

COHERENT INC  
Form 10-Q  
February 12, 2008

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

**For the Quarterly Period Ended December 29, 2007**

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: 0-5255**

**COHERENT, INC.**

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**94-1622541**  
(I.R.S. Employer  
Identification No.)

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5100 Patrick Henry Drive, Santa Clara, California 95054  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (408) 764-4000

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of shares outstanding of registrant's common stock, par value \$.01 per share, on February 1, 2008 was 31,543,190 shares.

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COHERENT, INC.

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**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This quarterly report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements included in or incorporated by reference in this quarterly report, other than statements of historical fact, are forward-looking statements. These statements are generally accompanied by words such as trend, may, will, could, would, should, expect, plan, anticipate, rely, believe, estimate, predict, intend, potential, continue, forecast or other comparable terminology, including without limitation statements made under Future Trends , Our Strategy , discussions regarding our bookings and in Management s Discussion and Analysis of Financial Condition and Results of Operations . Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Actual results of Coherent, Inc. (referred to herein as the Company, we, our or Coherent) may differ significantly from those anticipated in these forward-looking statements as a result of various factors, including those discussed in the sections captioned Future Trends, Risk Factors, Key Performance Indicators, as well as any other cautionary language in this quarterly report. All forward-looking statements included in the document are based on information available to us on the date hereof. We undertake no obligation to update these forward-looking statements as a result of events or circumstances or to reflect the occurrence of unanticipated events or non-occurrence of anticipated events.

## PART I. FINANCIAL INFORMATION

## Item I. FINANCIAL STATEMENTS

## COHERENT, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

*(Unaudited; in thousands, except per share data)*

	Three Months Ended	
	December 29, 2007	December 30, 2006
<b>Net sales</b>	\$ 144,296	\$ 147,509
<b>Cost of sales</b>	83,802	85,535
<b>Gross profit</b>	60,494	61,974
<b>Operating expenses:</b>		
Research and development	18,319	18,322
Selling, general and administrative	38,818	33,484
Restructuring and other charges		137
Amortization of intangible assets	2,206	1,943
Total operating expenses	59,343	53,886
<b>Income from operations</b>	1,151	8,088
<b>Other income (expense):</b>		
Interest and dividend income	4,069	6,073
Interest expense	(161)	(1,782)
Other net	1,973	983
Total other income, net	5,881	5,274
<b>Income before income taxes</b>	7,032	13,362
Provision for income taxes	2,303	2,604
<b>Net income</b>	\$ 4,729	\$ 10,758
<b>Net income per share:</b>		
Basic	\$ 0.15	\$ 0.34
Diluted	\$ 0.15	\$ 0.33
<b>Shares used in computation:</b>		
Basic	31,417	31,339
Diluted	31,959	32,125

*See Accompanying Notes to Condensed Consolidated Financial Statements*

**COHERENT, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

*(Unaudited; in thousands, except par value)*

	December 29, 2007	September 29, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 320,795	\$ 315,927
Restricted cash	2,514	2,460
Short-term investments	67,569	45,896
Accounts receivable net of allowances of \$2,827 and \$2,918, respectively	96,971	102,314
Inventories	112,889	112,893
Prepaid expenses and other assets	47,540	50,244
Deferred tax assets	39,554	35,844
Total current assets	687,832	665,578
Property and equipment, net	102,796	104,305
Goodwill	83,853	83,376
Intangible assets, net	33,585	35,570
Other assets	76,139	58,771
Total assets	\$ 984,205	\$ 947,600
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Current portion of long-term obligations	\$ 9	\$ 9
Accounts payable	26,585	27,849
Income taxes payable	3,071	17,829
Other current liabilities	85,654	83,058
Total current liabilities	115,319	128,745
Long-term obligations	20	21
Other long-term liabilities	88,882	47,848
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, par value \$.01 per share:		
Authorized 500,000 shares		
Outstanding 31,546 shares and 31,552 shares, respectively	313	313
Additional paid-in capital	382,873	380,516
Accumulated other comprehensive income	74,013	70,672
Retained earnings	322,785	319,485
Total stockholders' equity	779,984	770,986
Total liabilities and stockholders' equity	\$ 984,205	\$ 947,600

*See Accompanying Notes to Condensed Consolidated Financial Statements.*

## COHERENT, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

*(Unaudited; in thousands)*

	Three Months Ended	
	December 29, 2007	December 30, 2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 4,729	\$ 10,758
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,981	6,220
Amortization of intangible assets	2,206	1,943
Deferred income taxes	(3,385)	(578)
Stock-based compensation	2,260	3,491
Excess tax benefit from stock-based compensation arrangements		(77)
Non-cash restructuring and other charges (recoveries)		(114)
Amortization of bond issue costs		292
Other non-cash expense (income)	(236)	70
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	6,205	17,435
Inventories	667	1,531
Prepaid expenses and other assets	(8,635)	(2,642)
Other assets	(1,239)	(2,006)
Accounts payable	(598)	(1,913)
Income taxes payable/receivable	1,230	(2,446)
Other current liabilities	2,536	(5,537)
Other long-term liabilities	1,356	2,307
Net cash provided by operating activities	13,077	28,734
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(4,684)	(5,037)
Proceeds from dispositions of property and equipment	9,824	143
Purchases of available-for-sale securities	(151,939)	(213,601)
Proceeds from sales and maturities of available-for-sale securities	130,266	176,506
Proceeds from sale of business	6,519	
Change in restricted cash	(25)	(14)
Premiums paid for life insurance contracts		(2,800)
Other net	729	196
Net cash used in investing activities	(9,310)	(44,607)
<b>Cash flows from financing activities:</b>		
Repayment of capital lease obligations	(3)	(1)
Cash overdrafts decrease	(24)	(1,874)
Issuance of common stock under employee stock option and purchase plans		3,784
Excess tax benefits from stock-based compensation arrangements		77
Net cash provided by (used in) financing activities	(27)	1,986
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>1,128</b>	<b>3,482</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>4,868</b>	<b>(10,405)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>315,927</b>	<b>445,231</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 320,795</b>	<b>\$ 434,826</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		

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Interest	\$	98	\$	393
Income taxes	\$	5,145	\$	6,542
Cash received during the period for:				
Income taxes	\$	(377)	\$	1,008
<b>Noncash investing and financing activities:</b>				
Unpaid property and equipment	\$	872	\$	1,273
Net retirement of restricted stock awards	\$		\$	225

*See Accompanying Notes to Condensed Consolidated Financial Statements*



**COHERENT, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

**1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes thereto should be read in conjunction with the Coherent, Inc. (referred to herein as the Company, we, our or Coherent) consolidated financial statements and notes thereto filed on Form 10-K for the fiscal year ended September 29, 2007. In the opinion of management, all adjustments necessary for a fair presentation have been made and include only normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year. Our fiscal year ends on the Saturday closest to September 30. Fiscal years 2008 and 2007 include 52 weeks each.

**2. RECENT ACCOUNTING STANDARDS**

In June 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, ( FIN 48 ) which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards (SFAS) 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In addition, in May 2007, the FASB issued FASB Staff Position No. FIN 48-1, Definition of Settlement in FASB Interpretation No. 48, ( FSP FIN 48-1 ) to amend FIN No. 48 by providing that previously unrecognized tax benefits can be recognized when the tax positions are effectively settled upon examination by a taxing authority. According to FSP FIN 48-1, an enterprise's tax position will be considered effectively settled if the taxing authority has completed its examination, the enterprise does not plan to appeal, and the possibility is remote that the taxing authority would reexamine the tax position in the future. We adopted FIN 48 and FSP FIN 48-1 for our fiscal year 2008 beginning September 30, 2007. See Note 11, Income Taxes for additional information, including the effects of adoption on the Company's Condensed Consolidated Financial Statements.

In June 2006, the FASB ratified the consensus on Emerging Issues Task Force ( EITF ) Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement ( EITF 06-3 ) which requires a policy be adopted to present externally imposed taxes on revenue producing transactions on either a gross or net basis. Coherent's policy is to present such taxes on a gross basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. Taxes within the scope of this issue would include taxes that are imposed on a revenue transaction between a seller and a customer. We adopted EITF 06-3 for our fiscal year beginning September 30, 2007. The adoption of EITF 06-3 did not have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective for us for interim periods within our fiscal year beginning September 28, 2008. We are currently assessing the impact that the adoption of SFAS

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157 will have on our consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value.

Under SFAS 159, a company may elect to use fair value to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis. If the fair value option is elected, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for us for our fiscal year beginning September 28, 2008 with earlier adoption permitted. We have elected not to early adopt and are currently assessing the impact that the adoption of SFAS 159 will have on our consolidated financial position and results of operations.

### 3. REVENUE RECOGNITION

We recognize revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists, the product has been delivered or the service has been rendered, the price is fixed or determinable and collection is probable. Revenue from product sales is recorded when all of the foregoing conditions are met and risk of loss and title passes to the customer. Our products typically include a one-year warranty and the estimated cost of product warranty claims (based on historical experience) is recorded at the time the sale is recognized. Sales to customers are generally not subject to any price protection or return rights.

The vast majority of our sales are made to original equipment manufacturers ( OEMs ), distributors, resellers and end-users in the non-scientific market. Sales made to these customers do not require installation of the products by us and are not subject to other post-delivery obligations, except in occasional instances where we have agreed to perform installation or provide training. In those instances, we defer revenue related to installation services or training until these services have been rendered. We allocate revenue from multiple element arrangements to the various elements based upon relative fair values, which is determined based on the price charged for each deliverable on a standalone basis.

Our sales to distributors, resellers and end-user customers typically do not have customer acceptance provisions and only certain of our sales to OEM customers have customer acceptance provisions. Customer acceptance is generally limited to performance under our published product specifications. For the few product sales that have customer acceptance provisions because of other than published specifications, (1) the products are tested and accepted by the customer at our site or by the customer's acceptance of the results of our testing program prior to shipment to the customer, or (2) the revenue is deferred until customer acceptance occurs.

Sales to end-users in the scientific market typically require installation and, thus, involve post-delivery obligations; however, our post-delivery installation obligations are not essential to the functionality of our products. We defer revenue related to installation services until completion of these services.

For most products, training is not provided; therefore, no post-delivery training obligation exists. However, when training is provided to our customers, it is typically priced separately and is recognized as revenue after these services have been provided.

### 4. SHORT-TERM INVESTMENTS

We consider all highly liquid investments with maturities of three months or less at the time of purchase to be cash equivalents. Marketable short-term investments in debt securities are classified and accounted for as available-for-sale securities and are valued based on quoted market prices. Investments classified as available-for-sale are reported at fair value with unrealized gains and losses, net of related income taxes, recorded as a separate component of other comprehensive income (OCI) in stockholders' equity until realized. Interest and amortization of premiums and discounts for debt securities are included in interest income. Gains and losses on securities sold are determined based on the specific identification method and are included in other income (expense).

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Cash, cash equivalents and short-term investments consist of the following (in thousands):

	December 29, 2007				Fair Value
	Cost Basis	Unrealized Gains	Unrealized Losses		
Cash and cash equivalents	\$ 323,201	\$ 111	\$ (3)	\$	323,309
Less: restricted cash					(2,514)
				\$	320,795
Short-term investments:					
Available-for-sale securities:					
U.S. Treasury and agency obligations	\$ 39,305	\$ 254	\$ (4)	\$	39,555
State and municipal obligations	3,000	23			3,023
Corporate notes and obligations	24,978	74	(61)		24,991
Total short-term investments	\$ 67,283	\$ 351	\$ (65)	\$	67,569

	September 29, 2007				Fair Value
	Cost Basis	Unrealized Gains	Unrealized Losses		
Cash and cash equivalents	\$ 318,352	\$ 35	\$	\$	318,387
Less: restricted cash					(2,460)
				\$	315,927
Short-term investments:					
Available-for-sale securities:					
U.S. Treasury and agency obligations	\$ 6,036	\$ 7	\$	\$	6,043
Corporate notes and obligations	39,740	132	(19)		39,853
Total short-term investments	\$ 45,776	\$ 139	\$ (19)	\$	45,896

At December 29, 2007 and September 29, 2007, \$2.5 million of cash and cash equivalents were restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik.

## 5. INTANGIBLE ASSETS

The changes in the carrying amount of goodwill by segment for the period from September 29, 2007 to December 29, 2007 are as follows (in thousands):

	Commercial Lasers and Components	Specialty Laser Systems	Total
Balance as of September 29, 2007	\$ 24,091	\$ 59,285	\$ 83,376
Translation adjustments and other	47	430	477
Balance as of December 29, 2007	\$ 24,138	\$ 59,715	\$ 83,853

Components of our amortizable intangible assets are as follows (in thousands):

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	December 29, 2007			September 29, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Existing technology	\$ 54,303	\$ (28,578)	\$ 25,725	\$ 54,091	\$ (26,955)	\$ 27,136
Patents	10,310	(7,259)	3,051	10,184	(6,943)	3,241
Drawings	1,408	(1,408)		1,390	(1,390)	
Order backlog	4,966	(4,933)	33	4,907	(4,864)	43
Customer lists	5,396	(2,775)	2,621	5,366	(2,562)	2,804
Trade name	3,797	(1,877)	1,920	3,754	(1,751)	2,003
Non-compete agreement	2,424	(2,189)	235	2,408	(2,065)	343
Total	\$ 82,604	\$ (49,019)	\$ 33,585	\$ 82,100	\$ (46,530)	\$ 35,570

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Amortization expense for intangible assets for the three months ended December 29, 2007 was \$2.2 million. At December 29, 2007, estimated amortization expense for the remainder of fiscal 2008, the next five succeeding fiscal years and all fiscal years thereafter are as follows (in thousands):

		<b>Estimated Amortization Expense</b>
2008 (remainder)	\$	6,335
2009		7,902
2010		6,511
2011		5,092
2012		3,341
2013		2,394
Thereafter		2,010
Total	\$	33,585

**6. BALANCE SHEET DETAILS**

Inventories consist of the following (in thousands):

		<b>December 29, 2007</b>		<b>September 29, 2007</b>
Purchased parts and assemblies	\$	32,592	\$	29,786
Work-in-process		42,514		44,368
Finished goods		37,783		38,739
Inventories	\$	112,889	\$	112,893

Prepaid expenses and other assets consist of the following (in thousands):

		<b>December 29, 2007</b>		<b>September 29, 2007</b>
Prepaid and refundable income taxes	\$	13,397	\$	8,616
Prepaid expenses and other		34,143		41,628
Total prepaid expenses and other assets	\$	47,540	\$	50,244

Other assets consist of the following (in thousands):

		<b>December 29, 2007</b>		<b>September 29, 2007</b>
Assets related to deferred compensation arrangements	\$	31,957	\$	30,706
Deferred tax assets		41,513		25,165
Other assets		2,669		2,900
Total other assets	\$	76,139	\$	58,771

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Other current liabilities consist of the following (in thousands):

	<b>December 29, 2007</b>	<b>September 29, 2007</b>
Accrued payroll and benefits	\$ 23,618	\$ 28,247
Accrued expenses and other	16,176	18,471
Reserve for warranty	13,804	13,660
Other taxes payable	18,090	9,840
Deferred income	10,760	10,496
Customer deposits	2,777	1,868
Accrued restructuring charges	429	476
Total other current liabilities	\$ 85,654	\$ 83,058

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We provide warranties on certain of our product sales (generally one year) and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

Components of the reserve for warranty costs during the first quarter of fiscal 2008 and 2007 were as follows (in thousands):

	<b>First Quarter Fiscal 2008</b>	<b>First Quarter Fiscal 2007</b>
Beginning balance	\$ 13,660	\$ 11,462
Additions related to current period sales	5,654	5,261
Warranty costs incurred in the current period	(5,584)	(4,699)
Adjustments to accruals related to prior period sales	74	145
Ending balance	\$ 13,804	\$ 12,169

Other long-term liabilities consist of the following (in thousands):

	<b>December 29, 2007</b>	<b>September 29, 2007</b>
Deferred compensation	\$ 32,625	\$ 31,336
Long-term taxes payable	38,918	
Deferred tax liabilities	10,887	10,433
Deferred income	1,674	1,585
Asset retirement liability	1,285	1,256
Other long-term liabilities	3,493	3,238
Total other long-term liabilities	\$ 88,882	\$ 47,848

The following table reconciles changes in our asset retirement liability, which is reported in other long-term liabilities on our condensed consolidated balance sheets (in thousands):

	<b>First Quarter Fiscal 2008</b>	<b>First Quarter Fiscal 2007</b>
Beginning balance	\$ 1,256	\$ 1,765
Adjustment to asset retirement obligations recognized	(8)	(7)
Accretion recognized	24	37
Changes due to foreign currency exchange	13	111
Ending balance	\$ 1,285	\$ 1,906

## 7. STOCK-BASED COMPENSATION

### Stock-Based Benefit Plans



We have two Stock Option Plans for which all service providers are eligible participants and a Directors' Stock Option Plan for which only non-employee directors are eligible participants. The Directors' Stock Option Plan is designed to work automatically without administration, however to the extent administration is necessary, it will be performed by the Board of Directors or a committee thereof. Under these three plans, we may grant options to purchase up to an aggregate of 5,500,000, 6,300,000 and 681,000 shares of common stock, respectively of which no, 3,143,548 and 224,000 shares, respectively, remain available for grant at December 29, 2007. Employee options are generally exercisable between two to four years from the grant date at a price equal to the fair market value of the common stock on the date of the grant and generally vest 25% to 50% annually. We settle stock option exercises with newly issued shares of common stock. Grants under employee plans expire six years from the original grant date, unless otherwise determined by the Board or a committee thereof, up to a maximum of ten years. Director options are automatically granted to our non-employee directors. Such directors initially receive a stock option for 24,000 shares exercisable over a three-year period and an award of restricted stock units of 2,000 shares. Additionally, the non-employee directors receive an annual grant of 6,000 shares exercisable as to 50% of the shares on the day prior to each of the next two annual stockholder meetings. Grants under director plans expire ten years from the original grant date. In addition, each non-employee director

receives an annual grant of 2,000 shares of restricted stock units that vest on the day prior to the annual stockholder meeting held in the third calendar year following the date of grant.

Restricted stock awards granted under our Stock Option Plans are independent of option grants and are subject to restrictions. At December 29, 2007, we had 205,315 shares of restricted stock outstanding, including 48,800 performance-based restricted stock awards, all of which are subject to forfeiture if employment terminates prior to the release of restrictions. During this period, ownership of the shares cannot be transferred. The service-based restricted awards generally vest three years from the date of grant. The performance-based restricted stock grants are subject to annual vesting over three years depending upon the achievement of performance measurements tied to the Company's internal metrics for revenue growth and earnings before income, taxes, depreciation and amortization (EBITDA) percentage and is variable. For fiscal 2007 awards, none of the target shares were issued. The number of shares earned can range from 0% to 200% of the grant target for 2008. Restricted stock (not including performance-based restricted stock) has the same cash dividend and voting rights as other common stock and is considered to be currently issued and outstanding. The cost of the awards, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse.

We have an Employee Stock Purchase Plan ( ESPP ) whereby eligible employees may authorize payroll deductions of up to 10% of their regular base salary to purchase shares at the lower of 85% of the fair market value of the common stock on the date of commencement of the offering or on the last day of the six-month offering period. At December 29, 2007, 224,536 shares of our common stock were reserved for future issuance under the plan.

In the second quarter of fiscal 2007, the stock purchase plan was suspended and employee contributions made to the ESPP were returned while a voluntary review of our historical stock option practices was conducted. There was no activity under the ESPP in the first quarter of fiscal 2008.

#### **SFAS 123(R)**

In accordance with the fair value recognition provisions of SFAS No. 123 (Revised 2004), Share-Based Payment, ( SFAS 123(R) ), we recognize compensation expense for all share-based payment awards on a straight-line basis over the respective requisite service period of the awards.

#### **Determining Fair Value**

*Valuation and amortization method* We estimate the fair value of stock options granted using the Black-Scholes-Merton option-pricing formula and a single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

*Expected Term* The expected term represents the period that our stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards.

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*Expected Volatility* Our computation of expected volatility is based on a combination of historical volatility and market-based implied volatility.

*Risk-Free Interest Rate* The risk-free interest rate used in the Black-Scholes-Merton valuation method is based on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term.

*Expected Dividend* The expected dividend assumption is based on our current expectations about our anticipated dividend policy.

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The fair values of our stock options granted to employees and shares purchased under the stock purchase plan for the first quarter of fiscal 2008 and fiscal 2007 were estimated using the following weighted-average assumptions:

	Employee Stock Option Plans First Quarter		Employee Stock Purchase Plans First Quarter	
	Fiscal 2008	Fiscal 2007	Fiscal 2008 (1)	Fiscal 2007
Expected life in years	3.5	4.4		0.5
Expected volatility	29.5%	34.2%	%	29.0%
Risk-free interest rate	4.1%	4.7%	%	5.1%
Expected dividends	none	none		none
Weighted average fair value	\$ 9.01	\$ 12.04	\$	\$ 8.43

(1) During the second quarter of fiscal 2007, the stock purchase plan was suspended and employee contributions were returned while a voluntary review of our historical stock option practices was conducted. There was no activity under the ESPP during the first quarter of fiscal 2008.

### Stock Compensation Expense

The following table shows total stock-based compensation expense included in the Condensed Consolidated Statements of Operations for the first quarter of fiscal 2008 and 2007 (in thousands):

	First Quarter Fiscal 2008	First Quarter Fiscal 2007
Cost of sales	\$ 385	\$ 437
Research and development	320	560
Selling, general and administrative	2,000	2,495
Income tax benefit	(772)	(1,301)
	\$ 1,933	\$ 2,191

During the first quarter of fiscal 2008, \$0.3 million for all stock plans was capitalized into inventory, \$0.2 million was amortized to cost of sales and \$0.3 million remained in inventory at December 29, 2007. As required by SFAS 123(R), management made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest.

At December 29, 2007, the total compensation cost related to unvested stock-based awards granted to employees under the Company's stock option plans but not yet recognized was approximately \$8.5 million, net of estimated forfeitures of \$0.3 million. This cost will be amortized on a straight-line basis over a weighted-average period of approximately 1.1 years and will be adjusted for subsequent changes in estimated forfeitures.

In accordance with SFAS 123(R), the cash flows resulting from excess tax benefits (tax benefits related to the excess of proceeds from an employee's exercises of stock options over the stock-based compensation cost recognized for those options) are classified as financing cash flows. During the first quarter of fiscal 2008 and fiscal 2007, we recorded no and \$0.1 million, respectively, of excess tax benefits as cash flows from financing activities.

**Stock Options & Awards Activity**

The following is a summary of option activity for our Stock Option Plans (in thousands, except per share amounts and remaining contractual term in years):

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at September 30, 2007	3,196	\$ 28.54		
Granted	775	32.95		
Exercised				
Forfeitures	(6)	31.81		
Expirations	(87)	27.04		
Outstanding at December 29, 2007	3,878	\$ 29.45	3.0	\$ 3,354
Vested and expected to vest at December 29, 2007	3,674	\$ 29.43	3.0	\$ 3,354
Exercisable at December 29, 2007	2,586	\$ 28.05	2.0	\$ 3,354

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the 0.6 million options that were in-the-money at December 29, 2007. During the first quarter of fiscal 2008, no options were exercised under the Company's stock option plans; therefore there was no intrinsic value. During the first quarter of fiscal 2007, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$0.5 million, determined as of the date of option exercise.

The following table summarizes our restricted stock award activity for the first quarter of fiscal 2008 (in thousands, except per share amounts):

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested stock at September 30, 2007	261	\$ 33.02
Granted		
Vested		
Forfeited	(56)	32.36
Nonvested stock at December 29, 2007	205	\$ 33.04

## 8. COMMITMENTS AND CONTINGENCIES

We are subject to legal claims and litigation arising in the ordinary course of business, such as employment or intellectual property claims, including, but not limited to, the matters described below. The outcome of any such matters is currently not determinable. Although we do not expect that such legal claims and litigation will ultimately have a material adverse effect on our consolidated financial position or results of operations, an adverse result in one or more matters could negatively affect our results in the period in which they occur.

Derivative Lawsuits Between February 15, 2007 and March 2, 2007, three purported shareholder derivative lawsuits were filed in the United States District Court for the Northern District of California against certain of Coherent's current and former officers and directors. Coherent is named as a nominal defendant. The complaints generally allege that the defendants breached their fiduciary duties and violated the securities laws in connection with the granting of stock options, the accounting treatment for such grants, and the issuance of allegedly misleading public statements and stock sales by certain of the individual defendants. On May 29, 2007, these lawsuits were consolidated under the caption *In*

*re Coherent, Inc. Shareholder Derivative Litigation*, Lead Case No. C-07-0955-JF (N.D. Cal.). On June 25, 2007, plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts causes of action for alleged violations of federal securities laws, violations of California securities laws, breaches of fiduciary duty and/or aiding and abetting breaches of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, insider selling and misappropriation of information. The consolidated complaint seeks, among other relief, disgorgement and damages in an unspecified amount, an accounting, rescission of allegedly improper stock option grants, punitive damages and attorneys' fees and costs.

The Company's Board of Directors has appointed a Special Litigation Committee ( SLC ) comprised of independent director Sandeep Vij to investigate and evaluate the claims asserted in the derivative litigation and to determine what action(s) should be taken with respect to the derivative litigation. The SLC's investigation is ongoing.

Securities and Exchange Commission Inquiry In 2006, the Company was advised that the San Francisco District Office of the Securities and Exchange Commission was conducting an informal inquiry relating to the Company's past granting of stock options. The Company is cooperating fully with the inquiry.

Income Tax Audits The Internal Revenue Service ( IRS ) is conducting an audit of our 2003 and 2004 tax returns. The IRS has issued a number of Notices of Proposed Adjustments to these returns. Among other items, the IRS has challenged our research and development credits and our extraterritorial income ( ETI ) exclusion. We have agreed to the various adjustments proposed by the IRS and we believe that we have adequately provided for these exposures and any other items identified by the IRS as a result of the audit of these tax years. As part of its audit of our 2003 and 2004 years, the IRS has requested information related to our stock option investigation and we will comply with this request and address any issues that are raised in a timely manner. The IRS has also indicated that it may consider an audit of our 2005 and 2006 tax returns.

The IRS is also auditing the research and development credits generated in the years 1999 through 2001 and carried forward to future tax years. We believe that we have adequately provided for any adjustments that may be proposed by the IRS related to these credits.

The German tax authorities are conducting an audit of our subsidiary in Göttingen for the tax years 1999 through 2005. We believe that we have adequately provided for any adjustments that may be proposed by the German tax authorities.

## 9. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss), net of income taxes, are as follows (in thousands):

	First Quarter	
	Fiscal 2008	Fiscal 2007
Net income	\$ 4,729	\$ 10,758
Other comprehensive income (loss):		
Translation adjustment	3,186	6,827
Net gain on derivative instruments, net of taxes	1	30



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Changes in unrealized gains (losses) on available-for-sale securities, net of taxes		154		145
Other comprehensive income (loss), net of tax		3,341		7,002
Comprehensive income	\$	8,070	\$	17,760

The following summarizes activity in accumulated other comprehensive income (loss) related to derivatives, net of income taxes, held by us (in thousands):

Balance, October 1, 2006	\$	(135)
Changes in fair value of derivatives		
Net losses reclassified from OCI		30
Balance, December 30, 2006	\$	(105)
Balance, September 30, 2007	\$	(98)
Changes in fair value of derivatives		
Net losses reclassified from OCI		1
Balance, December 29, 2007	\$	(97)

Accumulated other comprehensive income (net of tax) at December 29, 2007 is comprised of accumulated translation adjustments of \$74.1 million and net loss on derivative instruments of \$0.1 million. Accumulated other comprehensive income (net of tax) at September 29, 2007 is comprised of accumulated translation adjustments of \$71.0 million, net loss on derivative instruments of \$0.1 million and unrealized loss on available-for-sale securities of \$0.2 million, respectively.

## 10. EARNINGS PER SHARE

Basic earnings per share is computed based on the weighted average number of shares outstanding during the period, excluding unvested restricted stock. Diluted earnings per share is computed based on the weighted average number of shares outstanding during the period increased by the effect of dilutive employee stock awards, including stock options, restricted stock and stock purchase contracts, using the treasury stock method.

The following table presents information necessary to calculate basic and diluted earnings per share (in thousands, except per share data):

	First Quarter	
	Fiscal 2008	Fiscal 2007
Weighted average shares outstanding(1) basic	31,417	31,339
Dilutive effect of employee stock awards	542	786
Weighted average shares outstanding diluted	31,959	32,125
Net income	\$ 4,729	\$ 10,758
Net income per basic share	\$ 0.15	\$ 0.34
Net income per diluted share	\$ 0.15	\$ 0.33

(1) Net of restricted stock

A total of 2,519,135 and 1,007,657 potentially dilutive securities have been excluded from the dilutive share calculation for the first quarter of fiscal 2008 and fiscal 2007, respectively, as their effect was anti-dilutive.

In September 2004, the Emerging Issues Task Force ( EITF ) reached final consensus on EITF No. 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share , that contingently convertible debt should be treated as convertible debt and included in the calculation of diluted earnings per share (EPS). The assumed proceeds under the treasury stock method were calculated by subtracting the aggregate weighted-average conversion price from the average market price of the shares related to the contingently convertible debt. As the market price for our shares did not reach the conversion price at any point during the quarter ended December 30, 2006, there was no dilutive effect from our \$200.0 million 2.75% convertible subordinated notes in our diluted EPS calculation under the treasury stock method for the first quarter of fiscal 2007. Therefore we did not include any shares related to the convertible subordinated notes, in accordance with the provisions of EITF No. 90-19, Convertible Bonds With Issuer Option to Settle in Cash Upon Conversion and SFAS No. 128, Earnings Per Share . The contingently convertible debt was paid on August 21, 2007; therefore there was no impact in the first quarter of fiscal 2008.

## 11. INCOME TAXES

The Company accounts for income taxes under the provisions of SFAS No. 109, Accounting for Income Taxes (SFAS 109). Under the provisions of SFAS 109, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the

years in which those temporary differences are expected to be recovered or settled.

Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries. The Company's estimated effective tax rate for the three months ended December 29, 2007 was 32.8%. The difference between the statutory rate of 35% and the Company's effective tax rate for the three months ended December 29, 2007 was due primarily to the benefit of foreign tax credits and research and development tax credits, partially offset by permanent differences related to deemed dividend inclusions under the Subpart F tax rules.

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the

recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

Effective September 30, 2007, the Company adopted the provisions of FIN 48 and FSP FIN 48-1. Upon adoption, the Company recorded a cumulative effect of a change in accounting principle that resulted in a decrease to retained earnings of \$1.4 million in accordance with the transition rules under FIN 48. The Company had historically classified interest and penalties and unrecognized tax benefits as current liabilities. With the adoption of FIN 48, the Company classifies gross interest and penalties and unrecognized tax benefits that are not expected to result in payment or receipt of cash within one year as non-current liabilities in the condensed consolidated balance sheets. The total amount of gross unrecognized tax benefits as of the date of adoption of FIN 48 was \$44.9 million, of which \$21.7 million, if recognized, would affect the Company's effective tax rate. As of December 29, 2007, the total amount of gross unrecognized tax benefits was \$45.3 million, of which \$22.0 million, if recognized, would affect the Company's effective tax rate. The Company's total gross unrecognized tax benefit was classified as non-current liabilities in the condensed consolidated balance sheets.

The Company's policy to include interest and penalties related to unrecognized tax benefits within the provision for income taxes did not change as a result of adopting FIN 48. As of the date of adoption, the Company had accrued \$4.7 million for the gross interest and penalties relating to the gross unrecognized tax benefits. As of December 29, 2007, the total amount of gross interest and penalties accrued was \$5.2 million, which is classified as non-current liabilities in the condensed consolidated balance sheets.

The Company is subject to taxation and files income tax returns in the U.S. federal jurisdiction and in many state and foreign jurisdictions. For U.S. federal income tax purposes, all years prior to 1999 are closed. The years 2003 and 2004 are currently under examination by the IRS. The IRS has also indicated that it may consider an audit of our 2005 and 2006 tax returns. In major state jurisdictions and major foreign jurisdictions, the years subsequent to 1998 generally remain open and could be subject to examination by the taxing authorities.

Management believes that it has adequately provided for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. Should any issues addressed in the Company's tax audits be resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs. Although timing of the resolution and/or closure of audits is highly uncertain, the Company does not believe it is reasonably possible that its unrecognized tax benefits would materially change in the next 12 months.

## 12. SEGMENT INFORMATION

During the second quarter of fiscal 2007, we established a new organizational and reporting structure whereby our previously single reportable operating segment was separated into two operating segments: Commercial Lasers and Components (CLC) and Specialty Lasers and Systems (SLS). CLC focuses on higher volume products that are offered in set configurations. The product architectures are designed for easy exchange at the point of use such that product service and repairs are based upon advanced replacement and depot (i.e., factory) repair. CLC's primary markets include OEM components and instrumentation and materials processing. SLS develops and manufactures configurable, advanced-performance products largely serving the microelectronics and scientific research markets. The size and complexity of many of the SLS products require service to be performed at the customer site by factory-trained field service engineers.

We have identified CLC and SLS as operating segments for which discrete financial information was available. Both operating segments have engineering, marketing, product business management and product line management. Prior period financial information has been restated to conform to the current segment presentation. A small portion of our outside revenue is attributable to projects and recently developed products

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for which a segment has not yet been determined. The associated direct and indirect costs are presented in the category of Corporate and other, along with other corporate costs as described below.

Pursuant to SFAS 131, Disclosures about Segments of an Enterprise and Related Information, our Chief Executive Officer has been identified as the chief operating decision maker (CODM) as he assesses the performance of the segments and decides how to allocate resources to the segments. Income (loss) from operations is the measure of profit and loss that our CODM uses to assess performance and make decisions. Assets are not a measure used to assess the performance of the company by the CODM; therefore we do not report assets by segment internally or in our disclosures. Income (loss) from operations represents the net sales less the cost of sales and direct operating expenses incurred within

the operating segments as well as allocated expenses such as shared sales and manufacturing costs. We do not allocate to our operating segments certain operating expenses, which we manage separately at the corporate level. These unallocated costs include stock-based compensation, corporate functions (certain research and development, management, finance, legal and human resources) and are included in the results below under Corporate and other in the reconciliation of operating results. Management does not consider unallocated Corporate and other costs in its measurement of segment performance.

The following table provides net sales and income from operations for our operating segments (in thousands):

	<b>Three Months Ended</b>	
	<b>December 29, 2007</b>	<b>December 30, 2006</b>
<u>Net sales:</u>		
Commercial Lasers and Components	\$ 68,604	\$ 67,227
Specialty Laser Systems	75,667	78,770
Corporate and other	25	1,512
Total net sales	\$ 144,296	\$ 147,509
<u>Income from operations:</u>		
Commercial Lasers and Components	\$ 5,547	\$ 8,770
Specialty Laser Systems	9,177	10,880
Corporate and other	(13,573)	(11,562)
Total income from operations	\$ 1,151	\$ 8,088

### 13. SUBSEQUENT EVENT

On February 12, 2008, the Company announced that the Board of Directors has authorized the Company to repurchase up to \$225 million of its common stock through a modified Dutch Auction tender offer and an additional \$25 million of its common stock, following the completion or termination of the tender offer, under its stock repurchase program, terminating no later than February 11, 2009.

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

**COMPANY OVERVIEW**

**BUSINESS BACKGROUND**

We are one of the world's leading suppliers of photonics-based solutions in a broad range of commercial and scientific research applications. We design, manufacture and market lasers, precision optics and related accessories for a diverse group of customers. Since inception in 1966, we have grown through internal expansion and through strategic acquisitions of complementary businesses, technologies, intellectual property, manufacturing processes and product offerings.

During the second quarter of fiscal 2007, we established a new organizational and reporting structure whereby our previously single reportable operating segment was separated into two operating segments: Commercial Lasers and Components (CLC) and Specialty Lasers and Systems (SLS). The new segmentation reflects the go-to-market strategies for various products and markets. While both segments work to deliver cost-effective photonics solutions, CLC focuses on higher volume products that are offered in set configurations. The product architectures are designed for easy exchange at the point of use such that substantially all product service and repairs are based upon advanced replacement and depot (i.e., factory) repair. CLC's primary markets include OEM components and instrumentation and materials processing. SLS develops and manufactures configurable, advanced-performance products largely serving the microelectronics and scientific research markets. The size and complexity of many of the SLS products require service to be performed at the customer site by factory-trained field service engineers. Prior period segment information has been restated to conform to the current presentation.

Income (loss) from operations is the measure of profit and loss that our chief operating decision maker (CODM) uses to assess performance and make decisions. Income (loss) from operations represents the net sales less the cost of sales and direct operating expenses incurred within the operating segments as well as allocated expenses such as shared sales and manufacturing costs. We do not allocate to our operating segments certain operating expenses, which we manage separately at the corporate level. These unallocated costs include stock-based compensation, corporate functions (certain research and development, management, finance, legal and human resources) and are included in Corporate and Other. Management does not consider unallocated Corporate and Other costs in its measurement of segment performance.

**MARKET APPLICATIONS**

Our products address a broad range of applications that we group into the following markets: Microelectronics, Materials Processing, OEM Components and Instrumentation and, Scientific Research and Government Programs. Effective the first quarter of fiscal 2008, we combined the former Graphic Arts and Display market applications for bookings and revenues into the OEM Components and Instrumentation market applications. Prior period market application information for bookings and revenues reflects this combination.



## OUR STRATEGY

We strive to develop innovative and proprietary products and solutions that meet the needs of our customers and that are based on our core expertise in lasers and optical technologies. In pursuit of our strategy, we intend to:

- **Leverage our technology portfolio and application engineering to lead the proliferation of photonics into broader markets** We will continue to identify opportunities in which our technology portfolio and application engineering can be used to offer innovative solutions and gain access to new markets.
- **Optimize our leadership position in existing markets** There are a number of markets where we have historically been at the forefront of technological development and product deployment and from which we have derived a substantial portion of our revenues. We plan to optimize our financial returns from these markets.
- **Maintain and develop additional strong collaborative customer and industry relationships** We believe that the Coherent brand name and reputation for product quality, technical performance and customer satisfaction will help us to further develop our loyal customer base. We plan to maintain our current customer relationships and develop new ones with customers who are industry leaders and work together with these customers to design and develop innovative product systems and solutions as they develop new technologies.

- **Develop and acquire new technologies and market share** We will continue to enhance our market position through our existing technologies and develop new technologies through our internal research and development efforts, as well as through the acquisition of additional complementary technologies, intellectual property, manufacturing processes and product offerings.
- **Focus on long-term improvement of adjusted EBITDA expressed as a percentage of net sales** We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization, stock compensation expenses and other non-operating income and expense items.

## APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the SEC. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We have identified the following as the items that require the most significant judgment and often involve complex estimation: revenue recognition, accounting for long-lived assets (including goodwill and intangible assets), inventory valuation, warranty reserves, stock-based compensation and accounting for income taxes.

### *Revenue Recognition*

We recognize revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists, the product has been delivered or the service has been rendered, the price is fixed or determinable and collection is probable. Revenue from product sales is recorded when all of the foregoing conditions are met and risk of loss and title passes to the customer. Our products typically include a one-year warranty and the estimated cost of product warranty claims (based on historical experience) is recorded at the time the sale is recognized. Sales to customers are generally not subject to any price protection or return rights.

The vast majority of our sales are made to original equipment manufacturers (OEMs), distributors, resellers and end-users in the non-scientific market. Sales made to these customers do not require installation of the products by us and are not subject to other post-delivery obligations, except in occasional instances where we have agreed to perform installation or provide training. In those instances, we defer revenue related to installation services or training until these services have been rendered. We allocate revenue from multiple element arrangements to the various elements based upon relative fair values, which is determined based on the price charged for each deliverable on a standalone basis.

Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected. Failure to obtain anticipated orders due to delays or cancellations of orders could have a material adverse effect on our revenue. In addition, pressures from customers to reduce our prices or to modify our existing sales terms may have a material adverse effect on our revenue in future periods.

Our sales to distributors, resellers and end-user customers typically do not have customer acceptance provisions and only certain of our sales to OEM customers have customer acceptance provisions. Customer acceptance is generally limited to performance under our published product specifications. For the few product sales that have customer acceptance provisions because of higher than published specifications, (1) the

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products are tested and accepted by the customer at our site or by the customer's acceptance of the results of our testing program prior to shipment to the customer, or (2) the revenue is deferred until customer acceptance occurs.

Sales to end-users in the scientific market typically require installation and, thus, involve post-delivery obligations; however our post-delivery installation obligations are not essential to the functionality of our products. We defer revenue related to installation services until completion of these services.

For most products, training is not provided; therefore, no post-delivery training obligation exists. However, when training is provided to our customers, it is typically priced separately and recognized as revenue after these services have been provided.

### ***Long-Lived Assets***

We evaluate long-lived assets whenever events or changes in business circumstances or our planned use of assets indicate that their carrying amounts may not be fully recoverable or that their useful lives are no longer appropriate. Reviews are performed to determine whether the carrying values of assets are impaired based on comparison to either the discounted expected future cash flows (in the case of goodwill) or to the undiscounted expected future cash flows (for all other long-lived assets). If the comparison indicates that impairment exists, the impaired asset is written down to its fair value. Significant management judgment is required in the forecast of future operating results that are used in the preparation of expected discounted and undiscounted cash flows.

At December 29, 2007, we had \$117.4 million of goodwill and purchased intangible assets on our consolidated balance sheet. At December 29, 2007, we had \$102.8 million of property and equipment on our consolidated balance sheet. The Company reviewed impairment indicators during the first quarter of fiscal 2008 and determined that no impairment was indicated.

It is reasonably possible that the estimates of anticipated future net revenue, the remaining estimated economic life of the products and technologies, or both, could differ from those used to assess the recoverability of these assets. In that event, additional impairment charges or shortened useful lives of certain long-lived assets may be required.

### ***Inventory Valuation***

We record our inventory at the lower of cost (computed on a first-in, first-out basis) or market. We write-down our inventory to its estimated market value based on assumptions about future demand and market conditions. Inventory write-downs are generally recorded within guidelines set by management when the inventory for a device exceeds 12 months of its demand and when individual parts have been in inventory for greater than 12 months. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required which could materially affect our future results of operations. Due to rapidly changing forecasts and orders, additional write-downs for excess or obsolete inventory, while not currently expected, could be required in the future. In the event that alternative future uses of fully written down inventories are identified, we may experience better than normal profit margins when such inventory is sold. Differences between actual results and previous estimates of excess and obsolete inventory could materially affect our future results of operations. We write-down our demo inventory by amortizing the cost of demo inventory over a twenty month period starting from the fourth month after such inventory is placed in service.

### ***Warranty Reserves***

We provide warranties on certain of our product sales (generally one year) and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

### ***Stock-Based Compensation***

Prior to October 2, 2005, our stock-based employee compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Effective October 2, 2005, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment ( SFAS 123(R) ), requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected to use the modified prospective transition method as permitted by SFAS 123(R). Under this transition method, stock-based compensation expense for the first quarter of fiscal 2008 and 2007 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of October 1, 2005, as well as grants in fiscal 2008, 2007 and 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, as adjusted for estimated forfeitures.

SFAS 123(R) requires the use of option pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption was determined using our historical volatility.

**Income Taxes**

As part of the process of preparing our consolidated financial statements, we are required to estimate our income tax provision (benefit) in each of the jurisdictions in which we operate. This process involves us estimating our current income tax provision (benefit) together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheets.

We record a valuation allowance to reduce our deferred tax assets to an amount that more likely than not will be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the allowance for the deferred tax assets would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax assets in the future, an adjustment to the valuation allowance for the deferred tax assets would be charged to income in the period such determination was made.

Effective September 30, 2007, the Company adopted the provisions of FIN 48, which creates a single model to address accounting for uncertainty in tax positions by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 establishes a two-step approach for evaluating tax positions. The first step, recognition, occurs when a company concludes (based solely on the technical aspects of the matter) that a tax position is more likely than not to be sustained upon examination by a taxing authority. The second step, measurement, is only considered after step one has been satisfied and measures any tax benefit at the largest amount that is deemed more likely than not to be realized upon ultimate settlement of the uncertainty. These determinations involve significant judgment by management. Tax positions that fail to qualify for initial recognition are recognized in the first subsequent interim period that they meet the more likely than not standard, when they are resolved through negotiation or litigation with factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are complex and are subject to change as a result of changes in fiscal policy, changes in legislation, evolution of regulations and court filings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially to reverse previously recorded tax liabilities.

**KEY PERFORMANCE INDICATORS**

The following is a summary of some of the quantitative performance indicators (as defined below) that may be used to assess our results of operations and financial condition:

	3 Months Ended		Change	% Change
	December 29, 2007	December 30, 2006		
	(Dollars in thousands)			
Bookings	\$ 154,857	\$ 136,208	\$ 18,649	13.7%
Net sales - CLC	\$ 68,604	\$ 67,227	\$ 1,377	2.0%
Net sales - SLS	\$ 75,667	\$ 78,770	\$ (3,103)	(3.9)%
Gross profit as a percentage of net sales - CLC	42.2%	45.4%	(3.2)%	(7.1)%
Gross profit as a percentage of net sales - SLS	42.3%	39.3%	3.0%	7.7%
Research and development as a percentage of net sales	12.7%	12.4%	0.3%	2.2%

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Income before income taxes	\$	7,032	\$	13,362	\$	(6,330)	(47.4)%
Cash provided by operating activities	\$	13,077	\$	28,734	\$	(15,657)	(54.5)%
Days sales outstanding in receivables		60.5		58.0		2.5	4.3%
Days sales outstanding in inventories		70.4		60.9		9.5	15.6%
Capital spending as a percentage of net sales		3.2%		3.4%		(0.2)%	(4.9)%

Definitions and analysis of these performance indicators are as follows:

## **Bookings**

Bookings represent orders expected to be shipped within 12 months and services to be provided pursuant to service contracts. While we generally have not experienced a significant rate of cancellation, bookings are generally cancelable by our customers without substantial penalty and, therefore, we can not assure all bookings will be converted to net sales.

First quarter bookings increased 13.7% from the same quarter one year ago. Bookings increased in each of the markets: OEM components and instrumentation, microelectronics, materials processing, and scientific and government programs.

### OEM Components and Instrumentation

Effective in the first quarter of fiscal 2008, we have incorporated the former graphic arts and display market into OEM components and instrumentation market. Bookings from instrumentation applications remained strong for OPS, Compass and LDM products. A number of applications contributed to this strength including cytometry, microscopy and genetic sequencing. Orders from medical OEMs increased significantly from the fourth quarter of fiscal 2007 and from the first quarter of fiscal 2007. The refractive surgery market was the most active with orders from many of the key customers. In the non-refractive market, the first photocoagulator platform incorporating the OPSL 577 is in the FDA approval process.

### Microelectronics

Orders from semiconductor capital equipment applications, including inspection and metrology, decreased from the fourth quarter of fiscal 2007 as the industry continues to struggle with capacity requirements and capital investments. Despite the short term decrease, we are receiving encouraging signals from multiple customers regarding design wins and we could see benefits from these wins in the fourth fiscal quarter of 2008.

Advanced packaging bookings increased significantly from the fourth quarter of fiscal 2007 with record orders from laser direct imaging customers. Increased end user adoption in Asia was cited as the driver for the bookings growth. More than half of these units will go into production environments rather than prototyping applications, a positive trend for future growth. In order to fully capitalize on the opportunity, we must support higher tool throughput by increasing the laser output power and reducing the dollar per Watt cost, which we believe we are capable of doing.

Success in microvia applications depends on throughput and feature size advancement. We have been addressing these through developments in carbon dioxide (CO<sub>2</sub>) and ultra violet (UV) laser technologies. As an example, our newest CO<sub>2</sub> designs deliver higher peak powers, which are important for copper direct drilling in PCBs, and enhanced duty cycles. Within the industry, the introduction of X-66 flip-chip substrates using the 45nm design rule creates new growth opportunities, although this is dampened by current softness in personal computer (PC) demand, which we believe is temporary.



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Bookings for flat panel display manufacturers in the first quarter of fiscal 2008 included strong bookings for service as well as for non-annealing applications. Customers are at or close to maximized yields, which is a positive indicator for future business. We have also demonstrated key results using our SLS process in active matrix liquid crystal display (AMLCD) and active matrix organic light-emitting diode (AMOLED) to achieve large panel sizes. This is critical to our next generation deployment.

Laser-based silicon singulation and scribing are gaining momentum. We have been developing new technology for this space based upon a fiber platform. We will be formally releasing this new platform before the end of the third fiscal quarter.

### Materials Processing

Materials processing orders grew from the prior year period, but decreased from the fourth quarter of fiscal 2008. The sequential decrease appears to reflect the timing of orders rather than a change in market conditions.

During the first quarter of fiscal 2008, we introduced multiple new products. We released our new E-Series CO<sub>2</sub> platform at the Fabtech show this past November. The E-Series represents the new standard for sealed CO<sub>2</sub> lasers. It has an integrated RF power supply for ease of deployment, the lowest cost of ownership in the industry, superior mode quality for processing power and a modular design that facilitates scalability. Feedback from our lead customers has been terrific and the early order bookings are strong. We also released an IR version of our HOPS platform for certain marking applications. The Mini-IR meets all the performance criteria required for CW marking and includes direct modulation capabilities.

### Scientific and Government Programs

Bookings were led by ultrafast lasers in the first quarter of fiscal 2008. Funding for research in the life sciences led to a record number of orders for our Chameleon lasers. In the physical sciences, we experienced increased demand for our Mira and Micra products. We also introduced a new ultrafast laser at the recent Photonics West. The Mantis is a short pulse laser well-suited as a seed source for an amplifier system, incorporating a high-power OPS laser, which has a favorable cost basis compared to our traditional pump lasers.

### **Net Sales**

Net sales include sales of lasers, precision optics, related accessories and service contracts. Net sales for the first fiscal quarter decreased 2.2% from the same quarter one year ago. For a description of the reasons for changes in net sales refer to the Results of Operations section of this quarterly report.

### **Gross Profit as a Percentage of Net Sales**

Gross profit as a percentage of net sales ( gross profit percentage ) is calculated as gross profit for the period divided by net sales for the period. Gross profit percentage in the first quarter for CLC decreased to 42.2% from 45.4% in the same quarter one year ago. Gross profit percentage in the first quarter for SLS increased to 42.3% from 39.3% in the same quarter one year ago. For a description of the reasons for changes in gross profit refer to the Results of Operations section of this quarterly report.

### **Research and Development as a Percentage of Net Sales**

Research and development as a percentage of net sales ( R&D percentage ) is calculated as research and development expense for the period divided by net sales for the period. Management considers R&D percentage to be an important indicator in managing our business as investing in new technologies is a key to future growth. R&D percentage increased to 12.7% from 12.4% in the first fiscal quarter from the same quarter one year ago. For a more complete description of the reasons for changes in R&D percentage refer to the Results of Operations section of this quarterly report.

### **Net Cash Provided by Operating Activities**

Net cash provided by operating activities shown on our Condensed Consolidated Statements of Cash Flows primarily represents the excess of cash collected from billings to our customers and other receipts over cash paid to our vendors for expenses and inventory purchases to run our business. This amount represents cash generated by current operations to pay for equipment, technology, and other investing activities, to repay debt, fund acquisitions, repurchase our common stock and for other financing purposes. We believe this is an important performance indicator because cash generation over the long term is essential to maintaining a healthy business and providing funds to help fuel growth. We believe generating positive cash from operations is an indication that our products are achieving a high level of customer satisfaction and that we are appropriately monitoring our expenses, inventory levels and cash collection efforts. For a more complete description of the reasons for changes

in Net Cash Provided by Operating Activities refer to the Liquidity and Capital Resources section of this quarterly report.

#### **Days Sales Outstanding in Receivables**

We calculate days sales outstanding ( DSO ) in receivables as net receivables at the end of the period divided by net sales during the period and then multiplied by the number of days in the period, using 90 days for quarters. DSO in receivables indicates how well we are managing our collection of receivables, with lower DSO in receivables resulting in more cash flow available. The more money we have tied up in receivables, the less money we have available for research and development, acquisitions, expansion, marketing and other activities to grow our business. Our DSO in receivables for the first quarter of fiscal 2008 increased 2.5 days from the same quarter one year ago due primarily to the impact of foreign exchange rates (0.8 days), the impact of royalty revenue in the first quarter of fiscal 2007 (0.5 days) and slower payment on certain receivables in Japan.

#### **Days Sales Outstanding in Inventories**

We calculate DSO in inventories as net inventories at the end of the period divided by net sales of the period and then multiplied by the number of days in the period, using 90 days for quarters. DSO in inventories indicates how well we are managing our inventory levels, with lower DSO in inventories resulting in more cash flow available. The more money we have tied up in inventory, the less money we have available for research and development, acquisitions, expansion, marketing and other activities to grow our business. Our DSO in inventories for the first quarter of fiscal 2008 increased 9.5 days from

the same quarter one year ago primarily due to increased inventory levels in preparation for new product launches, for customer support as well as the impact of foreign exchange rates (2.5 days).

### Capital Spending as a Percentage of Net Sales

Capital spending as a percentage of net sales ( capital spending percentage ) is calculated as capital expenditures for the period divided by net sales for the period. Capital spending percentage indicates the extent to which we are expanding or improving our operations, including investments in technology. Management monitors capital spending levels as this assists management in measuring our cash flows, net of capital expenditures. Our capital spending percentage decreased to 3.2% for the first quarter from 3.4% for the same quarter one year ago. We anticipate that capital spending for fiscal 2008 will be approximately 4% of net sales.

### SIGNIFICANT EVENTS

On December 18, 2007, we announced that the Securities and Exchange Commission ( SEC ) notified us that it had denied our motion to stay the decision of the NASDAQ Stock Market LLC ( Nasdaq ), to suspend and delist our common stock. Therefore, effective at the opening of business on Wednesday, December 19, 2007, our common stock was suspended from trading on the Nasdaq Global Select Market, and was subsequently delisted. Following our delisting from the Nasdaq Global Select Market, we began trading on the Pink Sheet Electronic Quotation Service. We have received confirmation that our shares of common stock will be re-listed on the NASDAQ Global Select Market with the opening of trading on Thursday, February 14, 2008.

### RESULTS OF OPERATIONS

#### CONSOLIDATED SUMMARY

The following table sets forth, for the periods indicated, the percentage of total net sales represented by the line items reflected in our condensed consolidated statements of operations:

	Three Months Ended	
	December 29, 2007	December 30, 2006
<b>Net sales</b>	100.0%	100.0%
<b>Cost of sales</b>	58.1%	58.0%
<b>Gross profit</b>	41.9%	42.0%
<b>Operating expenses:</b>		
Research and development	12.7%	12.4%
Selling, general and administrative	26.9%	22.7%
Restructuring and other charges (recoveries)	%	0.1%
Amortization of intangible assets	1.5%	1.3%

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Total operating expenses	41.1%	36.5%
<b>Income from operations</b>	0.8%	5.5%
<b>Other income (expense):</b>		
Interest and dividend income	2.8%	4.1%
Interest expense	(0.1)%	(1.2)%
Other net	1.4%	0.7%
Total other income, net	4.1%	3.6%
<b>Income before income taxes</b>	4.9%	9.1%
Provision for income taxes	1.6%	1.8%
<b>Net income</b>	3.3%	7.3%

Net income for the first quarter of fiscal 2008 was \$4.7 million (\$0.15 per diluted share) including \$2.8 million of after-tax costs related to our restatement of financial statements and litigation resulting from our internal stock option investigation, and \$1.9 million after-tax of stock-based compensation expense as required by SFAS 123(R). Net income for the first quarter of fiscal 2007 was \$10.8 million (\$0.33 per diluted share) including \$1.0 million of after-tax costs related to our internal stock option investigation and \$2.2 million after-tax of stock-based compensation expense as required by SFAS 123(R) as well as a \$2.1 million one-time tax benefit.

**NET SALES****Market Application**

The following tables set forth, for the periods indicated, the amount of net sales and their relative percentages of total net sales by market application (dollars in thousands):

	Three Months Ended			
	December 29, 2007		December 30, 2006	
	Amount	Percentage of total net sales	Amount	Percentage of total net sales
<b>Consolidated:</b>				
Microelectronics	\$ 48,673	33.7%	\$ 55,730	37.8%
OEM components and instrumentation	40,981	28.4%	39,464	26.8%
Materials processing	24,503	17.0%	19,374	13.1%
Scientific and government programs	30,139	20.9%	32,941	22.3%
Total	\$ 144,296	100.0%	\$ 147,509	100.0%

Net sales for the first quarter of fiscal 2008 decreased by \$3.2 million, or 2%, net of an increase of \$4.2 million due to the impact of foreign currency exchange rates, compared to the first quarter of fiscal 2007. Decreases in the microelectronics and scientific and government programs markets were partially offset by increases in the materials processing and OEM components and instrumentation markets.

**The decrease in the** microelectronics market of \$7.1 million, or 13%, was primarily due to lower sales in micro material processing applications, PCB writing and the flat panel display market. Scientific and government program sales decreased \$2.8 million, or 9%, due to lower custom laser revenue due to exiting this business as well as lower demand for pumping, measuring and advanced research applications used by university and government research groups. Sales in the material processing market increased \$5.1 million, or 26%, primarily due to higher commercial laser shipments for non-metal cutting and marking applications. The increase in the OEM components and instrumentation market of \$1.5 million, or 4%, was due primarily to higher sales for medical and bioinstrumentation applications and increased sales for military applications, including \$2.8 million in revenues contributed by Nuvonyx (acquired in April 2007), partially offset by lower sales due to the sale of substantially all of the assets of CIOL in the fourth quarter of fiscal 2007.

Although we continue to have a sizeable backlog of orders, current market conditions make it difficult to predict future orders.

**Segments**

The following tables set forth, for the periods indicated, the amount of net sales and their relative percentages of total net sales by segment (dollars in thousands):

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	Three Months Ended			
	December 29, 2007		December 30, 2006	
	Amount	Percentage of total net sales	Amount	Percentage of total net sales
<b>Consolidated:</b>				
Commercial Lasers and Components (CLC)	\$ 68,604	47.6%	\$ 67,227	45.6%
Specialty Laser Systems (SLS)	75,667	52.4%	78,770	53.4%
Corporate and Other	25	0.0%	1,512	1.0%
Total	\$ 144,296	100.0%	\$ 147,509	100.0%

Net sales for the first quarter of fiscal 2008 decreased by \$3.2 million, or 2%, compared to the first quarter of fiscal 2007, with decreases of \$3.1 million, or 4%, in our SLS segment, decreases of \$1.5 million in Corporate and Other and increases of \$1.4 million, or 2%, in our CLC segment.

**The decrease in our SLS segment sales was primarily due to lower custom laser revenue as well as lower scientific applications sales to universities and lower semiconductor applications sales, partially offset by medical application sales. The increase**

in our CLC segment sales was primarily due to increased military application sales, including \$2.8 million in revenues contributed by Nuvonyx (acquired in April 2007), and increased bioinstrumentation and medical sales, partially offset by lower sales due to the sale of substantially all of the assets of CIOL in the fourth quarter of fiscal 2007. Corporate and Other sales decreased \$1.5 million in the first quarter of 2008 because of non-recurring royalty revenue from Luna Innovations, Inc. in the first quarter of fiscal 2007.

## **GROSS PROFIT**

### **Consolidated**

Our gross profit rate decreased to 41.9% from 42.0% in the first quarter of fiscal 2008 compared to the same period one year ago.

The 0.1% decrease in gross profit was primarily due to higher other costs (1.2%) including inventory provisions, duty and rework and a negative foreign exchange impact of approximately 1.0%. The decreases were almost completely offset by improved manufacturing efficiencies and lower materials costs (1.2%) and improved product mix, net of the impact of high margin royalty revenue from Luna Innovations in the first quarter of fiscal 2007 (0.9%).

Our gross profit rate has been and will continue to be affected by a variety of factors including market mix, manufacturing efficiencies, excess and obsolete inventory write-downs, warranty costs, pricing by competitors or suppliers, new product introductions, production volume, customization and reconfiguration of systems, commodity prices and foreign currency fluctuations.

### **Commercial Lasers and Components**

The gross profit rate in our CLC segment decreased to 42.2% from 45.4% in the first quarter of fiscal 2008 compared to the same period one year ago.

The 3.2% decrease in gross profit was primarily due to higher other costs (1.5%) due to higher inventory provisions and higher duties and freight, less favorable product mix (1.1%) due to increased volume in the materials processing market as well as lower margin business attributed to our April 2007 acquisition of Nuvonyx, partially offset by lower materials costs, and higher rework costs (0.5%).

### **Specialty Laser Systems**

The gross profit rate in our SLS segment increased to 42.3% from 39.3% in the first quarter of fiscal 2008 compared to the same period one year ago.



The 3.0% increase in our SLS segment was primarily due to more favorable product mix (3.6%) within the microelectronics, scientific and medical markets coupled with improved manufacturing efficiencies as well as lower warranty costs (0.6%) due to the continued benefit from reliability improvements, partially offset by higher other costs (0.7%) primarily due to higher inventory provisions, higher installation costs (0.3%) and higher rework costs (0.3%).

**OPERATING EXPENSES:**

	Three Months Ended			
	December 29, 2007		December 30, 2006	
	Amount	Percentage of total net sales	Amount	Percentage of total net sales
	(Dollars in thousands)			
Research and development	\$ 18,319	12.7%	\$ 18,322	12.4%
Selling, general and administrative	38,818	26.9%	33,484	22.7%
Restructuring and other charges		%	137	0.1%
Amortization of intangible assets	2,206	1.5%	1,943	1.3%
Total operating expenses	\$ 59,343	41.1%	\$ 53,886	36.5%

Research and development ( R&D ) expenses were flat during the first quarter of fiscal 2008 compared to the comparable period one year ago. Decreases due to lower stock-based compensation expense under SFAS 123(R) (\$0.3 million) and higher net reimbursements from customers for development projects (\$0.3 million), were offset by \$0.6 million higher project spending for tooling and supplies. On a segment basis, CLC project spending increased \$0.9 million, SLS project spending increased \$0.1 million and Corporate and Other spending decreased \$1.0 million.

Selling, general and administrative ( SG&A ) expenses increased \$5.3 million, or 16% during the first fiscal quarter of 2008 compared to the comparable period one year ago. The increase was primarily due to \$3.0 million higher costs related to our restatement of financial statements and litigation resulting from our internal stock option investigation, the impact of foreign currency exchange rates (\$1.0 million), higher legal and tax consulting costs (\$0.6 million), higher headcount related spending (\$0.5 million) and higher other spending (\$1.2 million) partially offset by \$0.5 million lower stock-based compensation expense under SFAS 123(R) and \$0.5 million lower expense due to lower gains on deferred compensation plan liabilities. On a segment basis, SLS expenses increased \$2.6 million due to higher headcount related expenses including the expansion into Asia, the impact of foreign currency exchange rates and higher depreciation of demonstration units. CLC expenses increased \$0.6 million primarily due to the impact of foreign currency exchange rates. Corporate and Other expenses increased \$2.1 million primarily due to \$3.0 million higher costs related to our restatement of financial statements and litigation resulting from our internal stock option investigation, offset by \$0.5 million lower stock-based compensation expense under SFAS 123(R) and \$0.5 million lower gains on deferred compensation plan liabilities.

Restructuring and other charges (recoveries) during the first quarter of fiscal 2007 were related to the \$0.3 million write-off of Excel acquisition related costs, primarily comprised of legal and consulting fees partially offset by \$0.2 million in adjustments to the estimated contractual obligation for lease and other facility costs of a previously vacated building, net of estimated sublease income.

Amortization of intangible assets increased \$0.3 million, or 14% in the first quarter of fiscal 2008 from the same period one year ago. The increases were primarily due the amortization of intangibles related to our April 2007 Nuvonyx acquisition.

#### **OTHER INCOME (EXPENSE)**

Other income, net of other expense, increased \$0.6 million during the first quarter of fiscal 2008 compared to the same quarter one year ago. The increase was primarily due to higher foreign currency exchange net gains (\$1.8 million) and lower interest expense (\$1.6 million) primarily due to the payoff of our convertible subordinated notes in the fourth quarter of fiscal 2007, partially offset by lower interest income (\$2.0 million) as a result of lower cash, cash equivalents and short-term investment balances, lower sublease income (\$0.3 million) and lower gains on deferred compensation plan assets (\$0.2 million).

#### **INCOME TAXES**

The effective tax rate on income before income taxes for the first quarter of fiscal 2008 of 32.8% was lower than the statutory rate of 35.0% due primarily to the benefit of foreign tax credits and research and development tax credits, partially offset by permanent differences related to deemed dividend inclusions under the Subpart F tax rules.

The effective tax rate on income before income taxes for the first quarter of fiscal 2007 of 19.5% was lower than the statutory rate of 35.0% due primarily to the benefit of foreign tax credits and research and development tax credits, including the retroactive reinstatement of the federal research and development tax credits in December 2006, partially offset by permanent differences related to deemed dividend inclusions under the Subpart F tax rules.

#### **FINANCIAL CONDITION**

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Sources and Uses of Cash**

Historically, our primary source of cash has been provided through operations. Other recent sources of cash include proceeds from our convertible subordinated note offering, proceeds received from the sale of stock through employee stock option and purchase plans, as well as through debt borrowings. Our historical uses of cash have primarily been for capital expenditures, acquisitions of businesses and technologies, payments of principal and interest on outstanding debt obligations and the repurchase of our common stock. Supplemental information pertaining to our historical sources and uses of cash is presented as follows and should be read in conjunction with our condensed consolidated statements of cash flows and the notes to condensed consolidated financial statements:

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	Three Months Ended	
	December 29, 2007	December 30, 2006
	(in thousands)	
Net cash provided by operating activities	\$ 13,077	\$ 28,734
Sales of shares under employee stock plans		3,784
Capital expenditures	(4,684)	(5,037)
Net payments on debt borrowings	(3)	(1)

Net cash provided by operating activities decreased by \$15.7 million for the first quarter of fiscal 2008 compared to the same period one year ago. The decrease in cash provided by operating activities was primarily due to lower cash flows from accounts receivable and prepaid expenses and lower net income partially offset by higher cash flows from other current liabilities. We believe that cash provided by operating activities will be adequate to cover our working capital needs, debt service requirements and planned capital expenditures for at least the next 12 months to the extent such items are known or are reasonably determinable based on current business and market conditions. However, we may elect to finance certain of our capital expenditure requirements through borrowings under our bank credit facilities or other sources of capital. We continue to follow our strategy to further strengthen our financial position by using available cash flow to fund operations.

We intend to continue pursuing acquisition opportunities at valuations we believe are reasonable based upon market conditions. However, we cannot accurately predict the timing, size and success of our acquisition efforts or our associated potential capital commitments. Furthermore, we cannot assure you that we will be able to acquire businesses on terms acceptable to us. We expect to fund future acquisitions through unrestricted cash balances and cash flows from operations. If required, we will look for additional borrowings or consider the issuance of securities. The extent to which we will be willing or able to use our common stock to make acquisitions will depend on its market value at the time and the willingness of potential sellers to accept it as full or partial payment.

Additional sources of cash available to us included a multi-currency line of credit and bank credit facilities totaling \$9.5 million as of December 29, 2007, of which \$9.4 million was unused and available. These credit facilities were used in Europe during the first quarter of fiscal 2008.

On February 12, 2008, the Company announced that the Board of Directors has authorized the Company to repurchase up to \$225 million of its common stock through a modified Dutch Auction tender offer and an additional \$25 million of its common stock, following the completion or termination of the tender offer, under its stock repurchase program, terminating no later than February 11, 2009.

Our ratio of current assets to current liabilities was 6.0:1 at December 29, 2007 compared to 5.2:1 at September 29, 2007. The increase in our ratio from September 29, 2007 to December 29, 2007 is primarily due to increases in cash, cash equivalents and short-term investments partially offset by decreases in income taxes payable and accounts receivable. Our cash position, short-term investments, working capital and current debt obligations are as follows:

	December 29, 2007	September 29, 2007
	(in thousands)	
Cash and cash equivalents	\$ 320,795	\$ 315,927
Short-term investments	67,569	45,896
Restricted cash, current	2,514	2,460
Working capital	572,513	536,833
Total debt obligations	29	30

### Current Restricted Cash

As part of our tender offer to purchase the remaining outstanding shares of Lambda Physik, we were required by local regulations to have funds available for the offer in an account located in Germany. As of December 29, 2007 and September 29, 2007, we had \$2.5 million restricted for remaining close out costs associated with our purchase of the remaining outstanding shares of Lambda Physik, which are included in current restricted cash on our consolidated balance sheets.

### Contractual Obligations and Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements as defined under Regulation S-K of the Securities Act of 1933. Information regarding our long-term debt payments, operating lease payments, obligations under SFAS 143, purchase commitments with suppliers and purchase obligations is provided in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the fiscal year ended September 29, 2007. There have been no material changes in contractual obligations since September 29, 2007. Information regarding our other financial commitments at December 29, 2007 is provided in the notes to the condensed consolidated financial statements in this filing.

During the first quarter of fiscal 2008, we adopted the provisions of FIN 48. We had historically classified interest and penalties and unrecognized tax benefits as current liabilities, but beginning with the adoption of FIN 48 we have reclassified gross interest and penalties and unrecognized tax benefits that are not expected to result in payment or receipt of cash within one year as non-current liabilities within the condensed consolidated balance sheets. As of December 29, 2007, we recorded gross unrecognized tax benefits of \$45.3 million and gross interest and penalties of \$5.2 million, both of which are classified as non-current liabilities in the condensed consolidated balance sheet. At this time, we are unable to make a reasonably reliable estimate of the timing of payments in individual years due to uncertainties in the timing of tax audit outcomes.

### Changes in Financial Condition

Cash provided by operating activities during the first quarter of fiscal 2008 was \$13.1 million, which included depreciation and amortization of \$8.2 million, net income of \$4.7 million, stock-based compensation expense of \$2.3 million and cash provided by operating assets and liabilities of \$1.5 million partially offset by increases in net deferred tax assets of \$3.4 million and other items aggregating \$0.2 million.

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Cash used in investing activities during the first quarter of fiscal 2008 was \$9.3 million, which included \$21.7 million, net, purchases of available-for-sale securities and \$4.7 million used to acquire property and equipment and improve buildings, partially offset by \$9.8 million proceeds from dispositions of property and equipment, \$6.5 million proceeds received from the sale of substantially all of the assets of CIOL in the fourth quarter of fiscal 2007 and \$0.8 million other.

Cash provided by financing activities during the first quarter of fiscal 2008 was less than \$0.1 million.

Changes in exchange rates during the first quarter of fiscal 2008 provided \$1.1 million, primarily due to the strengthening of the Euro and the Japanese Yen in relation to the U.S. dollar.

### **RECENT ACCOUNTING STANDARDS**

In June 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes, ( FIN 48 ) which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards (SFAS) 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. In addition, in

May 2007, the FASB issued FASB Staff Position No. FIN 48-1, Definition of Settlement in FASB Interpretation No. 48, ( FSP FIN 48-1 ) to amend FIN No. 48 by providing that previously unrecognized tax benefits can be recognized when the tax positions are effectively settled upon examination by a taxing authority. According to FSP FIN 48-1, an enterprise's tax position will be considered effectively settled if the taxing authority has completed its examination, the enterprise does not plan to appeal, and the possibility is remote that the taxing authority would reexamine the tax position in the future. We adopted FIN 48 and FSP FIN 48-1 for our fiscal year 2008 beginning September 30, 2007. See Note 11, Income Taxes of the condensed consolidated financial statements for additional information, including the effects of adoption on the Company's condensed consolidated financial statements.

In June 2006, the FASB ratified the consensus on Emerging Issues Task Force ( EITF ) Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement ( EITF 06-3 ) which requires a policy be adopted to present externally imposed taxes on revenue producing transactions on either a gross or net basis. Coherent's policy is to present such taxes on a gross basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. Taxes within the scope of this issue would include taxes that are imposed on a revenue transaction between a seller and a customer. We adopted EITF 06-3 for our fiscal year beginning September 30, 2007. The adoption of EITF 06-3 did not have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. SFAS 157 is effective for us for interim periods within our fiscal year beginning September 28, 2008. We are currently assessing the impact that the adoption of SFAS 157 will have on our consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 expands the use of fair value accounting but does not affect existing standards, which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure certain financial assets and financial liabilities, on an instrument-by-instrument basis. If the fair value option is elected, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for us for our fiscal year beginning September 28, 2008 with earlier adoption permitted. We have elected not to early adopt and are currently assessing the impact that the adoption of SFAS 159 will have on our consolidated financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised 2007) Business Combinations ( SFAS 141(R) ). SFAS 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. SFAS 141(R) also requires that acquisition related costs be recognized separately from the acquisition. SFAS 141(R) is effective for us for fiscal 2010. We are currently assessing the impact of SFAS 141(R) on our consolidated financial position and results of operations.

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

**Market risk disclosures**





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We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

### Interest rate sensitivity

A portion of our investment portfolio is composed of fixed income securities. These securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels at December 29, 2007, the fair value of the portfolio, based on quoted market prices, would decline by an immaterial amount. We have the ability to generally hold our fixed income investments until maturity and therefore we would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest rates on our securities portfolio. If necessary, we may sell short-term investments prior to maturity to meet our liquidity needs.

At December 29, 2007 the fair value of our available-for-sale debt securities was \$67.6 million, all of which were classified as short-term investments. Gross unrealized gains and losses on available-for-sale debt securities were \$351,000 and (\$65,000), respectively, at December 29, 2007.

### Foreign currency exchange risk

We maintain operations in various countries outside of the United States and foreign subsidiaries that manufacture and sell our products in various global markets. A majority of our sales are transacted in U.S. dollars. However, we do generate revenues in other currencies, primarily the Euro and Yen. As a result, our earnings and cash flows are exposed to fluctuations in foreign currency exchange rates. We attempt to limit these exposures through financial market instruments. We utilize derivative instruments, primarily forward contracts with maturities of twelve months or less, to manage our exposure associated with anticipated cash flows and net asset and liability positions denominated in foreign currencies. Gains and losses on the forward contracts are mitigated by gains and losses on the underlying instruments. We do not use derivative financial instruments for trading purposes.

We do not anticipate any material adverse effect on our consolidated financial position, results of operations or cash flows resulting from the use of these instruments. There can be no assurance that these strategies will be effective or that transaction losses can be minimized or forecasted accurately.

A hypothetical 10% appreciation of the forward adjusted U.S. dollar to December 29, 2007 market rates would decrease the unrealized value of our forward contracts by \$1.4 million. Conversely, a hypothetical 10% depreciation of the forward adjusted U.S. dollar to December 29, 2007 market rates would increase the unrealized value of our forward contracts by \$1.7 million.

The following table provides information about our foreign exchange forward contracts at December 29, 2007. The table presents the weighted average contractual foreign currency exchange rates, the value of the contracts in U.S. dollars at the contract exchange rate as of the contract maturity date and fair value. The U.S. notional fair value represents the contracted amount valued at December 29, 2007 rates.

Forward contracts to sell (buy) foreign currencies for U.S. dollars (in thousands, except contract rates):

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	<b>Average Contract Rate</b>	<b>U.S. Notional Contract Value</b>	<b>U.S. Notional Fair Value</b>
Euro	1.9667	\$ 10,817	\$ 7,915
British Pound Sterling	2.0507	\$ (6,767)	\$ (6,548)
Japanese Yen	113.0585	\$ (15,479)	\$ (15,563)
Canadian Dollar	1.0226	\$ 486	\$ 473
Korean Won	926.0216	\$ 1,555	\$ 1,539
Chinese RMB	7.2820	\$ 542	\$ 545

#### **Item 4. CONTROLS AND PROCEDURES**

##### **Management's Evaluation of Disclosure Controls and Procedures**

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as of December 29, 2007 ( Evaluation Date ). The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective for the purpose for which they were designed as of December 29, 2007.

##### **Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting that occurred during the quarter ended December 29, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

##### **Inherent Limitations over Internal Control**

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The Company's internal control over financial reporting includes those policies and procedures that:

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

Management, including the Company's Chief Executive Officer and Chief Financial Officer, does not expect that the Company's internal controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not 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 internal controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Also, any evaluation of the effectiveness of controls in future periods are subject to the risk that those internal controls may become inadequate because of changes in business conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

We are subject to legal claims and litigation arising in the ordinary course of business, such as product liability, employment or intellectual property claims, including, but not limited to, the matters described below. The outcome of any such matters is currently not determinable. Although we do not expect that such legal claims and litigation will ultimately have a material adverse effect on our consolidated financial position or results of operations, an adverse result in one or more matters could negatively affect our results in the period in which they occur.

#### **Derivative Lawsuits**

Between February 15, 2007 and March 2, 2007, three purported shareholder derivative lawsuits were filed in the United States District Court for the Northern District of California against certain of our current and former officers and directors. We are named as a nominal defendant. The complaints generally allege that the defendants breached their fiduciary duties and violated the securities laws in connection with the granting of stock options, the accounting treatment for such grants, the issuance of allegedly misleading public statements and stock sales by certain of the individual defendants. On May 29, 2007, these lawsuits were consolidated under the caption *In re Coherent, Inc. Shareholder Derivative Litigation*, Lead Case No. C-07-0955-JF (N.D. Cal.). On June 25, 2007, plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts causes of action for alleged violations of federal securities laws, violations of California securities laws, breaches of fiduciary duty and/or aiding and abetting breaches of fiduciary duty, abuse of control, gross mismanagement, constructive fraud, corporate waste, unjust enrichment, insider selling and misappropriation of information. The consolidated complaint seeks, among other relief, disgorgement and damages in an unspecified amount, an accounting, rescission of allegedly improper stock option grants, punitive damages and attorneys' fees and costs. To date, we have been paying the defense costs of the individual defendants.

In addition, our Board of Directors has appointed a Special Litigation Committee ( SLC ) comprised of independent director Sandeep Vij to investigate and evaluate the claims asserted in the derivative litigation and to determine what action(s) should be taken with respect to the derivative litigation. The SLC has retained legal counsel to assist it. The SLC's investigation is ongoing.

#### **SEC Inquiry**

In 2006, we were advised that the San Francisco District Office of the SEC is conducting an informal inquiry relating to our past granting of stock options. We are cooperating fully with the inquiry.

#### **Income Tax Audits**

The Internal Revenue Service ( IRS ) is conducting an audit of our 2003 and 2004 tax returns. The IRS has issued a number of Notices of Proposed Adjustments to these returns. Among other items, the IRS has challenged our research and development credits and our extraterritorial income ( ETI ) exclusion. We have agreed to the various adjustments proposed by the IRS and we believe that we adequately provided for these

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exposures and any other items identified by the IRS as a result of the audit of these tax years. As part of its audit of our 2003 and 2004 years, the IRS has requested information related to our stock option investigation and we will comply with this request and address any issues that are raised in a timely manner. The IRS has also indicated that it may consider an audit of our 2005 and 2006 tax returns.

The IRS is also auditing the research and development credits generated in the years 1999 through 2001 and carried forward to future tax years. We believe that we have adequately provided for any adjustments that may be proposed by the IRS related to these credits.

The German tax authorities are conducting an audit of our subsidiary in Göttingen for the tax years 1999 through 2005. We believe that we have adequately provided for any adjustments that may be proposed by the German tax authorities.

### **Other Matters**

As previously disclosed, the Company's proposed acquisition of Excel Technology, Inc. was the subject of a prohibition decision issued by the German Federal Cartel Office (FCO) in October 2006. While the agreement under which the Company was to acquire Excel was terminated, the Company is currently appealing the FCO's prohibition order to the appellate court in Germany.

**ITEM 1A. RISK FACTORS**

**BUSINESS ENVIRONMENT AND INDUSTRY TRENDS**

*Risks Associated with Our Industry, Our Business and Market Conditions*

**Our operating results, including net sales and stock price have varied in the past, and our future operating results will continue to be subject to quarterly and annual fluctuations based upon numerous factors, including those listed in this section and throughout this quarterly report. Our stock price will continue to be subject to daily variations as well. In addition, our future operating results and stock price may not follow any past trends.**

Our net sales and operating results may vary significantly from quarter to quarter and from year to year in the future. In particular we typically experience seasonality in our first fiscal quarter, resulting in lower net sales. We believe a number of factors, many of which are outside of our control, could cause these variations and make them difficult to predict, including:

- general economic uncertainties;
- fluctuations in demand for, and sales of, our products or prolonged downturns in the industries that we serve;
- the ability of our suppliers, both internal and external, to produce and deliver components and parts, including sole or limited source components, in a timely manner, in the quantity and quality desired and at the prices we have budgeted;
- timing or cancellation of customer orders and shipment scheduling;
- fluctuations in our product mix;
- foreign currency fluctuations;
- commodity pricing, including increases in oil prices;



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- introductions of new products and product enhancements by our competitors, entry of new competitors into our markets, pricing pressures and other competitive factors;
- our ability to develop, introduce, manufacture and ship new and enhanced products in a timely manner without defects;
- the rate of market acceptance of our new products;
- delays or reductions in customer purchases of our products in anticipation of the introduction of new and enhanced products by us or our competitors;
- maintenance of supply relating to products to the government on terms which we would prefer not to accept;
- our ability to control expenses;
- the level of capital spending of our customers;
- potential obsolescence of our inventory;
- costs and timing of adhering to developing governmental regulations on our products and business;
- SEC investigations and stockholder litigation related to our recent internal investigation of our practices related to historical stock option grants and the related restatement of our consolidated financial statements;
- the suspension of trading and subsequent delisting of our stock from trading on Nasdaq;
- costs related to acquisitions of technology or businesses; and
- distraction of management related to acquisition or divestment activities and the stock exchange listing processes.

In addition, we often recognize a substantial portion of our sales in the last month of the quarter. Our expenses for any given quarter are typically based on expected sales and if sales are below expectations in any given quarter, the adverse impact of the shortfall on our operating results may be magnified by our inability to adjust spending quickly enough to compensate for the shortfall. We also base our manufacturing on our forecasted product mix for the quarter. If the actual product mix varies significantly from our forecast, we may not be able to fill some orders during that quarter, which would result in delays in the

shipment of our products. Accordingly, variations in timing of sales, particularly for our higher priced, higher margin products, can cause significant fluctuations in quarterly operating results.

Due to these and other factors, we believe that quarter-to-quarter and year-to-year comparisons of our historical operating results may not be meaningful. You should not rely on our results for any quarter or year as an indication of our future performance. Our operating results in future quarters and years may be below public market analysts' or investors' expectations, which would likely cause the price of our stock to fall. In addition, over the past several years, the stock market has experienced extreme price and volume fluctuations that have affected the stock prices of many technology companies. There has not always been a direct correlation between this volatility and the performance of particular companies subject to these stock price fluctuations. These factors, as well as general economic and political conditions or investors' concerns regarding the credibility of corporate financial statements, may have a material adverse affect on the market price of our stock in the future.

**We are exposed to risks associated with worldwide economic slowdowns and related uncertainties.**

Concerns about consumer and investor confidence, volatile corporate profits and reduced capital spending, international conflicts, terrorist and military activity, civil unrest and pandemic illness could cause a slowdown in customer orders or cause customer order cancellations. In addition, political and social turmoil related to international conflicts and terrorist acts may put further pressure on economic conditions in the United States and abroad. Unstable political, social and economic conditions make it difficult for our customers, our suppliers and us to accurately forecast and plan future business activities. In particular, it is difficult to develop and implement strategy, sustainable business models and efficient operations, as well as effectively manage supply chain relationships in the face of such conditions. If such conditions persist, our business, financial condition and results of operations could suffer.

**We depend on sole source or limited source suppliers for some of our key components and materials, including exotic materials and crystals, in our products, which make us susceptible to supply shortages or price fluctuations that could adversely affect our business.**

We currently purchase several key components and materials used in the manufacture of our products from sole source or limited source suppliers, both internal and external. Some of these suppliers are relatively small private companies that may discontinue their operations at any time. We typically purchase our components and materials through purchase orders and we have no guaranteed supply arrangement with any of these suppliers. We may fail to obtain these supplies in a timely manner in the future. We may experience difficulty identifying alternative sources of supply for certain components used in our products. We would experience further delays while identifying, evaluating and testing the products of these potential alternative suppliers. Furthermore, financial or other difficulties faced by these suppliers or significant changes in demand for these components or materials could limit their availability. Any interruption or delay in the supply of any of these components or materials, or the inability to obtain these components and materials from alternate sources at acceptable prices and within a reasonable amount of time, would impair our ability to meet scheduled product deliveries to our customers and could cause customers to cancel orders.

We rely exclusively on our own production capability to manufacture certain strategic components, optics and optical systems, crystals, semiconductor lasers, lasers and laser-based systems. Because we manufacture, package and test these components, products and systems at our own facilities, and such components, products and systems are not readily available from other sources, any interruption in manufacturing would adversely affect our business. In addition, our failure to achieve adequate manufacturing yields of these items at our manufacturing facilities may materially and adversely affect our operating results and financial condition.

**Our future success depends on our ability to increase our sales volumes and decrease our costs to offset anticipated declines in the average selling prices ( ASPs ) of our products and, if we are unable to realize greater sales volumes and lower costs, our operating results may suffer.**

Our future success depends on the continued growth of the markets for lasers, laser systems, precision optics and related accessories, as well as our ability to identify, in advance, emerging markets for laser-based systems. We cannot assure you that we will be able to successfully identify, on a timely basis, new high-growth markets in the future. Moreover, we cannot assure you that new markets will develop for our products or our customers' products, or that our technology or pricing will enable such markets to develop. Future demand for our products is uncertain and will depend to a great degree on continued technological development and the introduction of new or enhanced products. If this does not continue, sales of our products may decline and our business will be harmed.

We have historically been the industry's high quality supplier of laser systems. We have, in the past, experienced decreases in the ASPs of some of our products. We anticipate that as competing products become more widely available, the ASPs of our products may decrease. If we are unable to offset the anticipated decrease in our ASPs by increasing our sales volumes, our net sales will decline. In addition, to maintain our gross margins, we must continue to reduce the cost of manufacturing our products while maintaining their high quality. From time to time, our products, like many complex technological products, may fail in greater frequency than anticipated. This can lead to further charges, which can result in higher costs, lower gross margins and lower operating results. Furthermore, as average ASPs of our current products decline, we must develop and introduce new products and product enhancements with higher margins. If we cannot maintain our gross margins, our operating results could be seriously harmed, particularly if the ASPs of our products decrease significantly.

**Our future success depends on our ability to develop and successfully introduce new and enhanced products that meet the needs of our customers.**

Our current products address a broad range of commercial and scientific research applications in the photonics markets. We cannot assure you that the market for these applications will continue to generate significant or consistent demand for our products. Demand for our products could be significantly diminished by disrupting technologies or products that replace them or render them obsolete. Furthermore, the new and enhanced products generally continue to be smaller in size and have lower ASPs, and therefore, we have to sell more units to maintain revenue levels.

During fiscal years 2007, 2006 and 2005, our research and development expenses have been in the range of 11% to 13% of net sales. Our future success depends on our ability to anticipate our customers' needs and develop products that address those needs. Introduction of new products and product enhancements will require that we effectively transfer production processes from research and development to manufacturing and coordinate our efforts with those of our suppliers to achieve volume production rapidly. If we fail to transfer production processes effectively, develop product enhancements or introduce new products in sufficient quantities to meet the needs of our customers as scheduled, our net sales may be reduced and our business may be harmed.

**We face risks associated with our foreign sales that could harm our financial condition and results of operations.**

For the first quarter of fiscal 2008, 65% of our net sales were derived from customers outside of the United States. For fiscal years 2007, 2006, and 2005, 68%, 68% and 65%, respectively, of our net sales were derived from customers outside of the United States. We anticipate that foreign sales will continue to account for a significant portion of our revenues in the foreseeable future. A global economic slowdown could have a negative effect on various foreign markets in which we operate. Such a slowdown may cause us to reduce our presence in certain countries, which may negatively affect the overall level of business in such countries. The majority of our foreign sales occur through our foreign sales subsidiaries and the remainder of our foreign sales result from exports to foreign distributors, resellers and customers. Our foreign operations and sales are subject to a number of risks, including:

- longer accounts receivable collection periods;
- the impact of recessions and other economic conditions in economies outside the United States;

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- unexpected changes in regulatory requirements;
- certification requirements;
- environmental regulations;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences;
- political and economic instability; and
- preference for locally produced products.

We are also subject to the risks of fluctuating foreign exchange rates, which could materially adversely affect the sales price of our products in foreign markets, as well as the costs and expenses of our foreign subsidiaries. While we use forward

exchange contracts and other risk management techniques to hedge our foreign currency exposure, we remain exposed to the economic risks of foreign currency fluctuations.

**We may not be able to protect our proprietary technology, which could adversely affect our competitive advantage.**

Maintenance of intellectual property rights and the protection thereof is important to our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We cannot assure you that our patent applications will be approved, that any patents that may be issued will protect our intellectual property or that any issued patents will not be challenged by third parties. Other parties may independently develop similar or competing technology or design around any patents that may be issued to us. We cannot be certain that the steps we have taken will prevent the misappropriation of our intellectual property, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

**We may, in the future, initiate claims or litigation against third parties for infringement of our proprietary rights to protect these rights or to determine the scope and validity of our proprietary rights or the proprietary rights of competitors. These claims could result in costly litigation and the diversion of our technical and management personnel. Adverse resolution of litigation may harm our operating results or financial condition.**

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. From time to time, like many other technology companies, we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which such third parties believe may cover certain of our products, processes, technologies or information. In the future, we may be a party to litigation to protect our intellectual property or as a result of an alleged infringement of others' intellectual property. These claims and any resulting lawsuit, if successful, could subject us to significant liability for damages or invalidation of our proprietary rights. These lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention. Any potential intellectual property litigation could also force us to do one or more of the following:

- stop manufacturing, selling or using our products that use the infringed intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, although such license may not be available on reasonable terms, or at all; or
- redesign the products that use the technology.

If we are forced to take any of these actions, our business may be seriously harmed. We do not have insurance to cover potential claims of this type.

**We are exposed to lawsuits in the normal course of business which could have a material adverse effect on our business, operating results, or financial condition.**

We are exposed to lawsuits in the normal course of our business, including product liability claims, if personal injury or death occurs from the use of our products. While we typically maintain customary levels of business insurance, including directors and officers policies, litigation can be expensive, lengthy, and disruptive to normal business operations, including the potential impact of indemnification obligations for individuals named in any such lawsuits. We may not, however, be able to secure insurance coverage on terms acceptable to us in the future. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit, including a recall or redesign of products if ultimately determined to be defective, could have a material adverse effect on our business, operating results, or financial condition.

**We depend on skilled personnel to operate our business effectively in a rapidly changing market, and if we are unable to retain existing or hire additional personnel when needed, our ability to develop and sell our products could be harmed.**

Our ability to continue to attract and retain highly skilled personnel will be a critical factor in determining whether we will be successful in the future. Recruiting and retaining highly skilled personnel in certain functions continues to be difficult. At certain locations where we operate, the cost of living is extremely high and it may be difficult to retain key employees and management at a reasonable cost. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Our failure to attract additional employees and retain our existing employees could adversely affect our growth and our business.



Our future success depends upon the continued services of our executive officers and other key engineering, sales, marketing, manufacturing and support personnel, any of whom may leave, which could harm our business and our results of operations.

**The long sales cycles for our products may cause us to incur significant expenses without offsetting revenues.**

Customers often view the purchase of our products as a significant and strategic decision. As a result, customers typically expend significant effort in evaluating, testing and qualifying our products before making a decision to purchase them, resulting in a lengthy initial sales cycle. While our customers are evaluating our products and before they place an order with us, we may incur substantial sales and marketing and research and development expenses to customize our products to the customer's needs. We may also expend significant management efforts, increase manufacturing capacity and order long lead-time components or materials prior to receiving an order. Even after this evaluation process, a potential customer may not purchase our products. As a result, these long sales cycles may cause us to incur significant expenses without ever receiving revenue to offset such expenses.

**The markets in which we sell our products are intensely competitive and increased competition could cause reduced sales levels, reduced gross margins or the loss of market share.**

Competition in the various photonics markets in which we provide products is very intense. We compete against a number of large public and private companies, including Newport Corporation; Excel Technology, Inc.; JDS Uniphase Corporation; Rofin-Sinar Technologies, Inc.; Trumpf GmbH; IPG Photonics Corporation; and Cymer, Inc., as well as other smaller companies. Some of our competitors are large companies that have significant financial, technical, marketing and other resources. These competitors may be able to devote greater resources than we can to the development, promotion, sale and support of their products. Some of our competitors are much better positioned than we are to acquire other companies in order to gain new technologies or products that may displace our product lines. Any of these acquisitions could give our competitors a strategic advantage. Any business combinations or mergers among our competitors, forming larger competitors with greater resources, could result in increased competition, price reductions, reduced margins or loss of market share, any of which could materially and adversely affect our business, results of operations and financial condition.

Additional competitors may enter the market and we are likely to compete with new companies in the future. We may encounter potential customers that, due to existing relationships with our competitors, are committed to the products offered by these competitors. As a result of the foregoing factors, we expect that competitive pressures may result in price reductions, reduced margins and loss of market share. For example, in markets where there are a limited number of customers, such as the microelectronics market, competition is particularly intense.

**Some of our laser systems are complex in design and may contain defects that are not detected until deployed by our customers, which could increase our costs and reduce our revenues.**

Laser systems are inherently complex in design and require ongoing regular maintenance. The manufacture of our lasers, laser products and systems involves a highly complex and precise process. As a result of the technological complexity of our products, changes in our or our suppliers' manufacturing processes or the inadvertent use of defective materials by us or our suppliers could result in a material adverse effect on our ability to achieve acceptable manufacturing yields and product reliability. To the extent that we do not achieve and maintain our projected yields or product reliability, our business, operating results, financial condition and customer relationships would be adversely affected. We provide warranties on certain of our product sales, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of failure rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs for each product line. If actual return rates and/or repair

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and replacement costs differ significantly from our estimates, adjustments to cost of sales may be required in future periods.

Our customers may discover defects in our products after the products have been fully deployed and operated under peak stress conditions. In addition, some of our products are combined with products from other vendors, which may contain defects. As a result, should problems occur, it may be difficult to identify the source of the problem. If we are unable to identify and fix defects or other problems, we could experience, among other things:

- loss of customers;
- increased costs of product returns and warranty expenses;

- damage to our brand reputation;
- failure to attract new customers or achieve market acceptance;
- diversion of development and engineering resources; and
- legal actions by our customers and/or their end users.

The occurrence of any one or more of the foregoing factors could seriously harm our business, financial condition and results of operations.

**If we fail to accurately forecast component and material requirements for our products, we could incur additional costs and incur significant delays in shipments, which could result in loss of customers.**

We use rolling forecasts based on anticipated product orders and material requirements planning systems to determine our product requirements. It is very important that we accurately predict both the demand for our products and the lead times required to obtain the necessary components and materials. We depend on our suppliers for most of our product components and materials. Lead times for components and materials that we order vary significantly and depend on factors including the specific supplier requirements, the size of the order, contract terms and current market demand for components. For substantial increases in our sales levels, some of our suppliers may need at least six months lead-time. If we overestimate our component and material requirements, we may have excess inventory, which would increase our costs. If we underestimate our component and material requirements, we may have inadequate inventory, which could interrupt and delay delivery of our products to our customers. Any of these occurrences would negatively impact our net sales, business or operating results.

**Our increased reliance on contract manufacturing may adversely impact our financial results and operations.**

Our manufacturing strategy includes partnering with contract manufacturers to outsource non-core subassemblies and less complex turnkey products, including some performed at international sites located in Asia and Eastern Europe. Our ability to resume internal manufacturing operations for certain products in a timely manner may be eliminated. The cost, quality, performance and availability of contract manufacturing operations are and will be essential to the successful production and sale of many of our products. The inability of any contract manufacturer to meet our cost, quality, performance and availability standards could adversely impact our financial condition or results of operations. We may not be able to provide contract manufacturers with product volumes that are high enough to achieve sufficient cost savings. If shipments fall below forecasted levels, we may incur increased costs or be required to take ownership of the inventory. Also, our ability to control the quality of products produced by contract manufacturers may be limited and quality issues may not be resolved in a timely manner, which could adversely impact our financial condition or results of operations.

**If we fail to manage our growth effectively, our business could be disrupted, which could harm our operating results.**

Our ability to successfully offer our products and implement our business plan in evolving markets requires an effective planning and management process. We continue to expand the scope of our operations domestically and internationally. The growth in sales, combined with the challenges of managing geographically-dispersed operations, has placed a significant strain on our management systems and resources, and our anticipated growth in future operations could continue to place such a strain. The failure to effectively manage our growth could disrupt our business and harm our operating results.

**Any acquisitions we make could disrupt our business and harm our financial condition.**

We have in the past made strategic acquisitions of other corporations and entities, including asset purchases, and we continue to evaluate potential strategic acquisitions of complementary companies, products and technologies. In the event of any future acquisitions, we could:

- issue stock that would dilute our current stockholders' percentage ownership;
- pay cash;
- incur debt;
- assume liabilities; or

- incur expenses related to in-process research and development, impairment of goodwill and amortization.

These purchases also involve numerous risks, including:

- problems combining the acquired operations, technologies or products;
- unanticipated costs or liabilities, including the costs associated with improving the internal controls of the acquired company;
- diversion of management's attention from our core businesses;
- adverse effects on existing business relationships with suppliers and customers;
- potential loss of key employees, particularly those of the purchased organizations; and
- the failure to complete acquisitions even after signing definitive agreements which, among other things, would result in the expensing of potentially significant professional fees and other charges in the period in which the acquisition or negotiations are terminated.

We cannot assure you that we will be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future, which may harm our business.

**We use standard laboratory and manufacturing materials that could be considered hazardous and we could be liable for any damage or liability resulting from accidental environmental contamination or injury.**

Although most of our products do not incorporate hazardous or toxic materials and chemicals, some of the gases used in our excimer lasers and some of the liquid dyes used in some of our scientific laser products are highly toxic. In addition, our operations involve the use of standard laboratory and manufacturing materials that could be considered hazardous. Also, if a facility fire were to occur at our Tampere, Finland, site and were to spread to a reactor used to grow semiconductor wafers, it could release highly toxic emissions. We believe that our safety procedures for handling and disposing of such materials comply with all federal, state and offshore regulations and standards. However, the risk of accidental environmental contamination or injury from such materials cannot be entirely eliminated. In the event of such an accident involving such materials, we could be liable for damages and such liability could exceed the amount of our liability insurance coverage and the resources of our business.

**Compliance or the failure to comply with current and future environmental regulations could cause us significant expense.**

We are subject to a variety of federal, state, local and foreign environmental regulations relating to the use, storage, discharge and disposal of hazardous chemicals used during our manufacturing process or requiring design changes or recycling of products we manufacture. If we fail to comply with any present and future regulations, we could be subject to future liabilities, the suspension of production or a prohibition on the sale of products we manufacture. In addition, such regulations could restrict our ability to expand our facilities or could require us to acquire costly equipment, or to incur other significant expenses to comply with environmental regulations, including expenses associated with the recall of any non-compliant product and the management of historical waste.

From time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. We continue to evaluate the necessary steps for compliance with regulations as they are enacted. These regulations include, for example, the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive ( RoHS ) and the Waste Electrical and Electronic Equipment Directive ( WEEE ) enacted in the European Union which regulate the use of certain hazardous substances in, and require the collection, reuse and recycling of waste from, certain products we manufacture. This and similar legislation that has been or is in the process of being enacted in Japan, China, Korea and various states of the United States may require us to re-design our products to ensure compliance with the applicable standards, for example by requiring the use of different types of materials. These re-designs or alternative materials may detrimentally impact the performance of our products, add greater testing lead-times for product introductions or have other similar effects. We believe we comply with all such legislation where our products are sold and we will continue to monitor these laws and the regulations being adopted under them to determine our responsibilities. In addition, we are monitoring legislation relating to the reduction of carbon emissions from industrial operations to determine whether

we may be required to incur any additional material costs or expenses associated with our operations. We are not currently aware of any such material costs or expenses. Our failure to comply with any of the foregoing regulatory requirements or contractual obligations could result in our being directly or indirectly liable for costs, fines or penalties and third-party claims, and could jeopardize our ability to conduct business in the United States and foreign countries.

**If our facilities were to experience catastrophic loss, our operations would be seriously harmed.**

Our facilities could be subject to a catastrophic loss from fire, flood, earthquake or terrorist activity. A substantial portion of our research and development activities, manufacturing, our corporate headquarters and other critical business operations are located near major earthquake faults in Santa Clara, California, an area with a history of seismic events. Any such loss at any of our facilities could disrupt our operations, delay production, shipments and revenue and result in large expenses to repair or replace the facility. While we have obtained insurance to cover most potential losses, after reviewing the costs and limitations associated with earthquake insurance, we have decided not to procure such insurance. We believe that this decision is consistent with decisions reached by numerous other companies located nearby. We cannot assure you that our existing insurance coverage will be adequate against all other possible losses.

**Provisions of our charter documents, Delaware law, our Common Shares Rights Plan, and our Change-of-Control Severance Plan may have anti-takeover effects that could prevent or delay a change in control.**

Provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition or make removal of incumbent directors or officers more difficult. These provisions may discourage takeover attempts and bids for our common stock at a premium over the market price. These provisions include:

- the ability of our board of directors to alter our bylaws without stockholder approval;
- limiting the ability of stockholders to call special meetings; and
- establishing advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

We are subject to Section 203 of the Delaware General Corporation Law, which prohibits a publicly held Delaware corporation from engaging in a merger, asset or stock sale or other transaction with an interested stockholder for a period of three years following the date such person became an interested stockholder, unless prior approval of our board of directors is obtained or as otherwise provided. These provisions of Delaware law also may discourage, delay or prevent someone from acquiring or merging with us without obtaining the prior approval of our board of directors, which may cause the market price of our common stock to decline. In addition, we have adopted a change of control severance plan, which provides for the payment of a cash severance benefit to each eligible employee based on the employee's position. If a change of control occurs, our successor or acquirer will be required to assume and agree to perform all of our obligations under the change of control severance plan.

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Our common shares rights agreement permits the holders of rights to purchase shares of our common stock to exercise the stock purchase rights following an acquisition of or merger by us with another corporation or entity, following a sale of 50% or more of our consolidated assets or earning power, or the acquisition by an individual or entity of 20% or more of our common stock. Our successor or acquirer is required to assume all of our obligations and duties under the common shares rights agreement, including in certain circumstances the issuance of shares of its capital stock upon exercise of the stock purchase rights. The existence of our common shares rights agreement may have the effect of delaying, deferring or preventing a change of control and, as a consequence, may discourage potential acquirers from making tender offers for our shares.

### **Changes in tax rates, tax liabilities or tax accounting rules could affect future results.**

As a global company, we are subject to taxation in the United States and various other countries and jurisdictions. Significant judgment is required to determine worldwide tax liabilities. Our future tax rates could be affected by changes in the composition of earnings in countries with differing tax rates, changes in the valuation of our deferred tax assets and liabilities, or changes in the tax laws. In addition, we are subject to regular examination of our income tax returns by the Internal Revenue Service ( IRS ) and other tax authorities. We regularly assess the likelihood of favorable or unfavorable outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. Although we believe our tax estimates are reasonable, there can be no assurance that any final determination will not be materially



different than the treatment reflected in our historical income tax provisions and accruals, which could materially and adversely affect our operating results and financial condition.

**Compliance with changing regulation of corporate governance and public disclosure may create uncertainty regarding compliance matters.**

Federal securities laws, rules and regulations, as well as the rules and regulations of self-regulatory organizations such as Nasdaq and the NYSE, require companies to maintain extensive corporate governance measures, impose comprehensive reporting and disclosure requirements, set strict independence and financial expertise standards for audit and other committee members and impose civil and criminal penalties for companies and their chief executive officers, chief financial officers and directors for securities law violations. These laws, rules and regulations have increased and will continue to increase the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management's attention from business operations. Changing laws, regulations and standards relating to corporate governance and public disclosure may create uncertainty regarding compliance matters. New or changed laws, regulations and standards are subject to varying interpretations in many cases. As a result, their application in practice may evolve over time. We are committed to maintaining high standards of ethics, corporate governance and public disclosure. Complying with evolving interpretations of new or changed legal requirements may cause us to incur higher costs as we revise current practices, policies and procedures, and may divert management time and attention from revenue generating to compliance activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may also be harmed.

**Governmental regulations affecting the import or export of products could negatively affect our revenues.**

The United States and various foreign governments have imposed controls, export license requirements and restrictions on the import or export of some technologies, especially encryption technology. In addition, from time to time, governmental agencies have proposed additional regulation of encryption technology, such as requiring the escrow and governmental recovery of private encryption keys. Governmental regulation of encryption technology and regulation of imports or exports, or our failure to obtain required import or export approval for our products, could harm our international and domestic sales and adversely affect our revenues.

**We may experience difficulties with our enterprise resource planning ( ERP ) system and other IT systems. System failure or malfunctioning may result in disruption of operations and the inability to process transactions, and this could adversely affect our ability to timely or accurately provide our financial results.**

System failure or malfunctioning could disrupt our ability to timely and accurately process and report key components of our results of operations, financial position and cash flows. Any disruptions or difficulties that may occur in connection with our ERP system or other systems could also adversely affect our ability to complete important business processes such as the evaluation of our internal controls and attestation activities pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. If we encounter unforeseen problems with regard to our ERP system or other systems, our business and resulting financial reporting could be adversely affected.

**Our market is unpredictable and characterized by rapid technological changes and evolving standards, and, if we fail to address changing market conditions, our business and operating results will be harmed.**

The photonics industry is characterized by extensive research and development, rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Because this market is subject to rapid change, it is difficult to predict its potential size or future growth rate. Our success in generating revenues in this market will depend on, among other things:

- maintaining and enhancing our relationships with our customers;
- the education of potential end-user customers about the benefits of lasers, laser systems and precision optics; and
- our ability to accurately predict and develop our products to meet industry standards.

For the first quarter of fiscal 2008, our research and development costs were \$18.3 million (12.7% of net sales). For our fiscal years 2007, 2006 and 2005, our research and development costs were \$74.6 million (12.4% of net sales), \$73.1 million (12.5% of net sales) and \$57.4 million (11.1% of net sales), respectively. We cannot assure you that our expenditures for research and development will result in the introduction of new products or, if such products are introduced, that those

products will achieve sufficient market acceptance. Our failure to address rapid technological changes in our markets could adversely affect our business and results of operations.

**Continued volatility in the semiconductor manufacturing industry could adversely affect our business, financial condition and results of operations.**

Our net sales depend in part on the demand for our products by semiconductor equipment companies. The semiconductor market has historically been characterized by sudden and severe cyclical variations in product supply and demand, which have often severely affected the demand for semiconductor manufacturing equipment, including laser-based tools and systems. The timing, severity and duration of these market cycles are difficult to predict, and we may not be able to respond effectively to these cycles. The continuing uncertainty in this market severely limits our ability to predict our business prospects or financial results in this market.

During industry downturns, our revenues from this market may decline suddenly and significantly. Our ability to rapidly and effectively reduce our cost structure in response to such downturns is limited by the fixed nature of many of our expenses in the near term and by our need to continue our investment in next-generation product technology and to support and service our products. In addition, due to the relatively long manufacturing lead times for some of the systems and subsystems we sell to this market, we may incur expenditures or purchase raw materials or components for products we cannot sell. Accordingly, downturns in the semiconductor capital equipment market may materially harm our operating results. Conversely, when upturns in this market occur, we must be able to rapidly and effectively increase our manufacturing capacity to meet increases in customer demand that may be extremely rapid, and if we fail to do so we may lose business to our competitors and our relationships with our customers may be harmed.

**Matters related to our voluntary review of our historical stock option granting practices and the restatement of our financial statements may result in additional litigation, regulatory proceedings and government enforcement actions.**

Our historical stock option granting practices and the restatement of our financial statements for periods from fiscal 1995 to the quarter ended July 1, 2006 have exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement actions. For more information regarding our current litigation and related inquiries, please see Part II, Item 1 Legal Proceedings as well as the other risk factors related to litigation set forth in this section. We have provided the results of our internal review to the Securities and Exchange Commission ( SEC ), and in that regard we have responded to informal requests from the SEC. We intend to continue to cooperate with the SEC. No assurance can be given regarding the outcomes from litigation, regulatory proceedings or any applicable government enforcement actions relating to our past stock option practices which may arise. The resolution of these matters may be time consuming, expensive, and may distract management from the conduct of our business. Furthermore, if we are subject to adverse findings in litigation, regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

In addition, while we believe that we have made appropriate judgments in determining the correct measurement dates for our stock option grants and the disclosures related thereto, in reviewing our annual report on Form 10-K for the period ended September 30, 2006, the SEC may make further inquiry with regards to the manner in which we accounted for and reported, or not reported, the corresponding financial impact. Accordingly, there is a risk that we may have to further revise the disclosures herein or to further restate our prior financial statements, amend prior filings with the SEC, or take other actions not currently contemplated.

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On December 18, 2007, we announced that the Securities and Exchange Commission ( SEC ) notified us that it had denied our motion to stay the decision of the Board of Directors of The NASDAQ Stock Market LLC ( Nasdaq ), to suspend and delist our common stock. Therefore, effective at the opening of business on Wednesday, December 19, 2007, our common stock was suspended from trading on the Nasdaq Global Select Market, and was subsequently delisted. Following our delisting from the Nasdaq Global Select Market, we began trading on the Pink Sheet Electronic Quotation Service.

The trading of our common stock over the counter may negatively impact the trading price of our common stock and the levels of liquidity available to our stockholders. In addition, the trading of our common stock over the counter will materially adversely affect our access to the capital markets and our ability to raise capital through alternative financing sources on terms acceptable to us or at all. Securities that trade over the counter are no longer eligible for margin loans, and a company trading over the counter cannot avail itself of federal preemption of state securities or blue sky laws, which adds substantial compliance costs to securities issuances, including pursuant to employee option plans, stock purchase plans and private or public offerings of securities. There may also be other negative implications, including the potential loss of confidence by suppliers, customers and employees and the loss of institutional investor interest in our company.

**We have been named as a nominal party to a consolidated shareholder derivative lawsuit relating to our historical stock option practices, and we may be named in additional lawsuits in the future. In addition, a number of our current and former directors and officers were also named in this lawsuit. This litigation could become time consuming and expensive and could result in the payment of significant judgments and settlements, which could have a material adverse effect on our financial condition and results of operations.**

In connection with our historical stock option practices and resulting restatement, three derivative actions were filed against certain of our current and former directors and officers purporting to assert claims on the Company's behalf, which were consolidated into a single action. Please see Part II, Item 1 Legal Proceedings. There may be additional lawsuits of this nature filed in the future. We cannot predict the outcome of these lawsuits, nor can we predict the amount of time and expense that will be required to resolve these lawsuits. If these lawsuits become time consuming and expensive, or if there are unfavorable outcomes in any of these cases, there could be a material adverse effect on our business, financial condition and results of operations.

Our insurance coverage will not cover our total liabilities and expenses in these lawsuits, in part because we have a significant deductible on certain aspects of the coverage. In addition, subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices and the related litigation and ongoing government inquiry. We currently hold insurance policies for the benefit of our directors and officers, although our insurance coverage may not be sufficient in some or all of these matters. Furthermore, the insurers may seek to deny or limit coverage in some or all of these matters, in which case we may have to self-fund all or a substantial portion of our indemnification obligations.

**We are subject to the risks of additional government actions, shareholder lawsuits and other legal proceedings related to our historical stock option practices, the resulting restatements, and the remedial measures we have taken.**

It is possible that there may be additional governmental actions, shareholder lawsuits and other legal proceedings brought against us in connection with our historical stock option practices. In addition, we may be sued or taken to arbitration by former officers and employees in connection with their stock options and other matters. These proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as the adverse resolution of any specific lawsuit, could have a material adverse effect on our business, financial condition and results of operations.

**Failure to maintain effective internal controls may cause us to delay filing our periodic reports with the SEC and adversely affect our stock price.**

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on internal control over financial reporting in their annual reports on Form 10-K that contain an assessment by management of the effectiveness of the Company's internal control over financial reporting. In addition, our independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of our internal control over financial reporting. Although we review our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, our failure to maintain adequate internal controls over financial reporting could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact our stock price.



**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**Item 5. OTHER INFORMATION**

Not applicable.

**Item 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
10.1*	2008 Officer s Variable Compensation Plan (A description of the summary of this exhibit was previously filed under item 5.02 of Form 8-K filed on December 19, 2007.)
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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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\* These exhibits were previously filed with the Commission as indicated and are incorporated herein by reference.

Identifies management contract or compensatory plans or arrangements required to be filed as an exhibit.



**COHERENT, INC.**

**SIGNATURES**

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

**Coherent, Inc.**  
(Registrant)

February 12, 2008

/s/:

**JOHN R. AMBROSEO**  
John R. Ambroseo  
President and Chief Executive Officer  
(Principal Executive Officer)

February 12, 2008

/s/:

**HELENE SIMONET**  
Helene Simonet  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

**EXHIBIT INDEX**

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