

UNITED FIRE & CASUALTY CO
Form 10-Q
April 25, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended March 31, 2008

Commission File Number 2-39621

UNITED FIRE & CASUALTY COMPANY

(Exact name of registrant as specified in its charter)

Iowa
(State of Incorporation)

42-0644327
(IRS Employer Identification No.)

118 Second Avenue, S.E., Cedar Rapids, Iowa 52407

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (319) 399-5700

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

YES NO

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

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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 April 21, 2008, 27,115,695 shares of common stock were outstanding.

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United Fire & Casualty Company and Subsidiaries

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Certification Pursuant to Section 906 - Chief Financial Officer

FORWARD-LOOKING INFORMATION

It is important to note that our actual results could differ materially from those projected in our forward-looking statements. Information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in Part I Item 2 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Part II, Item 1A “Risk Factors.”

PART I: FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****Consolidated Balance Sheets****United Fire & Casualty Company and Subsidiaries**

(Dollars in Thousands Except Per Share Data)

	March 31, 2008
	(unaudited)
ASSETS	
Investments	
Fixed maturities	
Held-to-maturity, at amortized cost (fair value \$19,915 in 2008 and \$27,981 in 2007)	\$ 19,360
Available-for-sale, at fair value (amortized cost \$1,786,713 in 2008 and \$1,786,915 in 2007)	1,814,472
Equity securities, at fair value (cost \$62,895 in 2008 and \$64,127 in 2007)	163,165
Trading securities, at fair value (amortized cost \$13,777 in 2008 and \$9,923 in 2007)	14,153
Mortgage loans	13,257
Policy loans	7,560
Other long-term investments	14,301
Short-term investments	95,302
	\$ 2,141,570
Cash and Cash Equivalents	\$ 268,476
Accrued Investment Income	28,618
Premiums Receivable	138,772
Deferred Policy Acquisition Costs	128,363
Property and Equipment (primarily land and buildings, at cost, less accumulated depreciation of \$31,077 in 2008 and \$30,198 in 2007)	10,259
Reinsurance Receivables and Recoverables	43,386
Prepaid Reinsurance Premiums	2,576
Income Taxes Receivable	-
Other Assets	17,202
TOTAL ASSETS	\$ 2,779,222

LIABILITIES AND STOCKHOLDERS' EQUITY**Liabilities**

Future policy benefits and losses, claims and loss settlement expenses

Property and casualty insurance	\$ 489,195
Life insurance	1,189,494
Unearned premiums	234,386
Accrued expenses and other liabilities	72,442
Income taxes payable	978
Deferred income taxes	33,398

The Company issued warrants to purchase 40

The amended conversion feature described a

In October 2005, the noteholder converted \$

In connection with the issuance of the Decem

The Company issued warrants to purchase 1,

Loss on equity in investment subsidiary

.

In July 2004, Lumera completed an initial pu

Gain on Sale of Securities of Equity Subsidia

During 2005 Microvision sold 812,000 share

Income Taxes.

No provision for income taxes has been reco

Inducement for Conversion of Preferred Stock

In September 2004, Microvision raised \$10.0

The net cash proceeds of \$9,910,000 were al

Subsequent to the relative fair value allocati

In August 2005, the holder of the Company's

YEAR ENDED DECEMBER 31, 2004 COM

Contract Revenue.

Contract revenue decreased by \$4.7 million,

In 2004, 55% of contract revenue was derive

In May 2004, Microvision entered into a \$3.

In December 2004, Microvision entered into

The Company had a contract revenue backlo

Product Revenue.

Product revenue increased \$1.5 million or 12

During 2004, Microvision earned \$864,000 f

During 2004 and 2003, Microvision recorded

The Company had a product revenue backlo

Cost of Contract Revenue.

Cost of contract revenue decreased by \$449,

During 2004, the Company experienced unpr

Cost of Product Revenue.

Cost of product revenue increased \$2.8 milli

Microvision's costs to produce Nomad units

Cost of product revenue in 2004 includes the

Research and Development Expense.

Research and development expense decrease

Research and development expense attributa

In April 2004, Lumera and the University of

Research and development expense in 2003

Sales, Marketing, General and Administrative

Sales, marketing, general and administrative

Non-Cash Compensation Expense.

Non-cash compensation expense decreased b

In September 2003, the Company issued two

In August 2000, the Company issued warran

During 2004, Lumera granted options to pur

During 2004, Lumera granted vested options

The following table shows the components o

Microvision stock, options and
Microvision stock options issu
Microvision stock and options
Lumera options issued to Micro
Lumera non-cash compensation e

At December 31, 2004, the Company had \$3

Interest Income and Expense.

Interest income in 2004 decreased by \$109,0

Interest expense was consistent with 2004 be

Loss on equity in investment subsidiary

In July 2004, Lumera completed an initial pu

Income Taxes.

No provision for income taxes has been reco

Non-cash Beneficial Conversion Feature of E

In September 2004, Microvision raised \$10.0

The warrant vested on the date of grant, has

The net cash proceeds of \$9,910,000 were al

Subsequent to the relative fair value allocatio

Liquidity and Capital Resources

Microvision has incurred significant losses s

As discussed elsewhere in this report, the Co

The Company plans to raise additional cash t

- Made significant changes to its senior management
- Announced a restructuring and realignment plan
- Begun adding members to the Board of Directors
- Engaged an investment bank to assist the Company

Cash used in operating activities totaled \$19.

The Company had the following material gain

- "Non cash interest expense, net" In connection with
- "Derivative feature of notes payable" In connection with
- "Allowance for receivables from related parties"

In 2005, Microvision determined that

- "Equity losses in Lamera", "Investment in Lu
- "Loss on debt extinguishment" In July 2005,
- The Company has concluded that the amend
- "Accounts receivable" and "Billings in exces
- "Inventory" Inventory decreased by \$2.4 mil

Raw materials
Work in process
Finished goods

Cash provided by investing activities totaled

The Company used cash of \$1.2 million for o

Cash provided by financing activities totaled

- In December 2005, the Company raised \$10.

The terms of the December Notes in

The Company concluded that the no

The warrants vested on the date of g

The Microvision common stock was

- In August and September 2005 the Company

In March 2005, the Company raised

The terms of the March Notes includ

The Company concluded that the no

The warrants vested on the date of g

In July 2005, the Company entered i

The Company has concluded that the

The amended conversion feature con

In October 2005, the noteholder con

The liability for both the initial warr

In September 2004, Microvision raised

The net cash proceeds of \$9.9 million

Subsequent to the relative fair value allocation

- In April 2004, Lumera raised \$2.3 million from
- In March 2004 Lumera raised \$500,000, before

The Company's investment policy restricts investments

Future operating expenditures and capital requirements

- the progress of research and development projects
- the progress in commercialization activities and
- the cost of filing, prosecuting, defending and
- competing technological and market developments
- Microvision's ability to establish cooperative

In order to maintain its exclusive rights under

The following table lists the Company's contractual

Contractual Obligations:

Open purchase orders *
Minimum payments under senior
convertible notes including
Minimum payments under capital
Minimum payments under operating
Minimum payments under research
and licensing agreements +

Total

* Open purchase orders represent commitments

+ License and royalty obligations continue to

Microvision's cash balance at December 31,

Microvision may also raise financing through

Should expenses exceed the amounts budgeted

New accounting pronouncements

In December 2004, the Financial Accounting

The Company is currently evaluating the

In November 2004 the FASB issued SFAS 1

In March 2005, the Securities and Exchange

Subsequent Events

In January 2006, the Company raised \$10,32

In January 2006 the Chief Executive Officer

ITEM 7A. QUANTITATIVE AND QUALI

Substantially all of the Company's cash equi

The maturities of cash equivalents and invest

Cash

Less than one year

All of the Company's development contract p

The Company owns 2.1 million shares of Lu

ITEM 8. FINANCIAL STATEMENTS AN

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Statements of Comprehensive Loss for the years ended December 31, 2005, 2004 and 2003

Consolidated 45

Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003

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Valuation and Qualifying Accounts and Reserves

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Microvision, Inc.:

We have completed integrated audits of Microvision's 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index, present fairly, in all material respects, the financial position of Microvision Inc. and its subsidiary at December 31, 2005 and

December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming that Microvision, Inc. will continue as a going concern. As more fully described in Note 1, the Company has incurred losses since inception, including a net loss of \$30.3 million for the year ended December 31, 2005 and its accumulated deficit was \$215.7 million at December 31, 2005. Additionally, the Company anticipates requiring additional financial resources to fund its operations at least through December 31, 2006. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans as to these matters are also described in Note 1. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in *Management's Report on Internal Control Over Financial Reporting*

appearing under Item 9A (b) that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control*

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- *Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Seattle, Washington
March 15, 2006

Microvision, Inc.

Consolidated Balance Sheets
(in thousands, except share and per share amounts)

	Decem 2005
Assets	
Current assets	
Cash and cash equivalents	\$ 6,860
Accounts receivable, net of allowances of \$264 and \$193	1,380
Costs and estimated earnings in excess of billings on uncompleted contracts	1,204
Inventory	759
Current restricted cash and investments	1,856
Other current assets	1,512
Total current assets	13,571
Investment in Lumera	3,582
Property and equipment, net	2,902
Restricted investments	1,000
Restricted investment in Lumera	2,184
Other assets	124
Total assets	\$ 23,363
Liabilities, Mandatorily Redeemable Convertible Preferred Stock and Shareholders' (Deficit) Equity	
Current liabilities	
Accounts payable	\$ 2,328
Accrued liabilities	4,513
Allowance for estimated contract losses	--
Billings in excess of costs and estimated earnings on uncompleted contracts	51
Liability associated with common stock warrants	3,452
Current portion of notes payable	7,896
Current portion of capital lease obligations	32
Current portion of long-term debt	22
Total current liabilities	18,294
Notes payable, net of current portion	1,447
Liability associated with embedded derivative feature	1,368
Capital lease obligations, net of current portion	105
Long-term debt, net of current portion	--
Deferred rent, net of current portion	1,492
Total liabilities	22,706
Commitments and contingencies (note 14)	--
Mandatorily redeemable convertible preferred stock, par value \$.001; 25,000 shares authorized; 5 and 10 shares issued and outstanding (liquidation preference of \$5,000 and \$10,000)	4,166
Shareholders' (Deficit) Equity	

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Common stock, par value \$.001; 73,000 shares authorized; 25,138 and 21,509 shares issued and outstanding	25
Additonal paid-in capital	212,993
Deferred compensation	(85)
Subscriptions receivable from related parties	--
Receivables from related parties, net	(792)
Accumulated deficit	(215,650)

Total shareholders' (deficit) equity	(3,509)

Total liabilities, mandatorily redeemable convertible preferred stock and shareholders' equity	23,363
	=====

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



Microvision, Inc.

Consolidated Statements of Operations
(in thousands, except per share amounts)

	Ye
	----- 2005 -----
Contract revenue	\$ 11,38
Product revenue	3,36

Total revenue	14,74

Cost of contract revenue	6,45
Cost of product revenue	8,63

Total cost of revenue	15,09

Gross margin	(34)

Research and development expense (exclusive of non-cash compensation expense of \$0, \$548, and \$1,006 for 2005, 2004 and 2003, respectively)	6,58
Sales, marketing, general and administrative expense (exclusive of non-cash compensation expense of \$429, \$1,570 and \$1,150 for 2005, 2004 and 2003 respectively)	19,92
Non-cash compensation expense	42

Total operating expenses	26,93

Loss from operations	(27,28)
Interest income	26
Interest expense	(3,25)
Gain on derivative features of notes payable, net	5,97
Loss on debt extinguishment	(3,31)
Other income (expense)	(2)

Loss before minority interests and equity in losses of Lumera	(27,64)
Minority interests in loss of consolidated subsidiary	-
Equity in losses of Lumera	(3,24)
Gain on sale of securities of equity subsidiary	2,70

Net loss	\$ (28,18)
Less: Stated dividend on mandatorily redeemable convertible preferred stock	(28)
Accretion to par value of preferred stock	(63)
Inducement for conversion of preferred stock	(1,18)

Net loss available for common shareholders	\$ (30,28)
	=====
Net loss per share basic and diluted	\$ (1.3)
	=====
Weighted-average shares outstanding basic and diluted	22,49
	=====

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

Microvision, Inc.

Consolidated Statements of Mandatorily Redeemable Convertible Preferred Stock and Stockholders' Equity
(in thousands)

	Mandatorily redeemable convertible preferred stock		Common Stock	
	Shares	Par Value	Shares	Par Value
Balance at December 31, 2002	--	\$ --	15,154	\$ --
Issuance of options to board members for services				
Issuance of stock, options and warrants to non-employees for services			9	
Exercise of warrants and options			82	
Sales of common stock			6,204	
Revaluations of warrants and options				
Extension of expiring employee options				
Amortization of deferred compensation				
Reclassification of receivables from related parties				
Establishment of par value of common stock				21
Other comprehensive income				
Net loss				
Balance at December 31, 2003	--	--	21,449	21
Issuance of options to board members for services				
Issuance of stock, options and warrants to non-employees for services				
Issuance of Lumera options to Microvision employees				
Amortization of deferred compensation				
Exercise of warrants and options			60	1
Sales of common stock				
Sales of preferred stock and warrants	10	8,590		
Beneficial conversion feature of mandatorily redeemable convertible preferred stock		(1,181)		
Dividend on preferred stock				
Non-cash accretion on mandatorily redeemable convertible preferred stock		238		
Net change in interest gain on Lumera initial public offering				
Other comprehensive income				
Net loss				
Balance at December 31, 2004	10	7,647	21,509	22
Issuance of stock, options and warrants to non-employees for services			7	
Deferred compensation on stock options				
Amortization of deferred compensation				
Exercise of warrants and options			5	--
Sales of common stock			2,171	2
Conversion of preferred stock	(5)	(4,539)	855	1

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Conversion of senior secured exchangeable convertible notes	310	--
Stock received for subscriptions receivable	(28)	--
Inducement to preferred shareholders		
Issuance of common stock and change in warrant value to preferred shareholders		
Beneficial conversion feature of mandatorily redeemable convertible preferred stock	421	
Issuance of common stock for payment on senior exchangeable convertible notes	258	--
Issuance of common stock for payment of interest on senior secured exchangeable convertible notes	40	--
Issuance of common stock on preferred dividend	11	--
Dividend on preferred stock		
Non-cash accretion on mandatorily redeemable convertible preferred stock	637	
Allowance for doubtful accounts on receivables from related parties		
Net loss		
Balance at December 31, 2005	5	\$ 4,166 25,138 \$ 25

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

Microvision, Inc.

Consolidated Statements of Comprehensive Income
(in thousands)

	Ye
	----- 2005 -----
Net loss	\$ (28,18
Other comprehensive loss	
Unrealized loss on investment securities, available-for-sale:	
Unrealized holding loss arising during period	-
Less: reclassification adjustment for gains realized in net loss	-
Net unrealized loss	-
Comprehensive loss	\$ (28,18

See accompanying notes to consolidated financial statements.

Microvision, Inc.

Consolidated Statement of Cash Flows
(in thousands)

	Year

	2005

Cash flows from operating activities	
Net loss	\$ (28,183)
Adjustments to reconcile net loss to net cash used in operations	
Depreciation	1,602
Loss (gain) on disposal of fixed assets	--
Non-cash expenses related to issuance of stock, warrants, and options, and amortization of deferred compensation	429
Non-cash interest expense, net	2,730
Derivative features of notes payable	(2,659)
Inventory write-downs	3,732
Allowance for receivables from related parties	1,031
Realized gain on sale of investment securities	--
Minority interests in loss of consolidated subsidiary	--
Equity in losses of Lumera	3,242
Gain on sale of securities of equity subsidiary	(2,700)
Loss on debt extinguishment	3,313
Non-cash deferred rent	(21)
Interest on notes payable	--
Allowance for estimated contract losses	(53)
Change in	
Accounts receivable	3,847
Intercompany receivable	--
Costs and estimated earnings in excess of billings on uncompleted contracts	(607)
Inventory	(1,324)
Other current assets	61
Other assets	340
Accounts payable	(1,050)
Accrued liabilities	(190)
Billings in excess of costs and estimated earnings on uncompleted contracts	(3,267)
Notes payable	--
Research liability, current and long-term	--

Net cash used in operating activities	(19,727)

Cash flows from investing activities	
Sales of investment securities	1,248
Purchases of investment securities	(1,248)
Sales of restricted investment securities	1,238
Purchases of restricted investment securities	(2,101)
Increase in restricted cash	(755)
Collections of receivables from related parties	--
Sale of long term investment - Lumera	3,893
Purchases of property and equipment	(1,239)

Net cash provided by used in investing activities	1,036

Cash flows from financing activities	

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Principal payments under capital leases	(46)
Proceeds from issuance of short term notes	--
Principal payments under long-term debt	(77)
Proceeds from issuance of notes and warrants	14,148
Payments on notes payable	(1,000)
Increase in deferred rent	1,492
Payment of preferred dividend	(173)
Net proceeds from issuance of common stock	9,939
Net proceeds from issuance of preferred stock and warrants	--
Net proceeds from sale of subsidiary's equity to minority interests	--

Net cash provided by financing activities	24,283

Net increase (decrease) in cash and cash equivalents	5,592
Cash and cash equivalents at beginning of period	1,268
Change in cash due to Lumera deconsolidation	--

Cash and cash equivalents at end of period	\$ 6,860
	=====
Supplemental disclosure of cash flow information	
Cash paid for interest	\$ 348
	=====
Supplemental schedule of non-cash investing and financing activities	
Property and equipment acquired under capital leases	\$ 135
	=====
Other non-cash additions to property and equipment	\$ 812
	=====
Conversion of preferred stock into common stock	\$ 4,117
	=====
Deferred compensation - warrants, options and stock grants	\$ 209
	=====
Issuance of common stock for payment of principal and interest on senior secured exchangeable convertible notes	\$ 997
	=====
Issuance of common stock and warrants for services	\$ --
	=====

The accompanying notes are an integral part of these financial statements.

1. The Company

The consolidated financial statements include the accounts of Microvision, Inc. ("Microvision"), a Delaware corporation, and Lumera Corporation ("Lumera"), a Delaware corporation, (collectively the "Company"). Prior to July 2004, Lumera was a subsidiary and was consolidated into Microvision. In July 2004, Lumera completed an initial public offering of its common stock and as a result of the change in ownership, ceased to be consolidated and became an equity method investment on Microvision.

Microvision was established to acquire, develop, manufacture and market scanned beam technology, which projects images using a single beam of light. Microvision has entered into contracts with commercial and U.S. government customers to develop applications using the scanned beam technology. Microvision has introduced two commercial products, Nomad, a see through head-worn display, and Flic, a hand-held bar code scanner. In addition, Microvision has produced and delivered various demonstration units using Microvision's display technology. Microvision is working to commercialize additional products for potential medical, defense, industrial, aviation, and consumer applications.

Lumera was established to develop, manufacture and market optical devices using organic non-linear electro-optical chromophore materials. Lumera is working to commercialize the devices for potential wireless networking and optical networking applications.

The accompanying consolidated financial statements have been prepared assuming that the Company continues as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

The Company's current cash resources are sufficient to fund operations through July 2006. The Company plans to raise additional cash before July 2006 through the sale of its common stock, preferred stock or through the issuance of debt. The Company has taken the following actions to reduce its use of cash and improve the operations of the Company:

- Made significant changes to its senior management team including appointing a new Chief Executive Officer.
- Announced a restructuring and realignment plan that targets a 30% reduction in operating loss
- Begun adding members to the Board of Directors with experience that directly supports the Company's business objectives.
- Engaged an investment bank to assist the Company in pursuing financing alternatives.

The Company's operating plan calls for the addition of sales, marketing, technical and other staff and the purchase of additional laboratory and production equipment. The Company's future expenditures and capital requirements will depend on numerous factors, including the progress of its research and development program, the progress in commercialization activities and arrangements, the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights, competing technological and market developments and the ability of the Company to establish cooperative development, joint venture and licensing arrangements. There can be no assurance that additional financing will be available to the Company or that, if available, it will be available on terms acceptable to the Company on a timely basis. If adequate funds are not available to satisfy either short-term or long-term capital requirements or planned revenues are not generated, the Company may be required to limit its operations substantially. This limitation of operations may include reduction in capital expenditures and reductions in staff and discretionary costs, which may include non-contractual research costs. The Company's capital requirements will depend on many factors, including, but not limited to, the rate at which the Company can, directly or through arrangements with original equipment manufacturers, introduce products incorporating the scanned beam technology

and optical polymer based products and the market acceptance and competitive position of such products.

2

Summary of significant accounting policies

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's management has identified the following areas where significant estimates and assumptions have been made in preparing the financial statements: revenue recognition, allowance for uncollectible receivables, management loans, inventory valuation and potential losses from litigation.

Principles of consolidation

The company has historically included both Microvision and Lumera Corporation ("Lumera"), a subsidiary that was consolidated through July 2004. In July 2004, Lumera completed an initial public offering of its common stock.

In connection with the Lumera initial public offering, all Lumera Series A and Series B Preferred Stock was converted into Lumera common stock. Immediately after the offering, Microvision owned 5,434,000 shares, or 33%, of the common stock of Lumera. As a result of the change in ownership percentage, Microvision

changed the method of accounting for its investment in Lumera to the equity method and after July 2004 recorded its share of Lumera income or losses. Microvision recorded a non-cash change in ownership interest gain of \$13.7 million to stockholders equity as a component of additional paid-in capital during 2004. At December 31, 2004 and 2005, Microvision owned 33% and 28%, respectively, of Lumera's common stock.

Cash, cash equivalents and investment securities

The Company considers all investments that mature within 90 days of the date of purchase to be cash equivalents. At December 31, 2005, all short-term investment securities held by the Company were classified as cash equivalents.

Inventory

Inventory consists of raw material; work in process and finished goods for the Company's Nomad and Flic products. Inventory is recorded at the lower of cost or market with cost determined on the weighted-average method. Management periodically assesses the need to provide for obsolescence of inventory and adjusts the carrying value of inventory to its net realizable value when required. In addition, Microvision reduces the value of its inventory to its estimated scrap value when management determines that it is not probable that the inventory will be consumed through normal production during the next twelve months.

Restricted cash and investments

As of December 31, 2005, restricted cash and investments includes:

- \$1.0 million irrevocable letter of credit as security on a lease agreement for the corporate headquarters building in Redmond, WA. The required letter of credit balance decreases over the term of the lease, which expires in 2013.
- \$754,000 cash received in connection with a lease agreement for the corporate headquarters building in Redmond, WA. The use of the cash is restricted to the terms of the tenant improvement agreement associated with the lease.

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- \$1.1 million certificates of deposit held as collateral for letters of credit issued in connection with a lease agreement for the former corporate headquarters building in Bothell, WA. The balance is required to be maintained for the remaining term of the lease, which expires in April 2006.
- \$1.0 million, 1,750,000 shares of Lumera common stock pledged as collateral for the Company's Notes.

Property and equipment

Property and equipment is stated at cost and depreciated over the estimated useful lives of the assets (two to five years) using the straight-line method. Leasehold improvements are depreciated over the shorter of estimated useful lives or the lease term.

Revenue recognition

Revenue has primarily been generated from contracts for further development of the scanned beam technology and to produce demonstration units for commercial enterprises and the United States government. Revenue on such contracts is recorded using the percentage-of-completion method measured on a cost incurred basis. The percentage of completion method is used because the Company can make reasonably dependable estimates of the contract cost. Changes in contract performance, contract conditions, and estimated profitability, including those arising from contract penalty provisions, and final contract settlements, may result in revisions to costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when realization is assured.

The Company recognizes losses, if any, as soon as identified. Losses occur when the estimated direct and indirect costs to complete the contract exceed unrecognized revenue. The Company evaluates the reserve for contract losses on a contract-by-contract basis.

Revenue from product shipments is recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition." Revenue is recognized when there is sufficient evidence of an arrangement, the

selling price is fixed and determinable and collection is reasonably assured. Revenue for product shipments is recognized upon acceptance of the product by the customer or expiration of the contractual acceptance period, after which there are no rights of return. Provisions are made for warranties at the time revenue is recorded. Warranty expense was not material for any periods presented.

Concentration of credit risk and sales to major customers

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash equivalents, investments and accounts receivable. The Company typically does not require collateral from its customers. The Company has a cash investment policy that generally restricts investments to ensure preservation of principal and maintenance of liquidity.

The United States government accounted for approximately 35%, 42%, and 49% of total revenue during 2005, 2004 and 2003, respectively. Contracts with three commercial customers represented 38%, 25%, and 35% of total revenues during 2005, 2004, and 2003, respectively. At December 31, 2004, one commercial customer accounted for 65% of the accounts receivable balance. The receivable was paid in full in January 2005. The United States government accounted for approximately 41% and 21% of the accounts receivable balance at December 31, 2005 and 2004, respectively. In 2005, 61% of consolidated revenue was earned from development contracts with two customers. In 2004, 11% of consolidated revenue was earned from a development contract with one customer.

Income taxes

Deferred tax assets and liabilities are recorded for differences between the financial statement and tax bases of the assets and liabilities that will result in taxable or deductible amounts in the future, based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is recorded for the amount of income tax payable for the period increased or decreased by the change in deferred tax assets and liabilities during the period.

Net loss per share

Basic net loss per share is calculated on the basis of the weighted- average number of common shares outstanding during the periods. Net loss per share assuming dilution is calculated on the basis of the weighted-average number of common shares outstanding and the dilutive effect of all potentially dilutive

securities, including common stock equivalents and convertible securities. Net loss per share assuming dilution for 2005, 2004 and 2003 is equal to basic net loss per share because the effect of dilutive securities outstanding during the periods including options and warrants computed using the treasury stock method, is anti-dilutive. The dilutive securities and convertible securities that were not included in earnings per share were 9,440,000, 6,836,000, and 6,295,000, at December 31, 2005, 2004 and 2003, respectively.

Research and development

Research and development costs are expensed as incurred.

Fair value of financial instruments

The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and long-term debt. The carrying amount of long-term debt at December 31, 2005 and 2004 was not materially different from the fair value based on rates available for similar types of arrangements. The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to the short maturities. The convertible notes are not publicly traded and it is not practicable for the Company to estimate the fair value of the convertible notes due to the absence of comparable publicly traded financial instruments.

Long-lived assets

The Company evaluates the recoverability of its long-lived assets when an impairment is indicated based on expected undiscounted cash flows and recognizes impairment of the carrying value of long-lived assets, if any, based on the fair value of such assets.

Stock-based compensation

The Company and Lumera each have stock-based employee compensation plans, which are more fully described in Note 13.

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and related amendments and interpretations, including FASB Interpretation Number ("FIN") 44, "Accounting for Certain Transactions Involving Stock Compensation," and complies with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Issue No. 96-18.

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Total non-cash stock option expense related to employee and director awards was \$94,000, \$1,057,000, and \$271,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Had compensation cost for employee and director options been determined using the fair values at the grant dates consistent with the methodology prescribed under SFAS 123, the Company's consolidated net loss available to common shareholders and associated net loss per share would have increased to the pro forma amounts indicated below (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Net loss available for common shareholders, as reported	\$ (30,284)	\$ (33,543)	\$ (26,1
Add: Stock-based employee compensation expense included in net loss available for common shareholders, as reported	94	339	2
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,931)	(5,886)	(8,9
Net loss available for common shareholders, pro forma	\$ (32,121)	\$ (39,090)	\$ (34,8
Net loss per share As reported	\$ (1.35)	\$ (1.56)	\$ (1.
Basic and diluted pro forma	\$ (1.43)	\$ (1.82)	\$ (1.

New accounting pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all employee share-based awards

granted after the effective date to be valued at fair value, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all share-based awards granted on or after January 1, 2006. In addition, companies must recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested employee awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. The first reporting period where employee share-based compensation will be recognized is March 31, 2006. Share-based compensation expense in 2006 will be affected by our stock price at the time of grants are awarded, the number and structure of stock-based awards our board of directors may grant during the year, any other actions taken with respect to outstanding options, as well as a number of complex and subjective valuation assumptions. These valuation assumptions include, but are not limited to, the future volatility of our stock price and employee stock option exercise behaviors. The Company is currently evaluating the alternative methods for implementing SFAS No. 123(R) and there is sufficient uncertainty surrounding future share-based compensation actions and valuation estimates that the Company is not in a position to provide a useful estimate of the financial statement impact of SFAS No. 123(R) in 2006 at this time.

In November 2004 the FASB issued SFAS 151 Inventory Cost - an Amendment of ARP No. 43, chapter 4 ("SFAS 151") which provides clarifies accounting for abnormal manufacturing costs. The Company is required to adopt SFAS 151 for years beginning after June 30, 2005. The Company does not believe that adoption of SFAS 151 will have a material impact on its financial statements.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107"), "Share Based Payment," which expresses the SEC's views on the interaction

between SFAS 123R and certain SEC rules and regulations. The Company is currently assessing the guidance in SAB 107 as part of its evaluation of the adoption of SFAS 123R.

3. Long-term contracts

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Cost and estimated earnings in excess of billings on uncompleted contracts comprises amounts of revenue recognized on contracts that the Company has not yet billed to customers because the amounts were not contractually billable at December 31, 2005 and 2004. The following table summarizes when the Company will be contractually able to bill the balance as of December 31, 2005 and 2004.

	Year Ended December 31,	
	2005	2004
Billable within 30 days	\$ 686,000	\$ 577,000
Billable between 31 and 90 days	3,000	2,000
Billable after 90 days	515,000	18,000
	-----	-----
	\$ 1,204,000	\$ 597,000
	=====	=====

"Billable after 90 days" includes \$496,000 of unbilled costs related to work on a development contract that are billable upon the completion of a contractual milestone that the Company plans to complete during the second quarter of 2006.

The Company's current contracts with the U.S. government are primarily cost plus fixed fee type contracts. Under the terms of a cost plus fixed fee contract, the U.S. government reimburses the Company for negotiated actual direct and indirect cost incurred in performing the contracted services. The Company is under no

obligation to spend more than the contract value to complete the contracted services. The period of performance is generally one year. Each of the Company's contracts with the United States government can be terminated for convenience by the government at any time.

In June 2005, the Company entered into a \$4,359,000 contract with General Dynamics C4 Systems to continue the development of a helmet-mounted display for the Air Warrior Block 3 system. General Dynamics is under contract with the U.S. Army's Product Manager -- Air Warrior in Huntsville, Ala., to develop and integrate the Air Warrior Block 3 system. The Microvision helmet-mounted display is being designed as a full-color, see-through, daylight and night- readable, high-resolution display.

In May 2004, Microvision entered into a \$3,900,000 contract modification with the U.S. Army's Aviation Applied Technology Directorate to continue work on an advanced helmet mounted display and imaging system to be used in the Virtual Cockpit Optimization Program.

In December 2004, Microvision entered into a \$6,200,000 contract with Ethicon Endo-Surgery, Inc. a subsidiary of Johnson & Johnson to integrate Microvision's technology into certain medical products. The

contract includes an exclusive license for Microvision's technology for certain human medical applications during the term of the development agreement.

In April 2003, the Company entered into a \$2,200,000 contract modification with the U.S. Army's Aviation Applied Technology Directorate to continue work on an advanced helmet mounted display and imaging system to be used in the Virtual Cockpit Optimization Program.

In April 2003, the Company entered into a \$1,600,000 contract modification with the U.S. Army's Medical Research Acquisition Activities, Telemedicine and Advanced Technology Research Center to continue development of a mobile wireless personal display system for medical applications.

The following table summarizes the costs incurred on the Company's revenue contracts:

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	December 31, 2005	December 31, 2004
Costs and estimated earnings incurred on uncompleted contracts	\$ 17,325,000	\$ 6,410,000
Billings on uncompleted contracts	(16,172,000)	(9,131,000)
	\$ 1,153,000	\$ (2,721,000)

Included in accompanying balance sheets under the following captions:

Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 1,204,000	\$ 597,000
Billings in excess of costs and estimated earnings on uncompleted contracts	(51,000)	(3,318,000)
	\$ 1,153,000	\$ (2,721,000)

4. Inventory

Inventory consists of the following:

	December 31, 2005	December 31, 2004
Raw materials	\$ 267,000	\$ 1,607,000
Work in process	141,000	77,000
Finished goods	351,000	1,483,000
	\$ 759,000	\$ 3,167,000

The inventory at December 31, 2005 and 2004 consisted of raw materials, work in process and finished goods for Nomad and Flic. Inventory is stated at the lower of cost or market, with cost determined on a weighted average basis. Management periodically assesses the need to provide for obsolescence of inventory and

adjusts the carrying value of inventory to its net realizable value when required. In addition, Microvision reduces the value of its inventory to its estimated scrap value when management determines that it is not probable that the inventory will be consumed through the normal course of business during the next twelve months. In 2005, 2004 and 2003, Microvision recorded inventory write-downs of \$3,732,000, \$2,084,000 and \$500,000 respectively.

5. Accrued liabilities

Accrued liabilities consist of the following:

	December 31,	
	2005	2004
Bonuses	\$ 1,000,000	\$ 1,600,000
Payroll and payroll taxes	732,000	763,000
Compensated absences	497,000	475,000
Taxes other than income taxes	12,000	43,000
Facility closing cost	--	253,000
Professional Fees	558,000	371,000
Relocation	166,000	90,000

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Consultants	525,000	
Other	1,023,000	943,000
	-----	-----
	\$ 4,513,000	\$ 4,538,000
	=====	=====

6. Property and equipment, net

Property and equipment consists of the following:

	December 31,	
	2005	2004
	-----	-----
Lab and production equipment	\$ 2,126,000	\$ 4,455,000
Leasehold improvements	3,990,000	2,165,000
Computer hardware and software	6,495,000	3,873,000
Office furniture and equipment	1,124,000	1,057,000
	-----	-----
	13,735,000	11,550,000
Less: Accumulated depreciation	(10,833,000)	(9,232,000)
	-----	-----
	\$ 2,902,000	\$ 2,318,000
	=====	=====

Depreciation expense was \$1,602,000, \$2,406,000 and \$3,113,000 in 2005, 2004 and 2003 respectively.

7. Receivables from related parties

In 2000, the Board of Directors authorized the Company to provide unsecured lines of credit to each of the Company's three senior officers. The limit of the line of credit is three times the executives' base salary less any amounts outstanding under the Executive Option Exercise Note Plan. In 2002 and 2001, the Board of Directors authorized a \$200,000 and \$500,000 addition, respectively, to the limit for one senior officer. The

lines of credit carry interest rates of 5.4% to 6.2%. The lines of credit must be repaid within one year of the senior officer's termination or within thirty days of demand by the Company in the event of a plan termination, provided that in the event of such a demand the senior officer may elect to deliver a promissory note with a one-year term in lieu of payment. At December 31, 2005 and 2004, a total of \$2,723,000 and \$2,723,000, respectively, was outstanding under the lines of credit.

In 2005, the Company determined that certain of its senior officers may have insufficient net worth and short-term earnings potential to repay loans outstanding under the Company's lines of credit. In 2003 and 2002, the Company recorded an allowance for doubtful accounts for receivables from senior officers of \$200,000 and \$700,000, respectively. In January 2006, two senior officers left the Company. Because the lines of credit are unsecured and collection is uncertain, the Company recorded an additional allowance of \$1,031,000 in December 2005. The balance of the allowance for doubtful accounts for receivables from senior officers was \$1,931,000 and \$900,000 at December 31, 2005 and 2004, respectively.

Under current SEC rules, the Company is prohibited from changing the repayment terms of the lines of credit. No repayments have been made on the outstanding lines of credit. At December 31, 2003, the Company reclassified the loan balance to shareholder's equity under the guidance provided by the SEC for loans to shareholders due to the absence of any repayments of the loans to date. The Company has no plans to forgive the principal balance outstanding under the lines of credit.

In 2000, three executive officers of the Company exercised a total of 128,284 stock options, in exchange for full recourse notes totaling \$285,000. These notes bear interest at 4.6% to 6.2% per annum. Each note is payable in full upon the earliest of (1) a fixed date ranging from January 31, 2001 to December 31, 2004 depending on the expiration of the options exercised; (2) the sale of all of the shares acquired with the note; (3) on a pro rata basis upon the partial sale of shares acquired with the note, or (4) within 90 days of the officer's termination of employment. At December 31, 2005 and 2004, a total of \$0 and \$165,600, respectively, was outstanding under the full recourse notes. The \$165,600 plus accrued interest was paid in full in February 2005. The notes are included as subscriptions receivable from related parties in shareholders' equity on the consolidated balance sheet.

The interest on both the lines of credit and the full recourse notes is forgiven if the executive is an employee of the Company at December 31 of the respective year. Compensation expense of \$156,000, \$163,000 and \$163,000 was recognized in 2005, 2004 and 2003, respectively, for interest forgiven.

8. Lumera Subsidiary Equity Transactions

In March 2000, Lumera issued 4,700,000 shares of its Class B common stock to the Company for services provided by the Company to Lumera valued at \$94,000. At the same time, Lumera issued 670,000 shares of its Class B common stock to certain Microvision employees for \$12,000 in cash.

In January 2001, Lumera issued 802,000 shares of Lumera Class A common stock to the University of Washington ("UW") at a value of \$3.75 per share in connection with the research agreement. The valuation of the shares issued to the UW was more than the per share carrying amount of the Company's interest in Lumera. Although the Company's percentage ownership in Lumera was reduced as a result of this transaction, the increased value of Lumera stock on the change in ownership interest resulted in a gain for the Company. The amount of the gain of \$3,001,000 resulting from the revaluation of the Company's interest in Lumera was credited to paid-in capital.

In March 2001, Lumera issued 2,400,000 shares of its Series A preferred stock at a price of \$10.00 per share. Included in this total were 264,000 shares issued to the Company in repayment of intercompany borrowings.

In October 2002, Lumera paid \$200,000 and issued a warrant to purchase 164,000 shares of Lumera Class A Common Stock at an exercise price of \$3.65 per share to Arizona Microsystems, Inc. in exchange for a license of certain Arizona Microsystems, Inc. technology. The warrant expires 10 years following the date of grant, and vests 25% on the date of grant and 25% annually from the date of grant. The warrant was valued at the date of grant at \$133,000. The total purchase price of \$333,000 was recorded as capitalized licensing costs. The fair value of the warrant was estimated using the Black Scholes option pricing model with a stock price of \$0.98 per share, dividend yield of zero percent; expected volatility of 100%; risk-free interest rate of 4.0% and expected life of ten years.

In August 2003, Lumera raised \$1,900,000, before issuance costs of \$34,000, from the sale of 944,000 shares of Series B convertible preferred stock to Microvision and other purchasers. Microvision purchased 434,000 of these shares for an aggregate purchase price of \$868,000. In October 2003, Lumera raised \$782,000 before

issuance costs of \$32,000, from the sale of 391,000 shares of Series B convertible preferred stock. Microvision did not purchase additional shares of Series B preferred stock in the October 2003 offering.

In August 2003, Lumera issued options to purchase an aggregate of 164,000 shares of its Class A Common Stock to two consultants in connection with entering into certain consulting agreements. Each holder was granted a warrant to purchase up to 82,000 shares of Class A Common Stock at a price of \$3.65 per share with a ten year life. In aggregate, 41,000 of the options were vested on the grant date. The remaining 123,000 shares vest one-third on each subsequent annual anniversary of the grant date were subject to remeasurement at each balance sheet date during the vesting period. The deferred compensation and liability related to these options was amortized to non-cash compensation expense over the two year period of service under the agreements. The aggregate value of both options was estimated

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at \$136,000 at the grant date and December 31, 2003. Total non-cash compensation expense was \$315,000 for the period from January 1, 2004 through July 2004, and \$32,000 for the year ended December 31, 2003. The fair values of the options were estimated at the grant date and December 31, 2003, using the Black Scholes option pricing model with the following weighted-average assumptions: underlying security fair market value of \$0.98, dividend yield of zero percent; expected volatility of 100% for both measurement dates; risk-free interest rates of 4.4% and 4.3%; and expected lives of 10 and 9.7 years, respectively.

During 2004, Lumera granted options to purchase 415,000 shares of Class A common stock to Lumera employees and directors with a weighted-average exercise price of \$2.00. Lumera subsequently determined that the fair market value of its common stock was greater than the exercise price of the options. Lumera recorded aggregate charges of \$216,000 during 2004 related to these grants.

During 2004, Lumera granted vested options to purchase 40,000 shares of Class A common stock to Microvision employees with a weighted-average exercise price of \$2.00. Lumera subsequently determined that the fair market value of its common stock was greater than the exercise price of the options. The Company recorded aggregate charges of \$134,000 during 2004 related to these grants.

In July 2004, Lumera completed an initial public offering of its common stock. As a result of the offering, Microvision's ownership interest in Lumera was reduced to 33%. As a result of the reduction in ownership, Microvision changed to the equity method of accounting for its investment in Lumera. Microvision recorded a non-cash change in interest gain of \$13.7 million during the third quarter. Because of uncertainty surrounding the ultimate realizability of the gain, the gain was recorded as an increase to stockholders' equity as a component of additional paid-in capital. As of December 31, 2005, Microvision owned 4,622,000 shares or 28% of Lumera's common stock.

During the period from inception to July 2004, losses in Lumera were first allocated to the holders of the common stock and then to the holders of the preferred shareholders pro rata in accordance with their respective ownership interest. Losses were not allocated to the options and warrants until exercised.

Lumera common stock, Series A preferred stock and Series B preferred stock were eliminated in consolidation with Microvision interests in Lumera common stock, Series A preferred stock, Series B preferred stock and options and warrants to purchase equity in Lumera held by investors other than the Company, and are presented as minority interests on the Company's consolidated balance sheet.

A reconciliation of the changes in ownership interests through Lumera's initial public offering is as follows (in thousands):

	Minority Interests				
	Common	Preferred	Total	Microvision	Total
Balance at December 31, 2002	\$ 308	\$ 6,915	\$ 7,223	\$ (440)	\$ 6,783
Issuance of preferred stock, net	--	1,735	1,735	868	2,603
Options and warrants	14	--	14	--	14
Loss allocation for 2003	--	(7,125)	(7,125)	(958)	(8,083)
Balance at December 31, 2003	322	1,525	1,847	(530)	1,317
Issuance of preferred stock, net	--	500	500	--	500
Preferred stock reallocation	--	413	413	(413)	--
Options and warrants	342	--	342	--	342
Loss allocation for 2004	--	(2,438)	(2,438)	(1,286)	(3,724)
Balance at July 2004	\$ 664	\$ --	\$ 664	\$ (2,229)	\$ (1,565)

As a result of the Series B stock issuance, the allocations of Lumera losses changed between Microvision and other minority interests and resulted in an additional \$413,000 of losses being allocated to minority interest during 2004, with a resultant change in interest loss allocated to Microvision. In July 2004, Microvision's ownership interest in Lumera was reduced to 33% as a result of Lumera completing an initial public offering of its common stock. As a result of the reduction in ownership, Microvision changed to the equity method of accounting for its investment in Lumera. Microvision recorded a non-cash change in interest gain of \$14,138,000 during the third quarter as a result of the change to the equity method. The net change in interest gain for 2004 was \$13,727,000. Because of uncertainty surrounding the ultimate realizability of the gain; the gain was recorded as an increase to stockholders' equity as a component of additional paid-in capital.

The following table shows the Lumera balances included in the consolidated balance sheet immediately prior to the change in interest and the reconciliation to the investment account shown at December 31, 2005.

Cash and cash equivalents	\$ 657
Costs and estimated earnings in excess of billings on uncompleted contracts	117
Other current assets	1,077
Property and equipment, net	2,369
Other assets	33
Accounts payable	(434)
Accrued liabilities	(1,315)
Current portion of research liability	(78)
Notes payable - current	(2,386)
Other long-term liabilities	(245)

Net Assets	(205)
Less minority interest options and warrants	(664)
Cumulative losses in excess of investment	(1,360)

	(2,229)
Gain on change in interest	14,138
Investment losses from July 2004 to December 31, 2004	(1,708)

Investment in Lumera at December 31, 2004	10,201
Investment losses from January 1, 2005 to December 31, 2005	(3,242)
Sales of Lumera Stock	(1,193)

Investment in Lumera at December 31, 2005	\$ 5,766
	=====

The difference between the amount at which an investment is carried at December 31, 2005 and the amount of underlying equity in net assets of Lumera is a result of equity transaction of Lumera for which Microvision does not recognize any change in interest gains or losses.

9. Long-term Notes

The following table summarizes the activity related to the issuance of convertible notes in 2005:

	Notes	Warrants	Embedded derivative feature	s
	-----	-----	-----	-----
March 10, 2005 issuance	\$ 5,395	\$ 1,650	\$ 2,955	\$
Debt restructuring at July 25, 2005		2,295	1,018	

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Conversion of debt to common stock at October 11, 2005	(1,398)		(439)
December 1, 2005 issuance	3,667	2,200	1,116
Principal payments on notes	(867)		
Discount accretion for the year ended December 31, 2005	2,546		
Changes in market value for the year ended December 31, 2005		(2,693)	(3,282)
	-----	-----	-----
Balances at December 31, 2005	\$ 9,343	\$ 3,452	\$ 1,368
	=====	=====	=====

December Notes

In December 2005, the Company raised \$10,000,000, before issuance costs of \$134,000, from the issuance of notes ("December Notes"), 838,000 shares of common stock and warrants to purchase an aggregate of 1,089,000 shares of Microvision common stock. The December Notes are convertible on demand by the holders into Microvision common stock at a conversion price of \$3.94 per share. The note holders may convert all or a portion of their December Notes. In addition, upon the request of the note holders, the Company is required to redeem the notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the December Notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the December Notes and the notes issued as of March 2005 ("March Notes") described below. Those shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

The terms of the December Notes include interest at LIBOR plus 3.0%, provided that the interest rate shall not be less than 6% or greater than 8% payable quarterly in cash or Microvision common stock if the stock price is greater than \$4.06 per share, at the election of the Company, subject to certain additional conditions. Under certain circumstances the interest rate increase to LIBOR plus 6% but not less than 12% or greater than 15%. If the Company chooses to pay interest in Microvision common stock as opposed to cash, the price will be based on 90% of the arithmetic average of the volume weighted average prices for the 20 trading days prior to the payment date. The December Notes are payable in five equal quarterly installments beginning in March 2006. The Company can elect to make the principal payments in common stock in lieu of cash if the stock price is greater than \$4.06 per share, subject to certain other conditions. If the Company elects to pay principal in stock the stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the December Notes into Microvision common stock if the stock price exceeds \$6.90 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the December Notes into Microvision common stock is an embedded derivative instrument as defined by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"). Accordingly, \$1.1 million of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 58%; expected dividend yield of 0%; risk free interest rates ranging from 4.01% to 4.39%; and contractual life of four to sixteen months, which corresponds to the principal repayment dates. Due to changes in Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to \$1,038,000 at December 31, 2005. The change in value of \$78,000 was recorded as a non-operating gain and included in Gain on derivative features of note payable in the consolidated statement of operations. At December 31, 2005 total principal payments of \$7.0 million remain under the December Notes.

The warrants issued with the December Notes vested on the date of grant, have an exercise price of \$3.94 per share of common stock share and expire in December 2010. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment

to the holders of the warrants. Accordingly, \$2.2 million of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 65%; expected dividend yield of 0%; risk free interest rate of 4.35%; and contractual life of five years.

The Microvision common stock was valued at the closing price on the date of closing of \$3.60 per share. Aggregate proceeds of \$3.0 million were allocated to the common stock. The remaining gross proceeds of \$3.7 million were allocated to the notes.

March Notes

In March 2005, the Company raised \$10,000,000, before issuance costs of \$423,000, from the issuance of convertible March Notes ("March Notes") and warrants to purchase an aggregate of 462,000 shares of Microvision common stock. The March Notes are convertible on demand by the holders into Microvision common stock at a conversion price of \$6.84 per share of Microvision common stock or Lumera common stock held by the Company at a conversion price of \$5.64 per share up to a limit of 1,750,000 shares of Lumera common stock. The right to convert the March Notes into shares of Lumera common stock was removed pursuant to the amendment described below. The initial conversion price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the conversion price of the March Notes. Due to below market issuances of Company's common stock the conversion price of the March Notes at December 31, 2005 was \$5.54 per share of common stock. In addition, upon the request of the Note holders, the Company is required to redeem the March Notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the March Notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the March Notes and the December Notes described above. Those shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

The terms of the March Notes include interest at LIBOR plus 3.0% payable quarterly in cash or Microvision common stock, at the election of the Company, subject to certain conditions. However, in no case shall the interest rate be less than 6.0% or greater than 8.0%. If the Company chooses to pay interest in Microvision common stock as opposed to cash, the price will be based on 92% of the arithmetic average of the volume weighted average prices for the 10 trading days prior to the payment date. The March Notes are payable in six equal quarterly installments beginning in December 2005. The Company can subject to certain conditions, elect to make the principal payments in common stock in lieu of cash. If the Company elects to pay principal in common stock, the Note holders can elect to receive Microvision or Lumera common stock. Payment in stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the March Notes into Microvision common stock if the stock price exceeds \$11.97 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the March Notes into Microvision or Lumera common stock is an embedded derivative instrument as defined by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"). Accordingly, \$2,955,000 of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The derivative instrument was valued using the higher of the Microvision or Lumera conversion feature. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 83%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of nine months to two years, which corresponds to the principal repayment dates. Due to changes in Lumera and Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to \$2,463,000 at July 25, 2005 the date of the deemed extinguishment described below. The decrease in the fair value of \$492,000 for the period from issuance to extinguishment was recorded as a non-operating gain and included in "Gain on derivative features of note payable" in the consolidated statement of operations. At December 31, 2005 total principal payments

of \$7.3 million remain under the March Notes.

The warrants issued with the March Notes vested on the date of grant, have an exercise price of \$6.84 per common share and expire in March 2010. The initial exercise price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the exercise price of the warrant. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the March Notes was adjusted to \$6.29 as of December 31, 2005.

The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, \$1,651,000 of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of five years. The remaining gross proceeds of \$5,394,000 were allocated to the Notes.

In July 2005, the Company entered into an agreement to amend the March Notes. In connection with the amendment, the Company issued three year warrants to purchase 750,000 shares of Microvision common stock at an exercise price of \$6.84 per share. The conversion price of the amended March Notes and exercise price of the warrants are subject to anti-dilution adjustments, subject to conditions. In addition, the price at which the note holders can convert the March Notes to Microvision common stock was reduced to \$5.85 per share, and the price at which the Company can mandatorily convert the March Notes to Microvision common stock was reduced to \$10.24. The note holders may convert all or a portion of their March Notes. As a result of the amendment, the March Notes are no longer exchangeable into Lumera common stock.

The Company has concluded that the amendment of the Notes met the criteria of a debt extinguishment. The Company recorded a charge of \$3,313,000 for the change in the fair value of the debt and related consideration between the original and the amended March Notes. The change in the value was measured as the value of the additional warrants that were issued to the note holders and the change in the price at which the debt could be converted to Microvision common stock. The additional warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 3.66%; and contractual life of three years. The additional warrants were initially valued at \$2,295,000. The change in the conversion feature was valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rates ranging from 3.25% to 3.58% and contractual life equal to the length of the option. The change in the conversion price was valued at \$1,018,000.

The amended conversion feature continued to meet the definition of a derivative under FAS 133 and accordingly has been recorded at fair value and included within long-term liabilities. The carrying amount of the derivative will be adjusted to fair value at each balance sheet date. An adjustment of in fair value \$2,712,000 was recorded for the period from July 25, 2005 to December 31, 2005.

In October 2005, the noteholder converted \$1.8 million of the March Notes to 310,000 shares of common stock. The value of the embedded derivative feature associated with the converted shares of \$439,000 was recorded to additional paid in capital.

The liability for both the initial warrant and the additional warrant are adjusted to the fair market value of \$1,273,000 at December 31, 2005. The combined adjustment during the year ended December 31, 2005 was \$2,672,000.

10. Convertible Preferred Stock

In August 2005, the holder of the Company's preferred stock agreed to convert 5,000 shares of the Company's preferred stock into 734,000 shares of common stock. As an inducement to convert the preferred stock the Company issued 124,000 shares of its common stock to the preferred stock holder and adjusted the exercise price from \$8.16 to \$6.84 per share for the existing warrants to purchase 362,000 shares of common stock issued in connection with the original sale of the Company's preferred stock. The value of the common shares issued of \$701,000, the change in the value of the warrants of \$62,000 and the amount of unamortized beneficial conversion feature on the preferred stock of \$421,000 was recorded as an inducement to convert the preferred stock and charged to common shareholders in 2005.

In September 2004, Microvision raised \$10,000,000 before issuance costs of \$90,000 from the sale of 10,000 shares of convertible preferred stock and a warrant to purchase 362,000 shares of common stock. The

preferred stock is convertible on demand by the holder into common stock at a conversion price of \$6.91 per share of common stock. The initial conversion price is subject to adjustment in the event Microvision issues common stock or derivative securities at a price per share of common stock below the market price or the conversion price of the preferred stock. Due to below market issuances of Company's common stock the conversion price of the Preferred Stock as of December 31, 2005 was \$6.36 per share of common stock.

In addition, upon the request of the preferred stockholder, Microvision is required to redeem the preferred stock for cash in certain circumstances, including in the event of a material breach of representations, warranties or covenants under the purchase agreement or a change in control. Accordingly, Microvision has classified the preferred stock as "mandatorily redeemable convertible preferred stock" in its consolidated balance sheet.

The preferred stock terms include a dividend of 3.5% per annum, payable quarterly in cash or registered common stock, at the election of the Company, subject to certain conditions. The preferred stock matures on September 10, 2007, at which time it is payable in cash or registered common stock, at the election of the Company, subject to certain conditions. Some of the conditions which would preclude the Company from paying in common stock are not within the Company's immediate control. The Company can elect to convert the preferred stock into common stock if the stock price exceeds \$12.09 per share, subject to certain conditions. The warrant was vested on the date of grant, has an exercise price of \$8.16 per share and expires on September 10, 2009. The initial exercise price is subject to adjustment in the event Microvision issues

common stock or derivative securities at a price per share of common stock below the market price or the exercise price of the warrant. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the Preferred Stock was adjusted to \$6.40 as of December 31, 2005.

The net cash proceeds of \$9,910,000 were allocated to the preferred stock and the warrant based on the relative fair values of the securities. The warrants were valued using the Black Scholes option-pricing model

with the following assumptions: expected volatility of 75%, risk free interest rate of 3.4%, and contractual life of five years. Proceeds of \$1.3 million were allocated to the warrant and were recorded as an increase to additional paid-in capital.

Subsequent to the relative fair value allocation, the effective conversion price of the convertible preferred stock was less than the closing price of Microvision's common stock on the date of commitment to purchase the preferred stock resulting in the recognition of a beneficial conversion feature in accordance with Emerging Issues Task Force No 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments.". This beneficial conversion feature was measured as \$1,181,000 which represents the

difference between the fair value of the common stock and the effective conversion price. This beneficial conversion feature was recorded to additional paid-in capital and will be recorded as a deemed dividend to preferred stockholders (accretion) over the stated life of the preferred stock which is three years.

During 2005, the Company recorded \$280,000 in dividends on the preferred stock and \$303,000 in accretion of the beneficial conversion feature of the preferred stock.

11. Common stock

In August and September 2005, the Company raised \$7,000,000, before issuance costs, through the sale of 1,333,000 shares of common stock at a price of \$5.25 per share and five-year fully exercisable warrants to purchase 301,000 shares of common stock at an exercise price of \$6.50 per share to a holder of the Company's preferred stock and other investors. The holder of the Company's preferred stock also agreed to convert 5,000 shares of the Company's preferred stock into 734,000 shares of common stock. (See Note 10).

In November 2003, the Company raised \$22,250,000, before issuance costs of \$1,454,000, from the sale of 3,560,000 shares of common stock to a group of private investors.

In August 2003, the Company issued 8,600 fully vested shares of Microvision common stock to a professional services firm in connection with consulting services provided to the Company. The shares were valued at \$7.28, the closing price on the date of issuance, and the full value of the shares, \$63,000, was charged to non-cash compensation at the time of issuance.

In March 2003, the Company raised \$12,560,000, before issuance costs of \$970,000, from the sale of 2,644,000 shares of common stock and warrants to purchase 529,000 shares of common stock at an exercise price of \$6.50 per share. Each share of common stock and accompanying partial warrant was sold for \$4.75. The warrants are first exercisable in September 2003 and expire in March 2008. The exercise price of the warrants was greater than the fair market value of the common stock on the date of issue.

12. Warrants

In September 2003, the Company issued two warrants to purchase an aggregate of 70,000 shares of common stock to a third party in exchange for services provided to the Company. One warrant grants the holder the right to purchase up to 60,000 shares of common stock at a price of \$7.50 per share. The warrant vests in three equal tranches on the date of grant, in December 2003, and March 2004. The other warrant grants the holder the right to purchase up to 10,000 shares at a price of \$12.00 per share and vests in March 2004. The unvested warrants were subject to remeasurement at each balance sheet date until vested. The deferred compensation related to these warrants was being amortized to non-cash compensation expense over the fourteen month service period of the agreement. Non-cash amortization expense related to these warrants was \$140,000 and \$192,000 for 2004 and 2003 respectively. The total value of the warrants was estimated on December 31, 2003 and the grant date at \$318,000 and \$328,000, respectively. The fair values of the warrants were estimated on the date of grant and December 31, 2003, using the Black Scholes option-pricing model with the following weighted-average assumptions: expected volatilities of 83%, risk-free interest rates of 2.7% and dividend yields of zero percent. The contractual lives used at the measurement dates above were 4 years and 3.9 years, respectively.

In August 2000, the Company issued warrants to purchase an aggregate of 200,000 shares of common stock to two consultants in connection with entering into certain consulting agreements with the Company. One of the consultants subsequently became a director. The warrants grant each of the holders the right to purchase up to 100,000 shares of common stock at a price of \$34.00 per share. The warrants to purchase an aggregate of 150,000 shares vested over three years and were subject to remeasurement at each balance sheet date during the vesting period. The remaining warrants to purchase an aggregate of 50,000 shares had a measurement date at the time of grant. The deferred

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compensation related to these warrants is being amortized to non-cash compensation expense over the five-year period of service under the agreements. The total original value of

both warrants were estimated at \$5,476,000.

On June 7, 2003, the warrants became fully vested and the value of both warrants was fixed. Total non-cash amortization expense was \$270,000, \$447,000, and \$595,000 for the years ended December 31, 2005, 2004 and 2003, respectively. The fair values of the warrants were estimated at June 7, 2003 and December 31, 2002 using the Black Scholes option-pricing model with the following weighted- average assumptions: dividend yield of zero percent, and expected volatility of 83% for all measurement dates; risk-free interest rates of 4.0%, and 5.0% and expected lives of 7.4 and 8.1 years.

The following summarizes activity with respect to Microvision common stock warrants during the three years ended December 31, 2005:

	Warrants to purchase common Shares	Weighted- average exercise price
	-----	-----
Outstanding at December 31, 2002	975,000	\$ 18.10
Granted:		
Exercise price greater than fair value	539,000	6.60
Exercise price less than fair value	60,000	7.50
Exercised	--	--
Canceled/expired	--	--

Outstanding at December 31, 2003	1,574,000	13.76
Granted:		
Exercise price greater than fair value	362,000	8.16
Exercised	(22,000)	6.50
Canceled/expired	(196,000)	18.41

Outstanding at December 31, 2004	1,718,000	12.14
Granted:		
Exercise price greater than fair value	2,602,000	5.59
Exercise price equal to fair value	7,000	5.32
Exercised	--	--
Canceled/expired	(207,000)	25.14

Outstanding at December 31, 2005	4,120,000	\$ 6.99
	=====	
Exercisable at December 31, 2005	4,120,000	\$ 6.99
	=====	

The following table summarizes information about the weighted-average fair value of Microvision common stock warrants granted:

	Year Ended December 31,		
	2005	2004	2003
	-----	-----	-----
Exercise price greater than fair value	\$ 2.74	\$ 4.07	\$ 1.69
Exercise price equal to fair value	3.24		
Exercise price less than fair value	--		4.10

The following table summarizes information about Microvision common stock warrants outstanding and exercisable at December 31, 2005:

Range of exercise prices	Warrants outstanding and exercisable		
	Number outstanding at December 31, 2005	Weighted average remaining contractual life (years)	Weighted average exercise price
\$3.94	1,090,000	4.92	\$ 3.94
\$4.80-\$5.32	241,000	1.64	4.81
\$6.10-\$6.29	1,513,000	3.47	6.25
\$6.40-\$6.56	1,006,000	2.65	6.47
\$7.50-\$12.00	70,000	1.70	8.14
\$34.00	200,000	4.61	34.00
\$3.94-\$34.00	4,120,000		

The fair value of the Microvision common stock warrants granted was estimated on the date of grant using the Black Scholes option-pricing model with the following weighted-average assumptions used for grants in 2005, 2004 and 2003, respectively: dividend yield of zero percent for all years; expected volatility of 70%, 75% and 83%; risk-free interest rates of 4.2%, 3.4%, and 2.1% and expected lives of 4, 5 and 3 years, respectively.

13. Options

The Company has several stock option plans ("Option Plans") that provide for granting incentive stock options ("ISOs") and nonqualified stock options ("NSOs") to employees, directors, officers and certain non-employees of the Company as determined by the Board of Directors, or its designated committee ("Plan Administrator"). The Company deems the fair market value of its stock on any given trading day to be the closing price of its stock on the NASDAQ National Market on that date.

In June 2005, shareholders approved an amendment to the Director Option Plan, increasing the number of shares reserved for the plan by 400,000, to 900,000 shares.

In June 2004, the Company granted its independent directors options to purchase an aggregate of 90,000 shares of common stock at an exercise price of \$8.35. The exercise price of the options was less than the fair market value of the shares at the date of grant. The Company recorded \$81,000 of deferred compensation expense related to these options in June 2004. The deferred compensation was amortized to non cash compensation expense over the one-year vesting period of the grants. Deferred compensation expense of \$35,000 and \$46,000 was recorded in 2005 and 2004, respectively.

In December 2003, the Board of Directors authorized extending the original expiration date for all outstanding employee options with original expiration terms of less than 10 years. Under terms of the offer, employees could extend the life of options that had original lives less than ten years by five years from the original expiration date. No other terms of the options were amended. All options were fully vested on the offer date. The extensions were voluntary and, in total, holders elected to extend 263,000 of the 264,000 eligible shares. At the time of the extensions the Company recorded \$145,000 in non-cash compensation expense for the

excess of the fair market value of the common stock over the relevant exercise prices of the options on the modification date.

In November 2002, the Company offered to exchange most of its outstanding options to purchase common stock for new options scheduled to be granted on or after June 11, 2003. All eligible options that were properly submitted for exchange were accepted and cancelled effective December 10, 2002. Employees tendered options to purchase an aggregate of 2,521,714 shares of the Company's common stock. Under the terms of the exchange program, the Company granted new options to purchase an aggregate of 1,731,825 shares of the Company's common stock on June 13, 2003. The exercise price of the new options was \$7.00 per share.

In May 2002, shareholders approved an amendment to the 1996 Stock Option Plan, increasing the number of shares reserved for the Plan by 2,500,000 to 8,000,000. The shareholders also approved amendments to the

Independent Director Stock Option Plan ("Director Option Plan") that increased the total shares reserved for the Plan by 350,000 to 500,000 shares; established a fully vested option grant to purchase 15,000 shares to each independent director upon initial election or appointment to the Board of Directors; increased the number of shares granted in the annual initial and reelection grants from 5,000 to 15,000; granted a one-time option to each independent director to purchase 10,000 shares; and, authorized the Board of Directors to make discretionary grants.

For Option Plan grants, other than non-discretionary grants to directors, the date of grant, option price, vesting period and other terms specific to options granted are determined by the Plan Administrator. The specific terms of Mandatory Director Grants are specified by the plan document.

Stock options issued under the Option Plans, other than the Director Option Plan, generally have vesting ranges from three years to four years; expirations of 10 years; and exercise prices greater than or equal to the fair market value of the Company's stock on the date of grant.

The Director Option Plan provides for two types of Mandatory Grants: a fully vested option to purchase 15,000 shares of common stock to each independent director upon initial election or appointment to the Board of Directors, and an additional initial or annual reelection option to purchase 15,000 shares of common stock, which the earlier of one year or no later than the Company's subsequent regularly scheduled annual shareholders' meeting. For both types of Mandatory Grants, the exercise prices are set equal to the closing price of the Company's common stock as reported on the NASDAQ National Market on the date of grant and have ten year terms. Upon leaving the Board, the director's grants remain exercisable until their expiration dates.

The following table summarizes activity with respect to Microvision common stock options for the three years ended December 31, 2005:

	Shares	Weighted- average exercise price
	-----	-----
Outstanding at December 31, 2002	3,076,000	\$ 16.03
Granted:		
Exercise price greater than fair value	1,935,000	7.15
Exercise price equal to fair value	378,000	6.76
Exercise price less than fair value	197,000	6.93
Exercised	(82,000)	6.60
Forfeited	(783,000)	10.06

Outstanding at December 31, 2003	4,721,000	12.43

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Granted:		
Exercise price greater than fair value	177,000	7.55
Exercise price equal to fair value	487,000	6.76
Exercise price less than fair value	90,000	8.35
Exercised	(38,000)	6.25
Forfeited	(319,000)	12.03

Outstanding at December 31, 2004	5,118,000	11.72

Granted:		
Exercise price greater than fair value	--	--
Exercise price equal to fair value	274,000	5.34
Exercise price less than fair value	300,000	5.32
Exercised	(5,000)	4.03
Forfeited	(367,000)	10.99

Outstanding at December 31, 2005	5,320,000	\$ 11.09
=====		
Exercisable at December 31, 2005	4,515,000	\$ 11.90
=====		

The following table summarizes information about the weighted-average fair value of Microvision common stock options granted:

	Year Ended December 31,		
	2005	2004	2003
Exercise price greater than fair value	\$ --	\$ 3.19	\$ 3.19
Exercise price equal to fair value	3.21	3.33	4.26
Exercise price less than fair value	3.66	4.58	2.69

The following table summarizes information about Microvision common stock options outstanding and exercisable at December 31, 2005:

Range of exercise prices	Options outstanding			Options exercisable	
	Number outstanding December 31, 2005	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable December 31, 2005	Weighted average exercise price
\$3.25-\$5.32	558,000	9.05	\$ 5.09	133,000	\$ 4.89
\$5.33-\$6.99	549,000	7.70	6.13	474,000	6.18
\$7.00-\$7.07	1,582,000	7.46	7.00	1,574,000	7.00
\$7.19-\$10.00	561,000	7.14	7.82	354,000	7.91
\$10.20-\$14.94	565,000	5.69	11.58	475,000	11.66
\$15.00-\$15.16	874,000	5.81	15.00	874,000	15.00
\$15.63-\$60.75	631,000	4.72	27.99	631,000	27.99

\$3.25-\$60.75	5,320,000			4,515,000	
=====					

Fair Value Disclosures

The fair values of Microvision common stock options granted were estimated on the date of each grant using the Black Scholes option pricing model with the following weighted average assumptions used for grants in 2005, 2004 and 2003, respectively: dividend yield of zero percent for all years; expected volatility of 70%, 76% and 83%; risk free interest rates of 4.0%, 3.0%, and 2.2%; and expected lives of 5, 3 and 3 years. Actual forfeitures of 7.2%, 6.8% and 25.4% were used for the years ended December 31, 2005, 2004, and 2003 respectively. Excluding shares cancelled under the voluntary extension for grants with terms less than ten years, the actual forfeiture rate for 2003 was 16.3%.

14. Commitments and contingencies

Agreements with the University of Washington

In October 1993, the Company entered into a Research Agreement and an exclusive license agreement ("License Agreement") with the UW. The License Agreement grants the Company the rights to certain intellectual property, including the technology being subsequently developed under the Microvision research agreement ("Research Agreement"), whereby the Company has an exclusive, royalty-bearing license to make, use and sell or sublicense the licensed technology. In consideration for the license, the Company agreed to pay a one-time nonrefundable license issue fee of \$5,134,000. Payments under the Research Agreement were credited to the license fee. In addition to the nonrefundable fee, which has been paid in full, the Company is required to pay certain ongoing royalties. Beginning in 2001, the Company is required to pay the UW a nonrefundable license maintenance fee of \$10,000 per quarter, to be credited against royalties due.

Litigation

The Company is subject to various claims and pending or threatened lawsuits in the normal course of business. The Company is not currently party to any legal proceedings that management believes the adverse

outcome of which would have a material adverse effect on the Company's financial position, results of operations or cash flows.

Lease commitments

The Company leases its office space and certain equipment under noncancelable capital and operating leases with initial or remaining terms in excess of one year. The Company entered into a facility lease that commenced in April 1999, which includes extension and rent escalation provisions over the seven-year term of the lease. Rent expense is recognized on a straight-line basis over the lease term.

The Company entered into a 90 month facility lease that commenced in February 2006. The lease includes extension and rent escalation provisions over the 90 month term of the lease. Rent expense will be recognized on a straight-line basis over the lease term.

Future minimum rental commitments under capital and operating leases for years ending December 31 are as follows:

	Capital leases	Operating leases
	-----	-----
2006	\$ 41,000	\$ 741,000
2007	39,000	850,000
2008	33,000	834,000
2009	27,000	837,000
2010	20,000	867,000
Thereafter	--	2,400,000
	-----	-----

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Total minimum lease payments	160,000	\$ 6,529,000
		=====
Less: Amount representing interest	(23,000)	

Present value of capital lease obligations	137,000	
Less: Current portion	(32,000)	

Long-term obligation at December 31, 2005	\$ 105,000	
	=====	

Operating lease commitments amounts do not include the impact of contractual sublease receipts of \$79,000 for the year ended December 31, 2006.

The capital leases are collateralized by the related assets financed and by security deposits held by the lessors under the lease agreements. The cost and accumulated depreciation of equipment under capital leases was \$1,309,000, and \$1,140,000, respectively at December 31, 2005 and \$1,175,000 and \$1,053,000, respectively, at December 31, 2004.

Net rent expense was \$1,435,000, \$1,689,000, and \$2,302,000 for 2005, 2004 and 2003, respectively. Rent expense in 2003 includes \$540,000 for the closure of the Company's facility in San Mateo, California. Sub-lease income of \$575,000, \$363,000 and \$226,000 for 2005, 2004, and 2003 respectively was included as a reduction in rent expense.

Long-term debt

During 1999, the Company entered into a loan agreement with the lessor of the Company's corporate headquarters to finance \$420,000 in tenant improvements. The loan carries a fixed interest rate of 10% per annum, is repayable over the initial term of the lease, which expires in 2006, and is secured by a letter of credit. The balance of the loan was \$22,000 and \$99,000 at December 31, 2005 and 2004 respectively.

15. Income taxes

A provision for income taxes has not been recorded for 2005, 2004 or 2003 due to valuation allowances placed against the net operating losses and deferred tax assets arising during such periods. A valuation allowance has been recorded for all deferred tax assets because based on the Company's history of losses since inception, the available objective evidence creates sufficient uncertainty regarding the realizability of the deferred tax assets.

At December 31, 2005, Microvision has net operating loss carry forwards of approximately \$191 million, for federal income tax reporting purposes. In addition, Microvision has research and development tax credits of \$2,559,000. The net operating loss carry forwards and research and development credits available to offset future taxable income, if any, will expire in varying amounts from 2008 to 2025 if not previously utilized. In certain circumstances, as specified in the Internal Revenue Code, a 50% or more ownership change by certain combinations of the Company's stockholders during any three-year period would result in limitations on the Company's ability to utilize its net operating loss carry-forwards. The Company has determined that such a change occurred during 1995 and the annual utilization of loss carry-forwards generated through the period of that change will be limited to approximately \$761,000. An additional change occurred in 1996; and the limitation for losses generated in 1996 is approximately \$1,600,000.

Deferred tax assets are summarized as follows:

	December 31,	
	----- 2005	2004 -----
Net operating loss carry forwards Microvision	\$ 65,006,000	\$ 57,112,000

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R&D credit carry forwards Microvision	2,559,000	2,218,000
Other	3,463,000	4,642,000
	-----	-----
	71,028,000	63,972,000
Less: Valuation allowance	(71,028,000)	(63,972,000)
	-----	-----
Deferred tax assets	\$ --	\$ --
	=====	=====

The valuation allowance and the research and development credit carry forwards account for substantially all of the difference between the Company's effective income tax rate and the Federal statutory tax rate of 34%.

Certain net operating losses arise from the deductibility for tax purposes of compensation under nonqualified stock options equal to the difference between the fair value of the stock on the date of exercise and the exercise price of the options. For financial reporting purposes, the tax effect of this deduction when recognized is accounted for as a credit to shareholders' equity.

16. Retirement savings plan

The Company has a retirement savings plan ("the Plan") that qualifies under Internal Revenue Code Section 401(k). The Plan covers all qualified employees. Contributions to the Plan by the Company are made at the discretion of the Board of Directors.

In February 2000, the Board of Directors approved a plan amendment to match 50% of employee contributions to the Plan up to 6% of the employee's per pay period compensation, starting on April 1, 2000. During 2005, 2004 and 2003, the Company contributed \$321,000, \$337,000 and \$392,000 respectively, to the Plan under the matching program.

17. Segment Information

Prior to Lumera's initial public offering in July 2004, the Company was organized into two segments - Microvision, which is engaged in scanned beam displays and related technologies, and Lumera, which is engaged in optical systems components technology. The segments were determined based on how management views and evaluates the Company's operations.

The accounting policies used to derive reportable segment results are described in Note 2, "Summary of Significant Accounting Policies."

A portion of each segments' administration expenses arise from shared services and infrastructure that Microvision has provided to both segments in order to realize economies of scale and to efficiently use resources. These efficiencies include costs of certain legal, accounting, human resources and other Microvision corporate and infrastructure costs. These expenses are allocated to the segments and the allocation has been determined on a basis that the Company considered to be a reasonable reflection of the utilization of services provided to, or benefits received by, the segments.

Since 2000, Microvision has held an investment in Lumera. From inception to July 2004, Lumera was a consolidated subsidiary and treated as a separate segment within Microvision. Subsequent to July 2004, Lumera became an equity method investment. Since July 2004, Microvision has operated as one segment.

At December 31, 2005 and 2004, Lumera was a significant unconsolidated equity investment of Microvision. For 2005 Lumera revenue was \$1,509,000, Gross profit was \$587,000, Loss from operations was \$11,108,000 and Net loss was \$10,453,000 For the period that Lumera was an unconsolidated investment in 2004 (July 2004 through

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December 31, 2004) Lumera revenue was \$303,000, Gross profit was \$85,000, Loss from operations was \$5,205,000 and Net loss was \$5,199,000. At December 31, 2005 Lumera had Current assets of \$22,384,000, Noncurrent assets of \$1,322,000, Current liabilities of \$1,552,000 and Shareholders equity of \$22,154,000 At December 31, 2004 Lumera had Current assets of \$19,623,000, Noncurrent assets of \$13,263,000, Current liabilities of \$1,493,000 and Shareholders equity of \$31,393,000.

The following tables reflect the results of the Company's reportable segments under the Company's management system. The performance of each segment is measured based on several metrics. These results are used, in part, by management, in evaluating the performance of, and in allocation of resources to, each of the segments (in thousands):

	Year Ended December 31, 2004			
	Microvision	Lumera	Elimination	Total
Contract Revenue	\$ 8,135	\$ 686	\$ --	\$ 8,821
Product Revenue	2,597	--	--	2,597
Cost of Contract Revenue	5,106	433	--	5,539
Cost of Product Revenue	3,868	--	--	3,868
Research and development expense	13,581	1,129	--	14,710
Marketing, general and administrative expense	17,795	1,433	--	19,228
Non-cash compensation expense	821	1,297	--	2,118
Interest income	270	2	--	272
Interest expense	31	120	--	151
Segment loss	32,257	3,724	(2,438)	33,543
Depreciation	1,711	695	--	2,406
Expenditures for capital assets	970	70	--	1,040
Segment assets	25,538	--	--	25,538

	Year Ended December 31, 2003			
	Microvision	Lumera	Elimination	Total
Contract Revenue	\$ 11,792	\$ 1,725	\$ --	\$ 13,517
Product Revenue	1,135	--	--	1,135
Cost of Contract Revenue	5,015	1,014	--	6,029
Cost of Product Revenue	1,017	--	--	1,017
Research and development expense	16,755	6,561	--	23,316
Marketing, general and administrative expense	14,557	1,270	--	15,827
Non-cash compensation expense	1,115	1,041	--	2,156
Interest income	342	39	--	381
Interest expense	51	--	--	51
Segment loss	25,205	8,083	(7,125)	26,163
Depreciation	1,924	1,185	--	3,109
Expenditures for capital assets	1,094	455	--	1,549
Segment assets	37,224	4,058	(7,364)	33,918

18. Quarterly Financial Information (Unaudited)

The following table presents the Company's unaudited quarterly financial information for the years ending December 31, 2005 and 2004:

	Year Ended December 31, 2005			
	December 31,	September 30,	June 30,	March 31,
Revenue	\$ 2,709,000	\$ 3,330,000	\$ 4,725,000	\$ 3,982,000
Gross Margin	(1,756,000)	(434,000)	840,000	1,004,000
Net loss available for common shareholde	(5,566,000)	(12,571,000)	(4,968,000)	(7,179,000)

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Net loss per share basic and diluted (0.23) (0.56) (0.23) (0.33)

	Year Ended December 31, 2004			
	December 31,	September 30,	June 30,	March 31,
Revenue	\$ 3,317,000	\$ 2,729,000	\$ 2,398,000	\$ 2,974,000
Gross Margin	76,000	263,000	568,000	1,104,000
Net loss	(8,247,000)	(10,094,000)	(8,512,000)	(6,690,000)
Net loss per share basic and diluted	(0.38)	(0.47)	(0.40)	(0.31)

19. Subsequent Event

In January 2006, the Company raised \$10,324,000 from the sale of 2,550,000 shares of Lumera common stock. As a result of the sale, the Company will record a "gain on sale of equity subsidiary" of approximately \$7.3 million. Subsequent to the sale, the Company owned 2,072,000 shares, or 12%, of the outstanding shares of Lumera common stock. After January 31, 2006, due to the change in ownership percentage, Microvision will account for its investment in Lumera using the cost method.

In January 2006 the Chief Executive Officer's employment was terminated and the Chief Financial Officer resigned. The Company appointed Alexander Y. Tokman to Chief Executive Officer in January 2006.



MICROVISION, INC.
VALUATION AND QUALIFYING ACCOUNTS AND RESERVES
(in thousands)

Description	Balance at beginning of fiscal period	Additions	
		Charges to costs and expenses	Charges to other accounts
Year Ended December 31, 2003			
Allowance for receivables from related parties	\$ 700	\$ 200	\$ --
Tax valuation allowance	52,059	--	11,454
Year Ended December 31, 2004			
Allowance for receivables from related parties	900	--	--
Tax valuation allowance	63,513	--	11,015
Year Ended December 31, 2005			
Allowance for receivables from related parties	900	1,031	--
Tax valuation allowance	63,972	--	7,056

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no changes in or disagreements with accountants in accounting or financial disclosure matters during the Company's fiscal years ended December 31, 2005 and 2004.

ITEM 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* The Chief Executive Officer and the Principal Financial Officer evaluated our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the "Exchange Act") prior to the filing of this annual report. Based on that evaluation, they concluded that, as of the end of the period covered by this annual report, our disclosure controls and procedures were, in design and operation is effective and such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

(b) *Management's Report on Internal Control Over Financial Reporting.* Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation under the framework in *Internal Control - Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2005.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included in Item 8 of this Annual Report on Form 10-K.

(c) *Changes in internal controls over financial reporting.* There have not been any changes in the Company's internal control over financial reporting during the quarter ended December 31, 2005 which have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Set forth below are the name, position held and age of each of the directors and executive officers of the Company. The principal occupation and recent employment history of each of the directors and executive officers are described below:

Name	Age	Position
Alexander Y. Tokman	44	President and Chief Executive Officer, Director
Richard A. Cowell (1) (2) (3) *	57	Director
Slade Gorton (1) (2) (3) *	77	Director
Marc Onetto (1) (2) (3) *	55	Director
Richard F. Rutkowski	49	Director
Ian D. Brown	43	Vice President Sales and Marketing
Todd R. McIntyre	44	Vice President of Global Strategic Marketing and Bu
Thomas M. Walker	41	Vice President, General Counsel and Secretary
Stephen R. Willey	52	President, Marketing and Sales, Asia
Jeff T. Wilson	45	Chief Financial Officer

* Independent Directors

(1)

Member of the Compensation Committee

(2)

Member of the Audit Committee

(3)

Member of the Nominating and Corporate Governance Committee

Alexander Tokman, has served as President, Chief Executive Officer and a director of Microvision since January 2006. Mr. Tokman served as Microvision's President and Chief Operating Officer from July 2005 to January 2006. From April 1995 to July 2005, Mr. Tokman served in various cross-functional and cross-business leadership positions at GE Healthcare, a subsidiary of General Electric most recently as a General Manager of its Global Molecular Imaging and Radiopharmacy unit from May 2003 to June 2005. From November 1989 to March 1995 Mr. Tokman served as technical programs lead and a head of I&RD at Tracor Applied Sciences a subsidiary of then Tracor, Inc. Mr. Tokman has both a M.S. and B.S. in Electrical Engineering from the University of Massachusetts, Dartmouth. He also is a certified Six Sigma & DFSS Black Belt and Master Black Belt.

Ian D. Brown, age 43, has served as Vice President, Sales and Marketing of Microvision since February 2006. Prior to joining Microvision, from March 1994 to February 2006, Mr. Brown served in various Sales and Marketing positions with General Electric Healthcare, Americas. Most recently from April 2004 to February 2006 Mr. Brown served as the Sales and Marketing Manager - Nuclear Medicine. From April 1989 to March 1994 Mr. Brown served as Technical Author - Nuclear Medicine Operator Documentation with IGE Medical Systems, Radlett, UK. Mr. Brown holds Ordinary & Higher National Certificates in Medical Physics & Physiological Measurements from Paddington College, London, Post Graduate Diploma in Management studies, University of Hertfordshire. He also holds a Six Sigma Black Belt.

Todd R. McIntyre, age 44, has served as Senior Vice President of Global Strategic Marketing and Business Development of Microvision since January 2006. Mr. McIntyre served as Senior Vice President of Business Development from November 2003 until January 2006, and Vice President of Business Development of Microvision from January 1996 to November 2003. Mr. McIntyre's experience in emerging markets includes business development and marketing with development stage companies in a variety of technology segments including wireless telecommunications products and services, internet software products, and digital and print media. Mr. McIntyre holds an M.B.A. from Stanford University and a B.A. from Hendrix College.

Thomas M. Walker, age 41, joined Microvision in May 2002 and serves as Vice President, General Counsel and Secretary. Prior to joining Microvision, Mr. Walker served as Senior Vice President, General Counsel and Secretary of Advanced Radio Telecom Corp., a publicly held technology and services company where he managed domestic and international legal affairs from April 1996 to April 2002. Prior to that, Mr. Walker advised publicly and privately held businesses while practicing in the Los Angeles offices of the law firms of Pillsbury Winthrop and Buchalter, Nemer Fields and Younger. Mr. Walker holds a B.A. from Claremont McKenna College and a J.D. from the University of Oregon.

Stephen R. Willey has served as President, Marketing and Sales, Asia of Microvision since January 2006. Mr. Willey served as President, Consumer Solutions from July 2005 to January 2006, as Microvision's Executive Vice President from October 1995 to August 2002 and as a director from June 1995 to April 2006. Prior to that, he served as an outside consultant to the company through The Development Group (DGI) a business and technology consulting firm that he founded. As principal of DGI, Willey had also provided senior management consulting services to CREO Products, Inc., an electro-optics equipment manufacturer, between June 1989 and December 1992. In 1993, Willey co-founded PRO.NET Communications, Inc., an Internet service company. Willey holds an M.B.A. from the University of California, Los Angeles, and an M.A.Sc. in Electronics from the University of British Columbia, Vancouver. He earned a B.Sc., Engineering (Physics) from McMaster University, Hamilton.

Jeff T. Wilson, age 45, has served as Chief Financial Officer of Microvision since April 2006, Vice President, Accounting of Microvision from April 2002 to April 2006, Principal Financial Officer since January 2006 and Principal Accounting Officer of Microvision since August 1999 and as Director of Accounting of Microvision from August 1999 to March 2002. Prior to joining Microvision, from 1991 to 1999 Mr. Wilson served in various accounting positions for Siemens Medical Systems, Inc., a developer and manufacturer of medical imaging equipment. Prior to 1991, Mr. Wilson served as a manager with the accounting firm Price Waterhouse (currently PricewaterhouseCoopers LLP). Mr. Wilson is a Certified Public Accountant. Mr. Wilson holds a B.S. in Accounting from Oklahoma State University.

Colonel Richard A. Cowell, USA, (Ret.) has served as a director of the Company since August 1996. Colonel Cowell is a Principal at Booz Allen Hamilton, Inc. where he is involved in advanced concepts development and technology transition, joint and service experimentation, and the interoperability and integration of command and control systems for Department of Defense and other agencies. Prior to joining Booz Allen Hamilton, Inc. in March of 1996, Colonel Cowell served in the United States Army for 25 years. Immediately prior to his retirement from the Army, Colonel Cowell served as Director of the Louisiana Maneuvers Task Force reporting directly to the Chief of Staff, Army. Colonel Cowell has authored and received awards for a number of documents relating to the potential future

capabilities of various services and agencies.

Slade Gorton joined the company as a director in September 2003. Mr. Gorton is currently Of Counsel at the law firm of Preston Gates & Ellis LLP. Prior to joining the firm, he represented Washington State in the United States Senate for 18 years. Mr. Gorton began his political career in 1958 as a Washington State Representative and went on to serve as State House Majority Leader. In 1968 he was elected Attorney General of Washington State where he served until 1980. Mr. Gorton also served on the President's Consumer Advisory Council (1975-77), the Washington State Criminal Justice Training Commission (1969-1981), the National Commission on Federal Election Reform (2001), and was chairman of the Washington State Law & Justice Commission (1969-76). Mr. Gorton also served in the U.S. Army, U.S. Air Force, and the U.S. Air Force Reserves. Mr. Gorton was a Commissioner on the National Commission on Terrorist Attacks upon the United States ("9-11 Commission").

Marc Onetto has served as a director of Microvision since March 2006. Since 2003, Mr. Onetto has served as Executive Vice President of Worldwide Operations for Solectron, a global provider of electronics manufacturing and integrated supply-chain services. Prior to joining Solectron, Mr. Onetto served 15 years with GE, most recently as Vice President of GE Corporate European operations. From 1992-2002 Mr. Onetto held several senior leadership positions at GE Medical Systems as head of its global supply chain and operations, global quality, and global process engineering. He was one of GE's Six Sigma pioneers and led the quality culture transformation across GE Medical Systems. Prior to GE, Mr. Onetto served 12 years with Exxon Corporation in supply operations, information systems and finance.

Richard F. Rutkowski has served as a director since August 1995. Mr. Rutkowski also served as the Company's Chief Executive Officer from September 1995 to January 2006 and President from July 1996 to August 2002. From November 1992 to May 1994, Mr. Rutkowski served as Executive Vice President of Medialink Technologies Corporation (formerly Lone Wolf Corporation), a developer of high-speed digital networking technology for multimedia applications in audio-video computing, consumer electronics, and telecommunications. From February 1990 to April 1995, Mr. Rutkowski was a principal of Rutkowski, Erickson, Scott, a consulting firm. Mr. Rutkowski also serves as a director of Lumera Corporation and CMT Crimble Microtest.

The Audit Committee

The Board of Directors has an Audit Committee which assists the Board of Directors by monitoring and overseeing: (1) the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company, (2) the integrity of the financial statements of the Company, (3) compliance by the Company with legal and regulatory requirements, and (4) the performance of the Company's internal finance and accounting personnel and its independent auditors. Messrs. Cowell, Gorton and Onetto currently serve on the Audit Committee, with Mr. Cowell serving as Chairman.

Audit Committee Financial Expert

The "audit committee financial expert" designated by our Board is Col. Richard A. Cowell (Ret.), an Independent Director. Col. Cowell holds a degree in accounting and has served for seven years as Chair of the Company's Audit Committee. During his twenty-five years of service in the United States Army, Col. Cowell oversaw and actively supervised various complex governmental projects that involved government accounting with a breadth and level of complexity comparable to accounting issues raised by the Company's financial statements, including issues relating to estimates, accruals, and reserves. Since retiring from the Army, Col. Cowell has served as a Principal at Booz Allen Hamilton, where he provides consulting services relating to significant government projects and grants which involve significant and complex accounting issues.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires that our directors, executive officers, and greater-than 10% shareholders file reports with the SEC relating to their initial beneficial ownership of the Company's securities and any subsequent changes. They must also provide us with copies of the reports.

Based on copies of reports furnished to us, we believe that all of these reporting persons complied with their filing requirements during 2005, except that Mr. Tokman, an executive officer of the Company, belatedly filed an Initial Statement of Beneficial Ownership of Securities on Form 3, reporting 1 transaction; and Mr. Willey, an executive officer of the Company, belatedly filed one Statement of Changes of Beneficial Ownership of Securities on Form 4 reporting 1 transaction.

Code of Ethics

The Company has adopted a code of ethics applicable to the Company's principal executive officer, principal financial officer, and principal accounting officer, known as the Code of Ethics for Microvision Executives. The Company has also adopted a code of conduct applicable to the Company's directors, officers, and employees, known as the Code of Conduct. The Code of Ethics for Microvision Executives and the Code of Conduct are available on the Company's website. In the event we amend or waive any of the provisions of the Code of Ethics for Microvision Executives applicable to our principal executive officer, principal financial officer, and principal accounting officer, we intend to disclose the same on the Company's website at

www.microvision.com.

ITEM 11. Executive Compensation.

The following table sets forth the compensation awarded or paid to or earned by the person who served as Chief Executive Officer during 2005 and the next four most highly compensated persons who served as executive officers during 2005 (the "Named Executive Officers"):

Summary Compensation Table

Name and Principal Position (3)	Fiscal Year	Annual Compensation		Long-term Compensation Awards
		Salary (\$)	Bonus (2) (\$)	Securities Underlying Options (#)
Richard F. Rutkowski Former Chief Executive Officer and Director	2005	377,104	--	--
	2004	364,000	50,000	80,000
	2003	353,000	10,000	361,751
Stephen R. Willey President, Marketing and Sales, Asia	2005	326,340	387	--
	2004	315,000	40,000	130,000
	2003	284,000	85,000	305,002
Richard A. Raisig Former Chief Financial Officer	2005	281,792	--	--
	2004	272,000	30,000	70,000
	2003	263,000	68,000	232,613
Vilakkudi Veeraraghavan Former Senior Vice President, Research & Product Development	2005	239,144	88	--
	2004	235,000	20,000	--
	2003	220,000	50,000	111,000
Todd R. McIntyre	2005	210,000	70,000	--

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Senior Vice President,	2004	200,000	50,000	30,000
Global Strategic Marketing and Business Development	2003	166,061	40,000	182,627

(1) All Other Compensation amounts for 2005 include contributions of \$1,500, \$6,169, \$6,300, \$6,300 and \$6,008 to the accounts of Messrs. Rutkowski, Willey, Raisig, Veeraraghavan and McIntyre, respectively, under the Company's qualified 401(k) Retirement Plan. The amounts also include forgiveness of \$95,632, \$22,181, and \$37,749 of interest for Messrs. Rutkowski, Willey, Raisig, respectively, under one or both of the Company's Executive Option Exercise Note Plan and Executive Loan Plan. For a description of the two plans, see "Executive Loan Plans" below. No Options, Restricted Stock Awards or Long-Term Incentive Plan payments were made as of December 31, 2005.

(2) Bonus amounts for 2005 include Patent Incentive Program bonuses of \$387 and \$88 for Messrs. Willey and Veeraraghavan respectively.

(3) Richard F. Rutkowski, Richard A. Raisig and Vilakkudi Veeraraghavan are no longer employed by the Company.

Stock Option Grants in the Last Fiscal Year

The Company did not grant any options to acquire common stock to its named executive officers during 2005.

Aggregated Option Values as of Year End 2005

The following table provides information regarding the aggregate number of options exercised during the fiscal year ended December 31, 2005, by each of the Named Executive Officers and the number of shares subject to both exercisable and unexercisable stock options as of December 31, 2005.

Aggregated Option Exercises in Last Fiscal

Year and FY-End Option Values

Name	Shares Acquired On Exercise	Value Realized (\$)	Number of Securities Underlying Unexercised Options at/SARS at December 31, 2005		Value of Unexercised In-the-Money Options at December 31, 2005 (1)	
			Exercisable	Unexercisable	Exercisable (\$)	Unexercisable (\$)
Richard F. Rutkowski	--	--	873,791	--	--	--
Stephen R. Willey	--	--	555,013	--	--	--
Richard A. Raisig	--	--	444,823	--	--	--
Vilakkudi Veeraraghavan	--	--	180,454	--	--	--
Todd R. McIntyre	--	--	239,430	--	--	--

(1) The value of unexercised in-the-money options is based on the difference between \$3.60 (the fair market value of the Company's common stock as reflected by the closing price of the common stock on the Nasdaq National Market as of December 31, 2005) and the exercise price of such options multiplied by the number of shares issuable upon exercise thereof. As of December 31, 2005, the exercise price of all options held by named executive officers was greater than \$3.60.

Executive Loan Plans

The Company previously adopted two loan plans under which Richard F. Rutkowski, Stephen Willey, and Richard Raisig were able to borrow funds from the Company. At the end of each year, the Company will forgive the interest that accrued under the loans if the executive remains employed by the Company. In 2005, the Company forgave \$95,632, \$22,181, and \$37,749 of interest for Messrs. Rutkowski, Willey, and Raisig, respectively. No additional loans have been made under either the Executive Option Exercise Loan Plan or the Executive Loan Plan since July 2002, and the Company does not intend to make any additional loans under these plans. The Company also has no plans to forgive the principal balance outstanding of the lines of credit. On February 16, 2005, Stephen Willey transferred 28,844 shares of the Company's common stock in full repayment of an existing loan and accrued interest thereon, which had become due on December 31, 2004. For additional details regarding loan balances and terms, see Item 13.

Certain Tax Considerations Related to Executive Compensation

As a result of Section 162(m) of the Internal Revenue Code of 1986, as amended, in the event that compensation paid by the Company to the Named Executive Officers in a year were to exceed an aggregate of \$1,000,000, the Company's deduction for such compensation could be limited to \$1,000,000.

Director Compensation

Pursuant to the Independent Director Stock Option Plan (the "Director Plan"), each Independent Director is granted a nonstatutory option to purchase 15,000 shares of common stock on the date on which he or she is first elected or appointed to the Board of Directors. These options are fully vested and immediately exercisable upon the date of grant. Each Independent Director also receives, upon his or her initial appointment or election and upon each subsequent reelection to the Board of Directors, an option to purchase 15,000 shares that will vest in full on the earlier of (i) the day prior to the date of the Company's annual meeting of shareholders next following the date of grant, or (ii) one year from the date of grant, provided the Independent Director continues to serve as a director on the vesting date. If an Independent Director ceases to be a director for any reason other than death or disability before his or her term expires, then any outstanding unvested options issued under the Director Plan to such Independent Director will be forfeited. Options vested as of the date of termination for any reason other than death or disability are exercisable through the date of expiration. The exercise price for each option is equal to the closing price of the Company's common stock as reported on the Nasdaq National Market on the date of grant. The options generally expire on the tenth anniversary of the date of grant.

In addition, each Independent Director receives the following cash compensation for his or her service as a director:

- A fee of \$20,000 that accrues as of the date of appointment or election to the Board of Directors, and as of the date of each subsequent reelection;
- A fee of \$3,000 for the Board chair or \$2,000 per director for each Board meeting attended by the director; and
- A fee of \$3,000 for the committee chair or \$2,000 per committee member for each committee meeting attended by the director that is held on a day other than a day on which a Board meeting is held.

All directors are reimbursed for reasonable travel and other out-of-pocket expenses incurred in attending meetings of the Board of Directors.

Compensation Committee Interlocks And Insider Participation

The Compensation Committee is composed entirely of the following Independent Directors: Slade Gorton, Richard Cowell and Mark Onetto. Dennis Reimer, who resigned from the Board of Directors on April 10, 2006, also served on

the Compensation Committee during 2005.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table shows as of April 11, 2006, the number of shares of common stock held by all persons we know to beneficially own at least 5% of the Company's common stock, the Company's directors, the Named Executive Officers, and all directors and executive officers as a group.

Name and Address of Beneficial Owner	Number of Shares (1)	Percentage of Common Stock (2)
Alexander Y. Tokman (3) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	60,000	*
Richard F. Rutkowski (4) 3125 E. Laurelhurst Dr. NE Seattle, WA 98105-5332	876,163	3.4%
Stephen R. Willey (5) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	725,404	2.8%
Richard A. Raisig (6) 4881 Birch Street Newport Beach, CA 92660	494,640	1.9%
Todd R. McIntyre (7) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	239,930	*
Vilakkudi Veeraraghavan (8) 2406 246th Place NE Redmond, WA 98074	180,454	*
Richard Cowell (9) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	85,067	*
Slade Gorton (10) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	46,000	*
Marc Onetto (11) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	15,000	*
All executive officers and directors as a group (12 persons) (12)	2,993,297	10.7%

* Less than 1% of the outstanding shares of common stock.

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission (the "SEC") and generally includes voting or investment power with respect to securities. Shares of common stock subject to options or warrants that are currently exercisable or convertible or may be exercised or converted within sixty days are deemed to be outstanding and to be beneficially owned by the person holding these options or warrants for the purpose of computing the number of shares beneficially owned and the percentage of ownership of the person holding these securities, but are not outstanding for the purpose of computing the percentage ownership of any other person or entity. Subject to community property laws where applicable, the Company believes that each shareholder named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned thereby.

(2) Percentage of common stock is based on 25,243,026 shares of common stock outstanding as of April 11, 2006.

(3) Includes 60,000 shares issuable upon exercise of options.

(4) Includes 873,791 shares issuable upon exercise of options.

(5) Includes 585,013 shares issuable upon exercise of options.

(6) Includes 444,823 shares issuable upon exercise of options.

(7) Includes 239,430 shares issuable upon exercise of options.

(8) Includes 180454 shares issuable upon exercise of options and warrants.

(9) Includes 78,867 shares issuable upon exercise of options.

(10) Includes 45,000 shares issuable upon exercise of options.

(11) Includes 15,000 shares issuable upon exercise of options.

(12) Includes 2,793,017 shares issuable upon exercise of options.

EQUITY COMPENSATION PLAN INFORMATION

The following table shows the number of shares of common stock that could be issued upon exercise of outstanding options and warrants, the weighted average exercise price of the outstanding options and warrants and the remaining shares available for future issuance as of December 31, 2005.

Equity Compensation Plan Information			
Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	4,982,000	\$ 10.79	3,131,000
Equity compensation plans not approved by shareholders	615,000	20.53	--

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Total	----- 5,597,000 \$ =====	11.86	----- 3,131,000 =====
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As of December 31, 2005, there were non-plan options to purchase a total of 338,000 shares of Microvision common stock outstanding. 329,000 of these were options approved by the Board of Directors and issued in October 2001, with exercise prices in excess of the fair value of Microvision common stock on the date of grant. The October 2001 options have a \$15.00 exercise price and vested 25% on the grant date and 25% at six-month intervals thereafter. The remaining 9,000 non-plan options were granted at fair values on the dates of grant and vest 25% at each annual anniversary date of the grants.

All non-plan options are non-qualified options with 10 year terms granted to non-executive employees. The options are administered by the Compensation Committee of the Board of Directors or its authorized agents. Options surrendered, exchanged for another option, canceled or terminated without having been exercised in full will again be available for issuance by the Company. The options are not transferable other than by will or the laws of descent and distribution. Each option is exercisable during the lifetime of the optionee only by such optionee, upon its vest date and thereafter through the expiration date, subject to the termination of employment provisions. Following termination of employment by the Company other than for cause, resignation in lieu of dismissal, disability or death, an option holder may exercise options, vested as of the date of termination, within three months before the options will automatically expire, and any unvested options will automatically expire upon the termination date. The number and class of shares covered by the options and the exercise price per share shall be proportionately adjusted for any change in the number of issued shares of common stock of the Company resulting from a stock split, stock dividend or consolidation of shares or any like capital stock adjustment. In the event of a merger, consolidation or plan of exchange to which the Company is a party or a sale of all or substantially all of the Company's assets, the Board of Directors may elect to treat the options in one of the following ways: (i) outstanding options would remain in effect in accordance with their terms; (ii) outstanding options would be converted into options to purchase stock in the surviving or acquiring corporation in the transaction; or (iii) outstanding options would be exercised within a period determined by the Board of Directors prior to the consummation of the transaction, after which time the options automatically expire. The Board may accelerate the vesting of the options so they are exercisable in full.

In August 2000, the Company issued two non-plan warrants to purchase an aggregate of 200,000 shares of Microvision common stock to two consultants in connection with entering into certain consulting agreements with the Company. Subsequently, one of the consultants was elected to the Board of Directors by shareholders. The warrants were fully outstanding as of December 31, 2005. The warrants have an exercise price of \$34.00 per share and are exercisable prior to their expiration in August 2010. As of the date of grant, all but 25,000 of the underlying shares of common stock issuable to each consultant upon exercise of the warrants were subject to lock-up restrictions that prevent the holder from transferring such shares. The number of shares subject to the lock-up restrictions is reduced by 25,000 for each consultant on each June 7 subsequent to the grant date. Rather than issue shares of common stock upon exercise of the warrants, the Company may elect to redeem the warrants if, in the opinion of the Board of Directors upon advice of counsel, it would be unlawful to issue the underlying securities. The warrants are transferable upon prior written approval of the Company. The Company cannot unreasonably withhold such approval with respect to transfers of warrants to purchase at least 10,000 shares that are not subject to the lock-up restrictions. If the Company terminates the consulting agreement due to the consultant's failure to provide consulting services during the first three years of the agreement, the consultant must return to the Company a pro-rata portion of the 75,000 warrants initially subject to the lock-up restrictions based on the number of calendar days remaining in the initial three year period. The number, class and price of securities for which the warrants may be exercised are subject to adjustment for certain changes in the Company's capital structure. The number of securities and exercise price per share will be proportionately adjusted if outstanding shares of the Company's common stock are divided into a greater number of shares or combined into a smaller number of shares, or a stock dividend is paid on the common stock. In the event of a change in the common stock from a merger, consolidation, reclassification, reorganization, partial or

complete liquidation, or other change in the capital structure of the Company, the Company will, as a condition of the change in capital structure, make provision for the warrant holder to receive upon the exercise of the warrants the kind and amount of shares of stock, other securities or property to which the holder would have been entitled if, immediately prior to the change in capital structure, the warrant holder had held the number of shares of common stock obtainable upon the exercise of the warrants, and the exercise price will be proportionately adjusted.

The Company has two warrants outstanding to purchase an aggregate of 70,000 shares of Microvision common stock that were issued in September 2003 to a third party for services. The first warrant for 60,000 shares has an exercise price of \$7.50 per share and vests in three equal tranches. The first tranche vests on the issue date, the second and third tranches vest three and six months following the issue date, respectively. The second warrant for 10,000 shares has an exercise price of \$12.00 per share and vests six months after the issue date. The Company may cancel unvested tranches or the second warrant prior to their respective vest dates if it determines in good faith, and notifies the holder, that it is not satisfied with the holder's performance under the agreement. Vested warrants are exercisable prior to their expiration in September 2007. The warrant holder may transfer any portion or all of the warrant shares by delivering the original warrant certificate and a form of assignment to the Company. The number and price of securities for which the warrant may be exercised are subject to adjustment for certain changes in the Company's capital structure. Where the outstanding shares of common stock are divided into a greater number of shares, combined into a smaller number of shares, or a stock dividend is paid on the common stock, the exercise price per share shall be proportionately adjusted by the ratio of common shares outstanding immediately before and after the transaction. In the event of a change in the common stock from a merger, consolidation, reclassification, tender offer or exchange offer, or partial or complete liquidation, the holder will be entitled to receive, upon the exercise of the warrants, the same amount and kind of securities, cash or property to which the holder would have been entitled if, immediately prior to the change in capital structure, the warrant holder had held the number of shares of common stock obtainable upon the exercise of warrants.

In July 2005, Microvision issued a warrant to purchase 6,925 shares of common stock to a third party for services. The warrant is immediately exercisable, has an exercise price of \$5.32 per share, and expires in July 2010. The number and price of securities for which the warrant may be exercised are subject to adjustment for certain changes in the Company's capital structure. Where the outstanding shares of common stock are divided into a greater number of shares, combined into a smaller number of shares, or a stock dividend is paid on the common stock, the exercise price per share shall be proportionately adjusted by the ratio of common shares outstanding immediately before and after the transaction. In the event of a change in the common stock from a reorganization, reclassification, consolidation, or merger, the holder will be entitled to receive, upon the exercise of the warrants, the same amount and kind of securities, cash or property to which the holder would have been entitled if, immediately prior to the change in capital structure, the warrant holder had held the number of shares of common stock obtainable upon the exercise of the warrants.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The Company has an existing executive loan plan under which Richard F. Rutkowski, Stephen R. Willey, and Richard A. Raisig have borrowed funds from the Company. No loans have been made under this executive loan plan since July 2002, and the Company does not intend to make any additional loans under this plan. The following table lists certain information describing each executive's loans as of December 31, 2005.

	Loan Plan	Total
	-----	-----
Mr. Rutkowski -		
Balance outstanding	\$ 1,708,000	\$ 1,708,000
Highest aggregate balance during year	\$ 1,708,000	\$ 1,708,000
Mr. Willey -		
Balance outstanding	\$ 370,000	\$ 535,600

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Highest aggregate balance during year	\$	370,000	\$	535,600
Mr. Raisig -				
Balance outstanding	\$	645,000	\$	645,000
Highest aggregate balance during year	\$	645,000	\$	645,000
Other Information -				
Interest Rate Range		5.43%-6.22%		4.64%-6.22%

Under the Loan Plan, the advances must be repaid within one year of the executive's termination of employment or within 30 days of termination of the Loan Plan by the Board of Directors unless the executive elects to convert the outstanding balance to a one-year term note. Mr. Rutkowski and Raisig's employment terminated in January 2006.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The Company was billed the following fees for audit and other services from PricewaterhouseCoopers LLP, our independent registered accounting firm.

Audit Fees

The aggregate fees for professional services rendered by PricewaterhouseCoopers LLP for the audit of the Company's annual financial statements and the reviews of the financial statements included in the Company's Quarterly Reports on Form 10-Q were \$686,445 for the year ended December 31, 2005 and were \$501,702 for the year ended December 31, 2004.

Audit Related Fees

There were no fees for audit related services in 2005 or 2004.

Tax Fees

Fees for tax services, including tax compliance, tax advice, and tax planning, totaled \$17,558 in 2005 and \$15,700 in 2004.

All Other Fees

Fees for all other services not described above totaled \$200 in 2005 for tuition for a training conference provided by PricewaterhouseCoopers LLP and \$0 in 2004.

The Company's Audit Committee has considered whether the provision of services under the heading "All Other Fees" is compatible with maintaining the accountants' independence and has determined that it is consistent with such independence.

The Board of Directors has selected PricewaterhouseCoopers LLP to serve as the Company's independent accountants for fiscal year 2006. Representatives of PricewaterhouseCoopers LLP are expected to be present at the Annual Meeting and will have an opportunity to make a statement and to respond to appropriate questions.

Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Auditor

The Audit Committee pre-approves all audit services and all permitted non-audit services by the independent auditors. The Audit Committee has delegated the authority to take such action between meetings to the Audit Committee

chairman, who reports the decisions made to the full Audit Committee at its next scheduled meeting.

The Audit Committee evaluates whether the Company's use of the independent auditors for permitted non-audit services is compatible with maintaining the independence of the independent auditors. The Audit Committee's policies prohibit the Company from engaging the independent auditors to provide any services relating to bookkeeping or other services related to accounting records or financial statements, financial information systems design and implementation, appraisal or valuation services, fairness opinions or contribution-in-kind reports, actuarial services, or internal audit outsourcing services unless it is reasonable to conclude that the results of these services will not be subject to audit procedures. The Audit Committee's policies completely prohibit the Company from engaging the independent auditors to provide any services relating to any management function, expert services not related to the audit, legal services, broker-dealer, investment adviser, or investment banking services or human resource consulting.

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of the report

I. Financial Statements

Microvision Financial Statements

Balance Sheets as of December 31, 2005 and 2004

Statements of Operations for the years ended December 31, 2005, 2004 and 2003

Statements of Shareholders' Equity for the years ended December 31, 2005, 2004 and 2003

Statements of Comprehensive Loss for the years ended December 31, 2005, 2004 and 2003

Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003

Valuation and Qualified Accounts and Reserves for the years ended December 31, 2005, 2004 and 2003

Lumera Financial Statements

Balance Sheets as of December 31, 2005 and 2004

Statements of Operations for the years ended December 31, 2005, 2004 and 2003

Statements of Shareholders' Equity for the years ended December 31, 2005, 2004 and 2003

Statements of Comprehensive Loss for the years ended December 31, 2005, 2004 and 2003

Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003

Valuation and Qualifying Accounts and Reserves for the years ended December 31, 2005, 2004 and 2003

J. None

(b) Exhibits

- 3.1 Certificate of Incorporation of Microvision, Inc. ⁽²⁾
- 3.2 Bylaws of Microvision, Inc. ⁽²⁾
- 3.3 Certificate of Designations, Preferences and Rights of the Series A Convertible Preferred Stock of Microvision, Inc. ⁽¹⁴⁾
- 4.1 Form of Specimen Stock Certificate for Common Stock. ⁽²⁾
- 4.2 Form of Indenture. ⁽⁶⁾
- 4.3 Form of Warrant issued on July 22, 2002. ⁽¹⁰⁾
- 4.4 Form of Warrant issued on March 5, 2003. ⁽⁹⁾
- 4.5 Registration Rights Agreement dated as of September 9, 2004 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 4.6 Warrant No. 76 to Purchase Common Stock of Microvision, Inc. issued September 10, 2004 to Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 4.7 Form of Warrant issued under the Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 4.8 Registration Rights Agreement executed in connection with the Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 4.9 Form of Amended and Restated Note issued as of March 11, 2005 under the Master Amendment Agreement dated July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾
- 4.10 Form of Warrant issued as of July 25, 2005 under the Master Amendment Agreement dated as of July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾
- 4.11 Registration Rights Agreement dated as of August 8, 2005 by and between Microvision, Inc., Satellite Strategic Finance Associates, LLC and Satellite Strategic Finance Partners, Ltd.. ⁽²⁰⁾
- 4.12 Warrant No. 86 to Purchase Common Stock of Microvision, Inc. issued August 9, 2005 to Satellite Strategic Finance Partners, Ltd. ⁽²⁰⁾
- 4.13

- Warrant No. 87 to Purchase Common Stock of Microvision, Inc. issued August 9, 2005 to Satellite Strategic Finance Associates, LLC. ⁽²⁰⁾
- 4.14 Warrant No. 88 to Purchase Common Stock of Microvision, Inc. issued August 31, 2005 to Omicron Master Trust ⁽²¹⁾
- 4.15 Form of Note issued as of December 1, 2005 under the Securities and Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽²²⁾
- 4.16 Form of Warrant issued under the Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽²²⁾
- 4.17 Form of Amended and Restated Pledge and Security Agreement executed in connection with the Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽²²⁾
- 10.1 Assignment of License and Other Rights between The University of Washington and the Washington Technology Center and the H. Group, dated July 25, 1993. ⁽¹⁾
- 10.2 Project II Research Agreement between The University of Washington and the Washington Technology Center and Microvision, Inc., dated October 28, 1993. ⁽¹⁾⁺
- 10.3 Exclusive License Agreement between The University of Washington and Microvision, Inc., dated October 28, 1993. ⁽¹⁾⁺
- 10.4 Exclusive License Agreement between the University of Washington and Microvision, Inc. dated March 3, 1994. ⁽⁹⁾
- 10.5 1993 Stock Option Plan. ^{(1)*}
- 10.6 1996 Stock Option Plan, as amended. ^{(8)*}
- 10.7 Independent Director Stock Option Plan, as amended. ^{(8)*}
- 10.8 Form of Executive Option Exercise Loan Plan. ^{(3)*}
- 10.9 Lease Agreement between S/I Northcreek II, LLC and Microvision, Inc., dated October 27, 1998. ⁽¹³⁾
- 10.9.1 Lease Amendment No 1 to Lease between S/I Northcreek II, LLC and Microvision, Inc. dated July 12, 1999. ⁽⁵⁾
- 10.9.2 Lease Amendment No 2 to Lease between S/I Northcreek II, LLC and Microvision, Inc. dated February 14, 2000. ⁽⁵⁾

- 10.10 Form of Consulting Agreement between Microvision, Inc. and Avram Miller and Jacqueline Brandwynne dated August 10, 2000.⁽⁴⁾
- 10.11 Form of Common Stock Purchase Warrant issued to Avram Miller and Jacqueline Brandwynne dated August 10, 2000.⁽⁴⁾
- 10.12 Executive Loan Plan and Related Form of Note.^{(7)*}
- 10.13 Form of Stock Purchase Agreement dated March 22, 2002.⁽¹¹⁾
- 10.14 Form of Stock Purchase Agreement dated July 22, 2002.⁽¹⁰⁾
- 10.15 Form of Securities Purchase Agreement dated as of March 3, 2003.⁽⁹⁾
- 10.16 Form of the Option Agreement for options granted outside of the Plans.⁽¹²⁾
- 10.17 Securities Purchase Agreement dated as of September 9, 2004 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 10.18 License and Development Agreement dated as of December 30, 2004 by and between Microvision, Inc. and Ethicon Endo-Surgery, Inc. ⁽¹⁶⁾⁺
- 10.19 Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 10.20 Employment Agreement between Microvision, Inc. and Alexander Y. Tokman dated July 18, 2005.⁽¹⁷⁾
- 10.21 Master Amendment Agreement dated July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾
- 10.22 Lease Agreement between Carramerica Reality Operating Partnership, L.P. and Microvision, Inc., dated July 15, 2005.⁽¹⁹⁾
- 10.23 Securities Purchase Agreement dated as of August 8, 2005 by and between Microvision, Inc., Satellite Strategic Finance Associates, LLC and Satellite Strategic Finance Partners, Ltd. ⁽²⁰⁾
- 10.24 Conversion and Modification Agreement dated as of August 8, 2005 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽²⁰⁾
- 10.25 Securities Purchase Agreement dated as of August 31, 2005 by and between Microvision, Inc. and Omicron Master Trust. ⁽²¹⁾

10.26	Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽²²⁾
23	Consent of Independent Registered Public Accounting Firm, as previously filed on the original Form 10-K
23.1	Consent of Independent Registered Public Accounting Firm, as filed with the amended Form 10-K/A
31.1	Chief Executive Officer certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Principal Financial Officer certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Chief Executive Officer certification pursuant to Rule 13a-14(b) or Rule 15d-14(b) and Section 1350, Chapter 63 of Title 18 United States Code (18 U.S.C. 1350), as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
32.2	Principal Financial Officer certification pursuant to Rule 13a-14(b) or Rule 15d-14(b) and Section 1350, Chapter 63 of Title 18 United States Code (18 U.S.C. 1350), as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to the Company's Form SB-2 Registration Statement, Registration No. 333-05276-LA.

(2) Incorporated by reference to the Company's Post-Effective Amendment to Form S-3 Registration Statement, Registration No. 333-102244.

(3) Incorporated by reference to the Company's Form 10-QSB for the quarterly period ended June 30, 1998, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.

(4) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended September 30, 2000, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.

(5) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 1999, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.

(6) #9; Incorporated by reference to the Registration Statement on Form S-3, Registration No. 333-69652.

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- (7) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2001, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (8) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended June 30, 2002.
- (9) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 5, 2003.
- (10) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 23, 2002.
- (11) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 26, 2002.
- (12) Incorporated by reference to the Company's Schedule TO file on November 1, 2002.
- (13) Incorporated by reference to the Company's Form 10-QSB for the quarterly period ended September 30, 1998, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (14) Incorporated by reference to the Company's Current Report on Form 8-K filed on September 10, 2004.
- (15) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 14, 2005.
- (16) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2004.
- (17) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 7, 2005.
- (18) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 29, 2005.
- (19) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended June 30, 2005.
- (20) #9; Incorporated by reference to the Company's Current Report on Form 8-K filed on August 10, 2005.
- (21) #9; Incorporated by reference to the Company's Current Report on Form 8-K filed on September 2, 2005.
- (22) Incorporated by reference to the Company's Current Report on Form 8-K filed on December 1, 2005.
- (23) #9; Incorporated by reference to the Company's Current Report on Form 8-K/A filed on December 2, 2005.

+ Subject to confidential treatment.

* Management contracts and compensatory plans and arrangements required to be filed as exhibits pursuant to Item 15(b) of this Report.

(c) **Lumera financial statements**

LUMERA CORPORATION
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Report of Independent Registered Public Accounting Firm

Financial Statements

Balance Sheets
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Statements of Changes in Mandatorily Redeemable Convertible Preferred Stock and Shareholder's Equity (Deficit)
Statements of Comprehensive Loss
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Notes to Financial Statements

Supplemental Schedule

Schedule II - Valuation and Qualifying Accounts and Reserves

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To Board of Directors
and Shareholders of
Lumera Corporation:

In our opinion, the financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Lumera Corporation at December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Prior to July 28, 2004, the Company was a subsidiary of Microvision, Inc. As discussed in Note 3, the Company had extensive transactions and relationships with that entity for each of the three years ended December 31, 2005

/s/ PRICEWATERHOUSECOOPERS LLP

Seattle, Washington

March 16, 2006

LUMERA CORPORATION

BALANCE SHEETS

	December 31, 2005	December 31, 2004
<i>Assets</i>		
Current Assets		
Cash and cash equivalents	\$ 4,885,000	\$ 3,505,000
Investment securities, available-for-sale, current	16,871,000	15,460,000
Accounts receivable	—	32,000
Costs and estimated earnings in excess of billings on uncompleted contracts	77,000	3,000
Other current assets	551,000	623,000
Total current assets	22,384,000	19,623,000
Investment securities, available-for-sale, long-term	—	11,216,000
Property and equipment, net	1,276,000	2,047,000
Other assets	46,000	—
TOTAL ASSETS	\$ 23,706,000	\$ 32,886,000
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES		
Accounts payable	\$ 493,000	\$ 416,000
Current portion of research liability	—	101,000
Accrued liabilities	1,059,000	976,000
Total current liabilities	1,552,000	1,493,000
Total liabilities	1,552,000	1,493,000
COMMITMENTS AND CONTINGENCIES (Note 10)		
SHAREHOLDERS' EQUITY (DEFICIT)		
Common stock, \$0.001 par value, 120,000,000 shares authorized; 16,748,116 shares issued and outstanding at December 31, 2005, and 16,546,430 shares issued and outstanding at December 31, 2004	17,000	16,000
Additional Paid-in Capital	71,070,000	70,435,000
Deferred stock-based compensation	(215,000)	(666,000)
Accumulated other comprehensive gain (loss)	(18,000)	(145,000)
Accumulated deficit	(48,700,000)	(38,247,000)
Total shareholders' equity (deficit)	22,154,000	31,393,000
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	\$ 23,706,000	\$ 32,886,000

The accompanying notes are an integral part of these financial statements.

LUMERA CORPORATION
STATEMENTS OF OPERATIONS

	2005	Year ended December 31, 2004	2003
Revenue	\$ 1,509,000	\$ 989,000	\$ 1,725,000
Cost of revenue	922,000	651,000	1,014,000
GROSS PROFIT	587,000	338,000	711,000
Research and development expense	6,540,000	4,561,000	7,602,000
Marketing, general and administrative expense	5,155,000	4,588,000	1,270,000
Total operating expenses	11,695,000	9,149,000	8,872,000
Loss from operations	(11,108,000)	(8,811,000)	(8,161,000)
Interest income	655,000	237,000	39,000
Interest expense		(349,000)	
Realized gain on sale of investment securities	-	-	39,000
Net loss	(10,453,000)	(8,923,000)	(8,083,000)
Deemed dividend upon issuance of mandatorily redeemable convertible preferred stock	-	(500,000)	-
NET LOSS AVAILABLE TO COMMON SHAREHOLDERS	\$ (10,453,000)	\$ (9,423,000)	\$ (8,083,000)
NET LOSS PER SHARE-BASIC AND DILUTED	\$ (0.63)	\$ (0.89)	\$ (1.31)
WEIGHTED-AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED	16,607,653	10,613,606	6,172,400

The accompanying notes are an integral part of these financial statements.

LUMERA CORPORATION

STATEMENTS OF CHANGES IN MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY (DEFICIT)

	Mandatorily Redeemable Convertible Preferred Stock		Common Stock		Paid-in Capital	Common Stock - A		Common Stock - B		Deferred Stock Compensation	Accumulated Other Comprehensive Income	Accumulated Deficit	Shareholders' Equity
	Shares	\$	Shares	\$	\$	Shares	\$	Shares	\$	\$	\$	\$	\$
31,	2,400,000	24,603,000				802,414	3,325,000	5,370,000	105,000	(8,000)	59,000	(21,241,000)	(1,000,000)
/													
ock t of sts	1,335,000	2,603,000					—				—		
on of													
on													
ive													
31,	3,735,000	27,206,000				802,414	3,361,000	5,370,000	105,000	(31,000)		(29,324,000)	(2,000,000)
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ock													
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31,												
			236,000									
on			(37,000)			37,000						
f	201,686	1,000	436,000									
on of												
on						414,000						
sive					—			127,000				
									(10,453,000)	(1		
31,	\$	—16,748,116	\$ 17,000	\$ 71,070,000	\$	—	\$	—	\$ (215,000)	\$ (18,000)	\$ (48,700,000)	\$ 2

The accompanying notes are an integral part of these financial statements.

LUMERA CORPORATION
STATEMENTS OF COMPREHENSIVE LOSS

	Year ended December 31,		
	2005	2004	2003
Net loss	\$ (10,453,000)	\$ (8,923,000)	\$ (8,083,000)
Other comprehensive income (loss) -			
Unrealized gain (loss) on investment securities, available-for-sale:			
Unrealized holding gains (losses) arising during period	127,000	(145,000)	(20,000)
Less: Reclassification adjustment for gains realized in net loss	—	—	(39,000)
Net unrealized gain (loss)	127,000	(145,000)	(59,000)
Comprehensive loss	\$ (10,326,000)	\$ (9,068,000)	\$ (8,142,000)

The accompanying notes are an integral part of these financial statements.

LUMERA CORPORATION
STATEMENTS OF CASH FLOWS

	2005	Year ended December 31, 2004	2003
Cash flows from operating activities			
Net loss	\$ (10,453,000)	\$ (8,923,000)	\$ (8,083,000)
Adjustments to reconcile net loss to net cash used in operations			
Depreciation	1,297,000	1,198,000	1,185,000
Noncash expenses related to issuance of stock, options and amortization of deferred compensation	469,000	1,985,000	1,041,000
Amortization on investments	254,000		
Realized gain on sale of investment securities	—	—	(39,000)
Interest on Notes Payable	—	301,000	(39,000)
Change in			
Accounts receivable	32,000	119,000	(68,000)
Costs and estimated earnings in excess of billings on uncompleted contracts	(74,000)	163,000	(18,000)
Other current assets	72,000	(568,000)	57,000
Other assets	(46,000)	100,000	100,000
Accounts payable	77,000	29,000	51,000
Payable to related party	—	(42,000)	31,000
Accrued liabilities	264,000	142,000	136,000
Research liability	(101,000)	(1,847,000)	923,000
Net cash used in operating activities	(8,209,000)	(7,343,000)	(4,684,000)
Cash flows from investing activities			
Sales of investment securities	—	—	2,409,000
Purchases of investment securities	(16,122,000)	(29,821,000)	—
Maturities of investment securities	25,800,000	3,000,000	—
Purchases of property and equipment	(526,000)	(378,000)	(455,000)
Net cash provided by (used in) investing activities	9,152,000	(27,199,000)	1,954,000
Cash flows from financing activities:			
Proceeds from issuance of convertible notes	—	2,300,000	—
Principal payments on convertible notes	—	(2,300,000)	—
Net proceeds from issuance of common stock	—	36,964,000	—
Net proceeds from the exercise of stock options	437,000	23,000	—
redeemable convertible preferred stock	—	500,000	2,603,000
Net cash provided by financing activities	437,000	37,487,000	2,603,000
Net (decrease) increase in cash and cash equivalents	1,380,000	2,945,000	(127,000)
Cash and cash equivalents at beginning of period	3,505,000	560,000	687,000

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Cash and cash equivalents at end of period	\$	4,885,000	\$	3,505,000	\$	560,000
Value assigned to warrants issued in connection with convertible note	\$	—	\$	301,000	\$	—
Unrealized gain (loss) in investment securities, available-for-sale	\$	127,000	\$	(145,000)	\$	—
Accrued offering costs included in accounts payable	\$	—	\$	228,000	\$	—
Accrued liability for non-cash stock compensation	\$	84,000	\$	266,000	\$	—
Interest Paid	\$	—	\$	44,000	\$	—
Deemed dividend upon issuance of options to Microvision Employee	\$	—	\$	272,000	\$	—

The accompanying notes are an integral part of these financial statements.

LUMERA CORPORATION
NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Lumera Corporation (the "Company" or "Lumera") was incorporated in Washington State in early 2000 and reincorporated in Delaware in 2004, and was established to develop, manufacture and market devices using proprietary polymer materials. Until December 31, 2003, we were considered to be in the development stage. In early 2004, we commercialized the devices for potential wireless networking and optical networking applications and had largely completed financial planning, establishing sources of supply, acquiring plant and equipment and recruiting personnel. Therefore, we were considered to have exited the development stage in 2004. On July 28, 2004 when we completed its initial public offering ("IPO") of 6.0 million shares of common stock at an offering price of \$6.95 per share, raising proceeds of \$38.7 million before expenses. We were a majority owned subsidiary of Microvision, Inc. ("Microvision") until our IPO (see Note 3).

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We have identified revenue recognition and accounting for research payments under the University of Washington agreements as areas where significant estimates and assumptions have been made in preparing the financial statements. We also evaluate the requirement for allowances for uncollectible receivables, and the valuation allowances for deferred income tax assets.

Cash and Cash Equivalents - We consider all highly liquid investment securities with remaining maturities, at the date of purchase, of three months or less to be cash equivalents. Management determines the appropriate classification of investment securities at the time of purchase and evaluates such designation as of each balance sheet date. We have classified its entire investment portfolio as available-for-sale. Available-for-sale securities are stated at fair value with unrealized gains and losses included in shareholders equity (deficit) as a component of other comprehensive income (loss), unless the loss is deemed to be other-than-temporary, in which case it is recognized immediately as an expense. We estimate the fair value of our investment securities using readily available market information. Dividend and interest income are recognized when earned. Realized gains and losses are included in interest income or expense. The cost of securities is based on the specific identification method.

Concentration of Credit Risk - Financial instruments that potentially subject us to concentrations of credit risk are primarily cash and cash equivalents and investments. We have a cash investment policy that generally restricts investments to ensure preservation of principal and maintenance of liquidity. We typically do not require collateral from our customers. We make a provision for doubtful accounts when required. To date, we have not experienced any bad debts.

Revenue Recognition - Revenue has primarily been generated from research and development cost reimbursement contracts for the United States government. Revenue on such contracts is recorded using the percentage-of-completion method measured on a cost-incurred basis. Changes in contract performance, contract conditions, and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when realization is assured.

Losses, if any, are recognized in full as soon as identified. Losses occur when the estimated direct and indirect costs to complete the contract exceed the unrecognized revenue on the contract. We evaluate the reserve for contract losses on a contract-by-contract basis. No losses have been incurred on any contracts to date.

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The following table summarizes our contract revenue activity from our inception through December 31, 2005:

	Wideband polymer modulator		Polymer-based linear modulator		Electro-optic organic polymer		Polymer-based millimeter wave detection		Other	
	Award	Revenue	Award	Revenue	Award	Revenue	Award	Revenue	Award	Revenue
2001	\$ 1,623,000	\$ 821,000								
2002	1,031,000	885,000			\$ 149,000	\$ 61,000				
2003	950,000	1,118,000	\$ 497,000	\$ 95,000	400,000	488,000			\$ 24,000	\$ 24,000
2004	1,114,000	780,000		192,000						
2005	1,000,000	1,161,000		210,000			\$ 411,000	\$ 41,000	21,000	21,000
	\$ 5,718,000	\$ 4,765,000	\$ 497,000	\$ 497,000	\$ 549,000	\$ 549,000	\$ 411,000	\$ 41,000	\$ 45,000	\$ 45,000

All of our current and prior contracts with the government have been or are cost plus fixed fee type contracts. Under the terms of a cost plus fixed fee contract, the United States government pays us for actual direct and indirect costs incurred in performing the contracted services. We are under no obligation to spend more than the contract value to complete the contracted services. In addition, completion of the contracted services is generally on a best efforts basis. If the services are not completed, the government has the option to negotiate a follow-on contract to complete the services or to not pursue the services further with us. Contract deliveries consist of monthly financial reports, periodic technical reports and any devices if they have been successfully fabricated. There are no contractual provisions for repayments of any amounts disbursed to date under these contracts. The United States government accounted for 95% of revenues in 2005 and 99% of revenues in 2004 and 2003. Certain contracts awarded in one period may be partly performed in the next period.

Cost and estimated earnings in excess of billings on uncompleted contracts comprises amounts of revenue recognized on contracts that we have not yet billed to a customer because the amounts were not contractually billable at the balance sheet date. We were contractually able to bill 89% and 100% of the balance at December 31, 2005 and 2004, respectively, within 30 days of the respective year end.

Property and Equipment - Property and equipment is stated at cost. Depreciation is computed over the estimated useful lives of the assets (two to five years) using the straight-line method. Leasehold improvements are depreciated over the shorter of estimated useful lives or the initial lease term.

A summary of property and equipment at December 31 follows:

	2005		2004	
Computer equipment	\$	644,000	\$	491,000
Furniture and office equipment		20,000		20,000
Lab equipment		3,513,000		3,244,000
Leasehold improvements		2,831,000		2,727,000
	\$	7,008,000	\$	6,482,000
Less: Accumulated depreciation		(5,732,000)		(4,435,000)
	\$	1,276,000	\$	2,047,000

Depreciation expense was \$1,297,000, \$1,198,000 and \$1,185,000 for December 31, 2005, 2004 and 2003, respectively.

Valuation of Long-Lived Assets - We review the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Measurement of the impairment loss is based on the fair value of the asset, or group of assets. Generally, fair value will be determined using valuation techniques such as present value of expected future cash flows.

Research and Development - Research and development costs are expensed as incurred. As described in Note 10, we issued shares of common stock in connection with a research agreement. The value of these shares is amortized over the period of the research agreement.

Fair Value of Financial Instruments - Our financial instruments include cash and cash equivalents, investment securities, accounts receivable, accounts payable, and accrued liabilities. The carrying amounts of financial instruments approximate fair value due to their short maturities.

Income Taxes - We have filed a separate tax return since inception. We follow the liability method of accounting for income taxes. This liability method requires recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Stock Based Compensation - We have a stock-based employee compensation plan, which is described further in Note 7. We account for stock-based employee compensation arrangements on the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees* and related amendments and interpretations. We comply with the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*, which requires fair value recognition for employee stock-based compensation. We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") Issue No. 96-18.

Total non-cash stock option expense related to employee and director awards was \$384,000, \$1,285,000 and \$6,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Had compensation cost for employee options been determined using the fair values at the grant dates, consistent with the methodology prescribed under SFAS No. 123, our net loss available to common shareholders and associated net loss per share would have increased to the pro forma amounts indicated below:

	For the year ended December 31,		
	2005	2004	2003
Net loss available to common shareholders, as reported	\$ (10,453,000)	\$ (9,423,000)	\$ (8,083,000)
Deduct: Stock-based employee compensation expense included in net loss available to common shareholders, as reported	\$ 384,000	\$ 1,285,000	\$ 6,000
Add: Total stock-based employee compensation expense determined under fair value-based method for all awards	\$ (2,141,541)	\$ (2,009,000)	\$ (245,000)
Net loss available to common shareholders, pro forma	\$ (12,210,541)	\$ (10,147,000)	\$ (8,322,000)
Net loss per share, as reported (basic and diluted)	\$ (0.63)	\$ (0.89)	\$ (1.31)
Net loss per share, pro forma (basic and diluted)	\$ (0.74)	\$ (0.96)	\$ (1.35)

See Note 7 for the assumptions used in calculating the fair values of employee options.

Net Loss per Share - Basic net loss per share is calculated on the basis of the weighted-average number of common shares outstanding during the periods. Net loss per share assuming dilution is calculated on the basis of the weighted-average number of common shares outstanding and the dilutive effect of all potentially dilutive securities, including common stock equivalents and convertible securities.

Basic and diluted net loss per share is the same because all potentially dilutive securities outstanding are anti-dilutive. Potentially dilutive securities not included in the calculation of diluted earnings per share include options and warrants to purchase common stock for all periods presented, and Series A and Series B convertible preferred stock for 2003 and 2002 and periods prior to the IPO in 2004. Total common stock options and common stock warrants not included in the calculation of diluted earnings per share were 3,160,502 for the twelve months ended December 31, 2005 and 2,664,176 and 1,069,180 for the twelve months ended December 31, 2004 and 2003, respectively.

Recent Accounting Pronouncements - Beginning in January 2006 we will be recording expenses associated with share-based awards under the provisions of SFAS 123(R) using the modified prospective method. Under this method, we will record not only the fair value associated with new share-based awards as compensation expense, but also the remaining fair value associated with previous awards which were unvested at the end of 2005. As of December 31, 2005 the fair value associated with unvested stock option grants given to employees in periods before 2006 was approximately \$1,696,000 which will be expensed through 2009. We expect that the adoption of FAS123(R) on January 1, 2006 will impact 2006 earnings in the range of \$2.5 million to \$3.5 million.

2. INVESTMENT SECURITIES-AVAILABLE-FOR-SALE

Investment securities, which had maturities of less than one year, totaled \$16,871,000 at December 31, 2005. Investment securities at December 31, 2004 with maturities of less than one year totaled \$15,460,000 and maturities of greater than one year totaled \$11,216,000. We estimate the fair value of our investment securities using readily available market information. All investment securities have been classified as available-for-sale and are carried at estimated fair value with unrealized gains and losses included as a component of accumulated other comprehensive income in stockholders' equity. We had an unrealized gain on investment securities of \$127,000 for the year ending December 31, 2005 and an unrealized loss on investment securities of \$145,000 for the year ending December 31, 2004. We have concluded that these unrealized investment gains and losses are temporary due to our ability to hold these investments to maturity.

We had no net realized gains (losses) on investment securities for the year ending December 31, 2005 and 2004. Realized losses were \$39,000 for the year ended December 31, 2003.

3. RELATED PARTY TRANSACTIONS

Since inception until July 2004 we were a majority owned subsidiary of Microvision, Inc. The following table describes Microvision's ownership of Lumera at December 31 of each year:

	2005	2004	2003
Common Stock	27.60%	32.84%	—
Class B common stock	—	—	87.50%
Series A convertible preferred stock	—	—	11.00%
Series B convertible preferred stock	—	—	32.50%

In July 2004, all outstanding shares of the our Series A convertible preferred stock, Series B convertible preferred stock and Class B common stock were automatically converted to common stock upon completion of our IPO in July 2004. Prior to the IPO, Microvision owned approximately 52% of our outstanding common stock on an as if converted basis. In January 2006 Microvision sold 2.55 million of its shares, or approximately 16% of our outstanding shares; most of Microvision's remaining Lumera shares, which total approximately 12% of our outstanding shares as of March 1, 2006, are pledged as collateral under agreements which remain in effect until March 2007. Richard F. Rutkowski, until January 2006 the Chief Executive Officer of Microvision, is a current member of Microvision's board of directors and also a director of Lumera.

In February 2004, we agreed to pay Mr. Rutkowski a \$5,000 monthly retainer to supplement our management team during our public offering. During this retainer period, which ended in July 2004, Mr. Rutkowski also performed his role as Chief Executive Officer of Microvision. We also paid Mr. Rutkowski a one-time fee of \$100,000 upon the successful completion of our convertible note financing in April 2004. We recognized \$130,000 of administrative expense related to these fees in 2004. In addition, we paid Mr. Rutkowski a one-time fee of \$100,000 upon the participation in and successful completion of our initial public offering, which was treated as a cost of raising capital. The boards of both Microvision and Lumera approved paying Mr. Rutkowski these fees.

During 2003 and 2004, we were allocated lease and utilities costs from Microvision under a month-to-month lease. In addition, we were charged a \$5,000 per month fee to reimburse Microvision for certain other indirect charges.

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In 2004, we entered into a sublease agreement with Microvision for its corporate facilities at a base rate of approximately \$25,000 per month, plus common area charges, which is effective through April 6, 2006.

The following are a summary of charges we paid to Microvision for each year ended December 31:

	2005	2004	2003
Rent	\$ 323,000	\$ 320,000	\$ 317,000
Allocated Services	89,000	57,000	54,000
Management Fees	—	60,000	60,000
Total	\$ 412,000	\$ 437,000	\$ 431,000

4. ACCRUED LIABILITIES

Accrued liabilities consist of the following at December 31:

	2005	2004
Employee and benefit-related liabilities	\$ 372,000	\$ 363,000
Compensated absences	94,000	81,000
Professional fees	384,000	493,000
License and royalty fees	175,000	—
Other	34,000	39,000
	\$ 1,059,000	\$ 976,000

5. INCOME TAXES

No provision for income taxes has been recorded for any periods presented since we have incurred net losses from the date of our inception.

At December 31, 2005, we had \$44.1 million of federal net operating loss carry forwards, which may be used to offset future taxable income. These carry forwards expire beginning in 2018 through 2024. The Internal Revenue Code places certain limitations on the annual amount of net operating loss carry forwards that can be utilized if certain changes in our ownership occur.

At December 31, 2005 we had \$1,055,000 of research and experimentation credits carry forwards which begin to expire in 2019 through 2024.

Deferred taxes consist of the following at December 31:

	2005	2004
Deferred income tax assets		
Net operating loss carryforwards	\$ 14,997,000	\$ 11,673,000
R&D credit carryforwards	\$ 1,055,000	\$ 868,000
Other	\$ 1,412,000	\$ 1,194,000
Gross deferred tax assets	17,464,000	13,735,000
Less: valuation allowance	(17,464,000)	(13,735,000)
Net deferred tax asset	\$ —	\$ —

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We recorded a valuation allowance for the full amount of its deferred tax assets at December 31, 2005 and 2004, as we believe it is more likely than not that the deferred tax assets will not be realized.

The valuation allowance and the research and experimentation credits account for substantially all of the difference between our effective income tax rate and the Federal statutory rate of 34%.

6. SHAREHOLDERS' EQUITY (DEFICIT)

At December 31, 2005, our authorized capital consisted of 120 million shares of Common Stock, of which 1,299,956 shares are reserved for options granted under our 2000 Stock Option Plan and 2,500,000 shares are reserved for outstanding and future option grants under our 2004 Equity Incentive Plan. We also have 30,000,000 shares of authorized undesignated preferred stock, none of which have been issued.

In July 2004 we completed our initial public offering (the "IPO"), issuing 6 million shares of common stock at \$6.95 per share. Upon completion of the IPO all outstanding shares of our Common A and B and Preferred A and B shares were automatically converted to common shares. At December 31, 2005 there were 16,748,116 shares of common stock outstanding.

Common Stock - In March 2000, we issued 4,700,000 shares of its Class B common stock to Microvision, Inc. and 670,000 shares of its Class B common stock to certain Microvision directors, executives, and other individuals ("individuals"). The shares issued to Microvision were valued at \$94,000 and the proceeds were offset against the outstanding loan balance due. The shares issued to the individuals were valued at \$12,000 and were issued subject to subscription loans, for which cash was received in November 2000.

In January 2001, we issued 802,414 shares of Class A common stock valued at \$3,009,000 in connection with the research agreement described in Note 10.

Upon our initial public offering in July 2004 all shares of common A and B were automatically converted to Common Stock on a one-for-one basis.

Convertible Preferred Stock - In August through October 2003, we raised \$2,670,000 (before issuance costs of \$67,000) from the sale of 1,335,025 shares of Series B convertible preferred stock to private investors. In March 2004, we raised \$500,000 from the sale of 250,000 shares of Series B convertible preferred stock to private investors issued in March 2004. The \$2 per share conversion price of the Series B convertible preferred stock issued was less than the fair value of the Class A common stock on the issuance date. As a result, we recorded a \$500,000 beneficial conversion feature upon issuance of the preferred stock. This amount was immediately recorded as a deemed dividend to preferred shareholders because the Series B convertible preferred stock had no stated term and was immediately convertible into Class A common stock.

Upon our initial public offering in July 2004 all shares of convertible preferred stock were automatically converted to Common Stock. Each Series A Preferred share was converted into 1.14 shares of common stock in accordance with anti-dilution provisions enacted upon the sale of the Preferred B shares resulting in 2,727,291 shares of common stock issued in exchange for 2,400,000 Series A Preferred shares. Each share of Series B Preferred was exchanged for common shares on a one-for-one basis, resulting in the issuance of 1,585,025 shares of common stock issued in exchange for the Series B Preferred shares.

Dividends - No dividends on convertible preferred stock or common stock have been declared from inception through December 31, 2005.

Arizona Microsystems, L.L.C. warrants exercised - In October 2002, we issued a warrant to purchase 164,000 shares of Class A common stock at an exercise price of \$3.65 per share to Arizona Microsystems, L.L.C. for use of certain technology. These warrants were exercised in a cashless transaction for 38,935 shares of common stock in July 2004.

7. STOCK OPTIONS

Stock Option Plans In 2000, we adopted the 2000 Stock Option Plan (the "2000 Plan"). The 2000 Plan provided for the granting of stock options to our employees, consultants and non-employee directors. We reserved 3,000,000 shares of Class A Common Stock for issuance pursuant to the 2000 Plan. Following the adoption of the 2004 Equity Incentive Plan in July 2004, no more options will be issued under the 2000 Stock Option Plan. Grants, net of shares exercised and forfeited, under our 2000 Stock Option Plan totaled 1,299,956 shares at December 31, 2005.

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In July 2004, we adopted the 2004 Equity Incentive Plan (the "2004 Plan"). Awards under the Plan, can be a combination of stock options, stock appreciation rights, restricted stock, unrestricted stock, stock units (including restricted stock units), performance awards, cash awards and other awards not described that are convertible into or otherwise based on the our stock. To date, only stock option awards have been granted under the Plan.

The 2004 Plan established an initial option pool of 2,000,000 shares plus an annual increase beginning in 2005, equal to the least of (i) 2,000,000 shares, (ii) 13.4% of the number of shares of Stock outstanding as of our immediately preceding fiscal year, or (iii) such lesser amount, if any, as the Board may determine. Our Board of Directors elected to limit the increase in the option share pool by 500,000 shares in both 2005 and 2006, bringing the shares in the pool to a total of 3,000,000.

Options under both the 2000 plan and the 2004 Plan may be granted for periods up to 10 years. Options granted under either plan may be either Incentive Stock Options ("ISO"s) or non-qualified stock options. The exercise price of an ISO cannot be less than 100% of the estimated fair value of the common stock at the date of grant. To date, options granted to employees generally vest over four years.

The following table presents activity under the Plan:

Activity	Shares	Weighted-Average Exercise Price	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2002	633,430	\$ 8.18	
Granted			
Exercise price greater than fair value	308,450	\$ 3.38	\$ 0.65
Forfeited	(36,700)	\$ 10.00	
Outstanding at December 31, 2003	905,180	\$ 6.47	
Granted			
Exercise price greater than fair value	5,000	\$ 2.00	\$ 0.65
Exercise price at fair value	257,550	\$ 6.12	\$ 4.16
Exercise price less than fair value	709,900	\$ 2.19	\$ 3.99
Forfeited	(76,250)	\$ 4.01	
Exercised	(22,750)	\$ 1.01	
Outstanding at December 31, 2004	1,778,630	\$ 4.88	
Granted			
Exercise price greater than fair value			
Exercise price at fair value	733,950	\$ 5.05	\$ 3.56
Exercise price less than fair value			
Forfeited	(35,938)	\$ 5.95	
Exercised	(201,686)	\$ 2.16	
Outstanding at December 31, 2005	2,274,956	\$ 5.16	
Options Exercisable at:			
December 31, 2003	463,161	\$ 7.26	
December 31, 2004	1,105,033	\$ 5.42	
December 31, 2005	1,345,071	\$ 5.56	

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The following table presents outstanding and exercisable stock options at December 31, 2005:

Exercise Price	Shares	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$0.50 - \$2.50	680,551	7.50	\$ 1.91	512,973	\$ 1.88
\$3.65 - \$5.49	872,700	8.55	\$ 4.82	195,662	\$ 4.60
\$5.50 - \$10.00	721,705	6.19	\$ 8.62	636,436	\$ 8.82
	2,274,956	7.49	\$ 5.15	1,345,071	\$ 5.56

Non-Employee Options - Included in the option disclosures above are options granted to certain non-employees under our plan, as follows:

In August 2003, we issued options to purchase an aggregate of 164,000 shares of its Class A common stock to two consultants in connection with entering into certain consulting agreements. In April 2004, 61,500 of these shares were forfeited upon termination of one of the consulting agreements. The options have an exercise price of \$3.65 per share and a 10-year life. In aggregate, 41,000 of the options were vested on the grant date. The remaining 61,500 shares vest one-third on each subsequent annual anniversary of the grant date and are subject to re-measurement at each balance sheet date during the vesting period. The aggregate value of the outstanding options was estimated at \$136,000 at the grant date and December 31, 2003, \$415,000 at December 31, 2004 and at \$299,000 at December 31, 2005. The fair value of these options, net of forfeited options was recognized as compensation expense over the two-year period of service, which ended in August 2005. Total non-cash compensation expense related to these options was \$4,000, \$287,000 and \$32,000 for the year ended December 31, 2005, 2004 and 2003, respectively. The fair values of the options were estimated at the grant date and December 31, 2005, 2004 and 2003, using the Black-Scholes option pricing model with the following weighted-average assumptions: dividend yield of 0%; expected volatility of 100%; risk-free interest rates of 4.3%, 4.62%, and 4.4%; and expected lives of 10 years, for each of the measurement dates, respectively.

In March 2004, we granted options under the 2000 Plan to purchase 65,000 shares of Class A common stock to a Microvision employee. These options have been accounted for as a dividend to Microvision and recorded at their fair value of \$272,000, in accordance with the guidance in EITF Issue No. 00-23 Issue 21, Options Granted to Employees of Entities under Common Control.

Options issued at below market price - In March 2004 we granted options under the 2000 Plan to its CEO and each of our Directors to purchase an aggregate of 410,000 shares of common stock at a price below the then current market value. Our Directors were each awarded options to purchase 65,500 shares, of which 30,000 shares vested on the date of grant with 5,000 shares vesting quarterly thereafter until fully vested, have an exercise price of \$2 per share and a 10-year life. Our CEO was awarded an option to purchase 150,000 shares, of which 50,000 vested September 1, 2004 and 50,000 annually thereafter until fully vested, with an exercise price of \$2 per share and a 10-year life. The aggregate value of these options was estimated to be \$1,230,000 and is being recognized as compensation expense over the vesting periods. We recognized \$169,000 and \$922,000 of compensation expense associated with these option grants during the years ended December 31, 2005 and 2004, respectively, net of forfeited options. As of December 31, 2005, \$40,000 of deferred compensation remained to be amortized on these option grants.

In April 2004 we granted options under the 2000 Plan to its employees to purchase an aggregate of 156,650 shares of common stock at a price below the then current market value. The options have an exercise price of \$2.00 per share and a 10-year life. One quarter of the options vested on July 1, 2004 with the remaining options vesting annually over the subsequent three years until fully vested. In July 2004, we issued options under the 2000 Plan to its employees to purchase an aggregate of 78,250 shares of common stock at a price below the then current market value. The options have a weighted average exercise price of \$3.76 per share and a 10-year life. The aggregate value of these option grants was estimated at \$801,000 and is being recognized as compensation expense over the vesting period. We recognized compensation expense associated with these option grants of \$215,000 and \$360,000, net of forfeited options, for the years ended December 31, 2005 and 2004, respectively. As of December 31, 2005, \$162,000 of deferred compensation remained to be amortized.

A summary of stock compensation expense for each period is as follows:

	For the twelve months ended		
	December 31,		
	2005	2004	2003
Employees	\$ 343,000	\$ 644,000	\$ 6,000
Directors	41,000	641,000	-
Third Party	85,000	608,000	32,000
	\$ 469,000	\$ 1,893,000	\$ 38,000
Component of:			
Research and development	\$ 95,000	\$ 573,000	\$ 35,000
Marketing, general and administrative	374,000	1,320,000	3,000
	\$ 469,000	\$ 1,893,000	\$ 38,000

Fair Value Disclosure - The fair values of the options granted to employees were estimated on the date of each grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2005, 2004 and 2003, respectively:

	December 31,		
	2005	2004	2003
Risk Free Interest Rate	4.05%	3.2%	3.8%
Expected Life (in years)	5.6	5.2	7.0
Dividend Yield	0.0%	0.0%	0.0%
Volatility	83.0%	83.0%	83.0%

8. WARRANTS

In October 2002, we issued a warrant to purchase 164,000 shares of Class A common stock at an exercise price of \$3.65 per share to Arizona Microsystems, L.L.C. for use of certain technology. These warrants were exercised in a cashless transaction for 38,935 common shares in July 2004.

In April 2004 we issued warrants to purchasers of its convertible promissory notes for an aggregate of 115,000 shares of Common Stock at and exercise price of \$7.20 per share. The value of the warrants granted, which are exercisable through April 21, 2009, was estimated to be approximately \$344,000 using the Black Scholes option pricing model. The relative fair value of the warrants of \$301,000 was treated as a debt issuance cost and amortized to interest expense over the one-year term of the debt.

In July 2004 we issued warrants to its Underwriters in connection with our initial public offering to purchase a total of 600,000 shares of our common stock at a purchase price of \$8.34, or 120% of the price of the shares upon completion of our IPO. The warrants are exercisable through July 28, 2009. These warrants were treated as a cost of raising capital.

Microvision holds a warrant to purchase a total of 170,546 shares of Common Stock at an exercise price of \$8.80 per share. The warrant, which was originally issued in 2001 for 150,000 Series A Preferred shares in lieu of interest payments due on a convertible note, and was exercisable at \$10.00 per share, carried anti-dilution rights which, upon completion of our IPO, triggered an automatic adjustment to the number of shares and exercise price. The warrant, all of which was outstanding at December 31, 2005, expires in March 2011 and was valued by the amount of the interest forgiven or \$719,000, as this was considered to be more readily determinable than the fair value of the warrant.

9. CONVERTIBLE NOTES PAYABLE

In April 2004, we received cash proceeds from the issuance of convertible promissory notes in the aggregate principal amount of \$2.3 million. The notes accrued interest at a rate of 6.5% per annum and were payable on demand at the earlier of March 31, 2005 or upon the closing of an underwritten public offering of our common stock. The principal amount and any accrued but unpaid interest in respect of each note was convertible, at the option of the holder, into shares of our Class A common stock. The conversion price of the Notes was stated as the lesser of \$6.00 per share of common stock or the price per share offered to the public in any underwritten IPO of our common stock.

In connection with the sale of these convertible notes, we also issued warrants to purchase an aggregate of 115,000 shares of common stock at a price of \$7.20 per share. The warrants expire in April 2009. The value of the warrants granted was estimated to be approximately \$344,000 at the date of grant using the Black-Scholes option pricing model. We allocated the proceeds to the convertible note and warrant based on their relative fair value. The relative fair value of the warrants of \$301,000 was treated as a debt issuance cost and was amortized to interest expense over the one-year term of the debt.

Upon completion of our IPO in July 2004 the notes became due and payable. All of the note holders elected to receive cash payments, which resulted in principal and interest payments totaling \$2,344,000 in August 2004. The unamortized debt issuance costs were recognized immediately as interest expense at that time. During 2004, we recognized a total of \$345,000 of interest expense associated with the Notes.

10. COMMITMENTS AND CONTINGENCIES

Agreements with the University of Washington - In October 2000, we entered into a license agreement (the "License Agreement") and a research agreement (the "Sponsored Research Agreement" or the "SRA") with the University of Washington (the "UW"). The License Agreement grants us rights to certain intellectual property including technology being developed under the sponsored Research Agreement whereby we have a royalty-bearing license to make, sell or sublicense the licensed technology. Under the terms of the License Agreement, we issued 802,414 shares of our Class A common stock to the UW. The shares, although initially subject to a vesting schedule tied to performance under the Sponsored Research Agreement, were vested in full by mutual agreement between the UW and Lumera on January 8, 2001. The shares issued were valued by management at \$3,009,000, based on a value of \$3.75 per share on the date of issuance. We considered a number of factors, including an independent valuation, projected cash flows from our technology and expected future products, general market conditions and the risks inherent in achieving our business plan in determining the fair value of the common shares issued. The value of the shares issued was recorded as prepaid stock-based research expense and was fully amortized to expense as of March 31, 2004.

Under the terms of the License Agreement, we are also required to pay certain costs related to filing and processing of patents and copyrights related to the agreements. Additionally, we are required to pay certain ongoing royalty payments at a minimum of \$75,000 per annum. We have not made any royalty payments to date in excess of these minimums. These payments have been expensed as incurred.

As part of the Sponsored Research Agreement, we agreed to pay an aggregate of \$9,000,000 in quarterly payments over three years for research services. The first payment was made on February 26, 2001. We expensed the total expected payments on a straight-line basis because there was no more readily determinable pattern of the performance of the research services under the agreement.

In February 2002, Lumera and the UW amended the Sponsored Research Agreement to extend quarterly payments and performance through 2005. In March 2003, we entered into a second amendment to the SRA, which deferred certain 2003 payments until 2004. In November 2003, we entered into a third amendment to the SRA. Under the terms of the third amendment, our payment obligation to the UW was reduced to \$125,000 per quarter from October 1, 2003 to September 30, 2004, and \$300,000 for the quarter ending December 31, 2004. The amendment required us to make its unpaid payments of \$2,000,000 by May 2005. In April 2004, we entered into a fourth amendment to the SRA that required payments of \$125,000 for the quarters ending March 31, 2004 and September 30, 2004 and eliminated a contingent payment of \$2,000,000 that had been due in April 2004. For each of the quarters ending September 30, 2004 and December 31, 2004, we were required to pay \$250,000. Total payments under the Amended Sponsored Research Agreement, which terminated in June 2005, were \$5,750,000 instead of the \$9,000,000 under the terms of the original agreement.

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Subsequent to each amendment noted above, we prospectively adjusted the amortization of the research payments to account for the extended period over which the payments would be made and services provided. As a result of these adjustments, we had cumulatively recognized expenses in excess of payments made of \$1,948,000 at December 31, 2003. As a result of the fourth amendment and the elimination of the contingent \$2 million payment in 2005, we recognized a credit to research and development expense of \$2.4 million in 2004.

The following table summarizes payments made and expense recorded during the years ending December 31:

	2005	2004	2003
Payments made	\$ 1,018,000	\$ 800,000	\$ 1,300,000
Sponsored research	\$ 650,000	\$ (1,223,000)	\$ 1,924,000
Optical materials	166,000	50,000	300,000
Minimum royalty	75,000	75,000	75,000
Expenses recorded on payments	\$ 891,000	\$ (1,098,000)	\$ 2,299,000
Amortization of stock		159,000	1,003,000
Total expense recorded	\$ 891,000	\$ (939,000)	\$ 3,302,000

Helix Biopharma/Sensium - We have a licensing agreement with Sensium Technologies, Inc., a subsidiary of Helix BioPharma, which gives us an exclusive worldwide royalty bearing license in our field of business to a number of patents and the related technology for use in our NanoCapture™ Arrays. Under the terms of the agreement, we paid \$250,000 in license fees, half of which we paid upon signing in January 2005 and half in February 2006. We also paid \$125,000 in technology transfer fees during the first half of 2005. The Sensium licensing agreement contains minimum royalty provisions totaling \$50,000 for the first year, \$100,000 for the second year, \$150,000 for the third year and \$200,000 thereafter. Our license exclusivity is based upon achieving certain minimum revenues by the fourth royalty year.

Lease Commitments - We sublease our corporate facilities from Microvision at a base rate of approximately \$25,000 per month, plus common area charges; the sublease is effective through April 6, 2006. We signed a five year lease to expand our current facilities which begins April 7, 2006. Once we complete our tenant improvements, which we believe will require cash expenditures in the range of \$900,000 to \$1.2 million, our facilities will occupy approximately 32,175 square feet of space located in the same building we currently occupy. The total of the minimum rental payments over the life of the initial lease term is approximately \$2.5 million. We have an option to extend our new lease for one additional 5 year period. We had no other significant operating or capital leases at December 31, 2005.

Claims and Litigation - In our opinion, litigation, contingent liabilities and claims against us in the normal course of business are not expected to involve any judgments or settlements that would be material to our financial condition, results of operations or cash flows.

11. RETIREMENT SAVINGS PLAN

On August 31, 2004, we established its retirement savings plan (the "Plan"), which qualifies under the Internal Revenue Code Section 401(k) and covers all qualified employees. The Plan allows us to match 50% of an employee's contribution to the Plan up to a maximum 6% of the employee's base salary. During 2005 we contributed \$57,000 to the Plan under the matching program and from September through December 31, 2004, we contributed \$21,000 to the Plan under the matching program. Prior to August 31, 2004 our employees participated in the Microvision retirement savings plan. We contributed \$33,000 and \$43,000 in matching payments under the Microvision Plan in the first eight months of 2004, and in 2003, respectively.

12. QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table represents certain unaudited quarterly financial information for the eight quarters ended December 31, 2005. In our opinion, this information has been prepared on the same basis as the audited financial statements and includes all adjustments (consisting only of normal recurring adjustments) necessary to fairly state the unaudited quarterly results of operations set forth herein.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Fiscal Year
	(in thousands, except per share data)				
Total Revenue					
2005	\$ 240	\$ 348	\$ 681	\$ 240	\$ 1,509
2004	\$ 316	\$ 288	\$ 292	\$ 93	\$ 989
Gross Profit					
2005	72	131	215	169	587
2004	122	100	128	(12)	338
Net Loss Available to Common Shareholders					
2005	(2,878)	(2,926)	(2,034)	(2,615)	(10,453)
2004	(2,592)	(732)	(3,176)	(2,923)	(9,423)
Basic and diluted net loss per share attributable to common stockholders					
2005	\$ (0.17)	\$ (0.18)	\$ (0.12)	\$ (0.16)	\$ (0.63)
2004	\$ (0.50)	\$ (0.04)	\$ (0.24)	\$ (0.18)	\$ (0.89)

Quarterly and annual earnings per share are calculated independently, based on the weighted average number of shares outstanding during the periods.

Schedule II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

	Balance at Beginning of Fiscal Year	Charges to Costs and Expenses	Charges to Other Accounts	Deductions	Balance at End of Fiscal Period
Year ended December 31, 2003					
Tax valuation allowance	\$ 7,426,000	\$ 3,170,000	—	—	\$ 10,596,000
Year ended December 31, 2004					
Tax valuation allowance	\$ 10,596,000	\$ 3,139,000	—	—	\$ 13,735,000
Year ended December 31, 2005					
Tax valuation allowance	\$ 13,735,000	\$ 3,728,000			\$ 17,463,000

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

MICROVISION, INC.

Date: May 1, 2006

By /s/ Alexander Tokman

Alexander Tokman
President and Chief Executive Officer

EXHIBIT INDEX

The following documents are filed herewith or have been included as exhibits to previous filings with the Securities and Exchange Commission and are incorporated by reference as indicated below.

- 3.1 Certificate of Incorporation of Microvision, Inc. ⁽²⁾
- 3.2 Bylaws of Microvision, Inc. ⁽²⁾
- 3.3 Certificate of Designations, Preferences and Rights of the Series A Convertible Preferred Stock of Microvision, Inc. ⁽¹⁴⁾
- 4.1 Form of Specimen Stock Certificate for Common Stock. ⁽²⁾
- 4.2 Form of Indenture. ⁽⁶⁾
- 4.3 Form of Warrant issued on July 22, 2002. ⁽¹⁰⁾
- 4.4 Form of Warrant issued on March 5, 2003. ⁽⁹⁾
- 4.5 Registration Rights Agreement dated as of September 9, 2004 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 4.6 Warrant No. 76 to Purchase Common Stock of Microvision, Inc. issued September 10, 2004 to Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 4.7 Form of Warrant issued under the Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 4.8 Registration Rights Agreement executed in connection with the Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 4.9 Form of Amended and Restated Note issued as of March 11, 2005 under the Master Amendment Agreement dated July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾
- 4.10 Form of Warrant issued as of July 25, 2005 under the Master Amendment Agreement dated as of July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾

- 4.11 Registration Rights Agreement dated as of August 8, 2005 by and between Microvision, Inc., Satellite Strategic Finance Associates, LLC and Satellite Strategic Finance Partners, Ltd..⁽²⁰⁾
- 4.12 Warrant No. 86 to Purchase Common Stock of Microvision, Inc. issued August 9, 2005 to Satellite Strategic Finance Partners, Ltd.⁽²⁰⁾
- 4.13 Warrant No. 87 to Purchase Common Stock of Microvision, Inc. issued August 9, 2005 to Satellite Strategic Finance Associates, LLC.⁽²⁰⁾
- 4.14 Warrant No. 88 to Purchase Common Stock of Microvision, Inc. issued August 31, 2005 to Omicron Master Trust⁽²¹⁾
- 4.15 Form of Note issued as of December 1, 2005 under the Securities and Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto.⁽²²⁾
- 4.16 Form of Warrant issued under the Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto.⁽²²⁾
- 4.17 Form of Amended and Restated Pledge and Security Agreement executed in connection with the Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto.⁽²²⁾
- 10.1 Assignment of License and Other Rights between The University of Washington and the Washington Technology Center and the H. Group, dated July 25, 1993.⁽¹⁾
- 10.2 Project II Research Agreement between The University of Washington and the Washington Technology Center and Microvision, Inc., dated October 28, 1993.⁽¹⁾⁺
- 10.3 Exclusive License Agreement between The University of Washington and Microvision, Inc., dated October 28, 1993.⁽¹⁾⁺
- 10.4 Exclusive License Agreement between the University of Washington and Microvision, Inc. dated March 3, 1994.⁽⁹⁾
- 10.5 1993 Stock Option Plan.^{(1)*}
- 10.6 1996 Stock Option Plan, as amended.^{(8)*}
- 10.7 Independent Director Stock Option Plan, as amended.^{(8)*}
- 10.8 Form of Executive Option Exercise Loan Plan.^{(3)*}

- 10.9 Lease Agreement between S/I Northcreek II, LLC and Microvision, Inc., dated October 27, 1998.⁽¹³⁾
- 10.9.1 Lease Amendment No 1 to Lease between S/I Northcreek II, LLC and Microvision, Inc. dated July 12, 1999.⁽⁵⁾
- 10.9.2 Lease Amendment No 2 to Lease between S/I Northcreek II, LLC and Microvision, Inc. dated February 14, 2000.⁽⁵⁾
- 10.10 Form of Consulting Agreement between Microvision, Inc. and Avram Miller and Jacqueline Brandwynne dated August 10, 2000.⁽⁴⁾
- 10.11 Form of Common Stock Purchase Warrant issued to Avram Miller and Jacqueline Brandwynne dated August 10, 2000.⁽⁴⁾
- 10.12 Executive Loan Plan and Related Form of Note.^{(7)*}
- 10.13 Form of Stock Purchase Agreement dated March 22, 2002.⁽¹¹⁾
- 10.14 Form of Stock Purchase Agreement dated July 22, 2002.⁽¹⁰⁾
- 10.15 Form of Securities Purchase Agreement dated as of March 3, 2003.⁽⁹⁾
- 10.16 Form of the Option Agreement for options granted outside of the Plans.⁽¹²⁾
- 10.17 Securities Purchase Agreement dated as of September 9, 2004 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽¹⁴⁾
- 10.18 License and Development Agreement dated as of December 30, 2004 by and between Microvision, Inc. and Ethicon Endo-Surgery, Inc. ⁽¹⁶⁾⁺
- 10.19 Securities Purchase Agreement dated as of March 11, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁵⁾
- 10.20 Employment Agreement between Microvision, Inc. and Alexander Y. Tokman dated July 18, 2005.⁽¹⁷⁾
- 10.21 Master Amendment Agreement dated July 25, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽¹⁸⁾
- 10.22 Lease Agreement between Carramerica Reality Operating Partnership, L.P. and Microvision, Inc., dated July 15, 2005.⁽¹⁹⁾
- 10.23

- Securities Purchase Agreement dated as of August 8, 2005 by and between Microvision, Inc., Satellite Strategic Finance Associates, LLC and Satellite Strategic Finance Partners, Ltd. ⁽²⁰⁾
- 10.24 Conversion and Modification Agreement dated as of August 8, 2005 by and between Microvision, Inc. and Satellite Strategic Finance Associates, LLC. ⁽²⁰⁾
- 10.25 Securities Purchase Agreement dated as of August 31, 2005 by and between Microvision, Inc. and Omicron Master Trust. ⁽²¹⁾
- 10.26 Securities Purchase Agreement dated as of December 1, 2005 by and among Microvision, Inc. and the investors listed on the Schedule of Buyers thereto. ⁽²²⁾
- 23 Consent of Independent Registered Public Accounting Firm, as previously filed on the original Form 10-K
- 23.1 Consent of Independent Registered Public Accounting Firm, as filed with the amended Form 10-K/A
- 31.1 Chief Executive Officer certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Principal Financial Officer certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Chief Executive Officer certification pursuant to Rule 13a-14(b) or Rule 15d-14(b) and Section 1350, Chapter 63 of Title 18 United States Code (18 U.S.C. 1350), as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
- 32.2 Principal Financial Officer certification pursuant to Rule 13a-14(b) or Rule 15d-14(b) and Section 1350, Chapter 63 of Title 18 United States Code (18 U.S.C. 1350), as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to the Company's Form SB-2 Registration Statement, Registration No. 333-05276-LA.

(2) Incorporated by reference to the Company's Post-Effective Amendment to Form S-3 Registration Statement, Registration No. 333-102244.

(3) Incorporated by reference to the Company's Form 10-QSB for the quarterly period ended June 30, 1998, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the

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Company's Commission File Number, 0-21221.

- (4) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended September 30, 2000, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (5) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 1999, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (6) #9; Incorporated by reference to the Registration Statement on Form S-3, Registration No. 333-69652.
- (7) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2001, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (8) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended June 30, 2002.
- (9) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 5, 2003.
- (10) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 23, 2002.
- (11) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 26, 2002.
- (12) Incorporated by reference to the Company's Schedule TO file on November 1, 2002.
- (13) Incorporated by reference to the Company's Form 10-QSB for the quarterly period ended September 30, 1998, available at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 under the Company's Commission File Number, 0-21221.
- (14) Incorporated by reference to the Company's Current Report on Form 8-K filed on September 10, 2004.
- (15) Incorporated by reference to the Company's Current Report on Form 8-K filed on March 14, 2005.
- (16) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2004.
- (17) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 7, 2005.
- (18) Incorporated by reference to the Company's Current Report on Form 8-K filed on July 29, 2005.
- (19) Incorporated by reference to the Company's Form 10-Q for the quarterly period ended June 30, 2005.
- (20) #9; Incorporated by reference to the Company's Current Report on Form 8-K filed on August 10, 2005.
- (21) #9; Incorporated by reference to the Company's Current Report on Form 8-K filed on September 2, 2005.
- (22) Incorporated by reference to the Company's Current Report on Form 8-K filed on December 1, 2005.
- (23) Incorporated by reference to the Company's Current Report on Form 8-K/A filed on December 2, 2005.

+ Subject to confidential treatment.

* Management contracts and compensatory plans and arrangements required to be filed as exhibits pursuant to Item 15(b) of this Report.
