

INTEST CORP  
Form 10-Q  
November 13, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended

September 30, 2006 or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-22529

**inTEST Corporation**

(Exact Name of Registrant as Specified in its Charter)

Delaware

22-2370659

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

7 Esterbrook Lane  
Cherry Hill, New Jersey 08003

(Address of principal executive offices, including zip code)

**(856) 424-6886**

(Registrant's Telephone Number, including Area Code)

Indicate by check X 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

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

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

Number of shares of Common Stock, \$.01 par value, outstanding as of October 31, 2006:

9,298,705

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inTEST CORPORATION

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inTEST CORPORATION  
CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)  
(Unaudited)

|   | Sept. 30,<br>2006 | Dec. 31,<br>2005 |
|---|-------------------|------------------|
|   | -----             | -----            |
| ASSETS:   |                   |                  |
| Current assets:   |                   |                  |
| Cash and cash equivalents   | \$12,060          | \$ 7,295         |
| Trade accounts and notes receivable, net of allowance for<br>doubtful accounts of \$172 and \$199, respectively | 10,695            | 9,443            |
| Inventories   | 6,792             | 6,235            |
| Refundable domestic income taxes  | 24                | 24               |
| Prepaid expenses and other current assets   | <u>967</u>        | <u>609</u>       |
| Total current assets  | <u>30,538</u>     | <u>23,606</u>    |
| Property and equipment:   |                   |                  |
| Machinery and equipment   | 7,829             | 7,641            |
| Leasehold improvements  | <u>3,256</u>      | <u>3,214</u>     |
|   | 11,085            | 10,855           |
| Less: accumulated depreciation  | <u>(7,682)</u>    | <u>(6,904)</u>   |
| Net property and equipment  | <u>3,403</u>      | <u>3,951</u>     |

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|  |                 |                 |
|--|-----------------|-----------------|
| Other assets   | 646             | 594             |
| Goodwill   | 2,556           | 2,403           |
| Intangible assets, net   | <u>300</u>      | <u>315</u>      |
| Total assets   | <u>\$37,443</u> | <u>\$30,869</u> |
|  | =====           | =====           |
| LIABILITIES AND STOCKHOLDERS' EQUITY   |                 |                 |
| Current liabilities:   |                 |                 |
| Accounts payable   | \$ 4,387        | \$ 2,527        |
| Accrued wages and benefits   | 2,039           | 1,492           |
| Accrued warranty   | 945             | 935             |
| Accrued sales commissions  | 455             | 391             |
| Accrued restructuring and other charges  | 143             | 205             |
| Other accrued expenses   | 1,278           | 1,272           |
| Domestic and foreign income taxes payable  | 1,029           | 447             |
| Capital lease obligations  | 7               | 24              |
| Deferred rent  | <u>118</u>      | <u>118</u>      |
| Total current liabilities  | <u>10,401</u>   | <u>7,411</u>    |
| Capital lease obligations, net of current portion  | 18              | 23              |
| Deferred rent, net of current portion  | <u>540</u>      | <u>629</u>      |
| Total liabilities  | <u>10,959</u>   | <u>8,063</u>    |
|  | =====           | =====           |
| Commitments and contingencies  |                 |                 |
| Stockholders' equity:  |                 |                 |
| Preferred stock, \$0.01 par value; 5,000,000 shares authorized;<br>no shares issued or outstanding                   | -               | -               |
| Common stock, \$0.01 par value; 20,000,000 shares authorized;<br>9,489,655 and 9,460,255 shares issued, respectively | 95              | 95              |
| Additional paid-in capital   | 24,375          | 25,099          |
| Retained earnings  | 2,833           | 43              |
| Accumulated other comprehensive income   | 559             | 237             |
| Deferred stock compensation  | -               | (909)           |
| Treasury stock, at cost; 223,021 and 284,577 shares, respectively  | <u>(1,378)</u>  | <u>(1,759)</u>  |
| Total stockholders' equity   | <u>26,484</u>   | <u>22,806</u>   |
| Total liabilities and stockholders' equity   | <u>\$37,443</u> | <u>\$30,869</u> |
|  | =====           | =====           |

See accompanying Notes to Consolidated Financial Statements.

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inTEST CORPORATION  
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share data)  
(Unaudited)

|                  | Three Months Ended<br>Sept. 30, |              | Nine Months Ended<br>Sept. 30, |               |
|------------------|---------------------------------|--------------|--------------------------------|---------------|
|                  | 2006                            | 2005         | 2006                           | 2005          |
| Net revenues     | \$16,566                        | \$16,448     | \$49,187                       | \$39,288      |
| Cost of revenues | 9,659                           | 9,979        | 28,066                         | 25,464        |
| Gross margin     | <u>6,907</u>                    | <u>6,469</u> | <u>21,121</u>                  | <u>13,824</u> |

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|  |           |           |           |            |
|--|-----------|-----------|-----------|------------|
| Operating expenses:  |           |           |           |            |
| Selling expense  | 2,232     | 2,545     | 6,954     | 7,024      |
| Engineering and product development expense                              | 1,662     | 1,522     | 4,110     | 4,458      |
| General and administrative expense                                       | 2,097     | 1,912     | 6,501     | 5,890      |
| Restructuring and other charges  | -         | 28        | -         | 448        |
|  | -----     | -----     | -----     | -----      |
| Total operating expenses   | 5,991     | 6,007     | 17,565    | 17,820     |
|  | -----     | -----     | -----     | -----      |
| Operating income (loss)  | 916       | 462       | 3,556     | (3,996)    |
|  | -----     | -----     | -----     | -----      |
| Other income (expense):  |           |           |           |            |
| Interest income  | 98        | 27        | 226       | 150        |
| Interest expense   | (3)       | (6)       | (4)       | (11)       |
| Other  | 6         | 33        | 54        | 55         |
|  | -----     | -----     | -----     | -----      |
| Total other income   | 101       | 54        | 276       | 194        |
|  | -----     | -----     | -----     | -----      |
| Earnings (loss) before income taxes                                      | 1,017     | 516       | 3,832     | (3,802)    |
| Income tax expense   | 509       | 123       | 1,042     | 10         |
|  | -----     | -----     | -----     | -----      |
| Net earnings (loss)  | \$ 508    | \$ 393    | \$ 2,790  | \$ (3,812) |
|  | =====     | =====     | =====     | =====      |
| Net earnings (loss) per common share - basic                             | \$0.06    | \$0.05    | \$0.31    | \$(0.44)   |
| Weighted average common shares outstanding-basic                         | 9,053,603 | 8,823,979 | 9,020,173 | 8,764,115  |
| Net earnings (loss) per common share - diluted                           | \$0.06    | \$0.04    | \$0.31    | \$(0.44)   |
| Weighted average common and common share equivalents outstanding-diluted | 9,264,809 | 8,911,672 | 9,152,747 | 8,764,115  |

See accompanying Notes to Consolidated Financial Statements.

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inTEST CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS (LOSS)

(In thousands)  
(Unaudited)

|                     | Three Months Ended<br>Sept. 30, |        | Nine Months Ended<br>Sept. 30, |           |
|---------------------|---------------------------------|--------|--------------------------------|-----------|
|                     | 2006                            | 2005   | 2006                           | 2005      |
|                     | -----                           | -----  | -----                          | -----     |
| Net earnings (loss) | \$ 508                          | \$ 393 | \$2,790                        | \$(3,812) |

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|  |        |        |         |            |
|--|--------|--------|---------|------------|
| Foreign currency translation adjustments | (115)  | (56)   | 322     | (703)      |
|  | -----  | -----  | -----   | -----      |
| Comprehensive earnings (loss)            | \$ 393 | \$ 337 | \$3,112 | \$ (4,515) |
|  | =====  | =====  | =====   | =====      |

See accompanying Notes to Consolidated Financial Statements.

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inTEST CORPORATION  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(In thousands, except share data)  
(Unaudited)

|   | Common Stock<br>-----<br>Shares | Amount | Add'l<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Deferred<br>Stock<br>Compensation | Treasury<br>Stock |
|---|---------------------------------|--------|-----------------------------|----------------------|---|-----------------------------------|-------------------|
|   | -----                           | -----  | -----                       | -----                | -----   | -----                             | -----             |
| Balance, January 1, 2006  | 9,460,255                       | \$ 95  | \$25,099                    | \$ 43                | \$ 237  | \$ (909)                          | \$ (1,759)        |
| Reclassification of deferred<br>stock compensation upon<br>adoption of SFAS No. 123R  | -                               | -      | (909)                       | -                    | -   | 909                               | -                 |
| Net earnings  | -                               | -      | -                           | 2,790                | -   | -                                 | -                 |
| Other comprehensive income  | -                               | -      | -                           | -                    | 322   | -                                 | -                 |
| Stock options exercised   | 29,400                          | -      | 98                          | -                    | -   | -                                 | -                 |
| Amortization of deferred<br>stock compensation  | -                               | -      | 243                         | -                    | -   | -                                 | -                 |
| Issuance of 61,556 shares of<br>treasury stock to satisfy<br>profit sharing liability | -                               | -      | (156)                       | -                    | -   | -                                 | 381               |
|   | -----                           | -----  | -----                       | -----                | -----   | -----                             | -----             |
| Balance, September 30, 2006   | 9,489,655                       | \$ 95  | \$24,375                    | \$2,833              | \$ 559  | \$ -                              | \$ (1,378)        |
|   | =====                           | =====  | =====                       | =====                | =====   | =====                             | =====             |

See accompanying Notes to Consolidated Financial Statements.

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inTEST CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)  
(Unaudited)

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|  | Nine Months Ended<br>Sept. 30, |           |
|--|--------------------------------|-----------|
|  | 2006                           | 2005      |
|  | -----                          | -----     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                                |           |
| Net earnings (loss)  | \$ 2,790                       | \$(3,812) |
| Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities: |                                |           |
| Depreciation and amortization  | 1,128                          | 1,463     |
| Foreign exchange loss  | 88                             | 54        |
| Deferred compensation relating to restricted stock   | 243                            | 204       |
| Expense relating to issuance of treasury stock to satisfy profit sharing liability                   | 225                            | 300       |
| Gain on disposal of fixed assets   | (11)                           | (7)       |
| Proceeds from sale of demonstration equipment, net of gain   | 2                              | 10        |
| Changes in assets and liabilities:   |                                |           |
| Trade accounts and notes receivable  | (1,182)                        | (3,526)   |
| Inventories  | (516)                          | 2,159     |
| Refundable domestic income taxes   | -                              | 699       |
| Prepaid expenses and other current assets  | (361)                          | 5         |
| Other assets   | (51)                           | 102       |
| Accounts payable   | 1,738                          | 2,215     |
| Accrued wages and benefits   | 535                            | 42        |
| Accrued warranty   | 5                              | (255)     |
| Accrued sales commissions  | 57                             | 133       |
| Accrued restructuring and other charges  | (79)                           | (123)     |
| Other accrued expenses   | 3                              | 309       |
| Domestic and foreign income taxes payable  | 576                            | (163)     |
| Deferred rent  | (88)                           | (79)      |
|  | -----                          | -----     |
| Net cash provided by (used in) operating activities  | 5,102                          | (270)     |
|  | -----                          | -----     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                                |           |
| Purchase of property and equipment   | (551)                          | (1,337)   |
| Proceeds from sale of property and equipment   | 38                             | -         |
|  | -----                          | -----     |
| Net cash used in investing activities  | (513)                          | (1,337)   |
|  | -----                          | -----     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                                |           |
| Deferred rent resulting from landlord provided tenant improvements                                   | -                              | 854       |
| Repayment of capital lease obligations   | (22)                           | (78)      |
| Proceeds from stock options exercised  | 98                             | 44        |
|  | -----                          | -----     |
| Net cash provided by financing activities  | 76                             | 820       |
|  | -----                          | -----     |
| Effects of exchange rates on cash  | 100                            | (175)     |
|  | -----                          | -----     |
| Net cash provided by (used in) all activities  | 4,765                          | (962)     |
| Cash and cash equivalents at beginning of period   | 7,295                          | 7,686     |
|  | -----                          | -----     |
| Cash and cash equivalents at end of period   | \$12,060                       | \$ 6,724  |
|  | =====                          | =====     |
| <b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>                         |                                |           |
| Unvested restricted stock awards forfeited   | \$ -                           | \$ 24     |
|  | =====                          | =====     |
| Restricted stock awards granted  | \$ -                           | \$ 16     |
|  | =====                          | =====     |
| Release of contingent shares related to prior acquisition  | \$ -                           | \$ 360    |
|  | =====                          | =====     |
| Cash payments (refunds) for:   |                                |           |
| Domestic and foreign income taxes  | \$ 451                         | \$ (529)  |
| Interest   | 4                              | 11        |

inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(In thousands, except for share and per share data)

(1) NATURE OF OPERATIONS

We are an independent designer, manufacturer and marketer of manipulator and docking hardware products, temperature management systems and tester interface products that are used by semiconductor manufacturers in conjunction with automatic test equipment ("ATE") in the testing of integrated circuits ("ICs" or "semiconductors").

The consolidated entity is comprised of inTEST Corporation (parent) and our wholly-owned subsidiaries. We manufacture our products in the U.S., Germany and Singapore. Marketing and support activities are conducted worldwide from our facilities in the U.S., the U.K., Germany, Japan and Singapore.

The semiconductor industry in which we operate is characterized by rapid technological change, competitive pricing pressures and cyclical market patterns. This industry is subject to significant economic downturns at various times. Our financial results are affected by a wide variety of factors, including, but not limited to, general economic conditions worldwide or in the markets in which we operate, economic conditions specific to the semiconductor industry, our ability to safeguard patents and intellectual property in a rapidly evolving market, downward pricing pressures from customers, and our reliance on a relatively few number of customers for a significant portion of our sales. In addition, we are exposed to the risk of obsolescence of our inventory depending on the mix of future business and technological changes within the industry. As a result of these or other factors, we may experience significant period-to-period fluctuations in future operating results.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Use of Estimates

The accompanying unaudited consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated upon consolidation. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us 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. Certain of our accounts, including long-lived assets, goodwill, inventory, deferred income tax valuation allowances and product warranty reserves, are particularly affected by estimates.

In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position, results of operations, and changes in cash flows for the interim periods presented. Certain footnote information has been condensed or omitted from these consolidated financial statements. Therefore, these consolidated financial statements



should be read in conjunction with the consolidated financial statements and accompanying footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2005 (our "2005 Form 10-K").

**Reclassification**

Certain prior period amounts have been reclassified to be comparable with the current period's presentation.

**Inventories**

Inventory is valued at standard cost, which approximates actual cost computed on a first-in, first-out basis, not in excess of market value. Cash flows from the sale of inventory are recorded in operating cash flows. On a quarterly basis, we review our inventories and record excess and obsolete inventory charges based upon our established objective excess and obsolete inventory criteria. These criteria identify material that has not been used in a work order during the prior twelve months and the quantity of material on hand that is greater than the average annual usage of that material over the prior three years. In certain cases, additional excess and obsolete inventory charges are recorded based upon current industry conditions, anticipated product life cycles, new product introductions and expected future use of the inventory. The charges for excess and obsolete inventory we record establish a new cost basis for the related inventory. We incurred excess and obsolete inventory charges of \$128 and \$559 for the quarters ended September 30, 2006 and 2005, respectively, and \$409 and \$1,026 for the nine months ended September 30, 2006 and 2005, respectively.

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(Continued)

Goodwill and Intangibles

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, goodwill and other indefinite life intangible assets are no longer subject to amortization. Instead, they are subject to at least an annual assessment for impairment by applying a fair value based test.

Goodwill at both September 30, 2006 and December 31, 2005 relates to the manipulator/docking hardware segment. The following table sets forth changes in the amount of the carrying value of goodwill for the nine months ended September 30, 2006:

\$2,403

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|  |                |
|--|----------------|
| Balance - Beginning of period          | <u>153</u>     |
| Impact of foreign currency translation |                |
|  | <u>\$2,556</u> |
| Balance - End of period                |                |

As of September 30, 2006 and December 31, 2005, definite life intangibles totaled \$300 and \$315, respectively, net of accumulated amortization of \$200 and \$152, respectively. These definite life intangibles are the result of our acquisition of Intestlogic and are being amortized using the straight-line method over the remaining estimated useful life of approximately seven years. They are technology based and are allocated to the manipulator/docking hardware segment. The following table sets forth changes in the amount of the carrying value of definite life intangibles for the nine months ended September 30, 2006:

|  |              |
|--|--------------|
|  | \$315        |
| Balance - Beginning of period          |              |
|  | (37)         |
| Amortization                           |              |
|  | <u>22</u>    |
| Impact of foreign currency translation |              |
|  | <u>\$300</u> |
| Balance - End of period                |              |

Estimated annual amortization expense for each of the next five years is \$48.

**Revenue Recognition**

We recognize revenue in accordance with Staff Accounting Bulletin No. 104 ("SAB 104"), *Revenue Recognition*. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectibility is reasonably assured. Sales of our products are made through our sales employees, third-party sales representatives and distributors. There are no differences in revenue recognition policies based on the sales channel. We do not provide our customers with rights of return or exchanges. Revenue is generally recognized upon product shipment. Our sales agreements do not typically contain any customer-specific acceptance criteria, other than that the product performs within the agreed upon specifications. We test all products manufactured as part of our quality assurance process to determine that they comply with specifications prior to shipment to a customer. To the extent that any sales agreements contain customer-specific acceptance criteria, revenue recognition is deferred until customer acceptance.

**Product Warranties**

We generally provide product warranties and record estimated warranty expense at the time of sale based upon historical claims experience. Warranty expense for the quarters ended September 30, 2006 and 2005 was \$99 and \$164, respectively. Warranty expense for the nine months ended September 30, 2006 and 2005 was \$361 and \$425, respectively. Warranty expense is included in selling expense in the consolidated financial statements.

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## (2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(Continued)

The following table sets forth the changes in the liability for product warranties for the nine months ended September 30, 2006 and 2005:

|  | <u>2006</u>  | <u>2005</u>   |
|--|--------------|---------------|
| Balance - Beginning of period          | \$935        | \$1,216       |
| Payments made under product warranty   | (351)        | (696)         |
| Accruals for product warranties issued | <u>361</u>   | <u>425</u>    |
| Balance - End of period                | <u>\$945</u> | <u>\$ 945</u> |

Restructuring and Other Charges

We recognize a liability for restructuring costs at fair value only when the liability is incurred. The three main components of our restructuring plans are related to workforce reductions, the consolidation of excess facilities and asset impairments. Workforce-related charges are accrued when it is determined that a liability has been incurred, which is generally after individuals have been notified of their termination dates and expected severance benefits. Plans to consolidate excess facilities result in charges for lease termination fees and future commitments to pay lease charges, net of estimated future sub-lease income. We recognize charges for consolidation of excess facilities when we have vacated the premises. Assets that may be impaired consist of property, plant and equipment. Asset impairment charges are based on an estimate of the amounts and timing of future cash flows related to the expected future remaining use and ultimate sale or disposal of the asset. These estimates are derived using the guidance of SFAS No. 146, *Accounting for Exit or Disposal Activities*, and SFAS No. 144, *Accounting for the Impairment of Disposal of Long Lived Assets*.

Income Taxes

The asset and liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for operating loss and tax credit carryforwards and for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their

respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets if it is more likely than not that such assets will not be realized.

For the nine months ended September 30, 2006, we recorded income tax expense of \$1,042 compared to \$10 for the same period in 2005. Our effective tax rate was 27% for the first nine months of 2006 compared to 0% for the same period in 2005. The increase in our effective tax rate during 2006 as compared to 2005 reflects that a higher proportion of our taxable income for the first nine months of 2006 was generated by certain of our foreign operations where we do not have a history of operating losses and therefore do not have net operating loss carryforwards to offset income tax expense on those earnings. Due to our history of operating losses in our other operations, we have recorded a full valuation allowance against all domestic and certain foreign deferred tax assets, including net operating loss carryforwards, where we believe it is more likely than not that we will not have sufficient taxable income to utilize these assets before they expire. In addition, during the first nine months of 2005 we recorded an income tax benefit related to a domestic income tax refund we received during the second quarter of 2005. Our current estimate is that our consolidated effective income tax rate for 2006 will be approximately 27%.

**Net Earnings (Loss) Per Common Share**

Net earnings (loss) per common share is computed in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings (loss) per common share is computed by dividing net earnings (loss) by the weighted average number of common shares outstanding during each period. Diluted earnings (loss) per common share is computed by dividing net earnings (loss) by the weighted average number of common shares and common share equivalents outstanding during each period. Common share equivalents represent stock options and unvested shares of restricted stock and are calculated using the treasury stock method. Common share equivalents are excluded from the calculation if their effect is anti-dilutive.

The table below sets forth for the periods indicated a reconciliation of weighted average common shares outstanding - basic to weighted average common shares outstanding - diluted and the average number of potentially dilutive securities and their

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(Continued)

respective weighted average exercise prices that were excluded from the calculation of diluted earnings per share because their effect was anti-dilutive:

| Three Months Ended | Nine Months Ended |
|--------------------|-------------------|
| <u>Sept. 30,</u>   | <u>Sept. 30,</u>  |

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|   | <u>2006</u>      | <u>2005</u>      | <u>2006</u>      | <u>2005</u>      |
|---|------------------|------------------|------------------|------------------|
| Weighted average common shares outstanding -- basic                         | 9,053,603        | 8,823,979        | 9,020,173        | 8,764,115        |
| Potentially dilutive securities:  |                  |                  |                  |                  |
| Employee stock options and unvested shares of restricted stock              | <u>211,206</u>   | <u>87,693</u>    | <u>132,574</u>   | <u>-</u>         |
| Weighted average common shares outstanding -- diluted                       | <u>9,264,809</u> | <u>8,911,672</u> | <u>9,152,747</u> | <u>8,764,115</u> |
| Average number of potentially dilutive securities excluded from calculation | 125,050          | 465,625          | 279,166          | 772,467          |
| Weighted average exercise price of excluded securities                      | \$6.08           | \$2.66           | \$3.37           | \$2.86           |

Recently Adopted Accounting Standards

On January 1, 2006, we adopted SFAS No. 151, *Inventory Costs - An Amendment of ARB No. 43, Chapter 4*, which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Under SFAS No. 151, such items are recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of manufacturing be based on normal capacity of the production facilities. The adoption of this standard did not have a material impact on our consolidated financial position, results of operations or cash flows.

On January 1, 2006, we adopted SFAS No. 123 (revised 2004), *Share-Based Payment*, ("SFAS No. 123R") which amends SFAS No. 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25. SFAS No. 123R requires employee share-based equity awards to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25 and previously allowed under the original provisions of SFAS No. 123. SFAS No. 123R requires the use of an option pricing model for estimating fair value, which is then amortized to expense over the service periods. We adopted SFAS No. 123R using the modified prospective method. Under this method, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The modified prospective approach does not allow for the restatement of prior period amounts. The adoption of this standard did not have a material impact on our consolidated financial position, results of operations or cash flows. See further disclosures related to our stock-based compensation plans in Note 7.

In November 2005, the FASB issued FASB Staff Position ("FSP") FAS No. 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* ("FSP FAS 123R-3"). FSP FAS 123R-3 provides a practical exception when a company transitions to the accounting requirements in SFAS No. 123R. SFAS No. 123R requires a company to calculate the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to adopting SFAS No. 123R (the "APIC Pool"), assuming the company had been following the recognition provisions prescribed by FAS 123. We have elected to use the guidance in FSP FAS 123R-3 to calculate our APIC Pool. FSP FAS 123R-3 is effective immediately. The adoption of the FSP did not have a material impact on our consolidated financial position, results of operations or cash flows.

**New Accounting Standards**

In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*. FIN 48 provides guidance for the recognition and measurement of uncertain tax positions in an enterprise's financial statements. Recognition involves a determination of whether it is more likely than not that a tax position will be sustained upon examination with the presumption that the tax position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. FIN 48 is effective for fiscal years beginning after December 15, 2006. Early adoption is permitted if the enterprise has not issued financial statements, including interim financial statements, in the period of adoption. We are currently in the process of assessing the impact the adoption of FIN 48 will have on our financial statements.

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force on Issue No. 06-3 ("EITF 06-3"), *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. EITF 06-3 requires a company to disclose its accounting policy (i.e. gross vs. net basis) relating to the presentation of taxes within the scope of EITF 06-3. Furthermore, for taxes reported on a gross basis, an enterprise should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented. The guidance is effective for all periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently in the process of assessing the impact the adoption of SFAS 157 will have on our financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ("SAB 108"), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 provides interpretive guidance on how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in the current year financial statements. SAB 108 requires registrants to quantify misstatements using both an income statement ("rollover") and balance sheet ("iron curtain") approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. If prior year errors that had been previously considered immaterial now are considered material based on either approach, no restatement is required so long as management properly applied its previous approach and all relevant facts and circumstances were considered. If prior years are not restated, the cumulative effect adjustment is recorded in opening accumulated earnings (deficit) as of the beginning of the fiscal year of adoption. SAB 108 is effective for

fiscal years ending on or after November 15, 2006, with earlier adoption encouraged. We do not expect the adoption of SAB 108 to have a material impact on our consolidated financial position, results of operations or cash flows.

(3)

**MAJOR CUSTOMERS**

Texas Instruments Inc. accounted for 22% and 16% of our consolidated net revenues for the nine months ended September 30, 2006 and 2005, respectively. While all three of our operating segments sold products to this customer, these revenues were primarily generated by our manipulator/docking hardware segment. During the nine months ended September 30, 2006 and 2005, no other customer accounted for 10% or more of our consolidated net revenues.

**(4) INVENTORIES**

Inventories held at September 30, 2006 and December 31, 2005 were comprised of the following:

|                     | Sept. 30,      | Dec. 31,       |
|---------------------|----------------|----------------|
|                     | <b>2006</b>    | <b>2005</b>    |
| Raw materials       | \$5,231        | \$4,835        |
| Work in process     | 755            | 418            |
| Consigned inventory | 238            | 205            |
| Finished goods      | <u>568</u>     | <u>777</u>     |
|                     | <u>\$6,792</u> | <u>\$6,235</u> |

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**inTEST CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

(5)

**LEASEHOLD IMPROVEMENTS AND DEFERRED RENT**

In accordance with FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, we record tenant improvements made to our leased facilities based on the amount of the total cost to construct the improvements regardless of whether a portion of that cost was paid through an allowance provided by the facility's landlord. The amount of the allowance, if any, is recorded as deferred rent. We amortize deferred rent on a straight-line basis over the lease term and record the amortization as a reduction of rent expense.

In addition, certain of our operating leases contain predetermined fixed escalations of minimum rentals during the original lease terms. For these leases, we recognize the related rental expense on a straight-line basis over the life of the lease and record the difference between the amounts charged to operations and amounts paid as accrued rent which is included in other accrued expenses on our balance sheet.

During 2005, we recorded \$854 of additions to our leasehold improvements which were paid for on our behalf by the landlord of our new facility in San Jose, California. We also recorded this amount as deferred rent. There have been no similar transactions during 2006. Amortization of deferred rent for the nine months ended September 30, 2006 and 2005 was \$88 and \$79, respectively.

(6)

#### **RESTRUCTURING AND OTHER CHARGES**

In response to the cyclical nature of the ATE market in which we operate, we have taken various actions to restructure our operations in recent years. The goal of these actions was to significantly reduce our fixed operating costs and position ourselves to more effectively meet the needs and expectations of the fluid ATE market. The specific actions taken and the related costs incurred as a part of our various restructuring plans are more fully described in Note 9 to our consolidated financial statements in our 2005 Form 10-K.

As of December 31, 2005, the only restructuring plan which was not completed was the closure of our U.K. manufacturing operation (the "U.K. Operation Closure"). We announced the closure of this operation in mid-March 2005 and ceased manufacturing operations at this facility during the second quarter of 2005. During the nine months ended September 30, 2005, in connection with this plan, we recorded restructuring charges totaling \$413 which consisted of \$234 for severance and related payments and \$179 for lease termination costs. In the quarter ended September 30, 2005 we also recorded restructuring charges totaling \$35 for severance and related costs resulting from the termination of six employees at our facility in San Jose, California. Our facility in San Jose is the headquarters for our tester interface product segment.

During the nine months ended September 30, 2006, no additional restructuring charges were recorded. However, in accordance with SFAS No. 146, our accrual for lease termination costs related to the U.K. Operation Closure includes an estimate of future rental income that could be received if we were to enter into a sub-lease arrangement. At September 30, 2006, we had not sub-leased this facility. If we are unable to sublet this facility as planned, we may incur additional costs related to this facility in future periods.

The following table sets forth the changes in the liability for restructuring and other costs for the nine months ended September 30, 2006:

|                                     |
|-------------------------------------|
| U.K.<br>Operation<br><u>Closure</u> |
| \$205                               |



Balance - December 31, 2005

(62)

Cash payments related to lease obligations )

\$143

Balance - September 30, 2006

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**inTEST CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**(7) STOCK-BASED COMPENSATION**

As of September 30, 2006, we have certain stock-based employee compensation plans that are described more fully in Note 13 to our consolidated financial statements in our 2005 Form 10-K. As previously mentioned in Note 2, "Recently Adopted Accounting Standards," on January 1, 2006, we adopted SFAS No. 123R. The adoption of SFAS No. 123R did not have a material impact on our results of operations, financial condition or cash flows as we had no unvested stock options outstanding as of December 31, 2005. Our unvested restricted stock awards outstanding are accounted for based on their grant date fair value. We have not granted any stock options during 2006. As of September 30, 2006, total compensation expense to be recognized in future periods was \$658. All of this expense is related to nonvested shares of restricted stock. The weighted average period over which this expense is expected to be recognized is 2.3 years.

Prior to the adoption of SFAS No. 123R, we used the intrinsic value method prescribed by APB Opinion No. 25 to account for stock options and provided proforma disclosures, as required under SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosures*. Under the intrinsic value method, no stock-based employee compensation cost was reflected in the statement of operations when options granted under our stock-based employee compensation plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net earnings (loss) and net earnings (loss) per share for the three and nine months ended September 30, 2005 if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

|   | Three Months Ended<br><u>Sept. 30, 2005</u> | Nine Months Ended<br><u>Sept. 30, 2005</u> |
|---|---|--|
| Net earnings (loss), as reported                                | \$ 393                                      | \$(3,812)                                  |
| Add: Stock-based employee compensation expense included         | 72  | 203  |
| in reported net earnings (loss), net of related tax effects (1) |   |  |

|   |               |                  |
|---|---------------|------------------|
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (1) | <u>(102)</u>  | <u>(351)</u>     |
| Pro forma net earnings (loss)   | <u>\$ 363</u> | <u>\$(3,960)</u> |
|   | )             |                  |
| Net earnings (loss) per share:  |               |                  |
| Basic - as reported   | \$0.05        | \$(0.44)         |
| Basic - proforma  | \$0.04        | \$(0.45)         |
| Diluted - as reported   | \$0.04        | \$(0.44)         |
| Diluted - proforma  | \$0.04        | \$(0.45)         |

(1) Due to the valuation allowance provided on our net deferred tax assets, we have not recorded any tax benefits attributable to stock compensation expense.

The fair value for stock options granted during the first nine months of 2005 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

|  |         |
|--|---------|
| Risk-free interest rate                              | 3.89%   |
| Dividend yield                                       | 0.00%   |
| Expected common stock market price volatility factor | .99     |
| Weighted average expected life of stock options      | 5 years |

The per share weighted average fair value of stock options granted during the first nine months of 2005 was \$2.45.

(Unaudited)

## (7) STOCK-BASED COMPENSATION

(Continued)

Restricted Stock Awards

We record compensation expense for restricted stock awards (nonvested shares) based on the quoted market price of our stock at the grant date and amortize the expense over the vesting period. During the nine months ended September 30, 2006, we recorded compensation expense of \$243 related to nonvested shares. Of the compensation expense recognized, approximately \$14 was a component of cost of revenues, \$9 was a component of selling expense, \$13 was a component of engineering and product development expense and \$207 was a component of general and administrative expense. There was no compensation expense capitalized in 2006.

The following table summarizes the activity related to nonvested shares for the nine months ended September 30, 2006:

|  | Number<br>of Shares | Weighted<br>Average<br>Grant<br>Date<br>Fair Value |
|--|---------------------|--|
| Nonvested shares outstanding, January 1, 2006    | 203,750             | \$4.61   |
| Granted  | 7,500               | 3.75   |
| Vested   | (5,000)             | 3.63   |
| Forfeited  | <u>(7,500)</u>      | <u>4.80</u>  |
|  | )                   |  |
| Nonvested shares outstanding, September 30, 2006 | <u>198,750</u>      | <u>\$4.59</u>                                      |

The total fair value of the shares which vested during the nine months ended September 30, 2006 was \$18.

On May 2, 2006, the Board of Directors approved the acceleration of the vesting of 7,500 nonvested shares of restricted stock previously granted to two of our directors. One of these directors terminated his service effective August 2, 2006 as he did not stand for re-election at our 2006 Annual Meeting of Stockholders. The other director will be retiring effective November 1, 2006. The acceleration of vesting of these shares is effective on the last day of service of each of these directors. This action did not have a material impact on our consolidated financial position, results of operations or cash flows.

Stock Options

On December 14, 2005, the Board of Directors approved the acceleration of the vesting of 42,200 outstanding options with exercise prices ranging from \$2.99 to \$6.75 per share. At the date of the acceleration of vesting, only 9,000 of these shares were in-the-money by \$0.38 per share or a total of \$3. These options had been issued to employees during 2001 and 2002 under the 1997 Stock Plan and would otherwise have vested during 2006 and 2007. No compensation expense was required to be recorded in our consolidated financial statements during 2005 related to this action. Upon adoption of SFAS No. 123R, on January 1, 2006, we would have recorded compensation expense of approximately \$106 during 2006 and 2007 related to these options had we not accelerated their vesting. Of the total options for which we accelerated the vesting, 12,000 are held by two of our executive officers. None of the other accelerated options are held by our executive officers or directors. As a result of this action, as of December 31, 2005, all of our outstanding options are now exercisable. The Board of Directors accelerated the vesting of these options due to their concern that future compensation expense to be recorded in our financial statements upon the vesting of these options would be significantly in excess of the monetary value that would be ultimately realized by the optionees upon exercise of the underlying stock options due to a number of factors, the most significant of which was the volatility of our common stock share price.

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## (7) STOCK-BASED COMPENSATION

(Continued)

The following table summarizes the stock option activity for the nine months ended September 30, 2006:

|  | <u>Number<br/>of Shares</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> |
|--|-----------------------------|--|
| Options outstanding, January 1, 2006 (629,600 exercisable) | 629,600                     | \$ 3.87  |
| Granted  | -                           | -  |
| Exercised  | (29,400)                    | 3.33   |
|  | <u>(17,550)</u>             | 4.01   |

|   |   |                |      |
|---|---|----------------|------|
| Forfeited/Expired   | ) |                |      |
|   |   | <u>582,650</u> | 3.89 |
| Options outstanding, September 30, 2006 (582,650 exercisable) |   |                |      |

The total intrinsic value of the options exercised during the nine months ended September 30, 2006 was \$57.

The following table summarizes information about stock options outstanding at September 30, 2006. All options outstanding at September 30, 2006 are exercisable:

| <u>Range of Exercise Prices</u> | Number Outstanding and Exercisable at <u>Sept. 30, 2006</u> | Weighted Average <u>Remaining Life</u> | Weighted Average Exercise <u>Price</u> | Aggregate Intrinsic <u>Value</u> |
|---------------------------------|---|--|--|----------------------------------|
| \$2.99 - \$3.35                 | 366,000   | 6.08 years                             | \$3.12                                 | \$                               |
| \$3.61 - \$4.25                 | 91,600  | 3.85 years                             | \$4.00                                 | 960                              |
| \$5.66 - \$6.75                 | <u>125,050</u>  | 2.93 years                             | \$6.08                                 | <u>2</u>                         |
|                                 | <u>582,650</u>  |  | \$3.89                                 | <u>\$1,121</u>                   |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on a closing price for our stock of \$5.74 at September 30, 2006, assuming all option holders exercised their stock options that were in-the-money as of that date. In general, it is our policy to issue new shares upon the exercise of stock options.

(8)

#### EMPLOYEE BENEFIT PLANS

In addition to the employer matching for which employees of one of our subsidiaries, Temptronic Corporation ("Temptronic"), are eligible, upon the termination of the Temptronic Equity Participation Plan ("EPP"), we acknowledged that it was our intention to contribute \$3,000 in the aggregate to the inTEST 401(k) Plan as a form of profit sharing (not to exceed \$300 per year) for the benefit of Temptronic employees. The amount of these contributions approximates the amount that we had been committed to contribute to the EPP as of its termination date. All such profit sharing contributions are at the discretion of management, and will be allocated to employees annually in essentially the same manner in which the shares held by the EPP had been allocated. The vesting provisions for these contributions will be the same as those of the inTEST 401(k) Plan. Accruals for profit sharing contributions totaling \$225 were made during the nine months ended September 30, 2006 and 2005, respectively. Through September 30, 2006, we had made a total of \$675 in profit sharing contributions. We have historically funded these obligations through the use of treasury shares during the quarter subsequent to the quarter in which we record the

profit sharing liability. However, during the first quarter of 2005, we funded the obligations for both the third and fourth quarters of 2004.

(9) SEGMENT INFORMATION

We have three reportable segments: Manipulator/Docking Hardware Products, Temperature Management Systems and Tester Interface Products. We operate our business worldwide, and all three segments sell their products both domestically and internationally. All three segments sell to semiconductor manufacturers and ATE manufacturers. Intercompany pricing between segments is either a multiple of cost for component parts or a percentage discount from list price for finished goods.

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(9) SEGMENT INFORMATION (Continued)

The Manipulator/Docking Hardware segment includes the operations of our Cherry Hill, New Jersey manufacturing facility as well as the operations of four of our foreign subsidiaries: inTEST Limited (U.K.), inTEST Kabushiki Kaisha (Japan), inTEST PTE, Limited (Singapore) and Intestlogic GmbH (Germany). We closed our U.K. manufacturing operation during the quarter ended June 30, 2005. Sales of this segment consist primarily of manipulator and docking hardware products which we design, manufacture and market, as well as certain other related products which we market, but which are manufactured by third parties.

The Temperature Management segment includes the operations of Temptronic in Sharon, Massachusetts as well as Temptronic GmbH (Germany). Sales of this segment consist primarily of temperature management systems which we design, manufacture and market under our Temptronic product line. In addition, this segment provides after sale service and support, which is paid for by its customers.

The Tester Interface segment includes the operations of inTEST Silicon Valley Corporation. Sales of this segment consist primarily of tester interface products which we design, manufacture and market under our TestDesign product line.

The following table provides information about our segments for the three and nine months ended September 30, 2006 and 2005:

|   | Three Months Ended _____ Sept. 30, _____ |             | Nine Months Ended _____ Sept. 30, _____ |             |
|---|--|-------------|---|-------------|
|   | <u>2006</u>                              | <u>2005</u> | <u>2006</u>                             | <u>2005</u> |
| Net revenues from unaffiliated customers: | \$ 9,657                                 | \$10,265    | \$28,515                                | \$20,327    |
| Manipulator/Docking Hardware              | 6,129                                    | 5,039       | 16,715                                  | 15,431      |

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|                                      |                 |                 |                 |                  |
|--------------------------------------|-----------------|-----------------|-----------------|------------------|
| Temperature Management               |                 |                 |                 |                  |
|                                      | 1,533           | 1,772           | 6,095           | 5,220            |
| Tester Interface                     |                 |                 |                 |                  |
|                                      | <u>(753)</u>    | <u>(628)</u>    | <u>(2,138)</u>  | <u>(1,690)</u>   |
| Intersegment sales                   | )               | )               | )               | )                |
|                                      | <u>\$16,566</u> | <u>\$16,448</u> | <u>\$49,187</u> | <u>\$39,288</u>  |
| Intersegment sales:                  |                 |                 |                 |                  |
|                                      | \$ 1            | \$ -            | \$ 4            | \$ -             |
| Manipulator/Docking Hardware         |                 |                 |                 |                  |
|                                      | 734             | 521             | 1,634           | 1,450            |
| Temperature Management               |                 |                 |                 |                  |
|                                      | <u>18</u>       | <u>107</u>      | <u>500</u>      | <u>240</u>       |
| Tester Interface                     |                 |                 |                 |                  |
|                                      | <u>\$753</u>    | <u>\$628</u>    | <u>\$2,138</u>  | <u>\$1,690</u>   |
| Earnings (loss) before income taxes: |                 |                 |                 |                  |
|                                      | \$ 748          | \$1,234         | \$3,151         | \$(1,037)        |
| Manipulator/Docking Hardware         |                 |                 |                 |                  |
|                                      | 807             | 90              | 1,213           | 285              |
| Temperature Management               |                 |                 |                 |                  |
|                                      | (629)           | (633)           | (548)           | (2,617)          |
| Tester Interface                     |                 |                 |                 |                  |
|                                      | <u>91</u>       | <u>(175)</u>    | <u>16</u>       | <u>(433)</u>     |
| Corporate                            | )               | )               | )               | )                |
|                                      | <u>\$1,017</u>  | <u>\$516</u>    | <u>\$3,832</u>  | <u>\$(3,802)</u> |
| Net earnings (loss):                 |                 |                 |                 |                  |
|                                      | \$328           | \$1,128         | \$2,290         | \$(1,089)        |
| Manipulator/Docking Hardware         |                 |                 |                 |                  |
|                                      | 554             | 73              | 883             | 289              |
| Temperature Management               |                 |                 |                 |                  |
|                                      | (465)           | (633)           | (399)           | (2,579)          |
| Tester Interface                     |                 |                 |                 |                  |
|                                      | <u>91</u>       | <u>(175)</u>    | <u>16</u>       | <u>(433)</u>     |
| Corporate                            | )               | )               | )               | )                |

|                              |              |               |                 |                  |
|------------------------------|--------------|---------------|-----------------|------------------|
|                              | <u>\$508</u> | <u>\$ 393</u> | <u>\$2,790</u>  | <u>\$(3,812)</u> |
|                              |              |               | )               |                  |
|                              |              |               | Sept. 30,       | Dec. 31,         |
|                              |              |               | <u>2006</u>     | <u>2005</u>      |
| Identifiable assets:         |              |               |                 |                  |
|                              |              |               | \$23,410        | \$18,533         |
| Manipulator/Docking Hardware |              |               | 10,417          | 8,353            |
| Temperature Management       |              |               | <u>3,616</u>    | <u>3,983</u>     |
| Tester Interface             |              |               | <u>\$37,443</u> | <u>\$30,869</u>  |

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inTEST CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**(9) SEGMENT INFORMATION** (Continued)

The following table provides information about our geographic areas of operation. Net revenues from unaffiliated customers are based on the location of the selling entity.

|   | Three Months<br>Ended <u>Sept.</u><br><u>30,</u><br><u>2006</u> |              | Nine Months Ended<br><u>Sept. 30,</u><br><u>2006</u> |              |
|---|---|--------------|--|--------------|
|   | <u>2006</u>   | <u>2005</u>  | <u>2006</u>  | <u>2005</u>  |
| Net revenues from unaffiliated customers: |   |              |  |              |
| U.S.                                      | \$11,109  | \$11,422     | \$33,359   | \$27,671     |
| Europe                                    | 1,342   | 1,605        | 4,807  | 4,554        |
| Asia-Pacific                              | <u>4,115</u>  | <u>3,421</u> | <u>11,021</u>  | <u>7,063</u> |



\$16,566   \$16,448   \$49,187   \$39,288

|                    | Sept. 30,      | Dec. 31,       |
|--------------------|----------------|----------------|
|                    | <u>2006</u>    | 2005           |
| Long-lived assets: |                |                |
| U.S.               | \$3,118        | \$3,629        |
| Europe             | 242            | 266            |
|                    | <u>43</u>      | <u>56</u>      |
| Asia-Pacific       | <u>\$3,403</u> | <u>\$3,951</u> |

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## Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Overview

As discussed more fully in our 2005 Form 10-K, our business and results of operations are substantially dependent upon the demand for ATE by semiconductor manufacturers and companies that specialize in the testing of ICs. Demand for ATE is driven by semiconductor manufacturers that are opening new, or expanding existing, semiconductor fabrication facilities or upgrading existing equipment, which in turn is dependent upon the current and anticipated market demand for semiconductors and products incorporating semiconductors. In the past, the semiconductor industry has been highly cyclical with recurring periods of oversupply, which often have a severe impact on the semiconductor industry's demand for ATE, including the products we manufacture. This can cause wide fluctuations in both our orders and net revenues and, depending on our ability to react quickly to these shifts in demand, can significantly impact our results of operations. These industry cycles are difficult to predict. Because the industry cycles are generally characterized by sequential quarterly growth or declines in orders and net revenues throughout the cycle, year over year comparisons of operating results may not always be as meaningful as comparisons of periods at similar points in either up or down cycles. In addition, during both downward and upward cycles in our industry, in any given quarter, the trend in both our orders and net revenues can be erratic. This can occur, for example, when orders are pulled in, pushed out or canceled by one or more significant customers or when

customer forecasts and general business conditions fluctuate during a quarter.

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(Continued)

We believe that purchases of most of our products are typically made from semiconductor manufacturers' capital expenditure budgets. Certain portions of our business, however, are generally less dependent upon the capital expenditure budgets of the end users. For example, purchases of certain related ATE interface products, such as sockets and interface boards, which must be replaced periodically, are typically made from the end users' operating budgets. In addition, purchases of certain of our products, such as docking hardware, for the purpose of upgrading or improving the utilization, performance and efficiency of existing ATE, tend to be counter cyclical to sales of new ATE. Moreover, we believe a portion of our sales of temperature management systems results from the increasing need for temperature testing of circuit boards and specialized components that do not have the design or quantity to be tested in an electronic device handler. In addition, in recent quarters we have begun to market our temperature management systems in industries outside semiconductor test, such as the automotive, aerospace, medical and telecommunications industries. We believe that these industries usually are less cyclical than the ATE industry.

Net Revenues and Orders

The following table sets forth, for the periods indicated, the net revenues from unaffiliated customers both by product segment and geographic area (based on the location of the selling entity).

|   | <u>Three Months Ended</u> |              |                 | <u>Nine Months Ended</u> |                |
|---|---------------------------|--------------|-----------------|--------------------------|----------------|
|   | <u>Sept. 30.</u>          |              | <u>June 30.</u> | <u>Sept. 30.</u>         |                |
|   | <u>2006</u>               | <u>2005</u>  | <u>2006</u>     | <u>2006</u>              | <u>2005</u>    |
| Net revenues from unaffiliated customers: |                           |              |                 |                          |                |
| Manipulator/Docking Hardware              | \$ 9,657                  | \$10,265     | \$11,454        | \$28,515                 | \$20,327       |
| Temperature Management                    | 6,129                     | 5,039        | 5,545           | 16,715                   | 15,431         |
| Tester Interface                          | 1,533                     | 1,772        | 2,667           | 6,095                    | 5,220          |
|   | <u>(753)</u>              | <u>(628)</u> | <u>(777)</u>    | <u>(2,138)</u>           | <u>(1,690)</u> |
| Intersegment sales                        | )                         | )            | )               | )                        | )              |

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|   |                 |                 |                 |                 |                 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|
|   | <u>\$16,566</u> | <u>\$16,448</u> | <u>\$18,889</u> | <u>\$49,187</u> | <u>\$39,288</u> |
| Intersegment sales:                       |                 |                 |                 |                 |                 |
|   | \$ 1            | \$ -            | \$ 1            | \$ 4            | \$ -            |
| Manipulator/Docking Hardware              | 734             | 521             | 515             | 1,634           | 1,450           |
| Temperature Management                    | <u>18</u>       | <u>107</u>      | <u>261</u>      | <u>500</u>      | <u>240</u>      |
| Tester Interface                          | <u>\$753</u>    | <u>\$628</u>    | <u>\$777</u>    | <u>\$2,138</u>  | <u>\$1,690</u>  |
| Net revenues from unaffiliated customers: |                 |                 |                 |                 |                 |
|   | \$11,109        | \$11,422        | \$12,447        | \$33,359        | \$27,671        |
| U.S.                                      | 1,342           | 1,605           | 1,909           | 4,807           | 4,554           |
| Europe                                    | <u>4,115</u>    | <u>3,421</u>    | <u>4,533</u>    | <u>11,021</u>   | <u>7,063</u>    |
| Asia-Pacific                              | <u>\$16,566</u> | <u>\$16,448</u> | <u>\$18,889</u> | <u>\$49,187</u> | <u>\$39,288</u> |

During the third quarter of 2006, total consolidated net revenues decreased \$2.3 million or 12% from the level experienced in the second quarter of 2006. In the second quarter of 2006, we had several customers place large orders which were booked and shipped during the second quarter. This led to a particularly strong second quarter of 2006. Consequently, as we entered the third quarter, we anticipated that the third quarter would not be as strong as the second quarter had been. The decline, however, was larger than expected in our tester interface and manipulator/docking hardware product segments. We attribute the larger than expected decline in net revenues to a general slow down in demand from several of our major customers. The decline within our manipulator/docking hardware product segment was partially offset by continued strong demand for certain third party products we distribute through our operation in Japan, which is included in this segment. In contrast to the larger than expected declines in the net revenues of our manipulator/docking hardware and tester interface segments, we experienced stronger than expected demand in our temperature management product segment during the third quarter of 2006, which we attribute primarily to increased demand for our ThermoChuck line of products.

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On a consolidated basis, total orders for the quarter ended September 30, 2006 were \$13.0 million compared to \$20.4 million for the quarter ended June 30, 2006 and \$16.7 million for the quarter ended September 30, 2005. For our manipulator/docking hardware, temperature management and tester interface product segments, total orders for the quarter ended September 30, 2006 were \$7.1 million, \$4.7 million and \$1.2 million, respectively compared to \$11.9 million, \$5.8 million and \$2.7 million, respectively, for the second quarter of 2006 and \$11.1 million, \$3.9 million and \$1.7 million, respectively, for the third quarter of 2005. We believe the decline in our orders during the quarter ended September 30, 2006 indicates that we have entered the down portion of this business cycle. We cannot be certain what the level of our orders or net revenues will be in any future period.

Backlog

At September 30, 2006, our backlog of unfilled orders for all products was approximately \$5.8 million compared with approximately \$9.4 million at June 30, 2006 and \$6.8 million at September 30, 2005. Our backlog includes orders which we have accepted, substantially all of which we expect to deliver in 2006. While backlog is calculated on the basis of firm purchase orders, a customer may cancel an order or accelerate or postpone currently scheduled delivery dates. Our backlog may be affected by the tendency of customers to rely on short lead times available from suppliers, including us, in periods of depressed demand. In periods of increased demand, there is a tendency towards longer lead times that has the effect of increasing backlog. As a result, our backlog at a particular date is not necessarily indicative of sales for any future period.

Organizational Changes and Restructuring Charges

In response to the cyclical nature of the ATE market in which we operate, we have taken various actions to restructure our operations in recent years. The goal of these actions was to significantly reduce our fixed operating costs and position ourselves to more effectively meet the needs and expectations of the fluid ATE market. The most recent actions (during late 2004 and 2005) included organizational changes which allowed us to eliminate certain central corporate staff as well as workforce reductions and facility closures which allowed us to eliminate excess manufacturing capacity at certain of our locations. In addition, during periods of significant weakened demand, such as in late 2004, we also implemented headcount reductions and salary and benefit adjustments as temporary cost-saving measures which we have reinstated as warranted by increases in our sales levels and profitability. The various restructuring plans implemented in recent years, including the specific actions taken and costs incurred, are more fully described in our 2005 Form 10-K.

During the first nine months of 2006, we did not implement any additional restructuring plans. However, on April 1, 2006, we restored the salaries for certain staff in our manipulator/docking hardware product segment which had been reduced in late 2004. In addition, on July 1, 2006, we reinstated certain employee benefits and increased salaries for most of our domestic staff, the majority of whom had not had salary increases in two years.

We believe the actions taken in recent years to reorganize and decentralize our operations have made us a more competitive company and have positioned us to adapt more quickly to new market challenges and opportunities through continued research and development as well as strategic merger and acquisition

activities. As part of our continuing focus to determine methods to increase our profitability worldwide while operating in the cyclical ATE market, we intend to continue reviewing and evaluating actions that could better match our operating costs against our anticipated future revenue and product demand as we pursue additional growth opportunities.

Excess and Obsolete Inventory Charges

On a quarterly basis, we review our inventories and record charges for excess and obsolete inventory based upon our established objective excess and obsolete inventory criteria. These criteria identify material that has not been used in a work order during the prior twelve months and the quantity of material on hand that is greater than the average annual usage of that material over the prior three years. In certain cases, additional excess and obsolete inventory charges are recorded based upon current industry conditions, anticipated product life cycles, new product introductions and expected future use of the inventory. The excess and obsolete inventory charges we record establish a new cost basis for the related inventory. We incurred charges for excess and obsolete inventory of \$128,000 and \$559,000 for the quarters ended September 30, 2006 and 2005, respectively. We incurred charges for excess and obsolete inventory of \$409,000 and \$1.0 million for the nine months ended September 30, 2006 and 2005, respectively. The level of these charges was based upon a variety of factors including changes in demand for our products and new product designs. See, also, "Critical Accounting Policies," below.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. (Continued)

Product Warranty Charges

We accrue product warranty charges quarterly, based upon our historical claims experience. In addition, from time to time, we accrue additional amounts based upon known product warranty issues, such as product retrofits. For the quarters ended September 30, 2006 and 2005, our product warranty charges were \$99,000 and \$164,000, or 0.6%, and 1.0% of net revenues, respectively. For the nine months ended September 30, 2006 and 2005, our product warranty charges were \$361,000 and \$425,000, or 0.7%, and 1.1% of net revenues, respectively. The level of our product warranty charges both in absolute dollars and as a percentage of net revenues is affected by a number of factors including the cyclicity of demand in the ATE industry, the prototype nature of much of our business, the complex nature of many of our products and, at our discretion, providing warranty repairs or replacements to customers after the contracted warranty period has expired in order to promote strong customer relations. See, also, "Critical Accounting Policies," below.

Product/Customer Mix

Our three product segments each have multiple products that we design, manufacture and sell to our customers. The gross margin on each product we offer is impacted by a number of factors including the amount of intellectual property (such as patents) utilized in the product, the number of units ordered by the customer at one time, or the amount of inTEST designed and fabricated material included in our product compared with the amount of third-party designed and fabricated material included in our product. The weight of each of these factors, as well as the current market conditions, determines the ultimate sales price we can obtain for our products and the resulting gross margin.

The mix of products we sell in any period is ultimately determined by our customers' needs. Therefore, the mix of products sold in any given period can change significantly from the prior period. As a result, our consolidated gross margin can be significantly impacted in any given period by a change in the mix of products sold in that period.

We sell our products to both semiconductor manufacturers (end user sales) and to ATE manufacturers (OEM sales) who ultimately resell our equipment with theirs to semiconductor manufacturers. The mix of customers during any given period will affect our gross margin due to differing sales discounts and commissions. For the nine months ended September 30, 2006 and 2005, our OEM sales as a percentage of net revenues were 23% and 22%, respectively.

The impact of an increase in OEM sales as a percentage of net revenues is generally a reduction in our gross margin, as OEM sales historically have had a more significant discount than end user sales. Our current net operating margins on most OEM sales for these product segments, however, are only slightly less than margins on end user sales because of the payment of third party sales commissions on most end user sales. We also expect to continue to experience demands from our OEM customers' supply line management groups to reduce our sales prices to them. This continued price pressure may have the ultimate effect of reducing our gross and operating margins if we cannot further reduce our manufacturing and operating costs.

#### Risk Factors and Forward-Looking Statements

In addition to historical information, this discussion and analysis contains statements relating to possible future events and results that are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements can often be identified by the use of forward-looking terminology such as "believes," "expects," "intends," "may," "will," "should," "anticipates" or similar terminology. These statements involve risks and uncertainties and are based on various assumptions. Although we believe that our expectations are based on reasonable assumptions, investors and prospective investors are cautioned that such statements are only projections, and there cannot be any assurance that these events or results will occur.

Information about the primary risks and uncertainties that could cause our actual future results to differ materially from our historic results or the results described in the forward-looking statements made in this report or presented elsewhere by Management from time to time are included in Part I, Item 1A - "Risk Factors" of our 2005 Form 10-K. Material changes to such "risk factors" may be reported in subsequent Quarterly Reports on Form 10-Q in Part II, Item 1A. There have been no such changes from the risk factors set forth in our 2005 Form 10-K.

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#### Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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##### Results of Operations

All of our products are used by semiconductor manufacturers in conjunction with ATE in the testing of ICs. Consequently, the results of operations for each product segment are generally affected by the same factors. Separate

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discussions and analyses for each product segment would be repetitive and obscure any unique factors that affected the results of operations of our different product segments. The discussion and analysis that follows, therefore, is presented on a consolidated basis and includes discussion of factors unique to each product segment where significant to an understanding of that segment.

The following table sets forth for the periods indicated the principal items included in the Consolidated Statements of Operations as a percentage of total net revenues.

|   | <u>Percentage of Net</u>    |                          |                  |                  |
|---|-----------------------------|--------------------------|------------------|------------------|
|   | <u>Revenues</u>             |                          |                  |                  |
|   | <u>Quarters Ended Sept.</u> | <u>Nine Months Ended</u> | <u>Sept. 30,</u> | <u>Sept. 30,</u> |
|   | <u>2006</u>                 | <u>2005</u>              | <u>2006</u>      | <u>2005</u>      |
| Net revenues                                | 100.0%                      | 100.0%                   | 100.0%           | 100.0%           |
| Cost of revenues                            | <u>58.3</u>                 | <u>60.7</u>              | <u>57.1</u>      | <u>64.8</u>      |
| Gross margin                                | <u>41.7</u>                 | <u>39.3</u>              | <u>42.9</u>      | <u>35.2</u>      |
| Selling expense                             | 13.5                        | 15.5                     | 14.1             | 17.9             |
| Engineering and product development expense | 10.0                        | 9.2                      | 8.4              | 11.4             |
| General and administrative expense          | 12.7                        | 11.6                     | 13.2             | 15.0             |
| Restructuring and other charges             | <u>0.0</u>                  | <u>0.2</u>               | <u>0.0</u>       | <u>1.1</u>       |
| Operating income (loss)                     | 5.5                         | 2.8                      | 7.2              | (10.2)           |
| Other income                                | <u>0.6</u>                  | <u>0.3</u>               | <u>0.6</u>       | <u>0.5</u>       |
| Earnings (loss) before income taxes         | 6.1                         | 3.1                      | 7.8              | (9.7)            |
| Income tax expense                          | <u>3.0</u>                  | <u>0.7</u>               | <u>2.1</u>       | <u>0.0</u>       |
| Net earnings (loss)                         | <u>3.1</u>                  | <u>2.4</u>               | <u>5.7</u>       | <u>(9.7)</u>     |
|   | %                           | %                        | %                | )%               |

Quarter Ended September 30, 2006 Compared to Quarter Ended September 30, 2005

*Net Revenues.* Net revenues were \$16.6 million for the quarter ended September 30, 2006 compared to \$16.4 million for the same period in 2005, an increase of \$118,000 or less than 1%. During this time period, the net revenues (net of intersegment sales) of our manipulator/docking hardware and tester interface product segments decreased 6% and 9%, respectively, while the net revenues of our temperature management product segment increased 19%. For our manipulator/docking hardware and tester interface product segments, the decrease in net revenues compared to 2005 reflects the general slow down in demand from several of the major customers of these segments during the third quarter of 2006. The resulting decline in the net revenues of our manipulator/docking hardware product segment was partially offset by continued strong demand for certain third party products we distribute through our subsidiary in Japan, which is included in this segment. For our temperature management product segment, the increase in net revenues for the third quarter of 2006 as compared to the same period in 2005 reflects not only strong demand, particularly for our ThermoChuck products, but also the fact that this segment had seen somewhat of a decline in demand in the second half of 2005 that was not experienced by our other two product segments. As previously mentioned, the level of orders for all of our product segments declined during the third quarter of 2006 as compared to the second quarter of 2006, and we cannot be certain what the level of our orders or net revenues will be in any future period.

During the quarter ended September 30, 2006, our net revenues from customers in the U.S. and Europe decreased 3% and 16%, respectively, while our net revenues from customers in Asia increased 20% as compared to the same period in 2005. The lower percentage decrease from customers in the U.S. reflects the fact that most of our temperature management product segment sales are included in this region. The aforementioned increase in this segment's sales served to offset some of the decrease in the net revenues from the U.S. customers of our other two product segments. The increase in net revenues from customers in Asia primarily reflects the aforementioned demand for certain third-party products sold by our Japanese subsidiary.

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### Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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#### Gross Margin.

Gross margin was 42% for the quarter ended September 30, 2006 compared to 39% for the same period in 2005. We attribute the increase in gross margin primarily to a decrease in the level of charges for excess and obsolete inventory during the third quarter of 2006 as compared to the same period in 2005. The factors which can affect the level of our charges for excess and obsolete inventory in any given quarter are more fully discussed above under the section entitled "Excess and Obsolete Inventory Charges". This decrease was partially offset by an increase in operations expense, primarily as a result of higher levels of salary and benefits expense during the third quarter of 2006 compared to the same period in 2005. The higher salary and benefits expense reflects the actions taken April 1 and July 1, 2006 to restore and increase certain salaries and reinstate certain benefits.

*Selling Expense.* Selling expense was \$2.2 million for the quarter ended September 30, 2006 compared to \$2.5 million for the same period in 2005, a decrease of \$313,000 or 12%. The decrease was primarily driven by lower levels of



commissions in our manipulator/docking hardware product segment which we attribute to changes in product and customer mix, combined with a reduction in spending on certain limited duration marketing programs that were in place in early 2005 in our temperature management product segment. These decreases were partially offset by an increase in travel costs which reflects increased business development efforts and attendance at trade shows in 2006 as compared to 2005.

*Engineering and Product Development Expense.* Engineering and product development expense was \$1.7 million for the quarter ended September 30, 2006 compared to \$1.5 million for the same period in 2005, an increase of \$140,000 or 9%. The increase primarily reflects higher salary and benefits expense as a result of both additional headcount and the aforementioned restoration of certain salaries and benefits. In addition, spending on research and development materials increased, primarily for our manipulator/docking hardware product segment. These increases were partially offset by a reduction in expenditures for third-party consultants retained to assist in new product development efforts during the third quarter of 2005 for our tester interface product segment.

*General and Administrative Expense.* General and administrative expense was \$2.1 million for the quarter ended September 30, 2006 compared to \$1.9 million for the same period in 2005, an increase of \$185,000 or 10%. The increase was primarily driven by an increase in salary and benefits expense and accruals for performance based bonuses. The increase in salary and benefits expense reflects the restoration of certain salaries and benefits, as previously discussed. The increase in accruals for performance based bonuses is a function of our positive results for the quarter. These increases were partially offset by a reduction in the level of legal fees and other professional services.

*Restructuring and Other Charges.* We incurred no restructuring and other charges during the quarter ended September 30, 2006, whereas we incurred restructuring and other charges of \$28,000 during the same period in 2005. The restructuring and other charges recorded during the third quarter of 2005 consisted primarily of severance and related costs associated with a workforce reduction at our facility in San Jose, California.

*Other Income.* Other income was \$101,000 for the quarter ended September 30, 2006 compared to \$54,000 for the comparable period in 2005, an increase of \$47,000 or 87%. We attribute the increase primarily to higher interest income which was the result of both higher average cash balances and an increase in the rate of return earned on such balances. To a lesser extent, we also recorded gains related to the disposal of certain fixed assets. These increases were partially offset by a \$48,000 increase in foreign exchange transaction losses during the quarter.

*Income Tax Expense (Benefit).* For the quarter ended September 30, 2006, we recorded income tax expense of \$509,000 compared to \$123,000 for the same period in 2005. Our effective tax rate was 50% for the third quarter of 2006 compared to 24% for the same period in 2005. The increase in our effective tax rate during the third quarter of 2006 as compared to the same quarter in 2005 reflects that a higher proportion of our taxable income for the third quarter of 2006 was generated by certain of our foreign operations where we do not have a history of operating losses and therefore do not have net operating loss carryforwards to offset income tax expense on those earnings. Due to our history of operating losses in our other operations, we have recorded a full valuation allowance against all domestic and certain foreign deferred tax assets, including net operating loss carryforwards, where we believe it is more likely than not that we will not have sufficient taxable income to utilize these assets before they expire. Our current estimate is that our consolidated effective income tax rate for 2006 will be approximately 27%.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. (Continued)

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

*Net Revenues.* Net revenues were \$49.2 million for the nine months ended September 30, 2006 compared to \$39.3 million for the same period in 2005, an increase of \$9.9 million or 25%. During this time period, the percentage increases in the net revenues (net of intersegment sales) of our manipulator/docking hardware, temperature management and tester interface product segments were 40%, 8% and 12%, respectively. We attribute the increase in our consolidated net revenues primarily to higher level of demand in the first nine months of 2006 as compared to the same period in 2005. We attribute the larger percentage increase in the sales of our manipulator/docking hardware product segment primarily to the increase in sales to customers in Asia, as previously discussed. Although our consolidated net revenues increased during the first nine months of 2006 as compared to the same period in 2005, the level of orders for all of our product segments declined during the third quarter of 2006 as compared to the second quarter of 2006, and we cannot be certain what the level of our orders or net revenues will be in any future period.

During the nine months ended September 30, 2006, our net revenues from customers in the U.S., Europe and Asia increased 21%, 6% and 56%, respectively, as compared to the same period in 2005. The lower percentage increase from customers in Europe primarily reflects the closure of our U.K. operation in mid-2005. As a result of closing this operation, orders that would have been filled by this operation during 2006 were shipped instead from one of our other operations, some of which are located outside of Europe. The higher percentage increase in net revenues from customers in Asia primarily reflects the increased demand for certain third-party products sold by our Japanese subsidiary.

*Gross Margin.* Gross margin was 43% for the first nine months of 2006 compared to 35% for the same period in 2005. The increase in gross margin was primarily the result of a decrease in our fixed operating costs both as a percentage of net revenues and in absolute dollar terms, as well as a reduction in the level of charges for excess and obsolete inventory. As a percentage of net revenues, our fixed operating costs decreased to 15% for the nine months ended September 30, 2006 from 20% for the same period in 2005. This decrease primarily reflects that these costs were more fully absorbed in 2006 due to the significantly higher net revenue levels. In absolute dollar terms, our fixed operating costs decreased \$383,000 during the first nine months of 2006 as compared to the same period in 2005. This decrease primarily represents lower levels of depreciation, and, to a lesser extent, a reduction in insurance premiums and higher utilization rates for our internal machine shop operations at our Cherry Hill, New Jersey and San Jose, California facilities. The reduction in depreciation expense reflects the lower asset base at September 30, 2006 as compared to September 30, 2005.

*Selling Expense.* Selling expense was \$7.0 million for the first nine months of 2006 and 2005. Increases in travel costs and fees paid to third parties for installation of our products at customer sites, primarily in Asia, were offset by a decrease in expenditures related to certain limited duration marketing programs that were in place in early 2005 in our temperature management product segment.

*Engineering and Product Development Expense.* Engineering and product development expense was \$4.1 million for the first nine months of 2006 compared to \$4.5 million for the same period in 2005, a decrease of \$348,000 or 8%. We attribute the decrease primarily to the receipt of reimbursement payments totaling \$700,000 during the first and second quarters of 2006 for engineering services under a contract with one of the customers of our tester interface product segment. Under this contract we received payments based on achieving various milestones (as defined in the contract) related to specified product redesign activities. This contract ended during the second quarter of 2006 and no further payments will be received. In addition, expenditures for third-party consultants decreased during the first nine

months of 2006 as compared to the same period in 2005. These third-party consultants had been retained to assist in new product development efforts during 2005 for our tester interface product segment. These decreases were partially offset by higher salary and benefits expense and increased spending on research and development materials during the first nine months of 2006 as compared to the same period in 2005. The increase in salary and benefits expense was due to hiring additional staff at our tester interface and temperature management product segments as well the restoration of certain salaries and benefits. The increase in staff at our tester interface product segment primarily related to the engineering services contract previously discussed. When this contract ended, these individuals were either terminated or, in some cases, re-assigned to other projects. The increase in spending on materials was related to various new product development projects primarily in our manipulator/docking hardware and temperature management product segments.

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### Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. (Continued)

#### General and Administrative Expense.

General and administrative expense was \$6.5 million for the first nine months of 2006 compared to \$5.9 million for the same period in 2005, an increase of \$611,000 or 10%. The increase was primarily driven by an increase in salary and benefits expense which reflects the restoration of certain salaries and benefits in April and July 2006 as well as the accrual of performance based bonuses due to our positive results for the first nine months of 2006.

*Restructuring and Other Charges.* We incurred no restructuring and other charges during the first nine months of 2006, whereas we incurred restructuring and other charges of \$448,000 during the same period in 2005. The restructuring and other charges recorded during 2005 consisted primarily of severance and lease termination costs resulting from our decision to close our U.K. manufacturing operation. These charges also included a small amount of severance and related costs associated with a workforce reduction at our facility in San Jose, California

*Other Income.* Other income was \$276,000 for the nine months ended September 30, 2006 compared to \$194,000 for the comparable period in 2005, an increase of \$82,000 or 42%. The increase primarily reflects higher interest income which was the result of both higher average cash balances and an increase in the rate of return earned on such balances.

*Income Tax Expense (Benefit).* For the nine months ended September 30, 2006, we recorded income tax expense of \$1.0 million compared to \$10,000 for the same period in 2005. Our effective tax rate was 27% for the first nine months of 2006 compared to 0% for the same period in 2005. The increase in our effective tax rate during 2006 as compared to 2005 reflects that a higher proportion of our taxable income for the first nine months of 2006 was generated by certain of our foreign operations where we do not have a history of operating losses and therefore do not have net operating loss carryforwards to offset income tax expense on those earnings. Due to our history of operating losses in our other operations, we have recorded a full valuation allowance against all domestic and certain foreign deferred tax assets, including net operating loss carryforwards, where we believe it is more likely than not that we will not have sufficient taxable income to utilize these assets before they expire. In addition, during the first nine months of 2005 we recorded an income tax benefit related to a domestic income tax refund we received during the second quarter of 2005. Our current estimate is that our consolidated effective income tax rate for 2006 will be approximately 27%.

## **Liquidity and Capital Resources**

Net cash provided by operations for the nine months ended September 30, 2006 was \$5.1 million compared to net cash used in operations of \$270,000 for the same period in 2005. The shift to cash provided by operations for the first nine months of 2006 from cash used in operations for the same period in 2005 was primarily the result of our \$2.8 million net earnings in the first nine months of 2006 as compared to a net loss of \$3.8 million for the same period in 2005. During the nine months ended September 30, 2006, depreciation and amortization expense was \$1.1 million compared to \$1.5 million for the same period in 2005. This reduction reflects the lower asset base as of September 30, 2006 as compared to September 30, 2005. Accounts receivable increased \$1.2 million during the first nine months of 2006 as a result of the higher net revenue levels. Similarly, accounts payable increased \$1.7 million over the amount at December 31, 2005 which also reflects the increase in the level of business during the first nine months of 2006. Domestic and foreign income taxes payable increased \$576,000 as a result of the accrual of income taxes on the earnings of our foreign operations where we do not have net operating loss carryforwards to offset these liabilities. Accrued wages and benefits increased \$535,000 during the first nine months of 2006 reflecting higher accrued vacation and the accrual of performance based bonuses in 2006. Inventories increased \$516,000 reflecting the increased order activity during the first nine months of 2006. Prepaid expenses and other current assets increased \$361,000 primarily as a result of an increase in prepaid insurance as most of our corporate insurance policies renew in July each year.

Purchases of property and equipment were \$551,000 for the nine months ended September 30, 2006. These purchases primarily consisted of computer hardware and software for our three domestic facilities as well as purchases of demonstration equipment for our temperature management segment and quality assurance testing equipment for our tester interface segment. We also purchased two vehicles for our manipulator/docking hardware segment. Proceeds from the sale of property and equipment were \$38,000 for the nine months ended September 30, 2006. We have no significant commitments for capital expenditures for the balance of 2006, however, depending upon changes in market demand, we may make such purchases as we deem necessary and appropriate.

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## **inTEST CORPORATION**

### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. (Continued)**

Net cash from financing activities for the nine months ended September 30, 2006 was \$76,000, which represents proceeds from stock options exercised of \$98,000 offset by payments made under capital lease obligations of \$22,000. We have a secured credit facility that provides for maximum borrowings of \$250,000. We have not utilized this facility to borrow any funds. Our usage consists of the issuance of letters of credit in the face amount of \$250,000. We pay a quarterly fee of 1.5% per annum on the total amount of the outstanding letters of credit. The terms of the loan agreement require that we maintain a minimum level of \$200,000 of domestic cash. This credit facility expires on September 30, 2007.

We believe that our existing cash balance of \$12.1 million plus the anticipated cash to be provided from operations will be sufficient to satisfy our cash requirements for the foreseeable future. As previously discussed, however, the semiconductor industry is highly cyclical and we cannot predict future cycles with certainty. We cannot be certain what the rate of increase or decrease in our quarterly net revenues and bookings will be in future periods. As a result, we may require additional debt or equity financing to meet

working capital or capital expenditure needs in the future. We cannot be certain that, if needed, we would be able to raise such additional financing or upon what terms such financing would be available.

### **New or Recently Adopted Accounting Standards**

See the Notes to the consolidated financial statements for information concerning the implementation and impact of new or recently adopted accounting standards.

### **Critical Accounting Policies**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to inventories, long-lived assets, goodwill, identifiable intangibles, deferred income tax valuation allowances and product warranty reserves. We base our estimates on historical experience and on appropriate and customary assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Some of these accounting estimates and assumptions are particularly sensitive because of their significance to our consolidated financial statements and because of the possibility that future events affecting them may differ markedly from what had been assumed when the financial statements were prepared. As of September 30, 2006, there have been no significant changes to the accounting policies that we have deemed critical. These policies are more fully described in our 2005 Form 10-K.

### **International Operations**

Net revenues generated by our foreign subsidiaries were 32% and 30% of consolidated net revenues for the nine months ended September 30, 2006 and 2005, respectively. We anticipate that net revenues generated by our foreign subsidiaries will continue to account for a significant portion of consolidated net revenues in the foreseeable future. The net revenues generated by our foreign subsidiaries will continue to be subject to certain risks, including political and economic instability of foreign countries, the imposition of financial and operational controls or regulatory restrictions by foreign governments, the need to comply with a variety of U.S. and foreign export and import laws, weaknesses in the banking and equity markets of foreign countries, trade restrictions, changes in tariffs and taxes, longer payment cycles, fluctuations in foreign currency exchange rates, and the greater difficulty of administering business abroad. We cannot predict whether quotas, duties, taxes or other charges or restrictions will be implemented by the U.S. or any other country upon the importation or exportation of our products in the future. Any of these factors or the adoption of restrictive policies could have a material adverse effect on our business, financial condition or results of operations.

Net revenues denominated in foreign currencies were 21% and 19% of consolidated net revenues for the nine months ended September 30, 2006 and 2005, respectively. Although we seek to operate our business such that a significant portion of our product costs are denominated in the same currency as the associated sales, we may be adversely affected in the future due to our exposure to foreign operations. Moreover, net revenues denominated in currencies other than U.S. dollars expose us to currency fluctuations, which can adversely affect our results of operations.

**inTEST CORPORATION**

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Foreign Currency Risk

We are subject to the risk of changes in foreign currency exchange rates due to our global operations. We manufacture and sell our products primarily in North America, Europe and Asia. As a result, our financial results could be significantly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets in which we manufacture and sell our products. Our operating results are primarily exposed to changes in exchange rates between the U.S. dollar and the Euro, the Singapore dollar and/or the Japanese Yen.

As currency exchange rates change, translation of the statements of operations of our international businesses into U.S. dollars affects year-over-year comparability of operating results. We do not hedge operating translation risks because cash flows from international operations are generally reinvested locally. Changes in foreign currency exchange rates are generally reported as a component of stockholders' equity as all of our foreign subsidiaries report in their local currencies. Total other comprehensive income was \$322,000 for the nine months ended September 30, 2006 compared to other comprehensive loss of \$703,000 for the same period in 2005, due to changes in accumulated translation adjustments.

As of September 30, 2006 and December 31, 2005, our net current assets (defined as current assets less current liabilities) subject to foreign currency translation risk were \$5.6 million and \$3.4 million, respectively. The potential decrease in net current assets from a hypothetical 10% adverse change in quoted foreign currency exchange rates would be \$563,000 and \$339,000, respectively. The sensitivity analysis presented assumes a parallel shift in foreign currency exchange rates. Exchange rates rarely move in the same direction. This assumption may overstate the impact of changing exchange rates on individual assets and liabilities denominated in a foreign currency.

Interest Rate Risk

As of September 30, 2006, we had cash and cash equivalents of \$12.1 million. We generally place our investments in U.S. Treasury obligations or money market funds backed by such investments. We have not held and do not hold any derivatives related to our interest rate exposure. Due to the average maturity and conservative nature of our investment portfolio, a sudden change in interest rates would not have a material effect on the value of the portfolio. Management estimates that had the average yield of our investments decreased by 100 basis points, our interest income for the nine months ended September 30, 2006 would have decreased by less than \$72,000. This estimate assumes that the decrease occurred on the first day of 2006 and reduced the yield of each investment by 100 basis points. The impact on our future interest income of future changes in investment yields will depend largely on the gross amount of our cash, cash equivalents and short-term investments.

**Item 4. CONTROLS AND PROCEDURES**

CEO and CFO Certifications

. Included with this Quarterly Report as Exhibits 31.1 and 31.2 are two certifications, one by each of our Chief Executive Officer and our Chief Financial Officer (the "Section 302 Certifications"). This Item 4 contains information concerning the evaluations of our disclosure controls and procedures that are referred to in the Section 302 Certifications. This information should be read in conjunction with the Section 302 Certifications for a more complete

understanding of the topics addressed therein.

**Evaluation of Our Disclosure Controls and Procedures.** The SEC requires that as of the end of the quarter covered by this Report, our CEO and CFO must evaluate the effectiveness of the design and operation of our disclosure controls and procedures and report on the effectiveness of the design and operation of our disclosure controls and procedures.

"Disclosure controls and procedures" mean the controls and other procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 (the "Exchange Act"), such as this Report, is recorded, processed, summarized and reported within the time periods specified in the rules and forms promulgated by the SEC. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

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## inTEST CORPORATION

### Item 4. CONTROLS AND PROCEDURES

(Continued)

#### Limitations on the Effectiveness of Controls

. Our management, including the CEO and CFO, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, as opposed to absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within an entity have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, a system of controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Accordingly, our management has designed the disclosure controls and procedures to provide reasonable assurance that the objectives of the control system were met.

**CEO/CFO Conclusions about the Effectiveness of the Disclosure Controls and Procedures.** As required by Rule 13a-15(b), inTEST management, including our CEO and CFO, conducted an evaluation as of the end of the period covered by this Report, of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our CEO and CFO concluded that, as of the end of the period covered by this Report, our disclosure controls and procedures were effective at the reasonable assurance level. We noted, however, one aspect of our disclosure controls and procedures required improvement. In particular, after the end of the period covered by this Report, it was determined that the revenue from a sale in our tester interface product segment was improperly booked on September 30, 2006. We had delivered the goods to a shipping agent on September 30, 2006, but the carrier did not pick up the

goods from the shipping agent until October 2, 2006. Consequently, the revenue from this sale should not have been included in net revenues for the quarter ended September 30, 2006 as we had initially recorded. The financial statements in this Report do not include this sale in net revenues for the quarter or nine months ended September 30, 2006. While we infrequently use shipping agents, management determined to strengthen our internal controls over financial reporting with respect to recognition of revenues to require that an additional documented review control be performed to ascertain that shipped goods not be entered as sales without a confirming receipt or other evidence of delivery to the carrier.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

From time to time we may be a party to legal proceedings occurring in the ordinary course of business. We are not currently involved in any material legal proceedings.

### Item 1A. Risk Factors

Information regarding the primary risks and uncertainties that could materially and adversely affect our future performance or could cause actual results to differ materially from those expressed or implied in our forward-looking statements, appears in Part I, Item 1A -- "Risk Factors" of our 2005 Form 10-K. There have been no material changes from the risk factors as disclosed in that report.

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

None

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## inTEST CORPORATION

### Item 3. Defaults Upon Senior Securities

None

### Item 4. Submission of Matters to a Vote of Securities Holders

The Annual Meeting of Stockholders of the Company was held on August 2, 2006 (the "Meeting"). Notice of the Meeting was mailed to stockholders of record on or about June 30, 2006, together with proxy solicitation materials prepared in accordance with Section 14(a) of the Securities Exchange Act of 1934, as amended, and the regulations promulgated thereunder.

In the election of the members of the Board of Directors, there was no solicitation in opposition to the nominees of the Board of Directors for election to the Board of Directors and all such nominees were elected. The number of votes cast for or withheld for each nominee for election to the Board of Directors were as follows:



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| <u>Nominee</u>           | <u>For</u> | <u>Withheld</u> |
|--------------------------|------------|-----------------|
| Alyn R. Holt             | 7,052,997  | 1,073,108       |
| Robert E. Matthiessen    | 8,101,906  | 24,199          |
| Richard O. Endres        | 7,447,530  | 678,575         |
| Stuart F. Daniels, Ph.D. | 7,046,330  | 1,079,775       |
| James J. Greed, Jr.      | 8,061,787  | 64,318          |
| James W. Schwartz, Esq.  | 8,061,977  | 64,128          |
| Thomas J. Reilly, Jr.    | 8,062,705  | 63,400          |

### Item 5. Other Information

None

### Item 6. Exhibits

- 3.1 Articles of Incorporation: Previously filed by the Company as an Exhibit to the Company's Registration Statement on Form S-1, File No. 333-26457, and incorporated herein by reference.
- 3.2 By-Laws: Previously filed by the Company as an Exhibit to the Company's Registration Statement on Form S-1, File No. 333-26457, and incorporated herein by reference.
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a).
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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### Signatures

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

inTEST Corporation

Date: November 10,      /s/ Robert E. Matthiessen

2006

Robert E. Matthiessen  
*President and Chief Executive Officer*

Date: November 10,  
2006

/s/ Hugh T. Regan, Jr.  
Hugh T. Regan, Jr.  
*Secretary, Treasurer and Chief Financial Officer*

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