CYBEROPTICS CORP
Form 10-K
March 12, 2007
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) of the Securities Exchange

Act of 1934 for the Year Ended December 31, 2006.

o TRANSITION PURSUANT TO SECTION 13 or 15(d) of the Securities Exchange

Act of 1934 for the transition period from _____ to _____.

COMMISSION FILE NO. (0-16577)

CYBEROPTICS CORPORATION

(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of incorporation or organization)	**41-1472057** (I.R.S. Employer Identification No.)
5900 Golden Hills Drive **MINNEAPOLIS, MINNESOTA** (Address of principal executive offices)	**55416** (Zip Code)

(763) 542-5000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Exchange Act:Title of each class: Common Stock, no par value

Name of Exchange: NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Exchange Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES o NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES o NO x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES o NO x

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter: $111,440,936.

As of February 28, 2007, there were 8,884,012 shares of the registrant s Common Stock, no par value, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

The responses to items 10, 11, 12 and 13 herein are incorporated by reference to certain information in the Company s Definitive Proxy Statement for its Annual Meeting of Shareholders to be held May 21, 2007.

CYBEROPTICS CORPORATION

FORM 10-K

For the Fiscal Year Ended December 31, 2006

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PART I.

ITEM 1. DESCRIPTION OF BUSINESS

Background

CyberOptics® Corporation was founded in 1984 by Dr. Steven K. Case (Chairman of the Board of CyberOptics and full-time employee), a former professor at the University of Minnesota, with the goal of commercializing technology for non-contact three-dimensional sensing. Our headquarters are located at 5900 Golden Hills Drive in Golden Valley, Minnesota.

We are a leading global supplier of optical process control sensors and inspection systems that are used to control the manufacturing process and to ensure the quality of electronic circuit boards manufactured by our customers using surface mount technology (SMT). We also manufacture and sell sensors that assist with yield improvement, and the placement and transport of wafers during semiconductor fabrication. Our products assist the global SMT and semiconductor industries in meeting the rigorous quality demands for printed circuit board assembly and semiconductor wafers. Using a variety of proprietary technologies such as lasers, optics and machine vision, combined with software, electronics and mechanical design, our products enable manufacturers to increase production volume, product yields and quality by measuring the characteristics and placement of components both during and after the manufacturing process.

Our business is organized in two operating segments. Our Electronic Assembly segment designs, manufactures and sells optical process control sensors and inspection systems for the electronic assembly equipment market. Our Semiconductor segment designs, manufactures and sells optical and other process control sensors and related equipment for the semiconductor capital equipment market.

Most of our products (90% of revenue in 2006) are developed and sold for use in SMT electronic circuit board assembly or with equipment used in SMT electronic circuit board assembly as part of our Electronic Assembly segment. We sell products in this market both as sensor components that are incorporated into products manufactured by other companies for sale to circuit board assembly companies, and as more complete systems that are sold directly to circuit board assembly companies. Our sensor products are sold to manufacturers of pick-and-place machines to align electronic surface mount components during placement on the circuit board and to solder paste printer companies to align stencils with circuit boards. Our systems products are sold to contract manufacturers and other companies with surface mount assembly lines, to control quality as in-line systems. These system level products are used by manufacturers of circuit boards to measure screen printed solder paste, to inspect circuit boards and components after component placement, to confirm proper placement after full assembly of circuit boards and to inspect solder joints on printed circuit boards. Manufacturers of DRAM memory also use our system products to inspect assembly of their memory modules.

Our Semiconductor segment develops and sells products that assist with yield improvement in semiconductor fabrication, and for use with the robotic equipment that handles semiconductor wafers during the semiconductor fabrication process. In addition, we sell a frame grabber product

line for general industrial applications. These product lines are sold through CyberOptics Semiconductor, Inc. which was formed from the combination of HAMA Sensors, Inc. and Imagenation® Corporation, companies acquired in 1999 and 2000. Semiconductor products were 10% of total revenues in 2006.

Market Conditions Recent Development of the Business

Our operations are heavily influenced by market conditions in worldwide electronics markets, and particularly in the SMT electronic assembly segment of these markets. These markets have been very cyclical, with periods of strong growth followed by periods of excess capacity and reduced levels of capital spending. Periods of growth in the electronics equipment markets from 1997 through the second quarter of 1998, from the third and fourth quarters of 1999 to the second quarter of 2001, from the third quarter of 2003 through the third quarter of 2004, and more modestly from the third quarter of 2005 through the end of 2006 resulted in strong sales of our products, particularly OEM sensor products.

Consistent with our past practice, we continued to invest heavily throughout 2005 and 2006 in new product development. In the third quarter of 2005, we began shipping a new sensor to DEK International, GmbH, an important new original equipment manufacturer, for their industry leading line of solder paste screen printers. Late in 2006 we completed development of our 5th generation LaserAlign sensor for Juki s industry leading line of pick-and-place machines. The new sensor provides Juki with a 25% throughput improvement, alignment capability for the smallest components, improved reliability and the lowest cost of ownership. Sales to Juki accounted for 29% of our total revenue in 2006. We believe that the introduction of this new sensor will help ensure that Juki remains a significant customer for the foreseeable future.

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In 2005, we launched an enhanced version of our industry leading SE 300 solder paste inspection system, the SE 300 Ultra, and early in 2006 we introduced an enhanced version of our Flex series automated optical inspection system, the Flex Ultra. We continued to make improvements to these enhanced systems throughout 2006 to improve speed, measurement performance, reliability and ease of use, including simplified operator interfaces with foreign language capability.

Finally, throughout 2005 and 2006, we introduced or continued to develop various new sensors for our WaferSense family of precision measurement tools, including new automated leveling, gapping and teaching sensors to assist with process optimization and yield improvement in the semiconductor fabrication process.

Although we cannot predict with precision the trends and procurement cycles for capital equipment in markets for electronic inspection, we believe that the markets will remain strong for the next several quarters. We believe that the new products recently introduced or positioned for introduction in 2007 will support continued growth in future periods.

Objective

Our objective is to develop complete surface mount technology process control solutions for our customers. We intend to build upon our innovative products in systems for solder paste inspection, automated optical inspection and component alignment, with new sensing products that will be embedded inside SMT production equipment. We eventually intend to tie these products together as a full-line process control solution. We believe our new embedded process verification (EPV) sensor will eventually gain acceptance among manufacturers of pick and place machines as a further enhancement to inspection and control. During 2005, we introduced a new InPrinter Inspection Camera for DEK International GmbH. The camera is mounted inside their industry leading screen printer to ensure accurate board registration as well as to provide DEK with upgraded capability for solder paste and stencil inspection. Late in 2006 we completed development of our new 5th generation LaserAlign sensor for Juki s industry leading line of pick-and-place machines, providing Juki with a 25% throughput improvement, alignment capability for the smallest components, improved reliability and the lowest cost of ownership.

We have established an office in China to further penetrate the growing market for manufacturing production equipment there and to increase the percentage of worldwide production lines that use inspection in their production process to improve production yields and reduce cost. An enhanced version of our SE 300 solder paste inspection system, the SE 300 Ultra was introduced in 2005, and an enhanced version of our Flex series automated optical inspection system, the Flex Ultra, was introduced in 2006. We continued to make improvements to these enhanced systems throughout 2006 to improve speed, measurement performance, reliability and ease of use, including simplified operator interfaces with foreign language capability.

During 2004 and 2005, our Semiconductor segment introduced the new WaferSense Automatic Leveling Sensor (ALS), the first of a series in the WaferSense product line. WaferSense is a family of wireless, waferlike precision measurement tools for in-situ setup, calibration and process optimization in semiconductor processing equipment. We are currently working on several new additions to the WaferSense product line that will improve up-time and yield for semiconductor manufacturers.

Our ability to implement our strategy effectively is subject to numerous uncertainties and risks, including market conditions in the global SMT circuit board assembly and semiconductor fabrication capital equipment markets and our timely completion of development and successful commercial introduction of planned new products. We cannot assure you that our efforts will be successful.

OPERATIONS AND PRODUCTS

We develop, manufacture and sell intelligent, non-contact sensors and systems for process control and inspection. Our products are used primarily in the SMT electronic assembly and semiconductor fabrication sectors of the electronics industry and enable manufacturers to increase operating efficiencies, product yields and quality. In addition to proprietary hardware designs that combine precision optics, various light sources and multiple detectors, our products incorporate software that controls the hardware and filters and converts raw data into application specific information. Our product offerings are sold both to original equipment manufacturers that supply the SMT and semiconductor fabrication industries and to end-user customers who use our SMT Systems products directly for process and quality control in the circuit board manufacturing process.

SMT Electronic Assembly Sensors

Our SMT electronic assembly sensor product line, which has generated the largest component of our sales during the past nine years, is a family of sensors that uses similar technology, but that are customized for each customer and incorporated into the equipment manufactured by our customers for use in SMT circuit board assembly. We work closely with our original equipment manufacturer customers to integrate sensors into their equipment.

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LaserAlign. Our LaserAlign sensor family has accounted for the vast majority of sales in the SMT electronic assembly sensors product line. These sensors are sold for incorporation into component placement machines used in the SMT production line that are manufactured by a number of different OEM customers. Sales of these products, including service repairs, to Juki Corporation accounted for approximately 29% of our revenue in 2006 and 25% of our revenue in 2005. Sales of these products, including service repairs, to Assembleon B.V., accounted for approximately 14% of our revenue in 2006 and 13% of our revenue in 2005. Accordingly, revenues and operations are currently heavily influenced by the level of purchases from these two customers (including purchases of Board Align Camera by Assembleon B.V. see below) and by the cyclical nature of the SMT production industry.

The LaserAlign family of products aligns components during transport on a pick-and-place machine prior to placement on a circuit board. After solder paste has been deposited and inspected, extremely small surface mount components known as chip capacitors and resistors are placed on the solder pads by component placement machines. LaserAlign sensors are incorporated into the placement heads of component placement machines to ensure accurate component placement at high production speeds. Various high-speed component placement machines use between one and twenty LaserAlign sensors per machine. LaserAlign integrates an intelligent sensor, composed of a laser, optics and detectors with a microprocessor and software for making specific measurements. LaserAlign enables quick and accurate alignment of each component as it is being transported by the pick-and-place arm for surface mount assembly. Using non-contact technology, LaserAlign facilitates orientation and placement of components at higher speeds than can be achieved using conventional mechanical or machine vision component centering systems.

The LaserAlign sensor is offered in several different configurations to satisfy the requirements of the different machines on which it is used. The latest version of the LaserAlign sensor technology was introduced in 2006 in a 5th generation sensor for Juki Corporation. Revenue from new product shipments of LaserAlign sensors has been a principal contributor to our growth during the past five years and accounted for 36% of our revenue in 2006, 30% in 2005 and 32% in 2004.

BoardAlign Camera (BA Camera). The BA Camera, which is incorporated directly into the placement head of component placement machines, identifies fiducial markings on a circuit board and aligns the board in the component placement machine prior to component placement. The BA Camera was introduced in a sensor for Assembleon B.V. during 2003 to be incorporated into their latest version component placement machine. Revenue from shipments of BA Camera sensors to Assembleon B.V. accounted for 6% of our revenue in 2006, 6% in 2005 and 9% in 2004.

InPrinter Inspection Camera. The InPrinter Inspection Camera, which is mounted directly in screen printers manufactured by DEK International GmbH, identifies fiducial markings on a circuit board to ensure accurate board registration prior to placement of solder paste, as well as to provide an upgraded capability for 2D solder paste and stencil inspection. The Inprinter Inspection Camera was introduced for DEK International GmbH during the third quarter 2005. Revenue from shipments of the InPrinter Inspection Camera accounted for 4% of our revenue in 2006 and 3% in 2005.

SMT Systems Products

Our SMT systems product line consists of stand-alone measurement and inspection systems used in the SMT electronic assembly industry for process control and inspection. These systems are sold directly to end-user manufacturing customers that use them in a production line or along-side a production line to maintain process and quality control. Our products incorporate proprietary sensors as well as substantial, off the shelf, translation or robotics hardware and complete computer systems or processors with internally developed software.

SE 300 and SE 300 Ultra. We first introduced the SE 300 in March 2000 and recorded our first revenues from sale of the SE 300 in the fourth quarter of 2000. During 2005, we introduced the SE 300 Ultra, an enhanced version of our SE 300 product that offers faster inspection speeds, a conveyor that can accommodate a greater range of board sizes than the SE 300, flexible conveyor options and additional defect review options in run-time software. In addition, we introduced a sensor upgrade for the SE 300 that will provide some of the performance improvements that are available in the SE 300 Ultra.

The SE 300 and SE 300 Ultra are in-line systems that measure in three dimensions the amount of solder paste applied to the circuit board after the first step of the SMT assembly process. Because of the small size of the components that must be placed on each pad of solder paste and the density of components placed on the circuit board, a significant amount of SMT assembly problems are related to the quality of solder paste deposition. Misplaced solder paste or excess or inadequate amounts of paste can lead to improper connections or bridges between leads causing an entire circuit board to malfunction. The SE 300 and SE 300 Ultra are designed to inspect the height, area and volume of 100% of a circuit board at production line speeds and with resolution that allows it to measure the smallest chip scale packages and micro ball array component sites. The SE 300 and SE 300 Ultra can be retrofitted and integrated into most SMT production lines, providing real time quality control immediately after a printed circuit board leaves the screen printer and before component placement commences.

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We made regular improvements to the SE 300 from its introduction in 2000 until the SE 300 Ultra was introduced in 2005. We continued to enhance the SE 300 Ultra throughout 2005 and 2006 to improve speed, reliability and ease of use, including simplified operator interfaces with foreign language capability, to provide an inspection capability for flexible circuits, and to offer a new MicroPad sensor as an option to improve inspection measurement performance for the smallest solder paste deposits.

Revenues from shipments of the SE 300, SE 300 Ultra and sensor upgrades accounted for 20% of our revenue in 2006, 25% of our revenue in 2005 and 26% in 2004.

Automated Optical Inspection (Flex and Flex Ultra) Products. The Flex and Flex Ultra series of Automated Optical Inspection (AOI) products were initially introduced in the fourth quarter of 2000 and incorporates in-process technology acquired from Kestra, Ltd in 1999. Our Flex and Flex Ultra products allow for a variety of machine configurations (different number of cameras based on board size and resolution requirements) based on customer needs. These in-line products measure and inspect circuit boards after component placement to determine whether all components are present, that all components have been placed correctly and measure the quality of solder joints after reflow. These products incorporate high-resolution color cameras for improved imaging, and are designed to inspect the placement of the smallest components on circuit boards. The principal advantage of the Flex and Flex Ultra series of AOI products is ease of use for the operator compared to other AOI machines and the low level of false calls.

We have introduced a number of versions of the Flex series AOI products since their initial introduction in 2000. The latest Flex version introduced in 2006, the Flex Ultra, provides a 2x improvement in image resolution, better reliability, faster speed and up to a 50% improvement in performance measurement over our previous product.

Revenues from shipments of the Flex and Flex Ultra accounted for 11% of our revenue in 2006, 10% of our revenue in 2005 and 6% in 2004.

Semiconductor Products

Although we had sold some sensors for semiconductor wafer inspection prior to 1999, the semiconductor product line became a significant part of our business with the acquisition of certain assets of HAMA Laboratories, Inc. in 1999 and was further expanded with the acquisition of Imagenation Corporation in 2000. Currently, our principal semiconductor products are sensors that inspect the presence and orientation of semiconductor wafers in cassettes and FOUPS during the fabrication process. Other products include frame grabber and machine vision subsystems that were developed and sold by Imagenation. The majority of our semiconductor products are sold to original equipment manufacturers for incorporation into their workstations and systems. We have also introduced WaferSense (ALS), a wireless auto leveling sensor for calibration of semiconductor process tools. We anticipate that a greater proportion of our WaferSense sales will be to end-user customers than with our other semiconductor products. Overall, sales of our semiconductor products constituted 10% of our revenue in 2006, 13% in 2005 and 12% in 2004.

Wafer Mapping and Alignment Sensors. We manufacture and sell laser based reflective sensors that improve the performance of robotic wafer handling equipment. During the fabrication process, semiconductor wafers are stored in slotted cassettes during transport to various fabrication tools. Robotic equipment removes the wafers from the cassettes and inserts them into a fabrication tool. Our wafer mapping sensors inspect for the presence of wafers in the cassettes and determine if the wafer is properly present and located in the cassette. We introduced an improved version of the wafer mapper product, the EXQ mapper, in late 2003, and a new smaller form factor of this product, the EXQS, in 2005.

Frame Grabber Products and Machine Vision Subsystems. Frame grabber products are a machine vision component that captures, digitizes, and stores video images. These products are currently sold into a broad array of applications in a number of different industries, with strategic emphasis on semiconductor customers. We offer both digital and analog versions of frame grabbers under the Imagenation brand.

WaferSense Sensors. Our WaferSense family of sensors is intended to go where wafers go in semiconductor fabrication and provide measurements of critical factors that are currently impossible or extremely difficult to obtain. We introduced our first WaferSense product, the automatic leveling sensor (ALS), a level calibration tool for semiconductor process tools, in late 2004. The WaferSense ALS is a wireless, vacuum-compatible sensor that can be placed in cassettes, FOUPS, on end effectors, aligners, in load locks and process chambers used in semiconductor fabrication to ensure that all stations are level and coplanar. Because the user is not required to break down semiconductor fabrication equipment, or pressurize a vacuum chamber, we believe that WaferSense ALS will save significant time over the manual leveling currently used by customers and increase equipment up-time, through-put and process yield. Throughout 2005 and 2006 we introduced or continued to develop various new sensors for our WaferSense family of precision measurement tools, including new automated leveling, gapping and teachings sensors to assist with process optimization and yield improvement in the semiconductor fabrication process. We anticipate that a greater proportion of our WaferSense sales will be to end-user customers than with our other semiconductor products.

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Markets and Customers

We sell the vast majority of our products into the electronics manufacturing market (90% of total revenues in 2006), particularly the portion servicing manufacturers doing SMT circuit board assembly. The value of automation is high in this market because the products produced have

high unit costs and are manufactured at speeds too high for effective human intervention. Moreover, the trend in these industries toward smaller devices with higher circuit densities and smaller circuit paths requires manufacturing and testing equipment capable of extremely accurate alignment and multidimensional measurement such as achieved using non-contact optical sensors. Customers in these industries also employ knowledgeable engineers who are competent to work with computer-related equipment. Our LaserAlign products are sold to OEM s serving this market and the SE 300, SE 300 Ultra and Flex and Flex Ultra inspection systems are sold to end-user electronic assembly manufacturers in this market.

We sell our semiconductor products into the semiconductor capital equipment market, for use in the fabrication of semiconductor devices. This market has many of the same characteristics as the SMT electronics assembly market and requires non-contact optical measurement tools that enable the production of more complex, higher density and smaller semiconductor devices. We sell our wafer mapping and alignment sensors to manufacturers of equipment that transport wafers during the semiconductor manufacturing (front-end fabrication) process. Our new WaferSense family of precision measurement tools for process optimization in semiconductor processing equipment will be sold directly to semiconductor fabrication facilities for use by process and equipment engineers during the production of semiconductor wafers.

An increasing proportion of our end-user SMT System sales are being originated in the low cost geographies of Asia where most of the new worldwide production capacity for circuit board assembly is being added. Consequently, most capital equipment suppliers are increasing their sales and operational capabilities in Asia to pursue sales in this market. In response, we opened our Singapore office in 2001 to support SMT Systems sales throughout Asia and opened a sales office in China in October 2004. This market is also important to our OEM electronic assembly sensor product lines as our OEM customers are looking to sell their pick-and-place equipment into this market.

We sell our products worldwide to many of the leading manufacturers of electronic circuit board assembly equipment, manufacturers of semiconductor DRAM memory, semiconductor capital equipment manufacturers and end-user electronic assembly manufacturers, including Asian original design manufacturers (ODM s) and EMS s, who manufacture cell phones, laptops and server boards, among other electronic devices. Although we maintain sales offices in the UK, Singapore and China, all manufacturing of our products occurs in the United States and all sales originate in the United States.

There has been an increase in export sales from 2004 to 2006 as the result of the majority of new worldwide electronics and semiconductor capacity being added in Asia. In addition, a significant portion of our export sales to Europe are OEM electronic assembly sensors that ultimately are sold by our OEM customer into Asia. The following table sets forth the percentage of total sales revenue represented by total export sales (sales for delivery to countries other than the United States, including sales delivered through distributors) by location during the past three years:

	Year Ended December 31,		
	2006	**2005**	**2004**
Asia	50%	51%	46%
Europe	33%	30%	34%
Other (1)	1%	1%	1%

(1) Includes export sales in the Americas, primarily export sales to Canada, Mexico and Latin America.

See Note 10 to the Company s Consolidated Financial Statements contained in item 8 of this Form 10-K.

All export sales are negotiated, invoiced and paid in U.S. dollars. Accordingly, although changes in exchange rates do not affect revenue and income per unit, they can influence the willingness of customers to purchase units.

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Sales and Marketing

Our electronic assembly sensors are sold to large OEM customers by a direct sales staff located in Minnesota. Our systems products are primarily sold through independent representatives and distributors managed by direct sales personnel located in Minnesota, as well as in the UK, Singapore and China. We have agreements with 11 representatives and distributors in North and South America who focus primarily on SMT Systems products sold to end-users. We make most of our sales to international end-users of systems products through 25 representatives and distributors covering Europe (16) and the Pacific Rim (9).

Our wafer mapping semiconductor products are sold to large OEM customers by a direct sales staff located in Oregon and California. We sell our semiconductor frame grabber products through direct sales staff located in Portland, Oregon, and through 13 sales representatives throughout the world. These representatives are not under contract, but are authorized to sell frame grabber products and in many cases act as system integrators for our products. We have established a worldwide sales representative organization for our WaferSense semiconductor products. We currently have agreements in place or in process with sales representatives in the U.S. (6), Europe (2) and the Pacific Rim (5). Most of these sales representatives will also be authorized to sell wafer mapping semiconductor products.

We market our products through appearances at industry trade shows, advertising in industry journals, articles published in industry and technical journals and on the Internet. In addition, we have strategic relationships with certain key customers that serve as highly visible references.

Backlog

Our products are typically shipped two weeks to two months after the receipt of an order. Product backlog was $ 6.9 million at December 31, 2006, compared to $6.9 million on December 31, 2005, and $3.7 million on December 31, 2004. Backlog at December 31, 2006 totaling $6.5 million is deliverable in the first quarter of 2007. Sales of some surface mount technology (SMT) products may require customer acceptance due to performance or other acceptance criteria included in the terms of sale. For these SMT product sales, revenue is recognized at the time of customer acceptance. Although our business is generally not of a seasonal nature, sales may vary based on the capital procurement practices in the electronics and semiconductor industries. Our scheduled backlog at any time may vary significantly based on the timing of orders from OEM customers. Accordingly, backlog may not be an accurate indicator of performance in the future.

Research and Development

We differentiate our products primarily on the basis of customer benefits afforded by the use of clever and proprietary technology and on our ability to combine several different technical disciplines to address industry and customer needs. CyberOptics was founded by research scientists and has retained relationships with academic institutions to ensure that the most current information on technological developments is obtained. In addition, we actively seek ongoing strategic customer relationships with leading product innovators in our served markets and actively investigate the needs of, and seek input from, these customers to identify opportunities to improve manufacturing processes. Our engineers have

frequent interactions with our customers to ensure adoption of current technologies. In some instances, we receive funding from these customers through development contracts that provide the customer with an exclusive selling period but allow us to retain technology and distribution rights.

We believe that continued and timely development of new products and enhancements to existing products is essential to maintaining our industry leading position in the market. As a technology based company, we commit substantial resources to research and development efforts, which play a critical role in maintaining and advancing our position as a leading provider of optical sensors and systems. During 2006 and 2005, research and development efforts were focused on a number of development activities, including a 5th generation LaserAlign sensor for Juki, a new InPrinter Inspection Camera for DEK International GmbH, continued development of our Embedded Process Verification (EPV®) technology initiative, and continued development of and enhancements to the SE and Flex series inspection systems, including our SE 300 Ultra solder paste inspection system, and new Flex Ultra automated optical inspection system.

In addition, we have continued to enhance our semiconductor wafer mapping sensors for the semiconductor market. In 2005, we commenced shipment of the EX-QS wafer mapping sensor. In 2006 and 2005, we continued development of our WaferSense family of precision measurement tools, including new automated leveling, gapping and teachings sensors to assist with process automation and yield improvement in the semiconductor fabrication process.

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Research and development expenses were $8.1 million in 2006, $7.1 million in 2005 and $7.6 million in 2004. These amounts represented 14% of revenues in 2006, 17% in 2005 and 13% in 2004. Research and development expenses consist primarily of salaries, project materials, contract labor and other costs associated with ongoing product development and enhancement efforts. Research and development resource utilization is centrally managed based on market opportunities and the status of individual projects.

Manufacturing

Much of our product manufacturing, which is primarily circuit board manufacturing, lens manufacturing and metal parts production, is contracted with outside suppliers. Our production personnel inspect incoming parts, assemble sensor heads and calibrate and perform final quality control testing of finished products. Our products are not well suited for the large production runs that would justify the capital investment necessary for complete internal manufacturing. Our electronic assembly sensor products and SMT systems products are assembled in Minneapolis, MN, and our semiconductor products are assembled in Portland, OR.

A variety of components used in our products are available only from single sources and involve relatively long order cycles, in some cases over one year. We have located sources for substitute components. Use of those alternative components could require substantial rework of the product designs, resulting in periods during which we could not satisfy customer orders. We believe we have identified alternative assembly contractors for most of our subassemblies. An actual change in such contractors would likely require a period of training and testing. Accordingly, an interruption in a supply relationship or the production capacity of one or more of such contractors could result in the inability to deliver one or more products for a period of several months. To help prevent delays in the shipment of our products, we maintain in inventory, or on scheduled delivery from suppliers, what we believe to be a sufficient amount of certain components based on forecasted demand (forecast extends a minimum of 6 months).

Competition

Although we believe that our products offer unique capabilities, competitors offer technologies and systems that perform some of the visual inspection and alignment functions performed by our products. We face competition from a number of companies in the machine vision, image processing and inspection systems market, some of which are larger and have greater financial resources.

Our electronic assembly sensor products face competition in the market for alignment and inspection on OEM component placement machines primarily from manufacturers of vision (camera and software based) systems. Potential competitors in these markets include Cognex Corporation and Electro Scientific Industries, Inc. We compete in this market based on our ability to custom design products with stringent physical form requirements, speed, flexibility, cost and ease of control. In addition, our products compete with systems developed by OEMs using their own design staff for incorporation into their products. Our electronic assembly sensor products have historically competed favorably on the basis of these factors, and particularly on the basis of speed and product cost. Our sensor products are also better suited to align the smaller electronic component sizes currently available in the market. Nevertheless, advances in terms of speed by vision systems have reduced some of the advantages of our products in some configurations. We have introduced newer configurations adapted by several customers that we believe allow our sensors, and the component placement machines in which they are incorporated, to compete favorably based on the speed and accuracy of their performance, and their price. In addition, we are expanding our focus to incorporate additional inspection capabilities into our sensors, including our embedded process verification (EPV) technology initiative, which could give us a competitive advantage in this market.

The primary competition for sales of our SE 300 and SE 300 Ultra solder paste inspection products has been from Asian based companies such as KohYoung Technology (Korea), and Test Research, Inc. (Taiwan). GSI Lumonics, Inc. (SVS division), Agilent Technologies, Inc., CKD Corporation (Japan) and Orbotech, Ltd. (Israel) have also been competitors. We believe that a few of these competing systems have a lower price position than our SE 300 products. Although we believe our SE 300 products compete favorably against these competitive products on the basis of performance and reliability, the introduction of lower cost competitive models has required us to decrease the price of our SE 300 products in some markets. In addition, some manufacturers of screen printing equipment provide optional 2-D solder paste inspection, and other machine vision companies (AOI companies) have started offering 2-D and occasionally 3-D solder paste inspection products.

Our AOI inspection system products (Flex and Flex Ultra Products) face competition from a large number of AOI companies, the most significant being Agilent (formerly MVT), Orbotech, Ltd. (Israel), Viscom (Germany), Saki Corporation (Japan) and Omron, Ltd. (Japan). We believe that the technology used in the Flex series is differentiated from the competition and that it will compete effectively in this market based on measurement accuracy, cost, ease of use and the low rate of false calls.

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Our semiconductor products face competition in the wafer mapping and alignment market primarily from manufacturers of through-beam sensors developed by our customers using inexpensive sensors from general industrial market suppliers like Banner Engineering Corporation, Omron, Ltd (Japan) and Keyence, Ltd (Japan). We believe that our sensors compete favorably in this market based on performance and the unique advantages of the reflective mode of operations.

Our WaferSense family of sensors is intended to go where wafers go in semiconductor fabrication and provide measurements of critical factors that are currently impossible or extremely difficult to obtain. We believe our WaferSense products are unique to the marketplace and primarily face competition from the manual leveling and gapping techniques currently used by most customers to ensure that their semiconductor fabrication equipment is level and coplanar. Because the user is not required to break down semiconductor fabrication equipment, or pressurize a

vacuum chamber, we believe that our WaferSense products will save significant time over the manual techniques currently used by customers and will increase equipment up-time, through-put and process yield.

Although we believe our current products offer several advantages in terms of price and suitability for specific applications and although we have attempted to protect the proprietary nature of such products, it is possible that any of our products could be duplicated by other companies in the same general market.

Employees

As of December 31, 2006, we had 175 full-time and 4 part-time employees worldwide, including 39 in sales, marketing and customer support, 68 in manufacturing, purchasing and production engineering, 51 in research and development and 21 in finance, administration and information services. Of these employees, 132 are located at our corporate headquarters in Minneapolis and 47 are located in other offices (5 in the UK, 27 in Oregon, 8 in Singapore and 7 in China). All of our employees located in Oregon work in our Semiconductor business. To date, we have been successful in attracting and retaining qualified technical personnel, although there can be no assurance that this success will continue. None of our employees are covered by collective bargaining agreements or are members of a union.

Proprietary Protection

We rely on the technical expertise and know-how of our personnel and trade secret protection, as well as on patents, to maintain our competitive position. We attempt to protect intellectual property by restricting access to proprietary methods by a combination of technical and internal security measures. In addition, we make use of non-disclosure agreements with customers, consultants, suppliers and employees. Nevertheless, there can be no assurance that any of the above measures will be adequate to protect our proprietary technology.

We hold 87 patents (57 U.S. and 30 foreign) on a number of technologies, including those used in the LaserAlign systems and other products. Some of the patents relate to equipment such as pick-and-place machines, into which our sensor products are integrated. In addition, we have 120 pending patents (38 U.S. and 82 foreign). We protect the proprietary nature of our software primarily through copyright and license agreements, but also through close integration with our hardware offerings. We utilize 17 trademarks, 15 of which are registered trademarks, and 3 of which are foreign. We also have 8 domain names and several common law trademarks. It is our policy to protect the proprietary nature of our new product developments whenever they are likely to become significant sources of revenue. No guarantee can be given that we will be able to obtain patent or other protection for other products.

As the number of our products increases and the functionality of those products expands, we may become increasingly subject to attempts to duplicate our proprietary technology and to infringement claims. In addition, although we do not believe that any of our products infringe the rights of others, there can be no assurance that third parties will not assert infringement claims in the future or that any such assertion will not require us to enter into a royalty arrangement or result in litigation.

Government Regulation

Many of our products contain lasers. Products containing lasers are classified as either Class I, Class II or Class IIIb Laser Products under applicable rules and regulations of the Center for Devices and Radiological Health (CDRH) of the Food and Drug Administration. Such regulations generally require a self-certification procedure pursuant to which a manufacturer must file with the CDRH with respect to each product incorporating a laser device, periodic reporting of sales and purchases and compliance with product labeling standards. Our lasers are generally not harmful to human tissue, but could result in injury if directed into the eyes of an individual or otherwise misused. We are not aware of any incident involving injury or a claim of injury from our laser devices and believe that our sensors and sensor systems comply with all applicable laws for the manufacture of laser devices.

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ITEM 1A. RISK FACTORS

Our operations are subject to a number of risks and uncertainties that may effect our financial results, our accounting, and the accuracy of the forward making statements we make in this Form 10-K. We make statements regarding anticipated product introductions, changes in markets, customers and customer order rates, expenditures in research and development, growth in revenue, taxation levels, the effects of pricing, and the ability to continue to price foreign transactions in U.S. currency, all of which represent our expectations and beliefs about future events. Our actual results may vary from these expectations because of a number of factors that affect our business, the most important of which include the following:

The market for capital equipment for the electronics industry in which we operate is cyclical and we cannot predict with precision when market downturns will occur. We operate in a very cyclical market the electronics capital equipment market. We have been unable to predict with accuracy the timing or magnitude of periodic downturns in this market. These downturns, particularly the severe downturn in electronics production markets from 2001 through 2003, have severely affected our operations in the past and generated several years of unprofitable operations. We may be unable to foresee additional changes in these markets before they affect our operations in the future.

World events beyond our control may effect our operations. Our operations and markets could be negatively affected by world events that effect economies and commerce in countries, such as China, Singapore and Japan, in which we do business. Natural disasters, such as the SARS outbreak, have affected travel patterns and accessibility in these countries in the past and other natural occurrences, such as a bird flu outbreak, could affect the business we do in these countries in the future. Further, these countries may be affected by economic forces that are different from the forces that affect the United States and change the amount of business we conduct.

We are dependent upon two customers for a significant amount of our revenue. We have been dependent on two original equipment manufacturer customers for a large portion of our revenue (49% in 2006, 44% in 2005 and 50% in 2004). Our operations were significantly negatively affected by reduced order rates from these two customers during 2001, 2002 and the first half of 2003, and were favorably impacted by increased order rates in the last half of 2003 and the first three quarters of 2004. Order rates for these customers continued to sequentially decline through the second quarter of 2005, and then started to sequentially increase in the third and fourth quarters of 2005, peaking in the first quarter of 2006. Order rates leveled off at lower, but still favorable levels, for the remainder of 2006. If these customers are unsuccessful selling the products into which our sensors are incorporated, design their products to function without our sensors, purchase sensors from other suppliers, or otherwise terminate their relationships with us, our results of operations would be significantly negatively affected.

We are dependent upon a single product line in our systems business for over a quarter of our revenue. During 2006, approximately 20% of our total revenue was generated by sales of a single SMT Systems product line, the SE 300, and SE 300 Ultra. Sales of these products have been subject to increasing competition in the Asian markets, negatively impacting our market share and sales prices for our products. If we are not successful in continuing to sell and differentiate this product line relative to our competition, our results of operations would be negatively affected.

We generate more than three quarters of our revenue (approximately 85% in 2006) from export sales that are subject to risks of international operations. Our export sales are subject to many of the risks of international operations including:

currency controls and fluctuations in currency exchange rates;
changes in local market business requirements and increased cost and development time required to modify and translate our products for local markets;
inability to recruit qualified personnel in a specific country or region;
difficulty in establishing and maintaining relationships with local vendors;
differing foreign technical standards;
differing regulatory requirements;
export restrictions and controls, tariffs and other trade barriers;
difficulties in staffing and managing international operations;
reduced protection for intellectual property rights;
changes in political and economic conditions;
seasonal reductions in business activity;
potentially adverse tax assessments; and
terrorism, disease, or other events that may affect local economies and access.

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Because we price our products in US dollars, our products may have difficulty competing in periods of increasing strength of the dollar. All of our international export sales are negotiated, invoiced and paid in U.S. dollars, and accordingly, currency fluctuations do not affect our revenue and income per unit. However, significant fluctuations in the value of the U.S. dollar relative to other currencies could have an impact on the price competitiveness of our products relative to foreign competitors, which could impact the willingness of customers to purchase our products and have an impact on our results of operations.

Our products could become obsolete. Our current products, as well as the products we have under development, are designed to operate with the technology we believe currently exists or may exist for electronic components, printed circuit boards and memory modules. The technology for these components changes rapidly and, because it takes considerable time to develop new products, we must anticipate technological developments in order to effectively compete. Further, because we do not have unlimited development resources, we might chose to forgo the pursuit of what becomes a leading technology and devote our resources to technology that is less successful. If we incorrectly anticipate technology developments, or have inadequate resources to develop our products to deal with changes in technology, our products could become obsolete.

We compete in the electronics assembly sensor market with larger companies. Our electronic assembly sensor products compete with products made by larger machine vision companies, other optical sensor companies, and by solutions internally developed by our customers. Advances in machine vision technology in recent years have eliminated some, but not all, of the features that have differentiated our products from some of these competitors.

The market for surface mount capital equipment has become very price competitive. The electronics capital equipment market for surface mount technologies is becoming more mature, resulting in increased price pressure on suppliers of equipment. Consequently, our electronic assembly system and sensor products have become subject to increased levels of price competition and competition from other suppliers and technologies, including suppliers in Asia who have specifically designed their products to compete favorably against our products.

Our systems products carry lower margins. We use a different distribution network to sell our end-user systems products, and generate lower margins from these products, than the distribution system and margins from our electronic assembly sensor and semiconductor products. To the extent our end-user systems constitute a larger portion of our business, our profit margins may be affected.

Competitors in Asia may be able to compete favorably with us based on lower production and employee costs. We compete with large multinational systems companies in sales of end-user systems products, many of which are able to take advantage of greater financial resources and larger sales distribution networks. We also compete with new Asian based suppliers of end-user systems products, many of which may have lower overall production and employee costs and are willing to offer their products at lower selling prices to customers.

We are dependent upon outside suppliers for components of our products, and delays in or unavailability of those components would adversely effect our results. We use outside contractors to manufacture the components used in many of our products and some of the components we order require significant lead times that could affect our ability to sell our products if not available. In addition, if these components do not meet stringent quality requirements or become subject to obsolescence, there could be delays in product availability, and we could be required to make significant investments in designing replacement components.

Our operations could be effected by lead-free regulations. New regulations have been enacted in various countries requiring the reduction of hazardous substances in electronics products and capital equipment in future years. New regulations are also increasing

the obligations of manufacturers of electronics products and capital equipment to ensure proper disposal of their products when they are no longer being used by the customer. When effective, these regulations will impact production processes of our customers and require us to incorporate lead-free components into our products. If the production processes or our customers are interrupted, or we are not able to complete the transition to lead-free components in our products by the effective date of these regulations, our results of operations could be negatively affected. In addition the new regulations requiring us to ensure proper disposal of our products will increase our costs, and our results of operations could be negatively affected.

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Our growth has been dependent on technical innovation and is affected by the timing and success of product introductions. Although our results are cyclical, our objective is to grow revenue and profitability over the long term. Our growth has been in the past, and we anticipate that it will be in the future, dependent upon our ability to introduce new and innovative products. We plan to continue to introduce new products during fiscal 2007 and beyond. If those introductions are delayed, our revenue and profitability could be negatively affected. For example, we have devoted and continue to devote significant resources to complete development and commence sale of our embedded process verification (EPV) products. The introduction of these products has been delayed because of economic conditions affecting our customers, required adaptations for OEM requirements and other issues and these products have yet to generate substantial commercial sales.

The accuracy of our financial reporting is dependent on continued maintenance of adequate internal controls. Our ability to capture, process and report transactions in a timely and accurate manner in compliance with accounting principles generally accepted in the United States is dependant upon the operation of our internal controls over financial reporting. Although we believe our controls, policies, practices and systems are adequate to ensure the integrity of our financial reporting, unanticipated and unauthorized actions of employees (both domestic and internationally), temporary lapses in internal controls due to shortfalls in transition planning and oversight, or resource constraints could lead to improprieties and undetected errors that could impact our financial condition or results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease a 60,217 square foot mixed office and warehouse facility built to our specifications in Golden Valley, Minnesota, which functions as our corporate headquarters and primary manufacturing facility. The lease for this space will expire in June 2011. As of December 31, 2006, we also have operating leases in Oregon (for our semiconductor business), Singapore, Massachusetts, the United Kingdom, and Shanghai China, which expire in December 2009, May 2007, August 2008, June 2008 and August 2008, respectively. We believe that our leased facilities are adequate for our anticipated needs for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

We are not currently subject to any material pending or threatened legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of 2006.

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PART II.

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the Nasdaq Global Market. The following table sets forth, for the fiscal periods indicated, the high and low sales prices for our common stock as reported by the Nasdaq Global Market. These prices do not reflect adjustments for retail markups, markdowns or commissions.

	2006		2005	
Quarter	**High**	**Low**	**High**	**Low**
First	$16.25	$13.25	$15.36	$11.76
Second	$16.25	$12.00	$14.17	$10.31
Third	$14.10	$11.75	$15.36	$12.83
Fourth	$14.24	$11.07	$14.74	$12.26

As of February 28, 2007, there were approximately 219 holders of record of common stock and approximately 3,012 beneficial holders. We have never paid a dividend on our common stock. Dividends are payable at the discretion of the Board of Directors out of funds legally available therefore. Our board has no current intention of paying dividends.

Company Repurchase of Equity Securities

Period	**(a)**	**(b)**	**(c)**	**(d)**

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
October 1, 2006 to October 31, 2006	8,000	$12.4975	8,000	485,500
November 1, 2006 to November 30, 2006	112,646	$12.0215	112,646	372,854
December 1, 2006 to December 31, 2006	83,252	$12.4608	83,252	289,602
Total	203,898	$12.2502	203,898	289,602

(1) Prior to October 1, 2006, the Company had repurchased an aggregate of 6,500 shares of its common stock pursuant to the repurchase program that it publicly announced on July 26, 2006 providing for the repurchase of 500,000 shares, and with the repurchases of 203,898 shares in the fourth quarter, had repurchased an aggregate of 210,398 shares under that authorization. Also on July 26, 2006, the Company announced its intention to adopt a 10b5-1 plan to facilitate the purchase of the shares during periods it might otherwise be prevented by insider trading laws from making such repurchases. Shares were purchased in open market transactions pursuant to this 10b5-1 plan.

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Shareholder Return

The following graph compares the cumulative total shareholder return on our common stock from January 1, 2002 through December 31, 2006 with the cumulative total return on a broad market index (the Nasdaq US Index) and a peer group index (the Nasdaq Computer and Data Processing Index). In each case, we have calculated the cumulative return assuming an investment of $100 on January 1, 2002, and reinvestment of all dividends.

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ITEM 6. SELECTED FINANCIAL DATA

Five-Year Financial Summary

CyberOptics Corporation

(In thousands, except per share information)

Year Ended December 31	2006	2005 (1)	2004	2003 (2)	2002 (3)
Revenues	$57,089	$42,179	$58,037	$35,636	$24,634
Income (loss) from operations	$7,121	$3,104	$12,325	$(2,814)	$(13,908)
Net income (loss)	$6,390	$7,150	$10,626	$(2,637)	$(13,555)
Net income (loss) per share:					
Basic	$0.71	$0.80	$1.23	$(0.32)	$(1.66)
Diluted	$0.70	$0.79	$1.18	$(0.32)	$(1.66)
Cash and cash equivalents	$30,056	$19,592	$25,416	$11,354	$11,009
Marketable securities	18,951	21,548	14,868	13,468	9,809
Working capital	55,662	48,515	38,921	26,963	25,268
Total assets	82,010	73,027	65,096	47,926	48,274
Stockholders equity	73,020	66,190	57,951	41,752	44,062

(1) 2005 results include a $3.7 million non-cash income tax benefit related to a reduction in the valuation allowance for deferred income taxes in the fourth quarter of 2005.

(2) 2003 results include a $1.2 million charge for workforce reductions, leased facility consolidation and other restructuring charges and a $632,000 charge for accelerated amortization of intangible assets. In addition, 2003 includes a $645,000 gain from a technology transfer and license.

(3) 2002 results include an increase in the valuation allowance for deferred income taxes of approximately $4.3 million. In addition, 2002 results include a pre-tax charge of $1.6 million for workforce reduction costs and other restructuring charges.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations for the Three Years Ended December 31, 2006:

General Overview

Our products are sold primarily into the electronics assembly, semiconductor DRAM memory, and semiconductor fabrication capital equipment markets, where we sell products both to original equipment manufacturers of production equipment and to end-user customers that produce circuit boards and semiconductor wafers and devices. Historically these markets have been very cyclical, with periods of rapid growth as worldwide capacity is added to support increased consumer demand for electronic products, and new capital equipment is purchased as a result of technology changes in electronics components, such as miniaturization, and changing production requirements. These periods of growth have historically been followed by periods of excess capacity and reduced capital spending.

The worldwide demand for cell phones, laptops and other consumer electronics remained strong and continued to increase throughout 2006, driving the need for increased production of printed circuit boards and memory modules. In addition, the economies in the countries where most of our products are sold also remained strong. These factors combined to drive an increase in demand for our electronic assembly and semiconductor products in 2006 compared to 2005. Demand for our products started to increase in the third quarter of 2005, continued to improve throughout the first quarter of 2006, and then leveled off at lower, but still favorable levels, for the remainder of 2006. Our consolidated revenues for 2006 increased 35% from 2005 to $57.1 million. Income from operations for 2006, benefiting from the higher level of revenue and lower cost structure implemented during 2001, 2002 and 2003, improved 129% to $7.1 million from $3.1 million in 2005.

Our operating results declined in 2005 in response to downturns in both the electronic assembly and semiconductor capital equipment markets that begin late in the third quarter of 2004 and continued through the second quarter of 2005. Although the economies in the countries where most of our products are sold continued to be strong, the semiconductor market weakened, and with it, the circuit board production market. While this downturn was not as severe as the downturn experienced from 2001 to early 2003, it resulted in a significant decline in operating results over our exceptionally strong results in 2004. Consolidated revenues for 2005 declined 27% from 2004 to $42.2 million. Operating results for 2005 benefited from a lower cost structure implemented during 2001, 2002 and 2003. As a result, 2005 operating profits were $3.1 million despite lower revenues compared to 2004.

Order rates during the fourth quarter of 2006 were consistent with order levels for the second and third quarters of 2006. We believe the global markets for our electronic assembly and semiconductor products remain relatively strong. Although we cannot predict with precision the trends in the markets we serve, we do not anticipate any significant softening in our markets, at least for the early months of 2007.

During 2005, as a result of our lower cost structure and history of improved profitability, we reduced the valuation allowance for deferred income taxes that had been established in the third quarter of 2002. The reduction in the valuation allowance resulted in a non-cash income tax benefit in the fourth quarter of 2005 of $3.7 million. See Note 5 of this Form 10-K for a further discussion of the accounting treatment for income taxes.

Our balance sheet is also well positioned as the result of improved operating results and effective management of working capital and other assets. We have no debt and our cash and marketable securities are $49.0 million at December 31, 2006 compared to $41.1 million at December 31, 2005.

Segment Results

During the fourth quarter of 2005, we reorganized our business into two operating segments, the electronic assembly and semiconductor segments, in order to increase focus and management attention on growth opportunities in our markets. The electronic assembly segment designs, manufactures and sells optical process control sensors and inspection systems for the electronic assembly equipment market.

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The semiconductor segment designs, manufactures and sells optical and other process control sensors and related equipment for the semiconductor capital equipment market. Segment information follows:

(In thousands)	Year Ended December 31, 2006	2005	2004
Revenue:			
Electronic assembly	$51,142	$36,738	$51,019
Semiconductor	5,947	5,441	7,018
Total	$57,089	$42,179	$58,037
Gross margin:			
Electronic assembly	$25,926	$19,347	$28,953
Semiconductor	3,975	3,725	5,174
Total	$29,901	$23,072	$34,127
Operating expense:			
Electronic assembly	$18,110	$15,599	$17,115
Semiconductor	4,670	4,369	4,687
Total	$22,780	$19,968	$21,802
Income (loss) from operations:			
Electronic assembly	$7,816	$3,748	$11,838
Semiconductor	(695)	(644)	487
Total income from operations	$7,121	$3,104	$12,325
Interest income and other	1,943	951	343
Income before income taxes	$9,064	$4,055	$12,668

Revenues

Our revenues increased by 35% to $57.1 million in 2006 from $42.2 million in 2005, and decreased 27% in 2005 from $58.0 million in 2004. The following table sets forth, for the years indicated, revenues by product line (in thousands):

	2006	2005	2004
Electronic Assembly			
OEM Sensors	$32,006	$21,623	$31,275
SMT Systems	19,136	15,115	19,744
Total Electronic Assembly	51,142	36,738	51,019
Semiconductor	5,947	5,441	7,018
Total	$57,089	$42,179	$58,037

Electronic Assembly

Revenues from our electronic assembly sensors increased $10.4 million or 48 % during 2006 compared to 2005 and decreased $9.7 million or 31% during 2005 compared to 2004. During 2006, revenue from electronic assembly sensors were positively impacted by improved worldwide demand for cell phones, laptops and other consumer electronics, driving the need for increased production of printed circuit boards and memory modules. In addition, the economies in the countries where most of our products are sold also were strong. These factors combined to drive an increase in demand for our electronic assembly sensors in 2006 compared to 2005.

During 2005, revenue from electronic assembly sensors were negatively impacted by a downturn in our SMT electronic assembly market, which began in the fourth quarter of 2004, and continued through the second quarter of 2005. Sensor revenues were sequentially higher in the third and fourth quarters of 2005, but had not yet returned to the peak levels of 2004. In addition, 2005 sensor revenue was favorably impacted by the introduction of a new InPrinter Inspection camera for DEK International Gmbh.

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During 2004, sensor revenues were positively impacted by improved market conditions in the worldwide market for SMT capital equipment and by the introduction of two new sensors for one of our large customers. These sensors were designed for the latest generation pick-and-place machine of this customer, which was introduced during 2003 and resulted in a higher content of our products per machine than in the previous version.

Revenues from our SMT systems products increased $ 4.0 million or 27% during 2006 compared to 2005 and decreased $4.6 million or 23% during 2005 compared to 2004. Like our sensor revenue, revenue from our SMT system products were positively impacted by improved worldwide demand for electronics and favorable conditions in the countries where most of our products are sold. Revenue from our systems products in 2006 was also favorably impacted by the introduction of a new version of our Flex series AOI system, the Flex Ultra, in the first quarter of 2006. This system, which offers improved performance over earlier versions of our Flex AOI system, was favorably received by the market. Our sales of Flex products increased $2.3 million or 55% during 2006.

During 2005, revenue from our SMT system products were also negatively impacted by a downturn in the SMT electronic assembly market, but this negative impact was partially offset by positive market acceptance of our next generation solder paste inspection system, the SE 300 Ultra, and increased sales of our Flex series AOI systems. Sales of our Flex AOI systems increased approximately $.5 million compared to 2004.

During 2004, revenues from SMT systems, primarily our SE 300 solder paste inspection system, were positively impacted by improved market conditions in the SMT capital equipment markets and by success in selling systems to many of the large manufacturers of circuit boards in Asia (particularly China). A large portion of the worldwide production capacity for printed circuit boards is being added in Asia, and we have been successful in selling inspection systems to new and existing customers in that region through our expanded distribution capability (opened Singapore sales office in 2001 and a sales office in China in 2004). In addition, 2004 revenues from our Flex series AOI systems increased $1.5 million compared to 2003 levels. We believe that increased use of outsourcing for circuit board assembly, production difficulties associated with smaller component sizes, increased production speeds and increased cost pressure on companies manufacturing circuit boards has caused increased demand for our inspection equipment.

Export revenue from electronic assembly sensors and SMT systems totaled $46.5 million in 2006, $32.8 million in 2005 and $45.3 million in 2004, comprising 91% of electronic assembly revenue in 2006, and 89% of electronic assembly revenue in both 2005 and 2004. An increasing proportion of our sales have been to international customers as manufacturing of electronic components has migrated offshore, particularly to China and other areas of Asia.

We believe the market trend toward automated inspection using SMT inspection systems is continuing to grow and emerge due to ongoing miniaturization of SMT circuit board components. Required for downsizing products, some new generation components have become so small that it is now virtually impossible for the human eye to inspect circuit boards for defects in solder paste quality, component placement and solder joints. For this reason, we believe automated inspection has become the only viable means for inspecting SMT circuit boards with such tiny components, and we believe that our SMT systems products will be one of our primary growth drivers over the next few years.

Semiconductor

Revenues from semiconductor products increased by $0.5 million or 9% in 2006 compared to 2005, following a decrease of $1.6 million or 22% in 2005 compared to 2004. The increase in 2006 was due to improved conditions in the semiconductor fabrication capital equipment market that began late in the fourth quarter of 2005, resulting in higher revenues from our wafer mapping sensors and new WaferSense products. Revenues from our frame grabber products increased slightly in 2006 compared to 2005. The decrease in revenue in 2005 was due to lower revenues from wafer mapping sensors and frame grabber products, resulting from depressed market conditions in the semiconductor fabrication and general industrial capital equipment markets.

Our wafer mapping and frame grabber products are relatively mature. We anticipate that future growth in our semiconductor revenues, exclusive of changes related to capital procurement cycles, will come from our new WaferSense products. WaferSense is a family of wireless, wafer like precision measurement tools for in-situ setup, calibration and process optimization in semiconductor processing equipment. We are currently working on several new additions to the WaferSense product line, including additional leveling sensors and new gapping and teaching sensors.

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Export revenue from semiconductor products totaled $1.8 million or 31% of total semiconductor revenue in 2006, $1.6 million or 29% of total semiconductor revenue in 2005, and $1.5 million or 22% of total semiconductor revenue, in 2004. The increase in international revenue as a percentage of total semiconductor revenue in 2006 compared to 2005 is due to increased sales of frame grabbers in Europe. In addition, our wafer mapping sensors do not generate significant international sales. Fluctuations in the sales level of these products can also cause fluctuations in our international revenue, as a percentage of total semiconductor revenue. The increase in international revenue as a percentage of total semiconductor revenue for 2005, compared to 2004, is due to lower sales of wafer mapping sensors.

Adoption of SFAS No. 123(R)

During the first quarter of 2006, we began recording compensation expense for equity-based awards as required by SFAS No. 123(R). The following table sets forth compensation expense (pre-tax) by segment for our equity-based awards for the year ended December 31, 2006 (in thousands):

	Twelve months ended December 31, 2006		
(In thousands)	Electronic Assembly	Semi-Conductor	Total
Cost of revenue	$70	$13	$83
Research and development expenses	137	27	164
Selling, general and administrative expenses	479	52	531
Total	$686	$92	$778

Gross Margin

Our gross margin as a percentage of sales for both our electronic assembly and semiconductor products are somewhat dependent on the level of revenues and resulting production levels over which to spread fixed manufacturing overhead costs that do not vary with activity levels. In addition, with higher production volumes manufacturing processes become more efficient and we are able to negotiate lower material costs from our suppliers as the result of volume discounts which reduces the overall cost of producing products for sale. The mix of products sold can also have an impact on electronic assembly and semiconductor margins.

Electronic Assembly

Gross margin as a percentage of electronic assembly sales were 51% in 2006, 53% in 2005 and 57% in 2004. The decrease in gross margin as a percentage of sales in 2006, compared to 2005, was due to increasing competition resulting in lower sales prices for our electronic assembly products, particularly our SMT system products. Increased competition and resulting price pressure on our SMT system products reduced gross margins as a percentage of electronic assembly sales in 2006, compared to 2005, by approximately one percentage point. The remaining decrease in gross margin as a percentage of sales in 2006 was due to a $0.2 million inventory write-down of a non-OEM sensor product, increasing price competition for our other electronic assembly sensor products, and changes in mix of products sold. Our gross margin as a percentage of sales is generally lower for our system products as compared to our sensor products.

The decrease in gross margin as a percentage of sales in 2005, compared to 2004, was due in part, to pricing pressures from increased competition for sales of our solder paste inspection machines, reducing electronic assembly gross margins as a percentage of sales by approximately two percentage points. The remaining decrease in gross margin as a percentage of sales in 2005 was due to product mix, with a higher percentage of our sensor and system sales coming from lower margin products, and the lower level of production volumes, which reduced manufacturing efficiency when compared to 2004.

As the market for automated inspection has continued to grow and emerge, additional competitors have entered the marketplace for these products. Although we believe our SMT system products compete favorably against these competitive products on the basis of performance and reliability, the introduction of lower price competitive models has required us to decrease the selling price of our products in some markets. With respect to our systems products, and particularly our solder paste inspection machines, we anticipate that pricing pressures will continue in 2007 due to the additional competition in the marketplace for all forms of automated circuit board inspection.

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Semiconductor

Gross margin as a percentage of sales were 67% in 2006, 68% in 2005 and 74% in 2004. Similar to the electronic assembly segment, gross margin as a percentage of sales for the semiconductor segment is dependent on revenue mix and the level of production volume over which to spread fixed manufacturing overhead costs. Gross margins decreased as a percentage of revenue in 2006 from 2005 due to a change in revenue mix, with our highest margin wafer mapping sensors representing a smaller percentage of total semiconductor revenue. In addition, revenue from our lower margin leveling sensor products was up significantly in 2006 compared to 2005. Gross margins decreased as a percentage of revenue in 2005 from 2004 due to decreased volume, and a change in revenue mix, with lower sales of higher margin wafer mapping sensors.

We currently expect gross margins as a percentage of revenue from our semiconductor products to remain consistent or increase slightly in 2007 from 2006 levels, due to anticipated changes in revenue, and new product introductions, which are expected to carry slightly higher gross margins than our existing products.

Operating Expenses

We believe continued investment in research and development of new products, coupled with continued investment and development of our sales channels, is critical to future growth and profitability. We maintain research and development and sales and marketing expenses at relatively high levels, even during periods of downturn in our electronic assembly and semiconductor capital equipment markets, as we continue to fund development of important new products, and continue to invest in our sales channels and develop new sales territories.

We are currently expecting research and development, and selling, general and administrative expenses to be higher in 2007, compared to 2006, as we continue new product development efforts, and continue development of our sales channels and new sales territories. We are considering additional research and development projects, and may elect to increase expenditures based on an assessment of the future revenue and profit potential of these projects. Further, sales commissions and other selling, general and administrative costs may be higher in 2007 if revenue and profit levels increase over 2006 levels.

Fluctuations in the level of research and development and selling, general and administrative expenses as a percentage of revenue for both the electronic assembly and semiconductor segments are primarily due to fluctuations in the level of revenue in 2006, 2005 and 2004**.**

Electronic Assembly

Research and development expenses were $6.3 million or 12% of revenue in 2006, $5.4 million or 15% of revenue in 2005 and $5.8 million or 11% of revenue in 2004. The 15% increase in research and development expense in 2006 compared to 2005 was due to increased compensation costs of $0.5 million, including increases in company wide incentive compensation costs in 2006, resulting from higher levels of revenue and profit, and stock compensation costs resulting from our adoption of SFAS No. 123(R). The remaining increase in research and development expense in 2006 was due to higher costs for other expenses related to our development projects, such as travel, occupancy and supplies.

During 2006 we completed development of our 5th generation LaserAlign sensor for Juki s industry leading line of pick-and-place machines. The new sensor provides Juki with a 25% throughput improvement, alignment capability for the smallest components, improved reliability and the lowest cost of ownership. Early in 2006 we introduced an enhanced version of our Flex series automated optical inspection system, the Flex Ultra. We continued to make improvements to our SE 300 Ultra and Flex Ultra SMT products throughout 2006, including improvements for speed, measurement performance, reliability, ease of use, and simplified operator interfaces with foreign language capability. We also continued work on our EPV technological initiative.

The 6% decrease in research and development expenses in 2005 compared to 2004, was principally due to a $0.3 million decrease in company wide incentive compensation costs in 2005, resulting from lower levels of revenue and profits. During 2005 we completed development of our new SE 300 Ultra solder paste inspection system, and our new InPrinter Inspection camera for DEK International Gmbh. We also started development of an enhanced version of our Flex series automated optical inspection system. During 2004, research and development efforts were primarily focused on initial development activities for several new sensor products, including development activities for the new Embedded Process Verification sensor family (EPV®), continued development of the SE and Flex series inspection systems, next generation LaserAlign products, and board alignment cameras.

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Selling, general and administrative expenses were $11.7 million or 23% of revenue in 2006, $10.1 million or 27% of revenue in 2005 and $11.1 million or 22% of revenue in 2004. The 17% increase in selling, general and administrative expenses in 2006 compared to 2005 was due to increased compensation costs of $1.5 million, including increases for company wide incentive compensation costs in 2006, resulting from higher levels of revenue and profit, stock compensation expense resulting from adoption of SFAS No. 123 (R), plus additional field sales and applications support personnel required to generate the higher level of SMT systems sales in 2006. Travel costs were higher in 2006 due to the additional field sales and support headcount added in 2005 and 2006.

The 9% decrease in selling, general and administrative expenses in 2005 compared to 2004, was principally due to a $1.4 million reduction in sales commissions and company wide incentive compensation costs associated with lower levels of revenue and profits in 2005, partially offset by increased costs for our new sales office in China that opened in December 2004.

Semiconductor

Research and development expenses were $1.8 million or 31% of revenue in 2006, $1.7 million or 31% of revenue in 2005 and $1.9 million or 27% of revenue in 2004. The 11% increase in research and development expense in 2006 compared to 2005 is due to increased compensation costs for company wide incentive compensation programs and stock compensation expense resulting from adoption of SFAS No. 123 (R). A $0.1 million decrease in incentive compensation costs, resulting from lower levels of revenue and profit in 2005, contributed to the 11% decrease in research and development expense in 2005 compared to 2004.

During 2006 and 2005, we continued to develop various new sensors for our WaferSense family of precision measurement tools, including new automated leveling, gapping and teachings sensors to assist with process optimization and yield improvement in the semiconductor fabrication

process.

Selling, general and administrative expenses were $2.3 million or 39% of revenue in 2006, $2.0 million or 37% of revenue in 2005 and $2.0 million or 29% of revenue in 2004. The 18% increase in selling, general and administrative expense in 2006 compared to 2005 is due to costs for additional management, higher sales commissions, equity compensation costs resulting from adoption of SFAS No. 123 (R) and company wide incentive compensation costs resulting from higher levels of revenue and profit. Expenses in 2005 were flat compared to 2004, as a $0.2 million reduction in costs for sales commissions and company wide incentive compensation programs, resulting from lower revenue and profit levels in 2005, were offset by higher costs for additional management and marketing employees.

Amortization of Intangible Assets

Amortization of acquired intangible assets related to our electronic assembly segment was $0.1 million in 2006, 2005 and 2004. We expect amortization expense for acquired intangible assets related to our electronic assembly segment to be $0.1 million in 2007.

Amortization of acquired intangible assets related to our semiconductor segment was $0.5 million in 2006, $0.7 million in 2005 and $0.8 million in 2004. The decrease in semiconductor related amortization was due to certain acquired intangible assets becoming fully amortized during 2006 and 2005. We expect amortization expense for acquired intangible assets related to our semiconductor segment will be less than $0.1 million in 2007.

Interest Income and Other

Interest income and other primarily includes interest earned on investments and gains and losses associated with foreign currency transactions. Interest income and other increased during 2006 and 2005 as the result of additional invested funds, higher rates of interest earned on those funds and lower foreign currency transaction losses. Interest income and other increased during 2004 as the result of additional invested funds, partially offset by increased foreign currency transaction losses.

Income Taxes

We currently have significant deferred tax assets as a result of foreign net operating loss carry forwards, U.S. tax credit carry forwards and temporary differences between taxable income on our tax returns and income before income taxes under U.S. generally accepted accounting principals. A deferred tax asset generally represents future tax benefits to be received when these carry forwards can be applied against future taxable income or when expenses previously reported in our financial statements become deductible for income tax purposes. We assess the realizability of our deferred tax assets and the need for a valuation allowance based on Statement of Financial Accounting Standards No. 109.

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In the third quarter of fiscal 2002, we recorded a full valuation allowance against our deferred tax assets. Our decision to record the valuation allowance was based on the cumulative losses we had incurred over the three years prior to that date, the fact that we were continuing to generate operating losses and that we fully utilized our loss carry back benefit in 2002. From the third quarter of fiscal 2002 through the third quarter of 2005, we continued to provide a full valuation allowance against all future tax benefits produced by our operating results.

During 2004, we recorded an income tax provision of approximately $2.0 million resulting in an effective income tax rate of approximately 16% because we had utilized our available tax operating losses and were subject to Alternative Minimum Tax limitations. Because we continued to maintain a valuation allowance on deferred tax assets, projected current taxes payable comprised the entire tax provision, and were the basis for our effective tax rate.

During the fourth quarter of 2005, we reduced the valuation allowance on our deferred tax assets, initially established in the third quarter of 2002, resulting in a non-cash income tax benefit of $3.7 million. Our tax benefit for 2005, including reversal of the valuation allowance, was equal to $3.1 million. We considered a number of factors in our decision to reduce the valuation allowance on deferred tax assets, including our anticipated level of profitability in the future, our history of recent profitability and cumulative profitability since inception, and utilization of our available U.S. based net operating loss carry forwards. After considering these factors, we concluded that a reduction in the valuation allowance was appropriate. Accordingly, the benefit we will derive in future accounting periods from carry forwards and deductible temporary differences has been reflected as a deferred tax asset on our balance sheet.

Due to the prior year reduction of the valuation allowance, we were taxed at a more normalized rate in 2006. Our tax provision for 2006 includes a $0.2 million income tax benefit from favorable resolution of a tax contingency accrual for prior year s income taxes, resulting from the closing of a domestic statute of limitations. We also recognized a $0.2 million income tax benefit that resulted from the federal R&D tax credit signed into law in the fourth quarter of 2006 and made retroactive for the full year. For 2006, including the income tax benefits described above, we recorded a tax provision at a consolidated worldwide effective tax rate of 29.5%.

Liquidity and Capital Resources

Our cash and cash equivalents increased by $10.5 million during 2006 primarily because of maturities of $2.7 million of marketable securities, net of purchases, $9.8 million of cash generated from operating activities, partially offset by the purchase of $1.4 million of capital assets and $0.6 million of cash used by financing activities. Our cash and cash equivalents fluctuate in part because of maturities of marketable securities, and investment of cash balances in marketable securities, or from other sources of cash, in addition to marketable securities. Accordingly, we believe the combined balances of cash and marketable securities provide a more reliable indication of our available liquidity. Our combined balances of cash and marketable securities increased $7.9 million to $49.0 million as of December 31, 2006 from $41.1 million as of December 31, 2005.

We generated $9.8 million of cash from operations during 2006. Cash generated from operations included net income of $6.4 million, which included $3.5 million of net non-cash expenses for depreciation and amortization, provisions for inventory obsolescence, doubtful accounts and deferred taxes, foreign currency transactions and stock compensation expense. Changes in operating assets and liabilities included increases in accounts payable of $1.1 million and increases in accrued expenses of $1.3 million. This cash generated was offset by an increase in accounts receivable of $.7 million, increases in inventory of $1.6 million and decreases in advance customer payments of $0.4 million. Increases in accounts payable are the result of inventory purchases to support additional customer evaluations of our SMT system products. The increase in accrued expenses resulted from the accrual of company wide incentive compensation costs due to higher levels of revenue and profit in 2006 and increases in warranty reserves resulting from higher revenue levels. Increases in accounts receivable are due to higher revenue levels in 2006, compared to 2005. The decrease in advance customer payments is due to lower sales from customers who pay prior to our recognition of revenue from the related sale.

We generated $1.6 million of cash from operations during 2005. Cash generated from operations primarily included net income of $7.1 million, which included net non-cash expenses for depreciation and amortization, provisions for inventory obsolescence and doubtful accounts of $2.2 million, tax benefits from the exercise of stock options of $0.1 million and increases in accounts payable of $1.1 million. This cash generated was adjusted by $3.7 million related to the non-cash deferred tax provision and offset by an increase in accounts receivable of $2.4 million, increases in inventory of $0.8 million and increases in other assets of $0.5 million, as well as reductions in accrued expenses of $1.9 million. Increases in accounts payable are the result of increased inventory purchases. The increase in deferred taxes resulted from the reversal of the valuation allowance established in 2002. Increases in accounts receivable are due to higher revenue levels in the fourth quarter of 2005, compared to 2004, and proportionately more system sales through distributors, which increases the timing of receivable collections. Increases in inventory are the result of purchases to support higher order rates and backlog at the end of 2005, compared to 2004. Decreases in accrued expenses are primarily due to payment of 2004 incentive compensation accruals in 2005.

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We used $1.3 million of cash for investing activities during 2006 compared to $7.9 million in 2005. Changes in the level of investments in marketable securities, resulting from the purchases and maturities of those securities, provided $2.7 million of cash in 2006 and used $6.7 million of cash in 2005. We used approximately $1.4 million of cash in 2006 and $1.2 million of cash in 2005 for the purchase of fixed assets and capitalized patent costs.

We used $0.6 million of cash in 2006 for financing activities and generated $0.4 million of cash from financing activities during 2005. Stock option exercises and issuance of common stock under the Employee Stock Purchase Plan generated $1.8 million of cash in 2006 compared to $0.9 million of cash in 2005. The tax benefits from exercise of stock options generated $0.2 million of cash in 2006. During 2006, $2.6 million of cash was used to repurchase common stock compared to common stock repurchases of $0.5 million in 2005. At December 31, 2006, we had authority to purchase up to an additional 289,602 shares of our common stock under a stock repurchase program for a total of 500,000 shares approved by our board of directors in July 2006. Future repurchases under this authorization could be a use of cash in 2007.

At December 31, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of establishing off-balance sheet arrangements or other contractually narrow or limited purposes. We do not believe we are exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Except for our obligations under facilities leases and purchase contracts, we had no material commitments for expenditures as of December 31, 2006. While there were no material commitments, we evaluate investment opportunities that come to our attention and could make a significant commitment in the future. Our cash and equivalents and investments totaled $49.0 million at December 31, 2006. We believe that on-hand cash, cash equivalents and marketable securities, coupled with anticipated future cash flow from operations, will be adequate to fund our cash flow needs for the foreseeable future, including contractual obligations discussed below.

The following summarizes our contractual obligations at December 31, 2006, and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

December 31, 2006 (in 000 s)	**Total**	**1 3 Years**	**After 3 Years**

		Less Than 1 Year		
Contractual Obligations:				
Non-cancelable operating lease obligations	$4,587	$1,114	$3,007	$466
Purchase obligations	5,860	5,860		
Total contractual cash obligations	$10,447	$6,974	$3,007	$466

We lease a 60,217 square foot mixed office and warehouse facility built to our specifications in Golden Valley, Minnesota, which functions as our corporate headquarters and primary manufacturing facility. The lease for this space is set to expire in June 2011.

Purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding. Included in the purchase obligations category above are obligations related to purchase orders for inventory purchases under our standard terms and conditions and under negotiated agreements with vendors and utilities. We expect to receive consideration (products or services) for these purchase obligations. The purchase obligation amounts do not represent all anticipated purchases in the future, but represent only those items for which we are contractually obligated. The majority of our products and services are purchased as needed, with no contractual commitment. Consequently, these amounts will not provide a reliable indicator of our expected future cash outflows on a stand-alone basis.

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Related Party Transactions

We did not engage in any related party transactions during the three year period ended December 31, 2006.

Inflation and Foreign Currency Translation

Changes in our revenues have resulted primarily because of changes in the level of unit shipments and the relative strength of the worldwide electronics and semiconductor fabrication capital equipment markets. We believe that inflation has not had a significant effect on our operations. All of our international export sales are negotiated, invoiced and paid in U.S. dollars. Accordingly, although currency fluctuations do not significantly affect our revenue and income per unit, they can influence the price competitiveness of our products and the willingness of existing and potential customers to purchase units. In general, because the dollar has declined during the past few years relative to local currency, the currency fluctuations have enhanced our competitive position. This has been largely offset by the entrance of other companies in our markets who compete with us on the basis of price.

We enter into foreign currency swap agreements to hedge short term inter-company financing transactions with our subsidiary in the United Kingdom. These currency swap agreements are structured to mature near the last day of each quarter, and are designated as cash flow hedges. At December 31, 2006, we had one open swap agreement that was purchased on December 29, 2006. As a result, any unrealized gains or losses as of December 31, 2006 were inconsequential. During the year ended December 31, 2006, we recognized a net loss of approximately $0.3 million from settlement of foreign currency swap agreements that offset the approximately $0.3 million transaction gain on the underlying inter-company balance.

We have sales offices located in the UK, Singapore, and China. We do not believe that currency fluctuations will have a material impact on our consolidated financial statements.

Recent Accounting Developments

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 Accounting for Income Taxes . FASB Interpretation No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of the interpretation to have a significant impact on our financial position and results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards (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 will apply whenever another standard requires (or permits) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value to any new circumstances, and is effective beginning after December 31, 2007. We are currently evaluating the impact of adopting SFAS No. 157 on our financial position and results of operations.

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Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to revenue recognition, bad debts, warranty obligations, inventory valuation, intangible assets, and income taxes. We base these estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that we believe have the most effect on our reported financial position and results of operations are as follows:

Revenue Recognition

Revenue from all customers, including distributors, is recognized when all significant contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. Generally, revenues are recognized upon shipment under FOB shipping point terms. Estimated returns and warranty costs are recorded at the time of sale. Sales of some surface mount technology (SMT) products may require customer acceptance due to performance or other acceptance criteria included in the terms of sale. For these SMT product sales, revenue is recognized at the time of customer acceptance.

When a sale involves multiple elements, revenue is allocated to each respective element in accordance with Emerging Issues Task Force (EITF) 00-21 Accounting for Revenue Arrangements with Multiple Deliverables. Allocation of revenue to undelivered elements of the arrangement is based on fair value of the element being sold on a stand-alone basis.

Costs related to products delivered are recognized in the period revenue is recognized. Cost of goods sold consists primarily of direct labor, allocated manufacturing overhead, raw materials and components and excludes amortization of intangible assets.

Allowance for Doubtful Accounts.

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. In making the determination of the appropriate allowance for doubtful accounts, we consider specific accounts, historical write-offs, changes in customer relationships and credit worthiness and concentrations of credit risk. Specific accounts receivable are written-off once a determination is made that the account is uncollectible. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The allowance for doubtful accounts is $0.2 million as of December 31, 2006.

Allowance for Warranty Expenses.

We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of component suppliers, warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required. The allowance for warranties is $0.8 million at December 31, 2006.

Reserve for Inventory Obsolescence.

We write down inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected, or if in the future we decide to discontinue sales and marketing of any of our products, additional inventory write-downs may be required. At December 31, 2006, we had a reserve for obsolete and excess inventory of $0.9 million.

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Valuation of Intangible and Long-Lived Assets.

We assess the impairment of identifiable intangible assets, long lived assets and related goodwill whenever events or changes in circumstances indicate the carrying value may not be recoverable. Factors we consider important, which could trigger an impairment review include the following:

- Significant under-performance relative to expected historical or projected future operating results.
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business.
- Significant negative industry or economic trends.
- Significant decline in our stock price for a sustained period; and our market capitalization relative to net book value.
- For intangible assets and long-lived assets, if the carrying value of the asset exceeds the undiscounted cash flows from such asset.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any potential impairment based on a projected discounted cash flow method using a discount rate that we believe is commensurate with the risk inherent in our current business model. Annually, we also test for impairment of goodwill for each of our reporting units by estimating their fair value, utilizing a discounted cash flow methodology to determine a reasonable valuation. The evaluation of asset impairment requires us to make assumptions about future cash flows over the life of the asset being evaluated. These assumptions require significant judgment and actual results may differ from assumed or estimated amounts.

Deferred Tax Assets.

We currently have significant deferred tax assets as a result of foreign net operating loss carryforwards, tax credit carryforwards and temporary differences between taxable income on our tax returns and income before income taxes under U.S. generally accepted accounting principals. A deferred tax asset generally represents future tax benefits to be received when these carryforwards can be applied against future taxable income or when expenses previously reported in our financial statements become deductible for income tax purposes. We assess the realizability of our deferred tax assets and the need for a valuation allowance based on Statement of Financial Accounting Standards No. 109.

In the third quarter of fiscal 2002, we recorded a full valuation allowance against our deferred tax assets. Our decision to record the valuation allowance was based on the cumulative losses we had incurred over the three years prior to that date, the fact that we were continuing to generate operating losses and that we fully utilized our loss carryback benefit in 2002. From the third quarter of 2002 through the third quarter of 2005, we continued to provide a full valuation allowance against all future tax benefits produced by our operating results.

During the fourth quarter of 2005, we reduced the valuation allowance on our deferred tax assets initially established in the third quarter of 2002, resulting in a non-cash income tax benefit of $3.7 million.

We considered a number of factors in our decision to reduce the valuation allowance on deferred tax assets in 2005, and our ongoing assessment of the realizability of our deferred tax assets in 2006, including our anticipated level of profitability in the future, our history of recent profitability and cumulative profitability since inception, and utilization of our available U.S. based net operating loss carryforwards. After considering these factors, we concluded that a reduction in the valuation allowance was appropriate in 2005. Accordingly the benefit we will derive in future accounting periods from deductible temporary differences has been reflected as a deferred tax asset on our balance sheet.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We invest excess funds not required for current operations in marketable securities. The investment policy for these marketable securities is approved annually by the Board of Directors and administered by management. A third party, approved by our Board of Directors, manages the portfolio at the direction of our management. The investment policy dictates that marketable securities consist of U.S. Government or U.S. Government agency securities, various tax exempt securities or certain approved corporate instruments with maturities of five years or less and an average portfolio maturity of not more that 18 months. As of December 31, 2006 our portfolio of marketable securities had an average term to maturity of less than one year. All marketable securities are classified as available for sale and carried at fair value. We estimate that a hypothetical 1% increase in market interest rates would decrease the market value of our marketable securities by approximately $0.2 million. If such a rate increase occurred, our net income would only be impacted if securities were sold prior to maturity.

We enter into foreign currency swap agreements to hedge short term inter-company financing transactions with our subsidiary in the United Kingdom. These currency swap agreements are structured to mature near the last day of each quarter, and are designated as cash flow hedges. At December 31, 2006, we had one open swap agreement that was purchased on December 29, 2006. As a result, any unrealized gains or losses as of December 31, 2006 were inconsequential. During the year ended December 31, 2006, we recognized a net loss of approximately $0.3 million from settlement of foreign currency swap agreements that offset the approximately $0.3 million transaction gain on the underlying inter-company balance.

Our foreign currency swap agreements contain credit risk to the extent that our bank counter-parties may be unable to meet the terms of the agreements. We minimize such risk by limiting our counter-parties to major financial institutions. We do not expect material losses as a result of defaults by other parties.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CONSOLIDATED BALANCE SHEETS

CYBEROPTICS CORPORATION

(In thousands, except share information)	**As of December 31, 2006**	**2005**
ASSETS		
Cash and cash equivalents	$30,056	$19,592
Marketable securities	12,175	15,607
Accounts receivable, less allowance for doubtful accounts of $221 and $286 in 2006 and 2005, respectively	10,471	9,775
Inventories	8,357	7,512
Other current assets	868	924
Deferred tax assets, net	2,725	1,942
Total current assets	64,652	55,352
Marketable securities	6,776	5,941
Equipment and leasehold improvements, net	1,814	1,378
Intangible and other assets, net	1,214	1,737
Goodwill	5,160	4,856
Deferred tax assets, net	2,394	3,763
Total assets	$82,010	$73,027
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$3,783	$2,633
Advance customer payments	76	428
Accrued expenses	5,131	3,776
Total current liabilities	8,990	6,837
Commitments		
Stockholders equity:		
Preferred stock, no par value, 5,000,000 shares authorized, none outstanding		
Common stock, no par value, 37,500,000 authorized, 8,861,909 and 8,899,409 shares issued and outstanding at December 31, 2006 and 2005, respectively	49,544	49,351
Accumulated other comprehensive loss	(453)	(700)
Retained earnings	23,929	17,539
Total stockholders equity	73,020	66,190
Total liabilities and stockholders equity	$82,010	$73,027

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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CONSOLIDATED STATEMENTS OF OPERATIONS

CYBEROPTICS CORPORATION

(In thousands, except per share amounts)	Year ended December 31, 2006	2005	2004
Revenues	$57,089	$42,179	$58,037
Cost of revenues	27,188	19,107	23,910
Gross margin	29,901	23,072	34,127
Research and development expenses	8,112	7,095	7,623
Selling, general and administrative expenses	14,077	12,044	13,102
Restructuring and severance costs			169
Amortization of intangibles	591	829	908
Income from operations	7,121	3,104	12,325
Interest income and other	1,943	951	343
Income before income taxes	9,064	4,055	12,668
Income tax provision (benefit)	2,674	(3,095)	2,042
Net income	$6,390	$7,150	$10,626
Net income per share Basic	$0.71	$0.80	$1.23
Net income per share Diluted	$0.70	$0.79	$1.18
Weighted average shares outstanding Basic	8,991	8,882	8,629
Weighted average and common equivalent shares outstanding Diluted	9,081	9,026	9,003

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

CYBEROPTICS CORPORATION

(In thousands)	Year ended December 31, 2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$6,390	$7,150	$10,626
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,884	1,996	2,114
Provision for doubtful accounts	38	68	23
Provision for inventory obsolescence	373	123	303
Deferred income tax provision (benefit)	735	(3,672)	180
Foreign currency transaction (gains) losses	(294)	351	(268)
Tax benefit from stock option exercise		98	678
Stock compensation expense	778		
Changes in operating assets and liabilities:			
Accounts receivable	(734)	(2,420)	326
Inventories	(1,573)	(777)	(3,141)
Other current assets	79	(474)	(120)
Accounts payable	1,143	1,090	(1,558)
Advance customer payments	(352)	(1)	429
Accrued expenses	1,342	(1,891)	2,100
Net cash provided by operating activities	9,809	1,641	11,692
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities of available for sale marketable securities	16,670	7,310	12,791
Purchases of available for sale marketable securities	(13,983)	(13,997)	(14,386)
Purchase of license			(500)
Additions to equipment and leasehold improvements	(1,131)	(1,012)	(467)
Additions to patents	(266)	(199)	(214)
Net cash provided (used) by investing activities	1,290	(7,898)	(2,776)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from exercise of stock options	1,459	435	4,702
Excess tax benefits from equity compensation plans	185		
Proceeds from issuance of common stock under Employee Stock Purchase Plan	326	471	444
Repurchase of common stock and other	(2,579)	(473)	
Net cash provided (used) by financing activities	(609)	433	5,146
Effects of exchange rate changes on cash and cash equivalent	(26)		
Net increase (decrease) in cash and cash equivalents	10,464	(5,824)	14,062
Cash and cash equivalents beginning of year	19,592	25,416	11,354
Cash and cash equivalents end of year	$30,056	$19,592	$25,416

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

CYBEROPTICS CORPORATION

(In thousands)	Common Stock		Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholders Equity
	Shares	Amount			
BALANCE, DECEMBER 31, 2003	8,291	$42,415	$ (426)	$(237)	$ 41,752
Excess tax benefit from exercise of stock options		678			678
Exercise of stock options net of shares exchanged as payment and subsequently retired	494	4,702			4,702
Issuance of common stock under Employee Stock Purchase Plan	62	444			444
Comprehensive income:					
Market value adjustments of marketable securities			(195)		(195)
Cumulative translation adjustment			(56)		(56)
Net income				10,626	10,626
Total comprehensive income					10,375
BALANCE, DECEMBER 31, 2004	8,847	$48,239	$ (677)	$10,389	$ 57,951
Excess tax benefit from exercise of stock options		679			679
Exercise of stock options net of shares exchanged as payment and subsequently retired	51	435			435
Issuance of common stock under Employee Stock Purchase Plan	39	471			471
Repurchase of common stock	(38)	(473)			(473)
Comprehensive income:					
Market value adjustments of marketable securities			31		31
Cumulative translation adjustment			(54)		(54)
Net income				7,150	7,150
Total comprehensive income					7,127
BALANCE, DECEMBER 31, 2005	8,899	$49,351	$ (700)	$17,539	$ 66,190
Excess tax benefit from exercise of stock options		185			185
Exercise of stock options net of shares exchanged as payment and subsequently retired	144	1,459			1,459
Stock compensation		802			802
Issuance of common stock under Employee Stock Purchase Plan	29	326			326
Repurchase of common stock	(210)	(2,579)			(2,579)
Comprehensive income:					
Market value adjustments of marketable securities			58		58
Cumulative translation adjustment			189		189
Net income				6,390	6,390
Total comprehensive income					6,637

BALANCE, DECEMBER 31, 2006	8,862	$49,544	$ (453)	$23,929	$ 73,020

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CYBEROPTICS CORPORATION

NOTE 1 BUSINESS DESCRIPTION AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business

We are a leading global supplier of optical process control sensors and inspection systems that are used to control the manufacturing process and to ensure the quality of electronic circuit boards manufactured by our customers using surface mount technology (SMT). We also manufacture and sell sensors that assist with yield improvement, and the placement and transport of wafers during semiconductor fabrication.

Principles of Consolidation

The consolidated financial statements include the accounts of CyberOptics Corporation and its wholly-owned subsidiaries. In these Notes to the Consolidated Financial Statements, these companies are collectively referred to as CyberOptics, we, us, or our. All significant inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

We consider all highly liquid investments purchased with an original maturity of 90 days or less to be cash equivalents. Cash and cash equivalents consist of funds maintained in demand deposit accounts, money market accounts, corporate debt instruments and U.S. Government backed obligations.

Marketable Securities

Marketable securities generally consist of U.S. government or U.S. government backed obligations and corporate debt instruments. Marketable securities are classified as short-term or long-term in the balance sheet based on their maturity date and expectations regarding sales. All marketable securities have maturities of five years or less.

All marketable securities are classified as available for sale, with a carrying amount of $18,951,000 at December 31, 2006 and $21,548,000 at December 31, 2005. At December 31, 2006, short-term marketable securities included U.S. government backed obligations of $10,180,000 and corporate debt instruments of $1,995,000, while long-term marketable securities included U.S. government backed obligations of $5,006,000 and corporate debt instruments of $1,770,000. At December 31, 2005, both short and long term marketable securities consisted entirely of U.S. government or U.S government backed obligations.

Available for sale securities are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders equity until realized. These fair values are primarily determined using quoted market prices. The carrying amounts of securities, for purposes of computing unrealized gains and losses, are determined by specific identification. The cost of securities sold is determined by specific identification. Net unrealized holding gains and losses and realized gains and losses were not significant for the periods presented. Unrealized losses (pre-tax) of $18,000 at December 31, 2006 and $109,000 at December 31, 2005 were recorded as a component of accumulated other comprehensive loss in stockholders equity.

Inventories

Inventories are stated at the lower of cost or market, with cost determined using the first-in, first-out (FIFO) method. Appropriate consideration is given to deterioration, obsolescence, and other factors in evaluating net realizable value.

Allowance for Doubtful Accounts

Allowances for doubtful accounts are maintained for estimated losses resulting from the inability of our customers to make required payments. In making the determination of the appropriate allowance for doubtful accounts, we consider specific accounts, historical write-offs, changes in customer relationships and credit worthiness and concentrations of credit risk. Specific accounts receivable are written-off once a determination is made that the account is uncollectible.

Equipment and Leasehold Improvements

Equipment and leasehold improvements are stated at cost. Significant additions or improvements extending asset lives are capitalized, while repairs and maintenance are charged to expense as incurred. In progress costs are capitalized with depreciation beginning when assets are placed in service. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets, ranging from three to ten years. Leasehold improvements are depreciated using the straight-line method over the shorter of the asset useful life or the underlying lease term. Gains or losses on dispositions are included in current operations.

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Intangible Assets

Identified intangible assets (excluding goodwill) are being amortized on a straight-line basis over periods ranging from four to ten years, based upon their estimated life. The straight-line method of amortization reflects an appropriate allocation of the cost of intangible assets to earnings in proportion to the economic benefits obtained by us in each reporting period.

Intangible and other long lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. An impairment loss would be recognized when future undiscounted cash flows expected to result from use of the asset and eventual disposition are less than the carrying amount. We periodically assess the potential impairment of our intangible and other long-lived assets based on anticipated un-discounted cash flows.

Goodwill represents the excess of purchase price over the fair value of net assets acquired in a business combination. We evaluate the carrying value of goodwill for our reporting units during the fourth quarter of each year and between annual evaluations if events occur or circumstances change that indicate goodwill might be impaired. Goodwill is tested by comparing the fair the value of each reporting unit, as determined based on their future estimated discounted cash flows, to the carrying value for each reporting unit.

Patents

Patents consist of legal and patent registration costs for protection of our proprietary sensor technology. We amortize patent costs on a straight-line basis over a three year period, based upon their estimated life.

Revenue Recognition

Revenue from all customers, including distributors, is recognized when all significant contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. Generally, revenues are recognized upon shipment under FOB shipping point terms. Estimated returns and warranty costs are recorded at the time of sale. Sales of some surface mount technology (SMT) products may require customer acceptance due to performance or other acceptance criteria included in the terms of sale. For these SMT product sales, revenue is recognized at the time of customer acceptance.

When a sale involves multiple elements revenue is allocated to each respective element in accordance with Emerging Issues Task Force (EITF) 00-21 Accounting for Revenue Arrangements with Multiple Deliverables. Allocation of revenue to undelivered elements of the arrangement is based on fair value of the element being sold on a stand-alone basis.

Costs related to products delivered are recognized in the period revenue is recognized. Cost of goods sold consists primarily of direct labor, manufacturing overhead, raw materials and components and excludes amortization of intangible assets.

Foreign Currency Translation

Financial position and results of operations of our international subsidiaries are measured using local currency as the functional currency. Assets and liabilities of these operations are translated at the exchange rates in effect at each fiscal year-end. Statements of operations accounts are translated at the average rates of exchange prevailing during the year. Translation adjustments arising from the use of differing exchange rates from period to period are included as a cumulative translation adjustment in stockholders equity. Foreign currency transaction gains and losses are included as a component of net income.

Research and Development

Research and development (R&D) costs, including software development, are expensed when incurred. Software development costs are required to be expensed until the point that technological feasibility and proven marketability of the product are established; costs otherwise capitalizable after such point also are expensed because they are insignificant. All other R&D costs are expensed as incurred. Research and development expenses consist primarily of salaries, project materials, contract labor and other costs associated with ongoing product development and enhancement efforts.

Advertising Costs

We expense all advertising costs as incurred, and the amounts were not material for all periods presented.

Income Taxes

Deferred income taxes are recorded to reflect the tax consequences in future years of differences between the financial reporting and tax bases of assets and liabilities. Income tax expense is the sum of the tax currently payable and the change in the deferred tax assets and liabilities during the period, excluding changes in deferred tax assets recorded to equity and goodwill. Valuation allowances are established when, in the opinion of management, there is uncertainty that some portion or all of the deferred tax assets will not be realized. We assess the realizability of our deferred tax assets and the need for a valuation allowance based on Statement of Financial Accounting Standards No. 109.

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Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares plus common equivalent shares outstanding. Common equivalent shares consist of common shares issuable upon exercise of stock options, restricted stock units and from participation in our employee stock purchase plan, as calculated using the treasury stock method. The calculation of diluted income per common share includes potentially dilutive shares of 90,000 for the year ended December 31, 2006, 144,000 for the year ended December 31, 2005 and 374,000 for the year ended December 31, 2004. The calculation of diluted net income per common share excludes potentially dilutive shares of 260,000 for the year ended December 31, 2006, 227,000 for the year ended December 31, 2005 and 172,000 for the year ended December 31, 2004, because their effect would be anti-dilutive.

Stock-Based Compensation

Effective January 1, 2006, we adopted the provisions of SFAS 123(R) using the modified prospective method. Results of operations for prior annual periods have not been restated to reflect recognition of stock-based compensation expense. Upon adoption of SFAS 123(R), we applied an estimated forfeiture rate to unvested awards. Previously, we recorded forfeitures as incurred. SFAS 123(R) also requires the benefit of tax

deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under previous accounting guidance. This requirement reduces net operating cash flows and increases net financing cash flows in periods subsequent to adoption. Total cash flows however remain unchanged from those reported under previous accounting rules. We elected to use the alternative transition guidance known as the short-cut method provided by FASB Staff Position No. FAS 123(R)-3 to determine our pool of windfall tax benefits at adoption of SFAS No. 123(R). See Note 2 to the Consolidated Financial Statements for additional information on stock-based compensation under SFAS No. 123(R).

Fair Value Disclosures Prior to Adopting SFAS No. 123(R)

Prior to the January 1, 2006, we accounted for equity-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25 and related interpretations. As a result, no compensation expense for equity-based awards was recognized in our statement of operations prior to the first quarter of 2006, as all options granted had an exercise price equal to the market value of the award on the date of grant, and our employee stock purchase plan was deemed to be non-compensatory under APB No. 25. Results of operations for fiscal year 2005 and prior periods have not been restated to reflect recognition of compensation expense for equity-based awards. The following table illustrates the effect on net income and net income per share if we had adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation for the years ended December 31, 2005 and 2004:

	Year ended December 31	
(In thousands, except per share information)	**2005**	**2004**
Net income as reported	$7,150	$10,626
Deduct: Total stock-based compensation expense determined under fair value, net of related tax effects	831	(1,845)
Net income Pro forma	$7,981	$8,781
Net income per share:		
As reported Basic	$0.80	$1.23
Pro forma Basic	$0.90	$1.02
As reported Diluted	$0.79	$1.18
Pro forma Diluted	$0.89	