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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D. C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

Commission file number 1-4298

**COHU, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
Incorporation or Organization)*

**95-1934119**

*(I.R.S. Employer Identification No.)*

**12367 Crosthwaite Circle, Poway, California**

*(Address of principal executive offices)*

**92064-6817**

*(Zip Code)*

**Registrant's telephone number, including area code (858) 848-8100**

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.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of September 29, 2006 the Registrant had 22,617,215 shares of its \$1.00 par value common stock outstanding.

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SEPTEMBER 30, 2006

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**Part I — Financial Information****Item 1. Financial Statements**

**COHU, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except par value)

	<u>September 30, 2006</u> (Unaudited)	<u>December 31, 2005 *</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 24,957	\$ 38,543
Short-term investments	115,143	100,202
Accounts receivable, less allowance for doubtful accounts of \$1,527 in 2006 and \$1,258 in 2005	45,648	46,324
Inventories:		
Raw materials and purchased parts	28,293	23,842
Work in process	15,111	11,434
Finished goods	11,341	7,153
	54,745	42,429
Deferred income taxes	21,143	19,775
Other current assets	4,101	5,840
Current assets of discontinued operations	507	3,504
Total current assets	266,244	256,617
Property, plant and equipment, at cost:		
Land and land improvements	6,965	7,978
Buildings and building improvements	22,964	25,130
Machinery and equipment	28,203	29,296
	58,132	62,404
Less accumulated depreciation and amortization	(28,238)	(31,517)
Net property, plant and equipment	29,894	30,887
Deferred income taxes	2,529	2,232
Goodwill	12,898	9,597
Other intangible assets, net of accumulated amortization of \$1,660 in 2006 and \$2,084 in 2005	7,310	6,553
Other assets	158	198
Noncurrent assets of discontinued operations	482	893
	<u>\$ 319,515</u>	<u>\$ 306,977</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 8,208	\$ 7,611
Accrued compensation and benefits	10,496	13,189
Accrued warranty	6,364	4,561
Customer advances	2,537	2,810
Deferred profit	11,090	13,816
Income taxes payable	5,494	3,889
Other accrued liabilities	3,517	3,912
Current liabilities of discontinued operations	350	534
Total current liabilities	48,056	50,322
Accrued retiree medical benefits	1,514	1,443
Deferred income taxes	4,450	5,087
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$1 par value; 1,000 shares authorized, none issued	—	—
Common stock, \$1 par value; 60,000 shares authorized, 22,617 shares issued and outstanding in 2006 and 22,380 shares in 2005	22,617	22,380
Paid-in capital	44,439	37,717
Retained earnings	198,498	190,225
Accumulated other comprehensive loss	(59)	(197)
Total stockholders' equity	265,495	250,125
	<u>\$ 319,515</u>	<u>\$ 306,977</u>

\* Derived from December 31, 2005 audited financial statements.

The accompanying notes are an integral part of these statements.

**COHU, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited)  
(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Net sales	\$ 74,787	\$ 66,823	\$ 193,499	\$ 158,965
Cost and expenses:				
Cost of sales	48,130	40,210	124,862	95,761
Research and development	11,267	7,449	28,550	20,907
Selling, general and administrative	10,698	9,125	27,984	23,719
Gain on sale of facilities	—	—	(2,963)	—
	<u>70,095</u>	<u>56,784</u>	<u>178,433</u>	<u>140,387</u>
Income from operations	4,692	10,039	15,066	18,578
Interest income	1,764	965	4,807	2,545
Income from continuing operations before income taxes	6,456	11,004	19,873	21,123
Income tax provision (benefit)	1,958	1,350	6,598	(651)
Income from continuing operations	4,498	9,654	13,275	21,774
Discontinued operations (Note 2):				
Loss from discontinued metal detection equipment operation, including loss on sale of \$466 and \$1,272 for the three and nine months ended September 30, 2006 before income taxes, respectively	(459)	(142)	(1,434)	(139)
Income tax benefit	(158)	(50)	(499)	(49)
Loss from discontinued operations	(301)	(92)	(935)	(90)
Net income	<u>\$ 4,197</u>	<u>\$ 9,562</u>	<u>\$ 12,340</u>	<u>\$ 21,684</u>
Income per share:				
Basic:				
Income from continuing operations	\$ 0.20	\$ 0.43	\$ 0.59	\$ 1.00
Income (loss) from discontinued operations	(0.01)	0.00	(0.04)	0.00
Net income	<u>\$ 0.19</u>	<u>\$ 0.43</u>	<u>\$ 0.55</u>	<u>\$ 1.00</u>
Diluted:				
Income from continuing operations	\$ 0.19	\$ 0.42	\$ 0.58	\$ 0.97
Income (loss) from discontinued operations	(0.01)	0.00	(0.04)	0.00
Net income	<u>\$ 0.18</u>	<u>\$ 0.42</u>	<u>\$ 0.54</u>	<u>\$ 0.97</u>
Weighted average shares used in computing income (loss) per share:				
Basic	<u>22,609</u>	<u>22,021</u>	<u>22,563</u>	<u>21,786</u>
Diluted	<u>22,806</u>	<u>22,915</u>	<u>22,892</u>	<u>22,409</u>
Cash dividends declared per share	<u>\$ 0.06</u>	<u>\$ 0.06</u>	<u>\$ 0.18</u>	<u>\$ 0.16</u>

The accompanying notes are an integral part of these statements.

**COHU, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(in thousands)

	September 30, 2006	September 24, 2005
<b>Cash flows from continuing operating activities:</b>		
Net income	\$ 12,340	\$ 21,684
Loss from discontinued operations	935	90
Adjustments to reconcile net income to net cash provided from continuing operating activities:		
Depreciation and amortization	4,860	3,837
Gain on sale of facilities	(2,963)	—
Share-based compensation expense	2,625	—
Deferred income taxes	(2,390)	(5,126)
Increase in accrued retiree medical benefits	71	101
Tax benefit from stock options	—	1,650
Excess tax benefits from stock options exercised	(850)	—
Changes in current assets and liabilities, excluding effects of acquisitions and divestitures:		
Accounts receivable	2,618	(23,445)
Inventories	(9,161)	(2,777)
Refundable income taxes	—	812
Other current assets	940	200
Accounts payable	(3,530)	3,118
Customer advances	(273)	1,254
Deferred profit	(2,840)	3,303
Income taxes payable, including excess stock option exercise benefit	2,954	1,658
Accrued compensation, warranty and other liabilities	(1,705)	1,473
Net cash provided from continuing operating activities	3,631	7,832
<b>Cash flows from investing activities, excluding effects from acquisitions and divestitures:</b>		
Purchases of short-term investments	(63,097)	(89,919)
Sales and maturities of short-term investments	48,382	71,465
Purchases of property, plant and equipment	(4,028)	(2,738)
Cash received from facility sale	6,239	—
Payment for purchase of Unigen assets	(7,700)	—
Cash received from disposition of discontinued operations, net	2,663	—
Payment for purchase of KryoTech assets	—	(2,863)
Other assets	40	52
Net cash used for investing activities	(17,501)	(24,003)
<b>Cash flows from financing activities:</b>		
Issuance of stock, net	3,484	6,933
Excess tax benefits from stock options exercised	850	—
Cash dividends	(4,050)	(3,250)
Net cash provided from financing activities	284	3,683
Net decrease in cash and cash equivalents from continuing operations	(13,586)	(12,488)
Cash and cash equivalents of continuing operations at beginning of period	38,543	59,590
Cash and cash equivalents of continuing operations at end of period	\$ 24,957	\$ 47,102
<b>Cash flows from discontinued operations:</b>		
Cash (used for) provided from operating activities of discontinued operations	\$ (195)	\$ 142
Cash used for investing activities of discontinued operations	(9)	(87)
Increase (decrease) in cash and cash equivalents from discontinued operations	(204)	55
Cash and cash equivalents of discontinued operations at beginning of period	204	1
Cash and cash equivalents of discontinued operations at end of period	\$ —	\$ 56
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		
Income taxes, net of refunds	\$ 6,217	\$ 88
Inventory capitalized as capital assets	\$ 367	\$ 1,265
Dividends declared but not yet paid	\$ 1,357	\$ 1,328

The accompanying notes are an integral part of these statements.

**Cohu, Inc.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**  
**September 30, 2006**

**1. Summary of Significant Accounting Policies**

**Interim Basis of Presentation**

Our fiscal years are based on a 52- or 53-week period ending on the last Saturday in December. The condensed consolidated balance sheet at December 31, 2005 has been derived from our audited financial statements at that date. The condensed consolidated interim financial statements as of September 30, 2006 and for the three- and nine-month periods then ended (also referred to as “the third quarter of fiscal 2006” and “year-to-date 2006”) and September 24, 2005 (also referred to as “the third quarter of fiscal 2005” and “year-to-date 2005”) are unaudited. However, in management’s opinion, these financial statements reflect all adjustments (consisting only of normal, recurring items) necessary to provide a fair presentation of our financial position, results of operations and cash flows for the periods presented. The third quarter of fiscal 2006 and 2005 were comprised of 14 and 13 weeks, respectively, and year-to-date 2006 and 2005 were comprised of 39 weeks and 38 weeks, respectively.

Our interim results are not necessarily indicative of the results that should be expected for the full year. For a better understanding of Cohu, Inc. and our financial statements, we recommend reading these condensed consolidated interim financial statements in conjunction with our audited financial statements for the year ended December 31, 2005, which are included in our 2005 Annual Report on Form 10-K, filed with the U. S. Securities and Exchange Commission (“SEC”). In the following notes to our interim condensed consolidated financial statements, Cohu, Inc. is referred to as “Cohu”, “we”, “our” and “us”.

**Risks and Uncertainties**

We are subject to a number of risks and uncertainties that may significantly impact our future operating results. These risks and uncertainties are discussed under Item 1A. “Risk Factors” included in this Form 10-Q. As our interim description of risks and uncertainties only includes any material changes to our annual description, we also recommend reading the description of the risk factors associated with our business previously disclosed in Item 1A. of our 2005 Annual Report on Form 10-K. Understanding these risks and uncertainties is integral to the review of our interim condensed consolidated financial statements.

**Discontinued Operations**

On May 12, 2006, we sold our metal detection equipment business, FRL, Incorporated (“FRL”). Subsequent to the sale, the operating results of FRL are being presented as discontinued operations (Note 2) and all prior period financial statements have been reclassified accordingly.

**Share-based Compensation**

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-based Payment*, (“Statement No. 123R”) and SEC Staff Accounting Bulletin No. 107, (“SAB 107”) requiring the measurement and recognition of all share-based compensation under the fair value method.

During fiscal 2006, we began recognizing share-based compensation under Statement No. 123R for all awards granted during 2006 and for the unvested portion of previous award grants based on each award’s grant date fair value. We implemented Statement No. 123R using the modified prospective transition method. Under this transition method our financial statements and related information presented, pertaining to periods prior to our adoption of Statement No. 123R, have not been adjusted to reflect the fair value of share-based compensation expense.

We estimate the fair value of each share-based award on the grant date using the Black-Scholes valuation model. To facilitate our adoption of Statement No. 123R, we applied the provisions of SAB 107 in developing our methodologies to estimate our Black-Scholes model inputs. Option valuation models, including Black-Scholes, require the input of highly subjective assumptions, and changes in the assumptions used can materially affect the grant date fair value of an award. These assumptions include the risk-free rate of interest, expected dividend yield, expected volatility, and the expected life of the award. The risk-free rate of interest is based on the U.S. Treasury rates appropriate for the expected term of the award. Expected dividends are based, primarily, on historical factors related to our common stock. Expected volatility is based on historic, weekly stock price observations of our common stock during the period immediately preceding the share-based award grant that is equal in length to the award’s expected term. We believe that historical volatility is the best estimate of future volatility. Due to a limited amount of historical option exercise data related to options with a five-year

**Cohu, Inc.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**  
**September 30, 2006**

contractual term, we adopted SAB 107's simplified method for estimating the expected term of share-based awards granted during the first six months of fiscal 2006. During the third quarter of fiscal 2006 we granted options with a ten-year contractual term and utilized historical option exercise data for estimating the expected life of those awards. Statement No. 123R also requires that estimated forfeitures be included as a part of the grant date expense estimate. We used historical data to estimate expected employee behaviors related to option exercises and forfeitures. Prior to our adoption of Statement No. 123R, we reduced pro-forma share-based compensation expense, presented in the notes to our financial statements, for actual forfeitures as they occurred.

Share-based compensation expense related to restricted stock unit awards is calculated based on the market price of our common stock on the date of grant, reduced by the present value of dividends expected to be paid on our common stock prior to vesting of the restricted stock unit.

The following weighted average assumptions were used to value share-based awards granted:

**Employee Stock Options**

	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Dividend yield	1.4%	1.0%	1.4%	1.0%
Expected volatility	48.2%	47.0%	48.1%	58.3%
Risk-free interest rate	4.7%	4.0%	4.7%	3.7%
Expected term of options	4.5 years	4.0 years	4.5 years	4.0 years
Weighted-average grant date fair value per share	\$6.70	\$8.47	\$6.71	\$7.75

**Employee Stock Purchase Plan**

	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Dividend yield	1.5%	1.0%	1.4%	1.0%
Expected volatility	50.7%	42.0%	45.1%	51.2%
Risk-free interest rate	4.8%	2.8%	4.6%	2.4%
Expected term of options	0.5 years	0.5 years	0.5 years	0.5 years
Weighted-average grant date fair value per share	\$5.49	\$4.00	\$5.84	\$4.67

**Restricted Stock Units**

	Three and nine months ended September 30, 2006
Dividend yield	1.4%
Risk-free interest rate	4.7%
Weighted-average estimated value per share	\$15.53

Reported share-based compensation is classified, in the condensed consolidated interim financial statements, as follows:

<i>(in thousands)</i>	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Cost of sales	\$ 114	\$ —	\$ 280	\$ —
Research and development	343	—	765	—
Selling, general and administrative	668	—	1,580	—
Total share-based compensation	1,125	—	2,625	—
Income tax benefit	(159)	—	(345)	—
Total share-based compensation, net of tax	<u>\$ 966</u>	<u>\$ —</u>	<u>\$ 2,280</u>	<u>\$ —</u>



**Cohu, Inc.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**  
**September 30, 2006**

Prior to our adoption of Statement No. 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash inflows in our consolidated statements of cash flows, in accordance with the provisions of the Emerging Issues Task Force (“EITF”) Issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*. Statement No. 123R requires the benefit of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis.

At September 30, 2006, excluding a reduction for forfeitures, we had approximately \$6.6 million of pre-tax unrecognized compensation cost related to unvested stock options which is expected to be recognized over a weighted-average period of approximately 1.7 years.

At September 30, 2006, excluding a reduction for forfeitures, we had approximately \$3.8 million of pre-tax unrecognized compensation cost related to unvested restricted stock units which is expected to be recognized over a weighted-average period of approximately 3.8 years.

Prior to the first quarter of fiscal 2006, we accounted for share-based awards to employees under Accounting Principles Board Opinion Number 25, *Accounting for Stock Issued to Employees*, (“APB 25”). As a result of adopting Statement No. 123R diluted net income per share for the third quarter of fiscal 2006 and year-to-date 2006 are \$0.07 and \$0.11 lower, respectively, than if we had continued to account for share-based compensation under APB 25. Under APB 25, no share-based employee compensation cost was reflected in our consolidated statements of income, as all options granted under our share-based compensation plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The pro forma information presented in the following table illustrates the effect on net income and net income per share if we had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Share-based Compensation*, as amended by FASB Statement No. 148, *Accounting for Share-based Compensation – Transition and Disclosure*, to share-based employee compensation during 2005:

<i>(in thousands, except per share amounts)</i>	Three months ended September 24, 2005	Nine months ended September 24, 2005
Net income, as reported	\$ 9,562	\$ 21,684
Less: Total share-based employee compensation expense determined under fair value based method for all awards, net of related tax effect	(1,053)	(3,167)
Pro forma net income	<u>\$ 8,509</u>	<u>\$ 18,517</u>
Income per share:		
Basic:		
Net income — as reported	\$ 0.43	\$ 1.00
Net income — pro forma	\$ 0.39	\$ 0.85
Diluted:		
Net income — as reported	\$ 0.42	\$ 0.97
Net income — pro forma	\$ 0.37	\$ 0.83

#### Income Per Share

Income per share is computed in accordance with FASB Statement No. 128, *Earnings per Share*. Basic income per share is computed using the weighted average number of common shares outstanding during each period. Diluted income per share includes the dilutive effect of common shares potentially issuable upon the exercise of stock options utilizing the treasury stock method. For purposes of computing diluted income per share, stock options with exercise prices that exceed the average fair market value of our common stock for the period are excluded. For the three- and nine-month periods ended September 30, 2006, options to purchase approximately 1,496,000 and 964,000 shares of common stock, respectively, were excluded from the computation. For the three- and nine-month periods ended September 24, 2005, options to purchase approximately 44,000 and 501,000 shares of common stock, respectively, were excluded from the computation. The following table reconciles the denominators used in computing basic and diluted income per share:

**Cohu, Inc.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**  
**September 30, 2006**

<i>(in thousands)</i>	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Weighted average common shares outstanding	22,609	22,021	22,563	21,786
Effect of dilutive stock options	197	894	329	623
	<u>22,806</u>	<u>22,915</u>	<u>22,892</u>	<u>22,409</u>

### Revenue Recognition

Our revenue recognition policy is disclosed in Note 1 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005. As more fully described in that policy, revenue from products that have not previously satisfied customer acceptance is recognized upon customer acceptance. The gross profit on sales that are not recognized is generally recorded as deferred profit and reflected as a current liability in the consolidated balance sheet.

At September 30, 2006, we had deferred revenue totaling approximately \$32.1 million and deferred profit of \$11.1 million. At December 31, 2005, we had deferred revenue totaling approximately \$30.7 million and deferred profit of \$13.8 million. During the third quarter of fiscal 2006 our microwave communication business contract with the United Arab Emirates Armed Services (“UAE”) was accepted and paid and, as a result, approximately \$7.9 million in revenue was recognized.

### Retiree Medical Benefits

We provide post-retirement health benefits to certain executives and directors under a noncontributory plan. The net periodic benefit cost incurred during the third quarter and year-to-date 2006 and 2005 was not significant.

### Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*, (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing 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. This pronouncement is effective for fiscal years beginning after December 15, 2006, and we will adopt FIN 48 effective the beginning of fiscal 2007. We are currently assessing the impact of FIN 48 on our consolidated financial statements.

In September 2006, the SEC Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, (“SAB 108”), that provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. This pronouncement is effective for fiscal years ending after November 15, 2006.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*, (“Statement No. 157”). This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. Statement No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except Statement No. 123(R) and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. We do not expect the adoption of Statement No. 157 to have a material impact on our financial position, results of operations, or cash flows.

In September 2006, the FASB issued Statement No. 158, *Employer’s Accounting for Defined Benefit Pension and Other Postretirement Plans*, (an amendment of FASB Statements No. 87, 88, 106, and 132R) (“Statement No. 158”). Statement No. 158 requires an employer to recognize in its statement of financial position an asset for a

**Cohu, Inc.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**  
**September 30, 2006**

plan's over funded status or a liability for a plan's under funded status, measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions), and 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 our comprehensive income and as a separate component of stockholders' equity. This pronouncement will be effective for us as of the end of the fiscal year ending after December 15, 2006 and we will adopt Statement No. 158 in the fourth quarter of fiscal 2007. We are currently evaluating the impact of Statement No. 158 on our results of operations and financial condition.

## 2. Discontinued Operations

On May 12, 2006, we sold substantially all the assets of our metal detection equipment business, FRL. Our decision to sell FRL resulted from management's determination that this industry segment was no longer a strategic fit within our organization. During the third quarter of fiscal 2006 we finalized a working capital adjustment to the purchase price, in accordance with the sale agreement, and finalized the sales price of FRL. As a result of this adjustment the final sales price was reduced from \$3.2 million to approximately \$2.7 million, increasing our loss on disposal in the third quarter of fiscal 2006.

A summary of key financial information of our discontinued operations is as follows:

<i>(in thousands)</i>	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Net sales	\$ —	\$ 1,787	\$ 2,356	\$ 5,806
Income (loss) from operations	\$ 7	\$ (142)	\$ (162)	\$ (139)
Income tax provision (benefit)	2	(50)	(57)	(49)
Income (loss) from operations	5	(92)	(105)	(90)
Loss on sale of metal detection equipment business	(466)	—	(1,272)	—
Income tax benefit	(160)	—	(442)	—
Loss on sale of metal detection business, net	(306)	—	(830)	—
Discontinued operations, net	\$ (301)	\$ (92)	\$ (935)	\$ (90)

## 3. Strategic Technology Transactions, Goodwill and Other Intangible Assets

### Unigen Acquisition

On December 29, 2005, we entered into an exclusive, perpetual, irrevocable, world-wide, royalty-free license for certain patents with Unisys Corporation ("Unisys") for a one-time cash payment of \$5.0 million. On March 16, 2006, we purchased certain intellectual property, fixed assets, inventory and a customer contract of Unisys' Unigen operation ("Unigen"). The results of Unigen's operations have been included in our consolidated financial statements since that date. Unigen developed, manufactured and marketed advanced thermal solutions for use in semiconductor test and burn-in.

Included in the assets we acquired were the patents licensed from Unisys in December 2005 and, as a result, these two transactions have been combined for purposes of allocating the total purchase price to the assets acquired. The purchase price of this acquisition was approximately \$17.2 million, and was funded primarily by our cash reserves (\$7.7 million), cash previously paid in December 2005 for the patent license and a deposit on the acquisition (\$5.3 million), other acquisition costs (\$0.2 million) and certain Unigen liabilities assumed (\$0.1 million). We also recorded a \$4.0 million liability for amounts owed to Unisys for inventory we acquired. The acquisition was considered a business in accordance with EITF 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business" ("EITF 98-3"), and the total cost of the acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values in accordance with FASB Statement No. 141, *Business Combinations*, ("Statement No. 141"). All assets are expected to be fully deductible for tax purposes. The goodwill was assigned to our semiconductor equipment segment.

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The allocation of purchase price to the acquired assets and assumed liabilities was as follows (*in thousands*):

Current assets	\$ 5,464
Fixed assets	1,522
Intangible assets	7,020
Goodwill	3,301
Total assets acquired	17,307
Current liabilities assumed	(142)
Net assets acquired	<u>\$ 17,165</u>

Amounts allocated to intangible assets are being amortized on a straight-line basis over their estimated useful lives currently estimated at five years. Pro forma results of operations have not been presented because the effect of the acquisition was not material.

*KryoTech Acquisition*

On May 6, 2005, we purchased substantially all the assets and operations of KryoTech, Inc. ("KryoTech"). The results of KryoTech's operations have been included in the consolidated financial statements since that date. KryoTech, based in West Columbia, South Carolina, designed, developed manufactured and marketed advanced thermal solutions for electronic systems and products, including semiconductor equipment.

The purchase price of this acquisition was approximately \$3.6 million, and was funded primarily by our cash reserves (\$2.9 million). The purchase price also included the payment of the outstanding principal balance and accrued interest on the promissory note with KryoTech (\$0.5 million), other acquisition costs (\$0.2 million) and certain KryoTech liabilities assumed (\$0.5 million). The acquisition was considered a business in accordance with EITF 98-3, and the total cost of the acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values in accordance with Statement No. 141. All assets are expected to be fully deductible for tax purposes. The goodwill was assigned to our semiconductor equipment segment.

The allocation of the purchase price to the acquired assets and assumed liabilities was as follows (*in thousands*):

Current assets	\$ 740
Fixed assets	54
Intangible assets	1,950
Backlog	90
Goodwill	1,257
Total assets acquired	4,091
Current liabilities assumed	(461)
Net assets acquired	<u>\$ 3,630</u>

Amounts allocated to other intangible assets are being amortized on a straight-line basis over their estimated useful lives of three years. Pro forma results of operations have not been presented because the effect of the acquisition was not material.

Purchased intangible assets, subject to amortization, were as follows:

<i>(in thousands)</i>	September 30, 2006		December 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Unigen technology	\$ 7,020	\$ 740	\$ —	\$ —
Patent license	—	—	5,037	—
KryoTech technology	1,950	920	1,950	434
BMS technology	—	—	1,650	1,650
	<u>\$ 8,970</u>	<u>\$ 1,660</u>	<u>\$ 8,637</u>	<u>\$ 2,084</u>

Amortization expense related to purchased and other intangible assets was approximately \$0.5 million in the third quarter of fiscal 2006, and approximately \$1.2 million in the first nine months of fiscal 2006. Amortization expense related to purchased and other intangible assets was approximately \$0.3 million in the third quarter of fiscal 2005, and approximately \$0.7 million in the first nine months of fiscal 2005. As of September 30, 2006,

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we expect amortization expense in future periods to be as follows: remainder of 2006 – \$519,000; 2007 – \$2,072,000; 2008 – \$1,640,000; 2009 – \$1,422,000; 2010 – \$1,422,000, 2011 – \$235,000.

**4. Employee Stock Benefit Plans**

**Employee Stock Purchase Plan** – The Cohu, Inc. 1997 Employee Stock Purchase Plan (“the Plan”) provides for the issuance of a maximum of 1,400,000 shares of our Common Stock. Under the Plan, eligible employees may purchase shares of common stock through payroll deductions. The price paid for the common stock is equal to 85% of the fair market value of our Common Stock on specified dates. At September 30, 2006, there were approximately 724,000 shares available for issuance under the Plan.

**Stock Options and Restricted Stock Units** – Under our equity incentive plans, stock options may be granted to employees, consultants and outside directors to purchase a fixed number of shares of our Common Stock at prices not less than 100% of the fair market value at the date of grant. Options generally vest and become exercisable after one year or in four annual increments beginning one year after the grant date and expire five to ten years from the grant date. At September 30, 2006, approximately 1,335,000 shares were available for future equity awards under the 2005 Equity Plan.

Stock option activity under our share-based compensation plans for the third quarter of fiscal 2006 was as follows:

<i>(in thousands, except per share data)</i>	Shares	Weighted Average Exercise Price
Outstanding, June 24, 2006	2,242	\$15.74
Granted	287	\$16.40
Exercised	(12)	\$12.35
Canceled	(26)	\$16.33
Outstanding, September 30, 2006	<u>2,491</u>	\$15.83
Options exercisable at September 30, 2006	1,302	\$15.45

Stock option activity under our share-based compensation plans year-to-date 2006 was as follows:

<i>(in thousands, except per share data)</i>	Shares	Weighted Average Exercise Price
Outstanding, January 1, 2006	2,504	\$15.66
Granted	299	\$16.48
Exercised	(203)	\$14.41
Canceled	(109)	\$16.38
Outstanding, September 30, 2006	<u>2,491</u>	\$15.83
Options exercisable at September 30, 2006	1,302	\$15.45

Information about stock options outstanding at September 30, 2006 is as follows (*options in thousands*):

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Approximate Remaining Life (Years) Weighted Average	Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 7.69 — \$12.07	396	4.1	\$ 11.55	322	\$ 11.53
\$13.40 — \$14.08	249	3.8	\$ 13.82	236	\$ 13.81
\$14.27 — \$14.68	214	5.6	\$ 14.49	188	\$ 14.52
\$15.04 — \$17.50	1,028	8.5	\$ 16.06	183	\$ 16.32
\$17.59 — \$38.31	604	5.9	\$ 19.55	373	\$ 19.92
	<u>2,491</u>	6.5	\$ 15.83	<u>1,302</u>	\$ 15.45

The aggregate intrinsic value of options exercised during the third quarter of fiscal 2006 and year-to-date 2006 was approximately \$0.1 million and \$2.4 million, respectively. The aggregate intrinsic value of options outstanding and exercisable at September 30, 2006 was approximately \$6.0 million and \$3.9 million, respectively.

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In the third quarter of fiscal 2006, we began issuing restricted stock units. Restricted stock units vest over either a one-year or a four-year period from the date of grant. Prior to vesting, restricted stock units do not have dividend equivalent rights, do not have voting rights and the shares underlying the restricted stock units are not considered issued and outstanding. Shares of our common stock will be issued on the date the restricted stock units vest.

Restricted stock unit activity under our share-based compensation plans for the third quarter of fiscal 2006 was as follows:

<i>(in thousands)</i>	Units
Outstanding, June 24, 2006	—
Granted	257
Vested	—
Canceled	(3)
Outstanding, September 30, 2006	<u>254</u>

**5. Comprehensive Income**

Comprehensive income represents all non-owner changes in stockholders' equity and consists of, on an after-tax basis where applicable, the following:

<i>(in thousands)</i>	Three months ended September 30, 2006	September 24, 2005	Nine months ended September 30, 2006	September 24, 2005
Income from continuing operations	\$ 4,498	\$ 9,654	\$ 13,275	\$ 21,774
Loss from discontinued operations	(301)	(92)	(935)	(90)
Net income	4,197	9,562	12,340	21,684
Change in unrealized loss on investments	216	(40)	138	(70)
Comprehensive income	<u>\$ 4,413</u>	<u>\$ 9,522</u>	<u>\$ 12,478</u>	<u>\$ 21,614</u>

Accumulated other comprehensive loss totaled approximately \$0.1 million and \$0.2 million at September 30, 2006 and December 31, 2005, respectively, and was attributed to after-tax unrealized losses and gains on investments.

**6. Income Taxes**

The income tax provision (benefit) included in the statements of income for the three and nine months ended September 30, 2006 and September 24, 2005, is based on the estimated annual effective tax rate for the entire year. These estimated effective tax rates are subject to adjustment in subsequent quarterly periods as our estimates of pretax income for the year are increased or decreased. The effective tax rate of 33.2% for the nine months ended September 30, 2006 is less than the U.S. federal statutory rate primarily due to state research and development tax credits, export sales benefits, and the domestic manufacturing deduction offset by the effects of Statement No. 123R that does not allow deferred tax benefits to be recognized on compensation expense related to incentive stock options.

Our income tax provision (benefit) in fiscal 2005 was impacted by (i) research tax credits and export sales benefits and (ii) a reduction in the valuation allowance on deferred tax assets of \$1.6 million and \$3.3 million for the three and nine months ended September 24, 2005, respectively. In addition, in March 2005, the Internal Revenue Service completed a routine examination of our consolidated tax returns for the period 2000 through 2002. The examination resulted in no assessment related to our tax returns as filed. Consequently, approximately \$3.0 million of accrued taxes related to the examined years were reversed with a corresponding credit to income tax expense in the quarter ended March, 2005.

In accordance with FASB Statement No. 109, *Accounting for Income Taxes*, ("Statement No. 109") net deferred tax assets are reduced by a valuation allowance if, based on all the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance of approximately \$1.8 million was provided on deferred tax assets at September 30, 2006 and December 31, 2005. The amount of deferred tax assets considered realizable was determined based on (i) taxable income in prior carryback years; (ii) future reversals of existing taxable temporary differences (i.e. offset gross deferred tax assets against gross

**Cohu, Inc.**  
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deferred tax liabilities); (iii) tax planning strategies and (iv) future taxable income, exclusive of reversing temporary differences and carryforwards.

We have derived significant tax benefits from export sales. As a result of the American Jobs Creation Act of 2004, the export sales benefit derived from the Extraterritorial Income Exclusion ("ETI") was repealed subject to a phase-out that limits the full tax benefit to 60% in 2006. The ETI benefit was replaced with a deduction for domestic manufacturing activities subject to a phase-in beginning in 2005. The future tax benefits we derive from the domestic manufacturing deduction will likely be less than those from ETI.

The federal research credit expired on December 31, 2005. Legislation to retroactively reinstate the credit is pending in the U.S. Congress; however it had not been enacted and signed into law as of September 30, 2006. Accordingly, no benefit from the federal research credit has been included in estimating the 2006 effective tax rate. If Congress retroactively reinstates the research credit, the effect of the credit will be reflected in the computation of the annual effective tax rate beginning as of the first period that includes the enactment date of the legislation.

## 7. Geographic Consolidation

On April 10, 2003, we announced that our Delta Design, Inc. subsidiary was relocating its Littleton, Massachusetts operation to its headquarters facility in Poway, California. The consolidation was substantially completed in March, 2004. There were no charges to operations recorded during the three-month period ended September 30, 2006. For the nine-month period ended September 30, 2006 we recorded charges to operations, totaling \$9,000 for severance and one-time termination benefits. These charges are included in cost of sales. For the three and nine-month periods ended September 24, 2005, we recorded charges to operations totaling \$13,000 for severance and one-time termination benefits. These charges are included in cost of sales (\$6,000), research and development (\$3,000) and selling, general and administrative expense (\$4,000). Cumulative charges to operations for severance and other exit costs for the period April 10, 2003 to September 30, 2006, were approximately \$1.1 million.

On May 5, 2006, we completed the sale of the land and building previously used by our operations in Littleton, Massachusetts to FPK Realty, LLC, ("FPK"). The property was sold for \$6.5 million in cash, less related costs, resulting in a net pretax gain of approximately \$3.0 million. In conjunction with the sale, Cohu entered into a one-year leaseback agreement with FPK for a portion of the facility. Total lease payments to be made under the lease are approximately \$0.2 million. The sale-leaseback transaction was accounted for pursuant to FASB Statement No. 98, *Accounting for Leases*.

The following table reconciles amounts accrued and paid under the consolidation plan.

Three months ended September 30, 2006 (in thousands)	Severance and other payroll	Other exit costs	Total
Liability at June 24, 2006	\$ 234	\$ —	\$ 234
Costs accrued	—	—	—
Amounts paid or charged	(40)	—	(40)
Liability at September 30, 2006	<u>\$ 194</u>	<u>\$ —</u>	<u>\$ 194</u>
Nine months ended September 30, 2006 (in thousands)	Severance and other payroll	Other exit costs	Total
Liability at January 1, 2006	\$ 273	\$ —	\$ 273
Costs accrued	9	—	9
Amounts paid or charged	(88)	—	(88)
Liability at September 30, 2006	<u>\$ 194</u>	<u>\$ —</u>	<u>\$ 194</u>

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Three months ended September 24, 2005 (in thousands)	Severance and other payroll	Other exit costs	Total
Liability at June 25, 2005	\$ 260	\$ —	\$ 260
Costs accrued	13	—	13
Amounts paid or charged	—	—	—
Liability at September 24, 2005	<u>\$ 273</u>	<u>—</u>	<u>\$ 273</u>

  

Nine months ended September 24, 2005 (in thousands)	Severance and other payroll	Other exit costs	Total
Liability at January 1, 2005	\$ 285	\$ —	\$ 285
Costs accrued	13	—	13
Amounts paid or charged	(25)	—	(25)
Liability at September 24, 2005	<u>\$ 273</u>	<u>—</u>	<u>\$ 273</u>

**8. Industry Segments**

We have three reportable segments as defined by FASB Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information". As discussed in Note 2, in May, 2006, we sold substantially all the assets of FRL, which comprised our metal detection equipment segment and have presented financial information for this segment as discontinued operations. Our reportable segments are business units that offer different products and are managed separately because each business requires different technology and marketing strategies.

Financial information concerning our reportable segments of our continuing operations is as follows:

(in thousands)	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
<b>Net sales by segment*:</b>				
Semiconductor equipment	\$ 55,894	\$ 59,695	\$ 160,001	\$ 138,548
Television cameras	5,321	3,840	13,566	12,329
Microwave communications	13,572	3,288	19,932	8,088
Total consolidated net sales and net sales for reportable segments	<u>\$ 74,787</u>	<u>\$ 66,823</u>	<u>\$ 193,499</u>	<u>\$ 158,965</u>
<b>Segment profit (loss):</b>				
Semiconductor equipment	\$ 4,204	\$ 11,419	\$ 14,241	\$ 22,818
Television cameras	237	(430)	(450)	(950)
Microwave communications	1,460	(132)	1,113	(938)
Profit for reportable segments	5,901	10,857	14,904	20,930
<b>Other unallocated amounts:</b>				
Gain on sale of facilities	—	—	2,963	—
Corporate expenses	(1,209)	(818)	(2,801)	(2,352)
Interest income	1,764	965	4,807	2,545
Income from continuing operations before income taxes	<u>\$ 6,456</u>	<u>\$ 11,004</u>	<u>\$ 19,873</u>	<u>\$ 21,123</u>

\* Intersegment sales were not significant in any period presented.



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<i>(in thousands)</i>	September 30, 2006	December 31, 2005
<b>Total assets by segment:</b>		
Semiconductor equipment	\$ 129,658	\$ 115,689
Television cameras	10,413	9,883
Microwave communications	12,346	13,919
Total assets for reportable segments	152,417	139,491
Corporate, principally cash and investments and deferred taxes	166,109	163,089
Discontinued operations	989	4,397
<b>Total consolidated assets</b>	<b>\$ 319,515</b>	<b>\$ 306,977</b>

**9. Contingencies**

We are occasionally involved in various legal proceedings, lawsuits, examinations by various tax authorities and claims that have arisen in the ordinary course of our businesses. Although the outcome of such legal proceedings, claims and examinations cannot be predicted with certainty, we do not believe any such matters exist at this time that will have a material adverse effect on our financial position or results of operations.

**10. Guarantees**

Our products are generally sold with a 12-month to 36-month warranty period following sale or installation. Parts and labor are covered under the terms of the warranty agreement. The warranty provision is based on historical and projected experience by product and configuration.

Changes in accrued warranty, of our continuing operations, during the third fiscal quarter and year-to-date 2006 and 2005 were as follows:

<i>(in thousands)</i>	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Balance at beginning of period	\$ 6,310	\$ 3,858	\$ 4,560	\$ 4,157
Warranty expense accruals	2,518	2,688	9,134	4,685
Warranty payments	(2,464)	(2,006)	(7,359)	(4,763)
Warranty liability assumed	—	—	29	461
<b>Balance at end of period</b>	<b>\$ 6,364</b>	<b>\$ 4,540</b>	<b>\$ 6,364</b>	<b>\$ 4,540</b>

Warranty expense during the first nine months of fiscal 2006 was impacted by higher than expected costs associated with supporting certain customer test handler applications and a change in estimate of future handler support costs.

In the ordinary course of business, from time-to-time, we provide standby letters of credit to certain parties. As of September 30, 2006, the maximum potential amount of future payments that Cohu could be required to make under these standby letters of credit is approximately \$1.0 million. We have not recorded any liability in connection with these guarantee arrangements beyond that required to appropriately account for the underlying transaction being guaranteed. We do not believe, based on historical experience and information currently available, that it is probable that any amounts will be required to be paid under these arrangements.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*This Form 10-Q contains certain forward-looking statements including expectations of market conditions, challenges and plans, within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and is subject to the Safe Harbor provisions created by that statute. Such forward-looking statements are based on management's current expectations and beliefs, including estimates and projections about our industries and include, but are not limited to, statements concerning financial position, business strategy, and plans or objectives for future operations. Forward-looking statements are not guarantees of future performance, and are subject to certain risks, uncertainties, and assumptions that are difficult to predict and may cause actual results to differ materially from management's current expectations. Such risks and uncertainties include those set forth in this Quarterly Report on Form 10-Q and our 2005 Annual Report on Form 10-K under the heading "Item 1A. Risk Factors". The forward-looking statements in this report speak only as of the time they are made, and do not necessarily reflect management's outlook at any other point in time. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events, or for any other reason, however, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the SEC after the date of this Quarterly Report.*

### OVERVIEW

Our primary business activity involves the development, manufacture, marketing, sale and servicing of test handling equipment and burn-in related thermal sub-systems for the global semiconductor industry. This business is significantly dependent on capital expenditures by semiconductor manufacturers and test subcontractors, which in turn are dependent on the current and anticipated market demand for semiconductors that are subject to significant cyclical trends in demand. Changes in the semiconductor, electronics, computer and telecommunications industries, as well as rapidly shifting global economic conditions, have had and will continue to have a significant impact on our businesses.

Our orders during the first nine months of 2006 have been strong, particularly in view of challenging industry-wide conditions for back-end semiconductor equipment. We do not expect near term orders to continue at the level we experienced in the third quarter of 2006. During the first nine months of 2006 there has been a decrease in demand for our advanced thermal handlers which has been offset by an increase in orders for our high-speed test handlers and burn-in related products. As a result of this shift in product mix, increased customer support costs and other factors described herein, our gross margin has declined during 2006. If this shift in product mix continues, our future gross margin percentage will be negatively impacted. We will continue to focus on reducing product costs and overall spending, while we develop new product offerings for the test handler and burn-in markets.

Our deferred revenue totaled \$32.1 million at September 30, 2006. This is a decrease of approximately \$10.5 million from June 24, 2006. The decrease in deferred revenue is primarily the result of the recognition of approximately \$7.9 million in revenue associated with our microwave communication business contract with the United Arab Emirates Armed Services ("UAE") which was accepted and paid during the third quarter of fiscal 2006. Additionally, during the third quarter of fiscal 2006 our semiconductor equipment business recognized deferred revenue upon receipt of customer acceptance for certain test handling equipment. The deferred revenue amounts recognized were partially offset by additional deferrals of semiconductor equipment product sales, including burn-in equipment acquired from Kryotech and Unisys, which as of September 30, 2006 are still awaiting customer acceptance.

Our operating results in the last three years have been impacted by charges to cost of sales related to excess, obsolete and lower of cost or market inventory issues. These charges totaled approximately \$16.6 million during the three-year period ended December 31, 2005 (approximately \$7.9 million in the first nine months of fiscal 2006) and were primarily the result of decreases in customer forecasts, competitive conditions in the test handler industry and, to a lesser extent, changes in our sales product mix as a result of new product introductions. During the third quarter of fiscal 2006 we experienced a decline in customer forecasts for a burn-in system acquired from Unisys that negatively impacted our forecasted inventory usage and, as a result, we recorded a charge of approximately \$4.6 million in addition to our charges for other products. Exposure related to inventories is common in the semiconductor equipment industry due to the narrow customer base, the custom nature of the products and inventory and the shortened product life cycles caused by rapid changes in semiconductor manufacturing technology. Increased competition, particularly in the last several years, has also negatively impacted our gross margins on certain products and we believe it is likely these conditions will exist for the foreseeable future.

Our other operating costs consist of research and development ("R&D") and selling, general and administrative expenses ("SG&A"). Both R&D and SG&A expense increased in 2006, due to increased headcount, increased

business volume, investment in product development programs and share-based compensation.

Our non-semiconductor equipment businesses have comprised approximately 14% of our revenues during the last three years. During 2006, results have improved in our microwave communications and our television camera businesses.

Our financial condition is strong with significant cash and short-term investments and no long-term debt. During the three-year period ended September 30, 2006, total cash and investments increased from \$107.6 million at September 30, 2003 to \$140.1 million at September 30, 2006.

Our management team uses several performance metrics to manage our various businesses. These metrics, which tend to focus on near-term forecasts due to the limited order backlog in our businesses, include (i) order bookings and backlog for the most recently completed quarter and the forecast for the next quarter; (ii) inventory levels and related excess exposures typically based on the next twelve month's forecast; (iii) gross margin and other operating expense trends; and (iv) industry data and trends noted in various publicly available sources. Due to the short-term nature of our order backlog that historically has represented about three months of business and the inherent volatility of the semiconductor equipment business, our past performance is frequently not indicative of future operating results or cash flows.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debts, inventories, intangible assets, income taxes, warranty obligations and contingencies and litigation. We base our estimates on historical experience, forecasts and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies, that are more fully described in our Consolidated Financial Statements included in Item 15 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, affect the significant judgments and estimates used in the preparation of our consolidated financial statements.

**Share-based Compensation:** On January 1, 2006, we adopted the provisions of Statement No.123R and SAB 107 requiring the measurement and recognition of all share-based compensation under the fair value method. During fiscal 2006, we began recognizing share-based compensation, under Statement No. 123R, for all awards granted in fiscal 2006 and for the unvested portion of previous award grants based on each award's grant date fair value. We implemented Statement No. 123R using the modified prospective transition method. Under this transition method our financial statements and related information presented, pertaining to periods prior to our adoption of Statement No. 123R, have not been adjusted to reflect the fair value of share-based compensation expense.

We estimate the fair value of each share-based award on the grant date using the Black-Scholes valuation model. To facilitate our adoption of Statement No. 123R, we applied the provisions of SAB 107 in developing our methodologies to estimate our Black-Scholes model inputs. Option valuation models, including Black-Scholes, require the input of highly subjective assumptions, and changes in the assumptions used can materially affect the grant date fair value of an award. These assumptions include the risk-free rate of interest, expected dividend yield, expected volatility, and the expected life of the award. The risk-free rate of interest is based on the U.S. Treasury rates appropriate for the expected term of the award. Expected dividends are based primarily on historical factors related to our common stock. Expected volatility is based on historic, weekly stock price observations of our common stock during the period immediately preceding the share-based award grant that is equal in length to the award's expected term. We believe that historical volatility is the best estimate of future volatility. Due to a limited amount of historical option exercise data related to options with a five-year contractual term, we adopted SAB 107's simplified method for estimating the expected term of share-based awards granted during the first six months of fiscal 2006. During the third quarter of fiscal 2006 we granted options with a ten-year contractual term and utilized historical option exercise data for estimating the expected life of those awards. Statement No. 123R also requires that estimated forfeitures be included as a part of the grant date estimate. We used historical data to estimate expected employee behaviors related to option exercises and forfeitures. Prior to our adoption of Statement No. 123R, we reduced pro-forma share-based compensation expense, presented in the notes to our financial statements, for actual forfeitures as they occurred.

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**Revenue Recognition:** We generally recognize revenue upon shipment and title passage for established products (i.e., those that have previously satisfied customer acceptance requirements) that provide for full payment tied to shipment. Revenue for products that have not previously satisfied customer acceptance requirements or from sales where customer payment dates are not determinable is recognized upon customer acceptance. For arrangements containing multiple elements, the revenue relating to the undelivered elements is deferred at estimated fair value until delivery of the deferred elements.

**Accounts Receivable:** We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

**Warranty:** We provide for the estimated costs of product warranties in the period sales are recognized. Our warranty obligation estimates are affected by historical product shipment levels, product performance and material and labor costs incurred in correcting product performance problems. Should product performance, material usage or labor repair costs differ from our estimates, revisions to the estimated warranty liability would be required.

**Inventory:** We record valuation reserves on our inventory for estimated excess and obsolete inventory and lower of cost or market concerns equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future product demand, market conditions and product selling prices. If future product demand, market conditions or product selling prices are less or more favorable than those projected by management or if continued modifications to products are required to meet specifications or other customer requirements, increases to inventory reserves may be required.

**Income Taxes:** We estimate our liability for income taxes based on the various jurisdictions where we conduct business. This requires us to estimate our actual current tax exposure and to assess temporary differences that result from differing treatment of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities that are reflected in the consolidated balance sheet. The net deferred tax assets are reduced by a valuation allowance if, based upon all available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. Establishing, reducing or increasing a valuation allowance in an accounting period results in an increase or decrease in tax expense in the statement of operations. We must make significant judgments to determine the provision for income taxes, deferred tax assets and liabilities and any valuation allowance to be recorded against net deferred tax assets. Our gross deferred tax asset balance as of September 30, 2006 was \$26.3 million, with a valuation allowance of \$1.8 million for state tax credit and loss carryforwards. The deferred tax assets consist primarily of deductible temporary differences, tax credit and net operating loss carryforwards.

**Intangible Assets:** At September 30, 2006, intangible assets other than goodwill were evaluated for impairment using undiscounted cash flows expected to result from the use of the assets as required by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, ("Statement No. 144"), and we concluded there was no impairment loss. We are required to assess goodwill impairment using the methodology prescribed by FASB Statement No. 142, *Goodwill and Other Intangible Assets*, ("Statement No. 142"). Statement No. 142 requires that goodwill be tested for impairment on an annual basis and more frequently in certain circumstances. The required annual goodwill impairment test is performed as of October 1<sup>st</sup> of each year. We did not recognize any goodwill impairment as a result of performing this annual test in fiscal 2005 and 2006.

**Contingencies:** We are subject to certain contingencies that arise in the ordinary course of our businesses. In accordance with FASB Statement No. 5, *Accounting for Contingencies*, ("Statement No. 5") we assess the likelihood that future events will confirm the existence of a loss or an impairment of an asset. If a loss or asset impairment is probable, as defined in Statement No. 5 and the amount of the loss or impairment is reasonably estimable, we accrue a charge to operations in the period such conditions become known.

**Recent Accounting Pronouncements:** In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*, ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing 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. This pronouncement is effective for fiscal years beginning after December 15, 2006, and we will adopt FIN 48 effective the beginning of fiscal 2007. We are currently assessing the impact of FIN 48 on our consolidated financial statements.

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In September 2006, the SEC Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, (“SAB 108”), that provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. This pronouncement is effective for fiscal years ending after November 15, 2006.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*, (“Statement No. 157”). This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. Statement No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except Statement No. 123(R) and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. We do not expect the adoption of Statement No. 157 to have a material impact on our financial position, results of operations, or cash flows.

In September 2006, the FASB issued Statement No. 158, *Employer’s Accounting for Defined Benefit Pension and Other Postretirement Plans*, (an amendment of FASB Statements No. 87, 88, 106, and 132R) (“Statement No. 158”). Statement No. 158 requires an employer to recognize in its statement of financial position an asset for a plan’s over funded status or a liability for a plan’s under funded status, measure a plan’s assets and its obligations that determine its funded status as of the end of the employer’s fiscal year (with limited exceptions), and 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 our comprehensive income and as a separate component of stockholders’ equity. This pronouncement will be effective for us as of the end of the fiscal year ending after December 15, 2006 and we will adopt Statement No. 158 in the fourth quarter of fiscal 2007. We are currently evaluating the impact of Statement No. 158 on our results of operations and financial condition.

## RESULTS OF OPERATIONS

The following table summarizes certain operating data from continuing operations as a percentage of net sales for the three- and nine-month periods ended September 30, 2006 and September 24, 2005.

	Three months ended		Nine months ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	(64.4)	(60.2)	(64.5)	(60.2)
Gross margin	35.6	39.8	35.5	39.8
Research and development expense	(15.0)	(11.1)	(14.7)	(13.2)
Selling, general and administrative expense	(14.3)	(13.7)	(14.5)	(14.9)
Gain on sale of facilities	—	—	1.5	—
Income from operations	6.3%	15.0%	7.8%	11.7%

In May, 2006, we sold our metal detection equipment business, FRL. Subsequent to the sale, the operating results of FRL are being presented as discontinued operations and all prior period financial statements have been reclassified accordingly. The discussion below covers the comparative results from continuing operations.

### Third Fiscal Quarter 2006 Compared to Third Fiscal Quarter 2005

#### Net Sales

Our net sales increased 11.9% to \$74.8 million in 2006, compared to net sales of \$66.8 million in 2005. Sales of semiconductor test handling equipment in the third quarter of fiscal 2006 decreased 6.4% from the comparable 2005 period and accounted for 74.8% of consolidated net sales in 2006 versus 89.3% in 2005. The primary reason for the decrease in sales of our semiconductor equipment business was decreased shipments of our advanced thermal test handlers due to a decline in customer demand. Semiconductor test handling equipment was a lower percentage of consolidated sales in the third quarter of fiscal 2006 as a result of the recognition of \$7.9 million in revenue from our contract with the UAE for microwave communications equipment.

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Sales of television cameras and other equipment accounted for 7.1% of net sales in 2006 and increased 38.6% when compared to the same period in 2005. The primary reason for the increase in sales of our television camera business was increased demand for board level cameras from original equipment manufacturers and increased demand for closed circuit security cameras.

Sales of microwave equipment accounted for 18.1% of net sales in fiscal 2006 and increased 312.8% when compared to fiscal 2005. The increase in sales of our microwave communications business was primarily attributable to the recognition of approximately \$7.9 million in revenue associated with our contract with the UAE which was accepted and paid and increased demand for our other products during the third quarter of fiscal 2006.

### **Gross margin**

Our gross margin, as a percentage of net sales, decreased to 35.6% in 2006 from 39.8% in 2005. The decrease was the result of lower margins in our semiconductor equipment and microwave communications businesses. During the third quarter of fiscal 2006, high-speed test handlers accounted for a greater percentage of revenue than in fiscal 2005. Our high-speed test handlers have significantly lower gross margins than our advanced thermal test handlers. The decline in gross margin due to this shift in product mix was offset by the recognition of deferred revenue with above average gross margins. Our consolidated gross margin was also negatively impacted when our microwave communications business recognized approximately \$7.9 million in revenue associated with its contract with the UAE which generated a gross margin of approximately 21%. The remaining revenue of \$1.0 million and associated profit under this contract will be recognized upon completion of the two-year warranty period. Additionally, during the third quarter of fiscal 2006, we recorded approximately \$0.1 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

Our gross margin has been impacted by charges to cost of sales related to excess, obsolete and lower of cost or market inventory issues. We compute the majority of our excess and obsolete inventory reserve requirements using a one-year inventory usage forecast. During the third quarter of fiscal 2006 and 2005, we recorded net charges to cost of sales of approximately \$6.8 million and \$2.3 million, respectively, for excess and obsolete inventory. Approximately \$4.6 million of the charge recorded during the third fiscal quarter of 2006 was a result of a decline in customer forecasts for a burn-in system, acquired from Unisys, which negatively impacted our forecasted inventory usage. While we believe our reserves for excess and obsolete inventory and lower of cost or market concerns are adequate to cover our known exposures at September 30, 2006, reductions in customer forecasts or continued modifications to products, as a result of our failure to meet specifications or other customer requirements, will result in additional charges to operations that could negatively impact our gross margin in future periods. Conversely, if our actual inventory usage is greater than our forecasted usage, our gross margin in future periods may be favorably impacted.

### **Research and Development Expense**

R&D expense as a percentage of net sales was 15.0% in 2006, compared to 11.1% in 2005, increasing from \$7.4 million in fiscal 2005 to \$11.3 million in fiscal 2006. Higher R&D expense in 2006 was primarily a result of increased engineering headcount and overhead costs as a result of our Unigen acquisition and labor and material costs for new product development within our semiconductor equipment business. Additionally, during the third quarter of fiscal 2006, we recorded approximately \$0.3 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

### **Selling, General and Administrative Expense**

SG&A expense as a percentage of net sales increased to 14.3% in 2006, from 13.7% in fiscal 2005, increasing from \$9.1 million in 2005 to \$10.7 million in 2006. The increase in SG&A expense was primarily related to increased business volume, and recognition of deferred costs associated with our microwave communications contract with the UAE. Additionally, during the third quarter of fiscal 2006, we recorded approximately \$0.7 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

### **Interest Income**

Interest income was approximately \$1.8 million and \$1.0 million in fiscal 2006 and 2005, respectively. The increase in interest income resulted from an increase in our average cash and cash equivalents and investment balances and higher interest rates in fiscal 2006.

### ***Income Taxes***

The provision for income taxes expressed as a percentage of pretax income was 30.3% in 2006 and 12.3% in 2005. The income tax provision included in the statements of income for the three months ended September 30, 2006 and September 24, 2005, is based on the estimated annual effective tax rate for the entire year. These estimated effective tax rates are subject to adjustment in subsequent quarterly periods as our estimates of pretax income for the year are increased or decreased. The effective tax rate of 30.3% for the three months ended September 30, 2006 is less than the U.S. federal statutory rate primarily due to state research and development tax credits, export sales benefits and the domestic manufacturing deduction offset by the effect of Statement No. 123R that does not allow deferred tax benefits to be recognized on compensation expense related to incentive stock options. The tax provision for the three months ended September 24, 2005 includes a reduction in the valuation allowance on deferred tax assets of approximately \$1.6 million.

In accordance with Statement No. 109, net deferred tax assets are reduced by a valuation allowance if, based on all the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance of approximately \$1.8 million was provided on deferred tax assets at September 30, 2006 and December 31, 2005. The amount of deferred tax assets considered realizable was determined based on (i) taxable income in prior carryback years; (ii) future reversals of existing taxable temporary differences (i.e. offset gross deferred tax assets against gross deferred tax liabilities); (iii) tax planning strategies; and (iv) future taxable income, exclusive of reversing temporary differences and carryforwards.

We have derived significant tax benefits from export sales. As a result of the American Jobs Creation Act of 2004, the export sales benefit derived from the ETI was repealed subject to a phase-out that limits the full tax benefit to 60% in 2006. The ETI benefit was replaced with a deduction for domestic manufacturing activities subject to a phase-in beginning in 2005. The future tax benefits we derive from the domestic manufacturing deduction will likely be less than those from ETI.

The federal research credit expired on December 31, 2005. Legislation to retroactively reinstate the credit is pending in the U.S. Congress; however it had not been enacted and signed into law as of September 30, 2006. Accordingly, no benefit from the federal research credit has been included in estimating the 2006 effective tax rate. If Congress retroactively reinstates the research credit, the effect of the credit will be reflected in the computation of the annual effective tax rate beginning as of the first period that includes the enactment date of the legislation.

### ***Other Items***

In May, 2006, we sold substantially all the assets of our metal detection equipment business, FRL. The disposition resulted in a loss of approximately \$1.3 million of which \$0.5 million was recorded in the three months ended September 30, 2006.

As a result of the factors set forth above, our income from continuing operations was \$4.5 million in 2006, compared to \$9.7 million in 2005. Our net income was \$4.2 million in 2006, compared to \$9.6 million in 2005.

### **Year-to-Date 2006 Compared to Year-to-Date 2005**

#### ***Net Sales***

Our net sales increased 21.7% to \$193.5 million in 2006, compared to net sales of \$159.0 million in 2005. Sales of semiconductor test handling equipment year-to-date 2006 increased 15.5% from the comparable 2005 period and accounted for 82.7% of consolidated net sales in 2006 versus 87.2% in 2005. The primary reason for the increase in sales of our semiconductor equipment business was increased customer demand for our high-speed test handlers in the first and second quarters of fiscal 2006 as compared to fiscal 2005. Additionally, we saw a significant increase in sales within our microwave communications business as a result of the recognition of our contract with the UAE.

Sales of television cameras and other equipment accounted for 7.0% of net sales in 2006 and increased 10.0% when compared to the same period in 2005. The primary reason for the increase in sales of our television camera business was increased demand for board level cameras from original equipment manufacturers and increased demand for closed circuit security cameras from international customers.

Sales of microwave equipment accounted for 10.3% of net sales in fiscal 2006 and increased 146.4% when compared to fiscal 2005. The increase in sales of our microwave communications business was primarily attributable to the recognition of approximately \$7.9 million in revenue associated with our contract with the UAE which was accepted and paid and increased demand for our products for homeland security applications.



### **Gross margin**

Gross margin, as a percentage of net sales, decreased to 35.5% in 2006 from 39.8% in 2005. The decrease was the result of lower margins in our semiconductor equipment business. During the first nine months of fiscal 2006, high-speed test handlers accounted for a greater percentage of revenue than in fiscal 2005. Our high-speed test handlers have significantly lower gross margins than our advanced thermal test handlers. This shift in product mix was partially offset as our semiconductor equipment business received customer acceptance and recognized deferred revenue with above average gross margins. Consolidated gross margin was also negatively impacted when our microwave communications business recognized approximately \$7.9 million in revenue associated with its contract with the UAE which generated a gross margin of approximately 21%. The remaining revenue of \$1.0 million and associated profit under this contract will be recognized upon completion of the two-year warranty period. Additionally, year-to-date 2006, we have recorded approximately \$0.3 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

During the first nine months of fiscal 2006 and 2005, we recorded net charges to cost of sales of approximately \$7.9 million and \$4.6 million, respectively, for excess and obsolete inventory. Approximately \$4.6 million of the charge recorded during the first nine months of 2006 was a result of a decline in customer forecasts for a burn-in system, acquired from Unisys, which negatively impacted our forecasted inventory usage.

### **Research and Development Expense**

R&D expense as a percentage of net sales was 14.7% in 2006, compared to 13.2% in 2005, increasing from \$20.9 million in fiscal 2005 to \$28.6 million in fiscal 2006. Higher R&D expense in 2006 was primarily a result of increased engineering headcount and overhead expense as a result of the Unigen acquisition and increased labor and material costs for product development within our semiconductor equipment business. Additionally, year-to-date 2006, we have recorded approximately \$0.8 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

### **Selling, General and Administrative Expense**

SG&A expense as a percentage of net sales decreased to 14.5% in 2006, from 14.9% in fiscal 2005, increasing in absolute dollars from \$23.7 million in 2005 to \$28.0 million in 2006. The increase in SG&A expense was primarily related to increased business volume within our semiconductor equipment business, the recognition of deferred costs associated with our microwave communications contract with the UAE and increases in headcount in our television camera and microwave equipment businesses. During fiscal 2006 we expanded our sales force at our television camera and microwave equipment businesses in an effort to increase our market share. Additionally, year-to-date 2006, we have recorded approximately \$1.6 million in share-based compensation expense as a result of our adoption of Statement No. 123R.

### **Interest Income**

Interest income was approximately \$4.8 million and \$2.5 million in fiscal 2006 and 2005, respectively. The increase in interest income resulted from an increase in our average cash and cash equivalents and investment balances and higher interest rates in fiscal 2006.

### **Income Taxes**

The provision (benefit) for income taxes expressed as a percentage of pretax income was 33.2% in 2006 and (3.1)% in 2005. The income tax provision (benefit) included in the statements of income for the nine months ended September 30, 2006 and September 24, 2005, is based on the estimated annual effective tax rate for the entire year. These estimated effective tax rates are subject to adjustment in subsequent quarterly periods as our estimates of pretax income for the year are increased or decreased. The effective tax rate of 33.2% for the nine months ended September 30, 2006 is less than the U.S. federal statutory rate primarily due to state research and development tax credits and export sales benefits and the domestic manufacturing deduction offset by the effects of Statement No. 123R that does not allow deferred tax benefits to be recognized on compensation expense related to incentive stock options.

Our income tax provision (benefit) in fiscal 2005 was impacted by (i) research tax credits and export sales benefits and (ii) a reduction in the valuation allowance on deferred tax assets of \$3.3 million for the nine months ended September 24, 2005. In addition, in March 2005, the Internal Revenue Service completed a routine examination of our consolidated tax returns for the period 2000 through 2002. The examination resulted in no assessment related to our



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tax returns as filed. Consequently, approximately \$3.0 million of accrued taxes related to the examined years were reversed with a corresponding credit to income tax expense in the quarter ended March, 2005.

### **Other Items**

In May, 2006, we sold the land and building previously used by our operations in Littleton, Massachusetts. The property was sold for \$6.5 million in cash, less related costs, resulting in a net pretax gain of approximately \$3.0 million which was recognized in the second quarter of fiscal 2006.

In May, 2006, we sold substantially all the assets of our metal detection equipment business, FRL. The disposition resulted in a loss of approximately \$1.3 million that was recorded in the first nine months of fiscal 2006.

As a result of the factors set forth above, our income from continuing operations was \$13.3 million in 2006, compared to \$21.8 million in 2005. Our net income was \$12.3 million in 2006, compared to \$21.7 million in 2005.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our business is dependent on capital expenditures by semiconductor manufacturers and test subcontractors that are, in turn, dependent on the current and anticipated market demand for semiconductors. Demand for semiconductors is cyclical and volatile. In response, we have in the past implemented cost reduction programs aimed at aligning our ongoing operating costs with our currently expected revenues over the near term. These cost management initiatives have included consolidating facilities, reductions to headcount and reduced spending. The cyclical and volatile nature of our industry makes estimates of future revenues, results of operations and net cash flows difficult.

Our primary historical source of liquidity and capital resources has been cash flow generated by operations. While we maintain a credit facility, we have not used this as a source of cash and do not intend to do so. We use cash to fund growth in our operating assets, including accounts receivable and inventory, and to fund new products and product enhancements primarily through research and development.

### **Liquidity**

**Working Capital:** The following summarizes our cash, cash equivalents, investments and working capital from continuing operations:

<i>(in thousands)</i>	September 30, 2006	December 31, 2005	Increase	Percentage Change
Cash, cash equivalents and investments	\$140,100	\$138,745	\$ 1,355	1.0%
Working capital	218,031	203,325	14,706	7.2%

### **Cash Flows**

**Operating Activities:** Our net cash flows provided from operating activities year-to-date 2006 totaled \$3.6 million. The major components of cash flows provided by operating activities were net income of \$12.3 million, loss from discontinued operations of \$0.9 million, offset by depreciation and amortization of \$4.9 million, non-cash share-based compensation expense of \$2.6 million, an increase in deferred tax assets of \$2.4 million, tax benefits from stock options exercised of \$0.9 million, and other net changes in current assets. The net change in current assets and liabilities included a decrease in accounts receivable and an increase in inventories of \$2.6 million and \$9.2 million, respectively. The decrease in accounts receivable was primarily attributable to the timing of cash collections and the increase in inventory was, in part, attributable to inventory acquired for new products related to the Unigen transaction and to meet customer demand for our products.

**Investing Activities:** Our net cash used for investing activities in 2006 totaled \$17.5 million and was primarily the result of \$63.1 million cash used for purchases of short-term investments; partially offset by \$48.4 million in net proceeds from sales and maturities of short-term investments. Our other expenditures year-to-date 2006 include the purchase of Unigen assets for \$7.7 million and purchases of property, plant and equipment of \$4.0 million. The acquisition of the Unigen assets was a strategic transaction to strengthen the portfolio of thermal products, patents and other intellectual property within our semiconductor equipment business. The purchases of property, plant and equipment were primarily made to support activities in our semiconductor equipment business and consisted primarily of equipment used in engineering, manufacturing and related functions. Investing activities also included cash receipts in the amount of \$6.2 million from the sale of our facility in Littleton, Massachusetts and \$2.7 million from the sale of our metal detection equipment business, FRL

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**Financing Activities:** Our net cash provided from financing activities included \$3.5 million received from the issuance of stock upon the exercise of stock options, and the tax benefits from stock options exercised of \$0.9 million, offset by \$4.1 million for the payment of dividends.

### **Capital Resources**

In June, 2006, we renewed our \$5.0 million unsecured bank line of credit bearing interest at the bank's prime rate. The line of credit will now expire in July, 2007. Our bank line of credit requires that we maintain specified minimum levels of net worth, limits the amount of our capital expenditures and requires us to meet certain other financial covenants. We were in compliance with all covenants at September 30, 2006. No borrowings were outstanding at September 30, 2006; however, \$1.0 million of the credit facility was allocated to standby letters of credit at September 30, 2006, leaving the balance of \$4.0 million available for future borrowings.

We expect that we will continue to make capital expenditures to support our business and we anticipate that present working capital and available borrowings under our line of credit will be sufficient to meet our operating requirements for at least the next twelve months.

### **Contractual Obligations and Off-Balance Sheet Arrangements**

**Contractual Obligations:** Our significant contractual obligations consist of operating leases and have not changed materially from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Purchase Obligations:** From time to time, we enter into commitments with our vendors to purchase inventory at fixed prices or in guaranteed quantities. We are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as purchase orders may represent authorizations to purchase rather than binding agreements. Our purchase orders are based on our current manufacturing needs and are fulfilled by our vendors within relatively short time horizons. We do not have significant agreements for the purchase of raw materials or other goods specifying minimum quantities or set prices that exceed our expected requirements for the next nine months.

**Off-Balance Sheet Arrangements:** During the ordinary course of business, we provide standby letters of credit instruments to certain parties as required. As of September 30, 2006, the maximum potential amount of future payments that we could be required to make under these standby letters of credit was approximately \$1.0 million. No liability has been recorded in connection with these arrangements beyond those required to appropriately account for the underlying transaction being guaranteed. We do not believe, based on historical experience and information currently available, that it is probable that any amounts will be required to be paid under these arrangements.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

**Interest rate risk.**

At September 30, 2006 our investment portfolio includes fixed-income securities with a fair value of approximately \$115.1 million. These securities are subject to interest rate risk and will decline in value if interest rates increase. Due to the relatively short duration of our investment portfolio, an immediate ten percent change in interest rates (e.g. 5.00% to 5.50%) would have no material impact on our financial condition or results of operations.

**Foreign currency exchange risk.**

We generally conduct business, including sales to foreign customers, in U.S. dollars and as a result we have limited foreign currency exchange rate risk. Monetary assets and liabilities of our foreign operations are not significant. The effect of an immediate ten percent change in foreign exchange rates would not have a material impact on our financial condition or results of operations.

**Item 4. Controls and Procedures.**

**(a) Evaluation of Disclosure Controls and Procedures.** Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

**(b) Changes in Internal Controls.** During the last fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II — OTHER INFORMATION

### Item 1. Legal Proceedings

The information set forth above under Note 9 contained in the “Notes to Unaudited Condensed Consolidated Financial Statements” is incorporated herein by reference.

### Item 1A. Risk Factors

The most significant risk factors applicable to Cohu are described in Part I, Item 1A (Risk Factors) of Cohu’s Annual Report on Form 10-K for the fiscal year ended December 31, 2005 (our “2005 Form 10-K”). There have been no material changes to the risk factors previously disclosed in our 2005 Form 10-K, except that we have updated the risk factors set forth below to reflect events occurring since the filing of our 2005 Form 10-K.

***Semiconductor equipment is subject to rapid technological change, product introductions and transitions may result in inventory write-offs and our new product development involves numerous risks and uncertainties.***

Semiconductor equipment and processes are subject to rapid technological change. We believe that our future success will depend in part on our ability to enhance existing products and develop new products with improved performance capabilities. We expect to continue to invest heavily in research and development and must manage product transitions successfully, as introductions of new products, including the products obtained in our asset acquisitions with KryoTech and Unigen, may adversely impact sales and/or margins of existing products. In addition, the introduction of new products by us or by our competitors, the concentration of our revenues in a limited number of large customers, the migration to new semiconductor test handling methodologies and the custom nature of our inventory parts increases the risk that our established products and related inventory may become obsolete, resulting in significant excess and obsolete inventory exposure. This increased exposure resulted in significant charges to operations during each of the years in the three-year period ended December 31, 2005 and the nine months ended September 30, 2006. Future inventory write-offs and increased inventory reserve requirements could have a material adverse impact on our results of operations and financial condition.

The design, development, commercial introduction and manufacture of new semiconductor equipment is an inherently complex process that involves a number of risks and uncertainties. These risks include potential problems in meeting customer acceptance and performance requirements, integration of the equipment with other suppliers’ equipment and the customers’ manufacturing processes, transitioning from product development to volume manufacturing and the ability of the equipment to satisfy the semiconductor industry’s constantly evolving needs and achieve commercial acceptance at prices that produce satisfactory profit margins. The design and development of new semiconductor equipment is heavily influenced by changes in integrated circuit assembly, test and final manufacturing processes and integrated circuit package design changes. We believe that the rate of change in such processes and integrated circuit packages is accelerating. As a result of these changes and other factors, assessing the market potential and commercial viability of new test equipment is extremely difficult and subject to a great deal of risk. In addition, not all integrated circuit manufacturers employ the same manufacturing processes. Differences in such processes make it difficult to design standard semiconductor test products that are capable of achieving broad market acceptance. As a result, we might not accurately assess the semiconductor industry’s future test requirements and fail to design and develop products that meet such requirements and achieve market acceptance. Failure to accurately assess customer requirements and market trends for new semiconductor test products may have a material adverse impact on our operations, financial condition and results of operations.

The transition from product development to the manufacture of new semiconductor equipment is a difficult process and delays in product introductions and problems in manufacturing such equipment are common. We have in the past and may in the future experience difficulties in manufacturing and volume production of our new equipment. In addition, as is common with semiconductor equipment, our after sale support and warranty costs have been significantly higher with new products than with our established products. Future technologies, processes and product developments may render our current or future product offerings obsolete and we might not be able to develop, introduce and successfully manufacture new products or make enhancements to our existing products in a timely manner to satisfy

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customer requirements or achieve market acceptance. Furthermore, we might not realize acceptable profit margins on such products.

***If we cannot continue to develop, manufacture and market products and services that meet customer requirements for innovation and quality, our revenue and gross margin may suffer.***

The process of developing new high technology products and services and enhancing existing products and services is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. In addition, in the course of conducting our business, we must adequately address quality issues associated with our products and services, including defects in our engineering, design and manufacturing processes, as well as defects in third party components included in our products. In order to address quality issues, we work extensively with our customers and suppliers and engage in product testing to determine the cause of quality problems and to determine appropriate solutions. Finding solutions to quality issues can be expensive and may result in additional warranty, replacement and other costs, adversely affecting our profits. In addition, quality issues can impair our relationships with new or existing customers and adversely affect our reputation, which could lead to a material adverse effect on our operating results.

***Our backlog is limited and may not accurately reflect future business activity.***

Our order backlog has historically represented approximately three months of business, however, during the last year it has been significantly in excess of revenue recognized in the following quarter. Due to the possibility of customer changes in delivery schedules, cancellation of orders, potential delays in product shipments, difficulties in obtaining inventory parts from suppliers, failure to satisfy customer acceptance requirements and the inability to recognize revenue under accounting requirements, our backlog at any point in time may not be representative of sales in any future period. Furthermore, all orders are subject to cancellation or rescheduling by the customer with limited penalty. A reduction in backlog during any particular period could have a material adverse effect on our business, financial condition and results of operations. In addition, our backlog at September 30, 2006, may not be a reliable indicator of revenues in future periods due to delayed delivery dates or customer requested changes to delivery schedules, order cancellations and delays in recognizing revenue due to accounting requirements.

***New accounting rules may impact our future operating results.***

A change in accounting standards or a change in existing taxation rules can have a significant effect on our reported results. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements have occurred and may occur in the future. These new accounting pronouncements and taxation rules may adversely affect our reported financial results or the way we conduct our business.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

*Recent Sales of Unregistered Securities*

None

*Issuer Purchases of Equity Securities*

None

### **Item 3. Defaults Upon Senior Securities**

None

### **Item 4. Submission of Matters to a Vote of Security Holders**

None.

### **Item 5. Other Information**

None.

## Table of Contents

### **Item 6. Exhibits.**

- 3.1 Amended and Restated Certificate of Incorporation of Cohu, Inc. incorporated herein by reference to Exhibit 3.1(a) from the Cohu, Inc. Form 10-Q for the quarterly period ended June 30, 1999
- 3.1(a) Certificate of Amendment of Amended and Restated Certificate of Incorporation of Cohu, Inc. incorporated herein by reference from the Cohu, Inc. Form S-8 filed June 30, 2000, Exhibit 4.1(a)
- 3.2 Amended and Restated Bylaws of Cohu, Inc. incorporated herein by reference to Exhibit 3.2 from the Cohu, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on December 12, 1996
- 4.1 Rights Agreement dated November 15, 1996, between Cohu, Inc. and ChaseMellon Shareholder Services, L.L.C., incorporated herein by reference from the Cohu, Inc. Report on Form 8-K filed December 12, 1996, Exhibit 4.1
- 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**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.

\_\_\_\_\_  
COHU, INC.  
(Registrant)

Date: October 30, 2006

\_\_\_\_\_  
/s/ James A. Donahue  
James A. Donahue  
President & Chief Executive Officer

Date: October 30, 2006

\_\_\_\_\_  
/s/ John H. Allen  
John H. Allen  
Vice President, Finance & Chief Financial Officer

**EXHIBIT INDEX**

<u>Exhibit No.</u>	<u>Description</u>
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COHU, INC.  
SARBANES-OXLEY ACT SECTION 302(a)  
CERTIFICATION

I, James A. Donahue, certify that:

1. I have reviewed this Form 10-Q of Cohu, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 30, 2006

/s/ James A. Donahue

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James A. Donahue  
President and Chief Executive Officer

COHU, INC.  
SARBANES-OXLEY ACT SECTION 302(a)  
CERTIFICATION

I, John H. Allen, certify that:

1. I have reviewed this Form 10-Q of Cohu, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 30, 2006

/s/ John H. Allen

John H. Allen

Vice President Finance & Chief Financial Officer

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)

In connection with the accompanying Quarterly Report of Cohu, Inc. (the "Company") on Form 10-Q for the fiscal quarter ended September 30, 2006 (the "Report"), I, James A. Donahue, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, based on my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 30, 2006

/s/ James A. Donahue

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James A. Donahue,  
President and Chief Executive Officer

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. SECTION 1350)

In connection with the accompanying Quarterly Report of Cohu, Inc. (the "Company") on Form 10-Q for the fiscal quarter ended September 30, 2006 (the "Report"), I, John H. Allen, Vice President Finance & Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, based on my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 30, 2006

/s/ John H. Allen

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John H. Allen,  
Vice President Finance & Chief Financial Officer