fair value of acquired assets and liabilities assumed. The recognized amounts of identifiable assets acquired and liabilities assumed, based upon their preliminary fair values as of December 21, 2017 are set forth below:

Current assets	$13,950
Long-term assets	585
Identifiable intangible assets	55,001
Non-current deferred income tax liability	(19,969)
Total other liabilities assumed	(8,593)
Total identifiable net assets	40,974
Goodwill	93,498
Net assets acquired	$134,472

The amounts shown above may change as management finalizes its assessment of the fair value of acquired assets and liabilities and evaluates the income tax implications of this business combination.

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The goodwill of $93,498 arising from this acquisition consists largely of the growth potential, synergies and economies of scale expected from combining the operations of the Company with those of Ensenta Corporation, together with the value of Ensenta Corporation's assembled workforce. The goodwill from this acquisition has been allocated to our Payments segment and is not expected to be deductible for income tax purposes.

Identifiable intangible assets from this acquisition consist of customer relationships of $33,824, computer software of $16,639, and other intangible assets of $4,538. The weighted average amortization period for acquired customer relationships, computer software, and other intangible assets is 15 years, 10 years, and 10 years, respectively.

Current assets were inclusive of cash acquired of $7,273. The fair value of current assets acquired included accounts receivable of $4,668, none of which were expected to be uncollectible.

Costs incurred related to the acquisition of Ensenta Corporation in the second quarter of fiscal 2018 totaled $262 for legal, valuation, and other fees, and were expensed as incurred within selling, general, and administrative expenses.

The Company's consolidated statements of income for the three and six months ended December 31, 2017 included revenue of $928 and after-tax net income of $6,366 resulting from Ensenta Corporation's operations. The after-tax net income included a large tax benefit recorded as a result of the Tax Cuts and Jobs Act. Excluding the effects of the Tax Cuts and Jobs Act, the Company's after-tax net income resulting from Ensenta Corporation's operations totaled $26.

The accompanying consolidated statements of income for the three and six months ended December 31, 2017 do not include any revenues and expenses related to this acquisition prior to the acquisition date. The following unaudited pro forma consolidated financial information is presented as if this acquisition had occurred at the beginning of the earliest period presented. In addition, this unaudited pro forma financial information is provided for illustrative purposes only and should not be relied upon as necessarily being indicative of the historical results that would have been obtained if the acquisition had actually occurred during those periods, or the results that may be obtained in the future as a result of the acquisition.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2016	2017	2016
Revenue	$381,110	$354,358	$747,808	$704,749
Net Income	156,211	59,407	220,495	122,064
Basic Earnings Per Share	$2.02	$0.76	$2.85	$1.56
Diluted Earnings Per Share	$2.01	$0.76	$2.84	$1.55

Vanguard Software Group

On August 31, 2017, the Company acquired all of the equity interest of Vanguard Software Group, a Florida-based company specializing in the underwriting, spreading, and online decisioning of commercial loans, for $10,744 paid in cash. This acquisition was funded using existing operating cash. The addition of Vanguard Software Group to the Company's ProfitStars® Lending Solutions Group expands functionality offered to clients, allowing for near-real-time communication with Jack Henry and Associates' core processing and ancillary solutions, and also enhances cross-sell opportunities.

Management has completed a preliminary purchase price allocation of Vanguard Software Group and its assessment of the fair value of acquired assets and liabilities assumed. The recognized amounts of identifiable assets acquired and liabilities assumed, based upon their preliminary fair values as of August 31, 2017 are set forth below:

Current assets	$1,153
Long-term assets	9
Identifiable intangible assets	4,200
Total liabilities assumed	(1,117)
Total identifiable net assets	4,245
Goodwill	6,499
Net assets acquired	$10,744

The amounts shown above may change in the near term as management finalizes its calculation of the fair value of acquired assets and liabilities and evaluates the income tax implications of this business combination.

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The goodwill of $6,499 arising from this acquisition consists largely of the growth potential, synergies and economies of scale expected from combining the operations of the Company with those of Vanguard Software Group, together with the value of Vanguard Software Group's assembled workforce. The goodwill from this acquisition has been allocated to our Complementary segment and is expected to be deductible for income tax purposes.

Identifiable intangible assets from this acquisition consist of customer relationships of $2,234, computer software of $1,426, and other intangible assets of $540. The weighted average amortization periods for acquired customer relationships, computer software, and other intangible assets are 15 years, 10 years, and 10 years, respectively.

Current assets were inclusive of cash acquired of $289. The fair value of current assets acquired included accounts receivable of $847, none of which were expected to be uncollectible.

Costs incurred related to the acquisition of Vanguard Software Group were immaterial for the periods presented.

The Company's consolidated statements of income for the second quarter of fiscal 2018 included revenue of $395 and an after-tax net loss of $274 resulting from Vanguard Software Group's operations. For the six months ended December 31, 2017, the Company's consolidated statements of income included revenue of $493 and after-tax net loss of $398.

The accompanying consolidated statements of income for the three and six months ended December 31, 2017 do not include any revenues and expenses related to this acquisition prior to the acquisition date. The impact of this acquisition was considered immaterial to both the current and prior periods of our consolidated financial statements and pro forma financial information has not been provided.

NOTE 10. REPORTABLE SEGMENT INFORMATION

The Company is a provider of integrated computer systems that perform data processing (available for in-house installations or outsourced services) for banks and credit unions. Beginning in the first quarter of fiscal 2018, JHA changed its reportable segment structure from two customer-centric segments, Bank and Credit Union, to four product-centric segments. The change was made based on the view of our Chief Executive Officer, who is also our Chief Operating Decision Maker, that the Company could be more effectively managed using a product-centric approach and was driven by the first budgetary process under his administration. He requested changes in reports he regularly reviews for the purposes of allocating resources and assessing performance.

The Company’s operations are classified into four reportable segments: Core, Payments, Complementary, and Corporate & Other. The Core segment provides core information processing platforms to banks and credit unions, which consist of integrated applications required to process deposit, loan, and general ledger transactions, and maintain centralized customer/ member information. The Payments segment provides secure payment processing tools and services, including: ATM, debit, and credit card transaction processing services; online and mobile bill pay solutions; and risk management products and services. The Complementary segment provides additional software and services that can be integrated with our Core solutions or used independently. The Corporate & Other segment includes hardware revenue and costs, as well as operating costs not directly attributable to the other three segments.

The Company evaluates the performance of its segments and allocates resources to them based on various factors, including performance against trend, budget, and forecast. Only revenue and costs of revenue are considered in the evaluation for each segment.

The prior period presented has been retroactively restated to conform to the new segment structure adopted July 1, 2017.

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	Three Months Ended December 31, 2017				
	Core	Payments	Complementary	Corporate & Other	Total
REVENUE					
Services and Support	$127,787	$10,913	$ 84,528	$14,526	$237,754
Processing	6,611	115,096	15,279	16	137,002
Total Revenue	134,398	126,009	99,807	14,542	374,756
Cost of Revenue	59,199	59,052	41,379	52,023	211,653
Research and Development					22,414
Selling, General, and Administrative					45,613
Gain on Disposal of Businesses					(189)
Total Expenses					279,491
SEGMENT INCOME	$75,199	$66,957	$ 58,428	$(37,481)	
OPERATING INCOME					95,265
INTEREST INCOME (EXPENSE)					(104)
INCOME BEFORE INCOME TAXES					$95,161

	Three Months Ended December 31, 2016				
	Core	Payments	Complementary	Corporate & Other	Total
REVENUE					
Services and Support	$113,887	$11,290	$ 81,134	$15,404	$221,715
Processing	6,000	107,854	12,946	38	126,838
Total Revenue	119,887	119,144	94,080	15,442	348,553
Cost of Revenue	53,087	54,792	38,976	51,291	198,146
Research and Development					20,873
Selling, General, and Administrative					40,928
Gain on Disposal of Businesses					—
Total Expenses					259,947
SEGMENT INCOME	$66,800	$64,352	$ 55,104	$(35,849)	
OPERATING INCOME					88,606
INTEREST INCOME (EXPENSE)					(124)
INCOME BEFORE INCOME TAXES					$88,482

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	Six Months Ended December 31, 2017				
	Core	Payments	Complementary	Corporate & Other	Total
REVENUE					
Services and Support	$249,856	$20,000	$ 163,596	$28,598	$462,050
Processing	13,475	229,163	29,983	19	272,640
Total Revenue	263,331	249,163	193,579	28,617	734,690
Cost of Revenue	115,461	116,318	81,856	102,733	416,368
Research and Development					43,343
Selling, General, and Administrative					89,346
Gain on Disposal of Businesses					(1,894)
Total Expenses					547,163
SEGMENT INCOME	$147,870	$132,845	$ 111,723	$(74,116)	
OPERATING INCOME					187,527
INTEREST INCOME (EXPENSE)					(146)
INCOME BEFORE INCOME TAXES					$187,381

Six Months Ended
December 31, 2016

Core	Payments	Complementary	Corporate & Other

The following is a list of exhibits filed as part of this Annual Report on Form 10-K.

3.1(1)	Amended and Restated Certificate of Incorporation.
3.2(2)	Restated By-laws.
4.1(3)	Form of Common Stock Certificate.
4.2(4)	Stockholders Agreement by and among the Registrant, Healthpoint Capital Partners, L.P. and the stockholders of the Registrant, dated as of March 17, 2005.
10.1(5)*	Amended and Restated 2005 Employee, Director and Consultant Stock Plan.
10.2(6)*	Form of Non-Qualified Stock Option Agreement issued under the Amended and Restated 2005 Stock Plan.
10.3(7)*	Form of Incentive Stock Option Agreement issued under the Amended and Restated 2005 Stock Plan.
10.4(8)*	Form of Restricted Stock Agreement issued under the Amended and Restated 2005 Stock Plan.
10.5(9)	Lease Agreement by and between Alphatec Spine, Inc. and El Cedro LLC, dated as of March 31, 2001, amended by the First Amendment to the Lease Agreement, dated as of February 23, 2004 and extended by the Lease Extension Agreement, dated as of April 19, 2006.
10.6(10)	

	Lease Agreement by and between Alphatec Spine, Inc. and Roy P. Josepho and Roberta B. Josepho, Trustees, dated as of December 11, 2003 and amended by the First Amendment to the Lease Agreement, dated as of May 1, 2006.
10.7(11)	Lease Agreement by and between Alphatec Spine, Inc. and Roger D. Anderson Trust, dated as of September 3, 2004.
10.8(12)	Sublease Agreement by and between Alphatec Spine, Inc. and K2, Inc., dated as of July 29, 2005.

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10.9(13)	Sublease Agreement by and between Alphatec Spine, Inc. and K2, Inc., dated as of August 26, 2005.
10.10(14)	Supply Agreement by and between Alphatec Spine, Inc. and Invibio, Inc., dated as of October 18, 2004 and amended by Letter of Amendment in respect of the Supply Agreement, dated as of December 13, 2004.
10.11(15)	License Agreement by and between Alphatec Spine, Inc. and Cross Medical Products, Inc., dated as of April 24, 2003.
10.12(16)	Sales Agency Agreement by and between Alphatec Spine, Inc. and Keystone Surgical, LLC, dated as of October 1, 2005.
10.13(17)	Translation of Agreement for Transfer of Business Right by K.K. Mac and K.K. Alpha Tech Pacific, dated as of August 1, 2005.
10.14(18)	Private Label Supply Agreement by and between IsoTis OrthoBiologics, Inc. and Alphatec Spine, Inc., dated as of July 1, 2006.
10.15(19)	Patent License Agreement by and between Alphatec Spine, Inc. and Scient x S.A. dated January 23, 2007.
10.16(20)*	Employment Agreement by and among Alphatec Holdings, Inc., Alphatec Spine, Inc. and Dirk Kuyper, dated June 1, 2007.
10.17*	Employment Agreement by and among Alphatec Holdings, Inc., Alphatec Spine, Inc. and Kermit Stott, dated August 2007.
10.18(21)*	Employment Agreement by and among Alphatec Holdings, Inc., Alphatec Spine, Inc. and Steven M. Yasbek, dated as of October 18, 2006.
10.19(22)*	Employment Agreement by and among Alphatec Spine, Inc., Alphatec Holdings, Inc. and Steve Lubischer, dated November 10, 2006.
10.20*	Employment Agreement by and among Alphatec Holdings, Inc., Alphatec Spine, Inc. and Ebun Garner, dated July 17, 2006.
10.21	Separation Agreement by and among Alphatec Spine, Inc., Alphatec Holdings, Inc. and Steven Reinecke, dated October 22, 2007.
10.22	Separation Agreement by and among Alphatec Spine, Inc., Alphatec Holdings, Inc. and Ronald Hiscock, dated June 14, 2007.
10.23	Separation Agreement by and among Alphatec Spine, Inc., Alphatec Holdings, Inc. and Vicky Romanoski, dated June 14, 2007.
10.24(23)*	Consulting Agreement by and among Alphatec Spine, Inc., Alphatec Holdings, Inc. and Stephen J. Hochschuler, M.D., dated October 13, 2006.
10.25	Sales Agency Agreement by and between Alphatec Spine, Inc. and Western Spine, LLC, dated as of February 2, 2007.
10.26	Sales Agency Agreement by and between Alphatec Spine, Inc. and Fusion Medical, Inc., dated as of January 22, 2007.
10.27(24)	License Agreement by and between Alphatec Spine and JGMG Bengochea, LLC, dated as of September 11, 2007.
10.28(25)	License Agreement by and between Alphatec Spine and Stout Medical Group, LP, dated as of September 11, 2007.
10.29	License Agreement by and between Alphatec Spine and Progressive Spinal Technologies, LP, dated as of December 18, 2007.

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10.30(26)	Credit and Security Agreement, by and among, Alphatec holdings, Inc., Alphatec Spine, Inc., Nexmed, Inc. and Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services Inc., dated as of October 2, 2007.
21.1(27)	List of subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm.
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350 and Section 906 of the Sarbanes-Oxley Act of 2002.

* Management contract or compensatory plan or arrangement.
Confidential treatment has been requested with respect to portions of this document.
1 Incorporated by reference from Exhibit 3.2 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on April 20, 2006.
2 Incorporated by reference from Exhibit 3.4 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on May 26, 2006.
3 Incorporated by reference from Exhibit 4.1 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on May 26, 2006.
4 Incorporated by reference from Exhibit 4.2 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.
5 Incorporated by reference from Exhibit 10.5 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on May 26, 2006.
6 Incorporated by reference from Exhibit 10.6 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on April 20, 2006.
7 Incorporated by reference from Exhibit 10.7 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on April 20, 2006.
8 Incorporated by reference from Exhibit 10.8 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on April 20, 2006.
9 Incorporated by reference from Exhibit 10.20 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.
10 Incorporated by reference from Exhibit 10.21 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.
11 Incorporated by reference from Exhibit 10.22 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.
12 Incorporated by reference from Exhibit 10.23 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.
13 Incorporated by reference from Exhibit 10.24 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and

Exchange Commission on February 6, 2006.

14 Incorporated by reference from Exhibit 10.29 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on April 19, 2006.

15 Incorporated by reference from Exhibit 10.26 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on March 23, 2006.

16 Incorporated by reference from Exhibit 10.32 Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on March 23, 2006.

17 Incorporated by reference from Exhibit 10.31 Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on March 23, 2006.

18 Incorporated by reference from Exhibit 10.20 to the Annual Report on Form 10-K, filed with the Securities and Exchange Commission on April 2, 2007.

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19 Incorporated by reference from Exhibit 10.21 to the Annual Report on Form 10-K, filed with the Securities and Exchange Commission on April 2, 2007.
20 Incorporated by reference from Exhibit 10.1 to the Current Report on Form 8-K, filed with the Securities and Exchange Commission on June 6, 2007.
21 Incorporated by reference from Exhibit 10.2 to the Current Report on form 8-K, filed with the Securities and Exchange Commission on October 23, 2006.
22 Incorporated by reference from Exhibit 10.30 to the Annual Report on Form 10-K, filed with the Securities and Exchange Commission on April 2, 2007.
23 Incorporated by reference from Exhibit 10.27 to the Annual Report on Form 10-K, filed with the Securities and Exchange Commission on April 2, 2007.
24 Incorporated by reference from Exhibit 10.1 to the Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on November 9, 2007.
25 Incorporated by reference from Exhibit 10.2 to the Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on November 9, 2007.
26 Incorporated by reference from Exhibit 10.3 to the Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on November 9, 2007.
27 Incorporated by reference from Exhibit 21.1 to the Registration Statement on Form S-1, as amended (Registration No. 333-131609), filed with the Securities and Exchange Commission on February 6, 2006.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

ALPHATEC HOLDINGS, INC.

Dated: March 17, 2008

By: /s/ DIRK KUYPER
Name: **Dirk Kuyper**
Title: **President and Chief Executive Officer (principal executive officer)**

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

Signature	Title	Date
/s/ MORTIMER BERKOWITZ III **Mortimer Berkowitz III**	Chairman of the Board of Directors	March 17, 2008
/s/ STEVEN M. YASBEK **Steven M. Yasbek**	Chief Financial Officer, Vice President and Treasurer (principal financial and accounting officer)	March 17, 2008
/s/ ROHIT M. DESAI **Rohit M. Desai**	Director	March 17, 2008
/s/ JOHN H. FOSTER **John H. Foster**	Director	March 17, 2008
/s/ JAMES R. GLYNN **James R. Glynn**	Director	March 17, 2008
/s/ STEPHEN J. HOCHSCHULER, M.D. **Stephen J. Hochschuler, M.D.**	Director	March 17, 2008
/s/ R. IAN MOLSON **R. Ian Molson**	Director	March 17, 2008
/s/ STEPHEN E. O NEIL **Stephen E. O Neil**	Director	March 17, 2008

/s/ RICHARD RAVITCH	Director	March 17, 2008
Richard Ravitch		

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ALPHATEC HOLDINGS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of

Alphatec Holdings, Inc.

We have audited the accompanying consolidated balance sheets of Alphatec Holdings, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders equity (deficit), and cash flows for the years then ended and for the period from March 18, 2005 through December 31, 2005. We have also audited the accompanying consolidated statements of operations, stockholders equity and cash flows of Alphatec Manufacturing, Inc., (the Predecessor) for the period from January 1, 2005 through March 17, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Alphatec Holdings, Inc., at December 31, 2007 and 2006, and the consolidated results of its operations and its cash flows for the years then ended, and for the period March 18, 2005 through December 31, 2005, and the consolidated results of operations and cash flows of the Predecessor for the period from January 1, 2005 through March 17, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, Alphatec Holdings, Inc. changed its method of accounting for share-based payments in accordance with Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Alphatec Holdings, Inc. s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 13, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Diego, California

March 13, 2008

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ALPHATEC HOLDINGS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value data)

	December 31, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 25,843	$ 16,943
Restricted cash	2,000	1,100
Accounts receivable, net	13,035	10,583
Inventories, net	20,092	13,454
Prepaid expenses and other current assets	1,968	2,234
Deferred income tax asset	937	1,184
Total current assets	63,875	45,498
Property and equipment, net	12,229	12,583
Goodwill	60,003	60,389
Intangibles, net	9,634	10,185
Other assets	1,499	622
Total assets	$ 147,240	$ 129,277
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,948	$ 5,798
Accrued expenses	13,368	10,369
Lines of credit	2,546	3,163
Current portion of long-term debt	2,211	2,060
Total current liabilities	24,073	21,390
Long-term debt, less current portion	1,954	3,111
Other long-term liabilities	1,478	1,886
Deferred income tax liabilities	1,273	1,467
Minority interest		2,724
New Redeemable preferred stock, $0.0001 par value; 20,000 authorized at December 31, 2007 and 2006; 3,320 and 3,333 shares issued and outstanding at December 31, 2007 and 2006, respectively	23,612	23,703
Stockholders equity:		
Common stock, $0.0001 par value; 200,000 authorized; 47,169 and 34,774 shares issued and outstanding at December 31, 2007 and 2006, respectively	5	3
Additional paid-in capital	153,394	113,563
Accumulated other comprehensive income	334	111
Accumulated deficit	(58,883)	(38,681)
Total stockholders equity	94,850	74,996
Total liabilities and stockholders equity	$ 147,240	$ 129,277

See accompanying notes.

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ALPHATEC HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	Successor (1) Year ended December 31, 2007	Successor (1) Year ended December 31, 2006	Successor (1) March 18, 2005 to December 31, 2005	Predecessor (1) January 1, 2005 to March 17, 2005
Revenues	$ 80,031	$ 74,005	$ 36,276	$ 6,050
Cost of revenues	29,824	25,700	16,040	1,682
Gross profit	50,207	48,305	20,236	4,368
Operating expenses:				
Research and development	6,360	3,589	751	216
In-process research and development	9,344		3,100	
Sales and marketing	29,939	33,099	15,031	3,037
General and administrative	24,250	33,731	15,321	2,191
Total operating expenses	69,893	70,419	34,203	5,444
Operating loss	(19,686)	(22,114)	(13,967)	(1,076)
Other income (expense):				
Interest income	793	701	129	
Interest expense	(868)	(2,128)	(1,942)	(116)
Failed acquisition costs		(1,967)		
Other income (expense), net	149	(38)	(124)	5
Total other income (expense)	74	(3,432)	(1,937)	(111)
Loss before tax	(19,612)	(25,546)	(15,904)	(1,187)
Income tax provision (benefit)	590	270	(3,039)	2
Net loss	(20,202)	(25,816)	(12,865)	(1,189)
Accretion to redemption value of redeemable convertible preferred stock, Rolling common and Series C common stock		(3,450)	(7,601)	
Net loss available to common stockholders	$ (20,202)	$ (29,266)	$ (20,466)	$ (1,189)
Net loss per common share:				
Basic and diluted	$ (0.54)	$ (1.07)	$ (1.12)	$ (0.13)

Weighted-average shares used in computing net loss per share:				
Basic and diluted	37,283	27,238	18,201	9,211

(1) See Note 1 of the Notes to Consolidated Financial Statements.

See accompanying notes.

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ALPHATEC HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Common stock		Additional paid-in	Deferred	Notes receivable from	Accumulated other comprehensive income	Accumulated	Total stockholders equity
	Shares	**Amount**	**capital**	**compensation**	**stockholders**	**(loss)**	**deficit**	**(deficit)**
Predecessor:								
Balance at December 31, 2004	9,235	$ 92	$ 8,046	$ (1,139)	$ (37)	$ (120)	$ (5,014)	$ 1,828
Reacquisition of common stock	(10)		(9)		9			
Repayment of notes receivable from stockholders and related stock-based compensation expense			189		2			191
Stock-based compensation related to sale of stock to employees			832					832
Amortization of deferred employee stock-based compensation				1,139				1,139
Comprehensive loss:								
Foreign currency translation adjustments						(4)		(4)
Net loss							(1,189)	(1,189)
Total comprehensive loss								(1,193)
Balance at March 17, 2005	9,225	92	9,058		(26)	(124)	(6,203)	2,797
Successor:								
Issuance of restricted stock, net of	1,985	$	$	$	$	$	$	$

repurchases							
Issuance of common stock in connection with preferred stock sale	18,617	1	(1)				
Deferred employee stock-based compensation			20,531	(20,531)			
Cancellation of deferred employee stock-based compensation			(952)	953			1
Amortization of deferred employee stock-based compensation				1,282			1,282
Non-employee stock-based compensation			39				39
Accretion to redemption value of redeemable convertible preferred, Rolling common and Series C common			(7,601)				(7,601)
Comprehensive loss:							
Foreign currency translation adjustments					(113)		(113)
Net loss						(12,865)	(12,865)
Total comprehensive loss							(12,978)
Balance at December 31, 2005	20,602	1	12,016	(18,296)	(113)	(12,865)	(19,257)

See accompanying notes.

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ALPHATEC HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (Continued)

(In thousands)

	Common stock Shares	Amount	Additional paid-in capital	Deferred compensation	Stock subscription	Accumulated other comprehensive income (loss)	Accumulated deficit	Total stockholders equity (deficit)
Balance at December 31, 2005	20,602	1	12,016	(18,296)		(113)	(12,865)	(19,257)
Reversal of deferred compensation balance required with the adoption of SFAS No. 123(R)			(18,296)	18,296				
Exercise of stock options	1							
Stock-based compensation			8,828					8,828
Repurchase of common stock from employees	(248)							
Accretion to redemption value of redeemable convertible preferred, Rolling common and Series C common and dividend in kind	1,482		(3,450)					(3,450)
Series B stock dividend	1							
Record issuance of new common for redemption	3,636		44,238					44,238
Net proceeds from initial public offering, net of offering costs.	9,300	2	70,237					70,239
Other			(10)					(10)

Comprehensive loss:							
Foreign currency translation adjustments					224		224
Net loss						(25,816)	(25,816)
Total comprehensive loss							(25,592)
Balance at December 31, 2006	34,774	3	113,563		111	(38,681)	74,996
Stock-based compensation			314				314
Exercise of stock options	3						
Repurchase of common stock from terminated employees	(465)						
Net proceeds from secondary public offering net of offering costs	10,000	1	32,232				32,233
Issuance of common stock for escrow settlement	301		1,119	(1,119)			
Issuance of common stock for put settlement	805		2,873				2,873
Issuance of common stock for JOM acquisition	281		846				846
Issuance of common stock for restricted share awards granted to employees	720						
Issuance of common stock for acquired technology	750	1	2,343				2,344
Cancellation of redeemable preferred stock from terminated employees			104				104
Stock Subscription				1,119			1,119
Comprehensive loss:							

Foreign currency translation adjustments						223		223
Net loss							(20,202)	(20,202)
Total comprehensive loss								(19,979)
Balance at December 31, 2007	47,169	$ 5	$ 153,394	$	$	$ 334	$ (58,883)	$ 94,850

See accompanying notes.

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ALPHATEC HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
Operating activities:				
Net loss	$ (20,202)	$ (25,816)	$ (12,865)	$ (1,189)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	10,472	7,743	3,381	159
Stock-based compensation	314	8,828	1,322	2,160
Write-off of purchased in-process research and development			3,100	
Interest expense related to amortization of debt discount and revaluation of put right	149	1,272	1,452	
In-process research and development paid in stock	2,344			
Allowance for doubtful accounts	(351)	174	631	
Allowance for excess and obsolete inventory	1,175	3,027	5,315	
Deferred income taxes	32	285	(3,075)	
Changes in operating assets and liabilities:				
Accounts receivable	(1,469)	(1,446)	(3,657)	(1,401)
Inventories	(7,378)	(7,581)	(4,885)	(84)
Prepaid expenses and other current assets	484	(1,268)	(265)	(241)
Income taxes receivable		71	(17)	
Other assets	(359)	2,611	(197)	6
Accounts payable	(253)	1,722	(402)	86
Accrued expenses and other	1,805	1,785	2,128	298
Net cash used in operating activities	(13,237)	(8,593)	(8,034)	(206)
Investing activities:				
Acquisition of Japan Ortho Medical, net of cash acquired	222			
Investment in Noas Medical Company	(313)			
Acquisition of Alphatec Manufacturing, Inc., net of cash acquired	36	(5)	(69,990)	
Acquisition of certain assest and liabilities of Cortek, Inc., net of cash acquired		54	(7,398)	
Acquisition of Ishibe Medical Co. Ltd, net of cash acquired			651	
Purchases of instruments, property and equipment	(5,372)	(9,702)	(4,198)	(60)
Purchase of intangible assets	(2,612)			
Investment in certificate of deposit	(900)	(1,100)		

Net cash used in investing activities	(8,939)	(10,753)	(80,935)	(60)
Financing activities:				
Net proceeds from issuance of common stock	33,351	70,239		
Proceeds from issuance of Rolling common, Series C common and preferred stock		221	91,609	
Borrowings under lines of credit	20,839	25,627	4,840	
Repayments under lines of credit	(21,607)	(26,382)	(1,761)	
Escrow proceeds	952			
Principal payments on capital lease obligations	(545)	(669)	(579)	(155)
Proceeds from issuance of notes payable	577	4,629	1,192	
Principal payments on notes payable	(2,248)	(4,729)	(2,944)	(80)
Deferred costs paid in connection with initial public offering			(1,195)	
Repayment of supply agreement obligation		(75)	(75)	
Stock redemption		(35,153)		
Repayment of stockholder notes receivable		65	139	2
Net cash provided by (used in) financing activities	31,319	33,773	91,226	(233)
Effect of exchange rate changes on cash and cash equivalents	(243)	336	(77)	(2)
Net increase (decrease) in cash and cash equivalents	8,900	14,763	2,180	(501)
Cash and cash equivalents at beginning of period	16,943	2,180		1,557
Cash and cash equivalents at end of period	$ 25,843	$ 16,943	$ 2,180	$ 1,056

See accompanying notes.

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ALPHATEC HOLDINGS, INC.

CONSOLDIATED STATEMENTS OF CASH FLOWS (Continued)

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
		(In thousands)		
Supplemental disclosure of cash flow information:				
Cash paid for interest	$ 686	$ 658	$ 431	$ 102
Cash paid for income taxes	$ 93	$ 133	$ 89	$
Accretion to redemption value of redeemable stock	$	$ 3,450	$ 7,601	$
Repurchase of distribution rights	$	$	$ 3,098	$
Revaluation of put right (Minority interest)	$ 149	$ (810)	$ 598	$
Purchases of property and equipment through capital leases	$	$ 46	$ 246	$
Issuance (forgiveness) of notes receivable from stockholders	$	$ (10)	$ 204	$ (9)

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization, Basis of Presentation and Summary of Significant Accounting Policies

The Company

Alphatec Holdings, Inc. (Alphatec, the Successor or the Company) was incorporated in the state of Delaware in March 2005 in order to acquire 100% of the outstanding common stock of the Predecessor (as hereinafter defined) on March 18, 2005, as more fully described in Note 2.

Alphatec Spine, Inc., formerly known as Alphatec Manufacturing, Inc. (the Predecessor), is a California corporation organized in May 1990 and is primarily engaged in the development, manufacturing, and sale of medical devices for use in spinal and orthopedic surgeries. The Predecessor s principal operating activities are conducted through Alphatec Spine, Inc. and its consolidated subsidiaries, Nexmed, Inc. (Nexmed), a California corporation, Alphatec Pacific, Inc. (Alphatec Pacific), a Japanese corporation, and Milverton Limited (Milverton), a Hong Kong corporation.

Basis of Presentation

The consolidated financial statements of the Predecessor include the accounts of Alphatec Spine, Inc. and its wholly owned subsidiaries, Alphatec Pacific, Milverton and Nexmed.

The consolidated financial statements of the Successor include the accounts of Alphatec and Alphatec Spine, Inc. and its wholly owned subsidiaries, Nexmed, Milverton and Alphatec Pacific. Intercompany balances and transactions have been eliminated in consolidation.

The consolidated statement of operations for the period from March 18, 2005 to December 31, 2005 includes the results of the Cortek business from the beginning of the date that Alphatec Spine acquired substantially all of the assets of Cortek, September 9, 2005. See Note 2.

Nexmed did not have significant activity during any of the periods presented.

Foreign Currency Translation and Transactions

The Company s primary functional currency is the U.S. dollar, while the functional currency of the Company s Japanese and Hong Kong subsidiaries is the Japanese yen and the Hong Kong dollar, respectively. Assets and liabilities denominated in foreign currencies are translated at the rate of exchange on the balance sheet date. Revenues and expenses are translated using the average exchange rate for the period. Net gains and losses resulting from the translation of foreign financial statements are recorded as a separate component of stockholders equity.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The carrying value of accounts receivable, foreign cash accounts, prepaid expenses, other current assets, accounts payable, accrued expenses, and current portion of debt are considered to be representative of their

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

respective fair values because of the short-term nature of those instruments. Based on the borrowing rates currently available to the Company for loans with similar terms, management believes the fair value of notes payable, capital leases and other long-term debt approximates their carrying values.

Concentration of Credit Risk and Significant Customers

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents and accounts receivable. The Company limits its exposure to credit loss by depositing its cash and cash equivalents with high credit quality financial institutions.

The Company s customers are primarily hospitals or surgical centers and no single customer represented greater than 10 percent of consolidated revenues for any of the periods presented. Credit to customers is granted based on an analysis of the customers credit worthiness and credit losses have not been significant.

Revenue Recognition

The Company recognizes revenue when all four of the following criteria are met: (i) persuasive evidence that an arrangement exists; (ii) delivery of the products has occurred; (iii) the selling price is fixed or determinable; and (iv) collectibility is reasonably assured. In addition, the Company follows the provisions of Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*, which sets forth guidelines for the timing of revenue recognition based upon factors such as passage of title, installation, payment and customer acceptance.

The Company s revenue from sales of spinal and other surgical implants is recognized upon receipt of written acknowledgement that the product has been used in a surgical procedure or upon shipment to third-party customers who immediately accept title to such implant.

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if indicators of impairment exist, the Company assesses the recoverability of the affected long-lived assets by determining whether the carrying value of such assets can be recovered through undiscounted future operating cash flows. If impairment is indicated, the Company measures the amount of such impairment by comparing the carrying value of the asset to the undiscounted cash flows associated with the use of the asset. The Company believes the future cash flows to be received from the long-lived assets will exceed the assets carrying value, and accordingly the Company has not recognized any impairment losses through December 31, 2007.

Cash and Cash Equivalents

The Company considers all investments with an original maturity of three months or less when purchased to be cash equivalents. Cash equivalents primarily represent funds invested in money market funds, whose cost equals fair market value.

Restricted Cash

The Company has a certificate of deposit with Bank of the West as collateral for the standby letter of credit issued to secure the lines of credit for Alphatec Pacific with Resona Bank.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are presented net of allowance for doubtful accounts. The Company makes judgments as to its ability to collect outstanding receivables and provides allowance for a portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices and the overall quality and age of those invoices not specifically reviewed. Amounts determined to be uncollectible are written-off against the reserve. In determining the provision for invoices not specifically reviewed, the Company analyzes historical collection experience. If the historical data used to calculate the allowance provided for doubtful accounts does not reflect the Company s future ability to collect outstanding receivables or if the financial condition of customers were to deteriorate, resulting in impairment of their ability to make payments, an increase in the provision for doubtful accounts may be required.

Inventories

Inventories are stated at the lower of average cost or market and include material, labor and overhead costs. The Company reviews the components of its inventory on a quarterly basis for excess, obsolete and impaired inventory, based upon historical turnover and assumptions about future demand for products and market conditions. The allograft implants and tissue-based bone grafting products have up to a four-year shelf life and are subject to demand fluctuations based on the availability and demand for alternative products. The Company s estimates and assumptions for excess and obsolete inventory are reviewed and updated on a quarterly basis. Increases in the reserve for excess and obsolete inventory result in a corresponding expense to cost of goods sold.

The Company s business goal is to focus on continual product innovation, which could result in obsoleting the Company s products. Through December 31, 2007, the Company has not recorded excess and obsolescence expenses related to the introduction of next generation products.

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, generally ranging from two to seven years. Leasehold improvements and assets acquired under capital leases are amortized over the shorter of their useful lives or the terms of the related leases.

Goodwill and Other Intangible Assets

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires goodwill to be tested for impairment on an annual basis and earlier if indication of impairment exists, and written down when impaired. Furthermore, SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite.

The Company is amortizing its intangible assets, other than goodwill, on a straight-line basis over a three to ten-year period. No amortization of goodwill has been recorded.

Instead, the Company performs an impairment assessment by applying a fair-value based test in the fourth quarter of each year, or more frequently if changes in circumstances or the occurrence of events suggest the remaining value is not recoverable. The Company has not recognized any impairment losses through December 31, 2007.

Other Assets

As of December 31, 2007, other assets consisted of an investment in Noas Medical Company Ltd. (Noas), and deferred financing costs associated with the new line of credit with Merrill Lynch.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other Long-Term Liabilities

Other long-term liabilities consist of accruals for property and sales taxes and the long-term portion of severance payable.

Research and Development

Research and development expenses consist of costs incurred to further the Company s research and development activities and are expensed as incurred.

In-Process Research and Development

In-process research and development (IPR&D) consists of acquired research and development assets that were not currently technologically feasible on the date the Company acquired them and had no alternative future use at that date. The Company expects all acquired IPR&D will reach technological feasibility, but there can be no assurance that the commercial viability of these products will actually be achieved.

Product Shipment Cost

Product shipment costs are included in sales and marketing expense in the accompanying consolidated statements of operations.

Advertising Costs

Advertising costs are expensed as incurred. Total advertising costs for any of the periods presented in the accompanying statements of operations were not significant.

Income Taxes

The Company accounts for income taxes in accordance with the provisions of SFAS No. 109, *Accounting for Income Taxes* and FASB Interpretation Number (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*. SFAS No. 109 requires an asset and liability approach, which requires the recognition of deferred tax assets and deferred tax liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. In making such determination, a review of all available positive and negative evidence must be considered, including scheduled reversal of deferred tax liabilities, projected future taxable income, tax planning strategies, and recent financial performance. FIN No. 48 clarifies accounting for uncertainty in tax positions. FIN No. 48 requires that the Company recognize in its financial statements the impact of a tax position, if that position is more likely than not to be sustained on audit, based on the technical merits of the position.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123(R), *Share-Based Payment* using the prospective transition method and therefore, prior period results were not restated. SFAS No. 123(R) supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock issued to Employees*, and related interpretations, and revises guidance in SFAS No. 123, *Accounting for Stock-Based Compensation*. Under this transition method, the compensation cost related to all equity instruments granted prior to, but not yet vested as of, the adoption date is recognized based on the grant-date fair value which is estimated in accordance

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

with the original provisions of SFAS No. 123. Compensation costs related to all equity instruments granted after January 1, 2006 is recognized at grant-date fair value of the awards in accordance with the provisions of SFAS No. 123(R). Additionally, under the provisions of SFAS No. 123(R), the Company is required to include an estimate of the number of the awards that will be forfeited in calculating compensation costs, which is recognized over the requisite service period of the awards on a straight-line basis.

Valuation of Stock Option Awards

The weighted-average grant-date fair value of stock options granted during the year ended December 31, 2007 and December 31, 2006 was $3.92 and $5.60, respectively. The assumptions used to compute the share-based compensation costs for the stock options granted during the years ended December 31, 2007 and December 31, 2006 are as follows:

	Year ended December 31,	
Employee Stock Options	**2007**	**2006**
Risk-free interest rate	3.6 4.9%	4.5 4.7%
Expected dividend yield	%	%
Weighted average expected life (years)	6.3 6.5	6.5
Volatility	51 62%	62 65%
Forfeiture rate	15 20%	15%

The risk-free interest rate assumption was based on the U.S. Treasury s rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. The assumed dividend yield was based on the Company s expectation of not paying dividends in the foreseeable future. The weighted average expected life of options was calculated using the simplified method as prescribed by SAB No. 107, *Share-Based Payment*. This decision was based on the lack of relevant historical data due to the Company s limited historical experience. In addition, due to the Company s limited historical data, the estimated volatility also reflects the application of SAB No. 107, incorporating the historical volatility of comparable companies whose share prices are publicly available.

Compensation Costs

The compensation cost that has been included in the Company s consolidated statement of operations for all stock-based compensation arrangements is detailed as follows (in thousands, except per share amounts):

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
Cost of revenues	$ 112	$ 779	$ 106	$
Research and development	184	304	53	37

Sales and marketing	267	1,340	294	980
General and administrative	(249)	6,405	869	1,143
Total	$ 314	$ 8,828	$ 1,322	$ 2,160
Effect on basic and diluted net loss per share	$ (0.01)	$ (0.32)	$ (0.07)	$ (0.23)

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The stock-based compensation recorded in 2007 of $0.3 million is net of the reversal of $0.5 million of stock compensation related to certain executives that was recognized in 2006 in accordance with their employment contracts, and was reversed as a result of a settlement agreement that was reached in June 2007. The 2006 amount also included $1.3 million of IPO bonuses and $4.7 million for one time stock compensation charges for awards issued to employees with no remaining substantive service requirements.

In the fourth quarter of 2006 and continuing into 2007, the Company experienced significant turnover at both the executive and management levels, which affected the Company s estimated forfeiture rate. During 2007, the Company assessed the impact of such turnover on its forfeiture rate and in turn on stock-based compensation. As a result, the Company recorded an adjustment to reduce this expense by approximately $0.9 million. In accordance with SFAS No. 123(R), the impact of the change in the estimated forfeiture rate to compute stock-based compensation is recognized through a cumulative catch-up adjustment in the period it was determined.

As of December 31, 2007, there was $4.4 million of unrecognized compensation expense for stock options and awards which is expected to be recognized over a weighted average period of approximately 3.3 years. The total intrinsic value of options exercised was immaterial for the fiscal years ended December 31, 2007, 2006 and 2005.

Expense Prior to Adoption of SFAS No. 123(R)

Prior to the adoption of SFAS No. 123(R), the Company presented deferred compensation as a separate component of stockholders equity. In accordance with the provisions of SFAS No. 123(R), on January 1, 2006, the Company reclassified deferred compensation against additional paid-in capital and retained earnings.

In addition, prior to January 1, 2006, the Company applied the intrinsic-value-based method of accounting prescribed by APB Opinion No. 25, and related interpretations to account for its equity-based awards to employees and directors. Under this method, if the exercise price of the award equaled or exceeded the fair value of the underlying stock on the measurement date, no compensation expense was recognized. The measurement date was the date on which the final number of shares and exercise price were known and was generally the grant date for awards to employees and directors. If the exercise price of the award was below the fair value of the underlying stock on the measurement date, then compensation cost was recorded, using the intrinsic-value method, and was generally recognized in the statements of operations over the vesting period of the award.

SFAS No. 123 requires disclosure of pro forma information assuming use of the fair value method for reporting periods prior to January 1, 2006. The pro forma information is not included herein for any periods since difference between the intrinsic-value-based method and the fair value method was not material.

Equity instruments issued to non-employees are recorded at their fair value as determined in accordance with SFAS No. 123 and Emerging Issues Task Force (EITF) Issue No. 96-18, *Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods and Services*, and are periodically revalued as the equity instruments vest and are recognized as expense over the related service period. In connection with the sale of 120,487 shares of common stock to non-employees during the period from March 18, 2005 to December 31, 2005, the Company recorded total stock-based compensation within stockholders equity of $0.04 million.

Deferred Stock-Based Compensation Prior to 2006

The Predecessor, as a result of the valuation utilized in its merger with the Successor in March 2005, reassessed the fair value of the common stock used to grant equity awards for the period from January 1, 2004 to

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 17, 2005. In determining the fair value of the Predecessor s common stock, the Board of Directors considered, among other factors, (i) the advancement of the Company s technology, (ii) the Company s financial position, (iii) industry specific and general market conditions and (iv) the enterprise valuation utilized in the merger with the Successor.

In connection with the grant of equity awards to employees during the period from March 18, 2005 to December 31, 2005, the Successor recorded total deferred employee stock-based compensation within stockholders equity of $20.5 million, which represented the difference between the exercise price and the reassessed fair value of 122,297 stock options granted and 1,937,439 restricted shares sold.

Net Loss Per Share

The Company calculates net loss per share in accordance with SFAS No. 128, *Earnings per Share*. Basic earnings per share (EPS) is calculated by dividing the net income or loss available to common stockholders by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period and the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For purposes of this calculation, common stock subject to repurchase by the Company and options are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
	(In thousands, except per share amounts)			
Numerator:				
Net loss available to common stockholders	$ (20,202)	$ (29,266)	$ (20,466)	$ (1,189)
Denominator:				
Weighted average common shares outstanding	38,567	28,776	19,044	9,231
Weighted average unvested common shares subject to repurchase	(1,284)	(1,538)	(843)	
Vested common shares outstanding purchased with promissory notes and subject to variable accounting				(20)

Weighted average common shares outstanding basic		37,283		27,238		18,201	9,211
Effect of dilutive securities:							
Options							
Weighted average common shares outstanding diluted		37,283		27,238		18,201	9,211
Net loss per common share:							
Basic and diluted	$	(0.54)	$	(1.07)	$	(1.12)	$ (0.13)

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of December 31, 2007 and December 31, 2006, none of the outstanding new redeemable preferred stock is convertible to common stock. As of December 31, 2005, the outstanding preferred stock is excluded from the basic and diluted earnings per share calculations because of their anti-dilutive effect.

Segment Information

The Company applies the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. SFAS No. 131 requires public companies to report financial and descriptive information about their reportable operating segments. The Company identifies its operating segments based on how management internally evaluates separate financial information, business activities and management responsibility. The Company believes it operates in a single business segment.

During the years ended December 31, 2007 and 2006, the Company operated in two geographic locations, the U.S. and Asia. Revenues, attributed to the geographic location of the customer, were as follows (in thousands):

	Year ended December 31, 2007	Year ended December 31, 2006
United States	$ 66,722	$ 60,591
Asia	13,309	13,414
Total consolidated revenues	$ 80,031	$ 74,005

Total assets by region were as follows (in thousands):

	December 31, 2007	December 31, 2006
United States	$ 134,721	$ 120,584
Asia	12,519	8,693
Total consolidated assets	$ 147,240	$ 129,277

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements An amendment of ARB No. 51*, which requires an entity to clearly identify and report ownership interests in subsidiaries held by parties other than the parent in the consolidated statement of financial position within equity but separate from the parent s equity. SFAS No. 160 also requires that the amount of consolidated net income attributable to the parent and to the noncontrolling interest be identified and presented on the face of the consolidated income statement; that changes in a parent s ownership interest be accounted for as equity transactions; and that when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary and the gain or loss on the deconsolidation be measured at fair value. SFAS No. 160 is effective for fiscal years beginning after December 31, 2008. The Company does not anticipate that SFAS No. 160 will have a material effect on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations,* which requires an acquirer to recognize the assets acquired, the liabilities assumed, contractual contingencies, and contingent

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

consideration at their fair values as of the acquisition date. SFAS No. 141 also requires acquisition costs to be expensed as incurred, restructuring costs to be expensed in the period subsequent to the acquisition date, and changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date to impact tax expense. SFAS No. 141 also requires the acquirer in an acquisition implemented in stages to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values. SFAS No. 141 is effective for business combinations with an acquisition date after December 31, 2008.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* which offers entities the option to measure eligible financial instruments and certain other items at fair value and record unrealized gains and losses in earnings. SFAS No. 159 also establishes presentation and disclosure requirements for items reported at fair value in the financial statements. SFAS No. 159 is effective for fiscal years beginning after December 31, 2007. The Company does not anticipate that SFAS No. 159 will have a material effect on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in Generally Accepted Accounting Principles (GAAP) and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, SFAS No. 157 does not require any new fair value measurements, but may change current practice for some entities. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company does not anticipate that SFAS No. 157 will have a material effect on its consolidated financial statements.

2. Acquisitions and Investment

Alphatec Spine, Inc.

On March 18, 2005, the Successor acquired all of the outstanding capital stock of Alphatec Spine. The acquisition was funded out of the net proceeds from the Company s initial capitalization in March 2005. The results of operations of Alphatec Spine have been included in the consolidated financial statements of the Successor from the date of acquisition. The total cost of the acquisition was as follows (in thousands):

Cash paid for common stock and stock options	$ 70,000
Debt assumed as a result of acquisition	5,458
Direct costs	1,046
Total purchase price	$ 76,504

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price allocation is shown below (in thousands):

Cash and cash equivalents	$ 1,056
Accounts receivable	4,243
Inventories	4,669
Prepaid expenses and other current assets	483
Income taxes receivable	53
Property and equipment, net	3,607
Other assets	100
Accounts payable	(1,667)
Accrued and other expenses	(4,530)
Deferred income taxes	(3,075)
Net tangible assets	4,939
Developed product technology	13,700
Supplier agreement	221
In-process research and development	3,100
Goodwill	54,544
Total purchase price	$ 76,504

In connection with this transaction, the Company conducted a valuation of the acquired assets and assumed liabilities in order to allocate the purchase price in accordance with SFAS No. 141, *Business Combinations*. Unless otherwise noted below, the fair value of the acquired tangible assets, assumed liabilities and supplier agreement was equal to the Predecessor s carrying value on March 18, 2005, the date of acquisition. The Company allocated the excess purchase price over the fair value of acquired net tangible and intangible assets to goodwill. A strong scientific employee base having existing relationships with prominent spine surgeons and operations in an attractive market niche were among the factors that contributed to a purchase price resulting in the recognition of goodwill. Goodwill recorded for the acquisition of Alphatec Spine is not deductible for income tax purposes.

The developed product technology represented proprietary knowledge that was technologically feasible as of the valuation date, and included all fully functioning products at the date of the valuation. Specifically, developed product technology represented proprietary knowledge related to the following products of the Company: Zodiac Lumbar Fusion and Deformity System, Novel Spinal Spacers, ROC Lumbar Plating System, Deltaloc Reveal Anterior Cervical Plate, and Mirage Spinal Fixation System. The amount allocated to the developed product technology was assigned based on the estimated net discounted cash flows (income approach) from the related product line on March 18, 2005, the date of acquisition. The developed product technology is being amortized over a useful life of five years.

In accordance with SFAS No. 2, *Accounting for Research and Development Costs* , as clarified by the FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, an Interpretation of FASB Statement No. 2,* the amounts allocated to IPR&D expense were determined through established valuation techniques and were expensed upon acquisition as it was determined that the underlying projects had not reached technological feasibility and had no alternative future uses.

The fair value of the IPR&D was determined using the income approach. Under the income approach, the expected future cash flows from each project under development were estimated and discounted to their net present values at an appropriate risk-adjusted rate of return. Significant factors considered in the calculation of

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the rate of return were the weighted average cost of capital and return on assets, as well as the risks inherent in the development process, including the likelihood of achieving technological success and market acceptance. Each project was analyzed to determine technological innovations that were unique, the existence and reliance on core technology, the existence of any alternative future use or current technological feasibility, and the complexity, cost and time to complete the remaining development. Future cash flows for each project were estimated based on forecasted revenue and costs, taking into account product life cycles, and market penetration and growth rates.

The IPR&D expense includes only the fair value of IPR&D performed as of the respective acquisition dates. The fair value of developed technology was included in identifiable purchased intangible assets. The Company believes the amounts recorded as IPR&D expense, as well as developed technology, represented the fair values and approximated the amounts an independent party would pay for these projects at the time of the respective acquisition dates.

As a result of the required adjustment of acquired assets and liabilities to fair value at the date of purchase, using the income approach, the Company increased inventory by $1.1 million over the historical cost. The inventory adjustment resulted in Successor cost of revenues of $1.1 million over what would have been recorded by the Predecessor.

Pursuant to the acquisition agreement, the stockholders of the Predecessor put $3.0 million in escrow in order to fund potential indemnification claims for losses incurred by the Company. The Company subsequently filed a claim for indemnification of $4.5 million in claims, primarily relating to obsolete inventory, certain tax liabilities and uncollectible accounts receivable. On March 3, 2007, the Company settled the claim and received $1.0 million, which was applied as a reduction of goodwill. The remaining $2.2 million, including $0.2 million in interest earned, in the escrow fund was returned to the stockholders of Alphatec Manufacturing. Certain stockholders of Alphatec Manufacturing used the proceeds from the distribution to purchase an aggregate of $1.1 million of the Company s common stock in a private placement.

Cortek, Inc.

On September 9, 2005, Alphatec Spine acquired certain assets and assumed certain liabilities of Cortek, a manufacturer and distributor of precision-milled allograft products, in order to broaden the Company s product portfolio. The acquisition was funded out of the net proceeds from the Company s initial capitalization in March 2005. The results of operations of Cortek have been included in the consolidated financial statements of the Successor from the date of acquisition. At December 31, 2005, the total cost of the acquisition was as follows (in thousands):

Cash consideration	$ 6,500
Debt assumed as a result of acquisition	550
Direct costs	802
Total purchase price	$ 7,852

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price allocation is shown below (in thousands):

Accounts receivable	$ 1,608
Inventories	2,268
Prepaid expenses and other current assets	76
Property and equipment, net	266
Other assets	57
Accounts payable	(955)
Accrued expenses	(1,313)
Net tangible assets	2,007
Goodwill	5,845
Total purchase price	$ 7,852

In connection with this transaction, the Company conducted a valuation of the acquired assets and assumed liabilities in order to allocate the purchase price in accordance with SFAS No. 141. The Company has allocated the excess purchase price over the fair value of acquired net tangible assets to goodwill. The enhancement of the Company s existing portfolio of spine fusion products with a complementary offering of precision-milled allograft products was the primary factor that contributed to a purchase price resulting in the recognition of goodwill. Goodwill recorded for this acquisition will be deducted on a straight-line basis for income tax purposes over 15 years.

As a result of the required adjustment of acquired assets and liabilities to fair value at the date of purchase, using the income approach, the Company increased inventory by $0.4 million over the historical cost, resulting in a decrease of goodwill of the same amount. The increased inventory value was recorded as cost of revenues as the related products were sold. As of December 31, 2007 and 2006, $0.0 million of this amount remained in ending inventory.

During the fourth quarter of 2005, the Company revised the purchase price allocation and reduced inventory by $0.9 million to conform Cortek s accounting for inventory to the Company s accounting for inventory.

Acquisitions in Japan

Ishibe Medical Co., Ltd.

On November 1, 2005, Alphatec Pacific acquired all of the outstanding capital stock of Ishibe Medical Co., Ltd., a medical device distributor headquartered in Sapporo, Japan. The direct cost of the acquisition was less than $0.3 million. The acquisition resulted in an increase to intangibles of approximately $1.1 million for distribution rights which are being amortized over three years. The results of operations have been included in the consolidated financial statements from the date of acquisition.

Buyback of Distribution Rights

On August 11, 2005, the Company paid $3.1 million to repurchase its distribution rights in Japan. The transaction was entirely financed by Alphatec Pacific s current Chairman, President and Chief Executive Officer in return for the issuance of a note payable that was to be repaid in 18 equal monthly installments of $0.2 million (18.46% effective interest rate to scheduled maturity), beginning December 1, 2005. As additional compensation for making the loan to the Company, the Company granted Alphatec Pacific s Chairman, President and Chief Executive Officer a 20% interest in Alphatec Pacific, which had an estimated value of $0.6 million. This amount was recorded as debt issuance cost in the accompanying balance sheet. The note, plus accrued interest, totaling $3.0 million, was paid in full from the initial public offering proceeds in June 2006.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Japan Ortho Medical (formerly Blues Medica Japan)

On May 1, 2007, Alphatec Pacific acquired all of the outstanding capital stock of Blues Medica Japan (the JOM Predecessor), a spinal and orthopedic implant distributor. The results of operations of Japan Ortho Medical have been included in these consolidated financial statements from the date of acquisition. The total cost of the acquisition was as follows (in thousands):

Cash paid for common stock	$ 292
Debt assumed as a result of acquisition	1,143
Common stock issued	846
Direct costs	15
Total purchase price	$ 2,296

The purchase price allocation is shown below (in thousands):

Cash and cash equivalents	$ 505
Accounts receivable	478
Inventories	202
Prepaid expenses and other current assets	184
Property and equipment, net	718
Other assets	231
Accounts payable	(316)
Accrued and other expenses	(838)
Net tangible assets	1,164
Goodwill	486
Distribution rights	646
Total purchase price	$ 2,296

The fair value of the acquired tangible assets and assumed liabilities was equal to the JOM Predecessor s carrying value on May 1, 2007, the date of acquisition. The purchase agreement includes two contingent payments to the former owner of the JOM Predecessor based upon a percentage of the 2007 and 2008 revenues. This contingency is recorded in accrued expenses in the purchase price allocation and is based upon projected revenue. The Company performed a valuation of the distribution rights in order to allocate the purchase price in accordance with SFAS No. 141 between identifiable intangibles and goodwill in the fourth quarter of 2007. The distribution rights will be amortized on a straight-line basis over three years. The enhancement of the Company s Japanese distribution network was the primary factor that contributed to a purchase price resulting in the recognition of the distribution rights and goodwill as intangible assets.

Noas Medical Company

In April 2007, Alphatec Pacific purchased 7,500 shares, valued at $0.3 million, of Noas, a Japanese spinal and orthopedic implant distributor in order to establish a strategic alliance.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Balance Sheet Details

Accounts Receivable

Accounts receivable consist of the following (in thousands):

	December 31, 2007	December 31, 2006
Accounts receivable	$ 13,220	$ 11,203
Allowance for doubtful accounts	(185)	(620)
Accounts receivables, net	$ 13,035	$ 10,583

Inventories

Inventories consist of the following (in thousands):

	December 31, 2007			December 31, 2006		
	Gross	Reserve for excess and obsolete	Net	Gross	Reserve for excess and obsolete	Net
Raw materials	$ 2,271	$ (45)	$ 2,226	$ 1,725	$ (371)	$ 1,354
Work-in-process	1,117		1,117	406		406
Finished goods	26,812	(10,063)	16,749	21,637	(9,943)	11,694
Inventories, net	$ 30,200	$ (10,108)	$ 20,092	$ 23,768	$ (10,314)	$ 13,454

Property and Equipment

Property and equipment consist of the following (in thousands):

	Useful lives (in years)	December 31, 2007	December 31, 2006
Surgical instruments	2-3	$ 11,957	$ 6,673
Machinery and equipment	7	6,022	5,905
Computer equipment	5	1,564	1,316
Office furniture and equipment	5	2,597	2,464
Leasehold improvements	various	1,777	1,779
Building	39	382	
Land		61	
		24,360	18,137

Less accumulated depreciation and amortization	(12,131)	(5,554)
Property and equipment, net	$ 12,229	$ 12,583

The Company has assets under capital leases of $3.0 million and $3.0 million at December 31, 2007 and 2006, respectively. Accumulated depreciation on these assets totaled $1.7 million and $1.1 million at December 31, 2007 and 2006, respectively. Depreciation expense for these capital leases for the years ended December 31, 2007 and December 31, 2006 were $0.6 million and $0.6 million, respectively.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Acquired Intangibles

Acquired intangibles consist of the following (in thousands):

	Useful lives (in years)	December 31, 2007	December 31, 2006
Developed product technology	5	$ 13,700	$ 13,700
Distribution rights	3	2,735	1,930
Scient x license agreement	8	2,603	0
Supply agreement	10	225	225
		19,263	15,855
Less accumulated amortization		(9,629)	(5,670)
Intangibles, net		$ 9,634	$ 10,185

Aggregate amortization expense for the years ended December 31, 2007 and December 31, 2006 were $3.9 million and $3.4 million, respectively.

The future expected amortization expense related to intangible assets as of December 31, 2007 is as follows (in thousands):

Year ending December 31,	
2008	$ 3,805
2009	3,317
2010	1,109
2011	348
2012	348
Thereafter	707
Total	$ 9,634

Accrued Expenses

Accrued expenses consist of the following (in thousands):

	December 31, 2007	December 31, 2006
Current portion of severance payable	$ 710	$ 3,159
Commissions	1,766	2,111
Royalties	927	813
Payroll and related	2,375	1,305

Legal	129	913
Accrued earnout	566	
Consumption tax	648	614
Intellectual property	2,000	
Reserve for litigation costs	2,222	150
Other	2,025	1,304
Total accrued expenses	$ 13,368	$ 10,369

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Included in the current portion of the severance payable balance at December 31, 2006 is $0.6 million, which is the result of the termination of two employees who had employment agreements with the Predecessor. The employees were terminated by the Successor in 2005 and will be paid out in periodic installments through March 2008. Also, included in the current portion of the severance payable balance at December 31, 2006 is $2.6 million, which is the result of the termination of several employees during 2006. The long-term portion of severance payable to these employees, which was $0.7 million at December 31, 2006 is included in other long-term liabilities in the accompanying balance sheets.

4. Licenses and In-Process Research and Development

Scient x S.A.License

In January 2007, Alphatec Spine acquired an exclusive license agreement from Scient x S.A., a French spinal implant manufacturer. In January 2007, Alphatec Spine signed three license agreements with Scient x S.A., or Scient x, pursuant to which Alphatec Spine has rights under Scient x proprietary technology related to (i) the Scient x Isobar posterior dynamic stabilization rod, (ii) the Scient x Stella cervical plate, and (iii) the Scient x Antelys plate-cage construct, to produce, market, sell and distribute (a) a posterior dynamic stabilization rod, (b) a low profile cervical plate, and (c) a plate-cage construct; respectively in the U.S. Pursuant to the agreement related to the Isobar technology (i) Alphatec Spine has made an upfront payment of $2.6 million; (ii) Alphatec Spine is obligated to pay a royalty on sales (with minimum royalties for a period of three years); and (iii) Alphatec Spine is required to purchase a minimum amount of inventory from Scient x, at cost, for a period of two years.

Vertebral Compression Fracture Solution License

In September 2007, Alphatec Spine entered into an exclusive worldwide license agreement (the V-Stent License Agreement) with Stout Medical Group, LP (Stout) that allows Alphatec Spine to develop and commercialize Stout s vertebral compression fracture technology, which Stout had previously named the V-Stent, which is an expandable titanium cage that is designed to be implanted minimally invasively into a vertebral body to treat compression fractures of the vertebral body. The financial terms of the V-Stent License Agreement include: (i) an up-front license fee payment to be made by Alphatec Spine to Stout upon Stout s delivery of certain deliverables related to the prototype of the V-Stent; (ii) design, regulatory and sales milestone payments that could begin to be achieved and paid by Alphatec Spine to Stout in 2008; and (iii) royalty payments based on net sales of the licensed products with minimum annual royalties beginning in 2009. Stout provided the deliverables upon which the up-front payment was conditional in October 2007 and the Company recorded an IPR&D charge of $5.0 million in the fourth quarter of fiscal 2007, as the technological feasibility associated with the final prototype of the device had not been completed and there were no alternative future uses.

Guided Lumbar Interbody Fusion (GLIF) System

In September 2007, Alphatec Spine entered into an exclusive worldwide license (the GLIF License Agreement) from JGMG Bengochea, LLC (JGMG) that provides

Alphatec Spine with an exclusive worldwide license to develop and commercialize technology related to the GLIF system, which is designed to allow surgeons to perform a 360-degree minimally invasive procedure without the need for a second incision or repositioning of the patient, which is intended to reduce the length of the procedure, reduce the trauma to the patient and reduce the post-surgery recovery period. The financial terms of the GLIF License Agreement include: (i) an issuance of 750,000 of the Company s common stock to JGMG, a portion of which common stock shall be subject to a five-year lockup period, with automatic waivers of such lockup to occur upon the achievement of certain milestone events; (ii) design, regulatory and sales milestone payments that could begin to be achieved and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

paid by Alphatec Spine to JGMG in 2008; and (iii) royalty payments based on net sales of licensed products with minimum annual royalties beginning in 2010. The GLIF License Agreement expires upon the later of 2027 and the last expiration date of the patents contained within any products. In connection with the issuance of shares of common stock to JGMG pursuant to the GLIF License Agreement, the Company recorded an IPR&D charge of $2.3 million in the third quarter of fiscal 2007, as the technological feasibility associated with the GLIF since the final prototype of the device had not been completed and there were no alternative future uses.

OsseoScrew License Agreement

In December 2007, Alphatec Spine entered into an exclusive license agreement (the OsseoScrew License Agreement) from Progressive Spinal Technologies LLC, or (PST), that provides Alphatec Spine with an exclusive worldwide license to develop and commercialize PST s technology related to a pedicle screw designed to be used for patients that have osteoporosis or poor bone density. The technology consists of an expandable titanium pedicle screw that is designed to be implanted into the pedicle and then expanded in order to achieve increased purchase within the pedicle. This solution is designed for patients who are not viable candidates for procedures that use the current standard of pedicle screw. The financial terms of the OsseoScrew License Agreement include: (i) a cash payment payable following the execution of the agreement; (ii) development and sales milestone payments in cash and the Company s common stock that could begin to be achieved and paid in 2008; and (iii) a royalty payment based on net sales of licensed products with minimum annual royalties beginning in 2009. The Company recorded an IPR&D charge of $2.0 million in the fourth quarter for the initial payment, as the technological feasibility associated with the IPR&D since the final prototype of the device had not been established and no alternative future use exists.

5. Related Party Transactions

For the twelve months ended December 31, 2007 and December 31, 2006, the Company incurred costs of $0.4 million and $0.5 million respectively, to Foster Management Company for travel expenses, including the use of Foster Management Company s airplane. Foster Management Company is an entity owned by John Foster who served in 2006 and 2007 as both the Company s Chief Executive Officer and Chairman of the Board. Mr. Foster does not currently hold either of these positions, although he is a member of the Company s Board of Directors. Mr. Foster is a Managing Member of HGP, LLC and the Chairman, Chief Executive Officer, a member of the Board of Managers and a Managing Director of HealthpointCapital, LLC., an affiliate of the Company s largest stockholder.

In connection with the Company s September 2007 public offering of 10,000,000 shares of common stock described in Note 10 below, the Company sold 2,750,000 shares of common stock to HealthpointCapital Partners II, L.P., an affiliate of HealthpointCapital, the Company s largest stockholder, at a price $3.45 per share.

In August 2005, Alphatec Spine entered into a stock purchase agreement with Roy Yoshimi, then Alphatec Pacific s Chairman, President and Chief Executive Officer pursuant to which Alphatec Spine had an obligation to repurchase the shares of Alphatec Pacific owned by Mr. Yoshimi upon certain conditions, or upon the election of Mr. Yoshimi at any time following the first anniversary of the Company s initial public offering. Mr. Yoshimi exercised this right on June 2, 2007 and the Company s Board of Directors elected to pay the purchase price of $2.9 million for such Alphatec Pacific shares in the form of 804,874 shares of the Company s common stock in accordance with the stock purchase agreement governing such transaction.

In October 2006, the Company entered into a Consulting Agreement with one of its directors, Dr. Stephen H. Hochschuler (the Consulting Agreement). Pursuant to the terms of the Consulting Agreement, the Company

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

agreed to appoint Dr. Hochschuler to its Board of Directors until the next annual meeting of the Company s stockholders or his successor is duly appointed and qualified. Dr. Hochschuler s appointment was effective October 25, 2006. Pursuant to the Consulting Agreement Dr. Hochschuler is required to provide advisory services to the Company related to the spinal implant industry and the Company s research and development strategies. The agreement has a three-year term. In return for such advisory services, the Company is obligated to pay Dr. Hochschuler cash and equity compensation.

6. Supply Agreements

In July 2006, Alphatec Spine entered into a 30-month agreement to sell the products of a third party under Alphatec Spine s private label. As of December 31, 2007, we have a minimum purchase commitment of $6.0 million over the remaining life of the contract.

In March 2006, Alphatec Spine entered into a four-year agreement to sell the products of a third party under Alphatec Spine s private label. In March 2007 this agreement was mutually terminated, although Alphatec Spine retains the rights to sell its current inventory of such products.

In February 2006, Alphatec Spine entered into a three-year agreement to sell the products of third party under the Alphatec Spine s private label. The total minimum purchase commitment over the remaining life of the contract is $0.5 million.

In October 2004, the Predecessor entered into a ten-year agreement with one of its principal suppliers. This agreement fixes the price of materials with the supplier for the first 18 months and limits the annual price increase to eight percent for the remainder of the term of the agreement and requires three payments totaling $0.2 million. The Predecessor made a $0.1 million payment in November 2004 and the Company made $0.1 million payments in September 2005 and September 2006. The $0.2 million was recorded as an intangible asset in the accompanying balance sheet and is being amortized over 10 years, which is the term of the agreement.

7. Debt

Alphatec Spine had a two-year term, $12.0 million revolving line of credit with Bank of the West to provide working capital. As of September 30, 2007, there was no outstanding borrowing and no availability under this line of credit. On October 2, 2007, Alphatec Spine and Bank of the West mutually agreed to terminate this line of credit.

On October 2, 2007, the Company, Alphatec Spine, Nexmed, Inc. (collectively, the Borrowers) and Merrill Lynch Business Financial Services, Inc. (Merrill Lynch) entered into a three-year Credit and Security Agreement (the Credit Agreement) that provides for an aggregate $20.0 million commitment. This Credit Agreement replaced the Bank of the West Credit Agreement. The Credit Agreement consists of a $20.0 million note that bears interest at the rate of LIBOR plus 2.75% per annum. The amount available to be drawn under the note is limited to 85% of the net collectible value of eligible accounts receivable plus 75% of eligible inventory. As of December 31, 2007, the Company had approximately $13.8 million in availability under the note. The note is secured by a pledge of substantially all current existing and after-acquired property of the Borrowers. The Credit Agreement excludes from the collateral any intellectual property rights, including copyrights, patents, trademarks and inbound licenses relating to any of the copyrights, patents or trademarks, and any claims for damages relating to infringement of the intellectual property. While these items are excluded from collateral, the Credit Agreement contains a covenant in which the Borrowers have agreed not to place any lien on such assets without Merrill Lynch s consent.

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The Credit Agreement contains customary covenants, which, among other things, prohibit the Borrowers from assuming further debt obligations and any liens, unless otherwise permitted under the Credit Agreement. The entire outstanding principal amount of the note and any accrued but unpaid interest may be declared immediately due and payable in the event of the occurrence of an event of default as defined in the Credit Agreement, which includes the failure to make payments when due, breaches of representations, warranties or covenants, the occurrence of certain insolvency events, or the occurrence of an event or change which could have a material adverse effect on the Borrowers.

Alphatec Pacific has a $2.7 million credit facility with a Japanese bank, under which $2.5 million and $2.6 million was outstanding at December 31, 2007 and December 31, 2006, respectively. Under the terms of the credit facility, borrowings are due nine months from the date of borrowing and bear interest at 3.5%, and Alphatec Pacific is required to make monthly interest payments. The credit facility is secured by restricted cash of $2.0 million at December 31, 2007 and standby letters of credit issued through Bank of the West, which expired on October 31, 2007. In October 2007, Alphatec Pacific paid down $0.2 million of this credit facility and the Bank of the West standby letters of credit were replaced by letters of credit in the amount of $2.5 million issued through Merrill Lynch. In January 2008, Alphatec Pacific decided not to renew one of their lines of credit, which resulted in Alphatec Spine paying the bank $1.9 million. The second line of credit was renewed for $0.8 million.

During the second quarter of 2006, Alphatec Spine entered into term loans with General Electric Capital Corporation (GECC) for approximately $2.7 million in order to finance certain previously purchased machinery and office equipment. The loans are for a term of three years bearing interest from 11.23% to 11.42%, are secured by certain assets of Alphatec Spine, and may not be prepaid without the consent of the lender and are guaranteed by the Company. Under the terms of these loans, Alphatec Spine is required to make 36 equal monthly principal and interest payments of $0.1 million and is subject to certain covenants, that are defined in the credit agreement by and between the Borrowers and Merrill Lynch. The Merrill Lynch Credit Agreement contains customary covenants, which, among other things, prohibit the Borrowers from assuming further debt obligations and any liens, unless otherwise permitted under the Credit Agreement. If Alphatec Spine fails to satisfy these covenants and fails to cure any breach of these covenants within a specified number of days after receipt of notice, or fails to pay interest or principal under the loan when due, GECC could accelerate the entire amount borrowed, which would also trigger a default under Alphatec Spine s credit agreement with Merrill Lynch.

During the fourth quarter of 2006, Alphatec Spine entered into an additional term loan with GECC for approximately $1.0 million in order to finance certain previously purchased machinery and office equipment. The loan is for a term of three years, bearing interest of 10.55% and Alphatec Spine is required to make 36 equal monthly principal and interest payments of $0.03 million. The term loan has similar requirements as the term loan executed in the second quarter of 2006.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Long-term debt and note payable consists of the following (in thousands):

	December 31, 2007	December 31, 2006
Notes payable to Japanese Banks, bearing interest at rates ranging from 1.4% to 3.45%, maturity dates through January 2014, collateralized by substantially all assets of Alphatec Pacific and Japan Ortho Medical	$ 671	$ 286
Capital leases, bearing interest at rates ranging from 0.0% to 16.44%, generally due in monthly principal and interest installments, maturity dates through March 2010, collateralized by the related equipment (See Note 8)	819	1,363
Note payable related to equipment purchases, bearing interest at rates ranging from 10.55% to 11.42%, generally due in monthly principal and interest installments, maturity dates through December 2009, collateralized by the related equipment (See Note 7)	2,209	3,363
Bond payable to a Japanese Bank, bearing interest at 1.5%, maturity date through September 2012, collateralized by Japan Ortho Medical assets	311	
Other loan, bearing interest rate of 7.6%, generally due in monthly principal and interest installments, maturity dates through May 2008 (See Note 8)	155	159
Total debt	4,165	5,171
Less: current portion	(2,211)	(2,060)
Total long-term debt	$ 1,954	$ 3,111

Principal payments on long-term debt (excluding capital leases) are as follows as of December 31, 2007 (in thousands):

Year ending December 31,	
2008	$ 1,733
2009	1,220
2010	140
2011	126
2012	83
Thereafter	44
Total	$ 3,346

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Commitments and Contingencies

Leases

The Company leases certain equipment under capital leases which expire on various dates through 2010. The Company also leases its buildings and certain equipment and vehicles under operating leases which expire on various dates through 2011. Future minimum annual lease payments under such leases are as follows (in thousands):

Year ending December 31,	Operating	Capital
2008	$ 826	$ 519
2009	357	340
2010	280	12
2011	127	
	$ 1,590	871
Less: amount representing interest		(52)
Present value of minimum lease payments		819
Current portion of capital leases		(478)
Capital leases, less current portion		$ 341

Rent expense under operating leases for the year ended December 31, 2007, December 31, 2006, the period from March 18, 2005 to December 31, 2005, and the period from January 1, 2005 to March 17, 2005 was $1.4 million, $1.2 million, $1.0 million, $0 and $0.3 million, respectively.

Litigation

On June 26, 2006, Biedermann Motech GmbH and DePuy Spine, Inc., or DePuy, filed suits for patent infringement against a number of companies selling pedicle screws, including Alphatec Spine. The complaint against Alphatec Spine was filed in the U.S. District Court for the District of Massachusetts and alleges infringement of U.S. Patent No. 5,207,678, or the 678 Patent, owned by Biedermann Motech and exclusively licensed to DePuy in the U.S. The 678 Patent expires in July 2010. The complaint alleges that this patent covers certain pedicle screw designs and requests monetary damages and injunctive relief. On July 21, 2006, the plaintiffs filed a motion for preliminary injunction, requesting the Court to enjoin Alphatec Spine from making, using, and selling Alphatec Spine s Zodiac and Solanas products pending trial. Alphatec Spine opposed this motion, which was denied by the Court on October 26, 2006. On January 12, 2007, Alphatec Spine filed a motion for summary judgment that its products do not infringe this patent. The plaintiffs filed a cross motion for partial summary judgment that the accused Zodiac and Solanas products include one element of the asserted patent claims. Alphatec Spine s summary judgment motion was denied. On March 29, 2007, the Court ruled against Alphatec Spine and issued a claim construction order on one element of the asserted patent claim. In June 2007, the U.S. Patent and Trademark office decided to reexamine the 678 Patent following a request for reexamination that was made by a third party. In another case initiated by DePuy involving the alleged infringement of the 678 Patent by a spine company, the U.S. District Court for the Central District of California issued an order dated December 7, 2007 that granted DePuy s motion for reconsideration regarding the Court s prior invalidation of five of the seven claims of the 678 Patent. The Court has set a deadline of February 2008 for both parties to submit all briefs related to such reconsideration, which deadline has been extended to April 2008. Given that the Company s Zodiac and Solanas products constitute a significant portion of the Company s revenues, an adverse outcome in this suit would have a material adverse effect on the Company s business, financial conditions and results of operations.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On April 12, 2006, Alphatec Spine and HealthpointCapital, the Company s majority stockholder, and its affiliate, HealthpointCapital, LLC, were served with a complaint by Drs. Darryl Brodke, Alan Hilibrand, Richard Ozuna and Jeffrey Wang, or the claimant surgeons, in the Superior Court of California in the County of Orange, claiming, among other things, that, pursuant to certain contractual arrangements Alphatec Spine allegedly entered into with the claimant surgeons in 2001, it was required to pay the claimant surgeons quarterly royalties in an aggregate amount of 6% of the net sales of polyaxial screws, which the claimant surgeons allege were developed with their assistance prior to the cessation of such development activities in March 2002. Alphatec Spine first began to sell polyaxial screws in 2003 and has continued to sell them through the date of this annual report. In October of 2006, the parties to this litigation initiated a mediation session in an attempt to mediate a resolution to this matter, but were unsuccessful in doing so. Alphatec Spine brought a motion to compel arbitration of the claimant surgeons claims and is currently appealing the Court s denial of the motion. Alphatec Spine does not believe that any of the claimant surgeons are entitled to any royalty amounts and intends to vigorously defend itself against this complaint; however, Alphatec Spine cannot predict the outcome to this matter or the impact on the Company s financial statements, if any.

Alphatec Pacific Put Right

In August 2005, Alphatec Spine entered into a stock purchase agreement with Roy Yoshimi, then Alphatec Pacific s Chairman, President and Chief Executive Officer, pursuant to which Alphatec Spine had an obligation to repurchase the shares of Alphatec Pacific owned by Mr. Yoshimi upon certain conditions, or upon the election of Mr. Yoshimi at any time following the first anniversary of the Company s initial public offering. Mr. Yoshimi exercised this right on June 2, 2007 and the Company s Board of Directors elected to pay the purchase price of $2.9 million for such Alphatec Pacific shares in the form of 804,874 shares of the Company s common stock in accordance with the stock purchase agreement governing such transaction.

The fair value of the Alphatec Pacific shares owned by Mr. Yoshimi was established on August 11, 2005 in the amount of $0.6 million and was recorded as minority interest and as debt issuance cost for the note payable to Mr. Yoshimi. In June 2006, the Company paid off the note financing its repurchase of the distribution rights in Japan with proceeds from its initial public offering. The remaining balance of debt issuance costs was expensed at that time. Interest expense of $0.5 million and $0.1 million was recorded for amortization of debt issuance cost for the year ended December 31, 2006 and the period from March 18, 2005 to December 31, 2005, respectively.

Subsequent to the original valuation on August 11, 2005, the value of the put right is being accounted for under SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. In accordance with SFAS No. 150, the put right is classified as a liability and is represented by the minority interest in the accompanying consolidated balance sheet at December 31, 2006. The value of the put right at any reporting date is remeasured at the amount of cash that would be paid under the terms of the agreement as if the settlement occurred on that reporting date and recognizes the amount of the change from the previous reporting date as interest cost. In addition to the interest cost recorded for the change in the value of the put right, the Company consolidates 100% of Alphatec Pacific s operations. Interest income (expense) of $0.1 million and ($0.8) million, respectively, was recorded for the year ended December 31, 2007 and December 31, 2006.

Royalties

The Company has entered into various intellectual property agreements requiring the payment of royalties based on products sold. These royalties primarily relate to products sold by Alphatec Spine and are calculated either as a percentage of net revenue or on a per unit basis. Royalties are included on the accompanying consolidated statement of operations as a component of cost of revenues.

ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Severance Obligations

In the fourth quarter of 2006, the Company reorganized its executive management. In connection with this reorganization, the employment relationship with the following executives terminated: President and Chief Executive Officer, Senior Vice President and Chief Administrative Officer, Chief Financial Officer, Vice President Sales, Vice President Business Development and Marketing. In accordance with their employment agreements, the Company recorded $6.9 million in severance expense, which consisted of $3.7 million in stock compensation expense to account for employment contracts that allowed the terminated employee to continue to vest in the ownership of restricted stock, but were not providing services to the Company and $3.2 million in severance payments. As of the end of December 31, 2006, $0.1 million in severance payments had been paid. In 2007, the Company made $1.1 million in cash payments and reversed $2.0 million in severance expenses and $0.5 million in stock compensation expense due to a settlement that was reached with certain executives.

The Company has employment agreements with key executives that provide for the continuation of salary if terminated for reasons other than for cause, as defined in these agreements. At December 31, 2007, future employment commitments for such key executives were $0.7 million.

9. Predecessor Stockholders Equity

Indemnification Settlement

Pursuant to the acquisition agreement, the stockholders of the Predecessor put $3.0 million in escrow in order to fund potential indemnification claims for losses incurred by the Company. The Company subsequently filed a claim for indemnification of $4.5 million in losses, primarily relating to obsolete inventory, certain tax liabilities and uncollectible accounts receivable. On March 3, 2007, the Company settled the claim and received $1.0 million, which was applied as a reduction of goodwill. The remaining $2.2 million in the escrow fund, including $0.2 million in interest earned, was returned to the former stockholders of Alphatec Manufacturing. Certain former stockholders of Alphatec Manufacturing used the proceeds from the distribution to purchase an aggregate of $1.1 million of the Company s common stock in a private placement.

Stock Options

The Predecessor had an incentive stock option and nonqualified stock option plan (the Predecessor Plan). The Predecessor Plan was revised in 2002 and provided for the granting of options to selected employees, directors, and consultants of the Predecessor to purchase up to 2,000,000 shares of the Predecessor s common stock at prices not less than the fair market value of the stock at the date of grant. The option expiration dates were determined at the date of grant, were not to exceed 10 years, and the options generally became exercisable over a three-year period.

Stock option activity for the period ended March 17, 2005 was as follows (in thousands, except per share amounts):

	Number of options	Weighted average exercise price
Outstanding at December 31, 2004	1,346	$ 1.70
Granted		$
Cancelled		$
Exercised		$
Outstanding at March 17, 2005	1,346	$ 1.70

On March 17, 2005, when the Company acquired the Predecessor and the change in control provisions of the outstanding stock options were triggered, the outstanding unvested stock options became fully vested.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Successor Redeemable Convertible Preferred and Rolling Common Stock and Stockholders Equity

Initial Capitalization

In March 2005, the Company was capitalized through the sale of preferred stock units, consisting of shares of preferred stock and common stock, and the sale of Rolling common stock. The immediate redemption value of the preferred shares was equal to the unit price of the preferred stock unit and accordingly, none of the proceeds were allocated to the shares of common stock. During the fourth quarter of 2005 and the first quarter of 2006, the Company sold 138,345 shares of Series C common stock at $33.33 per share, resulting in $4.6 million of net proceeds.

Initial Public Offering, Redemption of Securities and New Redeemable Preferred Stock

In June 2006, the Company raised aggregate gross proceeds of approximately $83.7 million by selling 9.3 million shares of common stock at a per share price of $9.00 in the Company s initial public offering (the IPO). Of this amount, the Company paid approximately $5.9 million in underwriting fees and commissions, and approximately $7.6 million for offering-related costs. This resulted in aggregate net proceeds of $70.2 million. Offering costs included $1.0 million for advisory fees, and $0.1 million of out-of-pocket costs which were incurred, by HealthpointCapital, LLC, an affiliate of HealthpointCapital. Simultaneously with the closing of the IPO, the existing classes of common stock were also converted into a single class of common stock and all of the Company s redeemable convertible preferred stock was redeemed for a combination of $35.2 million of cash, 3.3 million shares of new redeemable preferred stock recorded at estimated fair value of $23.7 million and 3.9 million of new shares of common stock valued at $44.2 million. As of December 31, 2007, the new redeemable preferred stock estimated fair value decreased to $23.6 million due to shares being forfeited.

In September 2007, the Company received $32.2 million in net proceeds from an underwritten public offering of 10 million shares of common stock pursuant to the Company s outstanding shelf registration statement on Form S-3 (Registration No. 333-145614). The Company paid $1.9 million in underwriting fees and commissions and $0.4 million for offering-related costs.

There were 20 million shares of new redeemable preferred stock authorized as of December 31, 2007. The new redeemable preferred stock is not convertible into common stock but is redeemable at $9.00 per share, (i) upon the Company s liquidation, dissolution or winding up, or the occurrence of certain mergers, consolidations or sales of all or substantially all of the Company s assets, before any payment to the holders of the Company s common stock, or (ii) at the Company s option at any time. Holders of new redeemable preferred stock are generally not entitled to vote on matters submitted to the stockholders, except with respect to certain matters that will affect them adversely as class, and are not entitled to receive dividends. The carrying value of the new redeemable preferred stock is $7.11 per share at December 31, 2007 and 2006.

Under SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity,* the new redeemable preferred stock is required to be shown in the Company s financial statements separate from stockholders equity and any adjustments to its carrying value to its redemption value up to its redemption value of $9.00 per share will be reported as a dividend.

Beneficial Conversion Feature on Sale of Series C common stock

The Series C common stock was sold at a price per share below the anticipated IPO price. Accordingly, pursuant to EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features*, the

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company recorded a deemed dividend on the Series C common stock of $1.9 million at December 31, 2005 and an additional $0.1 million during the twelve months ended December 31, 2006, which is equal to the number of shares of Series C common stock sold multiplied by the difference between the estimated fair value of the underlying common stock and the Series C common stock conversion price per share. The deemed dividend increased the net loss applicable to common stockholders in the calculation of basic and diluted net loss per common share and was reported as an increase to the Series C common stock and a credit to additional paid-in capital.

In connection with the issuance of options to purchase 122,297 shares of Series A-1 common stock and the sale of 1,937,439 shares of Series A-1 common stock to employees during the period from March 18, 2005 to December 31, 2005, the Company recorded total deferred employee stock-based compensation within stockholders equity of $20.5 million, which represents the difference between the estimated fair value of the common stock and the option exercise price or stock issuance price at the date of issuance. The deferred employee stock-based compensation is amortized over the vesting period of the applicable equity instrument on a straight-line basis. Upon the adoption of SFAS No. 123(R) on January 1, 2006, the deferred compensation balance of $18.3 million was reclassified against additional paid-in capital and retained earnings.

The holders of new redeemable preferred stock are only entitled to vote with respect to amendments to the Company s Restated Certificate of Incorporation that relate solely to the terms of the redeemable preferred stock. Dividends may be declared and paid from funds lawfully available and subject to the rights and preferences of any shares of new redeemable preferred stock. The Company does not plan on declaring any dividends in the foreseeable future.

Stock Options

In 2005, the Company adopted its 2005 Employee, Director, and Consultant Stock Plan (the 2005 Plan). The 2005 Plan allows for the grant of options and restricted stock awards to employees, directors, and consultants of the Company. The 2005 Plan has 6,400,000 shares of common stock reserved for issuance. The Board of Directors determines the terms of the restricted stock and the term of each option, option price, number of shares for which each option is granted, whether restrictions will be imposed on the shares subject to options, and the rate at which each option is exercisable. Options granted under the 2005 Plan expire no later than 10 years from the date of grant (five years for incentive stock options granted to holders of more than 10% of the Company s voting stock). Options generally vest over a four or five year period and may be immediately exercisable upon a change of control of the Company. The exercise price of incentive stock options may not be less than 100% of the fair value of the Company s common stock on the date of grant. The exercise price of any option granted to a 10% stockholder may be no less than 110% of the fair value of the Company s common stock on the date of grant. At December 31, 2007, a total of 3,148,366 shares of common stock remained available for issuance under the 2005 Plan.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the Company s stock option activity under the 2005 Plan and related information is as follows:

	Shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
	(In thousands, except per share data)			
Outstanding at December 31, 2006	737	$ 3.76	9.54	$ 468
Granted	830	$ 3.92		
Exercised	(4)	$ 0.25		
Forfeited	(352)	$ 4.10		
Outstanding at December 31, 2007	1,211	$ 3.78	9.19	$1,611
Options vested and exercisable at December 31, 2007	107	$ 3.32	8.01	$ 205
Options vested and expected to vest at December 31, 2007	815	$ 3.77	9.16	$ 1,093

The weighted average fair value of options granted in the years ended December 31, 2007, 2006 and 2005 was $2.15, $5.60 and $10.09 per share, respectively. The aggregate intrinsic value of options at December 31, 2007 is based on the Company s closing stock price on December 29, 2007 of $5.04 per share. Proceeds from the exercise of stock options during the year ended December 31, 2007 was immaterial.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2007:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
	(In thousands, except per share data)				
$0.001	55	7.51	$ 0.001	21	$ 0.001
$3.21	250	8.79	$ 3.210	50	$ 3.210
$3.51	156	9.52	$ 3.647		$
$3.93	451	9.64	$ 3.930		$

$3.95	230	9.18	$ 4.349	20	$ 4.609
$5.89	69	8.21	$ 6.336	16	$ 6.311
$0.001	1,211	9.19	$ 3.784	107	$ 3.319

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Stock Awards

The following table summarizes information about the restricted stock awards activity:

	Shares	Weighted average grant date fair value	Weighted average remaining contractual life (in years)	Aggregate intrinsic value
	(In thousands, except per share data)			
Outstanding at December 31, 2006	1,663	$ 10.57	2.07	$ 17,500
Awarded	777	$ 4.13		
Released	(773)	$ 10.40		
Forfeited	(425)	$ 10.13		
Outstanding at December 31, 2007	1,242	$ 6.79	3.09	$ 8,435

The weighted average fair value per share of awards granted in the years ended December 31, 2007 and 2005 was $3.73 and $10.47, respectively. There were no restricted stock awards granted in the year ended December 31, 2006.

Common Stock Reserved for Future Issuance

Common stock reserved for future issuance consists of the following (in thousands):

	December 31, 2007
Stock options outstanding	1,211
Awards outstanding	11
Authorized for future grant under 2005 Plan	3,148
	4,370

The company recorded expense of $0.4 million, $0.1 million and $0.04 million in 2007, 2006 and 2005, respectively, related to the vesting of stock options and awards granted to non-employees under consulting agreements.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Income Taxes

The components of the provision (benefit) for income taxes are presented in the following table (in thousands):

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
Current:				
Federal	$ 77	$ (41)	$ 48	$
State	150			
Foreign	310	28	2	2
Total current benefit (provision)	537	(13)	50	2
Deferred:				
Federal	116	155	(2,481)	
State	25	33	(594)	
Foreign	(88)	95	(14)	
Total deferred benefit (provision)	53	283	(3,089)	
Total benefit (provision)	$ 590	$ 270	$ (3,039)	$ 2

The provision (benefit) for income taxes differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as a result of the following differences:

	Successor Year ended December 31, 2007	Successor Year ended December 31, 2006	Successor March 18, 2005 to December 31, 2005	Predecessor January 1, 2005 to March 17, 2005
Federal statutory rate	(35.0)%	(35.0)%	(35.0)%	(34.0)%
Adjustments for tax effects of:				
State taxes, net	(5.1)%	(3.0)%	(2.4)%	(3.7)%
In-process research and development	%	%	6.8%	%

Stock-based compensation	(0.3)%	12.1%	2.9%	5.4%
Foreign tax	1.4%	1.2%	(1.1)%	1.1%
Fair value change of put option	%	1.1%	2.9%	%
Other	3.5%	2.6%	1.2%	0.9%
Valuation allowance	38.5%	22.0%	5.5%	30.4%
	3.0%	1.0%	(19.2)%	0.1%

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Significant components of the deferred tax assets and liabilities are as follows (in thousands):

	December 31, 2007	December 31, 2006
Deferred tax assets:		
Allowances and reserves	$ 152	$ 400
Accrued expenses	2,236	1,876
Inventory reserves	3,009	2,764
Net operating loss carryforwards	9,913	5,140
Property and equipment	1,181	(56)
Income tax credit carryforwards	41	41
	16,532	10,165
Valuation allowance	(13,793)	(6,498)
Total deferred tax assets, net of valuation allowance	2,739	3,667
Deferred tax liability:		
Intangible assets	3,075	3,950
Total deferred tax liabilities	3,075	3,950
Net deferred tax liabilities	$ (336)	$ (283)

The realization of deferred tax assets may be dependent on the Company s ability to generate sufficient income in future years. As of December 31, 2007, a valuation allowance of $13.8 million has been established against the net deferred tax assets as realization is uncertain. Deferred tax liabilities associated with tax goodwill cannot be considered a source of taxable income to support the realization of deferred tax assets because the reversal of these deferred tax liabilities is considered indefinite.

The Company adopted the provisions of FIN No. 48, on January 1, 2007. As a result of the implementation of FIN No. 48, the Company decreased its deferred tax assets related to net operating loss (NOL) carryforwards, and offsetting valuation allowance, by approximately $0.4 million, with no net impact to the Audited Consolidated Financial Statements. As of January 1, 2007, the date of adoption, the Company s unrecognized tax benefits totaled $1.0 million exclusive of associated interest and penalties. Of this total, $0.1 million of the unrecognized tax benefits, if recognized, will affect the effective tax rate and $0.5 million, if recognized, will reduce goodwill. The remaining unrecognized tax benefits, if recognized, will not affect the effective tax rate due to the valuation allowance recorded against the deferred tax assets.

The following table summarizes the changes to unrecognized tax benefits for the year ended December 31, 2007 (in thousands):

Balance at January 1, 2007	$ 1,017
Additions based on tax positions related to the current year	504
Additions based on tax positions of prior years	53
Balance at December 31, 2007	$ 1,574

The Company does not expect any significant increases or decreases to its unrecognized tax benefits within the next 12 months.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company and its subsidiaries are subject to federal income tax as well as income tax of multiple state and foreign jurisdictions. With few exceptions, the Company is no longer subject to income tax examination by tax authorities in major jurisdictions for years prior to 2002. However, to the extent allowed by law, the taxing authorities may have the right to examine prior periods where NOLs and tax credits were generated and carried forward, and make adjustments up to the amount of the carryforwards. The Company is not currently under examination by the IRS, state and local, or foreign taxing authorities.

The Company has elected to recognize potential accrued interest and penalties related to unrecognized tax benefits as income tax expense. In conjunction with the adoption of FIN No. 48, the Company recognized approximately $0.1 million for the payment of interest and penalties on January 1, 2007. To the extent not assessed with respect to the uncertain tax positions, $0.1 million of this total will be reflected as a reduction of goodwill. During the year ended December 31, 2007, there were no significant changes in the accrued interest and penalties.

At December 31, 2007, the Company had net operating loss carryforwards of $25.6 million and $23.9 million, for federal and states, respectively, expiring at various dates through 2027. Utilization of the NOL and tax credit carryforwards may be subject to a substantial annual limitation due to ownership change limitations that have occurred previously or that could occur in the future provided by Section 382 of the Internal Revenue Code of 1986, as amended, as well as similar state and foreign provisions. These ownership changes may limit the amount of the NOL and tax credit carryforwards that can be utilized annually to offset future taxable income. Since the Company s formation, the Company has raised capital through the issuance of capital stock on several occasions (both pre- and post-initial public offering) which may have resulted in a change of control, as defined by Section 382, or could result in a change of control in the future. The Company has not completed a study to assess whether a change of control has occurred or whether there have been multiple changes of control since the Company s formation due to the significant complexity and cost associated with such study and that there could be additional changes in control in the future. If the Company has experienced a change of control at any time since Company formation, utilization of the Company s NOL and tax credit carryforwards would be subject to an annual limitation under Section 382. Any limitation may result in expiration of a portion of the carryforwards before utilization. Further, once a study is completed and any limitation known, the amounts currently presented as an uncertain tax position under FIN No. 48 may change. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in the Company s unrecognized tax benefits will not impact the Company s effective tax rate.

12. Restructuring

Relocation of Biologics Distribution Center

In the second quarter of 2007, the Company announced the relocation of its Massachusetts biologics distribution center to Carlsbad, California, the location of the Company s corporate headquarters. The Company completed the relocation in the fourth quarter of 2007. The Company recorded an aggregate of $0.5 million in the second and third quarters of 2007 for contract termination expenses in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities.*

Cost Reduction Plan

In August 2007, the Company announced a cost-reduction plan that resulted in the elimination of nine percent of all positions throughout the organization. The Company recorded a $0.4 million severance expense charge in the third quarter of 2007.

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ALPHATEC HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Employee Retirement Plans

The Predecessor had a 401(k) Plan for the benefit of its employees. The 401(k) Plan covered all eligible employees. All employees who had a minimum of six months of service could elect to contribute to the 401(k) Plan up to 20% of their compensation to the annual maximum limit established by the IRS. The Predecessor did not make any contributions to the 401(k) Plan from inception to March 17, 2005. The Successor assumed the 401(k) Plan upon acquisition of the Predecessor and amended the 401(k) Plan on August 1, 2005 to reflect the following changes: (i) all eligible employees may participate in the plan immediately with no waiting period, (ii) the Successor may make discretionary matches to the 401(k) Plan of up to 4% of each individual s compensation, and (iii) Successor match amounts are immediately vested. The Successor made matching contributions to the 401(k) Plan of $0.6 million, for both the years ended December 31, 2007 and 2006.

14. Quarterly Financial Data (Unaudited)

The following financial information reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results of the interim periods. Summarized quarterly data for fiscal 2007 and 2006 are as follows (in thousands, except per share data):

	Year ended December 31, 2007			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Selected quarterly financial data:				
Revenue	$ 19,550	$ 18,820	$ 20,319	$ 21,342
Gross profit	12,669	11,984	12,940	12,614
Total operating expenses	15,281	12,534	18,308	23,770
Net loss	(2,674)	(703)	(5,578)	(11,247)
Net loss available to common stockholders	(2,674)	(703)	(5,578)	(11,247)
Basic and diluted net loss per common share (1)	(0.08)	(0.02)	(0.16)	(0.24)

	Year ended December 31, 2006			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Selected quarterly financial data:				
Revenue	$ 18,029	$ 19,422	$ 17,358	$ 19,196
Gross profit	11,620	12,855	10,752	13,078
Total operating expenses	14,730	16,665	16,361	22,663
Net loss	(5,876)	(3,178)	(5,438)	(11,324)
Net loss available to common stockholders	(7,819)	(4,686)	(5,468)	(11,293)
Basic and diluted net loss per common share	(0.42)	(0.20)	(0.16)	(0.34)

(1) Basic and diluted net loss per share is computed independently for each of the quarters presented. Therefore, the sum of the quarterly per share amounts will not necessarily equal the total for the year.

15. Subsequent Events

Real Property Leases

On February 28, 2008, the Company entered into a sublease agreement (the Sublease) for 76,693 square feet of office, engineering, research and development and warehouse and distribution space (Building 1). The term of the Sublease commences upon delivery of the Building 1 premises (currently scheduled for May 1, 2008)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and ends on January 31, 2016. The Company is obligated under the Sublease to pay base rent and certain operating costs and taxes for Building 1. Monthly base rent payable by the Company is approximately $80,500 during the first year of the Sublease, increasing annually at a fixed annual rate of 2.5% to approximately $93,500 per month in the final year of the Sublease. The Company s rent is abated for months one through seven of the Sublease. Under the Sublease, the Company is required to provide the sublessor with a security deposit in the amount of approximately $93,500.

On March 4, 2008, the Company entered into another lease agreement (the Lease) for 73,480 square feet of office, engineering, research and development and warehouse and distribution space (Building 2). The Lease term is scheduled to commence on December 1, 2008 and ends on January 31, 2017. The Company is obligated under the Lease to pay base rent and certain operating costs and taxes for Building 2. The monthly base rent payable for Building 2 is approximately $73,500 during the first year of the Lease, increasing annually at a fixed annual rate of 3.0% to approximately $93,000 per month in the final year of the Lease. The Company s rent shall be abated for the months two through eight of the term of the Lease in the amount of $38,480. Under the Lease, the Company is required to provide the lessor with a security deposit in the amount of $293,200.00, consisting of cash and/or one or more letters of credit. Following the Company s achievement of certain financial milestones, the lessor is obligated to return a portion of the security deposit to the Company.

Expandable VBR License Agreement and Consulting Agreement

On March 10, 2008, the Company, Alphatec Spine and Stout Medical Group LP (Stout) entered into a License Agreement (the License Agreement) that provides Alphatec Spine with a worldwide license to develop and commercialize Stout s proprietary intellectual property related to an expandable interbody/vertebral body replacement device (the Expandable VBR Technology). The financial terms of the License Agreement include: (1) a $500,000 cash payment payable following the execution of the License Agreement; (2) the issuance of $500,000 of shares of the Company s common stock following the execution of the License Agreement; (3) development and sales milestone payments in cash and the Company s common stock that could begin to be achieved and paid in 2008; and (4) a royalty payment based on net sales of licensed products with minimum annual royalties beginning in 2009.

On March 10, 2008 the parties to the License Agreement entered into a Consulting Development Agreement (the Consulting Agreement) related to Stout s development of certain technology to be used in conjunction with the Expandable VBR Technology. The financial terms of the Consulting Agreement include: (1) a $500,000 cash payment payable in ten equal monthly installments, with the first payment being payable following the execution of the Consulting Agreement; (2) the issuance of $500,000 in restricted shares of the Company s common stock, with such shares only vesting to Stout if certain development milestones are achieved; and (3) a royalty payment based on net sales of products for which a royalty is not due pursuant to the License Agreement. In the event that Stout is unable to achieve certain development milestones Stout must repay the cash payment described above to Alphatec Spine, together with interest.

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SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

	Reserve for bad debt (1)	Reserve for excess and obsolete inventories (2)
	(In thousands)	
Balance at December 31, 2004	$ 160	$ 3,336
Provision	631	5,315
Write-offs and recoveries, net	(7)	
Balance at December 31, 2005	784	8,651
Provision	174	3,027
Write-offs and recoveries, net	(338)	(1,364)
Balance at December 31, 2006	620	10,314
Provision	(351)	1,175
Acquisition	5	
Foreign exchange impact		387
Write-offs and recoveries, net	(89)	(1,768)
Balance at December 31, 2007	$ 185	$ 10,108

(1) The provision is included in selling expenses.
(2) The provision is included in cost of revenues.