

MERCURY COMPUTER SYSTEMS INC
Form 10-Q
February 09, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2006**
OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO .**
COMMISSION FILE NUMBER 0-23599

MERCURY COMPUTER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

MASSACHUSETTS
(State or other jurisdiction of

incorporation or organization)

199 RIVERNECK ROAD

CHELMSFORD, MA
(Address of principal executive offices)

04-2741391
(I.R.S. Employer

Identification No.)

01824
(Zip Code)

978-256-1300

(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12 (b) OF THE

SECURITIES EXCHANGE ACT OF 1934:

Common Stock, Par Value \$.01 Per Share

Preferred Stock Purchase Rights

SECURITIES REGISTERED PURSUANT TO SECTION 12 (g) OF THE

SECURITIES EXCHANGE ACT OF 1934:

None

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Shares of Common Stock outstanding as of January 31, 2007: 22,231,124 shares

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED BALANCE SHEETS**

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

| | December 31, 2006 | June 30, 2006 |
|---|----------------------|-------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 16,736 | \$ 22,983 |
| Marketable securities | 73,916 | 113,057 |
| Accounts receivable, net of allowance of \$762 and \$584 at December 31, 2006 and June 30, 2006, respectively | 41,449 | 34,518 |
| Inventory | 26,149 | 19,870 |
| Deferred tax assets, net | 6,496 | 6,495 |
| Prepaid expenses and other current assets | 7,655 | 4,226 |
| Total current assets | 172,401 | 201,149 |
| Marketable securities | 45,882 | 26,162 |
| Property and equipment, net | 30,741 | 32,091 |
| Goodwill | 93,971 | 91,850 |
| Acquired intangible assets, net | 19,947 | 22,876 |
| Deferred tax assets, net | 9,513 | 7,535 |
| Other non-current assets | 4,395 | 4,783 |
| Total assets | \$ 376,850 | \$ 386,446 |
| Liabilities and Shareholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 18,224 | \$ 14,196 |
| Accrued expenses | 7,771 | 5,635 |
| Accrued compensation | 9,506 | 9,146 |
| Accrued warranty expenses | 2,326 | 2,601 |
| Notes payable and current portion of capital lease obligation | 60 | 10,067 |
| Income taxes payable | 1,574 | 3,247 |
| Deferred revenues and customer advances | 13,883 | 12,844 |
| Total current liabilities | 53,344 | 57,736 |
| Notes payable and non-current portion of capital lease obligation | 125,042 | 125,627 |
| Accrued compensation | 1,741 | 1,564 |
| Deferred tax liabilities, net | 7,852 | 8,732 |
| Other long-term liabilities | 979 | 798 |
| Total liabilities | 188,958 | 194,457 |

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Commitments and contingencies (Note J)

Shareholders' equity:

| | | |
|--|----------------|----------------|
| Preferred stock, \$.01 par value; 1,000 shares authorized; no shares issued or outstanding | | |
| Common stock, \$.01 par value; 85,000 shares authorized; 21,220 and 21,053 shares issued and outstanding at December 31, 2006 and June 30, 2006 respectively | 212 | 210 |
| Additional paid-in capital | 84,346 | 77,999 |
| Retained earnings | 101,120 | 113,808 |
| Accumulated other comprehensive income (loss) | 2,214 | (28) |
| Total shareholders' equity | 187,892 | 191,989 |
| | | |
| Total liabilities and shareholders' equity | \$ 376,850 | \$ 386,446 |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents**MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

| | Three months ended | | Six months ended | |
|--|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 | December 31, 2006 | December 31, 2005 |
| Net revenues | \$ 57,920 | \$ 62,501 | \$ 106,867 | \$ 129,401 |
| Cost of revenues | 25,249 | 23,699 | 47,197 | 48,218 |
| Gross profit | 32,671 | 38,802 | 59,670 | 81,183 |
| Operating expenses: | | | | |
| Selling, general and administrative | 22,938 | 21,215 | 43,621 | 41,374 |
| Research and development | 15,131 | 14,834 | 29,584 | 30,708 |
| Amortization of acquired intangible assets | 1,777 | 2,521 | 3,549 | 4,041 |
| In-process research and development | | | 3,060 | 548 |
| Restructuring | 287 | | 977 | |
| Impairment of long-lived assets | | | 79 | |
| Total operating expenses | 40,133 | 38,570 | 80,870 | 76,671 |
| (Loss) income from operations | (7,462) | 232 | (21,200) | 4,512 |
| Interest income | 1,601 | 1,483 | 3,399 | 3,052 |
| Interest expense | (1,594) | (1,050) | (2,548) | (2,086) |
| Other income (expense), net | 2,605 | (24) | 2,622 | (29) |
| (Loss) income before income taxes | (4,850) | 641 | (17,727) | 5,449 |
| Income tax (benefit) provision | (3,815) | (592) | (5,039) | 1,144 |
| Net (loss) income | \$ (1,035) | \$ 1,233 | \$ (12,688) | \$ 4,305 |
| Net (loss) earnings per share: | | | | |
| Basic | \$ (0.05) | \$ 0.06 | \$ (0.60) | \$ 0.21 |
| Diluted | \$ (0.05) | \$ 0.06 | \$ (0.60) | \$ 0.20 |
| Weighted-average shares outstanding: | | | | |
| Basic | 21,174 | 21,006 | 21,150 | 20,984 |
| Diluted | 21,174 | 21,376 | 21,150 | 21,435 |

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents**MERCURY COMPUTER SYSTEMS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(IN THOUSANDS)

(unaudited)

| | Six Months Ended December 31, | |
|---|--|-----------------|
| | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (12,688) | \$ 4,305 |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 8,939 | 8,678 |
| Stock-based compensation | 5,314 | 4,078 |
| Tax benefit from stock options | 46 | 550 |
| Changes in deferred income taxes | (3,002) | (2,553) |
| Non-cash interest | 423 | 432 |
| Impairment of long-lived assets | 79 | |
| In-process research and development | 3,060 | 550 |
| Loss on disposal of property and equipment | 100 | |
| Gross tax windfall from stock-based compensation | (46) | (180) |
| Changes in operating assets and liabilities, net of effects of businesses acquired: | | |
| Accounts receivable | (6,697) | (773) |
| Inventory | (6,189) | (3,673) |
| Prepaid expenses and other current assets | (3,199) | 3,213 |
| Other non-current assets | (18) | (255) |
| Accounts payable and accrued expenses | 3,637 | 504 |
| Deferred revenues and customer advances | 858 | 4,098 |
| Income taxes payable | (1,715) | 231 |
| Other long term liabilities | 352 | 1,138 |
| Net cash (used in) provided by operating activities | (10,746) | 20,343 |
| Cash flows from investing activities: | | |
| Purchases of marketable securities | (60,008) | (71,749) |
| Sales and maturities of marketable securities | 79,911 | 120,530 |
| Acquisition of businesses and assets, net of cash acquired | (1,513) | (67,535) |
| Purchases of property and equipment | (4,076) | (5,399) |
| Acquisition of intangible assets | (99) | (2,000) |
| Net cash provided by (used in) investing activities | 14,215 | (26,153) |
| Cash flows from financing activities: | | |
| Proceeds from employee stock plans | 1,058 | 4,789 |
| Proceeds from capital lease, net of repayments | 68 | |
| Gross tax windfall from stock-based compensation | 46 | 180 |
| Repurchases of common stock | (69) | (12,284) |
| Payments of principal under notes payable | (10,772) | (462) |
| Net cash used in financing activities | (9,669) | (7,777) |
| Effect of exchange rate changes on cash and cash equivalents | (47) | (16) |

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| | | |
|--|-----------|-----------|
| Net decrease in cash and cash equivalents | (6,247) | (13,603) |
| Cash and cash equivalents at beginning of period | 22,983 | 43,143 |
| Cash and cash equivalents at end of period | \$ 16,736 | \$ 29,540 |
| Cash paid during the period for: | | |
| Interest | \$ 1,028 | \$ 2,611 |
| Income taxes, net | 3,813 | 2,935 |
| Early debt retirement fee | 772 | |
| Supplemental disclosures non-cash activities: | | |
| Issuance of restricted stock awards to employees | \$ 790 | \$ 1,610 |
| Issuance of common stock related to acquisitions | | 5,172 |

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY COMPUTER SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

A. Description of Business

Mercury Computer Systems, Inc. (the Company or Mercury) designs, manufactures and markets high-performance embedded computer systems and software for embedded and other specialized computing markets. Our primary market segments are aerospace and defense which includes systems for radar, signals intelligence, sonar, smart weapons, and imagery applications; life sciences which includes systems for medical diagnostic imaging & visualization and picture archiving and communication systems (PACS); semiconductor which includes systems for semiconductor wafer inspection, reticle inspection and mask writing; geosciences which includes software for oil and gas exploration; and telecommunications applications.

B. Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany transactions and balances have been eliminated. Certain amounts in the consolidated financial statements for fiscal year 2006 have been reclassified to conform to the fiscal year 2007 presentation. These reclassifications had no effect on the previously reported net income or shareholders' equity.

In the fourth quarter of fiscal 2006, the Company reclassified its presentation of unpaid deferred revenue to deferred revenues to conform with current year presentation. Previously, all unpaid deferred revenue was classified as a contra-accounts receivable balance. Accordingly, the Company has revised the classification in the accompanying statements of cash flows which resulted in a change in cash provided by certain operating assets and liabilities, but did not impact the total cash provided by operating activities. This change in classification does not affect the previously reported consolidated statement of operations.

C. Stock-Based Compensation

STOCK OPTION PLANS

The number of shares authorized for issuance under the Company's 2005 Stock Incentive Plan (the 2005 Plan) is 1,942,264 shares as of the adoption of the 2005 Plan and will be increased by any future cancellations, forfeitures or terminations (other than by exercise) under the Company's 1997 Stock Option Plan. The 2005 Plan provides for the grant of non-qualified and incentive stock options, nonvested restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company's common stock at the date of grant. The options have a maximum term of 10 years and are exercisable at such times, in installments or otherwise, as the Board of Directors or a committee of the Board may determine. All nonvested restricted stock are granted with a time-based restriction period of no less than three years, provided however, that the time-based restriction may become vested incrementally over the three-year period. There were 1,940,565 shares available for future grant under the 2005 Plan at December 31, 2006.

The number of shares authorized for issuance under the Company's 1997 Stock Option Plan (the 1997 Plan) was 8,650,000 shares, of which 100,000 shares could be issued pursuant to nonvested restricted stock grants. The 1997 Plan provided for the grant of non-qualified and incentive stock options and nonvested restricted stock to employees and non-employees. All stock options were granted with an exercise price of not less than 100% of the fair value of the Company's common stock at the date of grant. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company's Board of Directors directed that no further grants of stock options or other awards would be made under the 1997 Plan. The foregoing action does not affect any outstanding awards under the 1997 Plan, which remain in full force and effect in accordance with their terms.

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The following table summarizes activity of the Company's stock option plans since June 30, 2006:

| | Options Outstanding | | Weighted Average |
|---|---------------------|------------------|------------------|
| | Number of | Weighted Average | Remaining |
| | | | Contractual Life |
| | Shares | Exercise Price | (Years) |
| Outstanding at June 30, 2006 | 4,836,595 | \$ 24.70 | 6.38 |
| Grants | 237,000 | 12.74 | |
| Exercises | (124,346) | 4.39 | |
| Cancellations (1) | (2,110,096) | 30.69 | |
| Outstanding at December 31, 2006 | 2,839,153 | \$ 20.14 | 6.43 |

(1) Options modified as part of the Company's shareholder-approved option exchange program, totaling 1,889,886 options, are included in the cancellations figure.

Information related to the stock options outstanding as of December 31, 2006 is as follows:

| Range of Exercise Prices | Number of Shares | Weighted-Average | Weighted-Average Exercise Price | Exercisable Number of Shares | Exercisable Price | Exercisable Weighted-Average Remaining Contractual Life (years) |
|--------------------------|------------------|------------------------------------|---------------------------------|------------------------------|-------------------|---|
| | | Remaining Contractual Life (years) | | | | |
| \$ 4.00 \$11.69 | 248,227 | 1.78 | \$ 9.04 | 248,227 | \$ 9.04 | |
| \$11.70 \$16.45 | 712,547 | 8.80 | \$ 14.96 | 146,547 | \$ 14.06 | |
| \$16.46 \$22.10 | 849,842 | 6.22 | \$ 18.93 | 705,417 | \$ 18.94 | |
| \$22.11 \$29.80 | 828,935 | 6.41 | \$ 25.02 | 605,040 | \$ 25.08 | |
| \$29.81 \$48.00 | 199,602 | 4.74 | \$ 37.31 | 199,602 | \$ 37.31 | |
| \$ 4.00 \$48.00 | 2,839,153 | 6.43 | \$ 20.14 | 1,904,833 | \$ 21.15 | 5.31 |

Options for the purchase of 3,336,670 shares were exercisable at June 30, 2006 with a weighted-average exercise price of \$26.18.

The aggregate intrinsic value of the Company's in-the-money outstanding and exercisable options as of December 31, 2006 and June 30, 2006 was \$1,125 and \$3,047, respectively. The intrinsic value of the options exercised during the three months ended December 31, 2006 and 2005 was \$79 and \$779, respectively. The intrinsic value of the options exercised during the six months ended December 31, 2006 and 2005 was \$150 and \$1,337, respectively. Nonvested common stock options are subject to the risk of forfeiture until the fulfillment of specified conditions. As of December 31, 2006, there was \$9,610 of total unrecognized compensation cost related to nonvested options granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 1.9 years from December 31, 2006. As of June 30, 2006, there was \$16,623 of total unrecognized compensation cost related to nonvested options granted under the Company's stock plans.

The following table summarizes the status of the Company's nonvested common stock awards (restricted stock) since June 30, 2006:

| | Restricted Stock Awards | |
|---|-------------------------|-----------------|
| | Number of | Grant Date |
| | Shares | Fair Value |
| Outstanding at June 30, 2006 | 592,596 | \$ 18.16 |
| Granted (1) | 532,935 | 9.89 |
| Vested | (5,498) | 26.75 |
| Forfeited | (49,998) | 17.91 |
| Outstanding at December 31, 2006 | 1,070,035 | \$ 14.01 |

-
- (1) Awards issued as a result of the Company's shareholder-approved option exchange program totaling 472,485 awards, at a weighted-average fair value of \$9.48, are included in the granted figure.

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Restricted stock awards are subject to the risk of forfeiture until the fulfillment of specified conditions. As of December 31, 2006, there was \$12,785 of total unrecognized compensation cost related to restricted stock awards granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 2.4 years from December 31, 2006. As of June 30, 2006, there was \$9,931 of total unrecognized compensation cost related to restricted stock awards granted under the Company's stock plans.

EMPLOYEE STOCK PURCHASE PLAN

During 1997, the Company adopted the 1997 Employee Stock Purchase Plan (ESPP) and authorized 500,000 shares for future issuance. In November 2006, the Company's shareholders approved an increase in the number of authorized shares under the 1997 Employee Stock Purchase Plan to 800,000 shares. Under the plan, rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at either the beginning or the end of each six-month offering period. The plan permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee's compensation as defined in the plan. There were 46,876 and 37,767 shares issued under the ESPP during the six months ended December 31, 2006 and 2005, respectively. Shares available for future purchase under the ESPP totaled 288,705 at December 31, 2006.

STOCK-BASED COMPENSATION

The Company has several stock-based employee compensation plans. On July 1, 2005, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS 123R), *Share-Based Payment*, using the modified prospective method, which results in the provisions of SFAS 123R only being applied to the consolidated financial statements on a going-forward basis (that is, the prior period results were not restated). Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period.

The Company recognized the full impact of its share-based payment plans in the consolidated statements of operations for the three and six months ended December 31, 2006 and 2005 under SFAS 123R and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. The following table presents share-based compensation expenses included in the Company's consolidated statement of operations:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|----------|----------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Cost of revenues | \$ 122 | \$ 22 | \$ 51 | \$ 167 |
| Selling, general and administrative | 2,379 | 1,601 | 4,135 | 2,976 |
| Research and development | 590 | 374 | 1,128 | 935 |
| Share-based compensation expense before tax | 3,091 | 1,997 | 5,314 | 4,078 |
| Income tax benefit | (511) | (540) | (1,487) | (1,220) |
| Net compensation expense | \$ 2,580 | \$ 1,457 | \$ 3,827 | \$ 2,858 |

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The weighted-average grant-date fair values of options granted during the three months ended December 31, 2006 and 2005 were \$6.77 and \$13.29, respectively, per option. The weighted-average grant-date fair values of options granted during the six months ended December 31, 2006 and 2005 were \$6.84 and \$13.90, respectively, per option. The fair value of options at date of grant was estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

| | Three Months Ended | | Six Months Ended | |
|-----------------------------|--------------------|---------|------------------|---------|
| | December 31, | | December 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| Option life (1) | 6 years | 6 years | 6 years | 6 years |
| Risk-free interest rate (2) | 4.6% | 4.3% | 4.7% | 4.1% |
| Stock volatility (3) | 49% | 50% | 51% | 48% |
| Dividend rate | 0% | 0% | 0% | 0% |

- (1) The option life was determined using the simplified method for estimating expected option life, as all options qualify as plain-vanilla options.
- (2) The risk-free interest rate for each grant is equal to the U.S. Treasury yield curve in effect at the time of grant for instruments with a similar expected life.
- (3) The stock volatility for each grant is measured using a weighted average of historical daily price changes of the Company's common stock over the most recent period equal to the expected option life of the grant, the historical short-term trend of the option and other factors, such as expected changes in volatility arising from planned changes in the Company's business operations.

The weighted-average fair value of stock purchase rights granted as part of the Company's ESPP during three months ended December 31, 2006 and 2005 was \$3.69 and \$7.13, respectively per right. The weighted-average fair value of stock purchase rights granted as part of the Company's ESPP during the six months ended December 31, 2006 and 2005 was \$3.71 and \$8.99, respectively per right. The fair value of the employees stock purchase rights were estimated using the Black-Scholes option-pricing model with the following assumptions:

| | Three Months Ended | | Six Months Ended | |
|-------------------------|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| Option life | 6 months | 6 months | 6 months | 6 months |
| Risk-free interest rate | 5.0% | 4.3% | 5.0% | 4.3% |
| Stock volatility | 30% | 61% | 30% | 61% |
| Dividend rate | 0% | 0% | 0% | 0% |

During the three months ended December 31, 2006 and 2005, the Company granted 37,750 and 52,990 shares, respectively, of restricted stock to certain employees and officers as permitted under the 1997 and 2005 Stock Plans. During the six months ended December 31, 2006 and 2005, the Company granted 60,450 and 63,066 shares, respectively, of restricted stock to certain employees and officers as permitted under the 1997 and 2005 Stock Plans. These restricted stock grants vest ratably in annual tranches over three to four years or cliff vest after four years and are subject to forfeiture if employment terminates during the prescribed retention period. Compensation expense for the number of shares issued is recognized ratably over the service period and is recorded in the consolidated statement of operations as a component of cost of revenues, selling, general and administrative and research and development expense.

STOCK OPTION EXCHANGE

On August 11, 2006, the Company commenced a shareholder-approved stock option exchange program pursuant to which eligible employees were given the opportunity to exchange outstanding options with exercise prices greater than \$23.00 per share for a lesser number of shares of restricted stock (and in certain cases, phantom stock units) in accordance with a fixed 4-to-1 exchange ratio. The Company's Board of Directors and its five most highly compensated executive officers (including its chief executive officer) were not eligible to participate in the exchange program.

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The election period for the exchange program expired on September 8, 2006, and on September 11, 2006, the Company accepted for exchange and cancellation options to purchase an aggregate of 1,889,886 shares. The Company granted awards covering 472,485 shares, with an aggregate incremental value on the day of the exchange of approximately \$500, in exchange for the cancelled options. The replacement awards were completely unvested at the time they were granted and will generally vest in three equal annual installments commencing on the first anniversary of the date of grant, with the exception of replacement awards granted to participating executive officers and to certain non-U.S. employees which will vest two-thirds on the second anniversary of the date of grant and one-third on the third anniversary of the date of grant.

D. Net Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted net (loss) earnings per share (in thousands, except share and per share data):

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|----------|----------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net (loss) income basic | \$ (1,035) | \$ 1,233 | \$ (12,688) | \$ 4,305 |
| Interest and amortization of deferred financing costs, net of tax, related to convertible notes | | | | |
| Adjusted net (loss) income for calculation of diluted earnings per share | \$ (1,035) | \$ 1,233 | \$ (12,688) | \$ 4,305 |
| Shares used in computation of net (loss) earnings per share basic | 21,174 | 21,006 | 21,150 | 20,984 |
| Potential dilutive common shares: | | | | |
| Shares issuable under Convertible Senior Notes | | | | |
| Stock option, restricted common stock and employee stock purchase plans | | 370 | | 451 |
| Shares used in computation of net (loss) earnings per share diluted | 21,174 | 21,376 | 21,150 | 21,435 |
| Net (loss) earnings per share basic | \$ (0.05) | \$ 0.06 | \$ (0.60) | \$ 0.21 |
| Net (loss) earnings per share diluted | \$ (0.05) | \$ 0.06 | \$ (0.60) | \$ 0.20 |

Equity instruments to purchase 3,864,532 and 4,465,201 shares of common stock were not included in the calculation of diluted net (loss) earnings per share for the three and six months ended December 31, 2006, respectively because the equity instruments were antidilutive. Equity instruments to purchase 3,970,959 and 3,703,975 shares of common stock were not included in the calculation of diluted net income per share for the three and six months ended December 31, 2005, respectively, because the equity instruments were antidilutive. Additionally, the 4,135,000 shares which represent the securities contingently issuable under the Company's outstanding Convertible Senior Notes were not included in the dilutive net (loss) earnings per share for the three and six months ended December 31, 2006 and 2005 because the equity instruments were antidilutive.

E. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged provided that the reporting entity has not yet issued financial statements for that fiscal year including financial statements for an interim period within that fiscal year. The Company is assessing SFAS No. 157 and has not yet determined the impact that the adoption of SFAS No. 157 will have on the Company's financial condition or results of operations.

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In September 2006, FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, which requires employers to: (a) recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status; (b) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year; and (c) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company does not expect the adoption of SFAS No. 158 to have a material impact on the Company's financial condition or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108)*. SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 permits registrants to record the cumulative effect of initial adoption by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings only if material under the dual method. SAB 108 is effective for fiscal years ending on or after November 15, 2006 and the Company plans to adopt SAB 108 in the fourth quarter of fiscal year 2007. The Company does not expect the adoption of SAB 108 to have a material impact on the Company's financial condition or results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. The Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, *Accounting for Income Taxes*. This Interpretation presents 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 is effective for fiscal years beginning after December 15, 2006. While additional efforts will be necessary to measure and disclose this information, the Company does not expect the adoption of Interpretation No. 48 to have a material impact on the Company's financial condition or results of operations.

In June 2006, the FASB reached consensus on Emerging Issues Task Force (EITF) No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (EITF 06-3)*. The scope of EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, and excise taxes. The Task Force affirmed its conclusion that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to Accounting Principles Board Opinion (APB) No. 22, *Disclosure of Accounting Policies*. If those taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. The Company does not expect the adoption of EITF No. 06-3 to have a material impact on the Company's financial condition or results of operations.

Table of Contents**F. Comprehensive (Loss) Income**

Total comprehensive (loss) income was as follows:

| | Three Months Ended | | Six Months Ended | |
|---|----------------------|----------------------|----------------------|----------------------|
| | December 31, 2006 | December 31, 2005 | December 31, 2006 | December 31, 2005 |
| Net (loss) income | \$ (1,035) | \$ 1,233 | \$ (12,688) | \$ 4,305 |
| Other comprehensive (loss) income: | | | | |
| Foreign currency translation adjustments | 1,097 | (439) | 1,760 | (629) |
| Change in unrealized gain (loss) on marketable securities | 107 | (67) | 483 | (354) |
| Other comprehensive income (loss) | 1,204 | (506) | 2,243 | (983) |
| Total comprehensive income (loss) | \$ 169 | \$ 727 | \$ (10,445) | \$ 3,322 |

G. Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market value, and consist of materials, labor and overhead. There are no amounts in inventory relating to contracts having production cycles longer than one year. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. The Company records a provision for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. Inventory was comprised of the following at December 31, 2006 and June 30, 2006:

| | December 31, | June 30, |
|-----------------|--------------|-----------|
| | 2006 | 2006 |
| Raw materials | \$ 9,403 | \$ 6,032 |
| Work in process | 11,566 | 9,666 |
| Finished goods | 5,180 | 4,172 |
| Total | \$ 26,149 | \$ 19,870 |

H. Operating Segment, Significant Customers and Geographic Information

Operating segments are defined as components of an enterprise evaluated regularly by the Company's senior management in deciding how to allocate resources and assess performance. The Company has five operating and reportable segments which were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company's management structure:

Defense Business Unit (Defense) This segment provides high-performance embedded computer systems as standard products to the defense markets by using commercial off-the-shelf (COTS) and selected rugged components. This segment also provides simulation software (commercial and defense) and customized design services to meet the specified requirements of a military application. On August 25, 2005, the Company acquired Echotek Corporation and their results are reported in this operating segment since the acquisition date. On September 5, 2006, the Company acquired Nav3D Corporation and their results are reported in this operating segment since the acquisition date. Beginning July 1, 2006, the VistaNav product line has been transferred from the CIV business unit to the Defense business unit, and the prior year tables below have been restated to conform to the current period presentation.

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Commercial Imaging and Visualization Business Unit (CIV) This segment provides high-performance embedded computer systems and two-dimensional (2D) and three-dimensional (3D) image processing and visualization software to the imaging and visualization market including life sciences (medical imaging and biotechnology) and geoscience (earth sciences including oil and gas

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exploration). On July 1, 2005, the Company acquired SoHard AG and their results are reported in this operating segment since the acquisition date. Beginning July 1, 2006, the VistaNav product line has been transferred from the CIV business unit to the Defense business unit, and the prior year tables below have been restated to conform to the current period presentation.

Advanced Solutions Business Unit (Advanced Solutions) This segment provides a host of high-performance I/O bandwidth computer systems, services and licenses of intellectual property for the semiconductor (photomask generation, reticle inspection and wafer inspection), telecommunication, military and aerospace markets.

Modular Products and Services Business Unit (MPS) This segment provides quick turn-around design for application-specific processor and high-performance I/O boards for the telecommunications, military and aerospace markets.

Other This segment is comprised of the Company's biotech venture which works with pharmaceutical and biotechnology researchers to generate and optimize drug candidates by use of the biotech venture's computational fragment-based drug design technology. The accounting policies of the reportable segments are the same as those described in Note B: Summary of Significant Accounting Policies in the Company's Annual Report filed on Form 10-K for the fiscal year ended June 30, 2006. The profitability measure employed by the Company and its chief operating decision maker for making decisions about allocating resources to segments and assessing segment performance is income (loss) from operations prior to stock compensation expense. As such, stock compensation expense has been excluded from each operating segment's income (loss) from operations below and reported separately to reconcile the reported segment income (loss) from operations to the consolidated operating income (loss) reported in the consolidated statements of operations. Additionally, asset information by reportable segment is not reported because the Company does not produce such information internally. The following is a summary of the performance of the Company's operations by reportable segment:

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| | Defense | Commercial Imaging and Visualization | Advanced Solutions | Modular Products and Services | Other | Stock Compensation Expense | Eliminations | Total |
|--|-----------|---|-----------------------|-------------------------------------|---------|----------------------------------|--------------|------------|
| THREE MONTHS ENDED | | | | | | | | |
| DECEMBER 31, 2006 | | | | | | | | |
| Net revenues to unaffiliated customers | \$ 26,788 | \$ 11,269 | \$ 14,149 | \$ 5,714 | \$ | \$ | \$ | \$ 57,920 |
| Intersegment revenues | | | | 104 | | | (104) | |
| Net revenues | 26,788 | 11,269 | 14,149 | 5,818 | | | (104) | 57,920 |
| Income (loss) from operations | (1,930) | (1,874) | (815) | 693 | (373) | (3,091) | (72) | (7,462) |
| Depreciation and amortization expense | 2,976 | 891 | 492 | 166 | 8 | | | 4,533 |
| THREE MONTHS ENDED | | | | | | | | |
| DECEMBER 31, 2005 | | | | | | | | |
| Net revenues to unaffiliated customers | \$ 33,822 | \$ 15,221 | \$ 10,740 | \$ 2,718 | \$ | \$ | \$ | \$ 62,501 |
| Intersegment revenues | | | | 76 | | | (76) | |
| Net revenues | 33,822 | 15,221 | 10,740 | 2,794 | | | (76) | 62,501 |
| Income (loss) from operations | (438) | 1,670 | 1,160 | (155) | | (1,997) | (8) | 232 |
| Depreciation and amortization expense | 3,296 | 1,041 | 416 | 135 | | | | 4,888 |
| SIX MONTHS ENDED | | | | | | | | |
| DECEMBER 31, 2006 | | | | | | | | |
| Net revenues to unaffiliated customers | \$ 49,041 | \$ 21,506 | \$ 26,992 | \$ 9,328 | \$ | \$ | \$ | \$ 106,867 |
| Intersegment revenues | | | | 345 | | | (345) | |
| Net revenues | 49,041 | 21,506 | 26,992 | 9,673 | | | (345) | 106,867 |
| Income (loss) from operations | (8,042) | (3,722) | (830) | 534 | (3,564) | (5,314) | (262) | (21,200) |
| Depreciation and amortization expense | 5,857 | 1,774 | 970 | 328 | | 10 | | 8,939 |
| SIX MONTHS ENDED | | | | | | | | |
| DECEMBER 31, 2005 | | | | | | | | |
| Net revenues to unaffiliated customers | \$ 74,904 | \$ 28,947 | \$ 20,050 | \$ 5,500 | \$ | \$ | \$ | \$ 129,401 |
| Intersegment revenues | | | | 220 | | | (220) | |
| Net revenues | 74,904 | 28,947 | 20,050 | 5,720 | | | (220) | 129,401 |
| Income (loss) from operations | 6,205 | 2,072 | 630 | (238) | | (4,078) | (79) | 4,512 |
| Depreciation and amortization expense | 5,532 | 2,051 | 828 | 267 | | | | 8,678 |

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The geographic distribution of the Company's revenues and long-lived assets is summarized as follows:

| | US | Europe | Asia Pacific | Eliminations | Total |
|---|------------|-----------|--------------|--------------|------------|
| THREE MONTHS ENDED DECEMBER 31, 2006 | | | | | |
| Net revenues to unaffiliated customers | \$ 50,265 | \$ 6,239 | \$ 1,416 | \$ | \$ 57,920 |
| Inter-geographic revenues | 1,864 | 72 | 8 | (1,944) | |
| Net revenues | 52,129 | 6,311 | 1,424 | (1,944) | 57,920 |
| Identifiable long-lived assets | 111,237 | 37,452 | 365 | | 149,054 |
| THREE MONTHS ENDED DECEMBER 31, 2005 | | | | | |
| Net revenues to unaffiliated customers | \$ 55,407 | \$ 5,326 | \$ 1,768 | \$ | \$ 62,501 |
| Inter-geographic revenues | 3,320 | 24 | | (3,344) | |
| Net revenues | 58,727 | 5,350 | 1,768 | (3,344) | 62,501 |
| Identifiable long-lived assets | 116,594 | 35,711 | 284 | | 152,589 |
| SIX MONTHS ENDED DECEMBER 31, 2006 | | | | | |
| Net revenues to unaffiliated customers | \$ 91,324 | \$ 12,874 | \$ 2,669 | \$ | \$ 106,867 |
| Inter-geographic revenues | 4,215 | 82 | 14 | (4,311) | |
| Net revenues | 95,539 | 12,956 | 2,683 | (4,311) | 106,867 |
| Identifiable long-lived assets | 111,237 | 37,452 | 365 | | 149,054 |
| SIX MONTHS ENDED DECEMBER 31, 2005 | | | | | |
| Net revenues to unaffiliated customers | \$ 114,048 | \$ 11,164 | \$ 4,189 | \$ | \$ 129,401 |
| Inter-geographic revenues | 7,565 | 258 | | (7,823) | |
| Net revenues | 121,613 | 11,422 | 4,189 | (7,823) | 129,401 |
| Identifiable long-lived assets | 116,594 | 35,711 | 284 | | 152,589 |

Foreign revenue is based on the country in which the Company's legal subsidiary is domiciled. Identifiable long-lived assets exclude deferred tax accounts, marketable securities and investments in subsidiaries.

Customers comprising 10% or more of the Company's revenues are as follows:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|-------|----------------------------------|-------|
| | 2006 | 2005 | 2006 | 2005 |
| Customer A (Advanced Solutions) | 12.7% | 10.0% | 13.5% | 9.7% |
| Customer B (Defense) | * | 17.2 | * | 15.6 |
| Customer C (Commercial Imaging and Visualization) | * | 12.7 | * | 10.6 |
| Customer D (Defense) | * | 12.1 | * | 14.4 |
| | 12.7% | 52.0% | 13.5% | 50.3% |

* Indicates that the amount is less than 10% of the Company's revenues for the respective period.

I. Goodwill and Acquired Intangible Assets

Acquired intangible assets result from the purchase of certain licensed technologies and business acquisitions, and consist of identifiable intangible assets, including completed technology, licensing agreements, customer backlog and customer relationships. Acquired intangible assets are reported at cost, net of accumulated amortization and are amortized on a straight-line basis over their estimated useful lives of up to seven years. Goodwill is the amount by which the cost of the acquired net assets in a business acquisition exceeded the fair values of the identifiable assets on the date of purchase. In accordance with the requirements of SFAS No. 142, Goodwill and Other Intangible Assets,

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goodwill is not amortized; rather goodwill is tested for impairment at least annually, on a reporting unit basis, or more frequently when events and circumstances occur indicating that the recorded goodwill may be impaired. If the book value of a reporting unit exceeds its fair value, the implied

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fair value of goodwill is compared with the carrying amount of goodwill. If the carrying amount of goodwill exceeds the implied fair value, an impairment loss is recorded in an amount equal to that excess.

The changes in the carrying amount of goodwill for the six months ended December 31, 2006 and the year ended June 30, 2006 were as follows:

| | Commercial | | Modular | Total |
|------------------------------|------------------------|---------------|--------------------------|-----------|
| | Imaging and Defense | Visualization | Products and Services | |
| JUNE 30, 2005 BALANCE | \$ 9,848 | \$ 18,180 | \$ 9,052 | \$ 37,080 |
| Goodwill recorded | 36,451 | 17,157 | | 53,608 |
| Foreign currency translation | | 1,162 | | 1,162 |
| JUNE 30, 2006 BALANCE | \$ 46,299 | \$ 36,499 | \$ 9,052 | \$ 91,850 |
| Goodwill recorded | 561 | | | 561 |
| Foreign currency translation | | 1,560 | | 1,560 |
| DECEMBER 31, 2006 BALANCE | \$ 46,860 | \$ 38,059 | \$ 9,052 | \$ 93,971 |

The increase in goodwill during the six months ended December 31, 2006 consisted of an increase of \$561 related to the acquisition by the Company of Nav3D Corporation (see Note M to the consolidated financial statements) and an increase of \$1,560 related to foreign currency translation adjustments.

The increase in goodwill during fiscal year 2006 consisted of an increase of \$17,157 related to the acquisition by the Company of SoHard AG (see Note M to the consolidated financial statements), an increase of \$36,451 related to the acquisition of Echotek Corporation (see Note M to the consolidated financial statements) and an increase of \$1,162 related to foreign currency translation adjustments.

Acquired intangible assets consisted of the following:

| | Gross | | Net | Average Useful Life |
|--|--------------------|-----------------------------|--------------------|---------------------------|
| | Carrying Amount | Accumulated Amortization | Carrying Amount | |
| DECEMBER 31, 2006 | | | | |
| Completed technology | \$ 17,566 | \$ (9,800) | \$ 7,766 | 3.3 years |
| Customer relationships | 12,727 | (3,874) | 8,853 | 5.4 years |
| Licensing agreements, trademarks and patents | 3,801 | (490) | 3,311 | 5.0 years |
| Assembled Workforce | 20 | (3) | 17 | 3.0 years |
| Backlog | 1,770 | (1,770) | | 0.4 years |
| Non-compete agreements | 142 | (142) | | 3.0 years |
| | \$ 36,026 | \$ (16,079) | \$ 19,947 | |
| JUNE 30, 2006 | | | | |
| Completed technology | \$ 17,330 | \$ (7,483) | \$ 9,847 | 3.3 years |
| Customer relationships | 12,206 | (2,646) | 9,560 | 5.4 years |
| Licensing agreements, trademarks and patents | 3,689 | (309) | 3,380 | 5.0 years |
| Backlog | 1,746 | (1,746) | | 0.4 years |
| Non-compete agreements | 135 | (46) | 89 | 3.0 years |

| | | |
|-----------|-------------|-----------|
| \$ 35,106 | \$ (12,230) | \$ 22,876 |
|-----------|-------------|-----------|

Amortization expense related to acquired intangible assets for the three months ended December 31, 2006 and 2005 was \$1,777 and \$2,521, respectively. Amortization expense related to acquired intangible assets for the

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six months ended December 31, 2006 and 2005 was \$3,549 and \$4,041, respectively. The Company also recorded an impairment charge of \$0 and \$79, respectively, during the three and six months ended December 31, 2006 related to the non-compete agreement. Estimated future amortization expense for acquired intangible assets remaining at December 31, 2006 is \$3,900 for fiscal 2007, \$7,801 for fiscal 2008, \$4,189 for fiscal 2009, \$2,492 for fiscal 2010, and \$1,565 thereafter.

J. Commitments and Contingencies

LEGAL CLAIMS

On December 20, 2006, the Internal Revenue Service (IRS) concluded its audit of the Company s tax years ended June 30, 2005, 2004 and 2003. The contested issues addressed in the IRS audit report concerned the Company s tax position on what constitutes qualifying research and development costs for purposes of the research and development tax credit. As of December 31, 2006, the Company reached a preliminary settlement with the IRS in the amount of \$1,574, including interest and penalties, which the Company has accrued in full and included in accrued expenses in the consolidated balance sheet at December 31, 2006. The Company expects the settlement to be finalized and paid during the third fiscal quarter of 2007.

In October 2006, the Company and one of its German subsidiaries commenced a series of legal actions in the District Court of Nuremberg-Fuerth, Germany against the former general manager of the subsidiary and a third-party company related to the former general manager alleging, among other things, that the former general manager had breached his non-competition obligations to the Company and the subsidiary and had otherwise engaged in conduct detrimental to the subsidiary while still employed by the subsidiary. In November 2006, the parties settled all of these legal actions, and a related labor suit, through the payment to the Company of damages in the amount of \$2,352 for breach of non-compete agreements, interference with the subsidiary s business and the assumption of certain non-medical professional service contracts by the third-party company. In connection with the settlement, the third-party company also agreed not to compete against the Company s German subsidiary in the field of image processing for medical and pharmaceutical applications within the European Union and Switzerland for a period ending on July 1, 2008. The settlement amount of \$2,352 was included in other income (expense) in the consolidated statements of operations.

On January 31, 2006, the Company received a written notice and request for indemnification from Seismic Micro-Technology, Inc. (SMT), which had been named as a defendant in a patent infringement suit entitled *Landmark Graphics Corporation, et al. v. Paradigm Geophysical Corporation, et al.*, filed in the United States District Court for the Southern District of Texas. SMT based its request for indemnification on the terms of certain application developer agreements it entered into with the Company and certain of its subsidiaries. The complaint alleges infringement by SMT of U.S. patent number 6,765,570, and seeks injunctive relief, treble damages, costs and attorneys fees. On February 22, 2006, SMT answered and filed counterclaims for declaratory judgment of non-infringement and invalidity. On February 28, 2006 the Company notified SMT that it would indemnify SMT from all costs and damages that may be awarded against SMT in the foregoing action, and would be responsible for attorneys fees and expenses incurred by SMT in defense of the action, subject to certain conditions, including the Company s right to control and direct the defense of the action on behalf of SMT. The Company believes there are meritorious defenses to the complaint and the Company intends to contest it vigorously. However, an adverse resolution of this litigation could have an adverse effect on the Company s consolidated financial position, results of operations or cash flows in the period in which the litigation is resolved. No amounts have been accrued for this loss contingency.

The Company is also subject to other legal proceedings, claims and tax audits that arise in the ordinary course of business. The Company does not believe the outcome of these matters will have a material adverse effect on its financial position, results of operations or cash flows.

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INDEMNIFICATION OBLIGATIONS

The Company's standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments the Company could be required to make under these indemnification provisions is, in some instances, unlimited.

K. Shareholders' Equity

In July 2005, the Company's Board of Directors authorized a share repurchase program for up to \$20,000 of the Company's currently outstanding common stock. This program is intended to offset the potential dilutive impact of the issuance of shares in connection with the Company's employee stock option and purchase plans. Repurchases of the Company's common stock may be made from time to time at management's discretion on the open market at prevailing market prices or in privately negotiated transactions. During the three and six months ended December 31, 2006, 3,000 shares of common stock were repurchased under this program for a total cost of \$49. During the three months ended December 31, 2005, 301,062 shares of common stock were repurchased under the program for a total cost of \$6,029. During the six months ended December 31, 2005, 531,862 shares of common stock were repurchased under this program for a total cost of \$12,284.

L. Product Warranty Liability

All of the Company's product sales generally include a 12 or 18-month standard hardware warranty, with the exception of product sales in the MPS segment, which generally include a three-year standard hardware warranty. At the time of product shipment, the Company accrues the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar transactions. The following table presents the changes in the Company's product warranty liability for the six months ended December 31, 2006 and 2005, respectively:

| | 2006 | 2005 |
|--|----------|----------|
| Beginning balance at June 30, | \$ 2,601 | \$ 1,620 |
| Accruals for warranties issued during the period | 1,589 | 3,519 |
| Warranty liabilities assumed in acquisitions | | 101 |
| Settlements made during the period | (1,864) | (2,117) |
| Ending balance at December 31, | \$ 2,326 | \$ 3,123 |

The Company recorded \$85 and \$16, respectively, for the fair value of product warranty liabilities assumed in connection with the acquisitions of Echotek Corporation and SoHard AG during the six months ended December 31, 2005.

M. Acquisitions

As part of a continuing growth strategy, the Company, from time to time, may acquire interests, either partially or wholly, in businesses the Company deems to be at favorable market prices. The Company generally attempts to make acquisitions from which it can expand its breadth of product offerings, increase its market share and/or realize sales and marketing synergies.

SoHard AG

On July 1, 2005, the Company acquired SoHard AG (SoHard) for a purchase price of \$23,294 (including direct transaction costs of \$1,003). SoHard is a market leader in the development of advanced software solutions

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for medical imaging systems, hardware and firmware for commercial embedded systems and software intelligence applications delivered via professional services. SoHard is headquartered in Furth, Germany. The results of SoHard's operations have been included in the Company's consolidated financial statements since July 1, 2005.

The acquisition of SoHard was accounted for in accordance with SFAS No. 141, *Business Combinations*. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at the date of acquisition. Fair values of intangible assets were determined by management using the assistance of independent third-party appraisals. The tangible long-lived assets were valued using the cost approach, while the intangible long-lived assets were valued using a discounted cash flow method. The excess of the purchase price over the estimated fair values of the tangible and intangible assets and liabilities was allocated to goodwill. Goodwill and intangible assets recognized in this transaction are not deductible for tax purposes. The Company believes that the high amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) the Company's willingness to pay for potential buyer-specific synergies related to market opportunities for combined existing and future product offering; (2) the Company's ability to protect its existing competitive advantages within certain product lines of its Commercial Imaging and Visualization Business Unit; and (3) the potential to sell Mercury products to existing SoHard customers.

The purchase price as of July 1, 2005 was allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

| | |
|---|-----------|
| Cash | \$ 888 |
| Accounts receivable | 1,180 |
| Inventory | 287 |
| Prepaid expenses and other current assets | 570 |
| Property and equipment | 418 |
| Customer relationships | 3,300 |
| Other acquired intangible assets (customer backlog, non-compete and completed technology) | 2,350 |
| In-process research and development | 450 |
| Goodwill | 17,157 |
| Current liabilities | (1,916) |
| Current portion of long-term notes payable | (36) |
| Deferred tax liabilities, net | (751) |
| Long-term notes payable | (603) |
| | \$ 23,294 |

The purchase price allocation was finalized in fiscal year 2006, upon completion of the fair-value appraisals of intangible assets and final assessment of the fair values of certain assumed assets and liabilities.

In-process research and development (IPR&D) consisted of one project under development at the acquisition date. Because the technological feasibility of this project had not been established and no future alternative uses existed, the purchased IPR&D was expensed at the acquisition date in the consolidated statement of operations. The value of the purchased IPR&D was determined using the residual income approach, which discounts expected future cash flows from projects under development to their net present value. Each project was analyzed to determine the technological innovations included; the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion.

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The amortization periods for the acquired intangible assets subject to amortization are as follows:

| | |
|---|----------------|
| Customer relationships | 6 years |
| Other acquired intangible assets (customer backlog, non-compete and completed technology) | 0.5 to 3 years |

Echotek Corporation

On August 31, 2005, the Company purchased Echotek Corporation (Echotek) for a purchase price of \$50,274 (including direct transaction costs of \$368). The purchase price (excluding transaction costs) was paid in a combination of cash totaling \$44,734 and 177,132 shares of Mercury common stock. The 177,132 shares of common stock were valued at \$5,172 based on the average closing price of the Company's common stock for the five-day period including two days before and after July 12, 2005, the date the Company executed the related merger agreement and announced the transaction. Based in Huntsville, Alabama, Echotek is a market leader in the development of data acquisition products. The results of Echotek's operations have been included in the Company's consolidated financial statements since September 1, 2005.

The acquisition of Echotek was accounted for in accordance with SFAS No. 141, *Business Combinations*. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at the date of acquisition. Fair values of intangible assets were determined management using the assistance of independent third-party appraisals. The tangible long-lived assets were valued using the cost approach, while the intangible long-lived assets were valued using a discounted cash flow method. The excess of the purchase price over the estimated fair value of the tangible and intangible assets and liabilities was allocated to goodwill. Goodwill and intangible assets recognized in this transaction are not deductible for tax purposes. The Company believes that the high amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) the Company's willingness to pay for potential buyer-specific synergies related to market opportunities for combined existing and future product offering; (2) the Company's intentions to utilize its financial stability and market presence to attract new customers that were not then customers of Echotek; and (3) the potential to continue developing next-generation technologies from the acquired workforce.

The purchase price as of August 31, 2005 was allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

| | |
|--|-----------|
| Accounts receivable | \$ 2,397 |
| Inventory | 1,219 |
| Prepaid expenses and other current assets | 133 |
| Property and equipment | 431 |
| Other assets | 2 |
| Goodwill | 36,451 |
| Completed technology | 10,230 |
| Customer relationships | 5,300 |
| Other acquired intangible assets (customer backlog and trademarks) | 2,050 |
| In-process research and development | 100 |
| Current liabilities | (989) |
| Deferred tax liabilities, net | (7,050) |
| | \$ 50,274 |

The purchase price allocation was finalized in fiscal year 2006, upon completion of the fair-value appraisals of intangible assets and final assessment of the fair values of certain assumed assets and liabilities.

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In-process research and development (IPR&D) consisted of eight projects under development at the acquisition date. Because the technological feasibility of these projects had not been established and no future alternative uses existed, the purchased IPR&D was expensed at the acquisition date and recorded in selling, general and administrative expense in the consolidated statement of operations. The value of the purchased IPR&D was determined using the residual income approach, which discounts expected future cash flows from projects under development to their net present value. Each project was analyzed to determine the technological innovations included; the utilization of core technology; the complexity, cost and time to complete development; any alternative future use or current technological feasibility; and the stage of completion.

The amortization period for the acquired intangible assets subject to amortization is as follows:

| | |
|--|----------------|
| Completed technology | 3 years |
| Customer relationships | 5 years |
| Other acquired intangible assets (customer backlog and trademarks) | 0.5 to 8 years |

The following table presents the Company's unaudited pro forma results of operations for the six months ended December 31, 2005, as if the Echotek acquisition had occurred at the beginning of the fiscal year. These pro forma results include adjustments related to the amortization of intangible assets with finite useful lives (totaling \$1,022 during the first six months of fiscal year 2006), adjustments to eliminate inter-company transactions (totaling \$13 during the first six months of fiscal year 2006), adjustments for non-recurring items (totaling \$741 of bonuses paid directly related to the acquisition during the first six months of fiscal year 2006) and adjustments for income tax effects (totaling \$26 during the first six months of fiscal year 2006). The table has been prepared for comparative purposes only and does not purport to be indicative of what would have occurred had the acquisition been made at the beginning of the period noted or of results that may occur in the future.

| For the six months ended December 31, | 2005 |
|---------------------------------------|------------|
| Net revenues | \$ 132,945 |
| Net income | 4,206 |
| Net earnings per share - basic | 0.20 |
| Net earnings per share - diluted | 0.19 |

Biotech

On July 25, 2006, the Company purchased an 18% equity interest in a development stage biotech company (Biotech) and acquired related intellectual property (IP) along with rights to any new or derivative IP for \$3,074 (including direct transaction costs of \$124 and put option of \$2,250). As part of this transaction, the other shareholders of Biotech were provided an option to put the remaining 82% equity interest to the Company for \$2,250 subject to certain adjustments. This put option for \$2,250 along with a deferred license payment of \$150 was accrued for at acquisition and included in the above-described purchase price consideration. If Biotech fails to exercise this put option, Biotech is required on December 31, 2007 to pay \$400 to the Company. Further, the Company is required to provide working capital financing to Biotech totaling \$950 at various points through April 1, 2007, which must be utilized as directed by the Company. Through December 31, 2006, the Company has provided \$550 of working capital cash to Biotech, of which \$252 was not utilized at December 31, 2006 and was included as cash and cash equivalents in the Company's consolidated balance sheet. Biotech works with pharmaceutical and biotechnology researchers to generate and optimize drug candidates by use of their computational fragment-based drug design technology. Biotech is currently headquartered in Cambridge, Massachusetts. The results of Biotech's operations have been included in the Company's consolidated financial statements since the acquisition date.

The acquisition of Biotech was accounted for as an asset acquisition. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at

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the date of acquisition. The intangible long-lived assets were valued using a discounted cash flow method. The excess of the purchase price over the estimated fair values of the tangible and intangible assets and liabilities was allocated to in-process research and development.

The purchase price as of July 25, 2006 was preliminarily allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

| | |
|---|----------|
| Cash and other current assets | \$ 2 |
| Acquired intangible assets (assembled workforce and completed technology) | 30 |
| In-process research and development | 3,060 |
| Other long term assets | 18 |
| Current liabilities | (36) |
| | \$ 3,074 |

The purchase price allocation is preliminary pending the final determination of the fair-value of intangible assets and assessment of the fair values of certain assumed assets and liabilities.

As of December 31, 2006, there was approximately \$2,400 of unpaid purchase price related to the Biotech acquisition. This liability is accrued and recorded in the consolidated balance sheet in accrued expenses and is expected to be paid by August 31, 2007.

The amortization periods for the acquired intangible assets subject to amortization are as follows:

| | |
|----------------------|---------|
| Completed technology | 5 years |
| Assembled workforce | 3 years |

Nav3D

On September 5, 2006, the Company purchased Nav3D Corporation (Nav3D) for \$850 in cash (including direct transaction costs of \$109), subject to certain post-closing adjustments. Nav3D works with OEM and end-user partners to create products using a combination of GPS navigation and motion sensing with three dimensional graphics. Nav3D is currently headquartered in San Carlos, California. The results of Nav3D's operations have been included in the Company's consolidated financial statements since the acquisition date.

The acquisition of Nav3D was accounted for in accordance with SFAS No. 141, *Business Combinations*. The purchase price of the acquisition was allocated to the assets acquired and liabilities assumed based on estimates of their respective fair values at the date of acquisition. The tangible long-lived assets were valued using the cost approach, while the intangible long-lived assets were valued using a discounted cash flow method. The excess of the purchase price over the estimated fair values of the tangible and intangible assets and liabilities was allocated to goodwill. Goodwill and intangible assets recognized in this transaction are not deductible for tax purposes. The Company believes that the high amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) the Company's willingness to pay for potential buyer-specific synergies related to market opportunities for combined existing and future product offering; (2) the willingness to pay for expertise that the Company believes will increase the Company's market presence in fields such as synthetic vision systems as well as unmanned aerial vehicles; (3) and the potential to sell Mercury products to existing Nav3D customers.

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The purchase price as of September 5, 2006 was preliminarily allocated based upon the fair value of the acquired assets and liabilities assumed as follows:

| | |
|---|---------------|
| Cash | \$ 11 |
| Accounts receivable | 35 |
| Prepaid expenses and other current assets | 4 |
| Property and equipment | 30 |
| Customer relationships | 290 |
| Completed technology | 80 |
| Goodwill | 561 |
| Current liabilities | (161) |
| | \$ 850 |

The purchase price allocation is preliminary pending the final determination of the fair-value of intangible assets and assessment of the fair values of certain assumed assets and liabilities.

The amortization periods for the acquired intangible assets subject to amortization are as follows:

| | |
|------------------------|---------|
| Customer relationships | 6 years |
| Completed technology | 7 years |

The pro forma statements reflecting the operating results of Nav3D as if Nav3D had been acquired as of July 1, 2005 would not differ materially from the operating results of the Company as reported.

N. Notes Payable

Notes payable consisted of the following:

| | December 31, | June 30, |
|---|---------------------|-------------------|
| | 2006 | 2006 |
| Convertible senior notes payable | \$ 125,000 | \$ 125,000 |
| Mortgage notes payable | | 9,997 |
| Other notes payable and capital lease obligations | 102 | 697 |
| Less: current portion | (60) | (10,067) |
| Total non-current notes payable | \$ 125,042 | \$ 125,627 |

The following summarizes the future cash payment obligations (excluding interest) as of December 31, 2006 (assuming the convertible senior notes are redeemed on the first optional redemption date):

| | |
|------------------|---------|
| Less than 1 year | \$ 60 |
| 1 2 years | 28 |
| 2 3 years | 125,014 |
| Thereafter | |

Convertible Senior Notes Payable

On April 29, 2004, the Company completed a private offering of \$125,000 aggregate principal amount of Convertible Senior Notes (the Notes), which mature on May 1, 2024 and bear interest at 2% per year, payable

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semiannually in arrears in May and November. The Notes are unsecured, rank equally in right of payment to the Company's existing and future senior debt, and do not subject the Company to any financial covenants.

Under certain circumstances, the Notes will be convertible into common stock at a conversion rate of 33.0797 shares per \$1,000 principal amount of the Notes, subject to adjustment in certain circumstances. The conversion rate is equal to an initial conversion price of approximately \$30.23 per share. At the option of the holder, the Notes may be converted on the final maturity date if, on or prior to May 1, 2019, the closing price of Mercury's common stock exceeds \$36.28 for at least 20 trading days in a specified 30-day period of each fiscal quarter or on any date after May 1, 2019, the closing price of Mercury's common stock exceeds \$36.28. The Notes may also be converted at the option of the holder if prior to May 1, 2019, the average trading price for the convertible senior notes is less than 98% of the average conversion value for the convertible senior notes during any five consecutive trading-day period. The convertible notes mature on May 1, 2024 and bear interest at 2% per year, payable semiannually in arrears in May and November. The convertible notes are unsecured, rank equally in right of payment to our existing and future senior debt, and do not subject the Company to any financial covenants. The holders may require the Company to repurchase the notes, in whole or in part, (a) on May 1, 2009, 2014 or 2019, (b) upon a change in control, or (c) if the Company's common stock is neither listed nor approved for trading on specified markets. At the Company's option, they may redeem any of the convertible notes on or after May 1, 2009 at a price equal to 100% of the principal amount of the convertible notes to be redeemed plus accrued and unpaid interest. As of December 31, 2006, no circumstances existed and no events had occurred that made the Notes convertible.

Upon issuance of the Notes, the Company received net proceeds of \$120,889 after offering expenses of \$4,111, which were recorded as deferred financing costs in other long-term assets on the balance sheet and are being amortized over the five-year term to May 1, 2009, the first optional redemption date of the debt. For the three months ended December 31, 2006 and 2005, respectively, additional interest expense from the amortization of these deferred financing costs totaled \$211 and \$216, respectively. For the six months ended December 31, 2006 and 2005, respectively, additional interest expense from the amortization of these deferred financing costs totaled \$423 and \$432, respectively. The unamortized balance of deferred financing costs totaled approximately \$1,974 and \$2,397 at December 31, 2006 and June 30, 2006, respectively.

Mortgage Notes Payable

In November 1999, the Company completed a lending agreement with a commercial financing company, issuing two 7.30% senior secured financing notes (the Mortgage Notes) due November 2014. The original principal amount of the Mortgage Notes totaled \$14,500. The Mortgage Notes were collateralized by the Company's corporate headquarters, which consists of two buildings. The terms of the Mortgage Notes, as amended, contained certain covenants, which, included the maintenance of an interest coverage ratio, certain leverage ratios and a minimum consolidated net worth. The Mortgage Notes also included significant prepayment penalties.

Since March 31, 2006, the Company had not been in compliance with certain of the financial covenants, and the Company elected to prepay the Mortgage Notes in full on October 19, 2006 instead of renegotiating the financial covenants with the holders of the Mortgage Notes. The amount paid by the Company in connection with the prepayment of the Mortgage Notes equaled \$10,463, which included the then outstanding principal amount of the Mortgage Notes plus a prepayment premium equal to \$708, and a waiver fee equal to \$15 in consideration of the noteholders waiver through October 19, 2006 of the Company's non-compliance with the financial covenants. The Company included the prepayment premium and waiver fee in interest expense in the consolidated statements of operations.

Other Notes Payable

As of December 31, 2006 the Company had other debt consisting of \$34 in notes payable for foreign subsidiaries (bearing an interest rate of 0%) and \$68 related to a capital lease obligation (bearing an interest rate of 7.18%).

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On September 1, 2006, the Company repaid the debt acquired in the SoHard AG acquisition. This early retirement of debt resulted in a cash payment of \$705, including \$64 related to prepayment penalties.

O. Property and Equipment

Property and equipment consisted of the following at December 31, 2006 and June 30, 2006:

| | December 31, | June 30, |
|---|--------------|-----------|
| | 2006 | 2006 |
| Computer equipment and software | \$ 58,228 | \$ 55,026 |
| Buildings | 15,823 | 15,823 |
| Furniture and fixtures | 7,052 | 6,932 |
| Land | 3,350 | 3,350 |
| Building and leasehold improvements | 3,502 | 3,357 |
| Capital leases | 80 | |
| Machinery and equipment | 1,669 | 1,224 |
| | 89,704 | 85,712 |
| Less: accumulated depreciation and amortization | (58,963) | (53,621) |
| | \$ 30,741 | \$ 32,091 |

Depreciation and amortization expense related to property and equipment for the three months ended December 31, 2006 and 2005 was \$2,757 and \$2,381, respectively. Depreciation and amortization expense related to property and equipment for the six months ended December 31, 2006 and 2005 was \$5,390 and \$4,637, respectively.

At December 31, 2006 and June 30, 2006 the Company had \$42 and \$5, respectively, in construction in process (CIP) related to the Company's implementation of Oracle's enterprise resource procurement (ERP) system, which is classified as computer software. In the six months ended December 31, 2006, the Company capitalized \$813 related to the ERP system and placed \$776 in service. Project-to-date, the Company has capitalized \$2,552 related to the ERP system and placed \$2,510 in service. The Company does not depreciate CIP until it is placed into service.

P. Income Tax (Benefit) Provision

The Company recorded a tax benefit during the six months ended December 31, 2006 reflecting a 28.4% effective tax benefit rate, as compared to 21.0% effective tax expense rate for the same period in fiscal 2005. The effective tax rate for the six months ended December 31, 2006 reflects the impact of several discrete items, primarily the settlement with the IRS relating the research and development tax credits (See Note J to the consolidated financial statements) and, consequently, the adjustment of the fiscal year 2006 research and development tax credit. Excluding the impact of all discrete items, the Company's fiscal year 2007 annual effective tax benefit rate would be estimated at 34.0%. The effective tax rate for the six months ended December 31, 2006 was lower than the U.S. statutory tax rate of 35% primarily due to losses, research and development tax credits, the extraterritorial income (ETI) benefit and other state tax benefits.

The Company recorded a tax benefit of \$3,815 for the three months ended December 31, 2006 in order to adjust the 10.1% effective annual tax benefit rate used in the three months ended September 30, 2006 to the 34.0% effective annual tax benefit rate currently expected for the full fiscal year. The forecasted annual effective tax benefit rate was increased in the current quarter as a result of increased net loss projections and the extension of the federal research and development credits.

Q. Restructuring Provision

In response to lower than expected demand in certain sectors of the Company's business, as well as the need to maintain a competitive cost structure and integrate the Company's Myriad Logic, Inc. acquisition, the

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Company incurred a gross restructuring charge of \$1,023 during the six months ended December 31, 2006 that was recorded related to the Company's 2007 restructuring plan (the 2007 Plan). The 2007 Plan included \$835 related to involuntary separation and retention costs for 13 employees, \$157 related to the abandonment of two operating leases and \$31 for other costs. These expenses were primarily related to the Defense Business Unit and are expected to be paid within the next 12-months.

In third and fourth quarters of fiscal year 2006, the Company also recorded a gross restructuring charge of \$2,142 related to the Company's 2006 restructuring plan (the 2006 Plan). The 2006 Plan included \$2,065 related to involuntary separation costs for 55 employees, \$25 for a facility closure and \$52 for other costs (primarily legal costs). All of these expenses were principally in the Defense and Commercial Imaging and Visualizations business units with a modest amount in the Advanced Solutions and Modular Products and Services business units. A gross incremental provision of \$12 was recorded during the six months ended December 31, 2006 to affect a slight adjustment to the severance estimate. The restructuring charges are classified as operating expenses in the consolidated statements of operations and are expected to be paid within the next 12-months.

The remaining restructuring liability is classified as accrued expenses in the consolidated balance sheets.

The following table presents the detail of expenses by operating segment for the 2006 Plan and 2007 Plan:

| | Severance | Facilities | Other | Total |
|--|------------------|-------------------|--------------|--------------|
| Restructuring liability at June 30, 2006 | \$ 433 | \$ | \$ | \$ 433 |
| Defense | \$ 748 | 107 | \$ 27 | \$ 882 |
| CIV | 48 | 50 | 4 | 102 |
| Advanced Solutions | 51 | | | 51 |
| MPS | | | | |
| Total provision | \$ 847 | \$ 157 | \$ 31 | \$ 1,035 |
| Cash paid | (846) | (89) | (31) | (966) |
| Reversals | (58) | | | (58) |
| Restructuring liability at December 31, 2006 | \$ 376 | \$ 68 | \$ | \$ 444 |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FORWARD-LOOKING STATEMENTS

From time to time, information provided, statements made by our employees or information included in our filings with the Securities and Exchange Commission may contain statements that are not historical facts but that are forward-looking statements, which involve risks and uncertainties. The words may, will, should, plans, expects, anticipates, continue, estimate, project, intend, and similar expressions identify forward-looking statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include, but are not limited to, general economic and business conditions, including unforeseen economic weakness in our markets, effects of continued geo-political unrest and regional conflicts, competition, changes in technology and methods of marketing, delays in completing various engineering and manufacturing programs, changes in customer order patterns, changes in product mix, continued success in technological advances and delivering technological innovations, continued funding of defense programs, timing of such funding, market acceptance of our products, shortages in components, production delays due to performance quality issues with outsourced components, inability to fully realize the expected benefits from acquisitions or delays in realizing such benefits, challenges in integrating acquired businesses and achieving anticipated synergies, difficulties in retaining key employees and customers, and various other factors beyond our control. These risks and uncertainties also include such additional risk factors as set forth under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, and other important factors disclosed previously and from time to time in our other filings with the Securities and Exchange Commission. We caution readers not to place undue reliance upon any such forward-looking statements, which speak only as of the date made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

OVERVIEW

We design, manufacture and market high-performance embedded, real-time digital signal and image processing solutions. Our solutions play a critical role in a wide range of applications, transforming sensor data to information for analysis and interpretation. In military reconnaissance and surveillance platforms our systems process real-time radar, sonar, and signals intelligence data. Our systems are also used in state-of-the-art medical diagnostic imaging devices including MRI, PET, and digital X-ray, and in semiconductor imaging applications including photomask generation and wafer inspection. We provide advanced three-dimensional (3D) image processing and visualization software and optimized systems to diverse end markets including life sciences, geosciences, and simulation. We also provide radio frequency (RF) products for enhanced communications capabilities in military and commercial applications.

We are an OEM supplier to our commercial markets and conduct business with our defense customers via commercial off-the-shelf (COTS) distribution, which means that product requests by customers are a primary driver of revenue fluctuations from quarter to quarter. Customers specify delivery date requirements that coincide with their need for our product. Because these customers may use our products in connection with a variety of defense programs or other projects with different sizes and durations, a customer's orders for one quarter generally do not indicate a trend for future orders by that customer. Additionally, order patterns of one customer do not necessarily correlate with the order patterns of another customer and, therefore, we generally cannot identify sequential quarterly trends, even within our business units.

During the six months ended December 31, 2006, revenues decreased by \$22.5 million compared to the same period in fiscal 2006, primarily as a result of a \$25.9 million decrease in revenues from our Defense Business Unit (Defense) and a \$7.4 million decrease in revenues from our Commercial Imaging and Visualization Business Unit (CIV), offset by a \$6.9 million increase from our Advanced Solutions Business Unit

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(Advanced Solutions) and a \$3.8 million increase from our Modular Product and Services Business Unit (MPS). Gross margins as a percentage of revenues decreased from 62.7% during the six months ended December 31, 2005 to 55.8% during the same period in fiscal 2007, primarily due to the spread of fixed costs over a lower revenue base in our Defense Business Unit, higher material costs and an unfavorable shift in customer and product mix, including increased revenues related to the Cell Broadband Engine (BE) processor family of products which carry a lower margin than our legacy products. Operating expenses increased by \$4.2 million during the six months ended December 31, 2006 as compared to the same period in fiscal year 2006 primarily due to a \$3.1 million in-process research and development charge incurred as a result of the Biotech acquisition.

In response to lower than expected demand in certain sectors of our business, as well as the need to maintain a competitive cost structure and integrate our previous acquisitions, we incurred a restructuring charge of \$1.0 million during the six months ended December 31, 2006. We believe the restructuring was necessary given the state of our markets and ability to absorb the capacity of our Silver Springs facility into our other facilities. We believe that this workforce reduction will enable us to remain competitive in the market and improve our long-term results. We intend to continue to monitor our cost structure and its impact on our results. Our cost structure is dependent, in part, on the timely development and continued visibility of the markets in which we currently compete as well as our ability to continue to identify and exploit new markets for our products. To the extent that our ability to grow the business, or certain areas of the business, does not occur as we forecasted, additional changes to our cost structure may be necessary.

On July 1, 2005, we acquired SoHard AG for \$23.3 million, consisting of cash payments of \$22.3 million and transaction costs of \$1.0 million directly related to the acquisition. SoHard is a market leader in the development of advanced software solutions for medical imaging systems, hardware and firmware for commercial embedded systems and software intelligence applications delivered via professional services. On August 31, 2005, we purchased Echotek Corporation for \$50.3 million, consisting of cash payments of \$44.7 million, 177,132 shares of Mercury common stock valued at \$5.2 million and transaction costs of \$0.4 million directly related to the acquisition. The results of SoHard's and Echotek's operations have been included in our consolidated financial statements since the acquisition date.

On July 25, 2006, we purchased an 18% equity interest in a development stage biotech company (Biotech) and acquired related intellectual property (IP) along with rights to any new or derivative IP for \$3.1 million (including direct transaction costs of \$0.1 million and put option of \$2.3 million). As part of this transaction, the other shareholders of Biotech were provided an option to put the remaining 82% equity interest to us for \$2.3 million subject to certain adjustments. This put option for \$2.3 million along with a deferred license payment of \$0.2 million was accrued for at acquisition and included in the above-described purchase price consideration. If Biotech fails to exercise this put option, Biotech is required on December 31, 2007 to pay \$0.4 million to us. Further, we are required to provide working capital financing to Biotech totaling approximately \$1.0 million at various points through April 1, 2007, which must be utilized as directed by us. Biotech works with pharmaceutical and biotechnology researchers to generate and optimize drug candidates by use of Biotech's computational fragment-based drug design technology. Biotech is currently headquartered in Cambridge, Massachusetts. The results of Biotech's operations have been included in our consolidated financial statements since the acquisition date.

On September 5, 2006 we purchased Nav3D Corporation (Nav3D) for \$0.9 million in cash (including direct transaction costs of \$0.1 million), subject to certain post-closing adjustments. Nav3D works with OEM and end-user partners to create products using a combination of GPS navigation and motion sensing with three dimensional graphics. Nav3D is currently headquartered in San Carlos, California. The results of Nav3D's operations have been included in our consolidated financial statements since the acquisition date.

Table of Contents**RESULTS OF OPERATIONS:**

The following tables set forth, for the periods indicated, certain financial data as a percentage of total revenues:

| | Three months ended | | Six months ended | |
|--|--------------------|-------|------------------|------|
| | December 31, | | December 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | 100% | 100% | 100% | 100% |
| Cost of revenues | 43.6 | 37.9 | 44.2 | 37.3 |
| Gross profit | 56.4 | 62.1 | 55.8 | 62.7 |
| Operating expenses: | | | | |
| Selling, general and administrative | 39.6 | 34.0 | 40.8 | 32.0 |
| Research and development | 26.1 | 23.7 | 27.7 | 23.7 |
| Amortization of acquired intangible assets | 3.1 | 4.0 | 3.3 | 3.1 |
| In-process research and development | | | 2.9 | 0.4 |
| Restructuring | 0.5 | | 0.9 | |
| Impairment of long-lived assets | | | 0.1 | |
| Total operating expenses | 69.3 | 61.7 | 75.7 | 59.2 |
| (Loss) income from operations | (12.9) | 0.4 | (19.9) | 3.5 |
| Interest and other income, net | 4.5 | 0.6 | 3.3 | 0.7 |
| (Loss) income before income taxes | (8.4) | 1.0 | (16.6) | 4.2 |
| (Benefit) provision for income taxes | (6.6) | (1.0) | (4.7) | 0.9 |
| Net (loss) income | (1.8)% | 2.0% | (11.9)% | 3.3% |

REVENUES

| (in thousands) | Three months ended | As a % of | Three months ended | As a % of | \$ Change | % Change |
|--|--------------------|-------------------|--------------------|-------------------|------------|----------|
| | December 31, 2006 | Total Net Revenue | December 31, 2005 | Total Net Revenue | | |
| Defense | \$ 26,788 | 46.2% | \$ 33,822 | 54.1% | \$ (7,034) | (20.8)% |
| Commercial Imaging and Visualization (CIV) | 11,269 | 19.5% | 15,221 | 24.4% | (3,952) | (26.0)% |
| Advanced Solutions | 14,149 | 24.4% | 10,740 | 17.2% | 3,409 | 31.7% |
| Modular Products and Services (MPS) | 5,714 | 9.9% | 2,718 | 4.3% | 2,996 | 110.2% |
| Other | | | | | | |
| Total revenues | \$ 57,920 | 100% | \$ 62,501 | 100% | \$ (4,581) | (7.3)% |

Total revenues decreased \$4.6 million or 7.3% to \$57.9 million during the three months ended December 31, 2006. International revenues represented approximately 10.0% and 6.0% of total revenues during the three months ended December 31, 2006 and 2005, respectively.

Defense revenues decreased \$7.0 million or 20.8% during the three months ended December 31, 2006 compared to the same period in fiscal 2006. The decrease was primarily related to a \$4.7 million decrease in signal intelligence applications, a \$1.9 million decrease in radio frequency products, and a \$1.2 million decrease in defense technology and applications shipments. Revenues in the Defense business continue to be adversely affected by the shift in government funding from procurement of intelligence, surveillance and reconnaissance (ISR) systems to more immediate and tactical requirements. Revenues were also impacted by the Berry Amendment which has caused several orders to slip out of the

second quarter of fiscal year 2007. The decreases

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in Defense revenues was partially offset by \$1.3 million in sales related to the Cell BE processor family of products which have been purchased by several prime defense contractors for internal research and development purposes.

CIV revenues decreased \$4.0 million or 26.0% during the three months ended December 31, 2006 compared to the same period in fiscal 2006. The decrease was primarily related to decreases in our legacy business lines, including a \$4.1 million decrease in MRI applications, a \$1.6 million decrease in revenues related to our digital X-ray applications and a \$0.5 million decrease in PET applications. This decrease was partially offset by a \$1.3 million increase in sales of our medical picture archiving and communication system (PACS) software, a \$0.6 million increase in our visualization software applications, and \$0.6 million in sales related to the Cell BE processor family of products. We are expecting that our 2D business with GE Healthcare, Motorola GmbH and Philips Medical Systems will continue to decrease over the near term as these customers transition to new platforms and new component manufacturers. We have started to see growth in our portfolio of new 3D image processing and visualization software applications. We perceive significant customer interest in the medical and oil and gas discovery industries for these products; however, the adoption rate of 3D applications by the marketplace is not yet increasing quickly enough to offset the decline in our existing 2D programs.

Advanced Solutions revenues increased \$3.4 million or 31.7% during the three months ended December 31, 2006 compared to the same period in fiscal 2006. The increase in revenues was primarily related to a \$2.0 million increase in revenues related to a large development effort for a telecommunications customer and \$1.7 million in sales related to the Cell BE processor family of products. Shipments of semiconductor imaging boards represented 58.3% and 79.9% of Advanced Solutions revenues for the three months ended December 31, 2006 and 2005, respectively. Also impacting the results of the Advanced Solutions business unit were program development delays that resulted in delayed product shipments. We expect these issues to be resolved in the third quarter of fiscal 2007.

MPS revenues increased \$3.0 million or 110.2% during the three months ended December 31, 2006 compared to the same period in fiscal 2006. The increase in revenue was primarily due to a \$3.2 million increase in sales of custom processor boards to two large telecommunications customers.

The Other business unit was formed on July 25, 2006 as a result of the acquisition of Biotech (see Note M to the consolidated financial statements) and had no revenues during the three months ended December 31, 2006. Biotech's operations are currently in the development stage with no material revenues expected to be generated during fiscal year 2007.

| (in thousands) | Six months ended December 31, 2006 | As a % of Total Net Revenue | Six months ended December 31, 2005 | As a % of Total Net Revenue | \$ Change | % Change |
|--|---|-----------------------------------|---|-----------------------------------|-------------|----------|
| Defense | \$ 49,041 | 45.9% | \$ 74,904 | 57.9% | \$ (25,863) | (34.5)% |
| Commercial Imaging and Visualization (CIV) | 21,506 | 20.1% | 28,947 | 22.4% | (7,441) | (25.7)% |
| Advanced Solutions | 26,992 | 25.3% | 20,050 | 15.5% | 6,942 | 34.6 % |
| Modular Products and Services (MPS) | 9,328 | 8.7% | 5,500 | 4.2% | 3,828 | 69.6 % |
| Other | | | | | | |
| Total revenues | \$ 106,867 | 100% | \$ 129,401 | 100% | \$ (22,534) | (17.4)% |

Total revenues decreased \$22.5 million or 17.4% to \$106.9 million during the six months ended December 31, 2006. International revenues represented approximately 10.6% and 6.0% of total revenues during the six months ended December 31, 2006 and 2005, respectively.

Defense revenues decreased \$25.9 million or 34.5% during the six months ended December 31, 2006 compared to the same period in fiscal 2006. The decrease was primarily related to a \$12.1 million decrease in

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signal intelligence applications, a \$10.5 million decrease in shipments serving radar applications and a \$3.7 million decrease in defense technology and applications. Contributing to these decreases in radar application and signal intelligence applications included a reprioritizing of funding by the federal government and the impact of the Berry Amendment which has caused several orders to slip out of the second quarter of fiscal year 2007. The decrease in Defense revenues was partially offset by \$1.3 million in sales related to the Cell BE processor family of products, and a \$0.5 million increase in incremental revenues related to the Echotek acquisition. The Echotek acquisition was finalized August 31, 2005, therefore, the six months ended December 31, 2006 included two additional months of revenue as compared to the same period in fiscal year 2006.

CIV revenues decreased \$7.4 million or 25.7% during the six months ended December 31, 2006 compared to the same period in fiscal 2006. The decrease was primarily related to decreases in our legacy business lines, including a \$6.2 million decrease in MRI applications, a \$3.3 million decrease in revenues related to our digital X-ray applications and a \$1.1 million decrease in PET applications. This decrease was partially offset by a \$1.9 million increase in sales of our medical picture archiving and communication system (PACS) software, and \$0.6 million in sales related to the Cell BE processor family of products. We are expecting that our 2D business with GE Healthcare, Motorola GmbH and Philips Medical Systems will continue to decrease over the near term as these customers transition to new platforms and new component manufacturers. We have started to see growth in our portfolio of new 3D image processing and visualization software applications. We perceive significant customer interest in the medical and oil and gas discovery industries for these products; however, the adoption rate of 3D applications by the marketplace is not yet increasing quickly enough to offset the decline in our existing 2D programs.

Advanced Solutions revenues increased \$6.9 million or 34.6% during the six months ended December 31, 2006 compared to the same period in fiscal 2006. The increase in revenues was related to a \$1.9 million increase in shipments of semiconductor imaging boards for developing and testing new semiconductors, a \$2.8 million increase related to a large development effort for a telecommunications customer, and \$2.4 million in sales related to the Cell BE processor family of products. Shipments of semiconductor imaging boards represented 68.2% and 82.3% of Advanced Solutions revenues for the six months ended December 31, 2006 and 2005, respectively.

MPS revenues increased \$3.8 million or 69.6% during the six months ended December 31, 2006 compared to the same period in fiscal 2006. The increase in revenue was primarily due to a \$5.1 million increase in sales of custom processor boards to two large telecommunications customers, offset by \$1.0 million decrease in sales to a mid-size telecommunications customer.

The Other business unit was formed on July 25, 2006 as a result of the acquisition of Biotech (see Note M to the consolidated financial statements) and had no revenues during the six months ended December 31, 2006. Biotech's operations are currently in the development stage with no material revenues expected to be generated during fiscal year 2007.

GROSS PROFIT

Gross profit was 56.4% for the three months December 31, 2006; a decrease of 570 basis points from the 62.1% gross profit achieved in the three months ended December 31, 2005. The decrease was primarily due to the spread of fixed costs over a lower revenue base in our Defense Business Unit, higher material costs and an unfavorable shift in customer and product mix, including increased revenues related to the Cell BE processor family of products which carry a lower margin than our legacy products.

Gross profit was 55.8% for the six months December 31, 2006; a decrease of 690 basis points from the 62.7% gross profit achieved in the six months ended December 31, 2005. The decrease in gross profit was primarily due to the spread of fixed costs over a lower revenue base in our Defense Business Unit, higher material costs and an unfavorable shift in customer and product mix, including increased revenues related to the Cell BE processor family of products which carry a lower margin than our legacy products.

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SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased 8.0% or \$1.7 million to \$22.9 million for the three months ended December 31, 2006 compared to \$21.2 million during same period in fiscal 2006. The increase was primarily due to a \$0.8 million increase in legal expense, a \$0.8 million increase in stock compensation expense and a \$0.2 million increase in bad debt expense. These increases were partially offset by various items including a \$0.4 million decrease in consultant expense and a \$0.2 million decrease in business meetings expense as compared to the same period in fiscal year 2006.

Selling, general and administrative expenses increased 5.3% or \$2.2 million to \$43.6 million for the six months ended December 31, 2006 compared to \$41.4 million during same period in fiscal 2006. The increase was primarily due to a \$1.3 million increase in legal expense, a \$1.2 million increase in stock compensation expense, a \$0.3 million increase in depreciation expense, and a \$0.2 million increase in bad debt expense. These increases were partially offset by various items including a \$0.6 million decrease in consultant expense and a \$0.3 million decrease in business meeting expense as compared to the same period in fiscal year 2006.

RESEARCH AND DEVELOPMENT

Research and development expenses increased 2% or \$0.3 million to \$15.1 million for the three months ended December 31, 2006 compared to \$14.8 million during the same period in fiscal 2006. The increase was primarily the result of an increase in equipment and software expense of \$0.3 million, an increase in prototype and development expense of \$0.2 million, an increase in our development effort of \$0.3 million related to our Biotech business, and an increase in stock compensation expense of \$0.2 million. This increase was partially offset by a decrease in compensation expense due a reduction in headcount of 19 employees that was attributable, in part, to our 2006 and 2007 Restructuring Plans. Research and development continues to be a focus of our business with approximately 26.1% and 23.7% of our revenues dedicated to research and development activities during the three months ended December 31, 2006 and 2005, respectively. One of the more significant research and development initiatives which began in fiscal year 2006 is our development efforts related to the Cell BE processor family of products which accounted for approximately \$3.7 million and \$1.5 million of the research and development expenses in the three months ended December 31, 2006 and 2005, respectively. We expect to continue to devote resources to the development of new products and the enhancement of existing products. We believe that research and development is critical to our strategic product development objectives and that to leverage our leading technology and meet the changing requirements of our customers, we will need to fund investments in several development projects in parallel.

Research and development expenses decreased 3.6% or \$1.1 million to \$29.6 million for the six months ended December 31, 2006 compared to \$30.7 million during the same period in fiscal 2006. The decrease was partially the result of a decrease in compensation expense due a reduction in headcount of 19 employees that was attributable, in part, to our 2006 and 2007 Restructuring Plans. The decrease was also due to a \$0.7 million decrease in prototype and development expense primarily related to project timing. Research and development continues to be a focus of our business with approximately 27.7% and 23.7% of our revenues dedicated to research and development activities during the six months ended December 31, 2006 and 2005, respectively. One of the more significant research and development initiatives which began in fiscal year 2006 is our development efforts related to the Cell BE processor family of products which accounted for approximately \$6.9 million and \$2.4 million of the research and development expenses in the six months ended December 31, 2006 and 2005, respectively.

AMORTIZATION OF ACQUIRED INTANGIBLE ASSETS

Amortization of acquired intangible assets decreased 28.0% or \$0.7 million to \$1.8 million for the three months ended December 31, 2006 compared to \$2.5 million during the same period in fiscal 2006. The decrease in amortization expenses for the three months ended December 31, 2006 was primarily due to several intangible assets becoming fully amortized prior to the start of fiscal year 2007.

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Amortization of acquired intangible assets decreased 12.5% or \$0.5 million to \$3.5 million for the six months ended December 31, 2006 compared to \$4.0 million during the same period in fiscal 2006. The decrease in amortization expenses for the six months ended December 31, 2006 was primarily the result of was primarily due to several intangible assets becoming fully amortized prior to the start of fiscal year 2007.

RESTRUCTURING EXPENSE

We incurred a net restructuring charge of \$0.3 million and \$1.0 million, respectively, during the three and six months ended December 31, 2006 related to our efforts to integrate our prior acquisitions and to decrease our operating expenses due to lower than expected demand for certain sectors of our business. The restructuring charges primarily relate to severance provided to involuntarily terminated employees. No such restructuring charges were incurred during the three and six months ended December 31, 2005. We intend to continue to monitor our cost structure and its impact on our results. Our cost structure is dependent, in part, on the timely development and continued visibility of the markets in which we currently compete as well as our ability to continue to identify and exploit new markets for our products. To the extent that our ability to grow the business, or certain areas of the business, does not occur as we forecasted, additional changes to our cost structure may be necessary.

IMPAIRMENT OF LONG-LIVED ASSETS

During the six months ended December 31, 2006, we incurred an impairment charge of \$0.1 million related to a non-compete agreement we determined to be impaired based upon actions taken by a former employee who was bound by the non-compete agreement. No such charges were incurred during the three months ended December 31, 2006 or the three and six months ended December 31, 2005.

INTEREST INCOME

Interest income for the three months ended December 31, 2006 increased by \$0.1 million to \$1.6 million compared to the same period in fiscal year 2006. Interest income for the six months ended December 31, 2006 increased by \$0.3 million to \$3.4 million compared to the same period in fiscal year 2006. The increases for both the three and six months ended December 31, 2006 were primarily related to increased rates of return on our marketable securities, partially offset by lower levels of cash and cash equivalents.

INTEREST EXPENSE

Interest expense for the three months ended December 31, 2006 increased by \$0.5 million to \$1.6 million compared to the same period in fiscal 2006. Interest expense for the six months ended December 31, 2006 increased by \$0.5 million to \$2.6 million compared to the same period in fiscal 2006. The increases for both the three and six months ended December 31, 2006 were primarily due to the penalties totaling \$0.7 million incurred related the prepayment of our mortgage notes on October 19, 2006 (see Note N to the consolidated financial statements).

OTHER INCOME (EXPENSE), NET

Other income (expense) for the three months ended December 31, 2006 increased by \$2.6 million to \$2.6 million compared to the same period in fiscal year 2006. Other income (expense) for the six months ended December 31, 2006 increased by \$2.7 million to \$2.6 million compared to the same period in fiscal year 2006. The increases for both the three and six months ended December 31, 2006 were primarily due to cash received totaling \$2.4 million as a result of the legal settlement with a former employee and a related company (see Note J to the consolidated financial statements). Also impacting other income (expense) were the realized gains and losses related to foreign currency transactions and the impact of our deferred compensation plan.

Table of Contents**INCOME TAX (BENEFIT) PROVISION**

We recorded a tax benefit during the six months ended December 31, 2006 reflecting a 28.4% effective tax benefit rate, as compared to a 21.0% effective tax expense rate for the same period in fiscal 2005. The effective tax rate for the six months ended December 31, 2006 reflects the impact of several discrete items, primarily the settlement with the IRS relating the research and development tax credits (See Note J to the consolidated financial statements) and, consequently, the adjustment of the fiscal year 2006 research and development tax credit. Excluding the impact of all discrete items, our fiscal year 2007 annual effective tax benefit rate would be estimated at 34.0%. The effective tax rate for the six months ended December 31, 2006 was lower than the U.S. statutory tax rate of 35% primarily due to losses, research and development tax credits, the extraterritorial income (ETI) benefit and other state tax benefits.

We recorded a tax benefit of \$3.8 million for the three months ended December 31, 2006 in order to adjust the 10.1% effective annual tax benefit rate used in the three months ended September 30, 2006 to the 34.0% effective annual tax benefit rate currently expected for the full fiscal year. The forecasted annual effective tax benefit rate was increased in the current quarter as a result of increased net loss projections and the extension of the federal research and development credits.

We review our annual effective income tax rate on a quarterly basis and make changes as necessary. The estimated annual effective income tax rate may fluctuate due to changes in forecasted annual operating income; changes to the valuation allowance for net deferred tax assets; changes to actual or forecasted permanent book to tax differences; impacts from future tax settlements with state, federal or foreign tax authorities; or impacts from tax law changes. In addition, we identify items which are not normal and recurring in nature and treat these as discrete events. The tax effect of discrete items is booked entirely in the quarter in which the discrete event occurs.

SEGMENT OPERATING RESULTS

Results from operations of the Defense segment decreased \$1.5 million for the three months ended December 31, 2006 to an operating loss of \$1.9 million as compared to an operating loss of \$0.4 million for the same period in fiscal year 2006. The decrease in operating results of the Defense segment was primarily related to the decrease in revenues and a shift in product mix to lower-margin products. The decrease in operating results of the Defense segment was partially offset by a \$3.5 million decrease in operating expenses largely due to a \$2.1 million decrease in research and development expenses related to project timing and a \$0.8 million decrease in sales expense.

Results from operations of the Defense segment decreased \$14.2 million for the six months ended December 31, 2006 to an operating loss of \$8.0 million as compared to income from operations of \$6.2 million for the same period in fiscal year 2006. The decrease in operating results of the Defense segment was primarily related to the decrease in revenues and a shift in product mix to lower-margin products. The decrease in operating results of the Defense segment was partially offset by a \$5.1 million decrease in operating expenses largely due to a \$3.9 million decrease in research and development expenses related to project timing and a \$1.4 million decrease in selling expense.

Results from operations of the CIV segment decreased \$3.5 million for the three months ended December 31, 2006 to an operating loss of \$1.9 million as compared to income from operations of \$1.7 million for the same period in fiscal year 2006. The decrease in operating results of the CIV segment was primarily related to a decrease in revenues. The decrease in operating results for the CIV segment was also impacted by \$1.5 million in additional administrative expenses due largely to the defense of a patent infringement lawsuit and legal actions associated with one of our German subsidiaries (see Note J to the Consolidated Financial Statements) and a \$0.4 million increase in research and development expenses primarily related to 3D Visage PACS products and the Cell BE processor based products.

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Results from operations of the CIV segment decreased \$5.8 million for the six months ended December 31, 2006 to an operating loss of \$3.7 million as compared to income from operations of \$2.1 million for the same period in fiscal year 2006. The decrease in operating results of the CIV segment was primarily related to a decrease in revenues. The decrease in operating results for the CIV segment was also impacted by \$2.5 million in additional administrative expenses largely due to the defense of a patent infringement lawsuit and legal actions associated with one of our German subsidiaries (see Note J to the Consolidated Financial Statements) and a \$0.9 million increase in research and development expenses primarily related to 3D Visage PACS products and the Cell BE processor based products.

Results from operations of the Advanced Solutions segment decreased \$2.0 million for the three months ended December 31, 2006 to an operating loss of \$0.8 million from an operating profit of \$1.2 million for the same period in fiscal year 2006. The decrease in results from operations was primarily driven by a change in margin due to customer mix and by an increase in research and development funding of approximately \$1.4 million primarily related the Cell BE processor development program.

Results from operations of the Advanced Solutions segment decreased \$1.4 million for the six months ended December 31, 2006 to an operating loss off approximately \$0.8 million as compared to income from operations of \$0.6 million for the same period in fiscal year 2006. The decrease in results from operations was primarily driven by a change in margin due to customer mix and by an increase research and development funding of approximately \$1.4 million primarily related the Cell BE processor development program.

Results from operations of the MPS segment increased \$0.8 million for the three months ended December 31, 2006 to operating income of \$0.6 million as compared to an operating loss of \$0.2 million for the same period in fiscal year 2006. The increase in results from operations was primarily due to an increase in revenue driven by sales of custom processor boards to two large telecommunications customers and a higher relative gross margin on a large custom board development order that was recognized in the second quarter of fiscal year 2006.

Results from operations of the MPS segment increased \$0.6 million for the six months ended December 31, 2006 to income from operations of \$0.3 million as compared to an operating loss of \$0.3 million for the same period in fiscal year 2006. The increase in results from operations was primarily due to an increase in revenue driven by sales of custom processor boards to two large telecommunications customers and a higher relative gross margin on a large custom board development order that was recognized in the second quarter of fiscal year 2006.

Losses from the operations of the Other segment were \$0.4 million and \$3.6 million for the three and six months ended December 31, 2006, respectively. The Other segment was formed as a result of the Biotech acquisition on July 25, 2006. The operating loss in the six months ended December 31, 2006 was primarily driven by a charge of \$3.1 million for in-process research and development related to the Biotech acquisition.

See Note H to our consolidated financial statements included in this report for more information regarding our operating segments.

OFF-BALANCE SHEET ARRANGEMENTS

Other than lease commitments incurred in the normal course of business, certain guarantees made related to the acquisition of a development-stage biotech company during the first quarter of fiscal year 2007 (see Note M to the Consolidated Financial Statements) and certain indemnification provisions (see Note J to the Consolidated Financial Statements), we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements. Additionally, we do not have an interest in, or relationships with, any special purpose entities.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES***(in thousands)*

| As of and for the six months ended December 31, | 2006 | 2005 |
|--|-------------|-------------|
| Net cash (used in) provided by operating activities | \$ (10,746) | \$ 20,343 |
| Net cash provided by (used in) investing activities | 14,215 | (26,153) |
| Net cash used in financing activities | (9,669) | (7,777) |
| Net decrease in cash and cash equivalents | (6,247) | (13,603) |
| Cash and cash equivalents at end of period | 16,736 | 29,540 |

Cash and Cash Equivalents

Our cash and cash equivalents decreased by \$12.8 million in the six months ended December 31, 2006 as compared to the same period in fiscal 2006 primarily as a result of cash outlays for severance and other restructuring obligations, the repayment of our Mortgage Notes and certain foreign debt and normal operating activities.

During the six months ended December 31, 2006, we used \$10.7 million in cash from operations compared to \$20.3 million generated from operations during the same period in fiscal year 2006. The \$31.1 million decrease in the amount of cash generated from operations was largely driven by lower comparative net income, a \$3.2 million decrease in deferred revenue and customer advances, a \$5.9 million decrease in trade accounts receivable, and approximately a \$2.0 million increase in income tax payments and payables. The net loss was offset by several non-cash expenses, including \$5.3 million of stock-based compensation expense, \$8.9 million in depreciation and amortization expense and a \$3.1 million in in-process research and development expense due to the Biotech acquisition. Our ability to continue to generate cash from operations will depend in large part on profitability, the rate of collection of accounts receivable, our inventory turns and our ability to manage other areas of working capital.

During the six months ended December 31, 2006, we generated \$14.2 million of cash from investing activities compared with \$26.2 million used in investing activities during the same period in fiscal year 2006. During the six months ended December 31, 2006, our cash used in the acquisition of businesses and capital expenditures was \$1.5 million and \$4.1 million, respectively. This was offset by net sales and maturities of marketable securities of \$19.9 million. During the same period in fiscal year 2006, cash used in the acquisition of businesses and capital expenditures was \$67.5 million and \$5.4 million, respectively, offset by net sales and maturities of marketable securities of \$48.8 million. We are currently pursuing the potential sale and leaseback of our corporate headquarters in Chelmsford, Massachusetts to generate positive cash flows from this capital asset, as we believe the cash generated from the sale of the buildings can earn a better return and be better utilized in another manner. It is uncertain at this time if and when the sale and leaseback of the buildings will be consummated; however, we anticipate it will be consummated within the next 12 months.

During the six months ended December 31, 2006, our financing activities used cash of \$9.7 million, which primarily consisted of \$9.7 million used to prepay in full our two mortgage notes payable and \$0.6 million related to the repayment of foreign debt, offset by \$1.1 million in proceeds from employee stock plans. During the same period in fiscal year 2006, financing activities used cash of \$7.8 million, which primarily consisted of \$12.3 million used for purchases of our common stock, offset by \$4.8 million in proceeds from employee stock plans.

During the six months ended December 31, 2006, our prime source of liquidity came from existing cash and marketable securities. Our near-term fixed commitments for cash expenditures consist primarily of payments under operating leases, an alliance purchase agreement, a supply agreement and inventory purchase commitments, as well as interest payments on our long-term debt. We do not currently have any material commitments for capital expenditures. If cash generated from operations is insufficient to satisfy working capital requirements, we may need to access funds through bank loans, sales of securities or other means. There can be no assurance that we will be able to raise any such capital on terms acceptable to us, on a timely basis or at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to effectively operate our business.

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Based on our current plans and business conditions, we believe that existing cash, cash equivalents and marketable securities will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months.

Debt

In November 1999, we completed a lending agreement with a commercial financing company, issuing two 7.30% senior secured financing notes (the Mortgage Notes) due November 2014. The original principal amount of the Mortgage Notes totaled \$14.5 million. The Mortgage Notes were collateralized by our corporate headquarters, which consists of two buildings. The terms of the Mortgage Notes, as amended, contained certain covenants, which, included the maintenance of an interest coverage ratio, certain leverage ratios and a minimum consolidated net worth. The Mortgage Notes also included significant prepayment penalties.

Since March 31, 2006, we had not been in compliance with certain of the financial covenants, and we elected to prepay the Mortgage Notes in full on October 19, 2006 instead of renegotiating the financial covenants with the holders of the Mortgage Notes. The amount paid in connection with the prepayment of the Mortgage Notes equaled \$10.5 million, which included the then outstanding principal amount of the Mortgage Notes plus a prepayment premium equal to \$0.7 million, and a minor waiver fee in consideration of the noteholders' waiver through October 19, 2006 of our non-compliance with the financial covenants.

The terms of our convertible senior notes contain certain contingent conversion provisions. Under certain circumstances, the notes will be convertible into our common stock at a conversion rate of 33.0797 shares per \$1,000 principal amount of the notes, subject to adjustment in certain circumstances. The conversion rate is equal to an initial conversion price of approximately \$30.23 per share. At the option of the holder, the convertible notes may be converted on the final maturity date if, on or prior to May 1, 2019, the closing price of our common stock exceeds \$36.28 for at least 20 trading days in a specified 30-day period of each fiscal quarter or on any date after May 1, 2019, the closing price of our common stock exceeds \$36.28. The Notes may also be converted at the option of the holder if prior to May 1, 2019, the average trading price for the convertible senior notes is less than 98% of the average conversion value for the convertible senior notes during any five consecutive trading-day period. The convertible notes mature on May 1, 2024 and bear interest at 2% per year, payable semiannually in arrears in May and November. The convertible notes are unsecured, rank equally in right of payment to our existing and future senior debt, and do not subject us to any financial covenants. The holders may require us to repurchase the notes, in whole or in part, (a) on May 1, 2009, 2014 or 2019, (b) upon a change in control, or (c) if our common stock is neither listed nor approved for trading on specified markets. At our option, we may redeem any of the convertible notes on or after May 1, 2009 at a price equal to 100% of the principal amount of the convertible notes to be redeemed plus accrued and unpaid interest.

Commitments and Contractual Obligations

The following is a schedule of our commitments and contractual obligations outstanding at December 31, 2006:

| | | Less Than | 2-3 | 4-5 | More Than |
|---|------------|-----------|------------|-----------|-----------|
| (in thousands) | Total | 1 Year | Years | Years | 5 Years |
| Notes payable and capital lease obligations | \$ 125,102 | \$ 60 | \$ 125,042 | \$ | \$ |
| Interest due on notes payable | 6,048 | 2,504 | 3,544 | | |
| Inventory purchase obligations | 22,376 | 22,376 | | | |
| Supply agreement | 4,193 | 1,935 | | 2,258 | |
| Alliance agreement | 72,307 | 4,662 | 31,645 | 36,000 | |
| License agreement | 80 | 80 | | | |
| ERP agreements | 1,583 | 1,583 | | | |
| Operating leases | 6,167 | 1,659 | 1,977 | 1,419 | 1,112 |
| IP Agreement | 1,000 | | 1,000 | | |
| Other long-term liabilities | 118 | | 118 | | |
| | \$ 238,974 | \$ 34,859 | \$ 163,326 | \$ 39,677 | \$ 1,112 |

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Notes payable, capital lease obligations and interest due on notes payable consists of various domestic and foreign debt agreements and the interest due on such agreements. (See Note N to the consolidated financial statements for further financial information regarding these agreements). Our pension obligation and deferred compensation plan liabilities which are not included in the table above, are included in accrued expenses in our consolidated balance sheets. The put option for \$2.3 million related to the acquisition of the development-stage biotech company, which is not included in the above table, is included in accrued expenses in our consolidated balance sheet. (See Note M to the consolidated financial statements for further information regarding this put option)

Inventory purchase obligations represent open non-cancelable purchase commitments for certain inventory components used in normal operations. The purchase commitments covered by these agreements are generally for less than one year and aggregated approximately \$22.4 million at December 31, 2006.

In June 2005, we entered into an alliance agreement with a third party to purchase certain computer equipment and services. This alliance agreement, as subsequently amended, is in effect until December 2011 and contains penalties for volume commitments and a variable early termination penalty that generally decreases over time based upon purchases. As of December 31, 2006, the total fee to terminate the alliance agreement in full, including termination of the minimum purchase commitments, was \$1.9 million. Aggregate minimum purchase commitments over the term of the agreement total approximately \$69.1 million, however, if the annual minimum purchase commitments are not achieved, we are only liable for a per unit penalty fee of \$50 for the difference between our actual purchases and the annual minimum volume commitment amount. Further, this agreement requires royalty payments based on future sales of the developed technologies and periodic payments totaling \$8.8 million related to the development and licensing of certain technology. As of December 31, 2006, the total minimum commitment related to the alliance agreement is \$72.4 million (portions of which are recorded as liabilities in the consolidated balance sheets as of December 31, 2006) assuming that we purchase the full minimum volume commitment and that we do not elect to terminate the agreement.

In July 2005, we began an ERP system upgrade to improve our ERP system capabilities and processes. In connection with the implementation of the ERP system upgrade, we entered into several agreements with a third-party relating to the initial phases of the implementation. As of December 31, 2006, there was \$1.6 million of funds authorized that have not been expended related to the ERP effort.

In September 2006, we entered into a supply agreement with a third party vendor to purchase certain inventory parts that went end of life. This supply agreement, as subsequently amended, commits the vendor to acquiring and storing approximately \$6.5 million of inventory until August 31, 2012 and allows the Company to place orders for the inventory four times a year. Upon the earlier of January 31, 2007 or completion of the wafer fabrication process, the Company is required to pay approximately \$1.9 million of the \$6.5 million. Further, upon expiration of the agreement on August 31, 2012, if the Company does not purchase the full \$6.5 million in inventory, the Company may be required to pay a penalty equal to 35% of the remaining inventory balance. As of December 31, 2006, \$0.6 million was included in accrued expenses in the consolidated balance sheets related to this agreement.

In September 2006, we entered into a License Agreement (IP Agreement) with a third party to obtain an exclusive license to certain intellectual property (IP). This license required an initial upfront payment of \$0.1 million and varying royalty payments to be based on future sales of product containing the IP. If the running royalty payments do not equal or exceed \$1.0 million (the Minimum Royalty) by September 1, 2008, we must pay the shortfall between the two amounts. Additionally, upon the occurrence of certain events, which are largely within our control, the license may be rendered non-exclusive. Upon occurrence of this event, the running royalty payment rates increase, the Minimum Royalty amount decreases to \$0.1 million and we become obligated to reimburse the third party for 50% of all patent costs incurred by the third party moving forward from the date the license was rendered non-exclusive.

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Our standard product sales and license agreements entered into in the ordinary course of business typically contain an indemnification provision pursuant to which we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to our products. Such provisions generally survive termination or expiration of the agreements. The potential amount of future payments we could be required to make under these indemnification provisions is, in some instances, unlimited.

RELATED PARTY TRANSACTIONS

We paid no life insurance premiums during the three and six months ended December 31, 2006, respectively, for the benefit of David Bertelli, the brother of our Chief Executive Officer and a former company vice president. We paid approximately \$0 and \$2.0 thousand of life insurance premiums during the three and six months ended December 31, 2005, respectively, for the benefit of David Bertelli.

We have an at-will agreement with Wellness Edge, a private company owned, in part, by the daughter of our Chief Executive Officer, to manage the employee fitness center. We paid Wellness Edge \$2.6 thousand and \$4.4 thousand during the three and six months ended December 31, 2006, respectively, and we owed \$1.8 thousand under this agreement as of December 31, 2006. We paid Wellness Edge \$10 thousand in relation to this agreement during fiscal year 2006 and owed no amounts under this agreement as of June 30, 2006.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged provided that the reporting entity has not yet issued financial statements for that fiscal year including financial statements for an interim period within that fiscal year. We are assessing SFAS No. 157 and have not yet determined the impact that the adoption of SFAS No. 157 will have on our financial condition or results of operations.

In September 2006, FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, which requires employers to: (a) recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status; (b) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year; and (c) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. We do not expect the adoption of SFAS No. 158 to have a material impact on our financial condition or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 permits registrants to record the cumulative effect of initial adoption by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings only if material under the dual method. SAB 108 is effective for fiscal years ending on or after

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November 15, 2006 and we plan to adopt SAB 108 in the fourth quarter of fiscal year 2007. We do not expect the adoption of SAB 108 to have a material impact on our financial condition or results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. The Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, *Accounting for Income Taxes*. This Interpretation presents 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 is effective for fiscal years beginning after December 15, 2006. While additional efforts will be necessary to measure and disclose this information, we do not expect the adoption of Interpretation No. 48 to have a material impact on our financial condition or results of operations.

In June 2006, the FASB reached consensus on Emerging Issues Task Force (EITF) No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement* (EITF 06-3). The scope of EITF 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, and excise taxes. The Task Force affirmed its conclusion that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to Accounting Principles Board Opinion (APB) No. 22, *Disclosure of Accounting Policies*. If those taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. We do not expect the adoption of EITF No. 06-3 to have a material impact on our financial condition or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in our exposure to market risk from June 30, 2006 to December 31, 2006.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective. We continue to review our disclosure controls and procedures and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our company's business.

Changes in Internal Control over Financial Reporting. There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On December 20, 2006, the Internal Revenue Service (IRS) concluded its audit of our tax years ended June 30, 2005, 2004 and 2003. The contested issues addressed in the IRS audit report concerned the our tax position on what constitutes qualifying research and development costs for purposes of the research and development tax credit. As of December 31, 2006, we reached a preliminary settlement with the IRS in the amount of \$1.6 million, including interest and penalties, which we have accrued in full and included accrued expenses in the consolidated balance sheets. We expect the settlement to be finalized and paid in during the third fiscal quarter of 2007.

In October 2006, we commenced a series of legal actions in the District Court of Nuremberg-Fuerth, Germany against the former general manager of the subsidiary and a third-party company related to the former general manager alleging, among other things, that the former general manager had breached his non-competition obligations to us and the subsidiary and had otherwise engaged in conduct detrimental to the subsidiary while still employed by the subsidiary. In November 2006, the parties settled all of these legal actions, and a related labor suit, through the payment of damages in the amount of \$2.4 million for breach of non-compete agreements, interference with the subsidiary's business and the assumption of certain non-medical professional service contracts by the third-party company. In connection with the settlement, the third-party company also agreed not to compete against our German subsidiary in the field of image processing for medical and pharmaceutical applications within the European Union and Switzerland for a period ending on July 1, 2008.

On January 31, 2006, we received a written notice and request for indemnification from Seismic Micro-Technology, Inc. (SMT), which had been named as a defendant in a patent infringement suit entitled *Landmark Graphics Corporation, et al. v. Paradigm Geophysical Corporation, et al.*, filed in the United States District Court for the Southern District of Texas. SMT based its request for indemnification on the terms of certain application developer agreements it entered into with us and certain of our subsidiaries. The complaint alleges infringement by SMT of U.S. patent number 6,765,570, and seeks injunctive relief, treble damages, costs and attorneys' fees. On February 22, 2006, SMT answered and filed counterclaims for declaratory judgment of non-infringement and invalidity. On February 28, 2006 we notified SMT that we would indemnify SMT from all costs and damages that may be awarded against SMT in the foregoing action, and would be responsible for attorneys' fees and expenses incurred by SMT in defense of the action, subject to certain conditions, including our right to control and direct the defense of the action on behalf of SMT. We believe there are meritorious defenses to the complaint and intend to contest it vigorously. However, an adverse resolution of this litigation could have an adverse effect on our consolidated financial position, results of operations or cash flows in the period in which the litigation is resolved. No amounts have been accrued for this loss contingency.

We are also subject to other legal proceedings, claims and tax audits that arise in the ordinary course of business and in the opinion of management the outcome of these matters will not have a material adverse effect on our financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS

You should carefully review and consider the information regarding certain factors that could materially affect our business, financial condition or future results set forth under Item 1A (Risk Factors) in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006. There have been no material changes from the factors disclosed in our 2006 Annual Report on Form 10-K, although we may disclose changes to such factors or disclose additional factors from time to time in our future filings with the Securities and Exchange Commission.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

- (a) The following table sets forth information about repurchases of our common stock as of and for the three months ended December 31, 2006.

| Period of Repurchase | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased As Part of Publicly Announced Program |
|-----------------------------|---|-------------------------------------|---|
| October 1-31, 2006 | | \$ | \$ |
| November 1-30, 2006 | 3,000 | 16.44 | |
| December 1-31, 2006 | | | |
| Total | 3,000 | \$ 16.44 | \$ |

ITEM 6. EXHIBITS

The following Exhibits are filed or furnished, as applicable, herewith:

- 12.1 Ratio of Earnings to Fixed Charges.
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a).
- 32.1+ Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- + Furnished herewith. This certificate shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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MERCURY COMPUTER SYSTEMS, INC.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Chelmsford, Massachusetts, on February 9, 2007.

MERCURY COMPUTER SYSTEMS

By: */s/* ROBERT E. HULT
Robert E. Hult

Senior Vice President and

Chief Financial Officer