

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-K**

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the fiscal year ended June 30, 2005

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 0-23125

**OSI SYSTEMS, INC.**

(Exact name of Registrant as specified in its charter)

**California**  
(State or Other Jurisdiction  
of Incorporation or Organization)

**12525 Chadron Avenue, Hawthorne, California**  
(Address of Principal Executive Offices)

**33-0238801**  
(I.R.S. Employer  
Identification No.)

**90250**  
(Zip Code)

**Registrant's Telephone Number, Including Area Code: (310) 978-0516**

**Securities registered pursuant to Section 12(b) of the Act: None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, no par value**  
(Title of Class)

Indicate by check mark whether the Registrant (1) 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 at least the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes ☒ No ☐

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

As of December 31, 2004 (the last day of the Registrant's second quarter of fiscal year 2005), the aggregate market value of the shares of the Registrant's Common Stock held by non-affiliates was approximately \$340,696,169, based on the last sales price of the Registrant's Common Stock on the NASDAQ National Market on such date. Shares of Common Stock held by each officer and director and by each person who owns more than 5% or more of the outstanding Common Stock of the Registrant have been excluded in that such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the Registrant's Common Stock outstanding as of September 23, 2005 was 16,245,224.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders (to be filed subsequently) are incorporated by reference into Part III.

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## PART I

### Forward Looking Statements

This report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements relate to expectations concerning matters that are not historical facts. Words such as “projects,” “believes,” “anticipates,” “plans,” “expects,” “intends” and similar words and expressions are intended to identify forward-looking statements. We believe that the expectations reflected in the forward-looking statements are reasonable, but those expectations may not prove to be correct. Important factors that could cause our actual results to differ materially from those expectations are disclosed in this report, including, without limitation, in the “Risk Factors That May Affect Operating Results” described in Item 7. All forward-looking statements are expressly qualified in their entirety by these factors and all related cautionary statements. We do not undertake any obligation to update any forward-looking statements.

### ITEM 1. BUSINESS

#### General

OSI Systems, Inc. and its subsidiaries is a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems. Our company was incorporated in 1987 in California. Our principal office is located at 12525 Chadron Avenue, Hawthorne, California 90250.

We design, manufacture and market security and inspection systems worldwide to end users under the “Rapiscan Systems” brand name. Rapiscan Systems products are used to inspect baggage, cargo, people, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening.

Our medical monitoring and anesthesia systems businesses design, manufacture and market their products worldwide to end users under several brand names. Our medical monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and related services are sold under the “Spacelabs Medical” brand name. Our anesthesia systems and components are sold under the “Blease” brand name. Our arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools, are sold under the “Dolphin” brand name and our peripheral bone densitometers and ultrasound bone sonometers are sold under the “Osteometer” brand name.

Our optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We design and manufacture optoelectronic devices and value-added subsystems worldwide for others through original equipment manufacturer arrangements, as well as for our own security and medical equipment businesses.

In fiscal year 2005, revenues from the sale of security and inspection systems amounted to \$123.2 million, or approximately 32% of our revenues. Revenues from the sale of medical monitoring and anesthesia systems amounted to \$195.7 million, or approximately 51% of our revenues. Revenues from the sale of optoelectronic devices and value-added subsystems amounted to \$66.1 million, or approximately 17% of revenues. Additional information concerning reporting segments is available in Note 13 to our financial statements.

## Industry Overview

We sell our security and inspection systems and medical monitoring and anesthesia systems primarily to end-users, while we design and manufacture our optoelectronic devices and value-added subsystems primarily for original equipment manufacturers.

**Security and Inspection Systems.** A variety of technologies are currently used worldwide in security and inspection applications, including: computed tomography, transmission and backscatter x-ray, metal detection, trace detection and x-ray, gamma-ray and neutron analysis. We believe that the market for security and inspection products will continue to be affected by the threat of terrorist incidents and by new government mandates and appropriations for security and inspection products in the United States and internationally.

In the 1970s, principally in response to civilian airline hijackings, the United States Government established security standards by setting guidelines for the screening of carry-on baggage for weapons. The United Nations later mandated these standards for adoption by all of its member states. Additionally, since 1998 the United Kingdom Department of Transport has required that its commercial airports deploy systems for 100% screening of international checked baggage. The International Civil Aviation Organization, an organization of 188 member states, has agreed to implement screening of 100% of all checked baggage by January 1, 2006 and the European Civil Aviation Conference, an organization of 41 member states has agreed to implement 100% screening of international checked baggage in the future. To date, the imposition of these and other standards has resulted in the installation of over 10,000 x-ray inspection systems worldwide.

In the United States, largely in response to the explosion of Pan Am Flight 103 in December 1988, Congress enacted the Aviation Security Improvement Act of 1990, which directed the air transportation regulatory authorities to establish and implement strict security measures and to deploy advanced technologies for the detection of explosives. Then, in July 1996, in response to a White House commission report on aviation safety and security, Congress enacted additional legislation appropriating monies for the initial deployment of advanced security and inspection technologies at major airports throughout the country.

The September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon using hijacked airliners has since led to nation-wide shifts in transportation and facilities security policies. Shortly following these attacks, Congress passed the Aviation and Transportation Security Act and integrated many U.S. security-related agencies, including the Federal Aviation Administration, into the U.S. Department of Homeland Security. Under its directive from Congress, the U.S. Department of Homeland Security has since undertaken numerous projects such as ones designed to distinguish terrorists from benign visitors entering the country, to prevent terrorists from obtaining and trafficking in weapons of mass destruction and their components, to secure sensitive U.S. technologies and to identify and screen high-risk cargo containers before they are loaded onto vessels destined for the U.S., among others. These projects, known, for example, as the America Shield Initiative, the Customs-Trade Partnership Against Terrorism and the U.S. Customs and Border Protection Container Security Initiative, have resulted in an increased demand for security and inspection products both in the United States and other nations.

Projects underway in the United States, such as the U.S. Customs and Border Protection Container Security Initiative and the Customs-Trade Partnership Against Terrorism, have created a ripple effect in other areas of the world because they call on other nations to bolster their port security strategies, including by acquiring or improving their security and inspection equipment. The international market for non-intrusive inspection equipment, therefore, continues to expand as countries that ship goods directly to the United States are required to improve their security infrastructure.

Furthermore, the U.S. Department of Homeland Security's Science and Technology Directorate has supported the development of new security inspection technologies and products. Our security and inspection systems group participates in a number of such research and development efforts, including projects to develop

new radiation and nuclear materials detection, aviation screening and suicide bomber detection technologies. The Science and Technology Directorate has also initiated programs for the development of technologies capable of protecting highways, railways and waterways from terrorist attack.

At the same time, the U.S. Department of Defense has recently established Northern Command in order to integrate many homeland military defense missions that had previously been performed by various branches and departments of the military. Northern Command has since begun to harden U.S. military bases against terrorist attack and has taken on missions to better safeguard locations within the United States that are considered critical infrastructure sites. Both of these activities often demand the purchase of security and inspection technologies. In addition to these homeland protection activities, the U.S. Department of Defense has also begun to invest more heavily in technologies and services that screen would-be attackers before they are able to reach soldiers and private-sector contractors deployed in overseas war zones such as Afghanistan and Iraq as well as other international areas of operation and military bases.

Similar initiatives by international organizations such as the European Union have also resulted in a growing worldwide demand for airline, cargo, port and border inspection technologies. For example, the European Union has mandated that all x-ray inspection systems used in the screening of airline carry-on baggage must, by July 2006, meet certain uniform performance criteria. The European Union is also expected to issue uniform performance standards for people, cargo, mail and parcel and hold baggage screening systems as well as new directives related specifically to maritime security. We anticipate that the promulgation of these new standards will establish performance baselines against which our security and inspection systems group will be able to direct certain of its research and development spending and market its products to customers located in the European Union.

As a result of these and other changes, sales of our security and inspection products have grown as compared to pre-September 11, 2001 levels. Major international projects recently installed or currently underway include system installations in Hong Kong, India, Jamaica, Malaysia, Mexico, Romania, South Korea and Taiwan, among others. These sites contain various cargo inspection product offerings including mobile, fixed and relocatable high-energy x-ray, mobile gamma-ray and hybrid x-ray/thermo neutron analysis scanning systems. We anticipate that there may be growing demand from governments and commercial enterprises for increasingly sophisticated solutions to screening vehicles, trucks, ocean-going cargo, rail cars and air pallet containers.

***Medical Monitoring and Anesthesia Systems.*** Though a well established market, healthcare is a rapidly growing sector of the U.S., Asian and European economies. An aging population that is requiring a growing number of critical care beds is, in part, fueling this growth.

Many factors such as a severe nursing shortage in the United States and Europe, stricter government requirements affecting the staffing and accountability and shrinking reimbursements from health insurance organizations are forcing healthcare providers to do more with less—improving patient safety and economic efficiencies with fewer resources. Our medical monitoring and anesthesia systems group designs, manufactures and markets products that respond to these new economic forces by helping hospitals reduce costs while maintaining or improving the quality of care their physicians and nurses are able to deliver.

Our Spacelabs Medical, Inc. subsidiary is a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. It designs, manufactures and markets patient monitoring solutions for critical care, emergency and perioperative areas of the hospital, wired and wireless networks and connectivity solutions, ambulatory blood pressure monitors and medical data services, all aimed at providing caregivers with instant patient information. By making critical patient information more readily accessible both inside and outside the hospital, delays in decision-making can be reduced, length of stay can be shortened and treatment errors can be minimized.

In February 2005, we acquired Blease Medical Holdings Limited, a global manufacturer and distributor of anesthesia delivery systems, ventilators and vaporizers. Blease sells its products primarily to hospitals for use in

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operating rooms and anesthesia induction areas as well as in magnetic resonance imaging (MRI) facilities. In addition, as pharmaceutical companies develop new anesthesia agents for the worldwide market, or as generic alternatives to patented anesthesia formulas become available, Blease works closely with them to support their new product introductions. As a result, Blease also sells its systems and components, such as anesthesia vaporizers and ventilators, directly to pharmaceutical companies and other manufacturers of anesthesia delivery systems.

Through our Dolphin Medical, Inc. subsidiary, we design, manufacture and market next-generation pulse oximetry instruments and compatible pulse oximetry sensors, which are used to non-invasively monitor oxygenation levels in a patient's blood. Through our Osteometer MediTech, Inc. subsidiary, we design, manufacture and market x-ray and ultrasound densitometers, which are used to diagnose osteoporosis as well as to provide follow-up bone density measurements.

During fiscal year 2005, we began exploring strategic alternatives for our medical monitoring and anesthesia systems group. This group has grown from approximately \$11 million in annual revenues in fiscal year 2003 to approximately \$196 million in fiscal year 2005, primarily as a result of the acquisitions of Spacelabs Medical and Blease. In connection with these efforts, we engaged a London-based investment bank to pursue the public offering and listing of approximately 30% to 35% of the equity in Spacelabs Healthcare, Inc., a newly formed subsidiary comprising the business operations of Spacelabs Medical, Blease, Dolphin and Osteometer. This offering and listing is planned in the United Kingdom on the AIM Exchange, which is owned and administered by the London Stock Exchange. The shares in Spacelabs Healthcare will not be offered or sold in the United States. Under Securities and Exchange Commission regulations, U.S. residents are prohibited from participating in this proposed offering, and any shares offered cannot be acquired by U.S. residents for a period of twelve months from the date of the offering. We currently expect to complete the proposed transaction during the second quarter of fiscal year 2006. However, the completion of the listing remains fully subject to a number of factors, including regulatory approvals and our satisfaction with the valuation, which may not occur.

**Optoelectronic Devices and Value-Added Subsystems.** Our optoelectronic devices and value-added subsystems are used for a wide variety of applications ranging from complex monitoring, measurement and positioning functions, such as in industrial robotics where our optoelectronic devices and value-added subsystems are used to detect the exact position, motion or size of another object, to simple functions, such as the detection of paper in the print path of a laser printer. Because optoelectronic devices and value-added subsystems can be used in a wide variety of measurement control and monitoring applications, they are used in a broad array of industrial applications and are key components in the telecommunications and fiber optics industries.

We believe that in recent years, advances in technology and reductions in the cost of key components of optoelectronic systems, including computer processing power and memory, have broadened the market by enabling the use of optoelectronic devices in a greater number of applications. In addition, we see a trend among original equipment manufacturers to increasingly outsource the design and manufacture of optoelectronic devices and value-added subsystems to fully-integrated, independent manufacturers, like us, who may have greater specialization, broader expertise and the flexibility to respond in shorter time periods than most original equipment manufacturers can accomplish in-house. We believe that our level of vertical integration, substantial engineering resources, expertise in the use and application of optoelectronic technology and low-cost international manufacturing operations enable us to compete effectively in the market for optoelectronic devices and value-added subsystems. Our optoelectronic devices and value-added subsystems are also used in our security and inspection systems and medical monitoring and anesthesia systems.

We have also penetrated several related markets that depend on our optoelectronic device and subsystem technologies. For example, we sell a series of high-speed photodetectors for use in fiber optic systems such as Gigabit Ethernet, Fiber Channel and other telecommunication and data communication applications. Through system engineering, product development, rapid prototyping and volume manufacturing, we develop, manufacture and market laser-based weapons simulation systems for the defense industry. Products include tactical engagement simulation systems, man worn laser detectors, small arms transmitters, controller guns and a

variety of targeting systems. We also develop, manufacture and sell laser-based remote sensing devices that are used in agricultural and mapping applications, as well as to detect and classify vehicles in toll and traffic management systems. Finally, our optoelectronic devices and value-added subsystems group recently added and enhanced its “box build” manufacturing services and PC board assembly capabilities utilizing state-of-the-art automated surface mount technology lines for use by customers in the medical electronics, automotive diagnostic electronics, telecommunications and digital audio systems industries, among others.

### **Growth Strategy**

Our primary objectives are to be a leading provider of security and inspection products, cutting-edge medical monitoring and anesthesia systems and specialized optoelectronic products, to enhance our position in the international inspection and detection marketplace, to capitalize on our research to provide reliable and cost-optimized medical devices and to leverage our expertise in the optoelectronic technology industry by entering into new markets. Key elements of this strategy include:

***Capitalizing on the Growing Market for Security and Inspection Systems.*** Heightened attentiveness to terrorist and other security threats may continue to drive growth in the market for security and inspection systems, not only in transportation security, but in facilities security, event security and materials inspection as well. In addition, the trend toward increased international transportation of goods may result in growth in the market for cargo inspection systems that are capable of screening shipping containers for contraband and assisting customs officials in the verification of shipping manifests. Package screening by freight forwarders also represents a potential growing sector, as new regulations in Europe require such screening and awareness of the need for such screening grows in the U.S. We intend to continue to expand our sales and marketing efforts both domestically and internationally, and to capitalize on opportunities to replace, service and upgrade existing security installations.

***Developing New Security and Inspection Technologies.*** We intend to continue to develop new security and inspection technologies such as our proprietary pulsed fast neutron analysis and real time tomography products. These and the other technological advances we make allow us to offer customers the broadest variety of advanced security solutions. In addition, through research and development and selective acquisitions, we may enhance and expand our current product offerings to better address new applications and security industry demands.

***Enhancing the Global Presence of our Security and Inspection Systems Group.*** In March 2005, we announced that the branding of security and inspection systems, which had previously been sold under various brand names including “Ancore,” “Eagle,” “Metor,” “Rapiscan,” and “Secure,” would be consolidated under one overall name—“Rapiscan Systems”. Since the announcement, all of the products of our security and inspection systems group of companies, including baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening systems are being marketed under the “Rapiscan Systems” umbrella. We undertook this effort in order to improve brand recognition for the broad range of complementary security products and technologies that we have acquired in recent years.

***Exploring Strategic Alternatives.*** During fiscal year 2005 we began exploring new strategic alternatives for our business groups. In connection with these efforts, we announced in September 2005 our intention to pursue the public offering and listing of approximately 30% to 35% of the equity in Spacelabs Healthcare, Inc. a newly formed subsidiary comprising the business operations of our medical monitoring and anesthesia systems group. Our medical monitoring and anesthesia systems group has grown from approximately \$11 million in annual revenues in fiscal year 2003 to approximately \$196 million in fiscal year 2005, primarily as a result of the acquisitions of Spacelabs Medical and Blease. This offering and listing is planned in the United Kingdom on the AIM Exchange, which is owned and administered by the London Stock Exchange. The shares in Spacelabs Healthcare will not be offered or sold in the United States. Under Securities and Exchange Commission regulations, U.S. residents are prohibited from participating in this proposed offering, and any shares offered

cannot be acquired by U.S. residents for a period of twelve months from the date of the offering. We expect to complete the proposed transaction during the second quarter of fiscal year 2006. However, the completion of the listing is fully subject to a number of factors, including regulatory approvals and our satisfaction with the valuation, which may not occur.

***Improving and Complementing Existing Medical Diagnostic Technologies.*** Spacelabs Medical develops medical monitoring systems aimed at lowering false alarm rates, thereby reducing time demands on physicians and nurses, and improving patient identification accuracy, thereby reducing physician and nursing errors. In February 2005, we acquired Blease, for its anesthesia delivery systems, ventilators and vaporizers to expand our product offerings in the perioperative marketplace and because we believed that the products of Blease and the products of Spacelabs Medical could, in certain important markets, be sold together through existing sales channels and distribution networks. At the same time, Spacelabs Medical and our Dolphin subsidiary are also working together, pursuing cable-free medical sensors and other wireless solutions that will allow for medical monitoring, patient data, transmission, alarm notifications and other information to be instantly transmitted at any time to any location. Finally, our medical monitoring and anesthesia systems group also continues to improve and develop its medical diagnostic tools aimed at bone metabolic diseases, such as osteoporosis, and patient monitors and accessories that utilize pulse oximetry technologies. Overall, our efforts at improving our existing medical diagnostic and anesthesia delivery technologies will continue to concentrate on the development of devices that make it possible for institutions from large hospitals to small clinics and physicians' offices to obtain accurate, precise, reliable and cost-effective results.

***Leveraging the Optoelectronic Design and Manufacturing Expertise to Address New Applications.*** We believe that one of our primary competitive strengths is our expertise in designing and manufacturing, at cost-effective rates, specialized optoelectronic devices and value-added subsystems for our own end products both in security and medical businesses and for the products of our original equipment manufacturer customers. Our optoelectronic devices and subsystems group currently designs and manufactures devices and subsystems for numerous customers serving hundreds of applications.

***Acquiring New Technologies and Companies.*** Our success depends in part on our ability to continually enhance and broaden our product offerings in response to changing technologies, customer demands and competitive pressures. We have developed expertise in our various lines of business and other areas through internal research and development efforts as well as through selective acquisitions.

In 1987, we formed Opto Sensors (Singapore) Pte. Ltd. to manufacture optoelectronic devices and value-added subsystems.

In 1990, we acquired UDT Sensors, Inc. to broaden our expertise and capabilities in developing and manufacturing optoelectronic devices and value-added subsystems.

In 1993, we acquired Rapiscan Security Products Limited (since renamed Rapiscan Systems Ltd.) in the United Kingdom and, through Rapiscan Security Products (U.S.A.), Inc., commenced our operations as a provider of security and inspection systems in the United States.

In 1993, we acquired Ferson Optics, Inc. (since renamed Ferson Technologies, Inc.) for its passive optic technologies.

In 1994 we, together with an unrelated third party formed ECIL-Rapiscan Security Products Limited in India for the purpose of the manufacture, assembly, service and testing of x-ray security and other products.

In 1994, we commenced operations of Opto Sensors (Malaysia) Sdn. Bhd. to take advantage of lower manufacturing costs in Malaysia.

In 1997, we acquired Advanced Micro Electronics AS for its hybrid optoelectronic capabilities and to expand our presence in Europe.



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In 1998, we acquired Osteometer MediTech A/S, a Danish manufacturer of diagnostic scanners used for the early detection of symptoms of osteoporosis. We acquired this business to capitalize on certain vertical integration opportunities and to gain marketing and sales access to end users in the healthcare market. In August 1999, we closed the operations of Osteometer in Denmark, and relocated certain of those operations to our Hawthorne, California facilities.

In 1998, we purchased the security products business of Metorex International Oy (since renamed Rapiscan Systems Oy) of Espoo, Finland. This acquisition brought a complete security metal detection product line to complement our existing security and inspection systems group.

In 1998, we acquired all the outstanding stock of Silicon Microstructures, Inc., a silicon pressure-sensor manufacturer, from Exar Corporation located in Fremont, California. On March 31, 2001, we sold all of the outstanding stock of Silicon Microstructures, Inc. to Elmos Semiconductor AG of Germany.

In 1998, we acquired substantially all of the assets and assumed certain liabilities of Corrigan Canada Ltd. in order to enhance the market presence of our security and inspection systems in Canada.

In 1998, we purchased a minority equity stake in Square One, Inc., a developer and manufacturer of infrared-based patient monitoring medical subsystems. In 2000, we acquired substantially all of Square One, Inc.'s assets in order to take advantage of certain vertical integration opportunities and expand our medical product offerings and customer base.

In 1999, we acquired Aristo Medical Products, Inc. for its pulse oximeter probe technologies for use in the healthcare field, thereby further enhancing our medical product operations.

In 1999, we formed OSI Medical, Inc. as a developer of next generation pulse oximeter instruments and probes for use in the healthcare field in order to take advantage of our growing expertise in this area.

In fiscal year 2000, we formed RapiTec, Inc., as a majority-owned subsidiary, in order to design, develop and engineer laser-based training systems for the defense industry. The establishment of this company allowed us to better penetrate the worldwide defense optoelectronics market. In January 2004, the minority shareholders of RapiTec accepted an offer by us to purchase all shares of RapiTec common stock held by them. As a result of the transaction, we now wholly own RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820,000 paid in fiscal year 2004, of which \$536,000 was allocated to goodwill, and a second cash payment of approximately \$279,000 paid in January 2005, which amount was also allocated to goodwill.

In 2001, we contributed most of our medical monitoring and anesthesia systems to a newly formed subsidiary Dolphin, for the purpose of consolidating our various medical devices into a single subsidiary. We merged OSI Medical, Inc. into Dolphin in March 2002. In December 2003, we entered into a stock purchase and option agreement with Conmed Corporation, whereby Conmed Corporation purchased a 9% interest in Dolphin and an option to purchase all of the remaining assets and the business of Dolphin. In addition, Conmed Corporation and Dolphin entered into a distribution agreement, which provides Conmed Corporation with distribution rights for certain Dolphin products within certain defined territories.

In July 2002, we acquired substantially all the assets of Thermo Centro Vision, Inc., based in Newbury Park, California, for its optoelectronic devices and value-added subsystems design and manufacturing capabilities. The acquisition was made through a newly formed, wholly owned subsidiary, Centro Vision, Inc.

In July 2002, we purchased a 6% interest in Imagis Technologies, Inc., a company that develops facial recognition software for security applications, in order to enhance the portfolio of products offered by our security and inspection systems group. At this time, its products are still under development. Based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, we recognized an other-than-temporary impairment of the carrying value of this investment during fiscal year 2004.

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In August 2002, we purchased a minority equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems. These systems, if successfully completed, could provide significant improvements over current hold baggage screening technologies. In June 2004, we increased our equity interest in CXR to approximately 75% and in December 2004 we acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest we have agreed to make certain royalty payments based on sales of CXR's products.

In November 2002, we acquired all the outstanding capital stock of Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company for its advanced inspection systems for aviation security, port and border inspection and counter-terrorism. Consideration paid for the acquisition consisted of a combination of our Common Stock and cash of approximately \$10.4 million including professional fees associated with the acquisition. In addition, during the five years following the close, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at \$34.0 million. As of June 30, 2005, no earn-out payments have been made.

In August 2003, we acquired the military, laser-based training business of Schwartz Electro-Optics, Inc. in a bankruptcy-court supervised auction in order to augment the defense optoelectronics capabilities of our RapiTec subsidiary. At the close of the transaction we paid approximately \$3.7 million including professional fees associated with the acquisition. The acquisition was made through a newly formed, wholly owned subsidiary, OSI Defense Systems, LLC. The acquired business develops and manufactures tactical engagement simulation systems, man worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems for the defense industry. Then, in November 2003, we acquired substantially all remaining assets of Schwartz Electro-Optics, Inc. in a bankruptcy-court supervised auction. We paid approximately \$1.6 million, including the assumption of certain liabilities and bankers' fees. The acquired assets comprise a business for the design, sales and manufacturing of laser-based systems used in traffic management, precision agricultural management and precision mapping and surveying, all of which offered us certain vertical integration opportunities. The business, located in Orlando, Florida, now operates under the name OSI Laserscan.

In October 2003, we acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4.5 million including professional fees associated with the acquisition. The acquisition was made through a wholly owned subsidiary, OSI Electronics, Inc. in order to improve and expand the manufacturing services offered by our optoelectronic devices and value-added subsystems group.

In December 2003, we acquired substantially all of the assets of J&D Engineering (UK) Limited, a company registered in England and Wales. We paid approximately £367,000 (or approximately \$649,000) including acquisition costs. A further £93,000 (or approximately \$171,000) was paid during the quarter ended March 31, 2004. The acquired assets comprise a business for the design, manufacture and sale of, among other products, metal frames for x-ray scanners. Our security and inspection systems group uses these metal frames in certain of its baggage and parcel and inspection systems.

In January 2004, we completed the acquisition of Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17.6 million (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. As of June 30, 2005, approximately \$8,000 has been earned and paid as part of this contingent consideration. This acquisition broadened our security product portfolio with the addition of the Eagle, a mobile x-ray inspection system that is designed to scan shipping containers at busy seaports.

In March 2004, we completed the acquisition of Spacelabs Medical, based in Issaquah, Washington, from Instrumentarium Corporation, now a subsidiary of General Electric Company. The acquisition price was

approximately \$47.9 million in cash (net of cash acquired), including acquisition costs. Spacelabs Medical is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors and medical data services. These are areas in which we have considerable interest as they represent a natural extension of our engineering and manufacturing expertise and will add to our presence in the medical device industry. The installed base of Spacelabs Medical's patient monitoring systems consists of approximately 100,000 units worldwide, with 60,000 in the United States, 30,000 in Europe and 10,000 in Asia. In June 2004, we notified General Electric Company, of a working capital and retention bonus adjustment resulting in what we believe to be a downward adjustment of the purchase price in the amount of \$25.9 million. In September 2004, General Electric Company responded that it believes the amount of the downward adjustments to be approximately \$7.8 million. In June 2005, we filed suit in Delaware seeking specific performance of our agreement with respect to an independent determination of the amount of the purchase price adjustment. The action is currently pending. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price.

In February 2005, we completed the acquisition of Blease for \$9.3 million in cash (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$11.2 million as of June 30, 2005). The acquisition of Blease expands the portfolio of products offered by our medical monitoring and anesthesia systems companies, enabling us to develop and market products for the perioperative market.

**Capitalizing on Vertical Integration.** Our vertical integration provides several advantages in our security and inspection, medical monitoring and anesthesia and optoelectronic devices and value-added subsystem segments. These advantages include reduced manufacturing and delivery times, lower costs due to our access to competitive international labor markets, direct sourcing of raw materials and quality control. We also believe that we offer significant added value to our original equipment manufacturer customers by providing a full range of vertically-integrated services including component design and customization, subsystem concept design and application engineering, product prototyping and development, efficient pre-production and short-run and high volume manufacturing. We believe that our vertical integration differentiates us from many of our competitors and provides value to our original equipment manufacturer customers who can rely on us to be an integrated supplier of optoelectronic devices and value-added subsystems. We intend to continue to leverage our vertically integrated services to create greater value for our customers in the design and manufacture of our products. We believe that this strategy better positions us for penetration into other end markets.

**Capitalizing on Global Presence.** We operate from locations in North America, Asia and Europe. We view our international operations as providing an important strategic advantage over competitors in each of the security inspection, medical monitoring and anesthesia delivery and optoelectronic devices and subsystems markets for three primary reasons. First, international manufacturing facilities allow us to take advantage of competitive labor rates in order to be a low cost producer. Second, our international offices strengthen our sales and marketing efforts and our ability to service and repair our systems by providing direct access to growing foreign markets and to our existing international customer base. Third, multiple manufacturing locations allow us to reduce delivery times to our global customer base. In the future, we intend to develop new sources of manufacturing and sales capabilities to maintain and enhance the benefits of our international presence.

**Selectively Entering New Markets.** We intend to selectively enter new markets that complement our existing capabilities in the design, development and manufacture of security systems, medical products and optoelectronic devices and value-added subsystems. We believe that by manufacturing other end products that rely on our existing technological capabilities, we will leverage our integrated design and manufacturing infrastructure to capture greater margins and to build a larger presence in those new end markets that present attractive competitive dynamics. We intend to achieve this strategy through internal growth and through selective acquisitions of end-product manufacturers.

## Products and Technology

We design, develop, manufacture and sell products ranging from complex security and inspection systems to medical monitoring and anesthesia systems to discrete optoelectronic devices and value-added subsystems.

**Security and Inspection Systems.** We design, manufacture and market security and inspection systems worldwide to end users under the “Rapiscan Systems” name. Rapiscan Systems products are used to inspect baggage, cargo, people, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening.

As a result of the terrorist attacks of September 11, 2001 and subsequent attacks in Africa, Europe, the Middle East and Southeast Asia, security and inspection products have increasingly been used at a wide range of facilities other than airports such as border crossings, railway stations, seaports, cruise line terminals, government and military installations and nuclear facilities. As a result of the additional markets, we have successfully diversified sales channels for our security and inspection products

Many of our security and inspection systems in each of the baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening product categories combine the use of x-ray technology with our optoelectronic capabilities. For example, some of our products include dual- or multi-energy x-ray technology with computer software enhanced imaging technology to facilitate the detection of materials such as explosives, weapons, narcotics, currency or other contraband. While all x-ray systems produce a two-dimensional image of the contents of the inspected object, the dual-energy x-ray systems also measure the x-ray absorption of the inspected object’s contents at two x-ray energies to determine the atomic number, mass and other characteristics of the object’s contents. The various organic and inorganic substances in the inspected object appear to operators of the inspection systems in various colors and this visual information can be used to identify and differentiate the inspected materials. Our baggage and parcel inspection, cargo and vehicle inspection and hold baggage screening inspection systems range in size from compact tabletop systems to large systems comprising entire buildings in which trucks, shipping containers or pallets are inspected.

Our cargo and vehicle inspection applications, in which trucks, shipping containers, pallets and other large objects can be inspected, are designed in various configurations, including fixed-site, gantry, relocatable, portal and mobile systems. These products are primarily used to verify the contents of trucks or cargo containers and to detect the presence of contraband. They offer significant improvements over past methods of cargo screening, such as manual searches, as our cargo systems are faster, more thorough and do not subject the cargo to pilferage. Entire shipping containers or trucks containing densely packed goods can be screened rapidly.

Many of our cargo and vehicle inspection systems utilize ionizing radiation, such as high-energy x-ray or gamma-ray beams, in conjunction with digital imaging equipment to non-intrusively inspect objects and present images to an inspector, showing shapes, sizes, locations and relative densities of the contents. Many of these systems, such as the Rapiscan Eagle, which was designed and developed under contract with U.S. Customs and Border Protection and the U.S. Department of Defense, have been built to meet specific customer inspection requirements.

Other cargo and vehicle inspection products automatically and non-intrusively detect explosives and other contraband through the use of pulsed fast neutron and thermal neutron technologies, as opposed to ionizing radiation. Pulsed fast neutron and thermal neutron technologies permit the operator to inspect cargo, vehicles and containers based on the distinctive chemical composition of various forms of contraband. Our pulsed fast neutron analysis technology uses a penetrating beam of fast neutrons to measure the elemental contents (oxygen, nitrogen, etc.) within scanned objects (cargo containers, trucks, etc.) and identify elemental signatures of explosives, drugs or other contraband. The systems utilizing this technology then display to the system operator a

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three-dimensional image of the scanned object, identifying the location and type of suspect material found. Our systems utilizing thermal neutron analysis technology use a similar method to detect bulk quantities of explosives and drugs concealed in trucks or cargo containers.

Our security and inspection systems group is the only provider among its competitors currently offering x-ray, gamma-ray and neutron-based material specific technologies. As a result, we believe we offer the broadest technology platform in the cargo and vehicle inspection systems industry. This broad platform also permits us to offer customers hybrid solutions utilizing two or more of the technologies together, thereby optimizing flexibility, performance and cost to meet the customer's unique application requirements. Cargo and vehicle inspection systems recently installed or currently underway include system installations in the United States, China, Hong Kong, India, Malaysia, Mexico, Romania, South Korea and Taiwan, among others.

Our security and inspection systems group also offers people screening products such as a line of "Metor" brand walk-through metal detection products for use at security checkpoints at airports, amusement parks, banks, courthouses, government buildings, sports arenas and other venues. It also offers the "Rapiscan Secure 1000" personnel screener, which uses extremely low dose backscatter x-ray imaging to detect contraband and weapons concealed underneath clothing and hair. The "Rapiscan Secure 1000" provides enhanced screening compared to metal detectors as it displays anomalies caused by very small amounts of metal as well as non-metallic items. As a result, the "Rapiscan Secure 1000" can simultaneously locate and detect conventional metal weapons, as well as ceramic knives, explosives, illicit drugs, precious metals, cameras, recording devices and other contraband or security threats.

The following table sets forth certain information related to the standard security and inspection products that we currently offer. We do, however, also customize our standard products to suit specific applications and customer requirements:

PRODUCT LINE	PRODUCT NAME / PRODUCT FAMILY	TECHNOLOGY	MARKET SEGMENT
<b>Baggage and Parcel Inspection</b>	Rapiscan 500/600 series x-ray systems	Dual-energy x-ray	Checkpoint inspection at airports, prisons, border crossings and government buildings. Postal facilities for mail screening
<b>Cargo and Vehicle Inspection</b>	Rapiscan Eagle	High energy x-ray	Cargo and vehicle inspection at airports, border crossings and sea ports
	Rapiscan VEDS	Thermal Neutron Analysis	
	Rapiscan GaRDS	Gamma ray	
	Rapiscan PFNA	Pulsed Fast Neutron Analysis	
<b>Hold Baggage Screening</b>	Rapiscan MVXR 5000	Multi-view, dual energy x-ray	Baggage inspection at airports
	Rapiscan XRD 1000	Dual energy x-ray diffraction	
<b>People Screening</b>	Metor series of metal detectors	Metal detectors	Checkpoint inspection at airports, border crossings, stadiums, prisons and government facilities
	Rapiscan Secure 1000	X-ray Backscatter	

**Medical Monitoring and Anesthesia Systems.** Our medical monitoring and anesthesia systems businesses design, manufacture and market their products worldwide to end users under several brand names. Our medical

monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and related services are sold under the “Spacelabs Medical” brand name. Our anesthesia systems and components are sold under the “Blease” brand name. Our arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools, are sold under the “Dolphin” brand name and our peripheral bone densitometers and ultrasound bone sonometers are sold under the “Osteometer” brand name.

The “Ultraview” patient monitors of our Spacelabs Medical subsidiary are used in perioperative, critical care and emergency ward environments. We also offer patient monitors for virtually all applications in the hospital, including neonatal, pediatric and adult critical and emergency care, as well as anesthesia and sub-acute care. Our patient monitoring systems comprise monitors and central nurse stations connected either wirelessly or through hospital networks, as well as stand alone monitors where the patient data can be transported physically from one monitor to another as the patient is moved. This ensures that hospital staff can access patient data where and when it is required. In addition, these products are “open architecture” in that they are designed to interact with hospital information systems acquired from other vendors. WinDNA, based on Citrix application server technology, is a feature of many of these products which allows clinicians to view and control Microsoft Windows applications on the patient monitor’s display, eliminating the need for separate terminals in the patient’s room. Attending nurses can thereby check laboratory results and other reports, enter orders, review protocols and do charting right at the patient’s bedside. Inputs can be made using a mouse, keyboard and touchscreen.

For electrocardiograph monitoring or multiparameter monitoring of ambulatory patients, we offer a digital telemetry system. The system operates between 608 and 614 MHz, a band not used for private land mobile radio, business radio services or broadcast analog and digital television. The “Ultraview” Digital Telemetry solution offered by our Spacelabs Medical subsidiary comprises a lightweight and compact transmitter that enables monitoring of heart rate, ST segment, arrhythmia and continuous SpO<sub>2</sub> (Pulse Oximetry). The multiparameter transmitter also integrates with the Spacelabs Medical “Ultralite” ambulatory blood pressure monitor for the transmission of non-invasive blood pressure values to a central station or a multi-disclosure and information system.

We believe we are also a world leader in ambulatory blood pressure monitoring, which is a routine procedure in many European countries and is increasingly being used in the United States. Many physicians are using ambulatory blood pressure monitoring to detect “white coat” hypertension, a condition in which people experience elevated blood pressure in the doctor’s office but not in their daily lives. Hypertension affects approximately 50 million Americans and is particularly prevalent in the Medicare population. Ambulatory blood pressure monitoring is also used to adjust drug therapies for hypertensive patients. It is estimated that as many as 20% of the persons diagnosed with hypertension based on blood pressure measurements taken in their physicians’ offices are not actually hypertensive. Ambulatory blood pressure monitoring helps improve diagnostic accuracy and minimize the associated costs of treatment.

Our Blease subsidiary is recognized as a leading designer and manufacturer of anesthesia delivery systems, anesthesia vaporizers and ventilators. Its “Focus,” “Genius” and “Sirius” anesthesia delivery systems provide flexible anesthesia solutions for most operating room environments, anesthesia induction areas, day surgery units, maternity suites, magnetic resonance imaging facilities and other areas where the administration of anesthesia is required. Its “Datum” anesthesia vaporizers and its line of anesthesia ventilators are also designed to be compatible with the anesthesia delivery systems of several other manufacturers. At the forefront in anesthesia ventilation, Blease recognized the needs of clinicians and the clinical benefits of allowing patients to breathe without the assistance of a ventilator (*i.e.*, on their own) as much as possible while undergoing anesthesia. As a result, in 1999 Blease became the first company to offer ventilators that allowed patients to breathe spontaneously while under anesthesia with the respiratory support of the ventilator used only when necessary to overcome the effects of general anesthesia. In addition, by incorporating spirometry loops into its ventilators, which produce graphical displays about the adequacy and state of a patient’s ventilation, clinicians were able to carefully monitor their patients and ensure the efficacy of the mode of ventilation provided. Blease continues to

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works closely with clinicians as well as with pharmaceutical companies in order to support the development of new technologies and the introduction of new anesthesia agents into the global marketplace.

Our medical monitoring and anesthesia systems group also manufactures and distributes the “DTX-200” and “DexaCare G4” dual energy x-ray forearm densitometers. These products are used to diagnose osteoporosis as well as to provide follow-up bone density measurements. We also manufacture and distribute the “DTU-One,” a calcaneus ultrasound bone sonometer. The “DTU-One” was the first commercially available ultrasound bone sonometer to use an imaging capability for osteoporosis screening.

We develop next-generation digital pulse oximetry instruments and compatible pulse oximetry sensors under the “Dolphin-one” product line. “Dolphin-one” products include the “Voyager,” “Dolphin-2100” and “Dolphin-2150”. The Voyager is the first pocket PC-based pulse oximetry product on the market. Our medical monitoring and anesthesia systems group also manufactures and distributes, under the “Dolphin 2000/3000” product line, sensors that are compatible with products made by other manufacturers of pulse oximetry technologies.

Finally, we believe that a substantial market exists for disposable supplies such as patient electrodes, specialty graph paper, sensors and connecting lead wires that are used with medical devices. As a result, we sell a broad line of such supplies as an adjunct to our medical device sales. In most cases, these products are obtained from original equipment manufacturers and are manufactured to our specifications.

The following table sets forth certain information related to the standard medical products we currently offer:

MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
Datum Vaporizer	Vaporization of inhalational anesthesia	Ambulatory surgery centers Operating rooms
DexaCare G4 DEXA Bone Densitometer	Detection, diagnosis and follow-up of treatment of osteopenia and osteoporosis	Medical clinics Physician offices Small hospitals
Dolphin-2000/3000 Pulse Oximeters	Continue or Periodic monitoring of oxygen saturation in arterial blood (compatible with the products of other manufacturers)	All hospital care areas Physician offices
Dolphin-2100 Pulse Oximeter	Continuous monitoring of oxygen saturation in arterial blood	All hospital care areas Physician offices
Dolphin-2150 Pulse Oximeter	Periodic monitoring of oxygen saturation in arterial blood	All hospital care areas Physician offices
DTX-200 DEXA Bone Densitometer	Detection, diagnosis and follow-up of treatment of osteopenia and osteoporosis	Medical clinics Physician offices Small hospitals
DTU-one Ultrasound Scanner	Detection of osteopenia and osteoporosis	Medical clinics Physician offices Small hospitals
Focus Anesthesia Delivery System	Delivery of inhalational anesthesia	Ambulatory surgery centers Operating rooms
Genius MRI Anesthesia Delivery System	Delivery of inhalational anesthesia	Anesthesia induction areas within hospitals MRI scanning facilities

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MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
Intesys Clinical Suite ICS	Solutions to make patient data available anytime, anywhere, even from outside the hospital	All hospital care areas
Maternal Obstetrical Monitor	Monitoring of mother and fetus, as well as newborn	Labor and delivery areas within hospitals
Sirius Anesthesia Delivery System	Delivery of inhalational anesthesia	Ambulatory surgery centers Operating rooms
Ultraview SL 2400	Patient monitoring at the bedside and in transport	All hospital care areas
Ultraview SL 2700	Patient monitoring at the bedside	All hospital care areas
Ultraview SL 2800	High-end patient monitoring at the bedside	All hospital care areas
Ultraview SL 3800	Centralized, real-time monitoring surveillance of patients	Central nurses' stations within hospitals
Voyager Pulse Oximeter	Periodic monitoring of oxygen saturation in arterial blood	All hospital care areas Physician offices

**Optoelectronic Devices and Value-Added Subsystems.** Optoelectronic devices generally consist of both active and passive components. Active components sense light of varying wavelengths and convert the light detected into electronic signals, whereas passive components amplify, separate or reflect light. The active components we manufacture consist of silicon, gallium arsenide and indium gallium arsenide photodetectors. Passive components include lenses, prisms, filters, mirrors and other precision optical products that are used by us in the manufacture of our optoelectronic products or are sold to others for use in telescopes, laser printers, copiers, microscopes and other detection and vision equipment. The devices we manufacture are both standard products and products customized for specific applications and are offered either as components or as subsystems.

In addition to the manufacture of standard and original equipment manufacturer products, we also specialize in designing and manufacturing customized optoelectronic devices and value-added subsystems for use in a wide range of products and equipment. An optoelectronic subsystem typically consists of one or more optoelectronic devices that are combined with other electronic components and packaging for use in an end product. The composition of a subsystem can range from a simple assembly of various optoelectronic devices that are incorporated into other subsystems (for example, a printed circuit board containing our optoelectronic devices) to complete end-products (for example, medical pulse oximeter probes that we manufacture and package on behalf of an original equipment manufacturer and then ship directly to the customer or the customer's distributors). We manufacture subsystems for a variety of applications, such as fiber optics, imaging electronics for medical CT scanners, disposable and reusable medical probes for use with medical pulse oximetry equipment, components and subsystems for laser gyroscopes used in military and commercial aviation, optoelectronic subsystems for slot machines, laser subsystems in military helicopter gun sighting equipment, positioning subassemblies for computer peripheral equipment, alignment subsystems for laser heads in optical disc drives and detection subsystems for submarines.

We have recently developed two-dimensional back-illuminated detector technology for security, medical and other industrial applications. This technology overcomes the limitations of conventional detectors by providing finer detector pitch density. We expect that this technology will be used in high-resolution multi-slice CT scanners and other applications requiring improved image resolution.



## Markets, Customers and Applications

**Security and Inspection Products.** Since entering the security and inspection products market in 1993, we have shipped over 10,000 baggage and parcel inspection and over 40,000 people screening systems to over 75 countries. The following is a representative list of certain customers and/or installations that have purchased our security and inspection products:

### OVERSEAS

Chek Lap Kok Airport, Hong Kong  
CKS International Airport, Taiwan  
Domodedova Airport, Moscow, Russia  
Dubai Airport, United Arab Emirates  
Gatwick Airport, United Kingdom  
Heathrow Airport, United Kingdom  
INFRAERO airports, Brazil  
Japanese Embassies, worldwide  
Korean Customs Service, South Korea  
Kremlin, Russia  
Malaysian Airport Board, Malaysia  
Narita Airport, Japan  
New Zealand Customs, New Zealand  
Pudong Shanghai International Airport, China  
TNT Freight, United Kingdom  
United Kingdom Prison System, United Kingdom  
Vatican City

### DOMESTIC

California Department of Corrections  
Cunard Line  
Federal Bureau of Prisons  
Federal Protective Service  
Federal Reserve Banks  
New York City Police Department  
Royal Caribbean Cruises  
United States Air Force  
United States Customs and Border Protection  
United States Department of Agriculture  
United States Department of Corrections  
U.S. Department of Homeland Security  
U.S. Marshals Service

Most security and inspection products were developed in response to civilian airline hijackings. Consequently, a significant portion of our security and inspection products have been and continue to be sold for use at airports. Recently, however, our security and inspection products have been used for security purposes at locations in addition to airports, such as courthouses, office buildings, mailrooms, schools, prisons, high-profile locations such as Buckingham Palace, the Kremlin and the Vatican and for high-profile events such as the Olympic Games. Furthermore, as terrorist attacks such as the March 2004 bombings of passenger trains at Atocha railway station in Madrid and the July 2005 bombings of the London underground and commuter bus systems continue to occur, overall transportation and travel industry sector demands have increased, resulting in heightened attention for our security and inspection products. In addition, our security and inspection products are increasingly being used for non-security purposes, such as for cargo inspection to detect narcotics and contraband and to verify manifests, prevention of pilferage at semiconductor manufacturing facilities, quality assurance and the detection of gold and currency.

In April 2000, the U.S. Government awarded us a contract to provide baggage and parcel inspection systems at selected airports throughout the United States. Under the original contract, the U.S. Government had the right to purchase from us up to 800 systems, for which the aggregate purchase price would be approximately \$40 million. In January 2005, this contract was extended and \$10 million in additional spending was allocated for the purchase of our systems. As a result, in fiscal years 2001 through 2005, our installed-base totaled approximately 1000 systems under this contract. In addition, we currently have a separate contract to service these systems.

Since 2001, we have completed the delivery of fixed site, relocatable, or mobile cargo and vehicle inspection systems to governments and government agencies in the United States, Hong Kong, India, Jamaica, Mexico, Malaysia, Romania, South Korea, Taiwan and other locations.

**Medical Monitoring and Anesthesia Systems.** Our medical monitoring and anesthesia systems are manufactured and distributed globally for use in critical care, emergency and perioperative areas within hospitals

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as well as physicians offices, medical clinics and ambulatory surgery centers. We also provide wired and wireless networks and clinical information access solutions, ambulatory blood pressure monitors and medical data services.

In the last twelve years, our medical monitoring and anesthesia delivery systems group has sold over 117,000 patient monitors, 35,000 ambulatory blood pressure monitors and 10,000 anesthesia delivery systems. Our medical monitoring and anesthesia systems business has distributors in over 70 countries and subsidiary or branch offices in the United States, Austria, Canada, Finland, France, Germany, Greece, India, Italy, Singapore, Malaysia and the United Kingdom.

In December 2004, Palmetto Health System in Columbia, South Carolina agreed to purchase patient monitoring equipment from us in order to outfit its new heart and vascular tower, which is scheduled to open in early 2006. This new 200,000 square-foot facility will be among the most comprehensive, patient-centered, physician-driven cardiac care centers in the nation.

In April 2005, our medical monitoring and anesthesia systems group was awarded a five-year contract to supply the University of Missouri Health Care System, which includes University Hospital and Clinics and Columbia Regional Hospital in Columbia, Missouri and the Missouri Rehabilitation Center in Mt. Vernon, Missouri with patient monitors and software in a statewide multi-facility equipment replacement project. University Hospital serves as the flagship hospital for the University of Missouri Health Care system, offering the only Level I trauma center in central Missouri.

In July 2005, Alfred I. duPont Children's Hospital, located outside Wilmington, Delaware, agreed to replace all of its patient monitoring equipment with Spacelabs Medical products. The contract is expected to result in the sale of up to 200 Ultraview SL 2800 monitors. Alfred I. duPont Children's Hospital, which is owned and operated by the Nemours Foundation, is a patient care, education and research facility that treats children that are experiencing acute, chronic and complex health problems. The Nemours Foundation operates one of the largest subspecialty group practices devoted to pediatric patient care, teaching and research in the United States.

The following is a representative list of certain customers and/or installations that have purchased our medical monitoring and anesthesia products:

### **OVERSEAS**

Diaconessenhuis Meppel, Netherlands  
Evangelisches Krankenhaus Bethesda, Germany  
Klinik St. Josef, Belgium  
LKW Villach, Austria  
Ramguiel University Hospital, France  
Schüchtermannklinik, Germany  
St Vincent's Hospital, Australia  
St. Elisabeth Ziekenhuis, Netherlands  
Ulleval Sjukhus, Norway  
Universitätsspital Zürich, Switzerland

### **DOMESTIC**

Albany Medical Center, Albany, NY  
Condell Medical Center, Liberty, IL  
Duke Univ. Medical Center, Durham, NC  
Harborview Medical Center, Seattle, WA  
Lakeland Regional Medical Center, Lakeland, FL  
Methodist Hospital, Houston, TX  
Northside Hospital, Atlanta, GA  
Spartanburg Reg. Healthcare System, Spartanburg, SC  
Tulane Univ. Hospital and Clinic, New Orleans, LA  
Women & Infants Hospital, Providence, RI

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***Optoelectronic Devices and Value-Added Subsystems.*** Our optoelectronic devices and value-added subsystems are used in a broad range of products by a variety of customers. The following table illustrates the major product categories for which we provide optoelectronic products and certain representative customers in each category. We expect that the list of product categories, the amount of business derived from each such product category, and the composition of our major customers will vary from period to period.

PRODUCT CATEGORY	REPRESENTATIVE MAJOR CUSTOMERS
Aerospace and Avionics	Honeywell ITT Industries Raytheon TME Systems
Analytical and Medical Imaging	Abaxis Beckman Coulter Johnson & Johnson Phillips Medical Siemens Medical
Fiber Optics/Telecommunications	Bookham JDS Uniphase
Gaming Industry	Bally Gaming
Homeland Security	BIR GE Infrastructure, Security Gilardoni
Industrial	Baumer Electric Dr. Johannes Heidenhain Metrologic Instruments Symbol Technologies Trimble Waterpik Technologies
Medical Monitoring	Datascope Invivo Research Newport Medical Smiths Medical Somanetics Corporation
Military/Defense and Weapons Simulations	Cubic Defense Systems EDO Corp. Lockheed Martin Raytheon
Office Automation	Eastman Kodak Xerox
Toll and Traffic Management	Computer Sciences Corporation Florida Department of Transportation TransCor

### **Marketing, Sales and Service**

We market and sell our security and inspection products worldwide through a direct sales and marketing staff of approximately 65 employees located in North America, Europe and Asia, in addition to an expansive global network of independent and specialized sales representatives. This sales staff is supported by a service

organization of approximately 90 persons located primarily in North America, Europe and Asia, as well as a global network of independent distributors. We also support these sales and customer relations efforts by providing operator training, computerized training and testing equipment, in-country service support, software upgrades and service training for customer technicians.

We market and sell our medical monitoring and anesthesia systems worldwide through a direct sales and marketing staff of approximately 245 sales personnel and 260 service personnel located in North America, Europe and Asia, in addition to a global network of independent distributors. We also support these sales and customer service efforts by providing operator in-service training, software updates and upgrades and service training for customer biomedical staff and distributors.

We market and sell our optoelectronic devices and value-added subsystems, through both a direct sales and marketing staff of approximately 25 employees located in, North America, Europe and Asia, and indirectly through a global network of independent sales representatives and distributors. Most of our in-house sales staff is based in the United States, while most of our independent sales representatives and distributors are located abroad. This sales staff is supported by an applications engineering group whose members are available to provide technical support. This support includes designing applications, providing custom tooling and process integration, defining solutions for customers and developing products that meet customer defined specifications.

We consider our maintenance service operations to be an important element of our business. After the expiration of our standard product warranty periods, we are sometimes engaged by our customers to provide maintenance services for our security and inspection products through annual maintenance contracts. We provide a variety of service and support options for our medical monitoring and anesthesia systems customers, ranging from complete on-site repair and maintenance service and telephone support to parts exchange programs for customers with the internal expertise to perform a portion of their own service needs. We believe that our international maintenance service capabilities allow us to be competitive in selling our security and inspection systems as well as our medical monitoring and anesthesia systems. Furthermore, we believe that as the installed base of both our security and inspection systems and medical monitoring and anesthesia systems increases, revenues generated from such annual maintenance service contracts and from the sale of replacement parts will increase.

### **Research and Development**

Our security and inspection systems are designed at our facilities in Hawthorne, Santa Clara and Sunnyvale, California, and internationally in Finland, Malaysia, India and the United Kingdom. These products include mechanical, electrical, electronic, digital electronic and software subsystems, which are all designed by us. In addition to product design, we provide system integration services to integrate our products into turnkey systems at the customer site. We support cooperative research projects with government agencies and, on occasion, provide contract research for our customers and government agencies.

Our medical monitoring and anesthesia systems are designed at our facilities in Hawthorne, California, Issaquah, Washington, and internationally in Malaysia and the United Kingdom. Such systems include mechanical, electrical, digital electronic and software subsystems, all of which are designed by us. We are also currently involved, both in the United States and abroad, in several research projects aimed at improving our medical systems and at expanding our current product line.

Our optoelectronic devices and value-added subsystems are primarily designed and engineered at our facilities in Camarillo, Hawthorne, Newbury Park and Upland, California, Orlando, Florida, North Andover, Massachusetts and Ocean Springs, Mississippi, and internationally in India, Malaysia and Norway. We engineer and manufacture subsystems to solve the specific application needs of our original equipment manufacturer customers. In addition, we offer entire subsystem design and manufacturing solutions. We consider our engineering personnel to be an important extension of our core sales and marketing efforts.

In addition to close collaboration with our customers in the design and development of our current products, we maintain an active program for the development and introduction of new products, enhancements and improvements to our existing products, including the implementation of new applications of our technology. We seek to further enhance our research and development program and consider such program to be an important element of our business and operations. As of June 30, 2005, we engaged approximately 255 full-time engineers, technicians and support staff in research and development. During fiscal year 2003, our research and development expenses were \$8.9 million, in 2004 they were \$14.6 million and in 2005 they were \$30.5 million. The increases in fiscal years 2004 and 2005 reflect increased research and development spending by our security and inspection systems businesses and the inclusion of research and development expenses following our acquisitions of Spacelabs Medical and the traffic management, agricultural management, mapping and surveying business assets of Schwartz Electro-Optics, Inc. that are now operating under the OSI Laserscan tradename. We intend to continue to invest in our research and development efforts in the future.

## **Manufacturing and Materials**

We currently manufacture our security and inspection systems in Hawthorne, Santa Clara and Sunnyvale, California and Ocean Springs, Mississippi, and internationally in India, Finland, Malaysia and the United Kingdom. We currently manufacture our medical monitoring and anesthesia systems in Hawthorne, California and Issaquah, Washington, and internationally in India, Malaysia, Singapore and the United Kingdom. We currently manufacture our optoelectronic devices and value-added subsystems in Camarillo, Hawthorne, Newbury Park and Upland, California, North Andover, Massachusetts and Ocean Springs, Mississippi, and internationally in India, Malaysia and Norway. Our principal manufacturing facility is in Hawthorne, California. However, most of our high volume, labor intensive manufacturing and assembly is performed at our facility in Malaysia. Since most of our customers currently are located in the United States, Europe and Asia, our ability to assemble products in these markets and provide follow-on service from offices located in these regions is an important component of our global strategy.

Our global manufacturing organization has expertise in optoelectronic, microelectronic and integrated value-added assemblies for commercial, medical, aerospace and defense industry applications. Our manufacturing includes silicon wafer processing and fabrication, optoelectronic device assembly and screening, thin and thick film microelectronic hybrid assemblies, surface mounted and thru-hole PCB electronic assemblies and value-added services including complete turn-key and box-build manufacturing. We outsource certain manufacturing operations, including our sheet metal fabrication and certain plastic components. The manufacturing process for components and subsystems consists of manual tasks performed by skilled and semi-skilled workers as well as automated tasks.

The principal raw materials and subcomponents used in producing our security and inspection systems consist primarily of x-ray generators, linear accelerators, detectors, data acquisition and computing devices, conveyor systems and video monitors. A large portion of the optoelectronic devices, subsystems and circuit card assemblies used in our inspection and detection systems are manufactured in-house. The x-ray generators and certain metal enclosures used in our baggage and parcel inspection systems are also manufactured in-house, while the x-ray generators and linear accelerators used in our cargo and vehicle inspection systems are purchased from unaffiliated third party providers. We purchase the x-ray tubes, computer hardware and certain standard mechanical parts and some of our metal enclosures from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our medical monitoring and anesthesia systems consist of printed circuit boards, housings, mechanical assemblies, pneumatic devices, cables, filters and packaging materials. We purchase certain devices, including computers, peripheral accessories and remote displays from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our optoelectronic devices and value-added subsystems consist of silicon wafers, ceramics, electronic subcomponents, light emitting diodes, phototransistors, printed circuit boards, headers and caps, housings, cables, filters and packaging materials. The

silicon-based optoelectronic devices manufactured by us are critical components in most of our subsystems. Since 1987, we have purchased substantially all of the silicon wafers we use to manufacture our optoelectronic devices from Siltronic Corp.

For cost, quality control and efficiency reasons, we generally purchase raw materials and subcomponents only from single vendors with whom we have ongoing relationships. We do, however, qualify second sources for most of our raw materials and critical components, or have identified alternate sources of supply. We purchase the materials pursuant to purchase orders placed from time to time in the ordinary course of business. Although to date none of our groups has experienced any significant shortages or material delays in obtaining any of its raw materials or subcomponents, it is possible that they may face such shortages or delays in one or more materials in the future.

#### **Patents, Trademarks, Tradenames and Licenses**

**Trademarks and Tradenames.** We have used, registered and applied to register certain trademarks and service marks to distinguish our products, technologies and services from those of our competitors in the United States and in foreign countries. We enforce our trademark, service mark and trade name rights in the United States and abroad.

**Patents.** We hold a number of U.S. and foreign patents relating to various aspects of our security and inspection products, medical monitoring and anesthesia systems and optoelectronic devices and subsystems. Our current patents will expire at various times between 2006 and 2021. However, it remains possible that pending patent applications or other applications that may be filed may not result in issued patents. In addition, issued patents may not survive challenges to their validity. Although we believe that our patents have value, our patents, or any additional patents that may be issued in the future, may not be able to provide meaningful protection from competition.

**Licenses.** Our security and inspection systems, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems groups have each entered into a variety of license arrangements under which they are permitted to manufacture, market, sell and/or service various types of software, data, equipment, components and enhancements to our own proprietary technology.

We believe that our patents, trademarks, tradenames and licenses are important to our business. The loss of some of our patents, trademarks or licenses might have a negative impact on our financial results and operations, however, we operate in a competitive environment with a known customer base and rely mainly on providing our consumers with quality products and services to ensure continuing business. Thus, with the exception of the loss of either the Spacelabs® or Rapiscan® trademarks, the impact of the loss of any single patent, trademark, tradename or license would not likely have a material adverse effect on our business. We consider the Spacelabs® trademark an important asset and have registered it in approximately forty countries. In addition, following the recent re-branding of our security and inspection systems group under the “Rapiscan Systems” name, we have instituted a similar registration program for the Rapiscan® trademark.

#### **Regulation of Medical Products**

The medical monitoring and anesthesia systems we manufacture and market are subject to regulation by numerous federal government agencies, principally the U.S. Food and Drug Administration (“FDA”), and by certain state and foreign authorities. They are also subject to various U.S. and foreign electrical safety standards.

The FDA has broad regulatory powers with respect to pre-clinical and clinical testing of new medical products and the manufacturing, marketing and advertising of medical products. It requires that all medical devices introduced into the market be preceded either by a pre-market notification clearance order under section 510(k) of the Food, Drug and Cosmetic Act, or an approved pre-market approval application. A 510(k) pre-market notification clearance order indicates that the FDA agrees with an applicant’s determination that the product for which clearance has been sought is substantially equivalent to another legally marketed medical

device. The clearance of a pre-market approval application, on the other hand, indicates that the FDA has determined that the device has been proven, through the submission of clinical trial data and manufacturing quality assurance information, to be safe and effective for its labeled indications. The process of obtaining 510(k) clearance typically takes between three and six months, but can take substantially longer. The pre-market approval application review process, on the other hand, can last more than a year. To date, all of the medical monitoring and anesthesia systems we manufacture and sell in the United States have required only 510(k) pre-market notification clearance.

Such regulatory approvals, when granted, may entail limitations on the indicated uses for which a product may be marketed, and such product approvals, once granted, may be withdrawn if problems occur after initial marketing. Manufacturers of FDA-regulated products are subject to pervasive and continuing governmental regulation, including extensive recordkeeping requirements and reporting of adverse experiences associated with product's manufacture and use. Compliance with these requirements is costly, and failure to comply can result in, among other things, fines, total or partial suspension of production, product recalls, failure of the FDA to review pending marketing clearances or approval applications, withdrawal of marketing clearances or approvals or even criminal prosecution.

We are also subject to regulation in the foreign countries in which we manufacture and market our medical monitoring and anesthesia systems. For example, the commercialization of medical devices in the European Union is regulated under a system that presently requires all medical devices sold in the European Union to bear the CE mark—an international symbol of adherence to quality assurance standards. Our manufacturing facilities in Hawthorne, California, Issaquah, Washington and Chesham, United Kingdom are all certified to the International Organization for Standardization's ISO 13485 standard for medical device companies. They are also certified to the requirements of the European Medical Device Directive 93 / 42 EEC, which allows them to self-certify that newly manufactured products can bear the CE mark.

We believe we are in material compliance with all applicable federal, state and foreign regulations regarding the manufacture and sale of our medical monitoring and anesthesia delivery systems. Such regulations and their enforcement do, however, constantly change, and we cannot predict what effect, if any, such changes may have on our businesses in the future.

### **Environmental Regulations**

We are subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances that have been released on or in our facilities or that have been disposed of off-site as waste. Such laws may impose liability without regard to whether we knew of, or caused, the release of such hazardous substances. We have conducted Phase I environmental site assessments for each of our properties in the United States at which we manufacture products. The purpose of each such report is to identify, as of the date of such report, potential sources of contamination of the property from past and present activities or from nearby operations. In certain cases, we have conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants. We believe that we are currently in compliance with all material environmental regulations in connection with our manufacturing operations, and that we have obtained all material environmental permits necessary to conduct our business. The amount of hazardous substances and wastes produced and generated by us may increase in the future depending on changes in our operations. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing process or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

During one such investigation, we discovered soil and groundwater contamination at our Hawthorne, California facility. We filed the requisite reports concerning this problem with the appropriate environmental

authorities in fiscal year 2001. We have not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. We also have notified the prior owners of the facility and the present owners and tenants of adjacent properties concerning the problem and have requested from such parties agreements to toll of the statute of limitations with respect to actions against such parties with respect to the contamination in order that we may focus our attention on resolution of the contamination problem. Our site was previously used for semiconductor manufacturing similar to that presently conducted on the site by us, and it is not presently known who is responsible for the contamination and the remediation. The groundwater contamination is a known regional problem, not limited to our premises or our immediate surroundings.

We have also been informed of soil and groundwater remediation efforts at a facility that our Ferson Technologies subsidiary previously leased in Ocean Springs, Mississippi. Ferson Technologies occupied the facility until October 2003. We believe that the owner and previous occupants of the facility have primary responsibility for such remediation and have an agreement with the facility's owner under which the owner is responsible for remediation of pre-existing conditions. However, we are unable at this time to ascertain whether Ferson Technologies bears any exposure for remediation costs under applicable environmental regulations.

## **Competition**

The markets in which we operate are highly competitive and characterized by evolving customer needs and rapid technological change. We compete with a number of other manufacturers, some of which have significantly greater financial, technical and marketing resources than we have. In addition, these competitors may have the ability to respond more quickly to new or emerging technologies, adapt more quickly to changes in customer requirements, have stronger customer relationships, have greater name recognition and may devote greater resources to the development, promotion and sale of their products than we do. As a result, we may not be able to compete successfully against current or future competitors in the security and inspection systems, medical monitoring and anesthesia systems, or optoelectronic devices and subsystems markets and future competitive pressures may materially and adversely affect our business, financial conditions and results of operations.

In the security and inspection market, competition is based primarily on such factors as product performance, functionality and quality, the overall cost effectiveness of the system, prior customer relationships, technological capabilities of the products, price, local market presence and breadth of sales and service organization. We believe that our principal competitors in the market for security and inspection products are the Security and Detection Systems division of L-3 Communications Corporation, the Smiths Detection division of Smiths Group plc, American Science and Engineering, Inc., GE Infrastructure, Security, a subsidiary of the General Electric Company, Science Applications International Corporation, Control Screening L.L.C., CEIA SpA, Garrett Electronics, Inc. and Nuctech Company Limited. Competition could result in price reductions, reduced margins and loss of market share. In the airline and airport security and inspection market, particularly in the upgrade and replacement market, we also compete for potential customers based on existing relationships between our competitors and the customers. Certain of our competitors have been manufacturing inspection systems since the 1980s and have established strong relationships with airlines, airports and other transportation security governing authorities. We believe that the image quality and resolution of certain of our security and inspection products is superior to the image quality offered by many of our competitors' x-ray based inspection products. Additionally, our true multi-zone metal detection technology provides the ability to detect small metallic objects and offer higher levels of discrimination in weapons-screening applications. Although we also have established relationships with a number of airport and airline customers, we may not be able to compete successfully in the future with existing competitors or new entrants. In the cargo and vehicle inspection systems market, we compete for potential customers based on price, performance and the ability to design both standard and customized products. Several of our competitors have operated in this area for longer than we have. However, due to our recent successes in designing and delivering high-energy x-ray systems, we believe we have demonstrated our ability to compete effectively. Additionally, although our competitors in the cargo and vehicle inspection market each offer products in competition with one or more of our products, our ability to supply high-energy x-ray, gamma-ray and thermal neutron analysis systems means that we offer among the widest array



of solutions available from a single supplier. This variety of technologies also permits us to offer unique hybrid systems to our customers that utilize two or more of these technologies, thereby optimizing flexibility, performance and cost to meet the customer's unique application requirements.

In the medical monitoring and anesthesia delivery market, competition is also based on a variety of factors including product performance, functionality, value and breadth of sales and service organization. We believe that our principal competitors in the market for medical monitoring and anesthesia systems are Criticare Systems, Inc., Philips Medical Systems, GE Medical Systems, Dräger Medical, Datascope Corp., Nihon Kohden Corporation, Penlon Ltd. and Nellcor, a division of the Tyco International, Inc. Competition could result in price reductions, reduced margins and loss of our market share. We believe that our patient monitoring products are easier to use than the products of many of our competitors because we offer a consistent user interface throughout many of our product lines. In addition to this advantage, the monitoring products of our Spacelabs Medical subsidiary are backward/forward compatible, meaning that new Spacelabs Medical monitors can interface with existing Spacelabs Medical monitor models, thus offering investment protection to our customers. Finally, while some of our competitors are beginning to introduce portal technology, which allows remote access to data from the bedside monitor, central station or other point of care, we believe that our products are superior in bringing instant access to labs, radiology and charting at the point of care. Although we have established relationships with a number of large hospitals, we may not be able to successfully compete in the future with existing competitors or with new entrants.

In the optoelectronic devices and subsystems market, competition for optoelectronic devices and value-added subsystems is based primarily on such factors as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support and on the ability to provide fully integrated services from application development and design through production. We believe that our major competitors in the optoelectronic device and subsystem market are PerkinElmer, Inc. and Hamamatsu Corporation. Because we specialize in custom subsystems requiring a high degree of engineering expertise, we believe that we generally do not compete to any significant degree with any other large United States, European or Asian manufacturers of standard optoelectronic components.

### **Backlog**

We measure our backlog as orders for which purchase orders or contracts have been signed, but which have not yet been shipped and for which revenues have not yet been recognized. We typically ship our security and inspection systems, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems within one to several months after receiving an order. However, such shipments may be delayed for a variety of reasons including any special design or engineering requirements of the customer. In addition, large orders (more than ten machines) of security and inspection products typically require more lead-time.

Cargo and vehicle inspection systems may require several months to several years lead-time. We have experienced some significant shipping delays associated with our cargo and vehicle inspection systems. Such delays can occur for many reasons, including: (i) additional time necessary to conduct inspections at the factory before shipment; (ii) a customer's need to engage in time-consuming special site preparation to accommodate the system, over which we have no control or responsibility; (iii) additional fine tuning of such systems once they are installed; (iv) design or specification changes by the customer; and (v) delays originating from other contractors on the project.

As of June 30, 2005, our backlog totaled approximately \$94.7 million, compared to approximately \$84.9 million as of June 30, 2004 and approximately \$53.0 million at June 30, 2003. We expect to ship most of our backlog as of June 30, 2005 during fiscal year 2006. Sales orders underlying our backlog are firm orders. Moreover, from time to time, we may agree to permit the cancellation of an order on a negotiated basis. Variations in the size of orders, product mix, or delivery requirements, among other factors, may result in substantial fluctuations in backlog from period to period. Backlog as of any particular date should not be relied upon as indicative of our revenues for any future period and cannot be considered a meaningful indicator of our performance on an annual or quarterly basis.

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### Employees

As of June 30, 2005, we employed approximately 2,340 people, of whom 1,070 were employed in manufacturing, 255 were employed in research and development, 280 were employed in finance and administration, 335 were employed in sales and marketing and 400 were employed in service capacities. Of the total employees, approximately 1,465 were employed in North America and South America, 500 were employed in Asia and 375 were employed in Europe. Eleven employees of our Advanced Microelectronics AS subsidiary in Norway and eight employees of our Rapiscan Systems Oy subsidiary in Finland are union members and have collective bargaining rights. None of our other employees are unionized. We have never experienced a work stoppage or strike, and management believes that its relations with employees are good.

### Available Information

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended. Therefore, we file periodic reports, proxy statements and other information with the Securities and Exchange Commission. Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the Securities and Exchange Commission at 100 F Street, N.E., Washington, D.C. 20549 or by calling 1-202-551-6551. In addition, the Securities and Exchange Commission maintains an Internet website (<http://www.sec.gov>) that contains reports, proxy statements and other information that issuers are required to file electronically.

Our Internet address is: <http://www.osi-systems.com>. We make available, free-of-charge through our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act and reports filed pursuant to Section 16 of the Exchange Act. We do so as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the Securities and Exchange Commission.

### ITEM 2. PROPERTIES

As of June 30, 2005, we owned four facilities. Three are located in Hawthorne, California (approximately 88,000 square feet). They are used by each of our security and inspection systems, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems segments for administrative, manufacturing, engineering, sales and marketing purposes. They also constitute our corporate headquarters. We also own one building in Horley, England (approximately 59,000 square feet). Our security and inspection systems and medical monitoring and anesthesia systems groups use this facility for manufacturing, engineering, sales and marketing functions.

As of June 30, 2005, we leased all of our other facilities. The following table lists our principal physical properties (*i.e.*, facilities greater than 10,000 square feet):

Location	Description of Facility	Approximate Square Footage	Expiration
Camarillo, California	Manufacturing, engineering, sales and marketing and service for our optoelectronics and value-added subsystems group	60,000	2010
Hawthorne, California	Manufacturing, engineering, sales and marketing and service for our security and inspection systems group	41,600	2006
Santa Clara, California	Manufacturing, engineering, sales and marketing for our security and inspection systems group	36,000	2006

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Location	Description of Facility	Approximate Square Footage	Expiration
Sunnyvale, California	Manufacturing, engineering, sales and marketing for our security and inspection systems group	28,300	2007
Upland, California	Manufacturing, engineering, sales and marketing for our optoelectronics and value-added subsystems group	22,000	2008
Orlando, Florida	Manufacturing, engineering, sales and marketing and service for our optoelectronics and value-added subsystems group	19,300	2008
North Andover, Massachusetts	Manufacturing, engineering, sales and marketing for our optoelectronics and value-added subsystems group	35,200	2010
Ocean Springs, Mississippi (1)	Manufacturing, engineering sales and marketing for our security and inspection systems and optoelectronics and value-added subsystems groups	12,800	2005
Issaquah, Washington (2)	Manufacturing, engineering, sales and marketing and service for our medical monitoring and anesthesia systems group	202,600	2014
Espoo, Finland	Manufacturing, engineering, sales and marketing for our security and inspection systems and medical monitoring and anesthesia systems groups	18,500	2006
Cherlapally, India	Manufacturing and engineering for our security and inspection systems, medical monitoring and anesthesia systems and optoelectronics and value-added subsystems groups	44,700	2009
Secunderabad, India (3)	Manufacturing and engineering for our security and inspection systems, medical monitoring and anesthesia systems and optoelectronics and value-added subsystems groups	16,900	2005
Johor Bahru, Malaysia (4)	Manufacturing, engineering sales and service for our security and inspection systems, medical monitoring and anesthesia systems and optoelectronics and value-added subsystems groups	99,000	2005-2006
Horten, Norway	Manufacturing, engineering, sales and marketing for our optoelectronics and value-added subsystems group	19,800	2008
Chesham, United Kingdom (5)	Manufacturing, engineering, sales and marketing for our medical monitoring and anesthesia systems group	18,800	2006-2009
Crawley, United Kingdom (6)	Manufacturing, engineering, sales and marketing for our security and inspection systems and medical monitoring and anesthesia systems groups	30,300	2005-2011

- (1) On July 29, 2005 we purchased this facility in Ocean Springs, Mississippi that we had previously been leasing. We intend to continue to use this facility for manufacturing, engineering and sales functions for our security and inspection systems and optoelectronics and value-added subsystems groups.
- (2) This lease of the 202,600 square foot facility in Issaquah, Washington, is composed of two leases in the same facility. One is a 107,000 square foot facility lease and the other is a 95,600 square foot facility lease. Both will terminate in December 2014.
- (3) The lease of the 16,900 square foot facility in Secunderbad, India is composed of four leases in the same or in a nearby facility: (i) two 5,500 square foot facility leases that will both terminate in September 2005, (ii) a 3,700 square foot facility lease that will terminate in September 2005 and (iii) a 2,200 square foot facility lease that will terminate in October 2005. In June 2005, we signed a 44,700 square foot facility lease in Cherlapally, India and intend to relocate all of our manufacturing and engineering work that is currently being performed in our Secunderbad facilities.
- (4) The lease of the 99,000 square foot facility in Johor Bahru, Malaysia is composed of three leases: (i) a 76,000 square foot facility lease that will terminate in December 2005, (ii) a 16,000 square foot facility lease that will terminate in January 2006 and (iii) a 7,000 square foot facility lease that will terminate in September 2005. We expect that both of the 76,000 square foot facility and 16,000 square foot facility leases will be renewed on similar terms. We do not currently intend to renew the 7,000 square foot facility lease.
- (5) This lease of the 18,800 square foot facility in Chesham, United Kingdom is composed of four leases in the same or in a nearby facility: (i) a 12,300 square foot facility lease that will terminate in December 2009, (ii) a 2,700 square foot facility lease that will terminate in March 2008, (iii) a 2,400 square foot facility lease that will expire in September 2006 and (iv) a 1,400 square foot facility lease that will expire in July 2007.
- (6) The lease of the 30,300 square foot facility in Crawley, United Kingdom is composed of three leases in the same or in a nearby facility: (i) a 13,900 square foot facility lease that will terminate in March 2011, (ii) a 10,000 square foot facility lease that will terminate in February 2009 and (iii) a 6,400 square foot facility lease that will terminate in December 2005.

We believe that our facilities are in good condition and are adequate to support our operations for the foreseeable future. We currently anticipate that we will be able to renew the leases that are scheduled to expire in the next few years on terms that are substantially the same as those currently in effect. However, even if we were not able to renew one or more of the leases, we believe that suitable substitute space is available to relocate any of the facilities. Accordingly, we do not believe that our failure to renew any of the leases that are scheduled to expire in the next few years will have a material adverse effect on our operations.

### **ITEM 3. LEGAL PROCEEDINGS**

In November 2002, L-3 Communications Corporation brought suit against us for a declaratory judgment that L-3 Communications Corporation had not breached its obligations to us concerning the acquisition of PerkinElmer, Inc.'s Security Detection Systems Business. In February 2003, we answered and asserted counterclaims against L-3 Communications Corporation for, among other things, fraud, breach of fiduciary duty, breach of contract and failure to negotiate in good faith. In March 2003, L-3 Communications Corporation amended its complaint and asserted claims against us for breach of contract, failure to negotiate in good faith and tortious interference. In its amended complaint, L-3 Communications Corporation requested both a declaratory judgment that it had fulfilled its obligations and an award of damages for an unspecified amount. In March 2005, the court in this action ruled that as a matter of law, L-3 Communications Corporation owed us a fiduciary duty. These actions are pending in the District Court for the Southern District of New York.

During 2003 and 2004, we were informed that Science Applications International Corporation ("SAIC") had made statements to prospective buyers of our gamma ray mobile detection system product that our product infringed upon unspecified SAIC patents. In April 2004, we received a letter from SAIC specifying a patent upon which SAIC claimed our product infringed. Contrary to SAIC's claim, the patent cited by SAIC actually

distinguished the technology used in our product as a different, pre-existing technology. We therefore filed a lawsuit in the U.S. District Court, Central District of California for declaratory judgment. SAIC has since counter-claimed for patent infringement, citing the same patent and unfair competition.

In March 2004, certain individuals named us and our subsidiary, Spacelabs Medical, as well as a hospital located in Bexar County, Texas, in a petition claiming that the individuals suffered injuries in March 2003 caused, in part, by a defective monitoring system manufactured by Spacelabs Medical. The amount of the claim has not yet been specified. The petition was filed in the 285<sup>th</sup> Judicial District Court in Bexar County, Texas.

In April 2004, certain individuals named our subsidiary, Spacelabs Medical, as well as several other defendants, in a petition that alleges, among other things, that a product possibly manufactured by Spacelabs Medical failed to properly monitor a hospital patient thereby contributing to the patient's death in November 2001. The amount of the claim has not yet been specified. The petition was filed in the 21<sup>st</sup> Judicial District Court, Parish of Tangipahoa, Louisiana.

In February 2005, Electromedical, a Greek distribution company, filed an action in the courts of Greece claiming that Spacelabs orally agreed to appoint Electromedical as Spacelabs' exclusive Greek distributor, but failed to do so. Electromedical claims that it incurred significant expenses as a result of Spacelabs' actions and demands Euro 872,414 (approximately \$1,054,000 as of June 30, 2005) in compensation.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, "Accounting for Contingencies," we have not accrued for loss contingencies relating to the above matters because we believe that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to us, the impact on our results of operations, financial position and/or liquidity could be material.

We are also involved in various other claims and legal proceedings arising out of the ordinary course of business which have not been previously disclosed in our quarterly and annual reports. In our opinion after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on our financial position, future results of operations, or cash flows.

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

None.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### Stock Market and Other Information

Our Common Stock is traded on the NASDAQ National Market under the symbol "OSIS".

The following table sets forth the high and low sale prices of a share of our Common Stock as reported by the NASDAQ National Market on a quarterly basis for the fiscal years ended June 30, 2004 and June 30, 2005. The prices shown reflect inter-dealer prices, without retail markup, markdown or commission and may not necessarily represent actual transactions.

2004:	High	Low
Quarter ended September 30, 2003	\$18.40	\$13.76
Quarter ended December 31, 2003	\$19.92	\$17.06
Quarter ended March 31, 2004	\$23.17	\$17.18
Quarter ended June 30, 2004	\$25.30	\$18.03
2005:	High	Low
Quarter ended September 30, 2004	\$19.97	\$14.41
Quarter ended December 31, 2004	\$23.40	\$15.50
Quarter ended March 31, 2005	\$22.70	\$16.06
Quarter ended June 30, 2005	\$17.78	\$13.80

As of September 23, 2005, there were approximately 114 holders of record of our Common Stock. This number does not include beneficial owners holding shares through nominees or in "street" name.

#### Dividend Policy

We have not paid any cash dividends since the consummation of our initial public offering in 1997 and anticipate that we will retain any available funds for use in the operation of our business. We do not currently intend to pay any cash dividends in the foreseeable future. Our Board of Directors will determine the payment of future cash dividends, if any. Certain of our current bank credit facilities restrict the payment of cash dividends and future borrowing may contain similar restrictions.

#### Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased under the Plans or Programs (1)
April 1, 2005 to April 30, 2005	—	—	—	1,488,000
May 1, 2005 to May 31, 2005	157,027	\$ 14.25	157,027	1,330,973
June 1, 2005 to June 30, 2005	—	—	—	1,330,973
Total	157,027	\$ 14.25	157,027	1,330,973

- (1) In March 1999, our Board of Directors authorized a stock repurchase program for the repurchase of up to 2 million shares of our Common Stock. In September 2004, we increased the number of shares available for repurchase under the stock repurchase program by 1 million shares. In May 2005, we repurchased 157,027 shares of our Common Stock at an average price of \$14.25 per share. At June 30, 2005, 1,330,973 shares were available for repurchase under the program.

## Equity Compensation Plans

The following table provides information concerning our equity compensation plans as of June 30, 2005.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders (1)	1,775,148	\$ 16.41	790,801
Equity participation plans not approved by security holders	—	—	—
Total	1,775,148	\$ 16.41	790,801

(1) Includes shares of our Common Stock issuable upon exercise of options from our 1987 Incentive Stock Option Plan and our 1997 Stock Option Plan.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth our selected consolidated financial data as of and for each of the five fiscal years ended June 30, 2005 and is derived from our consolidated financial statements. The consolidated financial statements as of June 30, 2004 and 2005, and for each of the years in the three-year period ended June 30, 2005, and the report of independent registered public accounting firm thereon, are included elsewhere in this Annual Report on Form 10-K. The following data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

	Year Ended June 30,				
	2001	2002	2003	2004 (1)	2005 (1)
(In thousands, except share and per share data)					
<b>Consolidated Statements of Operations Data:</b>					
Revenues	\$ 111,099	\$ 124,230	\$ 182,644	\$ 247,069	\$ 385,041
Cost of goods sold	80,851	85,908	122,661	163,712	243,415
Gross profit	30,248	38,322	59,983	83,357	141,626
Operating expenses:					
Selling, general and administrative	21,572	21,647	29,160	54,161	116,245
Research and development	6,671	6,434	8,865	14,638	30,537
Goodwill amortization	488	402	—	—	—
Management retention bonus (2)	—	—	—	1,104	1,824
Restructuring costs (3)	—	—	—	1,061	—
Total operating expenses	28,731	28,483	38,025	70,964	148,606
Income (loss) from operations	1,517	9,839	21,958	12,393	(6,980)
Gain on sale of subsidiary (4)	2,967	—	—	—	—
Gain on sale of investment (5)	1,119	—	—	—	—
Gain on sale of marketable securities (6)	—	—	1,767	376	—
Write-off of deferred acquisition costs (7)	—	—	(608)	—	—
Write down of equity investments (8)	—	—	(1,433)	(247)	(182)
Interest expense	(1,417)	(653)	(380)	(283)	(807)
Interest income	422	814	1,166	863	196
Income (loss) before income taxes and minority interest	4,608	10,000	22,470	13,102	(7,773)
Provision (benefit) for income taxes	1,250	3,000	6,521	3,316	(5,309)
Income (loss) before minority interest	3,358	7,000	15,949	9,786	(2,464)
Minority interest	146	(79)	(156)	170	69
Net income (loss)	\$ 3,504	\$ 6,921	\$ 15,793	\$ 9,956	\$ (2,395)
Net income (loss) available to common shareholders (diluted)	\$ 3,504	\$ 6,921	\$ 15,793	\$ 9,956	\$ (2,502)
Basic earnings (loss) per common share	\$ 0.39	\$ 0.63	\$ 1.13	\$ 0.68	\$ (0.15)
Diluted earnings (loss) per common share	\$ 0.38	\$ 0.60	\$ 1.09	\$ 0.65	\$ (0.15)
Weighted average shares outstanding (diluted)	9,115,673	11,478,371	14,513,374	15,236,399	16,222,998



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	Year Ended June 30,				
	2001	2002	2003	2004 (1)	2005 (1)
	(In thousands, except share and per share data)				
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents (9)	\$ 4,467	\$ 67,604	\$ 94,246	\$ 39,879	\$ 14,623
Working capital (9)	46,314	115,631	141,916	143,398	124,398
Total assets (9)	92,396	175,358	229,538	331,801	347,120
Long term debt	7,003	4,463	1,838	32	4,852
Total debt	9,728	7,088	4,463	2,553	21,103
Total shareholders' equity (9)	\$ 62,481	\$ 135,734	\$ 180,399	\$ 227,482	\$ 223,627

- (1) Results of operations for the fiscal years ended June 30, 2004 and 2005, and our financial position as of June 30, 2004 and 2005 incorporate the effect of several acquisitions, including Spacelabs Medical. See Item 7. "Management's Discussions and Analysis of Financial Condition and Results of Operations."
- (2) Represents an expense resulting from retention obligations of key personnel of Spacelabs Medical. For the year ended June 30, 2005, the expense had the effect of decreasing income from operations by \$1.8 million, net income by \$1.1 million and net income available to common shareholders by \$1.1 million. For the year ended June 30, 2004, the expense had the effect of decreasing income from operations by \$1.1 million, net income by \$784,000 and net income available to common shareholders by \$784,000.
- (3) Represents a charge resulting from consolidating and restructuring certain subsidiaries. For the fiscal year ended June 30, 2004, the charge had the effect of decreasing income from operations by \$1.1 million, net income by \$753,000, and net income available to common shareholders by \$753,000.
- (4) Represents the gain on the sale of Silicon Microstructures, Inc.
- (5) Represents the gain on the sale of an equity investment.
- (6) Represents the gain on the sale of marketable securities classified as available-for-sale.
- (7) Represents professional fees and other transaction costs related to our agreement with L-3 Communications Corporation for the joint acquisition of certain detection and security businesses then owned by PerkinElmer, Inc. In November 2002, L-3 Communications Corporation terminated this transaction prior to consummation.
- (8) Represents the recognition of an other-than-temporary impairment of an equity investment.
- (9) The increase in fiscal year 2004 includes net proceeds of \$31.0 million received under a private placement. The increase in fiscal year 2003 includes net proceeds of \$20.5 million received under a private placement. The increase in fiscal year 2002 includes net proceeds of \$56.8 million received under private placements.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Forward-looking Statements.**

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto appearing elsewhere in this Annual Report on Form 10-K. Certain statements contained herein that are not related to historical results, including, without limitation, statements regarding our business strategy, objectives and future financial position, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended and involve risks and uncertainties. These forward-looking statements may be identified by the use of forward-looking terms such as "anticipate," "believe," "expect," "may," "could," "likely to," "should," or "will," or by discussions of strategy that involve risks and uncertainties. These forward-looking statements include assertions regarding anticipated future revenues, sales, operations, demand, competition, capital expenditures, credit arrangements and other claims regarding matters that are not historical facts, involve predictions which are based upon a number of future conditions that ultimately may prove to be inaccurate.

Factors that may cause or contribute to such differences include those discussed in "Risk Factors," "Business," and "Management's Discussion and Analysis of Financial Condition and Results of Operations," as

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well as elsewhere in this Annual Report on Form 10-K and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. Such factors, of course, do not include all factors that might affect our business and financial condition. Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, such assumptions could prove to be inaccurate and actual results could differ materially from those expressed in or implied by the forward-looking statements.

All forward-looking statements contained in this Annual Report on Form 10-K are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

### **Overview**

We are a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems.

Our company was incorporated in 1987. Initially, we manufactured optoelectronic devices and value-added subsystems for customers in several industries, including makers of security and inspection systems and medical monitoring and imaging systems. Through acquisitions we have entered the security and medical products markets because we believe that vertical integration make us more competitive in these areas.

We now operate in three identifiable industry segments: (a) security and inspection systems, (b) medical monitoring and anesthesia systems and (c) optoelectronic devices and value-added subsystems. Both the security and inspection systems and the medical monitoring and anesthesia systems groups comprise primarily end-product businesses, whereas the optoelectronic devices and value-added subsystems group primarily supplies components and subsystems to original equipment manufacturers and to our businesses in our security and inspection systems and the medical monitoring and anesthesia systems groups. All inter-company sales are eliminated in consolidation. Further information concerning reporting segments is available in Note 13 to our consolidated financial statements.

We design, manufacture and market security and inspection systems worldwide to end users under the “Rapiscan Systems” name. Rapiscan Systems products are used to inspect baggage, cargo, people, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening.

Our medical monitoring and anesthesia systems businesses design, manufacture and market their products worldwide to end users under several brand names. Our medical monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and related services are sold under the “Spacelabs Medical” brand name. Our anesthesia systems and components are sold under the “Blease” brand name. Our arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools, are sold under the “Dolphin” brand name and our peripheral bone densitometers and ultrasound bone sonometers are sold under the “Osteometer” brand name.

Our optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We design and manufacture optoelectronic devices and value-added subsystems worldwide for others through original equipment manufacturer arrangements, as well as for our own security and medical equipment businesses.

In fiscal year 2005, revenues from the sale of security and inspection products amounted to \$123.2 million, or approximately 32% of our revenues, revenues from the sale of medical monitoring and anesthesia systems were \$195.7 million or 51% of our revenues, while revenues from the sale of optoelectronic devices and value-added subsystems amounted to \$66.1 million, or approximately 17% of our revenues.

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Our security and inspection systems group has continued to grow, despite challenges it faces in the cargo and vehicle inspection systems market segment. Our baggage and parcel inspection and people screening products continue to perform to our expectations. In recent years, we have invested significantly in the development of cargo and vehicle inspection systems and advancements in hold baggage screening systems. These investments include both the internal development of technologies and products, the acquisition of companies such as Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation) and Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), and our investment in CXR, a company we now wholly own.

The cargo and vehicle inspection systems market is still in its infancy and therefore has not generated significant sales. However, we anticipate that the United States Government will establish standards for cargo and vehicle inspection at airports, border crossings and seaports and that the establishment of these standards will create a larger market for our products. The United States Government continues to invest in research and development and testing of various cargo and vehicle inspection technologies and we participate substantially in these activities. However, as a result of our investments in cargo and vehicle inspection technologies and explosive detection systems, our security and inspection system group recorded an operating loss for the year. We offer a broad line of security and inspection screening products and technologies as compared to our competitors and therefore anticipate that we will be well-positioned to take advantage of market opportunities when they arise.

Our medical monitoring and anesthesia systems group grew substantially in fiscal year 2005 as we benefited from a full year of revenues from Spacelabs Medical, a global manufacturer and distributor of patient monitoring and clinical information systems that we acquired in March 2004 from Instrumentarium Corporation, now a subsidiary of General Electric Company. The acquisition price was approximately \$47.9 million in cash (net of cash acquired), including acquisition costs. Spacelabs Medical, based in Issaquah, Washington is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors and medical data services. These are areas in which we have considerable interest as they represent a natural extension of our engineering and manufacturing expertise and will add to our presence in the medical device industry.

In addition, we recently strengthened our perioperative products portfolio with the acquisition in February 2005 of Blease, a United Kingdom-based manufacturer and distributor of anesthesia delivery systems, ventilators and vaporizers. Consideration for the acquisition of Blease consisted of a cash payment of \$9.3 million (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$11.2 million as of June 30, 2005).

Other products offered by our medical monitoring and anesthesia systems group are experiencing growth, especially our pulse oximetry instruments which compete directly with products sold by Nellcor, the current market leader in this area who owns key patents which have recently expired in the United States and other countries. Overall, our medical monitoring and anesthesia systems group was profitable during fiscal year 2005 and should continue to generate profits as we consolidate and realize certain synergies stemming from the acquisitions of Spacelabs Medical and Blease.

Our optoelectronic devices and value-added subsystems group met our expectations during fiscal year 2005, with the exception of our defense optoelectronics businesses. Our defense optoelectronics businesses sell primarily to lead systems integrators, some of whom recently lost certain significant defense-related contracts. As a result, sales by our defense optoelectronics businesses declined, but were offset by growth in our commercial optoelectronics and value-added subsystems manufacturing operations.

During fiscal year 2005 we began exploring strategic alternatives for our business groups. Our medical monitoring and anesthesia systems group has grown from approximately \$11 million in annual revenues in fiscal year 2003 to approximately \$196 million in fiscal year 2005, primarily as a result of the acquisitions of Spacelabs

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Medical and Blease. As a result and in connection with these efforts, we engaged Collins Stewart, a London-based investment bank to pursue the public offering and listing of approximately 30% to 35% of the equity in Spacelabs Healthcare, a newly formed subsidiary comprising the business operations of the medical monitoring and anesthesia systems group. This offering and listing is planned in the United Kingdom on the AIM Exchange, which is owned and administered by the London Stock Exchange. The shares in Spacelabs Healthcare will not be offered or sold in the United States. Under Securities and Exchange Commission regulations, U.S. residents are prohibited from participating in this proposed offering of shares, and any shares offered cannot be acquired by U.S. residents for a period of twelve months from the date of the offering. Comparable companies of similar size and technologies have been valued at approximately one times revenue. We currently expect to complete the proposed transaction during the second quarter of fiscal year 2006. However, the completion of the listing remains fully subject to a number of factors, including regulatory approvals and our satisfaction with the valuation, which may not occur.

Overall as a company, we also continue to move towards the consolidation of our various businesses. In March 2004, we rebranded our security and inspection systems businesses under the “Rapiscan Systems” name. We have done so in order to generate manufacturing, sales force and administrative related efficiencies and to increase productivity. In addition, we continue to invest in critical areas such as sales, marketing and research and development. Our gross margin is dependent on our product mix. As our medical monitoring and anesthesia systems businesses grew and generated over 50% of our revenues in fiscal year 2005, our gross margin as a percentage of revenues has increased. However, our operating expenses as a percentage of revenues have also increased as our medical monitoring and anesthesia systems segment has higher operating expenses as a percentage of revenues as compared to our other segments.

Certain legal expenditures related to two lawsuits and costs associated with the implementation of and audit requirements imposed by the Sarbanes-Oxley Act of 2002 have contributed to our operating loss for the year. We are currently involved in two legal proceedings that have resulted in high litigation-related expenses, namely our lawsuit with L-3 Communications Corporation, which commenced in November 2002 and stems from circumstances surrounding the acquisition by L-3 Communications Corporation of PerkinElmer, Inc.’s Security Detection Systems Business and our lawsuit with Science Applications International Corporation, which commenced in April 2004 and stems from patent infringement claims related to a gamma-ray mobile detection system product we sell. These high levels of legal and audit-related expenses are expected to continue.

We engage in significant international operations. We currently manufacture our security and inspection systems at our facilities in Hawthorne, Santa Clara and Sunnyvale, California and Ocean Springs, Mississippi and internationally in India, Finland, Malaysia and the United Kingdom. Our medical monitoring and anesthesia systems are currently manufactured at our facilities in Hawthorne, California and Issaquah, Washington and internationally in the India, Malaysia, Singapore and the United Kingdom. Our optoelectronic devices and value-added subsystems are manufactured in Camarillo, Hawthorne, Newbury Park and Upland, California, Ocean Springs, Mississippi, North Andover, Massachusetts, and internationally in India, Malaysia, Norway and Singapore. As of June 30, 2005, we marketed our products worldwide through approximately 335 sales and marketing employees located in more than a dozen countries, in addition to a global network of independent sales representatives. Revenues from shipments made outside of the United States accounted for 51% of revenues in fiscal year 2003, 41% of revenues in fiscal year 2004, and 40% of revenues in fiscal year 2005. Information regarding our revenues and identifiable assets attributable to each of our business segments is set forth in Note 13 in our Consolidated Financial Statements.

### **Related-Party Transactions**

In 1994, we, together with an unrelated company, formed ECIL-Rapiscan Security Products Limited, a joint venture organized under the laws of India. We own a 36% interest in the joint venture, our chairman and chief executive officer owns a 10.5% interest, and the president of Rapiscan Systems owns a 4.5% ownership interest. Our initial investment was \$108,000. For the years ended June 30, 2003, 2004 and 2005 our equity earnings in the joint venture amounted to \$249,000, \$317,000 and \$213,000, respectively, and are included in selling,

general and administrative expenses. During the year ended June 30, 2001, we increased our initial investment by \$39,000. Our ownership interest remained at 36% as all the shareholders increased their respective investments proportionately. We, our chairman and chief executive officer and the president of Rapiscan Systems collectively control less than 50% of the board of directors voting power in the joint venture. As a result, we account for the investment under the equity method of accounting. The joint venture was formed for the purpose of the manufacture, assembly, service and testing of security and inspection systems and other products. Some of our subsidiaries are suppliers to the joint venture partner, which in turn manufactures and sells the resulting products. Sales to the joint venture partner for the fiscal years ended June 30, 2003, 2004 and 2005 were approximately \$468,000, \$677,000 and \$178,000, respectively.

We have contracted with entities owned by members of our Board of Directors to provide messenger services, auto rental and printing services. Included in cost of sales, selling, general and administrative expenses for the fiscal years ended June 30, 2003, 2004 and 2005 are approximately \$101,000, \$70,000 and \$60,000 for messenger service and auto rental, and \$104,000, \$73,000 and \$67,000 for printing services, respectively.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States. Our preparation of these consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, 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 base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

**Revenue Recognition.** We recognize revenue upon shipment of products when title and risk of loss passes, and when terms are fixed and collection is probable. In accordance with the terms of Staff Accounting Bulletin No. 104, "Revenue Recognition" and Emerging Issues Task Force 00-21 "Revenue Arrangements with Multiple Deliverables," where installation services, if provided, are essential to the functionality of the equipment, the portion of revenue for the sale attributable to installation is deferred and recognized when the installation services are provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the acceptance criteria are met. Concurrent with the shipment of the product, we accrue estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not the customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of revenue recognized. Critical judgments also include estimates of warranty reserves, which are established based on historical experience and knowledge of the product.

We undertake projects that include the design, development and manufacture or fabrication of large, complex cargo and vehicle inspection systems that are specially customized to our customer's specifications or that involve fixed-site construction. Sales under such contracts are recorded under the percentage-of-completion method in accordance with Statement of Position No. 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Costs and estimated revenues are recorded as work is performed based on the percentage that incurred costs bear to estimated total costs utilizing the most recent estimates of costs. If the current contract estimate indicates a loss, provision is made for the total anticipated loss in the current period. Critical estimates made by management related to revenue recognition under the percentage-of-completion method include the estimation of costs at completion and the determination of the overall margin rate on the specific project.

Revenues from separate service maintenance contracts are recognized ratably over the term of the agreements. For other services, service revenues are recognized as the services are performed. Deferred revenue for services arises from advance payments received from customers for services not yet performed. We record billed shipping and handling fees as revenue and the associated costs as cost of goods sold.

**Accounts Receivable.** The allowance for doubtful accounts involves estimates based on management's judgment, review of individual receivables and analysis of historical bad debts. We adjust customer credit limits based upon each customer's payment history and current credit worthiness, as determined by credit information available at that time. We continuously monitor collections and payments from our customers and we maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

**Inventory.** Inventory is stated at the lower of cost or market. Cost is determined on the first-in, first-out method. We write down inventory for slow-moving and obsolete inventory based on assessments of future demands, market conditions and customers who may be experiencing financial difficulties. If these factors are less favorable than those projected, additional inventory write-downs may be required.

**Deferred Tax Asset Valuation Allowance.** We record a valuation allowance to reduce our deferred tax assets when it is more likely than not, based upon currently available evidence and other factors, that we will not realize some portion or all of our deferred tax assets. We base our determination of the need for a valuation allowance on an on-going evaluation of past and current evidence, including, among other things, historical earnings, estimates of future earnings, the backlog of customer orders and the expected timing of deferred tax asset reversals. We charge or credit adjustments to the valuation allowance to income tax expense in the period in which these determinations are made. If we determine that we would be able to realize our deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase net income in the period this determination was made. Likewise, if we determine that we would not be able to realize all or part of our net deferred tax assets in the future, we would establish a valuation allowance for the deferred tax asset and would reduce net income in the period this determination was made.

**Goodwill.** We account for goodwill and intangible assets in accordance SFAS No. 142 "Goodwill and Other Intangible Assets." We assess impairment on an annual basis or on an interim basis if events occur or circumstances change that reduce the fair value of a reporting unit below its carrying value. This assessment requires the determination of the fair value of each reporting unit as compared to its carrying value. We determine the fair value of our reporting units on the income approach which requires the use of estimates of future revenues, cash flows and capital expenditures, as well as market trends and growth. We believe these estimates and assumptions to be reasonable, although they are inherently unpredictable and uncertain and actual results may differ from these estimates.

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### Results of Operations

The following table sets forth certain income and expenditure items as a percentage of total revenues for the periods indicated.

	Year Ended June 30,		
	2003	2004	2005
Revenues	100.0%	100.0%	100.0%
Cost of goods sold	67.2	66.3	63.2
Gross profit	32.8	33.7	36.8
Operating Expenses:			
Selling, general and administrative	16.0	21.9	30.2
Research and development	4.8	5.9	7.9
Restructuring costs	—	0.4	—
Management retention bonus	—	0.5	0.5
Total operating expenses	20.8	28.7	38.6
Income (loss) from operations	12.0	5.0	(1.8)
Gain on sale of marketable securities	1.0	0.2	—
Write-off of deferred acquisition costs	(0.3)	—	—
Write down of equity investments	(0.8)	(0.1)	—
Interest income (expense)	0.4	0.2	(0.2)
Income (loss) before provision for income taxes and minority interest	12.3	5.3	(2.0)
Provision (benefit) for income taxes	3.6	1.3	(1.4)
Income (loss) before minority interest	8.7	4.0	(0.6)
Minority interest	(0.1)	—	—
Net income (loss)	8.6	4.0	(0.6)

### Comparison of Fiscal Year Ended June 30, 2005 to Fiscal Year Ended June 30, 2004

**Revenues.** Revenues consist of sales of security and inspection products, medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems. Revenues are recorded net of inter-company eliminations. Revenues for the fiscal year ended June 30, 2005 increased by \$137.9 million, or 56%, to \$385.0 million, compared to \$247.1 million for the fiscal year ended June 30, 2004.

Revenues from the sale of security and inspection products increased by \$5.4 million, or 5%, to \$123.2 million, compared to \$117.8 million for fiscal year 2004. The increase was primarily attributable to an increase in the sales volume of our people screening systems and an increase in service revenues, offset by lower sales of baggage and parcel inspection systems to the U.S. Transportation Security Administration.

Revenues for the sale of medical monitoring and anesthesia systems increased by \$135.0 million, or 222%, to \$195.7 million, compared to \$60.7 million for fiscal year 2004. The increase was primarily attributable to the inclusion of the revenues of Spacelabs Medical, a company we acquired in March 2004. The increase was also attributable to the inclusion of revenues of Blease, a company we acquired in February 2005, as well as to growth in our pulse oximetry business. The revenue impact of Spacelabs Medical and Blease for the fiscal year ended June 30, 2005 was \$178.6 million, as compared to \$47.2 million for the fiscal year ended June 30, 2004.

Revenues for the sale of optoelectronic devices and value-added subsystems decreased by \$2.5 million, or 4%, to \$66.1 million, compared to \$68.6 million for fiscal year 2004. This result was primarily due to lower sales of defense optoelectronics, offset partially by increased sales of commercial optoelectronics.

**Gross Profit.** Gross profit consists of revenues less cost of goods sold. Cost of sales consists of material, labor and manufacturing overhead. Gross profit increased by \$58.2 million, or 70%, to \$141.6 million, compared

to \$83.4 million for fiscal year 2004. As a percentage of revenues, gross profit increased to 36.8% in fiscal year 2005 from 33.7% in fiscal year 2004. The increase in gross profit as a percentage of revenues, or gross margin, was primarily attributable to the inclusion of Spacelabs Medical, which generally has a higher gross margin, but also higher operating expenses. The increase is also attributable to a change in estimated warranty provision of approximately \$2.1 million due to lower than expected warranty claims on a specific product sold by the medical monitoring and anesthesia systems group. The increase was partially offset by the negative impact on margins of current cargo and vehicle inspection projects undertaken by the security and inspection systems group, consisting of either first-of-a-kind projects with new technologies, or development grants with minimal margins and large up-front engineering costs. The increase was also partially offset by lower sales of defense optoelectronics.

**Selling, General and Administrative.** Selling, general and administrative expenses consist primarily of compensation paid to sales, marketing and administrative personnel, professional service fees and marketing expenses. For the year ended June 30, 2005, such expenses increased by \$62.0 million, or 114%, to \$116.2 million, compared to \$54.2 million for fiscal year 2004. As a percentage of revenues, selling, general and administrative expenses increased to 30.2% in fiscal year 2005 from 21.9% in fiscal year 2004. The increase in selling, general and administrative expenses for fiscal year 2005 as compared to the prior year period was primarily attributable to the inclusion of selling, general and administrative expenses of Spacelabs Medical, a company we acquired in March 2004, Blease, a company we acquired in February 2005 and Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a company we acquired in January 2004. The selling, general and administrative expenses of these three companies totaled \$61.7 million for the fiscal year ended June 30, 2005, compared to \$16.9 million for the fiscal year ended June 30, 2004. The increase was also partially attributable to higher sales and marketing expenses by our security and inspection systems group related to efforts aimed at developing a broader market for cargo and vehicle inspection and hold baggage screening systems, as well as the establishment of a bad debt reserve of \$2.5 million for an international cargo and vehicle inspection system receivable. We are actively pursuing the collection of this receivable or repossession of the equipment. Finally, our corporate group also contributed to the increase in selling, general and administrative expenses due to higher legal expenses related to two legal proceedings, implementation expenses incurred to comply with the Sarbanes-Oxley Act of 2002, increased administrative headcount, outside consulting fees and legal settlement costs related to a dispute with the former president of Spacelabs Medical. Legal expenses related to two legal proceedings and implementation expenses related to compliance with the Sarbanes-Oxley Act of 2002 were \$6.6 million for the fiscal year ended June 30, 2005, as compared to \$1.9 million for the fiscal year ended June 30, 2004. These expenses are partially offset by collections of approximately \$1.8 million in recoveries of accounts receivable previously written off.

**Research and Development.** Research and development expenses include research related to new product development and product enhancement expenditures. For the year ended June 30, 2005, such expenses increased by \$15.9 million, or 109%, to \$30.5 million, compared to \$14.6 million in fiscal year 2004. As a percentage of revenues, research and development expenses increased to 7.9% in fiscal year 2005 from 5.9% in fiscal year 2004. The increase in research and development spending was partially due to the inclusion of the research and development of Spacelabs Medical, a company we acquired in March 2004, Blease, a company we acquired in February 2005 and OSI Laserscan a business we began to operate in November 2003. Research and development expenses for these three businesses amounted to \$15.1 million for the fiscal year ended June 30, 2005, as compared to \$4.0 million for the fiscal year ended June 30, 2004. The increase in research and development expense was also attributable to increased spending on our automated hold baggage screening and cargo and vehicle inspection systems.

**Management Retention Bonus.** Pursuant to the purchase agreement with Instrumentarium Corporation for the acquisition of Spacelabs Medical, we assumed management retention bonus agreements for key personnel of Spacelabs Medical. Approximately \$450,000 of the retention bonuses were earned following the acquisition date and were paid in June 2004. The remaining retention bonuses vest over a two-year period beginning either October 9, 2003 or March 19, 2004. As of June 30, 2004, we accrued a total of \$2.6 million, of which \$1.9 million related to the period prior to the acquisition of Spacelabs Medical. During the fiscal year ended June 30, 2005, we paid approximately \$2.3 million in bonuses and we recognized expense of approximately \$1.8 million.



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The current estimate of total retention bonuses paid and to be paid under these agreements is approximately \$5.4 million. As of June 30, 2005, we accrued a total of \$2.1 million for the retention bonuses. The accrual is included in accrued payroll and related expenses as of June 30, 2004 and 2005.

**Restructuring Charges.** In fiscal year 2004, we consolidated manufacturing processes and facilities of certain businesses of our medical monitoring and anesthesia systems and optoelectronic and value-added subsystems businesses. These consolidations resulted in a pre-tax charge of \$1.1 million. The consolidation consisted primarily of write-offs of equipment and leasehold improvements of \$993,000 that were retired during the period and charge related to clean up of a vacated facility of \$60,000. We do not expect to incur further costs in relation to these consolidations. These charges were recorded as restructuring charges in our consolidated financial statements for the fiscal year ended June 30, 2004. These charges were calculated in accordance with SFAS No. 144, "Impairment or Disposal of Long-Lived Assets" and SFAS No. 146, "Accounting for Exit or Disposal Activities". In fiscal year 2005, there were no such restructuring charges.

**Income from Operations.** Income from operations for fiscal year 2005 decreased by \$19.4 million, resulting in a loss from operations of \$7.0 million, as compared to income from operations of \$12.4 million in fiscal year 2004. The decrease in income from operations was primarily due to the negative impact on gross margins of current cargo and vehicle inspection installations performed by the security and inspection systems group, which installations consisted of either first-of-a-kind projects incorporating new technologies or which were funded by development grants carrying minimal margins and large up-front engineering costs. The decrease in income from operations was also due to increased general and administrative expenses and research and development expenses, partially offset by higher gross profit from the medical monitoring and anesthesia systems business.

**Gain on Sale of Marketable Securities.** In the fiscal year ended June 30, 2004, we realized a gain on sale of marketable securities of \$376,000.

**Write Down of Equity Investments.** During the fiscal year ended June 30, 2004, we recognized in our consolidated statement of operations a write down of equity investment of \$247,000 and in the fiscal year ended June 30, 2005, we recognized a write down of \$182,000.

In June 2004, QuadraMed, Corp., a publicly traded company, purchased for cash and restricted shares of QuadraMed Corp., our investment in Tempus Software, a privately held software company whose shares we had acquired in connection with our acquisition of Spacelabs Medical. As of March 31, 2005, the fair value of QuadraMed, Corp. shares had decreased based on the market price of QuadraMed, Corp. shares. Pursuant to SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"), we concluded that an other-than-temporary decline in value had occurred, and we recorded an \$182,000 write down of this investment. However, as of June 30, 2005, the market price of QuadraMed, Corp. shares had recovered, increasing the value of our investment by \$154,000 to \$799,000. Pursuant to SFAS 115, this increase has been recorded as a component of other comprehensive income. The restriction on the sale of our QuadraMed, Corp. shares lapsed on of June 30, 2005. As a result, we are now free to sell our QuadraMed, Corp. shares and, under SFAS 115, the fair value of the shares is now deemed to be equal to the quoted market price of the shares. As of June 30, 2005, our QuadraMed, Corp. shares have been classified as marketable securities available-for-sale in our consolidated balance sheet.

In July 2002, we purchased from Imagis Technologies, Inc., 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), 2-year warrants to purchase 291,667 additional shares of Imagis Technologies, Inc. common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis Technologies, Inc. develops facial recognition software for security applications. We have designated the investment as available for sale. The investment, adjusted for changes in the market value of Imagis Technologies, Inc.'s equity securities, is included in other assets in the accompanying consolidated financial statements. Based on the continued trading of Imagis Technologies, Inc. common stock below the original purchase price for a prolonged period of time, we recognized an other-than-temporary impairment of the carrying value of this investment of \$247,000 in fiscal year 2004.

**Interest Income.** For fiscal year 2005, we earned interest income of \$196,000, compared to \$863,000 for fiscal year 2004. The decrease in interest income for fiscal year 2005 was due to the decrease in interest earning deposits in the current year.

**Interest Expense.** For fiscal year 2005, our interest expense was \$807,000, compared to \$283,000 for fiscal year 2004. The increase in expense was due to an increase in borrowings in the current year as compared to the prior year.

**Provision (Benefit) for Income Taxes.** For fiscal year 2005, we had a tax benefit of \$5.3 million, compared to a tax provision of \$3.3 million for fiscal year 2004. As a percentage of income before provision for income taxes and minority interest, the benefit for income taxes was 68% for fiscal year 2005, compared to a provision for income taxes of 25.3% for fiscal year 2004. Included in the tax benefit for fiscal year 2005 is approximately \$3.5 million of benefit due to the outcome of a study conducted with the assistance of our outside tax advisors to determine available research and development tax credits. In addition, our effective tax rate is dependent on the mix of income/loss from U.S. and foreign locations due to tax rate differences between countries.

**Net Income (Loss).** For the reasons outlined above, the net loss for the year ended June 30, 2005 was \$2.4 million, compared to net income of \$10.0 million for the year ended June 30, 2004.

#### **Comparison of Fiscal Year Ended June 30, 2004 to Fiscal Year Ended June 30, 2003**

**Revenues.** Revenues for the fiscal year ended June 30, 2004, increased by \$64.4 million, or 35.3%, to \$247.1 million, compared to \$182.6 million for the fiscal year ended June 30, 2003.

Revenues from the sale of security and inspection products decreased \$3.0 million, or 2.5%, to \$117.8 million, compared to \$120.8 million for fiscal year 2003. The decrease in revenues from the sale of security and inspection products was due to the decrease in sales of x-ray kits to Invision Technologies, Inc. (now a part of GE Infrastructure, Security) of \$19.6 million and was offset in part by increased sales of baggage and parcel inspection systems in the United States and the international market, increased sales of cargo and vehicle inspection systems in the international market and inclusion of the revenues of Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation) of \$9.5 million, a company we acquired in January 2004.

Revenues from the sale of medical monitoring and anesthesia systems increased by \$49.8 million, or 458%, to \$60.7 million, compared to \$10.9 million for fiscal year 2003. The increase in revenues from the sale of medical monitoring and anesthesia systems resulted primarily from the inclusion of \$47.2 million in revenues of Spacelabs Medical, a company we acquired in March 2004, and additional revenue growth from the sale of pulse oximetry products.

Revenues from the sale of optoelectronic devices and value-added subsystems, increased by \$17.7 million, or 35%, to \$68.6 million, compared to \$50.9 million for fiscal year 2003. The increase in revenues from the sale of optoelectronic devices and value-added subsystems resulted from the inclusion of the revenues of OSI Electronics, OSI Defense Systems and OSI Laserscan, totaling \$24.0 million, offset in part by lower sales primarily from defense optoelectronics.

**Gross Profit.** Gross profit increased by \$23.4 million, or 39.0%, to \$83.4 million, compared to \$60.0 million for fiscal year 2003. As a percentage of revenues, gross profit increased to 33.7% in fiscal year 2004 from 32.8% in fiscal year 2003. The increase in gross margin as a percentage of revenues was driven by change in product mix, primarily due to the inclusion of the revenues of Spacelabs Medical, a business which has higher gross margins compared to our other businesses, and was offset in part by inclusion of the revenues of OSI Electronics, which sells products carrying lower gross margins as compared to our other businesses.

**Selling, General and Administrative.** For the year ended June 30, 2004, such expenses increased by \$25.0 million, or 85.7%, to \$54.2 million, compared to \$29.2 million for fiscal year 2003. The increase in selling, general and administrative expenses was due primarily to increased sales and marketing expenses for the sales of security and inspection systems of \$2.6 million, legal cost related to our lawsuit with L-3 Communications Corporation amounting to approximately \$1.2 million and the inclusion of selling, general and administrative expenses of recent acquisitions (primarily Spacelabs Medical), totaling approximately \$20.5 million.

**Research and Development.** Research and development expenses include research related to new product development and product enhancement expenditures. For the year ended June 30, 2004, such expenses increased by \$5.8 million, or 65.1%, to \$14.6 million, compared to \$8.9 million in fiscal year 2003. As a percentage of revenues, research and development expenses increased to 5.9% in fiscal year 2004 from 4.8% in fiscal year 2003. The increase in expenses was due primarily to increased research and development spending for security and inspection systems of \$1.5 million and the inclusion of the research and development expenses of Spacelabs Medical and OSI Laserscan operations totaling approximately \$4.0 million.

**Management Retention Bonus.** Pursuant to the terms of the purchase agreement with Instrumentarium Corporation for the acquisition of Spacelabs Medical, we assumed management retention bonus obligations for key personnel of Spacelabs Medical, which, as of June 30, 2004, we estimated at \$5.9 million. These retention bonuses vest over a two-year period which began October 2003. Included in accrued payroll and related expenses as of June 30, 2004, we accrued a total of \$2.6 million, of which \$1.9 million relates to the period prior to the acquisition of Spacelabs Medical.

**Restructuring Charges.** In the fiscal year 2004, we consolidated manufacturing processes and facilities of certain medical monitoring and anesthesia systems and optoelectronic devices and value-added subsystems businesses. These consolidations resulted in a pre-tax charge of \$1.1 million, consisting primarily of write-off of equipment and leasehold improvements of \$993,000 that were retired during the year and charges related to the clean-up of a vacated facility of \$60,000. These charges were calculated in accordance with SFAS No. 144, "Impairment or Disposal of Long-Lived Assets" and SFAS No. 146, "Accounting for Exit or Disposal Activities".

**Income from Operations.** Income from operations for fiscal year 2004 decreased by \$9.6 million, or 43.6%, to \$12.4 million, compared to \$22.0 million for fiscal year 2003. Income from operations decreased primarily due to increased selling, general and administrative expenses and increased research and development expenses, offset in part by an increase in revenues and in gross margins.

**Gain on Sale of Marketable Securities.** Gain on sale of marketable securities for the years ended June 30, 2004 and 2003 consisted of a realized gain on the sale of marketable securities classified as available for sale.

**Write Down of Equity Investments.** In July 2002, we purchased from Imagis Technologies, Inc., 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), 2-year warrants to purchase 291,667 additional shares of common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis Technologies, Inc. develops facial recognition software for security applications. We have designated the investment as available for sale. The investment, adjusted for changes in the market value of its equity securities, is included under other assets in the accompanying consolidated financial statements. Based on the continued trading of Imagis Technologies, Inc. common stock below the original purchase price for a prolonged period of time, we recognized an other-than-temporary impairment of the carrying value of this investment. For fiscal years 2003 and 2004, we recognized pre-tax charges of \$247,000 and \$1.4 million, respectively in our income statement.

**Interest Income.** For fiscal year 2004, we earned interest income of \$863,000, compared to \$1.2 million for fiscal year 2003. The decrease in interest income for fiscal year 2004 was due to the decrease in interest earning deposits in the current year.

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**Interest Expense.** For fiscal year 2004, our interest expense was \$283,000, compared to \$380,000 for fiscal year 2003. The decrease in expense stems primarily from a decrease in borrowings in the current year compared to the prior year.

**Provision for Income Taxes.** Provision for income taxes decreased to \$3.3 million for fiscal year 2004, compared to \$6.5 million for fiscal year 2003. As a percentage of income before provision for income taxes and minority interest, provision for income taxes was 25.3% for fiscal year 2004, compared to 29.1% for fiscal year 2003. The change in the effective income tax rate was due to a favorable determination of tax contingencies. Our tax rate is dependent upon the mix of income from U.S. and foreign operations.

**Net Income.** For the reasons outlined above, the net income for the year ended June 30, 2004 was \$10.0 million, compared to \$15.8 million for the year ended June 30, 2003.

### **Liquidity and Capital Resources**

We have financed our operations primarily through cash provided by operations, through various term loans, discounting facilities and credit lines extended to our different subsidiaries worldwide and from our private offerings. Cash and cash equivalents as of June 30, 2005 were \$14.6 million, a decrease of \$25.3 million, compared to \$39.9 million as of June 30, 2004. As of June 30, 2005, our principal source of liquidity consisted of our cash and the various credit agreements described below.

Our operations used net cash of \$12.9 million during fiscal year 2005 compared to net cash used in operations of \$10.4 million in fiscal year 2004. The amount of net cash used in operations reflects increases in accounts receivable, inventory, income tax receivable and a reduction in income tax payable and advances from customers, offset in part by an increase in accounts payable and other accrued expenses and current liabilities. The increase in accounts receivable of \$5.5 million was due to higher revenues and the increase in inventory of \$8.6 million was due to product mix and anticipated higher revenues.

The net cash used in investing activities was \$29.6 million during fiscal year 2005, compared to net cash used in investing activities of \$75.6 million in fiscal year 2004. In fiscal year 2005, net cash used in investing activities reflects primarily cash used for the acquisition of Blease, amounting to \$9.3 million, net of cash acquired and the increase in our equity investment in CXR of \$1.4 million. The investing activities also include purchases of property and equipment of \$16.8 million, primarily for manufacturing and office facilities located in Horley, England in which we co-located certain of our United Kingdom-based Rapiscan Systems and Spacelabs Medical operations. Net cash used in investing activities also increased as a result of expenditures of \$1.4 million related to capitalized software development by the security and inspection systems group.

Net cash provided by financing activities was \$16.0 million in fiscal year 2005, compared to \$30.5 million for fiscal year 2004. Net cash provided by financing activities resulted primarily from net proceeds on term debt of \$4.7 million to support the purchase of manufacturing and office facilities in Horley, England and net proceeds received from bank lines of credit of \$15.0 million mainly through borrowings under our credit agreement with Bank of the West. Additionally, net cash provided by financing activities included \$2.2 million in proceeds from the exercise of employee stock options, partially offset by the purchase of treasury stock of \$3.8 million and the repayment of long term debt of \$1.8 million.

In March 1999, we announced a stock repurchase program of up to 2,000,000 shares of our Common Stock. No share repurchases occurred during fiscal years 2003 or 2004. Through June 30, 2004, we had repurchased 1,404,500 shares at an average price \$4.37 per share. In September 2004, we repurchased 107,500 shares of our Common Stock at an average purchase price of \$14.73 per share and we increased the number of shares available for repurchase under the stock repurchase program by 1,000,000 shares. In May 2005, we repurchased 157,027 shares of Common Stock at an average price of \$14.25 per share. At June 30, 2005, 1,330,973 shares were

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available for repurchase under the program. The stock repurchase program did not have a material effect on our liquidity and is not expected to have a material effect on liquidity in the foreseeable future. We retire the treasury shares as they are repurchased, and they are disclosed as a deduction from common shares in our consolidated financial statements.

In May 2005, we entered into a second amended and restated credit agreement with Bank of the West, which provides for a \$50.0 million senior revolving line of credit, including a letter-of-credit, foreign exchange facility and an acquisition credit facility, which are secured by substantially all of the assets of our U.S. subsidiaries and our stock ownership in two significant foreign subsidiaries. The agreement provides that the aggregate principal balance of all advances under the various facilities shall not exceed the total balance available under the line of credit. Borrowings under the line of credit bear interest at the bank's variable reference rate (6.25% at June 30, 2005) or at our option, at the applicable LIBOR rate. Commitment fees are payable based on a rate of 0.125% of the unused borrowing facility.

The second amended and restated credit agreement expires in May 2008. At June 30, 2005, there was \$15.5 million outstanding under the revolving line of credit, composed of \$12.0 million at the bank's variable reference rate (6.25% at June 30, 2005) and \$3.5 million at the six-month LIBOR rate (4.68% at June 30, 2005). In addition, \$5.1 million was issued and outstanding under the letter of credit facility at June 30, 2005. Covenants in connection with the credit agreement impose restrictions and requirements related to, among other things, maintenance of certain financial ratios. As of June 30, 2005, we were not in compliance with certain covenants. However, the bank has waived our non-compliance with these covenants and we have signed a Proposed Summary of Terms & Conditions with the bank on September 12, 2005 in order to amend the terms and conditions of the credit agreement. The provisions of the Proposed Summary of Terms & Conditions provide for an asset-based credit facility with revised financial covenants. We anticipate executing the amended credit agreement prior to October 15, 2005 and expect to be in compliance with the amended terms and conditions.

Our Opto Sensors subsidiary in Singapore has entered into a revolving line of credit agreement with the Singapore branch of an Indian bank. This line of credit provides for various types of short term borrowing of up to 3.9 million Singapore dollars (approximately \$2.3 million at June 30, 2005). Borrowings under the line of credit bear interest at the bank's prime rate (6.75% at June 30, 2005) plus from 0.5% to 2.25% depending on the type of loan. Borrowings under the line of credit are secured by the assets of our Opto Sensors subsidiary and are guaranteed by us. At June 30, 2005, there were no amounts outstanding under the revolving line of credit. This facility expires in September 2005 and we believe it will be renewed under the same or similar terms.

Our Advanced Micro Electronics subsidiary in Norway has a loan agreement with a Norwegian bank that provides for revolving line-of-credit borrowings of up to 10.0 million Norwegian kroner (approximately \$1.5 million at June 30, 2005). Borrowings under this line of credit bear interest at a variable rate, which was 4.5% at June 30, 2005. Interest is payable quarterly. Borrowings under this line of credit are collateralized by certain Advanced Micro Electronics assets. At June 30, 2005, there were no amounts outstanding under this line of credit. This facility expires in March 2006 and we believe that it will be renewed on the same or similar terms.

In December 2004, our Rapiscan Systems subsidiary in the United Kingdom entered into a bank loan of \$5.3 million with a United Kingdom based bank to fund the acquisition of land and buildings in Horley, England. We co-located certain of our security and inspection systems and medical monitoring and anesthesia systems operations in this facility. The loan is repayable over a twenty-year period, with quarterly payments due of £34,500 (approximately \$61,800 at June 30, 2005). Outstanding borrowings bear interest at three-month LIBOR (4.99% at June 30, 2005) plus 1.2% and are payable on a quarterly basis. Of our outstanding balance, \$247,000 is due during the next twelve months and the balance of \$4.6 million is due over a long-term basis.

Our Rapiscan Systems subsidiary in the United Kingdom has a loan agreement with a United Kingdom based bank that provides for an overdraft facility up to a maximum amount of £2.0 million (approximately \$3.6 million at June 30, 2005) outstanding at any one time. Such amounts are secured by certain assets of our Rapiscan Systems subsidiary in the United Kingdom. At June 30, 2005, no amounts were outstanding under the

overdraft facility. Outstanding borrowings bear interest at a base rate (4.5% at June 30, 2005) plus 1.35% per annum. The agreement also provides for a £2.5 million (approximately \$4.5 million at June 30, 2005) facility for tender and performance bonds and a £2.0 million (approximately \$3.6 million at June 30, 2005) facility for the purchase of foreign exchange contracts and letters of credit. At June 30, 2005, £604,000 (approximately \$1.1 million at June 30, 2005) was outstanding under foreign exchange contracts and letters of credit. These facilities are secured by certain assets of our Rapiscan Systems subsidiary in the United Kingdom and we have further guaranteed these obligations up to \$3.3 million. As of June 30, 2005, £1,854,000 (approximately \$3.3 million at June 30, 2005) was outstanding under the performance bond facility. These facilities expire in May 2006 and we believe that they will be renewed on the same or similar terms.

Our Opto Sensors subsidiary in Malaysia has a loan agreement with a Malaysian bank that provides for overdraft borrowings of up to 3.0 million Malaysian ringgits (approximately \$789,000 at June 30, 2005). Borrowings under the line of credit bear interest at the bank's base lending rate (6.0% at June 30, 2005) plus 1.75%. Interest is payable monthly. As of June 30, 2005, no amounts were outstanding under this loan agreement. Borrowings under this loan agreement are secured by certain assets of the subsidiary and are guaranteed by us. This facility expires in December 2005 and we believe that it will be renewed on the same or similar terms.

Our Opto Sensors subsidiary in Malaysia also has an agreement with a Malaysian bank that provides for 17.5 million Malaysian ringgits (approximately \$4.6 million at June 30, 2005) under a performance bond facility. As of June 30, 2005, 17.5 million Malaysian ringgits (approximately \$4.6 million at June 30, 2005) were outstanding under this facility. The agreement provides for overdraft borrowings up to 2.0 million Malaysian ringgits (approximately \$526,000 at June 30, 2005). Borrowings under the overdraft facility bear interest at the bank's base lending rate (6.0% at June 30, 2005) plus 1.75%. At June 30, 2005, no amounts were outstanding under the overdraft facility. Borrowings under this loan agreement are secured by certain assets of the subsidiary and are guaranteed by us. This facility expires in January 2006 and we believe that it will be renewed on the same or similar terms.

Our Rapiscan Systems subsidiary in Finland has an agreement with a Finnish bank that provides for 525,000 euros (approximately \$635,000 at June 30, 2005) under a tender and performance bond facility. As of June 30, 2005, 142,420 euros (approximately \$172,000) was outstanding under this facility. The agreement also provides for a foreign currency overdraft facility up to 460,000 euros (approximately \$557,000 at June 30, 2005). At June 30, 2005, 208,000 euros (approximately \$252,000) was outstanding under the facility. Borrowings under these facilities bear interest rate at the bank's prime lending rate (2.5% at June 30, 2005) plus 1.0%. These facilities expire in February 2006 and we believe that they will be renewed at the same or similar terms.

Our Spacelabs Medical subsidiary has an arrangement with a bank in the United States that provides for up to \$100,000 in letters of credit and \$400,000 in overdraft borrowings. As of June 30, 2005, a \$58,400 standby letter of credit was outstanding under the letter of credit portion of the facility. The overdraft borrowings portion bears interest at the bank's prime rate (6.25% at June 30, 2005) plus 3%. There were no outstanding amounts under the overdraft borrowing portion of the facility as of June 30, 2005. The facility is collateralized by a guarantee from us.

We believe that cash from operations, existing cash and lines of credit will be sufficient to meet our cash requirements for the foreseeable future.

#### **Other Contractual Obligations and Commitments**

In fiscal year 2005, we committed to enter into new leases for computer equipment associated with a master lease agreement previously entered into with Dell Financial Services. The master lease agreement provided for the leasing of computer equipment over a period of 36 months. The new leases that are associated with the master lease agreement have been recorded as capital leases. The master lease agreement permits us to lease up

to \$1.0 million in equipment. During fiscal year 2005, we committed to a total of approximately \$730,000 of equipment under this agreement and do not currently expect to commit to any additional leases of equipment. As of June 30, 2005, \$507,000 was outstanding under these capital lease obligations.

In November 2004, we entered into an agreement with a third party for the design and manufacture of a patient monitor for our Spacelabs Medical subsidiary. Under the agreement we are required to buy a minimum number of monitors from the manufacturer during each year of the term of the agreement at a fixed price. We may provide one year's notice to terminate the agreement without cause at any time following the completion of the second year of the term of the agreement. Given this termination right, our minimum commitment under this agreement amounts to three years of purchases, which totals approximately \$8.9 million. We expect to take delivery on the first units under this agreement in fiscal year 2006.

Under the terms and conditions of the purchase agreements associated with the following five acquisitions, we may be obligated to make additional payments:

In August 2002, we purchased a minority equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems. In June 2004, we increased our equity interest in CXR to approximately 75% and in December 2004 we acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest we have agreed to make certain royalty payments based on sales of CXR's products.

In November 2002, we acquired all the outstanding capital stock of Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company. During the five years following the close, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at \$34.0 million. As of June 30, 2005, no earn-out payments had been made.

In January 2004, we completed the acquisition of Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately held company located in Sunnyvale, California. During the seven years following the close, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. As of June 30, 2005, approximately \$8,000 had been earned and paid as part of this contingent consideration.

In March 2004, we completed the acquisition of Spacelabs Medical from Instrumentarium Corporation. As a result of this acquisition, we assumed management retention bonus agreements for key personnel of Spacelabs Medical which could amount to \$5.4 million. These retention bonuses vest over a two-year period beginning either October 2003 or March 2004. As of June 30, 2005, a balance of \$2.1 million was included in our accrued payroll and related expenses for these retention bonuses. We expect to make all remaining payouts associated with these retention bonuses during fiscal year 2006.

In February 2005, we completed the acquisition of Blease. During the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$11.2 million as of June 30, 2005).

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The following is a summary of our contractual obligations and commitments at June 30, 2005 (in thousands):

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Total Debt (Excluding Capital Lease Obligations) (1)	\$ 20,596	\$ 15,999	\$ 520	\$ 494	\$ 3,583
Capital Lease Obligations	\$ 507	\$ 252	\$ 255	\$ —	\$ —
Operating Leases	\$ 54,416	\$ 10,211	\$13,985	\$10,010	\$ 20,210
Management Retention Bonus	\$ 2,052	\$ 2,052	\$ —	\$ —	\$ —
Purchase Obligations	\$ 55,419	\$ 47,969	\$ 5,960	\$ 1,490	\$ —
Defined Benefit Plan Obligation	\$ 4,092	\$ 936	\$ 204	\$ 68	\$ 2,884
<b>Total Contractual Obligations</b>	<b>\$137,082</b>	<b>\$ 77,419</b>	<b>\$20,924</b>	<b>\$12,062</b>	<b>\$ 26,677</b>
Other Commercial Commitments	Amount of Commitment Expiration Per Period				
	Total Amounts Committed	Less than 1 year	1-3 years	4-5 years	Over 5 years
Standby Letters of Credit	\$ 6,194	\$ 5,319	\$ 875	\$ —	\$ —
Performance Bonds	\$ 8,102	\$ 6,454	\$ 1,616	\$ 32	\$ —
<b>Total Commercial Commitments</b>	<b>\$ 14,296</b>	<b>\$ 11,773</b>	<b>\$ 2,491</b>	<b>\$ 32</b>	<b>\$ —</b>

- (1) We have presented the outstanding balance of \$15.5 million on bank lines of credit with Bank of the West at June 30, 2005 as due within less than one year in order to conform with the classification in the accompanying consolidated financial statements. In addition, our total debt obligations exclude interest costs due to their variable rate nature.

### Off Balance Sheet Arrangements

As of June 30, 2005, we had no off balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K.

### New Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 151, “Inventory Costs” (“SFAS 151”), an amendment of Accounting Research Bulletin No. 43, Chapter 4. SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe the adoption of SFAS 151 will have a material impact on our financial statements.

In December 2004, the FASB issued SFAS No. 123R, “Share-Based Payment” (“SFAS 123R”), which is effective for the annual periods beginning after June 15, 2005. SFAS 123R therefore becomes effective for us in the first quarter of fiscal year 2006. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized as an operating expense in the income statement. The cost is recognized over the requisite service period based on fair values measured on grant dates, and the new standard may be adopted using either the modified prospective transition method or the modified retrospective transition method. We have not yet completed our evaluation of the effect that SFAS 123R will have on our financial statements.

In December 2004, the FASB issued two FASB Staff Positions (“FSP”s): FSP SFAS 109-1, “Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004,” and FSP SFAS 109-2, “Accounting and



Disclosure Guidance for the Foreign Earnings Repatriation Provision Within the American Jobs Creation Act of 2004,” which were both effective upon issuance. FSP SFAS 109-1 clarifies that the tax deduction for domestic manufacturers under the American Jobs Creation Act of 2004 (the “Jobs Act”) should be accounted for as a special deduction in accordance with SFAS No. 109, “Accounting for Income Taxes” (“SFAS 109”). FSP SFAS 109-2 grants additional time to evaluate the Jobs Act’s impact on a company’s plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. We are currently evaluating the effect of the FSP’s on our consolidated financial statements.

In June 2005, the Emerging Issues Task Force modified its consensus on Issue No. 04-10, “Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds”. This guidance creates stricter standards for aggregating operating segments that do not meet the quantitative thresholds provided within SFAS 131, “Disclosures About Segments of an Enterprise and Related Information”. The guidance will be effective for fiscal years ending after September 15, 2005. We do not anticipate that adoption of this guidance will impact the presentation of our reportable segments.

In June 2005, the FASB issued an exposure draft of a proposed standard entitled “Business Combinations—a replacement of FASB Statement No. 141”. The proposed standard, if adopted, would provide new guidance for evaluating and recording business combinations and would be effective on a prospective basis for business combinations whose acquisition dates are on or after January 1, 2007. Upon issuance of a final standard, which is expected in 2006, we will evaluate the impact of this new standard and its effect on the process for recording business combinations.

In July 2005, the FASB issued an exposure draft of a proposed interpretation, “Accounting for Uncertain Tax Positions”. The proposed interpretation clarifies the accounting for uncertain tax positions in accordance with SFAS 109. The proposed interpretation requires that a tax position meet a “probable recognition threshold” for the benefit of the uncertain tax position to be recognized in the financial statements. A tax position that fails to meet the probable recognition threshold will result in either reduction of current or deferred tax asset or receivable, or recording a current or deferred tax liability. The proposed interpretation also provides guidance on measurement, derecognition of tax benefits, classification, interim period accounting disclosure and transition requirements in accounting for uncertain tax positions. The proposed interpretation has a 60-day comment period and will be effective for all companies as of the first fiscal year ending after December 15, 2005. Upon issuance of a final standard, which is expected in 2006, we will evaluate the impact that the interpretation will have on our consolidated financial statements.

### **Risk Factors That May Affect Operating Results**

*The following risk factors could materially and adversely affect our future operating results and could cause actual events to differ materially from those predicted in the forward-looking statements we make about our business.*

#### ***Fluctuations in our operating results may cause our stock price to decline.***

Given the nature of the markets in which we participate, we cannot reliably predict future revenues and profitability. Changes in competitive, market and economic conditions may cause us to adjust our operations. A high proportion of our costs are fixed, due in part to our significant sales, research and development and manufacturing costs. Thus, small declines in revenue could disproportionately affect our operating results. Factors that may affect our operating results and the market price of our Common Stock include:

- demand for and market acceptance of our products;
- competitive pressures resulting in lower selling prices;
- adverse changes in the level of economic activity in regions in which we do business;
- low or fluctuating levels of political stability in regions in which we do business;

- adverse changes in industries, such as semiconductors and electronics, on which we are particularly dependent;
- changes in the portions of our revenue represented by various products and customers;
- delays or problems in the introduction of new products;
- the announcement or introduction of new products, services or technological innovations by our competitors;
- variations in our product mix;
- the timing and amount of our expenditures in anticipation of future sales;
- exchange rate fluctuations;
- increased costs of raw materials or supplies;
- changes in the volume or timing of product orders;
- timing of completion of acceptance testing of some of our products;
- natural disasters; and
- changes in general economic factors.

***We face aggressive competition in many areas of business. If we do not compete effectively, our business will be harmed.***

We encounter aggressive competition from numerous competitors in many areas of our business. In the security and inspection and medical monitoring and anesthesia systems markets, competition is based primarily on such factors as product performance, functionality and quality, cost, prior customer relationships, technological capabilities of the product, price, certification by government authorities, local market presence and breadth of sales and service organization. In the optoelectronic devices and value-added subsystems market competition is based primarily on factors such as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support and on the ability to provide fully-integrated services from application development and design through volume subsystem production. We may not be able to compete effectively with all of our competitors. To remain competitive, we must develop new products and enhance our existing products in a timely manner. We anticipate that we may have to adjust prices of many of our products to stay competitive. In addition, new competitors may emerge, and entire product lines may be threatened by new technologies or market trends that reduce the value of these product lines.

***The September 11, 2001 terrorist attacks and the creation of the U.S. Department of Homeland Security have increased financial expectations that may not materialize.***

The September 11, 2001 terrorist attacks and the subsequent creation of the U.S. Department of Homeland Security have created increased interest in our security and inspection systems; however, we are not certain whether the level of demand will continue to be as high as anticipated. We do not know what solutions will continue to be adopted by the U.S. Department of Homeland Security as a result of the terrorism and whether our products will be a part of the solution. Additionally, should our products be considered as a part of the future security solution, it is unclear what the level may be and how quickly funding to purchase our products may be made available. These factors may adversely impact us and create unpredictability in revenues and operating results.

***If operators of our security and inspection systems fail to detect weapons, explosives or other devices that are used to commit a terrorist act, we could be exposed to product liability and related claims for which we may not have adequate insurance coverage.***

Our business exposes us to potential product liability risks that are inherent in the development, manufacturing, sale and service of security inspection systems. Our customers use our security and inspection

systems to help them detect items that could be used in performing terrorist acts or other crimes. Some of our security and inspection systems require that an operator interpret an image of suspicious items within a bag, parcel, container or other vessel. Others signal to the operator that further investigation is required. In either case, the training, reliability and competence of the customer's operator is crucial to the detection of suspicious items. Furthermore, security inspection by technological means is circumstance and application-specific. In addition, our security and inspection systems are not designed to work under all circumstances. We test the reliability of our security and inspection systems during both their development and manufacturing phases. We also perform such tests if we are requested to perform installation, warranty or post-warranty servicing. However, our security inspection systems are advanced mechanical and electronic devices and therefore can malfunction. In addition, there are also many other factors beyond our control that could lead to liability claims should an act of terrorism occur. We are mindful of the lawsuits that are pending against airlines and other vendors, including security inspection systems providers, in New York federal court resulting from the September 11, 2001 and 1993 World Trade Center bombing attacks. These attacks, and the potential for future attacks, have caused commercial insurance for such threats to become extremely difficult to obtain. It is very likely that, should we be found liable following a major act of terrorism, the insurance we currently have in place would not fully cover the claims for damages.

***Our medical monitoring and anesthesia systems could give rise to product liability claims that could materially and adversely affect our financial condition and results of operations.***

The development, manufacturing and sale of medical devices expose us to significant risk of product liability claims and, sometimes, product failure claims. We face an inherent business risk of financial exposure to product liability claims if the use of our medical devices results in personal injury or death. Substantial product liability litigation currently exists within the medical device industry. Some of our medical monitoring and anesthesia systems businesses have, in the past, been subject to product liability claims and/or issued product recalls. To date, no such claim or recall has had a significant impact on our operations. Future product liability claims may exceed the limits of our insurance coverages or such insurance may not continue to be available to us on commercially reasonable terms, or at all. Consequently, a product liability claim or other claim with respect to uninsured liabilities, or in excess of insured liabilities, could have a material adverse effect on our business, financial condition, operating results and cash flows.

***Our revenues are dependent on orders of security and inspection systems and medical monitoring and anesthesia systems, which may have lengthy and unpredictable sales cycles.***

Sales of security and inspection systems often depend upon the decision of governmental agencies to upgrade or expand existing airports, border crossing inspection sites, seaport inspection sites and other security installations. Sales outside of the United States of our medical monitoring and anesthesia systems depend in significant part on the decision of governmental agencies to build new medical facilities or to expand or update existing medical facilities. Accordingly, a significant portion of our sales of security and inspection systems and our medical monitoring and anesthesia systems is often subject to delays associated with the lengthy approval processes that typically accompany such capital expenditures. During these approval periods, we expend significant financial and management resources in anticipation of future orders that may not occur. If we fail to receive an order after expending such resources, such failure could have a material adverse effect on our business, financial condition and results of operations.

***If we do not introduce new products in a timely manner, our products could become obsolete and our operating results would suffer.***

We sell many of our products in industries characterized by rapid technological changes, frequent new product and service introductions and evolving industry standards and customer needs. Without the timely introduction of new products and enhancements, our products could become technologically obsolete over time, in which case our revenue and operating results would suffer. The success of our new product offerings will depend upon several factors, including our ability to:

- accurately anticipate customer needs;

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- innovate and develop new technologies and applications;
- successfully commercialize new technologies in a timely manner;
- price our products competitively and manufacture and deliver our products in sufficient volumes and on time; and
- differentiate our offerings from our competitors' offerings.

Some of our products are used by our customers to develop, test and manufacture their products. We therefore must anticipate industry trends and develop products in advance of the commercialization of our customers' products. In developing any new product, we may be required to make a substantial investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers' needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

***Interruptions in our ability to purchase raw materials and components may adversely affect our profitability.***

We purchase certain raw materials and subcomponents from third parties pursuant to purchase orders placed from time to time. Purchase order terms range from three months to one year at fixed costs, but we do not have guaranteed long-term supply arrangements with our suppliers. Any material interruption in our ability to purchase necessary raw materials or subcomponents could have a material adverse effect on our business, financial condition and results of operations.

***We may not be able to successfully implement our acquisitions strategy, integrate acquired businesses into our existing business or make acquired businesses profitable.***

One of our strategies is to supplement our internal growth by acquiring businesses and technologies that complement or augment our existing product lines. This growth has placed, and may continue to place, significant demands on our management, working capital and financial resources. We may be unable to identify or complete promising acquisitions for many reasons, including:

- competition among buyers;
- the need for regulatory approvals, including antitrust approvals; and
- the high valuations of businesses.

Some of the businesses we may seek to acquire may be marginally profitable or unprofitable. For these acquired businesses to achieve acceptable levels of profitability, we must improve their management, operations, products and market penetration. We may not be successful in this regard and may encounter other difficulties in integrating acquired businesses into our existing operations.

To finance our acquisitions, we may have to raise additional funds, through either public or private financings. We may be unable to obtain such funds or may be able to do so only on unfavorable terms.

***Our acquisition and alliance activities could disrupt our ongoing business.***

We intend to continue to make investments in companies, products and technologies, either through acquisitions or investments or alliances. Acquisitions and alliance activities often involve risks, including: (i) difficulty in assimilating the acquired operations and employees; (ii) difficulty in managing product co-development activities with our alliance partners; (iii) retaining the key employees of the acquired operation; (iv) disruption of our ongoing business; (v) inability to successfully integrate the acquired technologies and operations into our businesses and maintain uniform standards, controls, policies and procedures; and (vi) lacking the experience necessary to enter into new product or technology markets. In addition, from time to time, our competitors acquire or enter into exclusive arrangements with companies with whom we do business or may do

business in the future. Reductions in the number of partners with whom we may do business in a particular context may reduce our ability to enter into critical alliances on attractive terms or at all, and the termination of an existing alliance by a business partner may disrupt our operations.

***Failure to complete the offering and listing of Spacelabs Healthcare could negatively impact our share price.***

During fiscal year 2005, we began exploring strategic alternatives for our various business groups and primarily for our medical monitoring and anesthesia systems group. In connection with these efforts, we engaged Collins Stewart, a London-based investment bank to pursue the public offering and listing of approximately 30% to 35% of the equity in Spacelabs Healthcare, a newly formed subsidiary comprising the operations of our medical monitoring and anesthesia systems group. This offering and listing is planned in the United Kingdom on the AIM Exchange, which is owned and administered by the London Stock Exchange. The shares in Spacelabs Healthcare will not be offered or sold in the United States. Under Securities and Exchange Commission regulations, U.S. residents are prohibited from participating in this proposed offering of shares, and any shares offered cannot be acquired by U.S. residents for a period of twelve months from the date of the offering. The proposed transaction is expected to be completed in the second quarter of fiscal year 2006. However, the completion of the listing remains fully subject to a number of factors, including regulatory approvals and our satisfaction with the valuation, which may not occur. Currently, there are no binding commitments on the part of any underwriter to purchase or sell any shares of Spacelabs Healthcare. If the offering and listing are not completed for any reason, or not completed on time, we will be subject to several risks. The price of our Common Stock may decline since the current market price may reflect a market assumption that the offering and listing would be completed and that the related benefits would be realized, or as a result of the market's perception that the offering and listing were not consummated due to an adverse change in our medical monitoring and anesthesia systems group.

***Economic, political and other risks associated with international sales and operations could adversely affect our sales.***

In fiscal year 2003, revenues from shipments made outside of the United States accounted for approximately 51% of our revenues, 41% in fiscal year 2004 and 40% in fiscal year 2005. Of the revenues generated during fiscal year 2005 from shipments made to customers outside of the United States, 39% represented sales made by subsidiaries based in United States to foreign customers, and the balance represented sales generated by foreign subsidiaries. Since we sell our products worldwide, our businesses are subject to risks associated with doing business internationally. We anticipate that revenues from international operations will continue to represent a substantial portion of our total revenue. In addition, many of our manufacturing facilities, employees and suppliers are located outside the United States. Accordingly, our future results could be harmed by a variety of factors, including:

- changes in foreign currency exchange rates;
- changes in a country's or region's political or economic conditions, particularly in developing or emerging markets;
- longer payment cycles of foreign customers and difficulty of collecting receivables in foreign jurisdictions;
- trade protection measures and import or export licensing requirements;
- differing tax laws and changes in those laws;
- difficulty in staffing and managing widespread operations;
- differing labor laws and changes in those laws;
- differing protection of intellectual property and changes in that protection; and
- differing regulatory requirements and changes in those requirements.

***Our failure to protect our intellectual property could impair our competitive position.***

While we own certain patents and trademarks, some aspects of our business cannot be protected by patents or trademarks. Accordingly, in these areas there are few legal barriers that prevent potential competitors from copying certain of our products, processes and technologies or from otherwise entering into operations in direct competition with us.

***Our products may infringe on the intellectual property rights of others, and resulting claims against us could be costly and prevent us from making or selling certain products.***

Third parties may seek to claim that our products and operations infringe their patent or other intellectual property rights. In addition, we may find it necessary to initiate litigation in order to protect our patent or other intellectual property rights. Under either circumstance, we may incur significant expenses. In addition, claims of third parties against us could result in awards of substantial damages or court orders that could effectively prevent us from making, using or selling our products in the U.S. or abroad.

***Our competitors may seek to challenge the intellectual property rights on which some of our new and more promising products are based.***

As we introduce any new and potentially promising product, companies possessing competing technologies may be motivated to assert infringement claims in order to delay or diminish potential sales and challenge our right to market such product. Lengthy and costly litigation may be necessary in order to defend against these claims.

***Our ongoing success is dependent upon the continued availability of certain key employees.***

We are dependent in our operations on the continued availability of the services of our employees, many of whom are individually key to our current and future success, and the availability of new employees to implement our growth plans. In particular, we are dependent upon the services of Deepak Chopra, our Chairman of the Board of Directors, President and Chief Executive Officer. We have entered into a 5-year employment agreement with Mr. Chopra, which expires July 18, 2010 and we maintain a \$13.0 million policy of key man life insurance on the life of Mr. Chopra. The market for skilled employees is highly competitive, especially for employees in technical fields. While our compensation programs are intended to attract and retain the employees required for it to be successful, ultimately, we may not be able to retain the services of all of our key employees or a sufficient number to execute on our plans. In addition, we may not be able to continue to attract new employees as required.

***Substantial government regulation in the United States and abroad may restrict our ability to sell our medical monitoring and anesthesia systems.***

The FDA and comparable regulatory authorities in foreign countries extensively and rigorously regulate our medical monitoring and anesthesia systems, including related development activities and manufacturing processes. In the United States, the FDA regulates the introduction of medical devices as well as the manufacturing, labeling and record-keeping procedures for such products. We are required to:

- obtain clearance before we can market and sell medical devices;
- satisfy content requirements applicable to our labeling, sales and promotional materials;
- comply with manufacturing and reporting requirements; and
- undergo rigorous inspections.

Our future products may not obtain FDA clearance on a timely basis, or at all. Our medical monitoring and anesthesia systems must also comply with the laws and regulations of foreign countries in which we develop, manufacture and market such products. In general, the extent and complexity of medical device regulation is

increasing worldwide. This trend is likely to continue and the cost and time required to obtain marketing clearance in any given country may increase as a result. Our products may not obtain any necessary foreign clearances on a timely basis, or at all.

Once any of our medical monitoring and anesthesia systems is cleared for sale, regulatory authorities may still limit the use of such product, prevent its sale or manufacture or require a recall or withdrawal of such product from the marketplace. Following initial clearance from regulatory authorities, we continue to be subject to extensive regulatory requirements. Government authorities can withdraw marketing clearance due to our failure to comply with regulatory standards or due to the occurrence of unforeseen problems following initial clearance. Ongoing regulatory requirements are wide-ranging and govern, among other things:

- annual inspections to retain CE mark for sale of products in the European Union;
- product manufacturing;
- supplier substitution;
- product changes;
- process modifications;
- medical device reporting; and
- product sales and distribution.

***Our failure to comply with environmental regulations may create significant environmental liabilities and force us to modify our manufacturing processes.***

We are subject to various foreign and U.S. federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances or wastes that have been or are being disposed of offsite as wastes or that have been or are being released on or in our facilities. Such laws may impose liability without regard to whether we knew of, or caused, the release of such hazardous substances or wastes. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing processes, or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

***We may be exposed to potential risks relating to our internal controls over financial reporting and our ability to have those controls attested to by our independent registered public accounting firm.***

As directed by the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission adopted rules requiring public companies to include in their annual reports an assessment of the effectiveness of the company's internal controls over financial reporting. In addition, the independent registered public accounting firm auditing a public company's financial statements must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting, as well as the operating effectiveness of the company's internal controls over financial reporting. We evaluate our internal controls over financial reporting in order to allow our management to report on, and our independent registered public accounting firm to attest to, our internal controls.

We expect to expend significant resources in developing the necessary documentation and testing procedures required by the Sarbanes-Oxley Act of 2002. However, there will remain a risk that we will not comply with all of its requirements. For example, in connection with the audit of our financial statements as of and for the year ended June 30, 2005, our management and our independent registered public accounting firm identified two material weaknesses in our system of internal controls. These matters are discussed in additional detail in Item 9A of this report.

If our independent registered public accounting firm differs from us in its interpretation of the requirements imposed on us by the Sarbanes-Oxley Act of 2002, or if it is not satisfied with our internal controls over financial reporting or with the level at which such controls are documented, operated or reviewed, it may decline to attest to our management's assessment or it may issue a qualified report. In addition, if our independent registered public accounting firm is unable to rely on our internal controls over financial reporting in connection with its audit of our financial statements and if it is unable to devise alternative procedures in order to satisfy itself as to the material accuracy of our financial statements and related disclosures, it is possible that we could receive a qualified or adverse audit opinion in connection with those financial statements.

Accordingly, in the future we may not receive a favorable report from our independent registered public accounting firm regarding our internal controls over financial reporting and the operating effectiveness of our internal controls over financial reporting. If we identify significant deficiencies or material weaknesses in our internal controls over financial reporting that we cannot remediate in a timely manner or if we receive an adverse report from our independent registered public accounting firm with respect to our internal controls over financial reporting, investors and others may lose confidence in the reliability of our financial statements and the market for our Common Stock could be adversely affected.

***We receive significant amounts of research and development funding for our security and inspection systems from government grants and contracts. We may not continue to receive comparable levels of funding for future product development.***

The U.S. government currently plays an important role in funding the development of certain of our security and inspection systems and sponsoring their deployment at airports, ports and border crossings. However, in the future, additional research and development funds from the government may not be available to us. If the government fails to continue to sponsor our technologies we may have to expend more resources on product development or cease development of certain technologies, which could adversely affect our business. In addition, any future grants to our competitors may improve their ability to develop and market competing products and cause our customers to delay purchase decisions, which could harm our ability to market our products.

***Our Articles of Incorporation and other agreements contain provisions that could discourage a takeover.***

Our Articles of Incorporation authorize our Board of Directors to issue up to 10,000,000 shares of Preferred Stock in one or more series, to fix the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued shares of preferred stock, to fix the number of shares constituting any such series and to fix the designation of any such series, without further vote or action by shareholders. The terms of any series of preferred stock, which may include priority claims to assets and dividends and special voting rights, could adversely affect the rights of the holders of our Common Stock and thereby reduce the value of our Common Stock. We have no present plans to issue shares of Preferred Stock. The issuance of Preferred Stock, coupled with the concentration of ownership in the directors and executive officers, could discourage certain types of transactions involving an actual or potential change in control of our company, including transactions in which the holders of Common Stock might otherwise receive a premium for their shares over then current prices, otherwise dilute the rights of holders of Common Stock and may limit the ability of such shareholders to cause or approve transactions which they may deem to be in their best interests, all of which could have a material adverse effect on the market price of our Common Stock. We have in place a stockholder rights plan, adopted in 2000, under which our shareholders are entitled to purchase shares of preferred stock under certain circumstances. The stockholder rights plan may have the effect of impeding or preventing certain types of transactions involving a change in control of our company that could be beneficial to the shareholders.



***Our Articles of Incorporation limit the liability of its directors, which may limit the remedies we or our shareholders have available.***

Our Articles of Incorporation provide that, pursuant to the California Corporations Code, the liability of our directors for monetary damages shall be eliminated to the fullest extent permissible under California law. This is intended to eliminate the personal liability of a director for monetary damages in an action brought by us, or in our right, for breach of a director's duties to us or our shareholders and may limit the remedies available to us or our shareholders. This provision does not eliminate the directors' fiduciary duty and does not apply to liabilities for: (i) acts or omissions that involve intentional misconduct or a knowing and culpable violation of law; (ii) acts or omissions that a director believes to be contrary to the best interests of our company or our shareholders or that involve the absence of good faith on the part of the director; (iii) any transaction from which a director derived an improper personal benefit; (iv) acts or omissions that show a reckless disregard for the director's duty to the our company or our shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to our company or our shareholders; (v) acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to our company or our shareholders; (vi) certain transactions or the approval of transactions in which a director has a material financial interest; and (vii) expressly imposed by statute for approval of certain improper distributions to shareholders or certain loans or guarantees.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Market Risk**

We are exposed to certain market risks, which are inherent in our financial instruments and arise from transactions entered into in the normal course of business. We may enter into derivative financial instrument transactions in order to manage or reduce market risk in connection with specific foreign-currency-denominated transactions. We do not enter into derivative financial instrument transactions for speculative purposes.

We are subject to interest rate risk on our short-term borrowings under our bank lines of credit. Borrowings under these lines of credit do not give rise to significant interest rate risk because these borrowings have short maturities and are borrowed at variable interest rates. Historically, we have not experienced material gains or losses due to interest rate changes.

**Foreign Currency**

We maintain the accounts of our operations in Canada, India, Malaysia, Norway, Singapore and the United Kingdom in Canadian dollars, Indian rupees, Malaysian ringgits, Norwegian kroners, Singapore dollars and U.K. pounds, respectively. We maintain the accounts of our operations in Austria, Finland, France, Germany and Greece in euros. Foreign currency financial statements are translated into U.S. dollars at current rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. Gains and losses resulting from foreign currency transactions are included in income, while those resulting from translation of financial statements are excluded from income and accumulated as a component of shareholder's equity. We included transaction losses of approximately \$377,000 in income for fiscal year 2004 and \$237,000 for fiscal year 2005. A hypothetical 10% change in the relevant currency rates at June 30, 2005 would not have a material impact on our financial position or results of operations.

**Use of Derivatives**

Our use of derivatives consists primarily of foreign exchange contracts and interest rate swaps. We purchase forward contracts to hedge foreign exchange exposure related to commitments to acquire inventory for sale. We do not use the contracts for trading purposes. As of June 30, 2004 and 2005, there were no foreign exchange contracts or interest rate swaps outstanding.

## Importance of International Markets

International markets provide us with significant growth opportunities. However, the following events, among others, could adversely affect our financial results in subsequent periods: periodic economic downturns in different regions of the world, changes in trade policies or tariffs and political instability. For the year ended June 30, 2005, overall foreign currency fluctuations relative to the U.S. dollar had an immaterial effect on our consolidated revenues and results of operations. Despite changes in monetary policy in Malaysia, including the de-pegging of the Malaysian ringgit to the U.S. dollar, we believe that our foreign currency exposure in Malaysia will not be significant in the foreseeable future. We continue to perform ongoing credit evaluations of our customers' financial condition and, if deemed necessary, we require advance payments for sales. We monitor economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future. Due to our overseas investments and the necessity of dealing with local currencies in our foreign business transactions, we are at risk with respect to foreign currency fluctuations.

## Inflation

We do not believe that inflation has had a material impact on our results of operations.

## Interest Rate Risk

All highly liquid investments with maturity of three months or less are classified as cash equivalents and recorded in the balance sheet at fair value. Short-term investments are comprised of high-quality marketable securities.

The principal maturity and estimated value of our long-term debt exposure as of June 30, 2004 are as follows:

	Maturity		Total	Fair Value
	2005	2006		
Long-term debt				
Secured long term loan	\$1,798	\$ 32	\$1,830	\$ 1,830
Average interest rate	5.0%	5.0%	5.0%	

The principal maturity and estimated value of our long-term debt exposure as of June 30, 2005 are as follows:

	Maturity						Total	Fair Value
	2006	2007	2008	2009	2010	2011 and thereafter		
Long-term debt								
Secured long term loan and capital lease obligations	\$499	\$508	\$267	\$247	\$247	\$ 3,583	\$5,351	\$5,351
Average interest rate	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

We make reference here to the Index to Consolidated Financial Statements that appears on page F-1 of this report. The Report of Independent Registered Public Accounting Firm from Deloitte & Touche LLP, the Consolidated Financial Statements and the Notes to Consolidated Financial Statements listed in the Index to Consolidated Financial Statements, which appear beginning on page F-2 of this report, are incorporated by reference into this Item 8.

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

Not Applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

As of June 30, 2005, the end of the period covered by this report, our management, including our Chief Executive Officer and our Chief Financial Officer, reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) and 15d-15(e)). Such disclosure controls and procedures are designed to ensure that material information we must disclose in this report is recorded, processed, summarized and filed or submitted on a timely basis. Based upon that evaluation, two material weaknesses were identified (each described below), and, as a result, our management, Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of June 30, 2005.

**Management's Report on Internal Control over Financial Reporting**

We are responsible for establishing and maintaining adequate internal controls over financial reporting. Our internal controls over financial reporting include the policies and procedures that pertain to (a) the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (b) the recording of transactions as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles; (c) the making of receipts and expenditures only in accordance with authorizations of our management and directors; and (d) the prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements. We recognize that because of inherent limitations, internal controls 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. Accordingly, internal controls over financial reporting cannot provide absolute assurance of achieving financial reporting objectives.

As of June 30, 2005, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our internal controls over financial reporting. This evaluation was based on the framework in "Internal Control—Integrated Framework" published by the Committee of Sponsoring Organizations of the Treadway Commission. The evaluation included an assessment of the design of our internal controls over financial reporting and testing of the operational effectiveness of our internal controls over financial reporting. Our management, Chief Executive Officer and Chief Financial Officer reviewed the results of their evaluation with the Audit Committee of our Board of Directors and determined that as of June 30, 2005, there were two material weaknesses in our internal controls over financial reporting. As defined by the Public Company Accounting Oversight Board Auditing Standard No. 2, a material weakness is a significant control deficiency or a combination of significant control deficiencies that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In light of these two material weaknesses, our management, Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2005, we did not maintain effective internal controls over financial reporting. Deloitte & Touche LLP, an independent registered public accounting firm that audited the financial statements included in this Annual Report, has issued its attestation report on our management's assessment of our internal controls over financial reporting, which appears on page 59 to this report.

The two material weaknesses identified as of June 30, 2005 were as follows:

- 1) We identified certain computational errors in our annual income tax provision and related income tax receivable and payable, deferred tax assets and deferred tax liabilities for fiscal year 2005. These errors

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resulted from a deficiency in the operation of controls requiring the reconciliation of the components of our income tax provision to appropriate supporting documentation. Given the significance of the tax account balances and the absence of sufficient mitigating controls, these deficiencies represent a material weakness in internal control over financial reporting.

2) We identified certain transactions recorded as revenue by one of our Canadian subsidiaries in the quarter ended June 30, 2005 did not meet the criteria for revenue recognition in such period. These errors resulted from a deficiency in the operation of controls requiring the supervisory review of year-end revenue transactions to ensure proper cut-off at year end. The errors associated with these transactions totaled approximately \$1.4 million.

Deepak Chopra  
Chairman of the Board, President and  
Chief Executive Officer (Principal Executive Officer)

Anuj Wadhawan  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

September 28, 2005

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

No significant changes in our internal controls over financial reporting (as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) occurred during the fourth quarter of the fiscal year covered by this report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Subsequent to June 30, 2005, our management and the Audit Committee of our Board of Directors have initiated remedial measures to address the internal control deficiencies identified in this Item 9A. We believe that our planned corrective actions will remediate the internal control deficiencies identified in this report. We will continue to monitor the effectiveness of these actions and will make any other changes or take such other actions as management determines to be appropriate.

## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of OSI Systems, Inc.:  
Hawthorne, California

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that OSI Systems, Inc. and subsidiaries, (the "Company") did not maintain effective internal control over financial reporting as of June 30, 2005, because of the effect of the material weaknesses identified in management's assessment based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment: (1) Certain errors, which were material, were identified in the Company's income tax provision calculation. These errors resulted from a deficiency in the operation of controls requiring the reconciliation of the components of the Company's income tax provision to appropriate supporting documentation. This deficiency results in a more than remote likelihood that a material misstatement to the Company's income tax provision and the related income tax receivable and payable, deferred income tax asset, and deferred income tax liability accounts in the annual or interim financial statements will not be prevented or detected. (2) Certain errors, which

## [Table of Contents](#)

were material, were identified in connection with the Company's recognition of revenue at its Canadian subsidiary at year end. These errors resulted from a deficiency in the operation of controls requiring the supervisory review of year-end revenue transactions to ensure proper cut-off at year end. This deficiency results in a more than remote likelihood that a material misstatement to the Company's revenue, cost of sales, accounts receivable and inventory accounts in the annual or interim financial statements will not be prevented or detected. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements and financial statement schedule as of and for the year ended June 30, 2005, of the Company and this report does not affect our report on such financial statements and financial statement schedule.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of June 30, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of June 30, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended June 30, 2005, of the Company and our report dated September 28, 2005 expressed an unqualified opinion on those financial statements and financial statement schedule.

DELOITTE & TOUCHE LLP

Los Angeles, California  
September 28, 2005

### **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

### **ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about October 27, 2005.

### **ITEM 11. EXECUTIVE COMPENSATION**

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about October 27, 2005.

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

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about October 27, 2005.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about October 27, 2005.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2005 Annual Meeting of Shareholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about October 27, 2005.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) The following documents are filed as part of this report:

1. *Financial Statements.* Please see the accompanying Index to Consolidated Financial Statements, which appears on page F-1 of the report. The Report of Independent Registered Public Accounting Firm, the Consolidated Financial Statements and the Notes to Consolidated Financial Statements listed in the Index to Consolidated Financial Statements, which appear beginning on page F-2 of this report, are incorporated by reference into Item 8 above.

2. *Financial Statement Schedules.*

Schedule II—Valuation and Qualifying Accounts

No other financial statement schedules are presented as the required information is either not applicable or included in the Consolidated Financial Statements or notes thereto.

3. *Exhibits.* See Item 15(b) below.

(b) *Exhibits.* The exhibits listed on the accompanying Exhibit Index immediately following the signature page are filed as part of, or are incorporated by reference into, this report.

(c) *Financial Statement Schedules.* Reference is made to Item 15(a)(2) above.

OSI SYSTEMS, INC.  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of OSI Systems, Inc.:

Hawthorne, California

We have audited the accompanying consolidated balance sheets of OSI Systems, Inc. and subsidiaries (the “Company”) as of June 30, 2004 and 2005, and the related consolidated statements of operations, shareholders’ equity, and cash flows for each of the three years in the period ended June 30, 2005. Our audits also included the financial statement schedule listed in the index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of OSI Systems, Inc. and subsidiaries as of June 30, 2004 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the pro forma stock compensation fair value disclosures for the years ended June 30, 2003 and 2004 have been restated.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company’s internal control over financial reporting as of June 30, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated September 28, 2005 expressed an unqualified opinion on management’s assessment of the effectiveness of the Company’s internal control over financial reporting and an adverse opinion on the effectiveness of the Company’s internal control over financial reporting because of material weaknesses.

DELOITTE & TOUCHE LLP

Los Angeles, California

September 28, 2005

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**AS OF JUNE 30, 2004 AND 2005**  
**(Dollars in Thousands, Except Share Amounts)**

	2004	2005
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 39,879	\$ 14,623
Marketable securities, available-for-sale		816
Accounts receivable—net of allowance for doubtful accounts of \$774 and \$4,682 at June 30, 2004 and 2005, respectively	85,774	89,227
Other receivables	7,480	5,345
Inventory	97,174	107,441
Prepaid expenses	3,580	4,165
Deferred income taxes	6,611	10,537
Income tax receivable	391	5,519
Total current assets	240,889	237,673
PROPERTY AND EQUIPMENT—Net	18,775	30,974
GOODWILL	23,925	28,697
INTANGIBLE ASSETS—Net	44,914	47,287
INVESTMENTS	1,475	1,366
OTHER ASSETS	1,035	1,014
DEFERRED INCOME TAXES	788	109
<b>TOTAL</b>	<b>\$ 331,801</b>	<b>\$ 347,120</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Bank lines of credit	\$ 723	\$ 15,752
Current portion of long-term debt	1,798	499
Accounts payable	33,171	41,123
Deferred income taxes		2,191
Accrued payroll and related expenses	13,006	13,487
Income taxes payable	3,075	1,608
Advances from customers	12,197	2,565
Accrued warranties	9,190	6,641
Provision for losses on long-term contracts	858	321
Deferred revenue	2,134	6,419
Other accrued expenses and current liabilities	21,339	22,669
Total current liabilities	97,491	113,275
LONG-TERM DEBT	32	4,852
ACCRUED PENSION	1,529	1,819
DEFERRED INCOME TAXES	5,198	3,547
MINORITY INTEREST	69	
Total liabilities	104,319	123,493
<b>COMMITMENTS AND CONTINGENCIES (Note 6)</b>		
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, no par value—authorized, 10,000,000 shares; no shares issued or outstanding at June 30, 2004 and 2005		
Common stock, no par value—authorized, 40,000,000 shares; issued and outstanding, 16,213,428 and 16,193,239 shares at June 30, 2004 and 2005, respectively		
	170,129	169,406
Retained earnings	54,961	52,566
Accumulated other comprehensive income	2,392	1,655
Total shareholders' equity	227,482	223,627
<b>TOTAL</b>	<b>\$ 331,801</b>	<b>\$ 347,120</b>

See accompanying notes to consolidated financial statements.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands, Except Per Share Amounts)**

	2003	2004	2005
REVENUES	\$ 182,644	\$ 247,069	\$ 385,041
COST OF GOODS SOLD	122,661	163,712	243,415
GROSS PROFIT	59,983	83,357	141,626
OPERATING EXPENSES:			
Selling, general and administrative expenses	29,160	54,161	116,245
Research and development	8,865	14,638	30,537
Management retention bonus		1,104	1,824
Restructuring charges		1,061	
Total operating expenses	38,025	70,964	148,606
INCOME (LOSS) FROM OPERATIONS	21,958	12,393	(6,980)
GAIN ON SALE OF MARKETABLE SECURITIES	1,767	376	
WRITE OFF OF DEFERRED ACQUISITION COSTS	(608)		
WRITE DOWN OF EQUITY INVESTMENTS	(1,433)	(247)	(182)
INTEREST INCOME	1,166	863	196
INTEREST EXPENSE	(380)	(283)	(807)
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES AND MINORITY INTEREST	22,470	13,102	(7,773)
PROVISION (BENEFIT) FOR INCOME TAXES	6,521	3,316	(5,309)
MINORITY INTEREST IN NET (INCOME) LOSS OF SUBSIDIARY	(156)	170	69
NET INCOME (LOSS)	\$ 15,793	\$ 9,956	\$ (2,395)
EARNINGS (LOSS) PER COMMON SHARE—Basic	\$ 1.13	\$ 0.68	\$ (0.15)
EARNINGS (LOSS) PER COMMON SHARE—Diluted	\$ 1.09	\$ 0.65	\$ (0.15)

See accompanying notes to consolidated financial statements.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**FOR THE YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands, Except Share Amounts)**

	Preferred		Common		Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Comprehensive (Loss) Income	Total
	Number of Shares	Amount	Number of Shares	Amount				
BALANCE—July 1, 2002	—	\$ —	12,806,896	\$108,141	\$ 29,212	\$ (1,619)		\$135,734
Exercise of stock options			101,769	858				858
Stock option compensation				56				56
Tax benefit of stock options exercised				357				357
Shares purchased under employee stock purchase program			13,348	195				195
Issuance of common stock and warrants under private placement			1,250,000	20,528				20,528
Issuance of common stock as purchase consideration			347,890	5,749				5,749
Comprehensive income (loss):								
Net income					15,793		\$ 15,793	15,793
Other comprehensive income—translation adjustment						1,995	1,995	1,995
Unrealized loss on available for sale securities—net of tax						(468)	(468)	(468)
Change in fair value of derivative instruments—net of tax						50	50	50
Minimum pension liability adjustment—net of tax						(448)	(448)	(448)
Comprehensive income							\$ 16,922	
BALANCE—June 30, 2003	—	—	14,519,903	135,884	45,005	(490)		180,399
Exercise of stock options			177,244	1,233				1,233
Tax benefit of stock options exercised				907				907
Shares purchased under employee stock purchase program			16,281	217				217
Issuance of common stock and warrants under private placement			1,500,000	30,975				30,975
Adjustment for minority interest				913				913
Comprehensive income (loss):								
Net income					9,956		\$ 9,956	9,956
Other comprehensive income—translation adjustment						2,418	2,418	2,418
Unrealized loss on available for sale securities—net of tax						564	564	564
Change in fair value of derivative instruments—net of tax						64	64	64
Minimum pension liability adjustment—net of tax						(164)	(164)	(164)
Comprehensive income							\$ 12,838	
BALANCE—June 30, 2004	—	—	16,213,428	170,129	54,961	2,392		227,482
Exercise of stock options			201,899	1,492				1,492
Tax benefit of stock options exercised				905				905
Shares purchased under employee stock purchase program			42,439	701				701
Stock repurchased and retired			(264,527)	(3,821)				(3,821)
Comprehensive income (loss):								
Net income (loss)					(2,395)		\$ (2,395)	(2,395)
Other comprehensive income (loss) —translation adjustment						(660)	(660)	(660)
Unrealized gain on available for sale securities—net of tax						108	108	108
Minimum pension liability adjustment—net of tax						(185)	(185)	(185)
Comprehensive loss							\$ (3,132)	
BALANCE—June 30, 2005		\$	16,193,239	\$169,406	\$ 52,566	\$ 1,655		\$223,627

See accompanying notes to consolidated financial statements.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands)**

	2003	2004	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 15,793	\$ 9,956	\$ (2,395)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Provision for losses on accounts receivable (recoveries)	(13)	287	4,005
Depreciation and amortization	4,289	5,708	10,636
Write-off of deferred acquisition costs	608		
Write down of equity investments	1,433	247	182
Gain on sale of marketable securities	(1,767)	(376)	
Minority interest in net income (loss) of subsidiary	156	(170)	(69)
Equity in undistributed (earnings) losses of unconsolidated affiliates	(76)	102	(213)
Tax effect of stock option benefit	357	907	905
Stock option compensation	56		
Deferred income taxes	608	(1,450)	(3,368)
Restructuring charges		1,061	
Loss (gain) on sale of property and equipment	52	40	(12)
Changes in operating assets and liabilities—net of business acquisitions			
Accounts receivable	3,521	(16,623)	(5,454)
Other receivables	606	(4,551)	2,124
Inventory	(4,320)	(15,112)	(8,635)
Prepaid expenses	(136)	(1,035)	(378)
Accounts payable	(206)	11,111	4,836
Accrued payroll and related expenses	636	2,430	347
Income taxes receivable	(1)	4	(5,483)
Income taxes payable	171	(210)	(1,481)
Advances from customers	(3,497)	3,469	(9,600)
Accrued warranties	516	(1,339)	(2,998)
Deferred revenue	4,979	(4,282)	3,648
Other accrued expenses and current liabilities	(2,209)	(589)	544
Net cash provided by (used in) operating activities	21,556	(10,415)	(12,859)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from the sale of investments and marketable securities	18,271	5,256	
Purchases of investments and marketable securities	(22,990)		
Proceeds from sale of property and equipment	53	8	58
Additions to property and equipment	(3,569)	(5,404)	(16,821)
Cash paid for business acquisitions and minority interests—net of cash acquired	(5,373)	(77,511)	(11,450)
Cash received on note receivable	800		
Cash proceeds from sale of minority interest and distribution rights for Dolphin Medical		2,000	
Intangible and other assets	(2,081)	27	(1,404)
Net cash used in investing activities	(14,889)	(75,624)	(29,617)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from bank lines of credit		715	14,992
Proceeds from long-term debt			4,740
Payments on capital lease obligations			(260)
Payments on long-term debt	(2,627)	(2,633)	(1,799)
Proceeds from exercise of stock options, warrants and employee stock purchase plan	1,053	1,450	2,193
Purchase of treasury stock			(3,821)
Proceeds from private placement	20,528	30,975	
Net cash provided by financing activities	18,954	30,507	16,045
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>	1,021	1,165	1,175
<b>NET INCREASE (DECREASE) IN CASH EQUIVALENTS</b>	26,642	(54,367)	(25,256)
<b>CASH AND CASH EQUIVALENTS—Beginning of year</b>	67,604	94,246	39,879
<b>CASH AND CASH EQUIVALENTS—End of year</b>	\$ 94,246	\$ 39,879	\$ 14,623
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>			
Cash paid (received) during the year for:			
Interest	\$ (813)	\$ (587)	\$ 595
Income taxes, net	\$ 6,731	\$ 3,775	\$ 3,799
<b>SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES</b>			
Equipment purchased under capital lease obligations			\$ 730

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands)**

**Acquisition of Centro Vision, Inc.**

In July 2002, OSI Systems, Inc. (together with its subsidiaries, the “Company”) acquired substantially all the assets and business of Centro Vision, Inc., (“Centro Vision”), formerly Thermo Centro Vision, Inc., for \$1,450. The assets acquired and liabilities assumed were as follows:

Fair value of assets acquired	\$ 1,461
Goodwill	399
Liabilities assumed	(410)
	<hr/>
Cash paid	\$ 1,450
	<hr/>

**Acquisition of Ancore Corporation**

In November 2002, the Company acquired all the outstanding capital stock of Ancore Corporation (“Ancore”) (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation) for an initial purchase payment of \$2,120, including legal and professional fees of \$120, the issuance of 347,890 shares of OSI Common Stock valued at \$5,749, and subsequent contingent payments of \$2,574. In addition, during the five years subsequent to the acquisition, upon each commercial sale of a Pulsed Fast Neutron Analysis (“PFNA”) inspection system, the Company will pay former Ancore stockholders an earn-out of 6% of the price of the PFNA system, up to \$750 per system, in either cash or stock, at the Company’s election. The PFNA earn-out payments are capped at an aggregate of \$34,000. As of June 30, 2005, no earn-out payments have been realized.

The assets acquired and liabilities assumed were as follows:

Fair value of assets (net of cash) acquired	\$ 3,150
Core technology	6,800
Developed technology	5,700
Goodwill	4,129
Liabilities assumed	(2,812)
Provision for losses on long-term contract	(6,524)
	<hr/>
Shares issued and cash paid	\$ 10,443
	<hr/>

Intangible assets acquired have the following useful lives: Developed Technology—20 years; Core Technology—30 years.

**Acquisition of OSI Defense Systems, LLC**

In August 2003, the Company acquired certain assets representing the military laser-based training business of Schwartz Electro-Optics. The acquisition was made through a newly formed, wholly-owned subsidiary, OSI Defense Systems, LLC (“OSI Defense”). Of the purchase price of \$3,661 including acquisition costs, the Company had paid a deposit of \$250 in fiscal 2003. The following table shows the purchase price allocation:

Fair value of assets (net of cash) acquired	\$ 102
Goodwill	3,157
Customer relationships	445
Liabilities assumed	(43)
	<hr/>
Cash paid	\$ 3,661
	<hr/>

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands)**

**Acquisition of OSI Electronics, Inc.**

In October 2003, the Company acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4,473 including acquisition costs. The acquisition was made through a wholly-owned subsidiary, OSI Electronics, Inc. (“OSI Electronics”). The following table shows the allocation of purchase price:

Fair value of assets (net of cash) acquired	\$ 5,483
Customer relationships	40
Liabilities assumed	(1,050)
	<hr/>
Cash paid	\$ 4,473
	<hr/>

**Acquisition of OSI Laserscan**

In November 2003, the Company acquired substantially all of the assets of Schwartz Electro-Optics in a bankruptcy court supervised auction. The Company paid approximately \$1,600, including acquisition costs. The business operates under the name OSI Laserscan. The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$ 676
Goodwill	411
Developed technology	300
Customer relationships	250
Liabilities assumed	(37)
	<hr/>
Cash paid	\$1,600
	<hr/>

**Acquisition of J&D Engineering through Rapiscan Security Products Limited**

In December 2003, the Company acquired substantially all of the assets of J&D Engineering (UK) Limited (“J&D Engineering”), a company registered in England and Wales. The Company paid approximately £460,000 (or approximately \$820) including acquisition costs.

The acquisition was made through a wholly owned subsidiary, Rapiscan Security Products Ltd. (“Rapiscan UK”) The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$435
Goodwill	385
	<hr/>
Cash paid	\$820
	<hr/>

**Acquisition of the remainder of RapiTec, Inc.**

In January 2004, minority shareholders of RapiTec, Inc. (“RapiTec”) accepted an offer by the Company to purchase all shares of RapiTec common stock held by them. As a result of the transaction, the Company now wholly owns RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820, of which \$536 was allocated to goodwill, and a second cash payment of approximately of \$279 paid in January 2005, which has also been recorded as goodwill.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands)**

**Acquisition of Advanced Research & Applications Corp.**

In January 2004, the Company completed the acquisition of all of the outstanding capital stock of Advanced Research & Applications Corp. (“ARACOR”) (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17,602 (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on ARACOR’s net revenues, provided certain requirements are met. The contingent consideration is capped at \$30,000. As of June 30, 2005, approximately \$8 of the contingent consideration has been earned and paid. The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$ 2,509
Goodwill	8,302
Developed technology	14,300
Customer relationships	700
Liabilities assumed	(2,176)
Deferred taxes	(6,033)
	<hr/>
Cash paid	\$17,602
	<hr/>

Intangible assets acquired have the following weighted-average useful lives: Developed Technology—20 years; Customer Relationships—5 years.

**Acquisition of Spacelabs Medical, Inc.**

In March 2004, the Company completed the acquisition of certain assets and liabilities of Spacelabs Medical, Inc. (“Spacelabs Medical”) from Instrumentarium Corporation, now a subsidiary of General Electric Company, for approximately \$47,929 in cash (net of cash acquired), including acquisition costs (see Note 3).

The following table shows the allocation of the purchase price:

Current assets (net of cash)	\$ 65,663
Fixed assets	1,809
Developed technology	5,660
Tradenames	5,925
Customer relationships/backlog	3,280
Other long-term assets	2,115
	<hr/>
Total assets	84,452
Current liabilities	(36,523)
	<hr/>
Total consideration paid in cash	\$ 47,929
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Intangible assets acquired have the following useful lives: Developed Technology—10 years; Customer Relationships/Backlog—10 years. Acquired intangible assets include amounts assigned to tradenames that are not subject to amortization.



**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**  
**(Dollars in Thousands)**

**Acquisition of CXR Limited**

In August 2002, the Company purchased a minority interest in CXR Limited (“CXR”), a United Kingdom based research and development company that develops products able to generate x-ray images of fast moving objects. In June 2004, the Company subscribed to \$810 of additional shares issued by CXR. The Company further purchased shares held by third parties for a total of \$550, of which \$75 was allocated to goodwill and \$475 was allocated to amortizable intangible assets. With these additional investments, the Company increased its equity investment in CXR to approximately 75%. In December 2004, the Company purchased the remaining 25% interest. As compensation to the selling shareholders for this remaining interest, the Company has agreed, for a period of 18 years, to make royalty payments based on sales of CXR’s products.

**Acquisition of Blease Medical Holdings Limited**

In February 2005, the Company completed the acquisition of all of the outstanding capital stock of Blease Medical Holdings Limited (“Blease”) for \$9,279 in cash (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease’s net revenues, provided certain requirements are met. The contingent consideration is capped at £6,250 (approximately \$11,200 as of June 30, 2005). The preliminary allocation of the acquisition cost was based on an appraisal of fair values of the tangible and intangible assets acquired. The final determination of the purchase price is pending finalization of the acquisition costs incurred as well as the amount of contingent consideration that may become payable and may result in asset fair values and liabilities assumed that differ from the preliminary estimates of these amounts. The following table summarizes the preliminary purchase price allocation of the Blease assets acquired and liabilities assumed (in thousands):

Fair value of assets (net of cash) acquired	\$ 6,134
Goodwill	4,250
Customer relationships	750
Tradenames	1,200
Developed technology	2,500
In process research and development	300
Liabilities assumed	(4,968)
Net deferred income taxes	(887)
	<hr/>
Total consideration paid, net of cash acquired	\$ 9,279
	<hr/>

Acquired in-process research and development was charged to expense as of the acquisition date in accordance with FASB Interpretation No. 4, “Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.”

The Company believes that the Blease acquisition resulted in the recognition of goodwill primarily due to projected operating synergies of the combined businesses including, utilizing the Spacelabs Medical distribution channels and expanding the Company’s portfolio of products to reach more areas of the hospital.

Intangible assets acquired have the following useful lives: Developed Technology—10 years; Customer Relationships—7 years. Acquired intangible assets include amounts assigned to tradenames that are not subject to amortization.

See accompanying notes to consolidated financial statements.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 and 2005**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**General**—OSI Systems, Inc. and its subsidiaries is a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and anesthesia systems, and optoelectronic devices and value-added subsystems.

The Company designs, manufactures and markets security and inspection systems worldwide to end users under the “Rapiscan Systems” brand name. Rapiscan Systems products are used to inspect baggage, cargo, people, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

The Company’s medical monitoring and anesthesia systems businesses design, manufacture and market their products worldwide to end users under several brand names. The Company’s medical monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and related services are sold under the “Spacelabs Medical” brand name. The Company’s anesthesia systems and components are sold under the “Blease” brand name. The Company’s arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools, are sold under the “Dolphin” brand name and its peripheral bone densitometers and ultrasound bone sonometers are sold under the “Osteometer” brand name.

The Company’s optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. The Company designs and manufactures optoelectronic devices and value-added subsystems worldwide for others through original equipment manufacturer arrangements, as well as for its security and medical equipment businesses.

**Consolidation**—The consolidated financial statements include the accounts of OSI Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Cash Equivalents**—The Company considers all highly liquid investments purchased with maturity of three months or less as of the acquisition date, to be cash equivalents.

**Marketable Securities**—Marketable securities consist of equity securities categorized as available-for-sale and carried at fair value. Unrealized holding gains and losses on marketable securities are included in accumulated other comprehensive loss until realized. Fair value of marketable securities is determined by the quoted market prices of each marketable security. For purposes of determining gross realized gains and losses, the cost of the securities sold is based upon specific identification.

There were no marketable securities available for sale as of June 30, 2004. Net realized gains on sales of available-for-sale securities amounted to \$1,767,000 for the fiscal year ended June 30, 2003 and \$376,000 for the fiscal year ended June 30, 2004. There were no realized gains or losses from sales of available-for-sale securities for the fiscal year ended June 30, 2005.

**Concentrations of Credit Risk**—The Company’s financial instruments that are exposed to concentrations of credit risk consist primarily of its cash, cash equivalents, available-for-sale investments and accounts receivable. The Company restricts investments in cash equivalents to financial institutions with high credit standing. At June 30, 2004 approximately 86% of the Company’s cash equivalents were held at three financial institutions. At

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

June 30, 2005, approximately 53% of the Company's cash equivalents were held at two financial institutions. Credit risk on accounts receivable is minimized as a result of the large and diverse nature of the Company's worldwide customer base. No one customer accounted for more than 10% of accounts receivable or revenues as of June 30, 2004 or 2005. The Company performs ongoing credit evaluations of its customers' financial condition and maintains allowances for potential credit losses.

**Accounts Receivable**—The allowance for doubtful accounts involves estimates based on management's judgment, review of individual receivables and analysis of historical bad debts. The Company adjusts customer credit limits based upon each customer's payment history and current credit worthiness, as determined by credit information available at that time. The Company continuously monitors collections and payments from its customers and maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Accounts receivable consisted of the following at June 30 (in thousands):

	2004	2005
Trade receivables—net	\$81,601	\$86,744
Receivables related to long term contracts—unbilled costs and accrued profit on progress completed	4,173	2,483
<b>Total</b>	<b>\$85,774</b>	<b>\$89,227</b>

The unbilled costs and accrued profit at June 30, 2005 are expected to be entirely billed and collected during fiscal year 2006.

**Inventory**—Inventory is stated at the lower of cost or market. Cost is determined on the first-in, first-out method. The Company writes down inventory for slow-moving and obsolete inventory based on assessments of future demands, market conditions and customers who may be experiencing financial difficulties. If these factors are less favorable than those projected, additional inventory write-downs may be required.

Inventory consisted of the following at June 30 (in thousands):

	2004	2005
Raw materials	\$41,064	\$ 56,584
Work-in-process	25,283	22,132
Finished goods	30,827	28,725
<b>Total</b>	<b>\$97,174</b>	<b>\$ 107,441</b>

**Property and Equipment**—Property and equipment are stated at cost. Depreciation and amortization are computed using the straight-line and accelerated methods over the estimated useful lives of the assets. Amortization of leasehold improvements is calculated on the straight-line basis over the shorter of the useful life of the asset or the lease term.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

Property and equipment consisted of the following at June 30 (in thousands):

	Estimated Useful Lives	2004	2005
Land		\$ 1,263	\$ 5,564
Buildings	20 years	2,948	6,322
Equipment	5-8 years	17,786	23,890
Leasehold improvements	3-10 years	6,830	6,513
Tooling	3-5 years	2,661	2,911
Furniture and fixtures	8- 10 years	2,325	3,328
Computer equipment	3-4 years	9,994	12,252
Enterprise Resource Planning software	10 years	1,357	1,848
Vehicles	3-5 years	277	262
<b>Total</b>		<b>45,441</b>	<b>62,890</b>
Less accumulated depreciation and amortization		(26,666)	(31,916)
<b>Property and equipment—net</b>		<b>\$ 18,775</b>	<b>\$ 30,974</b>

During the fiscal years ended June 30, 2003, 2004 and 2005, depreciation expense was approximately \$3,685,000, \$3,969,000 and \$6,610,000, respectively.

Included in computer equipment above is approximately \$730,000 of assets under capital leases.

**Impairment of Long-Lived Assets**—The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If the sum of the expected future cash flows, undiscounted and without interest charges is less than the carrying amount of the asset, the Company recognizes an impairment loss based on the estimated fair value of the asset.

**Income Taxes**—Deferred income taxes are provided for temporary differences between the financial statement and income tax basis of the Company's assets and liabilities, based on enacted tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred income tax assets will not be realized.

**Fair Value of Financial Instruments**—The Company's financial instruments consist primarily of cash, marketable securities, accounts receivable, accounts payable and debt instruments. The carrying values of financial instruments, other than debt instruments, are representative of their fair values due to their short-term maturities. The carrying values of the Company's long-term debt instruments are considered to approximate their fair values because the interest rates of these instruments are variable or comparable to current rates offered to the Company.

**Derivative Instruments**—The Company may, from time to time, purchase foreign exchange contracts, in order to attempt to reduce foreign exchange transaction gains and losses, or enter into interest rate swaps. The Company accounts for derivative instruments in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivatives and Certain Hedging Activities." As of June 30, 2004 and 2005 there were no foreign exchange contracts or interest rate swaps outstanding.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

**Revenue Recognition**—The Company recognizes revenue upon shipment of products when title and risk of loss passes, and when terms are fixed and collection is probable. In accordance with the terms of Staff Accounting Bulletin No. 104, “Revenue Recognition,” and Emerging Issues Task Force (EITF) Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables,” where installation services, if provided, are essential to the functionality of the equipment, the portion of revenue for the sale attributable to installation is deferred and recognized when the installation service is provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the acceptance criteria are met. Concurrent with the shipment of the product, the Company accrues estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not the customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of revenue recognized. Critical judgments also include estimates of warranty reserves, which are established based on historical experience and knowledge of the product.

The Company undertakes projects that include the design, development and manufacture or fabrication of large complex cargo and vehicle inspection systems that are specially customized to customer’s specifications or that involve fixed site construction. Sales under such contracts are recorded under the percentage-of-completion method in accordance with Statement of Position No. 81-1 “Accounting for Performance of Construction-Type and Certain Production-Type Contracts.” Costs and estimated revenues are recorded as work is performed based on the percentage that incurred costs bear to estimated total costs utilizing the most recent estimates of costs. If the current contract estimate indicates a loss, provision is made for the total anticipated loss in the current period. Critical estimates made by management related to revenue recognition under the percentage-of-completion method include the estimation of costs at completion and the determination of the overall margin rate on the specific project.

Revenues from separate service maintenance contracts are recognized ratably over the term of the agreements. For other services, service revenues are recognized as the services are performed. Deferred revenue for services arises from advance payments received from customers for services not yet performed. The Company records billed shipping and handling fees as revenue and the associated costs as cost of goods sold.

**Research and Development Costs**—Research and development costs are those costs related to the development of a new product, process or service, or significant improvement to an existing product, process or service. Such costs are charged to operations as incurred. Grants for research and development are recorded as revenue in the period earned, and the related costs are classified in cost of goods sold.

**Foreign Currency Translation**—The accounts of the Company’s operations in Canada, India, Malaysia, Norway, Singapore and the United Kingdom are maintained in Canadian dollars, Indian rupees, Malaysian ringgits, Norwegian kroners and U.K. pounds, respectively. The accounts of the Company’s operations in Austria, Finland, France, Germany and Greece are maintained in euros. Foreign currency financial statements are translated into U.S. dollars at fiscal year end rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. Gains and losses resulting from foreign currency transactions are included in income, while those resulting from translation of financial statements are excluded from income and accumulated as a component of accumulated other comprehensive loss. Transaction losses of approximately \$475,000, \$377,000 and \$237,000, were included in income for the fiscal years ended June 30, 2003, 2004 and 2005, respectively.

**Earnings (Loss) per Share**—The Company has reflected the provisions of SFAS No. 128, “Earnings per Share,” in the accompanying consolidated financial statements for all periods presented. Earnings per common

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

share are computed using the weighted-average number of shares outstanding during the period. Diluted earnings per common share are computed using the weighted-average number of shares outstanding during the period plus the dilutive effect of potential common stock. Potential common stock types are the Company's stock options, stock warrants and Spacelabs Medical stock options (see Note 7).

As of June 30, 2003, 2004 and 2005, 1,170,200, 1,314,863 and 3,099,745, respectively, of potentially dilutive shares associated with stock options and stock warrants, collectively, were not included in diluted earnings per common share calculations because to do so would have been antidilutive.

The following table reconciles the numerator and denominator used in calculating basic earnings per common share and diluted earnings per common share for the fiscal years ended June 30:

	2003		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Earnings per common share:			
Income available to common shareholders	\$ 15,793,000	14,013,584	\$ 1.13
Effect of dilutive securities (Treasury stock method)		499,790	
Total	<u>\$ 15,793,000</u>	<u>14,513,374</u>	<u>\$ 1.09</u>
	2004		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Earnings per common share:			
Income available to common shareholders	\$ 9,956,000	14,733,700	\$ 0.68
Effect of dilutive securities (Treasury stock method)		502,699	
Total	<u>\$ 9,956,000</u>	<u>15,236,399</u>	<u>\$ 0.65</u>
	2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Loss per common share:			
Net loss	\$(2,395,000)	16,222,998	\$ (0.15)
Effect of dilutive interest in subsidiary stock	(107,000)		
Loss available to common shareholders	<u>(2,502,000)</u>		
Effect of dilutive securities (Treasury stock method)		—	
Total	<u>\$(2,502,000)</u>	<u>16,222,998</u>	<u>\$ (0.15)</u>

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

**Goodwill and Other Intangible Assets**—SFAS No. 142, “Goodwill and Other Intangible Assets,” requires testing goodwill for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that may reduce the fair value of a reporting unit below its carrying value. The Company performed its annual impairment test during the second quarter of fiscal years 2003, 2004 and 2005 and concluded that there was no impairment of goodwill for the fiscal years ended June 30, 2003, 2004 and 2005. The changes in the carrying amount of goodwill for the fiscal years ended June 30, 2004 and 2005, for each segment in which the company operates, are as follows (in thousands):

	Security Group	Healthcare Group	Optoelectronics and Manufacturing Group	Consolidated
Balance as of July 1, 2003	\$ 8,205	\$ 1,269	\$ 1,962	\$ 11,436
Reduction related to net operating losses acquired on purchase of Ancore	(631)			(631)
Goodwill acquired during the period	8,762		4,104	12,866
Foreign currency translation adjustment	254			254
Balance as of June 30, 2004	16,590	1,269	6,066	23,925
Goodwill acquired during the period	8	4,442	278	4,728
Foreign currency translation adjustment	(106)	150		44
Balance as of June 30, 2005	\$16,492	\$ 5,861	\$ 6,344	\$ 28,697

Additional information concerning reporting segments is available in Note 13 to the consolidated financial statements.

SFAS No. 142 requires that intangible assets that meet the criteria for recognition apart from goodwill be reclassified and that intangibles with indefinite lives cease to be amortized in favor of periodic impairment testing.

The Company has intangible assets for tradenames, which have indefinite lives and are therefore not subject to amortization. The carrying value of these tradenames was \$6,041,000 and \$7,083,000 at June 30, 2004 and 2005, respectively.

Intangible assets subject to amortization consisted of the following (in thousands):

		June 30, 2004			June 30, 2005		
	Weighted Average Lives	Gross Carrying Value	Accumulated Amortization	Intangibles Net	Gross Carrying Value	Accumulated Amortization	Intangibles Net
Purchased Software	5 years	\$ 327	\$ 310	\$ 17	\$ 327	\$ 327	\$
Software development costs	6 years	3,558	1,063	2,495	5,051	1,552	3,499
Patents	11 years	438	139	299	439	193	246
Core technology	25 years	6,800	359	6,441	9,213	681	8,532
Developed technology	18 years	26,221	1,116	25,105	26,400	2,989	23,411
Customer relationships/backlog	8 years	4,779	263	4,516	5,439	923	4,516
		\$42,123	\$ 3,250	\$ 38,873	\$46,869	\$ 6,665	\$ 40,204

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

Amortization expense for the fiscal years ended June 30, 2003, 2004 and 2005 was \$604,000, \$1,739,000 and \$4,026,000, respectively. At June 30, 2005, estimated future amortization expense is as follows (in thousands):

2006	\$ 3,335
2007	3,312
2008	3,174
2009	2,822
2010	2,686
2011 and thereafter	24,875
<b>Total</b>	<b>\$40,204</b>

Software development costs, for software products to be licensed to others, incurred before establishing technological feasibility, are charged to operations. Software development costs incurred after establishing technological feasibility and purchased software costs are capitalized on a product-by-product basis until the product is available for general release to customers at which time amortization begins. Annual amortization, charged to cost of sales, is the greater of: (i) the amount computed using the ratio that current gross revenues for a product bear to the total current and anticipated future gross revenues for that product or (ii) the straight-line method over the remaining estimated economic life of the product. During the fiscal years ended June 30, 2003, 2004 and 2005, the Company capitalized software development costs in the amount of \$443,000, \$90,000 and \$1,401,000, respectively.

**Provision for Warranties**—The Company offers its customers warranties on products sold to them. These warranties typically provide for repairs and maintenance of its products for a specified time period. Concurrent with the sale of products, a provision for estimated warranty expenses is recorded with a corresponding increase in cost of goods sold. This provision is adjusted periodically based on historical and anticipated experience. Actual expenses of repairs under warranty, including parts and labor are charged to this provision when incurred.

	<b>Provision for Warranties (in thousands)</b>
Balance on July 1, 2002	\$ 2,164
Additions	2,516
Reductions for warranty repair costs	(1,898)
Balance on June 30, 2003	2,782
Additions	2,718
Increase as a result of acquisitions	7,719
Reductions for warranty repair costs	(4,029)
Balance on June 30, 2004	9,190
Additions	5,559
Increase as a result of acquisitions	464
Revisions to prior estimates	(2,148)
Reductions for warranty repair costs	(6,424)
Balance on June 30, 2005	\$ 6,641



**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
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**New Accounting Pronouncements**—In November 2004, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 151, “Inventory Costs” (“SFAS 151”), an amendment of Accounting Research Bulletin No. 43, Chapter 4. SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe the adoption of SFAS 151 will have a material impact on its consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123R, “Share-Based Payment” (“SFAS 123R”), which is effective for the annual periods beginning after June 15, 2005. SFAS 123R therefore becomes effective for the Company in the first quarter of fiscal year 2006. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized as an operating expense in the income statement. The cost is recognized over the requisite service period based on fair values measured on grant dates, and the new standard may be adopted using either the modified prospective transition method or the modified retrospective transition method. The Company expects the adoption of this statement will have an adverse impact on its consolidated financial position and results of operations. The Company has not yet completed its evaluation of the effect that SFAS 123R will have on its consolidated financial statements.

In December 2004, the FASB issued two FASB Staff Positions (“FSP’s”): FSP SFAS 109-1, “Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004,” and FSP SFAS 109-2, “Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision Within the American Jobs Creation Act of 2004,” which were both effective upon issuance. FSP SFAS 109-1 clarifies that the tax deduction for domestic manufacturers under the American Jobs Creation Act of 2004 (the “Act”) should be accounted for as a special deduction in accordance with SFAS No. 109, “Accounting for Income Taxes” (“SFAS 109”). FSP SFAS 109-2 grants additional time to evaluate the Act’s impact on the Company’s plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. The Company is currently evaluating the effect of the FSP’s on the Company’s consolidated financial statements.

In June 2005, the EITF modified its consensus on Issue No. 04-10, “Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds.” This guidance creates stricter standards for aggregating operating segments that do not meet the quantitative thresholds provided within SFAS 131, “Disclosures About Segments of an Enterprise and Related Information.” The guidance will be effective for fiscal years ending after September 15, 2005. The Company does not anticipate that adoption of this guidance will impact the presentation of its reportable segments.

In June 2005, the FASB issued an exposure draft of a proposed standard entitled “Business Combinations—a replacement of FASB Statement No. 141.” The proposed standard, if adopted, would provide new guidance for evaluating and recording business combinations and would be effective on a prospective basis for business combinations whose acquisition dates are on or after January 1, 2007. Upon issuance of a final standard, which is expected in 2006, the Company will evaluate the impact of this new standard and its effect on the process for recording business combinations.

In July 2005, the FASB issued an exposure draft of a proposed interpretation, “Accounting for Uncertain Tax Positions.” The proposed interpretation clarifies the accounting for uncertain tax positions in accordance with SFAS 109. The proposed interpretation requires that a tax position meet a “probable recognition threshold” for the benefit of the uncertain tax position to be recognized in the financial statements. A tax position that fails to meet the probable recognition threshold will result in either reduction of current or deferred tax asset or

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

receivable, or recording a current or deferred tax liability. The proposed interpretation also provides guidance on measurement, derecognition of tax benefits, classification, interim period accounting disclosure, and transition requirements in accounting for uncertain tax positions. The proposed interpretation has a 60-day comment period and shall be effective for all companies as of the first fiscal year ending after December 15, 2005. Upon issuance of a final standard, which is expected in 2006, the Company will evaluate the impact that the interpretation will have on its consolidated financial statements.

**Stock-Based Compensation (As Restated)**—The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations to account for its stock-based employee compensation plans. These interpretations include FASB Interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25,” issued in March 2000. Under this method, compensation expense is generally recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. The Company has adopted the disclosure-only provisions of SFAS No. 123, “Accounting for Stock-Based Compensation,” and SFAS No. 148, “Accounting for Stock-Based Compensation-Transition and Disclosure,” which was released in December 2002 as an amendment to SFAS No. 123. These statements established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123 and SFAS No. 148, the Company has elected to continue to apply the intrinsic value-based method of accounting described above.

The Company accounts for stock-based awards to non-employees using the guidance of SFAS No. 123, as amended by SFAS No. 148, and EITF No. 96-18, “Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services,” whereby the fair value of such options is determined using the Black-Scholes option pricing model at the earlier of the date at which the non-employee’s performance is complete or a performance commitment is reached.

The Company applies APB Opinion No. 25 in accounting for substantially all of its stock-based awards and, accordingly, except for certain options issued to non-employees, as discussed above, no compensation cost using the intrinsic value method has been recognized for its stock option grants in the accompanying financial statements.

The Company has two employee stock options plans: the 1997 Stock Option Plan and the 2004 Spacelabs Medical Stock Option Plan (see Note 7).

Subsequent to the issuance of the Company’s fiscal year 2004 consolidated financial statements, the Company’s management determined that total stock-based employee compensation expense determined under the fair value based method, net of related tax effects, and the per share weighted-average fair value of stock options granted, for fiscal years 2003 and 2004, had been calculated incorrectly. As a result, the amounts presented below have been restated from the amounts previously reported to decrease pro forma stock-based compensation expense, net of related tax effects, and to increase pro forma net income by \$290,000 for fiscal year 2003 and by \$1,432,000 for fiscal year 2004, and to increase pro forma diluted earnings per share by \$0.04 per share for 2003 and by \$0.10 per share for 2004. The restated per share weighted-average fair value of stock options granted under the 1997 Stock Option Plan was \$10.91 for fiscal year 2003 and \$11.03 for fiscal year 2004. The restatement did not impact the Company’s consolidated financial position, results of operations or cash flows for any of the periods presented.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
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If the fair value based method had been applied in measuring stock compensation expense under SFAS No. 123, as amended by SFAS No. 148, the pro forma effect on net earnings and net earnings per share would have been as follows (in thousands except for per share amounts):

	Years Ended June 30,		
	2003 (Restated)	2004 (Restated)	2005
Net income (loss)—as reported	\$ 15,793	\$ 9,956	\$(2,395)
Add: Stock-based employee compensation expense included in reported net income—net of related tax effects	—	—	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards—net of related tax effects	(2,250)	(3,504)	(4,268)
<b>Pro forma net income (loss)</b>	<b>\$ 13,543</b>	<b>\$ 6,452</b>	<b>\$(6,663)</b>
<b>Earnings (loss) per share:</b>			
Basic—as reported	\$ 1.13	\$ 0.68	\$ (0.15)
Basic—pro forma	\$ 0.97	\$ 0.44	\$ (0.41)
Diluted—as reported	\$ 1.09	\$ 0.65	\$ (0.15)
Diluted—pro forma	\$ 0.93	\$ 0.41	\$ (0.42)

The per share weighted-average fair value of stock options (calculated as of the grant date) issued under the 1997 Stock Option Plan during fiscal years 2003, 2004 and 2005 was \$10.91, \$11.03 and \$8.91, respectively.

The fair value of option grants is determined using the Black-Scholes option pricing model with the following weighted average assumptions for the 1997 Stock Option Plan:

1997 Stock Option Plan	Year Ended June 30,		
	2003	2004	2005
Expected dividend	0.0%	0.0%	0.0%
Risk free interest rate	2.5%	2.5%	3.4%
Expected volatility	94.9%	77.1%	58.3%
Expected life (in years)	4.0	3.8	3.7

The fair value of option grants is determined using the Black-Scholes option pricing model with the following weighted average assumptions for the 2004 Spacelabs Medical Stock Option Plan:

2004 Spacelabs Medical Stock Option Plan	Year Ended June 30,	
	2004	2005
Expected dividend	0.0%	0.0%
Risk free interest rate	2.4%	3.2%
Expected volatility	51.5%	51.2%
Expected life (in years)	3.6	3.6

The per share weighted-average fair value of stock options (calculated as of the grant date) issued under the 2004 Spacelabs Medical Stock Option Plan during fiscal years 2004 and 2005 was \$0.23 and \$0.33, respectively.

As discussed previously, SFAS 123R is effective beginning in fiscal year 2006. SFAS 123R applies to new awards and to awards modified, repurchased, or cancelled after the effective date, as well as to the unvested portion of awards outstanding as of the effective date. Upon adoption, prior periods may be, but are not required,

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to be restated. The Company expects that the adoption of SFAS 123R will have an adverse impact on its net earnings and net earnings per share. The Company has not yet completed its evaluation of the effect that SFAS 123R will have on its consolidated financial statements.

**Use of Estimates**—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Reclassifications**—Certain reclassifications have been made to prior year amounts to conform to the current year's presentation.

**2. JOINT VENTURES AND EQUITY INVESTMENTS**

In January 1994, the Company, together with an unrelated company, formed ECIL-Rapiscan Security Products Limited, a joint venture organized under the laws of India. The Company, the Company's chairman and chief executive officer, along with another director and officer of the Company have a 36%, 10.5% and 4.5% ownership interest, respectively, in the joint venture. The Company's initial investment was \$108,000. The Company and its directors and officers, collectively control less than 50% of the board of directors' voting power in the joint venture. As a result, the Company accounts for the investment under the equity method of accounting.

The joint venture was formed for the purpose of the manufacture, assembly, service and testing of x-ray security and other products. Some of the Company's subsidiaries are suppliers to the joint venture partner. The joint venture partner utilizes the technology purchased from the Company's subsidiaries to manufacture products which are sold to the joint venture. Sales to the joint venture partner for the fiscal years ended June 30, 2003, 2004 and 2005 were approximately \$468,000, \$677,000 and \$178,000, respectively.

In August 2002, the Company invested \$775,000 to purchase a minority equity interest in CXR, a UK-based research and development company that develops real time tomography systems. The investment was accounted for under the equity method of accounting. As a result of adopting FASB Interpretation No. ("FIN") 46, "Consolidation of Variable Interest Entities," the Company began consolidating this investment during fiscal year 2004. In June 2004, the Company subscribed to \$810,000 of additional shares issued by CXR. The Company further purchased shares held by third parties for a total of \$550,000 and increased its interest to 75%. In December 2004, the Company acquired the remaining 25% interest. As compensation to the selling shareholders for this remaining interest, the Company agreed, for a period of 18 years, to make royalty payments based on sales of CXR's products. There were no such sales during the fiscal year ended June 30, 2005. As a result of this transaction, CXR is now a wholly-owned subsidiary of the Company.

For the fiscal years ended June 30, 2003, 2004 and 2005, the Company's equity in the earnings (losses) of the above-mentioned joint ventures amounted to \$76,000, (\$102,000) and \$213,000 respectively, and is included in selling, general and administrative expenses.

In July 2002, the Company purchased from Imagis Technologies, Inc. ("Imagis") 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), 2-year warrants to purchase 291,667 additional shares of Imagis common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis develops facial recognition software for security applications. The investment is classified as available-for-sale and as a result of the long term nature of this investment, is included in other assets in the accompanying consolidated financial

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statements. For the fiscal years ended June 30, 2003 and 2004, based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, other than temporary impairments in the carrying value of this investment totaling \$1,433,000 and \$247,000, respectively (pre-tax) were recognized.

In connection with the acquisition of Spacelabs Medical (see Note 3), the Company acquired 19.95% of the issued and outstanding shares of Tempus Software, Inc., a privately-held company (“Tempus”). In June 2004, QuadraMed Corp., a public company, traded over-the-counter at that time (“QuadraMed”), purchased all of the issued and outstanding shares of Tempus. In exchange for its Tempus shares, the Company received \$902,000 in cash plus restricted shares in QuadraMed. Such restricted shares were provisionally valued by the Company at \$322,000 until a more complete valuation of such shares could be finalized. In February 2005, the Company finalized its valuation and determined that the QuadraMed shares should in fact be valued at \$827,000 as of the acquisition date.

At March 31, 2005, the fair value of the Company’s QuadraMed shares had decreased based on the market price of QuadraMed’s shares that were publicly traded. In accordance with SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (“SFAS 115”), the Company concluded that an other-than-temporary decline in the value of its QuadraMed shares had occurred and recorded a write down of \$182,000 in its consolidated statements of operations.

As of June 30, 2005, the Company had held its restricted QuadraMed shares for a sufficient period such that under federal and state securities laws the shares became unrestricted. Therefore, the Company now deems the value of its QuadraMed shares to be equal the quoted market price of QuadraMed shares. As of June 30, 2005, the Company’s QuadraMed shares have accordingly been re-classified from investments to marketable securities available-for-sale in the accompanying consolidated balance sheet. As of June 30, 2005, the market price of QuadraMed’s shares had recovered and the Company determined that the value of its QuadraMed shares had risen by \$154,000, which represents the unrealized gains subsequent to the write down of such investment at March 31, 2005. In accordance with SFAS 115, this recovery has been recorded as a component of other comprehensive income.

In addition to the above, in connection with the purchase of Tempus by QuadraMed, the Company also received into an escrow account \$115,000 in cash and certain additional unregistered shares in QuadraMed, pending the resolution of certain purchase price adjustments. The Company has not yet assigned a value to the cash and shares held in escrow as uncertainties remain as to the amounts the Company will ultimately receive.

### **3. ACQUISITIONS AND DISPOSITIONS**

In October 2000 and May 2001, the Company invested an additional \$182,000 and \$100,000, respectively, to increase the Company’s equity percentage in OSI Medical to 74.8%. The Company merged OSI Medical into a newly formed subsidiary, Dolphin Medical, Inc. (“Dolphin”) in March 2002. Dolphin had been formed in September 2001 when the medical device business of the Company’s UDT Sensors, Inc. subsidiary was contributed to Dolphin in exchange for stock in Dolphin. In December 2003, the Company entered into a Stock Purchase and Option Agreement with Conmed Corporation, whereby Conmed Corporation purchased a 9% interest in Dolphin and an option to purchase all of the remaining shares of Dolphin. In addition, Conmed Corporation and Dolphin entered into a distribution agreement, which provides Conmed Corporation with distribution rights for certain Dolphin products within certain defined territories. The Company currently owns approximately 90% of Dolphin. The Company received \$2,000,000 in connection with the above-mentioned agreements of which \$800,000 is deferred over the five-year term of the distribution agreement.

In fiscal year 2000, the Company formed RapiTec, a majority-owned subsidiary. In January 2004, the minority shareholders of RapiTec accepted an offer by the Company to purchase all shares of RapiTec common

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stock held by them. As a result of the transaction, the Company now wholly owns RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820,000 paid in fiscal year 2004, of which \$536,000 was allocated to goodwill, and a second cash payment of approximately \$279,000 paid in January 2005, which amount was also allocated to goodwill. As of June 30, 2005, the Company has approximately \$815,000 in goodwill recorded for this acquisition, none of which is tax deductible.

In July 2002, the Company acquired substantially all the assets and business of Thermo Centro Vision, Inc., an opto-electronic subsystems designer and manufacturer based in Ventura County, California, for a purchase price of \$1,450,000. The acquisition was made through a newly formed, wholly owned subsidiary, Centro Vision. The acquisition has been accounted for using the purchase method of accounting. The excess of the purchase price over the fair value of the net assets acquired was allocated to goodwill. As of June 30, 2005, the Company has approximately \$399,000 in goodwill recorded for this acquisition, of which approximately \$399,000 is tax deductible. Although the agreement to purchase the assets and business of Thermo Centro Vision, Inc. included a provision for a contingent additional payment based on the financial performance of the business measured as of March 31, 2003, the minimum threshold for the contingent additional payment was not met. The Company is therefore under no further obligation to make additional purchase price payments in connection with this transaction.

In November 2002, the Company acquired all the outstanding capital stock of Ancore Corporation (recently renamed Rapiscan Systems High Energy Inspection Corporation) ("Ancore"), a Santa Clara, California based privately held high-technology developer and provider of advanced inspection systems for aviation security, port and border inspection and counter-terrorism to enhance the Company's cargo and vehicle inspection system offerings. Consideration paid for the acquisition consisted of a combination of the Company's common stock ("Common Stock") and cash. At the close of the acquisition, the Company paid \$2,000,000 in cash, and issued 347,890 shares of its Common Stock valued at \$5,749,000. Expenses associated with the acquisition were approximately \$120,000, and have been included in the total purchase price. As of June 30, 2005, the Company has approximately \$4,129,000 in goodwill recorded for this acquisition, none of which is tax deductible. The acquisition agreement contains certain provisions for additional contingent purchase price payments. On December 9, 2002, the Company filed a registration statement on Form S-3 with the Securities and Exchange Commission to register the shares issued as part of the Ancore purchase consideration, as well as shares potentially issuable in satisfaction of contingent payments.

In January 2003, an additional contingent cash payment of \$2,000,000 was made to former Ancore stockholders based on Ancore meeting certain performance criteria. The additional contingent consideration of \$2,000,000 has been included in the allocated purchase price. In May 2003, an additional contingent cash payment of approximately \$574,000 was made to former Ancore stockholders, based on Ancore meeting certain performance criteria. The additional \$574,000 has been included in the allocated purchase price. In addition, during the five years subsequent to the acquisition, upon each commercial sale of a Pulsed Fast Neutron Analysis ("PFNA") inspection system, the Company will pay former Ancore stockholders an earn-out of 6% of the price of the PFNA system, up to \$750,000 per system, in either cash or stock, at the Company's election. The PFNA earn-out payments are capped at an aggregate of \$34,000,000. As of June 30, 2005, no earn-out payments have been made.

In August 2003, the Company acquired certain assets representing the military laser-based training business of Schwartz Electro-Optics, Inc. for \$3.7 million. The acquisition was made through a newly formed, wholly-owned subsidiary, OSI Defense. The acquired business develops and manufactures tactical engagement simulation systems, man-worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems for the defense industry. As of June 30, 2005, the Company has approximately \$3,157,000 in goodwill

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recorded for this acquisition, of which approximately \$3,157,000 is tax deductible. In November 2003, the Company acquired substantially all remaining assets of Schwartz Electro-Optics, Inc. in a bankruptcy court supervised auction. The Company paid approximately \$1,600,000, including acquisition costs. The acquired assets comprise a business for the design, manufacturing and sale of laser-based systems used in traffic and toll management, precision agricultural management, and precision mapping and surveying. The business, located in Orlando, Florida now operates under the name OSI Laserscan. The acquisition was made through OSI Defense. As of June 30, 2005, the Company has approximately \$411,000 in goodwill recorded for this acquisition, of which approximately \$411,000 is tax deductible.

In October 2003, the Company acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4,473,000 including acquisition costs (net of cash acquired). The acquisition was made through a wholly-owned subsidiary, OSI Electronics.

In December 2003, the Company acquired substantially all of the assets of J&D Engineering, a company registered in England and Wales. The Company paid approximately £367,000 (or approximately \$649,000) including acquisition costs. A further £93,000 (or approximately \$171,000) was paid during the quarter ended March 31, 2004. The acquired assets comprise a business for the design, sale and manufacturing of, among other products, metal frames for x-ray scanners. The acquisition was made through the Company's wholly owned subsidiary, Rapiscan Security Products Limited, (recently renamed "Rapiscan Systems Limited")("Rapiscan Systems U.K.").

In January 2004, the Company completed the acquisition of all of the outstanding capital stock of Advanced Research and Applications Corp. (recently renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation) ("ARACOR"), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17,602,000 (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on ARACOR's net revenues, provided certain requirements are met. The contingent consideration is capped at \$30,000,000. As of June 30, 2005, approximately \$8,000 of the contingent consideration has been earned and paid. As of June 30, 2005, the Company has approximately \$8,302,000 in goodwill recorded for this acquisition, none of which is tax deductible. The acquisition of ARACOR broadens the Company's security product portfolio with ARACOR's mobile x-ray inspection system, the Eagle, which is designed for container scanning at busy seaports.

In March 2004, the Company completed the acquisition from Instrumentarium Corporation, now a subsidiary of General Electric Company, of certain capital stock and assets constituting substantially all of the business operations of Spacelabs Medical. The acquisition price was approximately \$47,929,000 in cash (net of cash acquired), including acquisition costs. Spacelabs Medical is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors and medical data services. In June 2004, the Company notified General Electric Company of a working capital and retention bonus adjustment resulting in what the Company believes to be a downward adjustment of the purchase price in the amount of \$25,900,000. In September 2004, General Electric Company responded that it believes the amount of the downward adjustment to be \$7,800,000. In June 2005, the Company filed suit in Delaware seeking specific performance of the purchase agreement with respect to an independent determination of the amount of the purchase price adjustment. The action is currently pending. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price.

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Pursuant to the terms of the purchase agreement, the Company assumed management retention bonus agreements for key personnel of Spacelabs Medical. The current estimate of total retention bonuses paid and to be paid under these agreements is approximately \$5,400,000. As of June 30, 2005, the Company has accrued a total of \$2,052,000 for the retention bonuses. The accrual is included in accrued payroll and related expense as of June 30, 2004 and 2005 and is summarized in the following table:

	Retention Bonus Accrual (in thousands)
Balance on March 19, 2004	\$ 1,902
Accruals	1,104
Payments	(403)
Balance on June 30, 2004	2,603
Accruals	1,824
Payments	(2,375)
Balance on June 30, 2005	\$ 2,052

In February 2005, the Company completed the acquisition of all of the outstanding capital stock of Blease for \$9,279,000 in cash (net of cash acquired), including acquisition costs. As of June 30, 2005, the Company has approximately \$4,250,000 in goodwill recorded for this acquisition, none of which is tax deductible. Furthermore, during the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$11,200,000 as of June 30, 2005). The results of operations of Blease have been included in the Company's consolidated statement of operations from the acquisition date, February 2005.

Supplemental pro-forma disclosures of the results of operations for the fiscal years ended June 30, 2004 and 2005 as though the Spacelabs and Blease acquisitions had been completed as of July 1, 2003 are as follows (in thousands except per share amounts):

	Unaudited	
	2004	2005
Revenues	\$375,565	\$395,610
Net loss before taxes	\$ (14,165)	\$ (9,076)
Net loss	\$ (8,819)	\$ (3,306)
Net loss available to shareholders	\$ (8,819)	\$ (3,413)
Diluted loss per share (1)	\$ (0.58)	\$ (0.21)

(1) Earnings per share is calculated based on 15,236,399 and 16,222,998 diluted ordinary shares for the fiscal years ended June 30, 2004 and 2005, respectively.

In fiscal year 2002, the Company entered into an agreement regarding a joint acquisition with L-3 Communications Corporation ("L-3") of certain detection and security businesses then owned by PerkinElmer, Inc. ("PerkinElmer"). The transaction as contemplated would have resulted in the acquisition from L-3 of a certain portion of PerkinElmer's detection and security businesses. L-3 completed the purchase of the entirety of the businesses from PerkinElmer in June 2002. In November 2002, L-3 terminated the L-3/OSI transaction prior to consummation. Due to L-3's termination of the transaction, an expense of \$608,000 was recorded for the fiscal year ended June 30, 2003, consisting of previously deferred transaction-related expenses.



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**4. LINE-OF-CREDIT BORROWINGS AND LONG-TERM DEBT**

In May 2005, the Company entered into a second amended and restated credit agreement with Bank of the West, which provides for a \$50,000,000 senior revolving line of credit, including a letter-of-credit, foreign exchange facility and an acquisition credit facility, which are secured by substantially all of the assets of the Company's U.S. subsidiaries and its stock ownership in Opto Sensors (Malaysia) Sdn. Bhd. ("Opto Malaysia") and Rapiscan Systems U.K. The agreement provides that the aggregate principal balance of all advances under the various facilities shall not exceed the total balance available under the line of credit. Borrowings under the line of credit bear interest at the bank's variable reference rate (6.25% at June 30, 2005) or at the Company's option, at the applicable LIBOR rate. Commitment fees are payable based on a rate of 0.125% of the unused borrowing facility.

The second amended and restated credit agreement expires in May 2008. At June 30, 2005, there was \$15,500,000 outstanding under the revolving line of credit, composed of \$12,000,000 at the bank's variable reference rate (6.25% at June 30, 2005) and \$3,500,000 at the six-month LIBOR rate (4.68% at June 30, 2005). In addition, \$5,100,000 was issued and outstanding under the letter of credit facility at June 30, 2005. Covenants in connection with the credit agreement impose restrictions and requirements related to, among other things, maintenance of certain financial ratios. As of June 30, 2005, the Company was not in compliance with certain covenants. However, the bank has waived the non-compliance with these covenants as of June 30, 2005. On September 12, 2005, the Company and the bank signed the proposed Summary of Terms & Conditions for purposes of amending the existing credit agreement. The proposed terms and conditions for the amended agreement include an asset-based credit facility with revised financial covenants; however, the final amended credit agreement has not yet been executed.

Opto Sensors (Singapore) Pte. Ltd. ("Opto Singapore"), a wholly-owned subsidiary of OSI Systems, Inc., has entered into a revolving line of credit agreement with the Singapore branch of an Indian bank. This line of credit provides for various types of short term borrowing of up to 3,900,000 Singapore dollars (approximately \$2,300,000 at June 30, 2005). Borrowings under the line of credit bear interest at the bank's prime rate (5.5% at June 30, 2004 and 6.75% at June 30, 2005) plus from 0.5% to 2.25% depending on the type of loan. Borrowings under the line of credit are secured by the assets of Opto Singapore and guaranteed by the Company. At June 30, 2005, there were no amounts outstanding under the revolving line of credit. This facility expires in September 2005 and the Company believes it will be renewed under the same or similar terms.

Advanced Micro Electronics AS ("AME"), a wholly-owned subsidiary of OSI Systems, Inc., has a loan agreement with a Norwegian bank that provides for revolving line-of-credit borrowings of up to 10,000,000 Norwegian kroner (approximately \$1,500,000 at June 30, 2005). Borrowings under this line of credit bear interest at a variable rate, which was 4.25% and 4.5% at June 30, 2004 and 2005, respectively. Interest is payable quarterly. Borrowings under this line of credit are collateralized by certain AME assets. At June 30, 2005, there were no amounts outstanding under this line of credit. This facility expires in March 2006 and the Company believes that it will be renewed on the same or similar terms.

In December 2004, Rapiscan Systems U.K., a wholly-owned subsidiary of OSI Systems, Inc., entered into a bank loan of \$5,300,000 with a United Kingdom based bank to fund the acquisition of land and buildings in Horley, England. The Company co-located certain of its security and inspection systems and medical monitoring and anesthesia systems operations in this facility. The loan is repayable over a twenty-year period, with quarterly payments due of £34,500 (approximately \$61,800 at June 30, 2005). Outstanding borrowings bear interest at 3 month LIBOR (4.99% at June 30, 2005) plus 1.2% and are payable on a quarterly basis.

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Rapiscan Systems U.K. has a loan agreement with a United Kingdom based bank that provides for an overdraft facility up to a maximum amount of £2,000,000 (approximately \$3,600,000 at June 30, 2005) outstanding at any one time. Such amounts are secured by certain assets of Rapiscan Systems U.K. At June 30, 2005, no amounts were outstanding under the overdraft facility. Outstanding borrowings bear interest at a base rate (4.5% at June 30, 2004 and 2005) plus 1.35% per annum. The agreement also provides for a £2,500,000 (approximately \$4,500,000 at June 30, 2005) facility for tender and performance bonds and a £2,000,000 (approximately \$3,600,000 at June 30, 2005) facility for the purchase of foreign exchange contracts and letters of credit. These facilities are secured by certain assets of Rapiscan Systems U.K. and the Company has further guaranteed these obligations up to \$3,300,000. As of June 30, 2005, £1,854,000 (approximately \$3,319,000 at June 30, 2005) was outstanding under the performance bond facility. At June 30, 2005, £604,000 (approximately \$1,000,000 at June 30, 2005) was outstanding under foreign exchange contracts and letters of credit. These facilities expire in May 2006 and the Company believes that they will be renewed on the same or similar terms.

Opto Malaysia has a loan agreement with a Malaysian bank that provides for overdraft borrowings of up to 3,000,000 Malaysian ringgits (approximately \$789,000 at June 30, 2005). Borrowings under the line of credit bear interest at the bank's base lending rate (6.0% at June 30, 2004 and 2005) plus 1.75%. Interest is payable monthly. As of June 30, 2005, no amounts were outstanding under this loan agreement. Borrowings under this loan agreement are secured by certain assets of Opto Malaysia and are guaranteed by the Company. This facility expires in December 2005 and the Company believes that it will be renewed on the same or similar terms.

Opto Malaysia also has an agreement with a Malaysian bank that provides for 17,500,000 Malaysian ringgits (approximately \$4,600,000 at June 30, 2005) under a performance bond facility. As of June 30, 2005, 17,500,000 Malaysian ringgits (approximately \$4,600,000 at June 30, 2005) were outstanding under this facility. The agreement provides for overdraft borrowings up to 2,000,000 Malaysian ringgits (approximately \$526,000 at June 30, 2005). Borrowings under the overdraft facility bear interest at the bank's base lending rate (6.0% at June 30, 2004 and 2005) plus 1.75%. At June 30, 2005, no amounts were outstanding under the overdraft facility. Borrowings under this agreement are secured by certain assets of Opto Malaysia and are guaranteed by the Company. This facility expires in January 2006 and the Company believes that it will be renewed on the same or similar terms.

Rapiscan Systems Oy ("Rapiscan Systems Finland") (previously known as Metorex Security Products Oy), a wholly-owned subsidiary of OSI Systems, Inc., has an agreement with a Finnish bank that provides for 525,000 euros (approximately \$635,000 at June 30, 2005) under a tender and performance bond facility. As of June 30, 2005, 142,420 euros (approximately \$172,000) was outstanding under this facility. The agreement also provides for a foreign currency overdraft facility up to 460,000 euros (approximately \$557,000 at June 30, 2005). At June 30, 2005, 208,000 euros (approximately \$252,000) was outstanding under the facility. Borrowings under these facilities bear interest rate at the bank's prime lending rate (2.5% at June 30, 2004 and 2005) plus 1.0%. These facilities expire in February 2006 and the Company believes that they will be renewed at the same or similar terms.

Spacelabs Medical, has an arrangement with a bank in the United States that provides for up to \$100,000 in letters of credit and \$400,000 for overdraft borrowings. As of June 30, 2005, a \$58,400 standby letter of credit was outstanding under the letter of credit portion of the facility. The overdraft borrowings portion bears interest at the bank's prime rate (6.25% at June 30, 2005) plus 3%. There were no outstanding amounts under the overdraft borrowing portions of the facility as of June 30, 2005. The facility is collateralized by a guarantee from the Company.

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Long-term debt consisted of the following at June 30 (in thousands):

	2004	2005
Four-year term loan payable in monthly installments of \$114,583 until paid in full on February 1, 2005. Interest is due monthly at a rate of 5.26%	\$ 940	\$ —
Four-year term loan payable in monthly installments of \$104,167 until paid in full on February 1, 2005. Interest is due monthly at a rate of 4.7%	858	—
Twenty-year term loan payable in quarterly installments of £34,500 (approximately \$61,800 at June 30, 2005) until paid in full on December 1, 2024. Interest is due quarterly at a rate of three-month LIBOR plus 1.2% (6.19% at June, 30, 2005)	—	4,817
Capital lease obligations due through fiscal year 2008	—	507
Other	32	27
	<u>1,830</u>	<u>5,351</u>
Less current portion of long-term debt	1,798	499
	<u>\$ 32</u>	<u>\$ 4,852</u>

Fiscal year principal payments of long-term debt as of June 30, 2005 are as follows (in thousands):

2006	\$ 499
2007	508
2008	267
2009	247
2010	247
2011 and thereafter	3,583
	<u>5,351</u>
Total	<u>\$ 5,351</u>

## 5. INCOME TAXES

For financial reporting purposes, income before provision for income taxes and minority interest includes the following components (in thousands):

	2003	2004	2005
Pre-tax income:			
United States	\$11,836	\$ 2,212	\$(12,512)
Foreign	10,634	10,890	4,739
	<u>\$22,470</u>	<u>\$13,102</u>	<u>\$ (7,773)</u>

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The Company's provision (benefit) for income taxes consists of the following (in thousands):

	2003	2004	2005
<b>Current:</b>			
Federal	\$ 2,969	\$ 756	\$(4,561)
State	398	122	694
Foreign	3,391	2,691	1,057
	<u>6,758</u>	<u>3,569</u>	<u>(2,810)</u>
Tax effect of stock option benefits	357	907	905
Change in valuation allowance	(1,642)		609
Deferred	1,048	(1,160)	(4,013)
	<u>1,048</u>	<u>(1,160)</u>	<u>(4,013)</u>
<b>Total provision (benefit) for income taxes</b>	<b>\$ 6,521</b>	<b>\$ 3,316</b>	<b>\$(5,309)</b>

The Company does not provide for U.S. income taxes on the undistributed earnings of the foreign subsidiaries, as it is the Company's intention to utilize those earnings in the foreign operations for an indefinite period of time. At June 30, 2005, undistributed earnings of the foreign subsidiaries amounted to approximately \$42,289,000. It is not practical to determine the amount of income or withholding tax that would be payable upon the remittance of these earnings.

Deferred income tax assets (liabilities) at June 30 consisted of the following (in thousands):

	2004	2005
<b>Deferred income tax assets:</b>		
State income tax credit carryforwards	\$ 1,300	\$ 2,759
Federal income tax credit carryforwards	203	
Net operating loss carryforwards	5,412	5,848
Revitalization zone deductions	999	967
Allowance for doubtful accounts	423	1,934
Inventory reserve	1,059	1,467
Provision for losses on long-term contracts	376	276
Inventory capitalization	439	2,974
Accrued liabilities	3,485	3,400
Other assets	2,995	4,382
	<u>16,691</u>	<u>24,007</u>
<b>Total deferred income tax assets</b>	<b>16,691</b>	<b>24,007</b>
Valuation allowance	(1,434)	(2,043)
	<u>15,257</u>	<u>21,964</u>
<b>Net deferred income tax assets</b>	<b>15,257</b>	<b>21,964</b>
<b>Deferred income tax liabilities:</b>		
Depreciation	(1,214)	(2,705)
State income taxes	(628)	(1,518)
Amortization of intangible assets	(11,090)	(10,437)
Other liabilities	(124)	(2,396)
	<u>(13,056)</u>	<u>(17,056)</u>
<b>Total deferred income tax liabilities</b>	<b>(13,056)</b>	<b>(17,056)</b>
	<u>\$ 2,201</u>	<u>\$ 4,908</u>
<b>Net deferred income taxes</b>	<b>\$ 2,201</b>	<b>\$ 4,908</b>

As of June 30, 2005, the Company has federal net operating loss carry forwards of approximately \$14,510,000 and state net operating loss carry forwards of approximately \$8,515,000. The Company's federal net

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operating losses will begin to expire in the tax year ending June 30, 2013 and the Company's state net operating losses will begin to expire in the tax year ending June 30, 2015.

As of June 30, 2005, the Company has state credit carry forwards, including research and development revitalization zone credits, of approximately \$3,726,000. The Company's state credit carry forwards will begin to expire in the tax year ending June 30, 2007.

The Company has established a valuation allowance in accordance with the provisions of SFAS No. 109. The valuation allowance relates to the net operating loss of a subsidiary, subject to Separate Return Limitation Year rules, and on unrealized capital loss related to a write down of an equity investment. The Company continually reviews the adequacy of valuation allowances and releases the allowances when it is determined that it is more likely than not that the benefits will be realized. During fiscal year 2005, the valuation allowance increased by approximately \$609,000. This amount relates to an unrealized capital loss which management believes is not more likely than not to be realized. As of June 30, 2005, the Company has a tax contingency reserve of \$1,331,000 for a variety of specific uncertain tax positions which is included in income taxes payable on the consolidated balance sheet.

The consolidated effective income tax rate differs from the federal statutory income tax rate due primarily to the following:

	2003	2004	2005
Provision for income taxes at federal statutory rate	35.0%	35.0%	(35.0)%
State income taxes and credits—net of federal benefit	2.9	0.6	(11.0)
Research and development tax credits	(1.3)		(24.1)
Subpart F income			5.6
Foreign income subject to tax at other than federal statutory rate	(4.6)	(7.7)	(2.6)
Nondeductible expenses	0.4	0.9	5.6
Other	4.0		(4.8)
Change in valuation allowance	(7.3)		7.8
Favorable determination of income tax contingencies		(3.5)	(9.8)
Effective income tax rate	29.1%	25.3%	(68.3)%

## 6. COMMITMENTS AND CONTINGENCIES

**Operating Leases**—The Company leases some of its production and office facilities and certain equipment under various operating leases. Most of these leases provide for increases in rents based on the Consumer Price Index and include renewal options ranging from six months to ten years. Future minimum lease payments under such leases as of June 30, 2005 are as follows (in thousands):

2006	\$ 10,211
2007	7,917
2008	6,068
2009	5,149
2010	4,861
2011 and thereafter	20,210
Total	\$ 54,416

Total rent expense included in the accompanying consolidated financial statements was \$1,980,000, \$4,507,000 and \$8,106,000 for the fiscal years ended June 30, 2003, 2004 and 2005, respectively.

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In October 2004, Spacelabs Medical amended two real property leases covering office and manufacturing facilities in Issaquah, Washington. Under the amendments, Spacelabs Medical extended the term of such leases by approximately two years and relinquished certain options it held to terminate portions of such leases early. As a result, the leases now expire in December 2014. In consideration, the landlord paid the Company \$2.0 million in cash which has been recorded as deferred rent to be amortized over the remaining term of the lease. The leases are accounted for as operating leases.

**Commitments**—In November 2004, the Company entered into an agreement with an OEM manufacturer to design and manufacture a patient monitor for Spacelabs Medical. The agreement specifies that the Company will buy a minimum number of monitors from the manufacturer during each year of the contract at a fixed price. The Company may provide 12 months notice to terminate the agreement without cause after the second year of the contract. Given this termination clause, the Company's minimum purchase commitment under this agreement is three years of purchases, which totals approximately \$8,900,000. The Company expects to take delivery on the first units under this contract within the 2006 fiscal year.

In fiscal year 2005, the Company committed to enter into new leases for computer equipment associated with a master lease agreement previously entered into with Dell Financial Services. The master lease agreement provided for the leasing of computer equipment over a period of 36 months. The new leases that are associated with the master lease agreement have been recorded as capital leases. The master lease agreement permits the Company to lease up to \$1.0 million in equipment. During fiscal year 2005, the Company committed to a total of approximately \$730,000 of equipment under this agreement and does not currently expect to commit to any additional leases of equipment. As of June 30, 2005, \$507,000 was outstanding under these capital lease obligations.

Under the terms and conditions of the purchase agreements associated with the following five acquisitions, the Company may be obligated to make additional payments:

In August 2002, the Company purchased a minority equity interest in CXR, a United Kingdom based research and development company that develops real time tomography systems. In June 2004, the Company increased its equity interest in CXR to approximately 75% and in December 2004 the Company acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest the Company has agreed to make certain royalty payments based on sales of CXR's products.

In November 2002, the Company acquired all the outstanding capital stock of Ancore (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company for its advanced inspection systems for aviation security, port and border inspection and counter-terrorism. Consideration paid for the acquisition consisted of a combination of the Company's Common Stock and cash of approximately \$10.4 million including professional fees associated with the acquisition. In addition, during the five years following the close, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at \$34.0 million. As of June 30, 2005, no earn-out payments have been made.

In January 2004, the Company completed the acquisition of ARACOR (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17.6 million (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. As of June 30, 2005, approximately \$8,000 had been earned and paid as part of this contingent consideration.

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In March 2004, the Company completed the acquisition of Spacelabs Medical from Instrumentarium Corporation. As a result of this acquisition, the Company assumed management retention bonus agreements for key personnel of Spacelabs Medical which could amount to \$5,400,000. These retention bonuses vest over a two-year period beginning either October 2003 or March 2004. As of June 30, 2005, a balance of \$2,100,000 was included in accrued payroll and related expenses for these retention bonuses. The Company expects to make all remaining payouts associated with these retention bonuses during fiscal year 2006.

In February 2005, the Company completed the acquisition of Blease for \$9,279,000 in cash (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease's net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately \$11,200,000 as of June 30, 2005).

**Environmental Contingencies**—The Company is subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, the Company may become liable for the costs of removal or remediation of certain hazardous substances that have been released on or in its facilities or that have been disposed of off-site as waste. Such laws may impose liability without regard to whether the Company knew of, or caused, the release of such hazardous substances. The Company has conducted Phase I environmental site assessments for each of its properties in the United States at which the Company manufacture products. The purpose of each such report is to identify, as of the date of such report, potential sources of contamination of the property from past and present activities or from nearby operations. In certain cases, the Company has conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants. The Company believes that it is currently in compliance with all material environmental regulations in connection with its manufacturing operations, and that it has obtained all material environmental permits necessary to conduct business.

During one investigation, the Company discovered soil and groundwater contamination at its Hawthorne, California facility. The Company filed the requisite reports concerning this problem with the appropriate environmental authorities in fiscal year 2001. The Company has not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. The Company also has notified the prior owners of the facility and the present owners and tenants of adjacent properties concerning the problem and has requested from such parties agreements to toll of the statute of limitations with respect to actions against such parties with respect to the contamination in order that the Company may focus its attention on resolution of the contamination problem. The Company's site was previously used for semiconductor manufacturing similar to that presently conducted on the site by the Company, and it is not presently known who is responsible for the contamination and the remediation. The groundwater contamination is a known regional problem, not limited to the Company's premises or its immediate surroundings.

The Company has also been informed of soil and groundwater remediation efforts at a facility that its Ferson Technologies subsidiary previously leased in Ocean Springs, Mississippi. Ferson Technologies occupied the facility until October 2003. The Company believes that the owner and previous occupants of the facility have primary responsibility for such remediation and have an agreement with the facility's owner under which the owner is responsible for remediation of pre-existing conditions. However, the Company is unable at this time to ascertain whether Ferson Technologies bears any exposure for remediation costs under applicable environmental regulations.

In accordance with SFAS No. 5, "Accounting for Contingencies," the Company has not accrued for loss contingencies relating to the above environmental matters because it believes that, although unfavorable

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outcomes may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.

**Legal Proceedings**—In November 2002, L-3 brought suit against the Company for a declaratory judgment that L-3 had not breached its obligations to the Company concerning the acquisition of PerkinElmer, Inc.'s Security Detection Systems Business. In February 2003, the Company answered and asserted counterclaims against L-3 for, among other things, fraud, breach of fiduciary duty, breach of contract and failure to negotiate in good faith. In March 2003, L-3 amended its complaint and asserted claims against the Company for breach of contract, failure to negotiate in good faith and tortious interference. In its amended complaint, L-3 requested both a declaratory judgment that it had fulfilled its obligations and an award of damages for an unspecified amount. In March 2005, the court in this action ruled that as a matter of law, L-3 owed us a fiduciary duty. These actions are pending in the District Court for the Southern District of New York.

During 2003 and 2004, the Company was informed that Science Applications International Corporation ("SAIC") had made statements to prospective buyers of Rapiscan's gamma ray mobile detection system product that the Company's product infringed upon unspecified SAIC patents. In April 2004, the Company received a letter from SAIC specifying a patent upon which SAIC claimed the Company's product infringed. Contrary to SAIC's claim, the patent cited by SAIC actually distinguished the technology used in the Company's product as a different, pre-existing technology. The Company therefore filed a lawsuit for declaratory judgment. SAIC has since counter-claimed for patent infringement, citing the same patent and unfair competition.

In March 2004, certain individuals named the Company and its subsidiary, Spacelabs Medical, as well as a hospital located in Bexar County, Texas, in a petition claiming that the individuals suffered injuries in March 2003 caused, in part, by a defective monitoring system manufactured by Spacelabs Medical. The amount of the claim has not yet been specified. The petition was filed in the 285th Judicial District Court in Bexar County, Texas.

In April 2004, certain individuals named Spacelabs Medical, as well as several other defendants, in a petition that alleges, among other things, that a product possibly manufactured by Spacelabs Medical failed to properly monitor a hospital patient thereby contributing to the patient's death in November 2001. The amount of the claim has not yet been specified. The petition was filed in the 21st Judicial District Court, Parish of Tangipahoa, Louisiana.

In February 2005, Electromedical, a Greek distribution company, filed an action in the courts of Greece claiming that Spacelabs orally agreed to appoint Electromedical as Spacelabs' exclusive Greek distributor, but failed to do so. Electromedical claims that it incurred significant expenses as a result of Spacelabs' actions and demands euro 872,414 (approximately \$1,054,000 as of June 30, 2005) in compensation.

In accordance with SFAS No. 5, "Accounting for Contingencies," the Company has not accrued for loss contingencies relating to the above matters because it believes that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.



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In August 2004, the former president of Spacelabs Medical submitted an arbitration claim alleging breach of a retention and severance agreement seeking approximately \$1.5 million and punitive damages. This claim was settled subsequent to June 30, 2005 for \$950,000. This settlement amount was included in accruals in the consolidated balance sheet as of June 30, 2005.

The Company is also involved in various other claims and legal proceedings arising out of the conduct of its business. In the Company's opinion after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on the Company's financial position, future results of operations, or cash flows.

## 7. STOCK OPTIONS

**The 1997 Stock Option Plan (the "1997 Plan")**—The 1997 Plan was established in May 1997 and authorizes the grant of up to 850,000 shares of the Company's Common Stock in the form of incentive and nonqualified options. The authorized shares under the 1997 Plan were increased to 2,350,000 in June 2003. Employees, officers and directors are eligible under this plan, which is administered by the Company's Board of Directors (the "Board of Directors"), who determine the terms and conditions of each grant, with the advice of and input from the Compensation Committee. The exercise price of nonqualified options may not be less than 85% of the fair market value of the Company's Common Stock at the date of grant. The exercise price of incentive stock options may not be less than the fair market value of the Company's Common Stock at the date of grant. The exercise price of incentive stock options granted to individuals that own greater than 10% of the Company's voting stock may not be less than 110% of the fair market value of the Company's Common Stock at the date of grant.

Exercise periods for incentive and nonqualified options granted under this plan may not exceed five years from the grant date.

The following summarizes stock option activity for the fiscal years ended June 30:

	Number of Options	Option Price	
		Weighted Average	Total
Outstanding—June 30, 2002	1,146,612	\$ 9.82	\$ 11,257,000
Granted	421,748	16.15	6,812,000
Exercised	(101,769)	8.43	(858,000)
Canceled	(87,050)	7.64	(665,000)
Outstanding—June 30, 2003	1,379,541	11.99	16,546,000
Granted	455,765	19.31	8,801,000
Exercised	(177,244)	6.99	(1,233,000)
Canceled	(5,175)	6.74	(40,000)
Outstanding—June 30, 2004	1,652,887	14.57	24,074,000
Granted	377,000	19.35	7,295,000
Exercised	(201,899)	7.39	(1,492,000)
Canceled	(52,840)	14.31	(756,000)
Outstanding—June 30, 2005	1,775,148	16.41	\$ 29,121,000

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The following summarizes pricing and term information for options outstanding as of June 30, 2005:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at June 30, 2005	Weighted- Average Remaining Contractual Life (Years)	Weighted- Average Exercise Price	Exercisable at June 30, 2005	Weighted- Average Exercise Price
\$3.13	80,875	0.80	\$3.13	80,875	\$3.13
3.44 to 5.00	142,533	1.03	3.86	142,533	3.86
7.70 to 9.48	35,087	0.68	8.48	35,087	8.48
14.76 to 20.91	1,516,653	3.13	18.48	603,601	18.21
\$3.13 to \$20.91	1,775,148	2.81	\$16.41	862,096	\$13.15

As of June 30, 2004, options exercisable were 653,474 at a weighted-average exercise price of \$10.39. As of June 30, 2003, options exercisable were 484,250 at a weighted-average exercise price of \$8.54.

**The 2004 Spacelabs Medical Stock Option Plan (the “2004 Spacelabs Plan”)**—The 2004 Spacelabs Plan was established in April 2004 and authorizes the grant of up to 10,000,000 shares of Spacelab Medical common stock in the form of nonqualified options. Employees, consultants and non-employee directors of Spacelabs Medical, the Company or the Company’s subsidiaries, are eligible under this plan, which is administered by the board of directors of Spacelabs Medical, who determine the terms and conditions of each grant. Exercise periods for the options granted under the 2004 Spacelabs Plan may not exceed ten years from the grant date, or such lesser period of time as is set forth in each individual stock option agreement.

The following summarizes stock option activity for the fiscal years ended June 30:

	Number of Options	Option Price	
		Weighted Average	Total
Outstanding—June 30, 2003	—		\$ —
Granted	4,897,500	0.58	2,840,550
Exercised	—	—	—
Canceled	(10,000)	0.58	(5,800)
Outstanding—June 30, 2004	4,887,500	0.58	2,834,750
Granted	4,188,500	0.80	3,362,075
Exercised	—	—	—
Canceled	(1,152,500)	0.59	(674,250)
Outstanding—June 30, 2005	7,923,500	0.70	\$ 5,522,575

The following summarizes pricing and term information for options outstanding as of June 30, 2005:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at June 30, 2005	Weighted- Average Remaining Contractual Life (Years)	Weighted- Average Exercise Price	Exercisable at June 30, 2005	Weighted- Average Exercise Price
\$0.58 to \$0.95	7,923,500	4.18	\$0.70	943,750	\$0.58

As of June 30, 2004, there were no options exercisable under the 2004 Spacelabs Plan.

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**8. EMPLOYEE STOCK PURCHASE PROGRAM**

In August 1998, the Board of Directors adopted the Company's Employee Stock Purchase Plan (the 1998 Plan"). The 1998 Plan, which was approved by the Company's shareholders in November 1998, provides persons who have been regular employees of the Company or its U.S. subsidiaries for at least six months and who meet certain other criteria, the opportunity to purchase through regular payroll deductions up to an aggregate of 200,000 shares of Common Stock. The 1998 Plan is administered by the Board of Directors or a committee of the board. The 1998 Plan qualifies as an "employee stock purchase plan" as defined in Section 423 of the Internal Revenue Code.

To participate in the 1998 Plan, eligible employees submit a form to the Company's payroll office authorizing payroll deductions in an amount between 1% and 10% of the employee's regular annual pay. At the end of each offering period, initially set at six months duration, the aggregate amount deducted from each participating employee's paycheck is applied to the purchase of a whole number of shares of Common Stock, with any sums remaining being returned to the employee. No interest accrues on payroll deductions. The purchase price of the Common Stock is 85% of the lesser of the fair market value of the Common Stock (as determined by the Board of Directors) on the first day or the last day of the offering period. If the aggregate number of shares of Common Stock that all participants elect to purchase during any offering period is greater than the number of shares remaining available for issuance under the 1998 Plan, the remaining shares will be allocated pro rata among participants. Notwithstanding any of the foregoing, no employee may purchase Common Stock under the 1998 Plan if (i) after any such purchase, the employee would own 5% or more of the total combined voting power or value of all classes of the Company's stock on a consolidated basis, or (ii) the rights to purchase Common Stock under the 1998 Plan and all other qualified employee stock purchase plans of the Company or any of its subsidiaries granted to that employee would exceed \$25,000 per calendar year.

A participant may elect to withdraw from the 1998 Plan at any time up to the last day of an offering period by filing a form to such effect. Upon withdrawal, the amount contributed to the employee will be refunded in cash, without interest. Any person withdrawing may not participate again in the 1998 Plan until the end of one complete offering period. Termination of a participant's employment for any reason shall be treated as a withdrawal.

The 1998 Plan purchased 13,348 shares of Common Stock for a total of \$195,000 during the fiscal year ended June 30, 2003, 16,281 shares of Common Stock for a total of \$217,000 during the fiscal year ended June 30, 2004 and 42,439 shares of Common Stock, for a total of \$701,000 during the fiscal year ended June 30, 2005. The Company's liability to the 1998 Plan was \$175,000 and \$580,000 at June 30, 2004 and 2005, respectively.

**9. SHAREHOLDERS' EQUITY**

In March 1999, the Board of Directors instituted a stock repurchase program under which the Company was authorized to purchase up to a total of 2,000,000 shares of its Common Stock. As of June 30, 2004, the Company had repurchased 1,404,500 shares at an average price of \$4.37 per share. In September 2004, the Company repurchased 107,500 shares of its Common Stock at an average purchase price of \$14.73 per share and increased the number of shares available for repurchase under the stock repurchase program by 1,000,000 shares. In May 2005, the Company repurchased 157,027 shares of Common Stock at an average price of \$14.25 per share. At June 30, 2005, 1,330,973 shares are available for repurchase under the stock repurchase program. The stock repurchase program did not have a material effect on the Company's liquidity and is not expected to have a material effect on liquidity in subsequent quarters. The Company retires the treasury shares as they are

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repurchased, and they are disclosed as a deduction from common shares in the accompanying consolidated financial statements.

In October 2002, the Company issued and sold an aggregate of 1,250,000 shares of Common Stock in a private placement to institutional investors for an aggregate sales price of \$21,600,000. After agent's commissions, and expenses, net proceeds to the Company were \$20,500,000. As part of the transaction, the Company issued to the investors warrants to purchase 281,250 additional shares of the Company's Common Stock at an exercise price of \$21.22 per share exercisable at any time in full or part no later than October 21, 2009. The fair value of the warrants was estimated at \$3,365,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 89% and a risk-free interest rate of 3.18%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2004 and 2005. The Company filed a registration statement on Form S-3 with the SEC on November 14, 2002 for the purpose of registering these securities.

In June 2004, the Company issued and sold an aggregate of 1,500,000 shares of Common Stock in a private placement to institutional investors for an aggregate sales price of \$32,300,000. After agent's commissions, and expenses, net proceeds to the Company were \$31,000,000. As part of the transaction, the Company issued to the investors warrants to purchase 337,500 additional shares of the Company's Common Stock at an exercise price of \$27.73 per share exercisable at any time in full or part no later than June 1, 2011. The fair value of the warrants was estimated at \$6,152,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 98% and a risk-free interest rate of 4.45%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2004 and 2005. As part of the transaction, the Company agreed to file a registration statement on Form S-3 with the SEC.

The following summarizes pricing and term information for warrants outstanding as of June 30, 2005:

Exercise Prices	Warrants Outstanding	
	Number Outstanding at June 30, 2005	Remaining Contractual Life (Years)
\$15.00	84,847	0.37
\$21.22	281,250	4.31
\$23.47	621,000	3.36
\$27.73	337,500	5.92

#### **10. RELATED-PARTY TRANSACTIONS**

The Company contracts with entities owned by directors of the Company to provide messenger service, auto rental and printing services. Included in cost of sales, selling, general and administrative expenses for the fiscal years ended June 30, 2003, 2004 and 2005 are approximately \$101,000, \$70,000 and \$60,000 for messenger service and auto rental and \$104,000, \$73,000 and \$67,000 for printing services, respectively.

#### **11. EMPLOYEE BENEFIT PLANS**

The Company has a qualified employee retirement savings plan. The plan provides for a contribution by the Company, which is determined annually by the Board of Directors. In addition, the plan permits voluntary salary

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reduction contributions by employees. The Company contributed \$123,000, \$239,000 and \$1,057,000 to the plan for the fiscal years ended June 30, 2003, 2004 and 2005, respectively.

During 2000, AME established a defined contribution plan. The plan provides for contributions by AME at a fixed percentage of employee salaries. Contributions made during the fiscal years ended June 30, 2003, 2004 and 2005 by AME were approximately \$164,000, \$149,000 and \$164,000, respectively.

The Rapiscan Systems U.K. Defined Benefit Plan covers certain Rapiscan Systems U.K. employees. The benefits under this plan are based on years of service and the employees' highest 12 months' compensation during the last five years of employment.

Rapiscan Systems U.K.'s funding policy is to make the minimum annual contributions required by applicable regulations based on an independent actuarial valuation sufficient to provide for benefits accruing after that date. The following provides a reconciliation of the changes in the plan's benefit obligation and fair value of assets for fiscal year 2004 and 2005, and a statement of the funded status as of June 30, 2004 and as of June 30, 2005 (in thousands):

	<u>2004</u>	<u>2005</u>
<b>Change in Benefit Obligation</b>		
Benefit obligation at beginning of year	\$ 3,181	\$ 3,446
Translation adjustment	287	(38)
Service costs	60	61
Interest costs	165	188
Plan participants' contributions	14	14
Actuarial loss (gain)	(77)	428
Actuarial loss from settlement	206	
Benefits paid	(390)	(7)
	<u>3,446</u>	<u>4,092</u>
<b>Change in Plan Assets</b>		
Fair value of plan assets at beginning of year	1,647	1,794
Translation adjustment	149	(20)
Actual return on plan assets	157	294
Company contributions	217	218
Plan participants' contributions	14	14
Benefits paid	(390)	(7)
	<u>1,794</u>	<u>2,293</u>
Funded status	(1,652)	(1,799)
Unrecognized net actuarial loss	1,477	1,689
	<u>\$ (175)</u>	<u>\$ (110)</u>
<b>Amount recognized in balance sheets consist of:</b>		
Accumulated other comprehensive income	\$ 1,354	\$ 1,709
Accrued pension liability	(1,529)	(1,819)
	<u>\$ (175)</u>	<u>\$ (110)</u>

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

	2003	2004	2005
<b>Net Periodic Benefit Costs</b>			
Service costs	\$ 56	\$ 60	\$ 63
Interest costs	169	165	195
Expected return on plan assets	(151)	(85)	(108)
Amortization of prior service costs	95		
Settlement cost	169	206	
Recognized actuarial loss	37	139	116
	<u>          </u>	<u>          </u>	<u>          </u>
Net periodic benefit cost	<u>\$ 375</u>	<u>\$485</u>	<u>\$ 266</u>

The accumulated benefit obligation for the Rapiscan Systems U.K. Defined Benefit Plan was \$3,323,000 as of June 30, 2004 and \$4,112,000 as of June 30, 2005.

**Plan Assumptions**

	2004	2005
<b>Weighted average assumptions at year-end:</b>		
Discount rate	5.8%	5.0%
Expected return on plan assets	6.2%	6.4%
Rate of compensation increase	4.5%	3.0%

The long term return on assets has been derived from the weighted average of assumed returns on each of the major asset categories. The weighted average is based on the actual proportion of each major asset class held, rather than a benchmark portfolio of assets. The expected returns for each major asset class have been derived from a combination of both historical market returns and current market data as well as the views of a range of investment managers.

Rate of compensation increase was estimated at 4.5% as of June 30, 2004. As of June 30, 2005 the directors of the pension plan have decreased the assumed rate of compensation increase to 3.0% to reflect projected compensation increases for the employees in the Rapiscan Systems U.K. Defined Benefit Plan.

**Plan Assets and Investment Policy**

	Fiscal year ended June 30, 2004		Fiscal year ended June 30, 2005	
	Proportion of Fair Value	Expected Rate of Return	Proportion of Fair Value	Expected Rate of Return
Equity securities	48.2%	7.0%	52.6%	8.0%
Debt securities	51.4%	5.5%	44.3%	4.6%
Other	0.4%	5.0%	3.1%	4.0%
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Combined	<u>100.0%</u>	<u>6.2%</u>	<u>100.0%</u>	<u>6.4%</u>

The pension plan assets are invested in a range of pooled investment funds that provide access to a diverse range of asset classes. The investment objective is to maximize the investment return over the long term without exposing the fund to an unnecessary level of risk. Within this objective it is recognized that benefits will be secured by the purchase of annuities at the time of employee retirement.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

The benchmark of the Trustees of the Rapiscan Systems U.K. Defined Benefit Plan is to hold assets broadly in the proportion 50% equity securities and 50% debt securities. This proportion is allowed to fluctuate with market movements and is not formally rebalanced. The equity holding is maintained in a balanced fund, with the decision on whether to hold UK equities or non-UK equities being under the control of the investment manager. Typically this proportion is close to 65% UK and 35% non-UK equities. The debt securities are predominantly from the UK, with 70% held in UK government bonds (gilts) and the balance held in corporate stock.

Day-to-day equities selection decisions are delegated to the investment manager, although these are monitored against performance and risk targets. Due to the nature of the pooled funds, there are no significant holdings in any single company (greater than 5% of the total assets). The investment strategy is reviewed on a regular basis, based on the results of the liability studies.

**Projected Benefit Payments**

The following table reflects estimated benefits payments, based upon the same assumptions used to measure the benefit obligation and net pension cost, as of June 30, 2005 (in thousands):

	<u>Pension Benefits</u>
<b>Fiscal Period</b>	
July 1, 2005 to June 30, 2006	\$ 936
July 1, 2006 to June 30, 2007	—
July 1, 2007 to June 30, 2008	204
July 1, 2008 to June 30, 2009	—
July 1, 2009 to June 30, 2010	68
July 1, 2010 to June 30, 2015	920

**Company Contribution**

Currently the agreed Company contribution rate is 17.9% of pensionable salaries, plus \$6,600 per month, with death-in-service insurance premiums being paid in addition. If the Company contributions continue at the current rate, the estimated total Company contributions for the fiscal year 2006 will be \$214,800.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

**12. UNAUDITED QUARTERLY RESULTS**

The following tables present unaudited quarterly financial information for the four quarters ended June 30, 2004 and 2005 (in thousands):

	Quarter Ended			
	September 30, 2003	December 31, 2003	March 31, 2004*	June 30, 2004*
		(Unaudited)		
Revenues	\$ 38,645	\$ 51,095	\$ 61,531	\$ 95,798
Costs of goods sold	26,079	36,498	41,957	59,178
Gross profit	12,566	14,597	19,574	36,620
Operating expenses:				
Selling, general and administrative expenses	7,521	8,189	12,344	26,107
Research and development	2,037	2,373	3,543	6,685
Restructuring charges	1,061			
Management retention bonus			75	1,029
Total operating expenses	10,619	10,562	15,962	33,821
Income from operations	1,947	4,035	3,612	2,799
Write down of equity investment	(247)			
Gain on sale of investment			376	
Interest income (expense)—net	223	221	144	(8)
Income before provision for income taxes and minority interest	1,923	4,256	4,132	2,791
Provision for income taxes	583	1,221	739	773
Minority interest in net (income) loss of subsidiary	(57)	9	48	170
Net income	\$ 1,283	\$ 3,044	\$ 3,441	\$ 2,188
Basic earnings per common share	\$ 0.09	\$ 0.21	\$ 0.24	\$ 0.14
Diluted earnings per common share	\$ 0.09	\$ 0.20	\$ 0.23	\$ 0.14

\* Results of operations for the three month periods ended March 31, 2004 and June 30, 2004 include the effect of the acquisition of Spacelabs Medical (see Note 3)



**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

	Quarter Ended			
	September 30, 2004	December 31, 2004	March 31, 2005	June 30, 2005
	(Unaudited)			
Revenues	\$ 87,644	\$ 102,531	\$ 94,153	\$ 100,713
Costs of goods sold	53,854	66,079	60,975	62,507
Gross profit	33,790	36,452	33,178	38,206
Operating expenses:				
Selling, general and administrative expenses	24,793	25,595	30,165	35,692
Research and development	6,670	7,066	7,306	9,495
Management retention bonus	549	549	288	438
Total operating expenses	32,012	33,210	37,759	45,625
Income (loss) from operations	1,778	3,242	(4,581)	(7,419)
Write down of equity investment			182	
Interest income (expense)—net	33	5	(126)	(523)
Income (loss) before provision for income taxes and minority interest	1,811	3,247	(4,889)	(7,942)
Provision (benefit) for income taxes	570	789	(1,961)	(4,707)
Minority interest in net (income) loss of subsidiary	69			
Net income (loss)	\$ 1,310	\$ 2,458	\$ (2,928)	\$ (3,235)
Basic earnings (loss) per common share	\$ 0.08	\$ 0.15	\$ (0.18)	\$ (0.20)
Diluted earnings (loss) per common share	\$ 0.08	\$ 0.15	\$ (0.18)	\$ (0.20)

### 13. SEGMENT INFORMATION

The Company has adopted SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information.” The Company has reflected the provisions of SFAS No. 131 in the accompanying consolidated financial statements for all periods presented. The Company operates in three identifiable industry segments, (a) security and inspection systems (“Security Group”), (b) medical monitoring, imaging, and related systems (“Healthcare Group”), and (c) optoelectronic devices and value-added subsystems (“Optoelectronics and Manufacturing Group”). The Company also has a corporate segment (“Corporate”) that includes executive compensation and certain other general and administrative expenses, expenses related to stock issuances and legal, audit and other professional service fees not allocated to product segments. Both the Security Group and the Healthcare Group are comprised of primarily end-product businesses whereas the businesses of the Optoelectronics and Manufacturing Group primarily supply components and subsystems to original equipment manufacturers, including to businesses of the Security Group and Healthcare Group through inter-company sales. Sales between segments are at transfer prices that are equivalent to market values. All other accounting policies of the segments are the same as described in Note 1 Summary of Significant Accounting Policies. The Company has restated its segment information for the years ended June 30, 2003 and 2004 to conform to the industry segment presentation. The Company has made certain allocations of prior period costs of goods sold and operating expenses in order to restate prior year information.

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

The following tables present the operations and identifiable assets by industry segment (in thousands):

2003						
	Security Group	Healthcare Group	Optoelectronics and Manufacturing Group	Corporate	Eliminations	Consolidated
Revenues:						
External customer revenue	\$ 120,793	\$ 10,881	\$ 50,970	\$ —	\$ —	\$ 182,644
Revenue between product segments	—	—	11,287	—	(11,287)	—
Total revenue	\$ 120,793	\$ 10,881	\$ 62,257	\$ —	\$ (11,287)	\$ 182,644
Income (loss) from operations	\$ 18,503	\$ (2,118)	\$ 10,518	\$ (5,550)	\$ 605	\$ 21,958
Capital expenditure	\$ 1,201	\$ 110	\$ 1,129	\$ 1,129	\$ —	\$ 3,569
Depreciation	\$ 1,367	\$ 279	\$ 1,803	\$ 236	\$ —	\$ 3,685
2004						
	Security Group	Healthcare Group	Optoelectronics and Manufacturing Group	Corporate	Eliminations	Consolidated
Revenues:						
External customer revenue	\$ 117,746	\$ 60,695	\$ 68,628	\$ —	\$ —	\$ 247,069
Revenue between product segments	—	—	15,382	—	(15,382)	—
Total revenue	\$ 117,746	\$ 60,695	\$ 84,010	\$ —	\$ (15,382)	\$ 247,069
Income (loss) from operations	\$ 10,473	\$ 83	\$ 10,117	\$ (7,744)	\$ (536)	\$ 12,393
Segment assets	\$ 134,665	\$ 112,889	\$ 47,267	\$ 39,598	\$ (2,618)	\$ 331,801
Capital expenditure	\$ 910	\$ 1,914	\$ 1,167	\$ 1,413	\$ —	\$ 5,404
Depreciation	\$ 1,763	\$ 351	\$ 1,616	\$ 239	\$ —	\$ 3,969
2005						
	Security Group	Healthcare Group	Optoelectronics and Manufacturing Group	Corporate	Eliminations	Consolidated
Revenues:						
External customer revenue	\$ 123,197	\$ 195,698	\$ 66,146	\$ —	\$ —	\$ 385,041
Revenue between product segments	—	—	18,412	—	(18,412)	—
Net revenues	\$ 123,197	\$ 195,698	\$ 84,558	\$ —	\$ (18,412)	\$ 385,041
Income (loss) from operations	\$ (5,438)	\$ 8,394	\$ 6,159	\$ (15,420)	\$ (675)	\$ (6,980)
Segment assets	\$ 143,168	\$ 127,906	\$ 57,446	\$ 21,603	\$ (3,003)	\$ 347,120
Capital expenditure	\$ 11,410	\$ 3,982	\$ 2,589	\$ (393)	\$ —	\$ 17,588
Depreciation	\$ 2,783	\$ 1,679	\$ 1,824	\$ 324	\$ —	\$ 6,610

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

The following tables present the revenues and identifiable assets by geographical area (in thousands):

	2003				
	North America	Europe	Asia	Eliminations	Total Consolidated
Revenues:					
External customer revenue	\$122,578	\$43,240	\$16,826	\$ —	\$ 182,644
Revenue between product segments	914	—	10,373	(11,287)	—
Total revenue	<u>\$123,492</u>	<u>\$43,240</u>	<u>\$27,199</u>	<u>\$ (11,287)</u>	<u>\$ 182,644</u>
	2004				
	North America	Europe	Asia	Eliminations	Total Consolidated
Revenues:					
External customer revenue	\$181,569	\$49,077	\$16,423	\$ —	\$ 247,069
Revenue between product segments	3,512	—	11,870	(15,382)	—
Total revenue	<u>\$185,081</u>	<u>\$49,077</u>	<u>\$28,293</u>	<u>\$ (15,382)</u>	<u>\$ 247,069</u>
Long-lived assets	<u>\$ 80,787</u>	<u>\$ 7,699</u>	<u>\$ 1,638</u>		<u>\$ 90,124</u>
	2005				
	North America	Europe	Asia	Eliminations	Total Consolidated
Revenues:					
External customer revenue	\$293,871	\$69,618	\$21,552	\$ —	\$ 385,041
Revenue between product segments	7,679	—	10,733	(18,412)	—
Total revenue	<u>\$301,550</u>	<u>\$69,618</u>	<u>\$32,285</u>	<u>\$ (18,412)</u>	<u>\$ 385,041</u>
Long-lived assets	<u>\$ 81,530</u>	<u>\$25,425</u>	<u>\$ 2,383</u>		<u>\$ 109,338</u>

**OSI SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**  
**FISCAL YEARS ENDED JUNE 30, 2003, 2004 AND 2005**

**14. SUBSEQUENT EVENTS**

On August 29, 2005, Ferson Technologies, Inc., a subsidiary of the Company which represents less than 1% of the Company's total consolidated revenues and less than 1% of total consolidated assets, suffered damage to its facilities, located in Ocean Springs, Mississippi, as a result of Hurricane Katrina. The Company does not expect that this damage will have a material impact on financial results but is in the process of assessing the extent of the damage and is unable at this time to determine the related costs. The Company is currently reviewing the terms of its property and business interruption coverage with its insurance broker and carriers.

The Company has engaged Collins Stewart, a London-based investment bank to pursue the public offering and listing of approximately 30% to 35% of the equity in Spacelabs Healthcare, a newly formed subsidiary comprising the business operations of the medical monitoring and anesthesia systems group. This offering and listing is planned in the United Kingdom on the AIM Exchange, which is owned and administered by the London Stock Exchange. The shares in Spacelabs Healthcare will not be offered or sold in the United States. Under Securities and Exchange Commission regulations, U.S. residents are prohibited from participating in this proposed offering, and any shares offered cannot be acquired by U.S. residents for a period of twelve months from the date of the offering. The Company currently expect to complete the proposed transaction during the second quarter of fiscal year 2006. However, any proposed listing is subject to a number of factors including regulatory approvals and the Company's satisfaction with the valuation. Therefore, the Company cannot provide any assurance regarding the completion of the offering or listing.

\* \* \* \* \*

**SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS**  
(In thousands)

Description	Balance at Beginning of period	Additions		Deductions- Write-offs	Balance at end of period
		Charged to costs and expenses	Charged in other accounts		
Balance for doubtful accounts:					
Year ended June 30, 2003	\$ 1,485	\$ (13)		\$ 374	\$ 1,098
Year ended June 30, 2004	\$ 1,098	\$ 287		\$ 611	\$ 774
Year ended June 30, 2005	\$ 774	\$ 4,005		\$ 97	\$ 4,682
Balance for warranty reserve					
Year ended June 30, 2003	\$ 2,164	\$ 2,516		\$ 1,898	\$ 2,782
Year ended June 30, 2004	\$ 2,782	\$ 2,718	\$ 7,719(1)	\$ 4,029	\$ 9,190
Year ended June 30, 2005	\$ 9,190	\$ 5,559	\$ 464	\$ 8,572(2)	\$ 6,641

(1) Included in the additions to the warranty reserve for the fiscal year ended June 30, 2004 is \$7,719 of additional warranty reserves relating to the acquisitions completed during fiscal year 2004.

(2) This amount includes a \$2,148 change in estimate for the warranty reserve in the fiscal year ended June 30, 2005.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

OSI SYSTEMS, INC.  
(Registrant)

Date: September 28, 2005

By: /s/ ANUJ WADHAWAN

Anuj Wadhawan, Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons, on behalf of the Registrant, and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ DEEPAK CHOPRA	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	September 28, 2005
Deepak Chopra		
/s/ ANUJ WADHAWAN	Chief Financial Officer (Principal Financial and Accounting Officer)	September 28, 2005
Anuj Wadhawan		
/s/ AJAY MEHRA	Executive Vice President, President of Rapiscan Systems and Director	September 28, 2005
Ajay Mehra		
/s/ STEVEN C. GOOD	Director	September 28, 2005
Steven C. Good		
/s/ MEYER LUSKIN	Director	September 28, 2005
Meyer Luskin		
/s/ CHAND R. VISWANATHAN	Director	September 28, 2005
Chand R. Viswanathan		

**INDEX TO EXHIBITS**

<b>No.</b>	<b>EXHIBIT DESCRIPTION</b>
3.1	Amended and Restated Articles of Incorporation of OSI Systems, Inc. (1)
3.2	Certificate of Amendment to Amended and Restated Articles of Incorporation (2)
3.3	Amended and Restated Bylaws of OSI Systems, Inc. (1)
4.1	Specimen Common Stock Certificate (3)
4.2	Rights Agreement dated July 31, 2000, between U.S. Stock Transfer Corporation and OSI Systems, Inc. (4)
4.3	Amendment No. 1, dated December 21, 2004, to Rights Agreement dated as of July 31, 2000, between U.S. Stock Transfer Corporation and OSI Systems, Inc. (5)
10.1	1987 Incentive Stock Option Plan, as amended, and form of Stock Option Agreement (1)
10.2	Amended 1997 Stock Option Plan (6)
10.3	Form of 1997 Stock Option Agreement (1)
10.4	Form of Indemnity Agreement for directors and executive officers of OSI Systems, Inc. (2)
10.5	Employment Agreement dated September 1, 2000, between Ajay Mehra and OSI Systems, Inc. (7)
10.6	Employment Agreement dated June 1, 2003, between Victor Sze and OSI Systems, Inc. (8)
10.7	Amendment to Employment Agreement dated July 18, 2005, between Victor Sze and OSI Systems, Inc. (9)
10.8	Employment Agreement dated June 1, 2003, between Anuj Wadhawan and OSI Systems, Inc. (8)
10.9	Amendment to Employment Agreement dated July 18, 2005, between Anuj Wadhawan and OSI Systems, Inc. (9)
10.10	Amended and Restated Employment Agreement dated July 18, 2005, between Deepak Chopra and OSI Systems, Inc. (9)
10.11	Merger Agreement and Plan of Organization dated December 18, 2003, among Advanced Research & Applications Corp., Robert A. Armistead, OSI Subsidiary, Inc. and OSI Systems, Inc. (10)
10.12	Purchase Agreement dated January 2, 2004, between Instrumentarium Corporation and OSI Systems, Inc. (11)
10.13	Letter Agreement dated March 19, 2004, between Instrumentarium Corporation and OSI Systems, Inc. amending and supplementing the Purchase Agreement dated as of January 2, 2004. (11)
10.14	Securities Purchase Agreement dated June 1, 2004, among OSI Systems, Inc. and various purchasers (12)
10.15	Registration Rights Agreement dated June 1, 2004, among OSI Systems, Inc. and various purchasers (12)
10.16	Lease (A) dated June 24, 2002, between S/I Sammamish I, LLC and Spacelabs Medical, Inc. (13)
10.17	Lease (B) dated June 24, 2002, between S/I Sammamish I, LLC and Spacelabs Medical, Inc. (13)
10.18*	First Amendment to Lease (A) dated October 12, 2004 between S/I Sammamish I, LLC and OSI Systems Inc.
10.19*	First Amendment to Lease (B) dated October 12, 2004 between S/I Sammamish I, LLC and OSI Systems Inc.
10.20	Share Purchase Agreement dated February 8, 2005, between the owners of Blease Medical Holdings Limited and OSI Systems, Inc. (14)

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No.	EXHIBIT DESCRIPTION
10.21*	Second Amended and Restated Credit Agreement, dated May 18, 2005, between Bank of the West and OSI Systems, Inc.
14.1*	Code of Ethics
21.1*	Subsidiaries of the Company
23.1*	Consent of Independent Registered Public Accounting Firm
31.1*	Certification Pursuant to Section 302
31.2*	Certification Pursuant to Section 302
32.1*	Certification Pursuant to Section 906
32.2*	Certification Pursuant to Section 906

\* Filed herewith

- (1) Previously filed with our Registration Statement filed June 13, 1997.
- (2) Previously filed with our Current Report on Form 8-K filed November 12, 2004.
- (3) Previously filed with Amendment No. 2 to our Registration Statement on Form S-1 filed August 15, 1997.
- (4) Previously filed with our Form 8-A on August 1, 2000.
- (5) Previously filed with our Current Report on Form 8-K filed December 23, 2004.
- (6) Previously filed with our Current Report on Form S-8 filed February 9, 2005.
- (7) Previously filed with our Annual Report on Form 10-K for the fiscal year ended June 30, 2000.
- (8) Previously filed with our Annual Report on Form 10-K for the fiscal year ended June 30, 2003.
- (9) Previously filed with our Current Report on Form 8-K filed July 20, 2005.
- (10) Previously filed with our Current Report on Form 8-K filed January 1, 2004.
- (11) Previously filed with our Current Report on Form 8-K filed March 26, 2004.
- (12) Previously filed with our Current Report on Form 8-K filed June 2, 2004.
- (13) Previously filed with our Annual Report on Form 10-K for the fiscal year ended June 30, 2004.
- (14) Previously filed with our Current Report on Form 8-K filed February 14, 2005.



FIRST AMENDMENT  
TO LEASE

This First Amendment to Lease is made and entered into as of this 12<sup>th</sup> day of October, 2004, by and between S/I Sammamish I, LLC, a Washington Limited Liability Company ("Landlord") and OSI Systems, Inc., a California Corporation, successor in interest to Spacelabs Medical, Inc., a Delaware Corporation ("Tenant").

RECITALS

A. Landlord and Tenant are parties to that certain Lease dated as of June 24, 2002, for certain space in Building A (the "Lease"). The Lease commenced on February 15, 2003. Spacelabs Medical, Inc. assigned its interest as Tenant under the Lease to OSI Systems, Inc. effective as of March 19, 2004.

B. Landlord and Tenant now desire to amend the Lease in part as set forth below, which amendment shall be contingent upon the amendment of Tenant's Lease in Building B.

Now, for and in consideration of the mutual terms and conditions set forth herein, the parties hereby agree to amend the Lease as follows:

1. Section 1.01(j), Term. This Section is amended and restated as follows:

Commencing upon the Commencement Date (as defined in Section 4.01) and expiring on the Expiration Date determined pursuant to Section 4.01 (subject to extension, if applicable, pursuant to Section 4.3 below).

2. Section 1.01(l), Base Rent. This Section is deleted in its entirety and is replaced as follows:

<u>Eleven (11) Year &amp; Ten (10) Months Rent Schedule</u>	<u>Mo. Rate Per RSF</u>	<u>Annual Rate Per RSF</u>	<u>Monthly Total</u>
Months 1 – 12	\$0.0000	\$ 0.00	\$ 0
Months 13 – 24	\$1.4125	\$16.95	\$135,035
Months 25 – 36	\$1.4542	\$17.45	\$139,018
Months 37 – 48	\$1.5000	\$18.00	\$143,400
Months 49 – 60	\$1.5500	\$18.60	\$148,180
Months 61 – 72	\$1.6017	\$19.22	\$153,119
Months 73 – 84	\$1.6550	\$19.86	\$158,218
Months 85 – 96	\$1.7100	\$20.52	\$163,476
Months 97 – 108	\$1.7667	\$21.20	\$168,893
Months 109 - 120	\$1.8250	\$21.90	\$174,470
Months 120 - 132	\$1.8250	\$21.90	\$174,470
Months 132 - 142	\$1.8250	\$21.90	\$174,470

3. Section 4.01, Term. This Section is amended in part by deleting the last sentence of this Section and replacing it with the following:

The Term shall expire on December 14, 2014 (the "Expiration Date").

4. Section 4.04, Option to Terminate. This Section is deleted in its entirety.

5. Amendment Consideration. In consideration for Landlord's amendment to this Lease, Landlord shall pay Tenant the sum of One Million and no/100 Dollars (\$1,000,000.00), which sum shall be paid to Tenant by cash or cash equivalent within five (5) business days after the date of full execution of both Lease Amendments.

6. Except as specifically amended herein, the Lease remains in full force and effect.

In witness whereof, the parties have executed this First Amendment to Lease effective as of the date first above written.

LANDLORD

S/I SAMMAMMISH I, LLC,  
A Washington Limited Liability Company

By: \_\_\_\_\_

Its: \_\_\_\_\_

TENANT

OSI SYSTEMS, INC.,  
A California Corporation

By: \_\_\_\_\_

Its: \_\_\_\_\_

FIRST AMENDMENT  
TO LEASE

This First Amendment to Lease is made and entered into as of this 12<sup>th</sup> day of October, 2004, by and between S/I Sammamish II, LLC, a Washington Limited Liability Company ("Landlord") and OSI Systems, Inc., a California Corporation, successor in interest to Spacelabs Medical, Inc., a Delaware Corporation ("Tenant").

RECITALS

A. Landlord and Tenant are parties to that certain Lease dated as of June 24, 2002, for certain space in Building B (the "Lease"). The Lease commenced on January 1, 2003. Spacelabs Medical, Inc. assigned its interest as Tenant under the Lease to OSI Systems, Inc. effective as of March 19, 2004.

B. Landlord and Tenant now desire to amend the Lease in part as set forth below, which amendment shall be contingent upon the amendment of Tenant's Lease in Building A.

Now, for and in consideration of the mutual terms and conditions set forth herein, the parties hereby agree to amend the Lease as follows:

1. Section 1.01(j), Term. This Section is amended and restated as follows:

Commencing upon the Commencement Date (as defined in Section 4.01) and expiring on the Expiration Date determined pursuant to Section 4.01 (subject to extension, if applicable, pursuant to Section 4.3 below).

2. Section 1.01(l), Base Rent. This Section is deleted in its entirety and replaced as follows:

<b>Eleven (11) Year &amp; Eleven and a half (11.5) Months Rent Schedule</b>	<b>Mo. Rate Per RSF</b>	<b>Annual Rate Per RSF</b>	<b>Monthly Total</b>
Months 1- 12	\$0.0000	\$ 0.00	\$ 0
Months 13 - 24	\$1.4125	\$16.95	\$151,058
Months 25 - 36	\$1.4542	\$17.45	\$155,514
Months 37 - 48	\$1.5000	\$18.00	\$160,416
Months 49 - 60	\$1.5500	\$18.60	\$165,763
Months 61 - 72	\$1.6017	\$19.22	\$171,289
Months 73 - 84	\$1.6550	\$19.86	\$176,992
Months 85 - 96	\$1.7100	\$20.52	\$182,874
Months 97 - 108	\$1.7667	\$21.20	\$188,934
Months 109 - 120	\$1.8250	\$21.90	\$195,173
Months 120 - 132	\$1.8250	\$21.90	\$195,173
Months 132 - 143.5	\$1.8250	\$21.90	\$195,173

3. Section 2.03, Contraction Option. This Section is deleted in its entirety.

4. Section 4.01, Term. This Section is amended in part by deleting the last sentence of this Section and replacing it with the following:  
The Term shall expire on December 14, 2014 (the "Expiration Date").

5. Section 4.04, Option to Terminate. This Section is deleted in its entirety.

6. Amendment Consideration. In consideration for Landlord's amendment to this Lease as well as to the Building A Lease, Landlord shall pay Tenant the sum of One Million and no/100 Dollars (\$1,000,000.00), which sum shall be paid to Tenant by cash or cash equivalent within five (5) business days after the date of full execution of both Lease Amendments.

6. Except as specifically amended herein, the Lease remains in full force and effect.

In witness whereof, the parties have executed this First Amendment to Lease effective as of the date first above written.

LANDLORD

S/I SAMMAMMISH II, LLC,  
A Washington Limited Liability Company

By: \_\_\_\_\_

Its: \_\_\_\_\_

TENANT

OSI SYSTEMS, INC.,  
A California Corporation

By: \_\_\_\_\_

Its: \_\_\_\_\_

## SECOND AMENDED AND RESTATED CREDIT AGREEMENT

THIS SECOND AMENDED AND RESTATED CREDIT AGREEMENT (the “Agreement”) is made and dated as of the 18th day of May, 2005, by and among BANK OF THE WEST (“BOW”), as the sole initial lender party hereto and the other lenders from time to time party hereto (each of BOW and such other lenders, being referred to herein individually as a “Lender” and, collectively, as the “Lenders”), BOW, as agent for the Lenders (in such capacity, the “Agent”), BOW, as the issuer of letters of credit hereunder (in such capacity, the “L/C Issuing Bank”), and OSI SYSTEMS, INC., a California corporation (the “Company”).

### RECITALS

A. BOW has previously extended to the Company certain credit facilities pursuant to that certain Amended and Restated Credit Agreement dated as of December 1, 2003 by and between BOW and the Company (as amended to date, the “Existing Credit Agreement”).

B. The Company and BOW have agreed to extend and otherwise amend the Existing Credit Agreement in certain respects and, for convenience of reference, to restate the Existing Credit Agreement in its entirety.

NOW, THEREFORE, in consideration of the above Recitals and for other good and valuable consideration, the receipt and adequacy of which are hereby acknowledged, the parties hereto hereby agree as follows:

### AGREEMENT

#### 1. Revolving Credit Facility.

1(a) Credit Amount. On the terms and subject to the conditions set forth herein, the Lenders severally agree that they shall from time to time to but not including the Revolving Loan Maturity Date (as that term and capitalized terms not otherwise defined herein are defined in Paragraph 15 below), make revolving loans (the “Revolving Loans” or a “Revolving Loan”) to the Company, pro rata in accordance with their respective Percentage Shares, in an aggregate amount not to exceed at any one time outstanding the lesser of:

(1) The Revolving Facility Credit Limit; and

(2) The Aggregate Credit Limit minus the sum of the aggregate amount of: (i) all Outstanding Letters of Credit and unpaid L/C Drawings on such date; plus (ii) the aggregate amount of all Acquisition Loans outstanding on such date.

In computing the availability of Revolving Loans pursuant to this Paragraph 1(a) the “amount” of Loans outstanding on any date in an Agreed Currency other than Dollars shall be determined in the Equivalent Amount of Dollars at such date.

1(b) Principal Repayment. The Company shall pay the principal amount of each Revolving Loan on the Revolving Loan Maturity Date. Principal amounts prepaid hereunder may be reborrowed on the terms and subject to the conditions set forth in Paragraph 8(b) below, it being expressly acknowledged and agreed that the credit facility provided under this Paragraph 1 is a revolving facility.

1(c) Payment of Interest. Interest on Revolving Loans shall be payable as provided in Paragraphs 5(b) and 5(d) below.

1(d) Use of Proceeds. The proceeds of Revolving Loans shall be used for working capital and general corporate needs.

2. Foreign Exchange Facility. Under the Existing Agreement BOW has, and may from time to time in the future elect to enter into FX Transactions with the Company and/or the Guarantors on such terms and conditions as may be agreed to between BOW and such Persons (BOW acting in such capacity, the "FX Provider"). The parties hereto hereby acknowledge that all now existing and hereafter obligations of the Company and the Guarantors with respect to such existing and future FX Transactions (the "FX Obligations") shall constitute "Obligations" hereunder for all purposes of this Agreement and the other Loan Documents.

3. Letter of Credit Facility.

3(a) Credit Limit. On the terms and subject to the conditions set forth herein, the L/C Issuing Bank shall from time to time from and after the Effective Date up to the Revolving Facility Maturity Date, issue standby and commercial/documentary letters of credit for the account of the Company (each a "Letter of Credit" and, collectively, the "Letters of Credit"); provided, however, that in no event shall the L/C Issuing Bank issue any Letter of Credit hereunder if after giving effect to such issuance, the aggregate amount of all Outstanding Letters of Credit (including all Outstanding Pre-Existing Letters of Credit) and unrepaid L/C Drawings would exceed the Aggregate Credit Limit minus the sum of: (i) the aggregate amount of all Revolving Loans outstanding on such date; plus (ii) the aggregate amount of all Acquisition Loans outstanding on such date. It computing the availability of Letters of Credit pursuant to this Paragraph 3(a), the "amount" of Loans outstanding on any date in an Agreed Currency other than Dollars shall be determined in the Equivalent Amount of Dollars at such date.

3(b) Issuance of Letters of Credit. Unless otherwise approved by the L/C Issuing Bank, each Letter of Credit, and any amendment, renewal or extension thereof, shall be requested by the Company at least three (3) Business Days prior to the proposed issuance, amendment, renewal or extension date by delivery to the L/C Issuing Bank of a duly executed Letter of Credit Application, with a copy to the Agent, accompanied by all other L/C Documents which the L/C Issuing Bank may require as a condition to the requested action. No Letter of Credit shall have a stated expiration date (or provide for the extension of such stated expiration date or the issuance of any replacement therefor) later than twenty four (24) months following the earlier to occur of: (a) its issuance date, and (b) the regularly scheduled Revolving Loan Maturity Date; provided, however that as an additional condition precedent to the issuance of any Letter of Credit with a stated expiration date later than six (6) months following the Revolving Loan Maturity Date (as determined as of the date of issuance of such Letter of Credit), no later than the Revolving Loan Maturity Date, the Company shall deposit a Dollar amount equal to the face amount of such Letter of Credit into a no-access account with the Agent (the "Letter of Credit Cash Collateral Account"). The Company hereby pledges, assigns and grants to the Agent on behalf of the Lenders a security interest in the Letter of Credit Cash Collateral Account, any and all funds from time to time contained therein, and all products and proceeds of the foregoing. At such time the Obligations with respect to any Letter of Credit for which the Company is required to cash collateralize in accordance with this Paragraph 3(b) shall have been fully satisfied or otherwise terminated, the Agent shall release its Lien on the portion of the funds contained in the Letter of Credit Cash Collateral Account attributable to such Letter of Credit and remit such funds to the Company.

3(c) Repayment of L/C Drawings. Any L/C Drawing under a Letter of Credit shall be payable in full by the Company on the date of such L/C Drawing.

3(d) Purchase of Participation Interests; Risk Sharing. Upon the issuance of each Letter of Credit (and upon the deemed issuance hereunder of the Pre-Existing Letters of Credit), the Lenders shall be automatically deemed to have purchased an undivided participation interest therein and in all rights and obligations relating thereto, pro rata in accordance with their respective Percentage Shares. The Lenders hereby absolutely and unconditionally (including, without limitation, following the occurrence of an Event of Default) agree to purchase and sell among themselves the Dollar amount of any L/C Drawing which is not paid on the date when due by the Company so that each unrepaid L/C Drawing shall be held and participated in by the Lenders in accordance with their respective Percentage Shares.

3(e) Absolute Obligation to Repay. The Company's obligation to repay L/C Drawings shall be absolute, irrevocable and unconditional under any and all circumstances whatsoever and irrespective of any set-off, counterclaim or defense to payment which the Company may have or have had, against any Lender or any other Person, including, without limitation, any set-off, counterclaim or defense based upon or arising out of:

(1) Any lack of validity or enforceability of this Agreement or any of the other Loan Documents;

(2) Any amendment or waiver of or any consent to departure from the terms of any Letter of Credit;

(3) The existence of any claim, setoff, defense or other right which the Company or any other Person may have at any time against any beneficiary or any transferee of any Letter of Credit (or any Person for whom any such beneficiary or any such transferee may be acting);

(4) Any allegation that any demand, statement or any other document presented under any Letter of Credit is forged, fraudulent, invalid or insufficient in any respect, or that any statement therein is untrue or inaccurate in any respect whatsoever or that variations in punctuation, capitalization, spelling or format were contained in the drafts or any statements presented in connection with any L/C Drawing;

(5) Any payment by the L/C Issuing Bank under any Letter of Credit against presentation of a draft or certificate that does not strictly comply with the terms of such Letter of Credit, or any payment made by the L/C Issuing Bank under any Letter of Credit to any Person purporting to be a trustee in bankruptcy, debtor-in-possession, assignee for the benefit of creditors, liquidator, receiver or other representative of or successor to any beneficiary or any transferee of any Letter of Credit, including any arising in connection with any insolvency proceeding;

(6) Any exchange, release or non-perfection of any Collateral; or

(7) Any other circumstance or happening whatsoever, whether or not similar to any of the foregoing, including any other circumstance that might otherwise constitute a defense available to, or a discharge of the Company.

Nothing contained herein shall constitute a waiver of the Company's rights against the L/C Issuing Bank arising out of the gross negligence or willful misconduct of the L/C Issuing Bank in connection with any Letter of Credit issued hereunder; provided, however, that it is expressly acknowledged and agreed by the Company that the exercise of any such rights is subject to and conditioned upon the prior payment in full of all Obligations, including, without limitation, unrepaid L/C Drawings, and the termination of the credit facility evidenced hereby.

3(f) Uniform Customs and Practice. The Uniform Customs and Practice for Documentary Credits as published by the International Chamber of Commerce most recently at the time of issuance of any Letter of Credit shall (unless otherwise expressly provided in such Letter of Credit) apply to such Letter of Credit.

3(g) Relationship to Letter of Credit Applications. In the event of any inconsistency between the terms and provisions of this Agreement and the terms and provisions of any Letter of Credit Application, the terms and provisions of this Agreement shall supersede and govern.

3(h) Use of Letters of Credit. The Letters of Credit may be requested by the Company on its own behalf or on behalf of any of the Guarantors. The Letters of Credit shall be used to support the working capital and general corporate needs of the Company and the Guarantors.

4. Acquisition Credit Facility.

4(a) Credit Limit. On the terms and subject to the conditions set forth herein, the Lenders severally agree that they shall from time to time to, but not including, the ninetieth (90<sup>th</sup>) day prior to the then current Revolving Loan Maturity Date, make loans (the "Acquisition Loans" or an "Acquisition Loan") to the Company, pro rata in accordance with their respective Percentage Shares, in an aggregate amount not to exceed at any one time outstanding the lesser of:

(1) The Acquisition Facility Credit Limit; and

(2) The Aggregate Credit Limit minus the sum of the aggregate amount of: (i) the aggregate amount of all Revolving Loans outstanding on such date; plus (ii) all Outstanding Letters of Credit and unpaid L/C Drawings on such date.

In computing the availability of Acquisition Loans pursuant to this Paragraph 4(a) the "amount" of Loans outstanding on any date in an Agreed Currency other than Dollars shall be determined in the Equivalent Amount of Dollars at such date.

4(b) Principal Repayment. The Company shall pay the principal amount of each Acquisition Loan as follows:

(1) In equal installments, each in an amount equal to two and one half of one percent (2.50%) of the original principal amount of such Acquisition Loan, commencing on the ninetieth (90<sup>th</sup>) day after the date such Acquisition Loan is funded and on the first Business Day of each calendar quarter thereafter, and

(2) On the Revolving Loan Maturity Date, in an amount equal to the then outstanding principal balance of such Acquisition Loan.



Principal amounts prepaid hereunder may be reborrowed on the terms and subject to the conditions set forth in Paragraph 8(b) below, it being expressly acknowledged and agreed that the credit facility provided under this Paragraph 4 is a revolving facility.

4(d) Payment of Interest. Interest on Acquisition Loans shall be payable as provided in Paragraphs 5(b) and 5(d) below.

4(e) Use of Proceeds. The proceeds of Acquisition Loans shall be used to finance Permitted Acquisitions.

5. Requests for and Funding of Loans; Pricing Provisions.

5(a) Requests for and Funding of Loans.

(1) If the Company desires to borrow Loans, the Company shall deliver a Loan Request to the Agent, no later than: (i) in the case of Loans to be funded as Prime Rate Loans, 12:00 p.m. (Los Angeles time) on the proposed funding date, and (ii) in the case of Loans to be funded as LIBO Rate Loans, 12:00 p.m. (Los Angeles time) on the third LIBOR Business Day preceding the proposed funding date.

(2) The principal amount of each LIBO Rate Loan (including Prime Rate Loans which are converted into LIBO Rate Loans) shall be in the minimum amount of \$100,000 and whole multiples of \$100,000 in excess thereof.

(3) All Loan Requests shall be irrevocable and shall be delivered in writing (which may be by facsimile transmission) or, but only with the prior agreement of the Agent, telephonically, with any Loan Request delivered telephonically to be promptly confirmed in writing (which may be by facsimile transmission). Upon receipt of a Loan Request, the Agent shall notify each of the Lenders of the receipt of such Loan Request by facsimile transmission no later than 2:00 p.m. (Los Angeles time) on the date received.

(4) The Lenders shall make available their applicable Percentage Shares of each proposed Loan by crediting the amount thereof, in immediately available same day funds, to the Funding Account no later than 10:30 a.m. (Los Angeles time) on the funding date.

(5) The failure of any Lender to advance its Percentage Share of any Loan shall not relieve any other Lender of its obligation hereunder to advance its Percentage Share of the principal amount thereof, but no Lender shall be responsible for the failure of any other Lender to make its required advance.

5(b) Applicable Interest Rates. The Company shall pay interest on all Loans outstanding hereunder from the date disbursed to but not including the date of payment, at a rate per annum equal to, at the option of and as selected by the Company from time to time (subject to the provisions of Paragraphs 5(c) and 5(e) below):

(1) The daily average Applicable Prime Rate during the applicable computation period; or

(2) The Applicable LIBO Rate for the selected Interest Period therefor.

5(c) Conversion and Continuation Options.

(1) The Company may elect from time to time to convert Loans outstanding (or portions thereof): (i) as LIBO Rate Loans to Prime Rate Loans by giving the Agent irrevocable notice of such election pursuant to a Notice of Conversion/Continuation no later than 9:00 a.m. (Los Angeles time) on the last day of the Interest Period for such LIBO Rate Loan, and (ii) as Prime Rate Loans to LIBO Rate Loans by giving the Agent irrevocable notice of such election no later than 12:00 noon (Los Angeles time) on the third (3rd) LIBOR Business Day preceding the proposed conversion date. Any conversion of LIBO Rate Loans may only be made on the last day of the applicable Interest Period. No Prime Rate Loan may be converted into a LIBO Rate Loan if an Event of Default or Potential Default has occurred and is continuing at the requested conversion date. All or any part of outstanding Loans may be converted as provided herein, provided that partial conversions shall be in an amount not less than the amount required pursuant to Paragraph 5(a)(2) above.

(2) The Company may elect from time to time to have any LIBO Rate Loan continued as such upon the expiration of the Interest Period applicable thereto by giving the Agent irrevocable notice of such election pursuant to a Notice of Conversion/Continuation no later than 12:00 noon (Los Angeles time) on the third (3rd) LIBOR Business Day preceding the last day of such Interest Period; provided, however, that no LIBO Rate Loan may be continued as such when any Event of Default or Potential Default has occurred and is continuing, but shall be automatically converted to a Prime Rate Loan on the last day of the Interest Period applicable thereto. If the Company shall fail to give notice of its election to continue a LIBO Rate Loan as such as provided above, the Company shall be deemed to have elected to convert the affected LIBO Rate Loan to a Prime Rate Loan on the last day of the applicable Interest Period.

(3) Each request for the conversion or continuation of a Loan (or portion thereof) shall be evidenced by the timely delivery by the Company to the Agent of a duly executed Notice of Conversion/Continuation (which delivery may be by facsimile transmission) or, but only with the prior agreement of the Agent, telephonically, with any Notice of Conversion/Continuation delivered telephonically to be promptly confirmed in writing (which may be by facsimile transmission).

5(d) Interest Billing and Payment Requirements.

(1) Interest accruing on Loans (or portions thereof) which are Prime Rate Loans shall be payable monthly, in arrears, for each month on the last Business Day of such month in the amount set forth in an interest billing for such Prime Rate Loans delivered by the Agent to the Company (which delivery may be telephonic and later confirmed in writing).

(2) Interest accruing on LIBO Rate Loans shall be payable, in arrears, on the last day of the applicable Interest Period therefor, or in the case of LIBO Rate Loans with Interest Periods ending later than three months from the date funded, at the end of each three month period from the date funded and at the end of the applicable Interest Period therefor.

5(e) Illegality. Notwithstanding any other provisions herein, if any law, regulation, treaty or directive or any change therein or in the interpretation or application thereof, shall make it unlawful for any Lender to make or maintain LIBO Rate Loans as contemplated by this Agreement: (1) the commitment of such Lender hereunder to make or to continue LIBO Rate Loans or to convert Prime Rate Loans to LIBO Rate Loans shall forthwith be canceled and (2) such Lender's Percentage Share of Loans then outstanding as LIBO Rate Loans, if any, shall be converted automatically to Prime Rate Loans at the end of their respective Interest Periods or within such earlier period as may be required by law. In the event of a conversion of any LIBO Rate Loan prior to the end of its applicable Interest Period, the Company hereby agrees promptly to pay any Lender affected thereby, upon demand, the amounts required pursuant to Paragraph 5(h) below, it being agreed and understood that such conversion shall constitute a prepayment for all purposes hereof. The provisions hereof shall survive the termination of this Agreement and payment of all outstanding Loans, unrepaid L/C Drawings and all other Obligations.

5(f) Requirements of Law; Increased Costs. In the event that any applicable law, order, regulation, treaty or directive issued by any central bank or other governmental authority, agency or instrumentality or in the governmental or judicial interpretation or application thereof, or compliance by any Lender with any request or directive (whether or not having the force of law) issued by any central bank or other governmental authority, agency or instrumentality:

(1) Does or shall subject any Lender to any tax of any kind whatsoever with respect to this Agreement or any Loan made or Letter of Credit issued hereunder, or change the basis of taxation of payments to such Lender of principal, fee, interest or any other amount payable hereunder (except for change in the rate of tax on the overall net income of such Lender);

(2) Does or shall impose, modify or hold applicable any reserve, capital requirement, special deposit, compulsory loan or similar requirements against assets held by, or deposits or other liabilities in or for the account of, advances or loans by, or other credit extended by, or any other acquisition of funds by, any office of such Lender which are not otherwise included in the determination of interest payable on the Obligations; or

(3) Does or shall impose on such Lender any other condition;

and the result of any of the foregoing is to increase the cost to such Lender of making, renewing or maintaining any Loan, or issuing, renewing or maintaining any Letter of Credit, or to reduce any amount receivable in respect thereof or the rate of return on the capital of such Lender or any corporation controlling such Lender, then, in any such case, the Company shall promptly pay to such Lender, upon its written demand made through the Agent, any additional amounts necessary to compensate such Lender for such additional cost or reduced amounts receivable or rate of return as determined by such Lender with respect to this Agreement, or Loans made, or Letters of Credit issued hereunder. If a Lender becomes entitled to claim any additional amounts pursuant to this Paragraph 5(f), it shall promptly notify the Company of the event by reason of which it has become so entitled. A certificate as to any additional amounts payable pursuant to the foregoing sentence containing the calculation thereof in reasonable detail submitted by a Lender to the Company shall be conclusive in the absence of manifest error. The provisions hereof shall survive the termination of this Agreement and payment of all outstanding Loans, unrepaid L/C Drawings and all other Obligations.

5(g) Funding. Subject to the provisions of Paragraph 5(l) below, each Lender shall be entitled to fund all or any portion of the Loans in any manner it may determine in its sole discretion, including, without limitation, within the London inter-bank market and within the United States.

5(h) Prepayment Premium. In addition to all other payment obligations hereunder, in the event: (1) if any LIBO Rate Loan is prepaid prior to the last day of the applicable Interest Period, whether following the occurrence of an Event of Default or otherwise, or (2) the Company shall fail to continue or to make a conversion to a LIBO Rate Loan after the Company has given notice thereof as provided in Paragraph 5(c) above, then the Company shall immediately pay to the Lenders holding the Loans prepaid or not made, continued or converted, through the Agent, an additional premium sum compensating each Lender for losses, costs and expenses incurred by such Lender in connection with such prepayment or such failure to borrow, continue or convert. The Company acknowledges that such losses, costs and expenses are difficult to quantify and that, in the case of the prepayment of or failure to continue or convert to a LIBO Rate Loan, the following formula represents a fair and reasonable estimate of such losses, costs and expenses:

$$\begin{array}{rclclcl}
 & [ & \text{Applicable LIBO} & \text{LIBO Rate} & ] & & \\
 & [ & \text{Rate for Increment} & \text{for such} & ] & & \\
 \text{Amount} & [ & \text{Being Prepaid or Not} & \text{Increment} & ] & & \\
 \text{Being} & [ & \text{Converted (as quoted} & \text{for Days} & ] & \text{Days Remaining in} & \\
 \text{Prepaid or} & \times [ & \text{on the first LIBOR} & \text{Remaining} & ] & \times & \text{Interest Period} \\
 \text{Being Not} & [ & \text{Business Day} & \text{in Interest} & ] & & \\
 \text{Converted} & [ & \text{following Lenders' } & \text{Period} & ] & & \\
 \text{or} & [ & \text{receipt of notice} & & ] & & \\
 \text{Continued} & [ & \text{thereof)} & & ] & & \\
 & & & & & & 360
 \end{array}$$

For purposes of calculating the current LIBO Rate for the days remaining in the Interest Period for the increment being prepaid or not converted or continued, such current LIBO Rate shall be an interest rate interpolated between LIBO Rates quoted for standard calendar periods for subsequent months' maturities in accordance with normal conventions. A certificate as to any additional amounts payable pursuant to the foregoing sentence containing the calculation thereof in reasonable detail submitted by a Lender to the Company shall be conclusive in the absence of manifest error. The provisions hereof shall survive the termination of this Agreement and payment of all outstanding Loans and unrepaid L/C Drawings and all other Obligations.

5(i) Default Interest. At the option of the Agent on behalf of the Lenders, notwithstanding anything to the contrary contained herein, on any date that there shall have occurred and be continuing an Event of Default, any and all Obligations outstanding shall bear interest at a per annum rate equal to two percent (2%) in excess of the highest rate applicable to Loans then outstanding under this Agreement, or, if such Obligations do not otherwise bear interest, at a per annum rate equal to two percent (2%) in excess of the Prime Rate.

5(j) Fees. The Company shall pay the following fees:

(1) Letter of Credit Fees.

(i) To the Agent for the pro rata benefit of the Lenders in accordance with their respective Percentage Shares:

(x) On or before the date of issuance by the L/C Issuing Bank of a Letter of Credit which is in the nature of a standby (as opposed to commercial/documentary) letter of credit, a non-refundable issuance fee in an amount equal to the Applicable L/C Fee Percentage multiplied by the face amount of such Letter of Credit for the effective term of such Letter of Credit;

(y) With respect to each Letter of Credit which is in the nature of a commercial/documentary letter of credit, such reasonable and standard costs and charges relating to the issuance, presentation, amendment and processing as the L/C Issuing Bank may require; and

(z) Such renewal, increase and extension fees relating to any Letter of Credit as are customarily charged by the L/C Issuing Bank to its customers from time to time.

(ii) Directly to the L/C Issuing Bank, from time to time upon demand, such fees and charges, including, without limitation, miscellaneous charges and transfer fees, relating to the Letters of Credit as the L/C Issuing Bank customarily charges with respect to similar letters of credit issued by it.

(2) Agent's Fee. To the Agent for its own account an agent's fee in such amount and payable on such as may be agreed in writing by the Company and the Agent.

(3) Unused Fee. To the Agent for the pro rata benefit of the Lenders in accordance with their respective Percentage Shares, on the last Business Day of each calendar quarter and on the Revolving Loan Maturity Date, a non-usage fee for such calendar quarter (or portion thereof) in the amount set forth in a fee billing delivered by the Agent to the Company, which non-usage fee shall equal: (i) the average Aggregate Credit Limit in effect during such calendar quarter (or portion thereof), minus the daily average amount of Revolving Loans, Acquisition Loans and Outstanding Letters of Credit during such calendar quarter (or portion thereof) multiplied by (ii) the product of: (y) one eighth of one percent (0.125%), and (z) a fraction, the numerator of which is the number of days in the applicable calculation period and the denominator of which is 360.

5(k) Computations. All computations of interest and fees payable hereunder shall be based upon a year of three hundred and sixty (360) days for the actual number of days elapsed.

5(l) Multicurrency Provisions. Upon the request of the Company, and subject to Agent's standard procedures regarding the funding of Loans in any Agreed Currency as well as the provisions of this Paragraph 5(l), the Lenders will fund Loans in any Agreed Currency so requested. Notwithstanding any provision of this Agreement to the contrary, with respect to Loans requested to be funded in an Agreed Currency:

(1) Each Loan Request for a Loan to be denominated in an Agreed Currency must be submitted to the Agent no less than three (3) Business Days prior to the requested funding date of such Loan.

(2) Each Loan to be funded in an Agreed Currency other than Dollars shall be funded at the Applicable LIBO Rate for such Loan.

(3) At no time shall Loans be outstanding hereunder in more than three (3) different Agreed Currencies.

(4) At the date of funding of any Loan in an Agreed Currency other than Dollars, the Equivalent Amount of such Loan at the funding date when added to the Equivalent Amount of all other outstanding Loans in an Agreed Currency other than Dollars shall not exceed \$18,000,000.00.

(5) If at any date the aggregate Equivalent Amount of outstanding Loans denominated in Agreed Currencies other than Dollars exceeds \$20,000,000, the Company shall immediately repay such Loans in an aggregate principal amount sufficient to eliminate any such excess.

(6) Each Loan requested to be funded in an Agreed Currency shall be in a minimum Approximate Equivalent Amount of \$100,000 and in multiples of an Approximate Equivalent Amount of \$100,000 if in excess thereof.

(7) Except in the Agent's discretion, no Loan may be requested to be funded in an Agreed Currency if an Event of Default shall then exist. During the existence of an Event of Default, at the Agent's election or upon the direction of the Majority Lenders, all or any part of any outstanding Loans denominated in any Agreed Currency shall be redenominated and converted into Loans made in Dollars.

(8) The Agent will determine the Dollar Amount of each such Loan pursuant to its customary procedures for funding loans made in such Agreed Currency and advise the Company and the Lenders as to such Dollar Amount prior to the requested funding date of such Loan. Each day upon or as of which the Agent so determines Dollar Amounts is hereinafter referred to as a "Computation Date" with respect to each Loan for which a Dollar Amount is determined on or as of such day.

(9) Each Loan shall be repaid and each payment of interest thereon shall be paid in the Agreed Currency in which such Loan was funded or, if such Loan was converted into another Agreed Currency, such other Agreed Currency. If specified by the Agent to the Company in writing, payments of any Loan funded in an Agreed Currency shall be paid at the Lending Installation so specified by the Agent. Each payment delivered to the Agent for the account of any Lender shall be delivered promptly by the Agent to such Lender in the same type of funds that the Agent received, such funds to be delivered, if requested by such Lender in a writing to the Agent, at such Lender's specified Lending Installation.

(10) Notwithstanding anything herein to the contrary, if, after the making of any Loan in any Agreed Currency other than Dollars, currency control or exchange regulations are imposed in the country which issues such currency with the result that the type of currency in which the Loan was made (the "Original Currency") no longer exists or the Company is not able to make payment to the Agent for the account of the Lenders in such Original Currency, then all payments to be made by the Company hereunder in such currency shall instead be made when due in Dollars in an amount equal to the Dollar Amount (as of the date of repayment and any conversion being determined at the then prevailing market rate, as determined by Agent in

accordance with its customary practices) of such payment due, it being the intention of the parties hereto that the Company take all risks of the imposition of any such currency control or exchange regulations.

(11) If Agent shall have notified the Company and the Lenders that any currency has ceased being an Agreed Currency (in accordance with the definitions of the terms "Agreed Currency" and "Eligible Currency") then promptly, but in any event within five (5) Business Days of receipt of such notice from the Agent, the Company shall repay all Loans in such affected currency or convert (at the then prevailing market rate, as determined by Agent in accordance with its customary practices) such Loans into Loans in Dollars or another Agreed Currency, subject to the other terms set forth in this Paragraph 5(l).

(12) If any Loan made (or to be made) would, but for the provisions of this Paragraph 5(l), be capable of being made in either the Euro or in a National Currency Unit, such Loan shall be made in the Euro.

(13) Each Lender will book its Loans at the appropriate Lending Installation listed on Annex 6 or such other Lending Installation designated by such Lender in accordance with this subparagraph (9). All terms of this Agreement shall apply to any such Lending Installation and the Loans issued hereunder shall be deemed held by each Lender for the benefit of any such Lending Installation. Each Lender may, by written notice to the Agent and the Company in accordance with Paragraph 14(f) below, designate replacement or additional Lending Installations through which Loans will be made by it and for whose account Loan payments are to be made.

(14) Notwithstanding the satisfaction of all conditions set forth in this Agreement regarding the funding of Loans, with respect to any Loan in any Agreed Currency other than Dollars, if there shall occur on or prior to the date of such Loan any change in national or international financial, political or economic conditions or currency exchange rates or exchange controls which would in the reasonable opinion of the Agent or the Majority Lenders make it impracticable for such Loan to be denominated in the Agreed Currency specified by the Company, then the Agent shall forthwith give notice thereof to the Company and the Lenders, and such Loans shall not be denominated in such Agreed Currency but shall be made in Dollars, in an aggregate principal amount equal to the Dollar Amount of the aggregate principal amount specified in the related Loan Request unless the Company notifies the Agent at least one Business Day before such date that (i) it elects not to borrow on such date or (ii) it elects to borrow on such date in a different Agreed Currency, as the case may be, in which the denomination of such Loans would in the opinion of the Agent and the Majority Lenders be practicable and in an aggregate principal amount equal to the Dollar Amount of the aggregate principal amount specified in the related Loan Request.

#### 6. Miscellaneous Provisions.

6(a) Open Book Account. The obligation of the Company to repay the Loans and L/C Drawings shall be evidenced by notations on the books and records of the Agent and each Lender. The Agent shall deliver a statement of account to the Company and each Lender monthly setting forth the unpaid balance of Loans, L/C Drawings, and settlement prices outstanding hereunder. Such statement shall (absent clerical error) be deemed conclusively correct and accepted by the Company and the Lenders unless any of such Persons notifies the Agent to the contrary within thirty (30) Business Days following delivery of such statement. Upon any advance, conversion or prepayment with respect to any

Loan, each Lender is hereby authorized to record the date and amount of each such advance and conversion made by such Lender, or the date and amount of each such payment or prepayment of principal of the Loan made by such Lender, the applicable Interest Period (if any) and interest rate with respect thereto, on its books (or by any analogous method any Lender may elect consistent with its customary practices) and any such recordation shall constitute prima facie evidence of the accuracy of the information so recorded absent manifest error. The failure of the Agent or any Lender to make any such notation shall not affect in any manner or to any extent the Company's Obligations hereunder.

6(b) Nature and Place of Payments. All payments made on account of the Obligations shall be made by the Company to the Agent for the account of the Lenders or the L/C Issuing Bank, as applicable, without setoff or counterclaim, in Dollars in immediately available same day funds, free and clear of and without deduction for any taxes, fees or other charges of any nature whatsoever imposed by any taxing authority and must be received by the Agent by 2:00 p.m. (Los Angeles time) on the day of payment, it being expressly agreed and understood that if a payment is received after 2:00 p.m. (Los Angeles time) by the Agent, such payment will be considered to have been made by the Company on the next succeeding Business Day and interest thereon shall be payable by the Company at the then applicable rate during such extension. All payments on account of the Obligations shall be made to the Agent through its Contact Office. If any payment required to be made by the Company hereunder becomes due and payable on a day other than a Business Day, the due date thereof shall be extended to the next succeeding Business Day and interest thereon shall be payable at the then applicable rate during such extension. The Agent is hereby irrevocably authorized by the Company to debit the general operating account of the Company, if any, maintained with the Agent for the full amount of monthly and periodic interest billings, fees and other Obligations payable hereunder; provided, however, that the failure of the Agent to so debit such account shall not in any manner or to any extent affect the obligation of the Company to pay such Obligations as provided herein and in the other Loan Documents.

6(c) Prepayments.

(1) The Company may prepay Prime Rate Loans in whole or in part at any time, it being acknowledged and agreed that LIBO Rate Loans may not be voluntarily prepaid prior to the last day of their applicable Interest Periods.

(2) Revolving Loans are subject to mandatory prepayment by the Company upon demand of the Agent on any date upon which the sum of: (i) the aggregate principal balance of Revolving Loans, plus (ii) the Dollar amount of all Outstanding Letters of Credit, plus (iii) the Dollar amount unrepaid L/C Drawings, plus (iv) the Dollar amount of Acquisition Loans outstanding exceeds the Revolving Facility Credit Limit.

(3) Acquisition Loans are subject to mandatory prepayment by the Company upon demand of the Agent on any date upon which the aggregate principal Dollar amount of Acquisition Loans exceeds the Acquisition Facility Credit Limit.

(4) Principal prepayments with respect to any Acquisition Loan on and after the ninetieth (90<sup>th</sup>) day following the funding date thereof shall be applied to remaining principal payments in inverse order of maturity.

(5) The Company shall pay in connection with any prepayment hereunder all interest accrued but unpaid on Loans to which such prepayment is applied, and all prepayment premiums, if any, on LIBO Rate Loans to which such prepayment is applied, concurrently with payment to the Agent of any principal amounts.



6(d) Allocation of Payments Received. Prior to the occurrence of an Event of Default and acceleration of the Obligations, all amounts received by the Agent on account of the Loans shall be applied against Loans in such order as the Company may direct in writing, subject to the requirement that disbursements to the Lenders shall be in accordance with their respective Percentage Shares. Such amounts shall be disbursed by the Agent to the Lenders pro rata in accordance with their respective Percentage Shares by wire transfer on the date of receipt if received by the Agent before 10:00 a.m. (Los Angeles time) or if received later, by 12:00 noon (Los Angeles time) on the next succeeding Business Day, without further interest payable by the Agent. Following the occurrence of an Event of Default and acceleration of the Obligations, all amounts received by the Agent on account of the Obligations shall be disbursed by the Agent as follows:

(1) First, to the payment of reasonable expenses incurred by the Agent in the performance of its duties and enforcement of its rights under the Loan Documents, including, without limitation, all costs and expenses of collection, attorneys' fees, court costs and foreclosure expenses;

(2) Then, to the Lenders and to BOW with respect to the FX Obligations, pro rata in accordance with the amount of Obligations held by the Lenders and BOW with respect to the FX Obligations, until all outstanding Loans, unrepaid L/C Drawings, FX Obligations and interest accrued thereon have been paid in full, said amounts to be allocated first to interest and then, but only after all accrued interest has been paid in full, to principal of Loans, unrepaid L/C Drawings and FX Obligations;

(3) Then, to the Lenders on account of all other outstanding Obligations,

(4) Then, and if but only if there remain Outstanding any Letters of Credit or FX Transactions, to the Agent to hold as cash collateral for the obligation of the Company to reimburse future L/C Drawings and FX Obligations as the same may occur, until there are no further Outstanding Letters of Credit or FX Transactions, with the Agent hereby irrevocably authorized by the Company to debit from time to time the amounts so held and to apply the same on account of such L/C Drawings or FX Obligations, as applicable; and

(5) Then, to such Persons as may be legally entitled thereto.

6(e) Telephonic/Facsimile Communications. Any agreement of the Agent and the Lenders herein to receive certain notices by telephone or facsimile is solely for the convenience and at the request of the Company. The Agent and the Lenders shall be entitled to rely on the authority of any Person purporting to be an authorized Person and the Agent and the Lenders shall not have any liability to the Company or other Person on account of any action taken or not taken by the Agent or the Lenders in reliance upon such telephonic or facsimile notice. The obligation of the Company to repay the Loans or any unpaid L/C Drawings shall not be affected in any way or to any extent by any failure by the Agent and the Lenders to receive written confirmation of any telephonic or facsimile notice or the receipt by the Agent and the Lenders of a confirmation which is at variance with the terms understood by the Agent and the Lenders to be contained in the telephonic or facsimile notice.

6(f) Rollover of Existing Obligations. There are currently outstanding under the Existing Credit Agreement those “Revolving Loans,” “Letters of Credit” and unrepaid “L/C Drawings” described on Annex 1 attached hereto. Effective as of the Effective Date, all “Revolving Loans,” “Letters of Credit” and unrepaid “L/C Drawings” outstanding under the Existing Credit Agreement shall automatically be deemed to be outstanding hereunder, in each case for all purposes of this Agreement and the other Loan Documents, including, without limitation, the determination of availability of Revolving Loans, Letters of Credit and Acquisition Loans on and after the Effective Date.

7. Security and Additional Credit Support.

7(a) Collateral Security. As collateral security for the Obligations, the Company has previously executed and delivered to the Agent for the benefit of the Lenders: (1) that certain Security Agreement dated December 1, 2003 (as previously amended, extended or replaced, the “Existing Security Agreement”) pursuant to which the Company has granted to the Agent for the benefit of the Lenders a perfected security interest in the Collateral of the Company with a priority acceptable to the Agent, and (2) UCC-1 financing statements, notices to and consents of third parties, landlord and mortgagee waivers the property access agreements and such additional and supplemental security agreements, including, without limitation, supplemental security agreements covering Collateral consisting of federally registered trademarks, copyrights and patents for filing with the Patent and Trademark Office or the U.S. Copyright Office, as the Agent has previously required (the “Existing Additional Company Collateral Documents”). On or before the Effective Date the Company shall execute and deliver, or cause to be executed to the Agent, for the benefit of the Lenders, an amendment and reaffirmation of the Existing Security Agreement, in the form of that attached hereto as Exhibit A (the “Reaffirmation of Security Agreement”) accompanied by such Stock certificates and Stock powers as are referenced therein not previously delivered to the Agent and which are required to be delivered pursuant to the Security Agreement as amended and reaffirmed by the Reaffirmation of Security Agreement.

7(b) Existing Guarantors: Guaranties; Guarantor Security Agreements. As additional credit and collateral support for the Obligations, each of the Existing Guarantors have each executed and delivered to the Agent for the benefit of the Lenders: (1) a credit guaranty (each as previously amended, extended or replaced, an “Existing Guaranty”), (2) a guarantor security agreement (each as previously amended, extended or replaced, an “Existing Guarantor Security Agreement”) pursuant to which such Existing Guarantor has granted to the Agent for the benefit of the Lenders a perfected security interest in the Collateral of such Existing Guarantor with a priority acceptable to the Agent, and (3) UCC-1 financing statements, notices to and consents of third parties, landlord and mortgagee waivers the property access agreements and such additional and supplemental security agreements as the Agent has previously required (the “Existing Additional Guarantor Collateral Documents”). On or before the Effective Date, the Company shall cause to be executed and delivered to the Agent for the benefit of the Lenders from each of the Existing Guarantors an amendment and master reaffirmation of the Existing Guaranties and the Existing Guarantor Security Agreements in the form of that attached hereto as Exhibit B (the “Master Reaffirmation of Guaranties and Guarantor Security Agreements”) along with such Stock certificates and Stock powers as are referenced therein not previously delivered to the Agent and which are required to be delivered pursuant to the Existing Guarantor Security Agreements as amended and reaffirmed by the Master Reaffirmation of Guaranties and Guarantor Security Agreements.

7(c) INTENTIONALLY OMITTED

7(d) Additional Documents. The Company agrees to execute and deliver and to cause to be executed and delivered to the Agent on behalf of the Lenders from time to time:

(1) From each Domestic Subsidiary of the Company organized or acquired following the Effective Date, a guaranty substantially in the form of the Existing Guaranties, a security agreement substantially in the form of the Guarantor Security Agreement, and UCC financing statements, such documents to be delivered immediately upon the formation or acquisition of such Subsidiary, accompanied by Stock certificates, Stock powers and other documents, instruments and agreements required thereunder;

(2) INTENTIONALLY OMITTED

(3) From each Lender with which the Company or any Guarantor Subsidiary maintains deposits, including, without limitation, future Lenders hereunder, an account control agreement in form and substance acceptable to the Agent (each, a "Lender Account Control Agreement");

(4) From the Company and each Domestic Subsidiary, the Stock certificates and Stock transfer powers therefor of each Material Foreign Subsidiary which becomes such following the Effective Date required to be delivered pursuant to the Security Agreement or the Guarantor Security Agreements, as applicable; and

(5) From the Company and the Subsidiaries of the Company and such Persons as the Agent may request, such confirmatory or supplementary security agreements, financing statements, account control agreements, consents and acknowledgements of third parties, intercreditor agreements and such other documents, instruments or agreements as the Agent may reasonably request, which are in the Agent's judgment necessary or desirable to obtain for the Agent on behalf of the Lenders, the benefit of the Collateral and the Loan Documents (the "Supplemental Collateral Documents").

8. Conditions to Credit Events.

8(a) First Credit Event. As conditions precedent to the first Credit Event hereunder:

(1) The Company shall have delivered or shall have had delivered to the Agent, in form and substance satisfactory to the Agent and its counsel, each of the following (with sufficient copies for each of the Lenders) and duly executed and certified as required:

(i) This Agreement;

(ii) The Reaffirmation of Security Agreement;

(iii) The Master Reaffirmation of Guaranties and Guarantor Security Agreements duly executed by each of the Existing Guarantors;

(iv) INTENTIONALLY OMITTED

(v) Such Supplemental Collateral Documents as may be requested of the Company and the Existing Guarantors by the Agent;

(vi) Such UCC searches showing the filing and priority of all UCC filings made on behalf of the Agent for the benefit of the Lenders in connection with the Existing Credit Agreement subject only to the security interests in and liens acceptable to the Agent in its sole and absolute discretion;

(vii) Certified copies of resolutions of the Board of Directors of the Company, each of the Existing Guarantors and each of the Existing Foreign Subsidiaries approving the execution and delivery of the Loan Documents to which such Person is party, the performance of the Obligations and the consummation of the transactions contemplated by the Loan Documents;

(viii) A certificate of the Secretary or an Assistant Secretary of the Company, each of the Existing Guarantors and each of the Existing Foreign Subsidiaries certifying the names and true signatures of the officers of such Person authorized to execute and deliver the Loan Documents to which such Person is party;

(ix) Certificates of good standing as of a recent date for the Company and each of the Guarantors from the Secretaries of State of California and each State in which such Person is incorporated or does business;

(x) A certificate of a Responsible Financial Officer of the Company in the form of that attached hereto as Exhibit D dated as of the Effective Date;

(xi) Such opinions of counsel to the Company and the Guarantors as the Agent may request; and

(xii) Such Stock certificates and Stock powers not previously delivered to the Agent as are required pursuant to the Existing Security Agreement, as amended and reaffirmed by the Reaffirmation of Security Agreement, and the Existing Guaranties, as amended and reaffirmed by the Master Reaffirmation of Guaranties and Guarantor Security Agreements.

(2) All acts and conditions (including, without limitation, the obtaining of any necessary regulatory approvals and the making of any required filings, recordings or registrations) required to be done and performed and to have happened precedent to the execution, delivery and performance of the Loan Documents and to constitute the same legal, valid and binding obligations, enforceable in accordance with their respective terms, shall have been done and performed and shall have happened in due and strict compliance with all applicable laws.

(3) All documentation, including, without limitation, documentation for corporate and legal proceedings in connection with the transactions contemplated by the Loan Documents shall be satisfactory in form and substance to the Agent and its counsel.

If the Effective Date shall not have occurred and the first Credit Event consummated on or before May 27, 2005 as a result of the failure of the conditions precedent thereto set forth above to have been met to the satisfaction of the Agent or otherwise, then this Credit Agreement and any right of the Company to receive credit hereunder shall automatically terminate and be of no further force or effect and the Agent

and the Lenders shall be entitled to exercise all rights, powers and remedies available to them under the Existing Credit Agreement. Notwithstanding the foregoing, it is expressly acknowledged and agreed by the Agent and the Lenders that certain of the documents, instruments and agreements required to be delivered on the Effective Date pursuant to this Paragraph 8(a) may be delivered on or before May 27, 2005 as provided more particularly in Paragraph 10(m) below and that provided all other conditions precedent set forth in this Paragraph 8 shall be satisfied, the Effective Date shall be deemed to have occurred.

8(b) All Credit Events. As conditions precedent to each Lender's obligation to make any Loan, including the first Loan and including the conversion of any Loan to another type of Loan or the continuation of any LIBO Rate Loan after the end of its applicable Interest Period, or of the L/C Issuing Bank to issue, amend, renew or extend any Letter of Credit, at and as of the date of such action:

(1) There shall have been delivered to the Agent a Loan Request or a Letter of Credit Application and any required L/C Documents, as applicable;

(2) If the requested Loan is an Acquisition Loan, the Agent shall have received timely all documents, instruments, agreements and information required to be provided in connection with a Permitted Acquisition accompanied by evidence satisfactory to the Agent that the proceeds of such Acquisition Loan will be utilized to consummate the subject Permitted Acquisition concurrently with the funding thereof;

(3) The representations and warranties contained in the Loan Documents shall be accurate and complete in all material respects as if made on and as of the date of such advance, conversion, continuance or issuance or, with respect to any representation made as of a specific date, shall have been accurate and complete as of such date;

(4) There shall not have occurred an Event of Default or Potential Default; and

(5) After giving effect to such Credit Event the Company shall be in compliance with the limitations of Paragraphs 1(a), 2(a), 3(a) and 4(a) above.

By delivering a Loan Request or Letter of Credit Application hereunder, the Company shall be deemed to have represented and warranted the accuracy and completeness of the statements set forth in subparagraphs (b)(2) through (b)(4) above, as applicable.

9. Representations and Warranties of the Company. As an inducement to the Agent and each Lender to enter into this Agreement, the Company represents and warrants to the Agent and each Lender that:

9(a) Financial Condition. The financial statements, dated the Statement Date and the Interim Date, copies of which have heretofore been furnished to each Lender by the Agent, are complete and correct and present fairly in accordance with GAAP the financial condition of the Company and its consolidated Subsidiaries at such dates and the consolidated and consolidating results of their operations and changes in financial position for the fiscal periods then ended.

9(b) No Change. Since the Statement Date no Material Adverse Effect has occurred. Except as expressly disclosed in writing to the Agent and the Lenders prior to the Effective Date, from

the Statement Date through the Effective Date, neither the Company nor any of its Subsidiaries has entered into, incurred or assumed any material long-term debt, mortgages, leases or oral or written commitments, nor commenced any significant project, nor made any purchase or acquisition of any significant property.

9(c) Legal Existence; Compliance with Law. The Company and each of its Subsidiaries: (1) is duly organized, validly existing and in good standing as a corporation or other legal entity under the laws of the jurisdiction of its organization and is qualified to do business in each jurisdiction where its ownership of property or conduct of business requires such qualification and where failure to qualify is reasonably likely to have a Material Adverse Effect, (2) has the corporate or other power and authority and the legal right to own and operate its property and to conduct business in the manner in which it does and proposes so to do, and (3) is in compliance with all Requirements of Law and Contractual Obligations, the failure to comply with which could have a Material Adverse Effect.

9(d) Power; Authorization; Enforceable Obligations. The Company and each of its Subsidiaries has the corporate power and authority and the legal right to execute, deliver and perform the Loan Documents to which it is a party and has taken all necessary corporate action to authorize the execution, delivery and performance of such Loan Documents. The Loan Documents to which the Company and each of its Subsidiaries is party have been duly executed and delivered on behalf of such Person and constitute legal, valid and binding obligations of such Person enforceable against such Person in accordance with their respective terms, subject to the effect of applicable bankruptcy and other similar laws affecting the rights of creditors generally and the effect of equitable principles whether applied in an action at law or a suit in equity.

9(e) No Legal Bar. The execution, delivery and performance of the Loan Documents to which the Company or any of its Subsidiaries is party, the borrowing hereunder and the use of the proceeds thereof, will not violate any Requirement of Law or any Contractual Obligation of the Company or any of its Subsidiaries the violation of which could have a Material Adverse Effect or create or result in the creation of any Lien on any assets of the Company or any of its Subsidiaries (other than any Lien created by the Security Documents).

9(f) No Material Litigation. Except as disclosed on Schedule 9(f), attached hereto, no litigation, investigation or proceeding of or before any arbitrator, court or Governmental Authority is pending or, to the knowledge of the Company, threatened by or against the Company or any of its Subsidiaries or against any of such parties' properties or revenues which is likely to be adversely determined and which, if adversely determined, is likely to have a Material Adverse Effect.

9(g) Taxes. The Company and each of its Subsidiaries have filed or caused to be filed all tax returns that are required to be filed and have paid all taxes shown to be due and payable on said returns or on any assessments made against them or any of their property other than taxes which are being contested in good faith by appropriate proceedings and as to which the Company or applicable Subsidiary has established adequate reserves in conformity with GAAP.

9(h) Investment Company Act. The Company is not an "investment company" or a company "controlled" by an "investment company" within the meaning of the Investment Company Act of 1940, as amended.

9(i) Subsidiaries. Attached hereto as Schedule 9(i) is an accurate and complete list of the Company's direct and indirect Subsidiaries (whether constituting Domestic Subsidiaries or Foreign Subsidiaries), their respective jurisdictions of incorporation and the percentage of their capital stock

owned by the Company or other Subsidiaries or Affiliates of the Company. All of the issued and outstanding shares of capital stock or other equity interests of such Subsidiaries have been duly authorized and issued and are fully paid and non-assessable.

9(j) Federal Reserve Board Regulations. Neither the Company nor any of its Subsidiaries is engaged or will engage, principally or as one of its important activities, in the business of extending credit for the purpose of “purchasing” or “carrying” any “margin stock” within the respective meanings of such terms under Regulation U. No part of the proceeds of any Loan will be used for “purchasing” or “carrying” “margin stock” as so defined or for any purpose which violates, or which would be inconsistent with, the provisions of the Regulations of the Board of Governors of the Federal Reserve System.

9(k) ERISA. The Company and each of its Subsidiaries is in compliance in all respects with the requirements of ERISA and no Reportable Event has occurred under any Plan maintained by the Company or any of its Subsidiaries which is likely to result in the termination of such Plan for purposes of Title IV of ERISA.

9(l) Assets. The Company and each of its Subsidiaries has good and marketable title to all property and assets reflected in the financial statements dated the Statement Date referred to in Paragraph 9(a) above, except property and assets sold or otherwise disposed of in compliance with Paragraph 11(g) below subsequent to the Statement Date. Neither the Company nor any of its Subsidiaries has outstanding Liens on any of its properties or assets nor are there any security agreements to which the Company or any of its Subsidiaries is a party, or title retention agreements, whether in the form of leases or otherwise, of any personal property except as reflected in the financial statements referred to in Paragraph 9(a) above or as permitted under Paragraph 11(a) below.

9(m) Securities Acts. The Company has not issued any unregistered securities in violation of the registration requirements of Section 5 of the Securities Act of 1933, as amended, or any other law, and is not violating any rule, regulation or requirement under the Securities Act of 1933, as amended, or the Securities and Exchange Act of 1934, as amended. The Company is not required to qualify an indenture under the Trust Indenture Act of 1939, as amended, in connection with its execution and delivery of the Loan Documents.

9(n) Consents, Etc. No consent, approval, authorization of, or registration, declaration or filing with any Governmental Authority or any other Person is required on the part of the Company or any of its Subsidiaries in connection with the execution and delivery of the Loan Documents or the performance of or compliance with the terms, provisions and conditions hereof or thereof other than such as have been obtained prior to the Effective Date.

9(o) Copyrights, Patents, Trademarks and Licenses, etc. The Company owns or is licensed or otherwise has the right to use all of the patents, trademarks, service marks, trade names, copyrights, contractual franchises, authorizations and other rights that are reasonably necessary for the operation of its business, without conflict with the rights of any other Person. To the best knowledge of the Company, no slogan or other advertising device, product, process, method, substance, part or other material now employed, or now contemplated to be employed, by the Company infringes upon any rights held by any other Person. Except as specifically disclosed in Schedule 9(f) hereto, no claim or litigation regarding any of the foregoing is pending or, to the knowledge of the Company, threatened, and, to the knowledge of the Company, no patent, invention, device, application, principle or any statute, law, rule, regulation, standard or code is pending or proposed, which, in either case, could, reasonably be expected to have a Material Adverse Effect. Set forth on Schedule 9(g) hereto are all federally registered patents, trademarks and copyrights owned by the Company and each of its Subsidiaries at the Effective Date.

9(p) Hazardous Materials. To the best of its knowledge, the operations of the Company and its Subsidiaries comply substantially, and during the term of this Agreement will at all times comply substantially, in all respects with all applicable Environmental Laws; the Company and each of its Subsidiaries has obtained licenses, permits, authorizations and registrations required under applicable Environmental Law ("Environmental Permits") and necessary for its ordinary operations, all such Environmental Permits are in good standing, and the Company and each of its Subsidiaries is in compliance with all material terms and conditions of such Environmental Permits; neither the Company, any of its Subsidiaries nor any of their respective present properties or operations are subject to any outstanding written order from or agreement with any Governmental Authority nor subject to any judicial or docketed administrative proceeding, respecting any Environmental Law, Environmental Claim or Hazardous Material not previously disclosed; there are no Hazardous Materials or other conditions or circumstances existing, or arising from operations prior to the date of this Agreement, with respect to any property of the Company or any of its Subsidiaries that would reasonably be expected to give rise to Environmental Claims; provided, however, that with respect to property leased from an unrelated third party, the foregoing representation is made to the best knowledge of the Company. In addition, to the best of its knowledge: (1) neither the Company nor any of its Subsidiaries has or maintains any underground storage tanks which are not properly registered or permitted under applicable Environmental Laws or which are leaking or disposing of Hazardous Materials off-site, and (2) the Company and each of its Subsidiaries has notified all of its employees of the existence, if any, of any health hazard arising from the conditions of their employment and have met all notification requirements under Title III of CERCLA and all other applicable Environmental Laws.

9(q) Regulated Entities. Neither the Company nor any of its Subsidiaries is subject to regulation under the Public Utility Holding Company Act of 1935, the Federal Power Act, the Interstate Commerce Act, any state public utilities code, or any other Federal or state statute or regulation limiting its ability to incur Indebtedness.

9(r) Foreign Asset Control Regulations, Etc. Neither the borrowings hereunder nor the use of the proceeds thereof will violate the Trading with the Enemy Act, as amended, or any of the foreign assets control regulations of the United States Treasury Department (31 CFR, Subtitle B, Chapter V, as amended) or the Anti-Terrorism Order or any enabling legislation or executive order relating to any of the same. Without limiting the generality of the foregoing, neither the Company nor any of its Subsidiaries: (1) is or will become a blocked person described in Section 1 of Anti-Terrorism Order, or (2) engages or will engage in any dealings or transactions or be otherwise associated with any such blocked person.

10. Affirmative Covenants. The Company hereby covenants and agrees with the Agent and each Lender that, as long as any Obligations remain unpaid, any Letter of Credit is Outstanding, any Lender has any obligation to make Loans or the L/C Issuing Bank has any obligation to issue Letters of Credit, the Company shall:

10(a) Financial Statements and Reports. Furnish or cause to be furnished to the Agent and to each of the Lenders directly:

(1) Within one hundred five (105) days after the last day of each fiscal year of the Company, audited consolidated and consolidating statements of income and statements of changes in financial position for such year and balance sheets as of the



end of such year presented fairly in accordance with GAAP and accompanied by an unqualified opinion of a nationally recognized firm of independent certified public accountants reasonably acceptable to the Agent;

(2) Within fifty (50) days after the last day of each calendar quarter, Company-prepared statements of income and changes in financial position of the Company on a consolidated and consolidating basis for such quarter and balance sheets as of the end of such quarter presented fairly in accordance with GAAP; and

(3) Concurrently with the delivery of each of the financial statements delivered pursuant to subparagraphs (1) and (2) above: (i) a certificate of a Responsible Financial Officer of the Company, stating that such financial statements are presented fairly in accordance with GAAP, confirming as of the last day of such fiscal period the continuing accuracy and completeness of all representations and warranties of the Company set forth in the Loan Documents or, with respect to any representation and warranty made as of a specific date, the accuracy and completeness as of such date, and that there does not exist a Potential Default or an Event of Default hereunder, (ii) a Compliance Certificate dated as of the date of such financial statements, and (iii) a certificate listing all Material Foreign Subsidiaries of the Company and specifically identifying any Foreign Subsidiaries on such schedule which have become Material Foreign Subsidiaries since the date of the most recent certificate delivered hereunder.

10(b) Other Information. Promptly furnish or cause to be furnished to the Agent (with the Agent providing the same to each of the Lenders) such additional financial and other information, including, without limitation, financial statements of the Company and the Guarantors as the Agent or any Lender (through the Agent) may from time to time reasonably request, including, without limitation, such information as is necessary to enable any Lender to participate out any of its interests in the Loans and other Obligations hereunder or to enable other financial institutions to become signatories hereto.

10(c) Payment of Indebtedness. Itself, and shall cause each of its Subsidiaries to, pay, discharge or otherwise satisfy at or before maturity or before it becomes delinquent, defaulted or accelerated, as the case may be, all its Indebtedness (including taxes), except: (1) Indebtedness being contested in good faith and for which provision is made to the satisfaction of the Agent for the payment thereof in the event the Company or such Subsidiary is found to be obligated to pay such Indebtedness and which Indebtedness is thereupon promptly paid by the Company or such Subsidiary, and (2) Subordinated Debt not permitted to be paid pursuant to the terms of any applicable subordination agreement.

10(d) Maintenance of Existence and Properties. Itself, and shall cause each of its Subsidiaries to, maintain its corporate or other such existence as a legal entity and maintain all rights, privileges, licenses, approvals, franchises, properties and assets necessary or desirable in the normal conduct of its business, and comply with all Contractual Obligations and Requirements of Law the failure to comply with which could have a Material Adverse Effect on the business, operations, assets or financial or other condition of the Company or the Company and its Subsidiaries taken as a whole.

10(e) Inspection of Property; Books and Records; Discussions. Itself, and shall cause each of its Subsidiaries to, keep proper books of record and account in which full, true and correct entries in conformity with GAAP and all Requirements of Law the failure to comply with which could have a Material Adverse Effect on the business, operations, assets or financial or other condition of the Company or the Company and its Subsidiaries taken as a whole shall be made of all dealings and

transactions in relation to its business and activities, and permit representatives of the Agent or any Lender to visit and inspect any of its properties and examine and make abstracts from any of its books and records at any reasonable time and as often as may reasonably be desired by the Agent or any Lender and to discuss the business, operations, properties and financial and other condition of the Company and any of its Subsidiaries with officers and employees of such parties, and with their independent certified public accountants.

10(f) Notices. Promptly give written notice to the Agent (with the Agent providing the same to each of the Lenders) of:

(1) The occurrence of any Potential Default or Event of Default;

(2) Any litigation or proceeding in which the Company or any its Subsidiaries is the defendant or in which the Company or any its Subsidiaries is otherwise at financial risk involving amounts in excess of \$250,000.00 in the aggregate; and

(3) Any other event constituting a material adverse change in the business, operations, property or financial or other condition of the Company or the Company and its Subsidiaries taken as a whole.

10(g) Expenses. Pay all reasonable out-of-pocket expenses (including fees and disbursements of counsel): (1) of the Agent incident to the preparation, negotiation and administration of the Loan Documents and the protection of the rights of the Lenders and the Agent under the Loan Documents, and (2) of the Agent and, following the occurrence of an Event of Default, each of the Lenders incident to the enforcement of payment of the Obligations, whether by judicial proceedings or otherwise, including, without limitation, in connection with bankruptcy, insolvency, liquidation, reorganization, moratorium or other similar proceedings involving the Company or a “workout” of the Obligations. The obligations of the Company under this Paragraph 10(g) shall be effective and enforceable whether or not any Loan is funded or any Letter of Credit is issued or hereunder and shall survive payment of all other Obligations.

10(h) Loan Documents. Comply with and observe all terms and conditions of the Loan Documents.

10(i) Insurance. Obtain and maintain insurance with responsible companies in such amounts and against such risks as are usually carried by corporations engaged in similar businesses similarly situated, and furnish any of the Lenders on request (made through the Agent) full information as to all such insurance.

10(j) Hazardous Materials. Itself, and shall cause each of its Subsidiaries to:

(1) Conduct its operations and keep and maintain all its Properties in compliance with all applicable Environmental Laws.

(2) Give prompt written notice to the Agent, but in no event later than ten days after becoming aware thereof, of the following: (i) any enforcement, cleanup, removal or other governmental or regulatory actions instituted, completed or threatened against the Company or any of its Affiliates or any of their respective properties pursuant to any applicable Environmental Laws, (ii) all other Environmental

Claims, and (iii) any environmental or similar condition on any real property adjoining or in the vicinity of the property of the Company or its Affiliates that could reasonably be anticipated to cause such property or any part thereof to be subject to any restrictions on the ownership, occupancy, transferability or use of such property under any Environmental Laws.

(3) Upon the written request of the Agent, submit to the Agent, at the Company's sole cost and expense, at reasonable intervals, a report providing an update of the status of any environmental, health or safety compliance, hazard or liability issue identified in any notice required pursuant to this section.

(4) At all times indemnify and hold harmless the Agent and the Lenders from and against all liability arising out of any Environmental Claims, except those Environmental Claims caused as a primary and direct result of the gross negligence or willful misconduct of the Agent or any of the Lenders.

10(k) ERISA. Furnish to the Agent:

(1) Promptly and in any event within thirty (30) days after the Company knows or has reason to know of the occurrence of a Reportable Event with respect to a Plan with regard to which notice must be provided to the PBGC, a copy of such materials required to be filed with the PBGC with respect to such Reportable Event and in each such case a statement of a Responsible Financial Officer of the Company setting forth details as to such Reportable Event and the action which the Company proposes to take with respect thereto;

(2) Promptly and in any event within thirty (30) days after the Company knows or has reason to know of any condition existing with respect to a Plan which presents a material risk of termination of the Plan, imposition of an excise tax, requirement to provide security to the Plan or incurrence of other liability by the Company or any ERISA Affiliate, a statement of a Responsible Financial Officer of the Company describing such condition;

(3) At least ten (10) days prior to the filing by an plan administrator of a Plan of a notice of intent to terminate such Plan, a copy of such notice;

(4) Promptly and in no event more than thirty (30) days after the filing thereof with the Secretary of the Treasury, a copy of any application by the Company or an ERISA Affiliate for a waiver of the minimum funding standard under Section 412 of the Code;

(5) Promptly and in any event within thirty (30) days after the Company knows or has reason to know of any event or condition which might constitute grounds under section 4042 of ERISA for the termination of, or the appointment of a trustee to administer, any Plan, a statement of a Responsible Financial Officer of the Company describing such event or condition;

(6) Promptly and in no event more than thirty (30) days after receipt thereof by the Company or any ERISA Affiliate, a copy of each notice received by the Company or an ERISA Affiliate concerning the imposition of any withdrawal liability under section 4202 of ERISA; and

(7) Promptly after receipt thereof a copy of any notice the Company or any ERISA Affiliate may receive from the PBGC or the Internal Revenue Service with respect to any Plan or Multiemployer Plan; provided, however, that this subparagraph (7) shall not apply to notices of general application promulgated by the PBGC or the Internal Revenue Service.

10(l) Compliance with Laws. Itself, and shall cause each of its Subsidiaries to, comply, in all material respects with all Requirements of Law and Contractual Obligations the failure to comply with which could have a Material Adverse Effect on the business, operations, assets or financial or other condition of the Company or the Company and its consolidated Subsidiaries taken as a whole.

11. Negative Covenants. The Company hereby covenants and agrees with the Agent and each Lender that, as long as any Obligations remain unpaid, any Letter of Credit is Outstanding, any Lender has any obligation to make Loans or the L/C Issuing Bank has any obligation to issue Letters of Credit, the Company shall not, directly or indirectly:

11(a) Liens. And shall not permit any Subsidiary to, create, incur, assume or suffer to exist any Lien upon any of its property and assets except:

(1) Liens or charges for current taxes, assessments or other governmental charges which are not delinquent or which remain payable without penalty, or the validity of which are contested in good faith by appropriate proceedings upon stay of execution of the enforcement thereof, provided the Company or such Subsidiary, as applicable, shall have set aside on its books and shall maintain adequate reserves for the payment of same in conformity with GAAP;

(2) Liens, deposits or pledges made to secure statutory obligations, surety or appeal bonds, or bonds to obtain, or to obtain the release of, attachments, writs of garnishment or for stay of execution, or to secure the performance of bids, tenders, contracts (other than for the payment of borrowed money), leases or for purposes of like general nature in the ordinary course of the business of the Company or such Subsidiary;

(3) Purchase money security interests for property hereafter acquired, conditional sale agreements, or other title retention agreements, with respect to property hereafter acquired; provided, however, that no such security interest or agreement shall extend to any property other than the property acquired;

(4) Statutory Liens of landlord's, carriers, warehousemen, mechanics, materialmen and other similar Liens imposed by law and created in the ordinary course of business for amounts not yet due or which are being contested in good faith by appropriate proceedings and with respect to which adequate reserves are being maintained in conformity with GAAP;

(5) Attachment and judgment Liens not otherwise constituting an Event of Default any of which Liens are in existence less than thirty (30) days after the entry thereof or with respect to which execution has been stayed, payment is covered in full by insurance, or the Company or such Subsidiary shall in good faith be prosecuting an appeal or proceedings for review and shall have set aside on its books such reserves as may be required by GAAP with respect to such judgment or award; and

(6) Liens securing Indebtedness permitted to be incurred as secured Indebtedness pursuant to subparagraphs (5), (6) and (7) of Paragraph 11(b) below; provided, however, that in no event shall any such Liens affect the Collateral or any portion thereof and, provided further, that in no event shall any Liens be permitted on the outstanding capital stock or other equity interests in any of the Foreign Subsidiaries other than in favor of the Agent for the benefit of the Lenders.

11(b) Indebtedness. And shall not permit any Subsidiary to, create, incur, assume or suffer to exist, or otherwise become or be liable in respect of any Indebtedness except:

(1) The Obligations;

(2) Indebtedness reflected in the financial statements referred to in Paragraph 9(a) above;

(3) Trade debt incurred in the ordinary course of business;

(4) Indebtedness secured by Liens permitted under Paragraph 11(a) (other than subparagraph (6) thereof) above;

(5) Secured and unsecured Indebtedness of the Company and its Domestic Subsidiaries in amount not to exceed \$10,000,000.00 in the aggregate incurred during the course of any single fiscal year of the Company;

(6) Secured and unsecured Indebtedness of Foreign Subsidiaries of the Company incurred in the ordinary course of business; provided, however, that in no event shall secured and unsecured Debt of Foreign Subsidiaries of the Company at any date be in an amount which, when added (without duplication) to liabilities of Foreign Subsidiaries of the Company relating to Debt outstanding pursuant to subparagraph (7) below, exceed \$45,000,000.00 in Equivalent Amount of Dollars outstanding at any date;

(7) Secured and unsecured Indebtedness of Foreign Subsidiaries of the Company in the nature of guaranties and other contingent and recourse obligations of Indebtedness of other Foreign Subsidiaries permitted pursuant to subparagraph 6 above; provided, however, that in no event shall guaranties and other contingent and recourse obligations of Debt of other Foreign Subsidiaries of the Company at any date be in an amount which, when added (without duplication) to Debt of Foreign Subsidiaries of the Company outstanding pursuant to subparagraph (6) above, exceed \$45,000,000.00 in Equivalent Amount of Dollars outstanding at any date; and

(8) Unsecured Indebtedness in the nature of guaranties and other contingent recourse obligations of the Company and its Domestic Subsidiaries relating to Indebtedness permitted pursuant to subparagraph (6) above; provided, that the contingent obligations of the Company and its Domestic Subsidiaries thereunder shall not exceed \$5,000,000.00 in the aggregate at any date.

11(c) Merger, Etc. And shall not permit any Subsidiary to, dissolve, merge or consolidate with any Person or permit any Person to merger into it, except that:

(1) Any Subsidiary of the Company may merge into or consolidate with the Company so long as the surviving Person is the Company;

(2) Any Domestic Subsidiary of the Company may merge into or consolidate with another Domestic Subsidiary of the Company, so long as the surviving Person is a wholly-owned Domestic Subsidiary of the Company; and

(3) Any Foreign Subsidiary of the Company may merge into or consolidate with another Foreign Subsidiary of the Company, so long as the surviving Person is a wholly-owned Foreign Subsidiary of the Company;

provided, however, that as a condition precedent to any transaction set forth in subparagraphs (1) through (3) above, the Company shall have delivered in writing to the Agent evidence satisfactory to the Agent, including, without limitation, pro forma financial projections in form and detail satisfactory to the Agent, that both before and immediately after giving effect to such transaction there shall not exist any Event of Default or Potential Default.

11(d) Acquisitions. And shall not permit any Subsidiary to, purchase or acquire or incur liability for the purchase or acquisition of any or all of the assets or business of any Person other than Permitted Acquisitions

11(e) Payment of Dividends. Declare or pay any dividends upon its shares of stock now or hereafter outstanding or make any distribution of assets to its stockholders as such, whether in cash, property or securities.

11(f) Purchase or Retirement of Stock. Acquire, purchase, redeem or retire any shares of its capital stock now or hereafter outstanding unless at the date thereof there does not exist an Event of Default or Potential Default and the aggregate value of shares of the capital stock of the Company acquired, purchased, redeemed, or retired by the Company during the then current fiscal year is not in excess of \$15,000,000.00.

11(g) Sale of Assets. And shall not permit any Subsidiary to, sell, lease, assign, transfer or otherwise dispose of any of its assets (other than obsolete or worn out property), whether now owned or hereafter acquired and whether in connection with the transfer, spin off or restructure of a portion of the business of such Person or otherwise, other than:

(1) Sales of inventory in the ordinary course of business as presently conducted and at fair market value;

(2) Transfers of assets of Foreign Subsidiaries to the Company and its Domestic Subsidiaries; and

(3) Other transfers of assets by the Company or any of its Domestic Subsidiaries to Foreign Subsidiaries of the Company (other than assets consisting of accounts receivable or other rights to the payment of money which may in no event be sold, assigned or transferred to Foreign Subsidiaries) so long as: (i) no Potential Default

or Event of Default exists at the time of such transfer or would occur after giving effect to such transfer and (ii) all such transfers made after the Effective Date do not, in the aggregate, involve: (y) tangible and intangible assets having a net book value in excess of twenty five percent (25%) of the net book value of all tangible and intangible assets of the Company and the Domestic Subsidiaries at and as of December 31, 2004, or (z) tangible assets having net book value in excess of fifteen percent (15%) of the net book value of all tangible assets of the Company and the Domestic Subsidiaries at and as of December 31, 2004, in each case as determined by the Agent in its reasonable business judgment with reference to the consolidating financial statements of the Company and the Domestic Subsidiaries dated as of such date.

11(h) Relocation of Assets. And shall not permit any of its Domestic Subsidiaries to change the physical location of any of its assets to a jurisdiction outside of the United States of America without prior notice to the Agent and the consent of the Agent, such consent not to be unreasonably withheld or delayed.

11(i) Financial Covenants.

(1) Permit the Company's consolidated Effective Tangible Net Worth, as of the end of each fiscal quarter of the Company beginning with the fiscal quarter ending December 31, 2004, to be less than the sum of (i) \$135,000,000.00 plus (ii) 75% of the Company's consolidated net profit after taxes, determined in accordance with GAAP (if positive and with no reduction in the event of loss), for the fiscal quarter ending December 31, 2004 and, thereafter, for each fiscal quarter thereafter.

(2) Permit, when measured as of the end of any fiscal quarter, the Company's Leverage Ratio, to be greater than 2.50:1.00.

(3) Permit, when measured as of any date, the Company's ratio of consolidated current assets to consolidated current liabilities, determined in accordance with GAAP, to be less than 1.25:1.00.

(4) Permit, when measured as of the end of any fiscal quarter, the Company's consolidated net profit after taxes for such fiscal quarter determined in accordance with GAAP, to be less than \$1.00.

(5) Permit, when measured as of the end of any fiscal quarter, the ratio of:

(i) The sum of: (y) Adjusted EBITDA minus (z) consolidated Capital Expenditures (other than Capital Expenditures financed through the incurrence of Indebtedness) for such fiscal quarter and the immediately preceding three fiscal quarters, to

(ii) The sum of the Company's consolidated (w) cash interest expense (determined in accordance with GAAP) for such fiscal quarter and the immediately preceding three fiscal quarters minus cash interest income for such fiscal quarter and the immediately preceding three fiscal quarters, plus (x) net cash tax expense (determined in accordance with GAAP) for such fiscal quarter and the immediately preceding three fiscal quarters, plus (y) current portion of

long term debt (determined in accordance with GAAP) for such fiscal quarter, plus (z) the current portion of capitalized lease obligations (determined in accordance with GAAP) for such fiscal quarter,

to be less than: (A) 1.25:1.00 for any fiscal quarter ending on or prior to March 31, 2006 and (B) 1.50:1.00 for any fiscal quarter ending on or after June 30, 2006.

11(j) Investments and Loans. And shall not permit any Subsidiary to, following the Effective Date, make or commit to make any advance, loan or extension of credit or capital contribution to, or purchase any stock, bonds, notes, debentures or other securities of, or make any other investment in, any Person, except Permitted Investments.

11(k) Change in Business. And shall not permit any Subsidiaries to, make any change in the principal nature of their respective businesses.

11(l) Transactions with Affiliates. And shall not permit any Subsidiaries to, make any payment to, or sell, lease, transfer or otherwise dispose of any of its properties or assets to, or purchase any property or assets from, or enter into or make or amend any contract, agreement, understanding, loan, advance or guarantee with, or for the benefit of, any Affiliate (each of the foregoing, an "Affiliate Transaction"), unless such Affiliate Transaction is on terms that are no less favorable to the Company or the relevant Subsidiary than those that would have been obtained in a comparable transaction by the Company or such Subsidiary with an unrelated Person.

12. Events of Default. Upon the occurrence of any of the following events (an "Event of Default"):

12(a) The Company shall fail to pay any principal on the Loans, any L/C Drawing, or pay any Obligations in connection with any FX Transaction on the date when due, or fail to pay within five days of the date when due any other Obligation under the Loan Documents; or

12(b) Any representation or warranty made by the Company in any Loan Document shall be inaccurate or incomplete in any material respect on or as of the date made; or

12(c) The Company shall fail to maintain its corporate existence or shall default in the observance or performance of any covenant or agreement contained in Paragraph 11 above; or

12(d) The Company shall fail to observe or perform any other term or provision contained in the Loan Documents and such failure shall continue for thirty (30) days; or

12(e) (1) The Company or any of its Subsidiaries shall default in any payment of principal of or interest on any Indebtedness (other than the Obligations), or (2) any Person shall default in the payment of any Indebtedness upon which the Company or any of its Subsidiaries is contingently liable, or (3) any other event shall occur, the effect of which is to permit such Indebtedness to be declared or otherwise to become due prior to its stated maturity; or

12(f) (1) The Company, any of its Subsidiaries, or any Guarantor shall commence any case, proceeding or other action (i) under any existing or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization or relief of debtors, seeking to have an order for relief entered with respect to it, or seeking to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other relief



with respect to it or its debts, or (ii) seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its assets, or the Company, any of its Subsidiaries, or any Guarantor shall make a general assignment for the benefit of its creditors; or (2) there shall be commenced against the Company, any of its Subsidiaries, or any Guarantor, any case, proceeding or other action of a nature referred to in clause (1) above which (i) results in the entry of an order for relief or any such adjudication or appointment, or (ii) remains undismissed, undischarged or unbonded for a period of thirty (30) days; or (3) there shall be commenced against the Company, any of its Subsidiaries, or any Guarantor, any case, proceeding or other action seeking issuance of a warrant of attachment, execution, distraint or similar process against all or substantially all of its assets which results in the entry of an order for any such relief which shall not have been vacated, discharged, stayed, satisfied or bonded pending appeal within sixty (60) days from the entry thereof; or (4) the Company, any of its Subsidiaries, or any Guarantor, shall take any action in furtherance of, or indicating its consent to, approval of, or acquiescence in (other than in connection with a final settlement), any of the acts set forth in clause (1), (2) or (3) above; or (5) the Company, any of its Subsidiaries, or any Guarantor, shall generally not, or shall be unable to, or shall admit in writing its inability to pay its debts as they become due; or

12(g) (1) Any Person shall engage in any “prohibited transaction” (as defined in Section 406 of ERISA or Section 4975 of the Code) involving any Plan, (2) any “accumulated funding deficiency” (as defined in Section 302 of ERISA), whether or not waived, shall exist with respect to any Plan, (3) a Reportable Event shall occur with respect to, or proceedings shall commence to have a trustee appointed, or a trustee shall be appointed, to administer or to terminate, any Single Employer Plan, which Reportable Event or institution of proceedings is, in the reasonable opinion of the Agent, likely to result in the termination of such Plan for purposes of Title IV of ERISA, and, in the case of a Reportable Event, the continuance of such Reportable Event unremedied for ten days after notice of such Reportable Event pursuant to Section 4043(a), (c) or (d) of ERISA is given or the continuance of such proceedings for ten days after commencement thereof, as the case may be, (4) any Single Employer Plan shall terminate for purposes of Title IV of ERISA, (5) any withdrawal liability to a Multiemployer Plan shall be incurred by the Company or (6) any other event or condition shall occur or exist; and in each case in clauses (1) through (6) above, such event or condition, together with all other such events or conditions, if any, is likely to subject the Company or any of its Subsidiaries to any tax, penalty or other liabilities in the aggregate material in relation to the business, operations, property or financial or other condition of the Company or the Company and its Subsidiaries taken as a whole; or

12(h) One or more judgments or decrees shall be entered against the Company or any of its Subsidiaries and such judgments or decrees shall not have been vacated, discharged, stayed, satisfied or bonded pending appeal within thirty (30) days from the entry thereof;

12(i) Any Guarantor shall fail to observe or perform any provision of any Loan Document to which it is a party or shall attempt to rescind or revoke any Loan Document to which it is a party, with respect to future transactions or otherwise, or any representation or warranty set forth in any Loan Document to which any Guarantor is party shall be inaccurate or incomplete in any material respect as of the date made; or

12(j) There shall occur a Change of Control;

THEN, automatically upon the occurrence of an Event of Default under Paragraph 12(f) above, at the option of any Lender upon the occurrence of an Event of Default under Paragraph 12(a) above and, in all other cases, at the option of the Majority Lenders, each Lender’s obligation to make Loans and the L/C Issuing Bank’s obligation to issue Letters of Credit with the Company hereunder shall terminate and the principal balance of outstanding Loans and interest accrued but unpaid thereon and the aggregate

contingent liability of the Company to reimburse the L/C Issuing Bank and the Lenders for future L/C Drawings with respect to Outstanding Letters of Credit and the aggregate contingent liability of the Company to make any payment with respect to FX Obligations and all other Obligations shall become immediately due and payable, without demand upon or presentment to the Company, which are expressly waived by the Company and the Agent and the Lenders may immediately exercise all rights, powers and remedies available to them at law, in equity or otherwise. All amounts paid by the Company on account of the aggregate contingent liability of the Company under Outstanding Letters of Credit and outstanding FX Transactions shall be held by the Agent as collateral security for the benefit of the L/C Issuing Bank, the Lenders, and the FX Provider until there are no Letters of Credit Outstanding, all unrepaid L/C Drawings have been paid in full with interest thereon as provided herein, and all FX Transactions have matured and all FX Obligations have been paid in full, the Company hereby being automatically deemed to have granted to the Agent, the L/C Issuing Bank, the Lenders and the FX Provider a first priority, perfected security interest in all such monies and to have authorized the Agent to debit such monies in satisfaction of the obligation of the Company to repay L/C Drawings and Obligations connected with FX Transactions; provided, that, nothing contained herein shall in any manner or to any extent affect the liability of the Company with respect to L/C Drawings or FX Transactions in the event for whatever reason the Agent does not so debit such monies on account thereof.

13. The Agent.

13(a) Appointment. Each Lender hereby irrevocably designates and appoints the Agent as the agent of such Lender under the Loan Documents and each such Lender hereby irrevocably authorizes the Agent, as the agent for such Lender, to take such action on its behalf under the provisions of the Loan Documents and to exercise such powers and perform such duties as are expressly delegated to the Agent by the terms of the Loan Documents, together with such other powers as are reasonably incidental thereto. Notwithstanding any provision to the contrary elsewhere in the Loan Documents, the Agent shall not have any duties or responsibilities, except those expressly set forth herein or therein, or any fiduciary relationship with any Lender, and no implied covenants, functions, responsibilities, duties, obligations or liabilities shall be read into the Loan Documents or otherwise exist against the Agent. The Company shall pay to the Agent an agency fee in such amount and at such times as the Agent and the Company may from time to time agree in writing.

13(b) Delegation of Duties. The Agent may execute any of its duties under the Loan Documents by or through agents or attorneys-in-fact and shall be entitled to advice of counsel concerning all matters pertaining to such duties. The Agent shall not be responsible for the negligence or misconduct of any agents or attorneys-in-fact selected by it with reasonable care.

13(c) Exculpatory Provisions. Neither the Agent nor any of its officers, directors, employees, agents, attorneys-in-fact or Affiliates shall be (1) liable for any action lawfully taken or omitted to be taken by it or such Person under or in connection with the Loan Documents (except for its or such Person's own gross negligence or willful misconduct), or (2) responsible in any manner to any of the Lenders for any recitals, statements, representations or warranties made by the Company or any officer thereof contained in the Loan Documents or in any certificate, report, statement or other document referred to or provided for in, or received by the Agent under or in connection with the Loan Documents or for the value, validity, effectiveness, genuineness, enforceability or sufficiency of the Loan Documents or for any failure of the Company to perform its obligations hereunder. The Agent shall not be under any obligation to any Lender to ascertain or to inquire as to the observance or performance of any of the agreements contained in, or conditions of, the Loan Documents or to inspect the properties, books or records of the Company.

13(d) Reliance by Agent. The Agent shall be entitled to rely, and shall be fully protected in relying, upon any note, writing, resolution, notice, consent, certification, affidavit, letter, cablegram, telegram, telecopy, telex or teletype message, statement, order or other document or conversation reasonably believed by it to be genuine and correct and to have been signed, sent or made by the proper Person or Persons and upon advice and statements of legal counsel (including, without limitation, counsel to the Company), independent accountants and other experts selected by the Agent. The Agent may deem and treat the payee of any note as the owner thereof for all purposes. As to the Lenders: (1) the Agent shall be fully justified in failing or refusing to take any action under the Loan Documents unless it shall first receive such advice or concurrence of the Majority Lenders or all of the Lenders, as appropriate, or it shall first be indemnified to its satisfaction by the Lenders ratably in accordance with their respective Percentage Shares against any and all liability and expense which may be incurred by it by reason of taking or continuing to take any action (except for liabilities and expenses resulting from the Agent's gross negligence or willful misconduct), and (2) the Agent shall in all cases be fully protected in acting, or in refraining from acting, under the Loan Documents in accordance with a request of the Majority Lenders or all of the Lenders, as appropriate, and such request and any action taken or failure to act pursuant thereto shall be binding upon all the Lenders.

13(e) Notice of Default. The Agent shall not be deemed to have knowledge or notice of the occurrence of any Potential Default or Event of Default hereunder unless the Agent has received notice from a Lender or the Company referring to the Loan Documents, describing such Potential Default or Event of Default and stating that such notice is a "notice of default." In the event that the Agent receives such a notice, the Agent shall give notice thereof to the Lenders. The Agent shall take such action with respect to such Potential Default or Event of Default as shall be reasonably directed by the Majority Lenders provided that such action is consistent with the provisions of this Agreement; provided that, unless and until the Agent shall have received such directions, the Agent may (but shall not be obligated to) take such action, or refrain from taking such action, with respect to such Potential Default or Event of Default as it shall deem advisable in the best interest of the Lenders.

13(f) Non-Reliance on Agent and Other Lenders. Each Lender expressly acknowledges that neither the Agent nor any of its officers, directors, employees, agents, attorneys-in-fact or Affiliates has made any representations or warranties to it and that no act by the Agent hereinafter taken, including any review of the affairs of the Company, shall be deemed to constitute any representation or warranty by the Agent to any Lender. Each Lender represents to the Agent that it has, independently and without reliance upon the Agent or any other Lender, and based on such documents and information as it has deemed appropriate, made its own appraisal of and investigation into the business, operations, property, financial and other condition and creditworthiness of the Company and made its own decision to make its loans hereunder and enter into this Agreement. Each Lender also represents that it will, independently and without reliance upon the Agent or any other Lender, and based on such documents and information as it shall deem appropriate at the time, continue to make its own credit analysis, appraisals and decisions in taking or not taking action under this Agreement, and to make such investigation as it deems necessary to inform itself as to the business, operations, property, financial and other condition and creditworthiness of the Company. Except for notices, reports and other documents expressly required to be furnished to the Lenders by the Agent hereunder, the Agent shall not have any duty or responsibility to provide any Lender with any credit or other information concerning the business, operations, property, financial and other condition or creditworthiness of the Company which may come into the possession of the Agent or any of its officers, directors, employees, agents, attorneys-in-fact or Affiliates.

13(g) Indemnification. The Lenders agree to indemnify the Agent in its capacity as such (to the extent not reimbursed by the Company and without limiting the obligation of the Company

to do so), ratably according to the respective amounts of their Percentage Shares, from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements of any kind whatsoever which may at any time (including without limitation at any time following the payment of the Obligations) be imposed on, incurred by or asserted against the Agent in any way relating to or arising out of the Loan Documents or any documents contemplated by or referred to herein or the transactions contemplated hereby or any action taken or omitted by the Agent under or in connection with any of the foregoing; provided that no Lender shall be liable for the payment of any portion of such liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements resulting from the Agent's gross negligence or willful misconduct. The agreements in this subsection shall survive the payment of the Obligations.

13(h) Agent in Its Individual Capacity. The Agent and its Affiliates may make loans to, accept deposits from and generally engage in any kind of business with the Company as though the Agent were not the Agent hereunder. With respect to such loans made or renewed by them, the Agent shall have the same rights and powers under the Loan Documents as any Lender and may exercise the same as though it were not the Agent, and the terms "Lender" and "Lenders" shall include the Agent in its individual capacity.

13(i) Successor Agent. The Agent may resign as Agent under the Loan Documents upon sixty (60) days' notice to the Lenders and agrees that it will so resign in the event it ceases to hold any Percentage Share of the Obligations. If the Agent shall resign as provided herein, then the Lenders (other than the Agent) shall appoint from among the Lenders a successor agent or, if such Lenders are unable to agree on the appointment of a successor agent, the Agent shall appoint a successor agent for the Lenders (which successor agent shall, in either case and assuming that there does not exist a Potential Default or Event of Default, be reasonably acceptable to the Company), whereupon such successor agent shall succeed to the rights, powers and duties of the Agent, and the term "Agent" shall mean such successor agent effective upon its appointment, and the former Agent's rights, powers and duties as Agent shall be terminated, without any other or further act or deed on the part of such former Agent or any of the parties to this Agreement or any of the Loan Documents or successors thereto. After any retiring Agent's resignation hereunder as Agent, the provisions of this Paragraph 13 shall inure to its benefit as to any actions taken or omitted to be taken by it while it was Agent under the Loan Documents.

#### 14. Miscellaneous Provisions.

14(a) No Assignment. The Company may not assign its rights or obligations under this Agreement without the prior written consent of one hundred percent (100%) of the Agent and the Lenders. Any attempted assignment in violation of this provision shall automatically be deemed null and void. Subject to the foregoing, all provisions contained in this Agreement or any document or agreement referred to herein or relating hereto shall inure to the benefit of each Lender, its successors and assigns, and shall be binding upon the Company, its successors and assigns.

14(b) Amendment. This Agreement may not be amended or terms or provisions hereof waived unless such amendment or waiver is in writing and signed by the Majority Lenders, the Agent and the Company; provided, however, that without the prior written consent of one hundred percent (100%) of the Agent and the Lenders, no amendment or waiver shall: (1) reduce the principal of, or rate of interest or fees on, the Loans or any Letter of Credit or extend or otherwise modify the required amount or due date for any Loan or any L/C Drawing, (2) modify any Lender's Percentage Share (except as the result of an assignment permitted under Paragraph 14(h)(1) below), (3) modify any provision of the Loan Documents requiring one hundred percent (100%) of the Lenders to act, (4) modify the definition of "Majority Lenders," (5) release any Guarantor from its obligations under its Guaranty or

Guarantor Security Agreement or, except as expressly contemplated by the Loan Documents, release any collateral at any time held for the Obligations, (6) amend this Paragraph 14(b) or (7) increase or extend any of the Lenders' commitments to provide Loans, Letters of Credit or other financing hereunder. It is expressly agreed and understood that the failure by the required Lenders to elect to accelerate amounts outstanding hereunder and/or to terminate the obligation of the Lenders to make Loans or the L/C Issuing Bank to issue Letters of Credit with the Company hereunder shall not constitute an amendment or waiver of any term or provision of this Agreement.

14(c) Cumulative Rights; No Waiver. The rights, powers and remedies of the Lenders hereunder are cumulative and in addition to all rights, power and remedies provided under any and all agreements between the Company and the Lenders relating hereto, at law, in equity or otherwise. Any delay or failure by the Lenders to exercise any right, power or remedy shall not constitute a waiver thereof by the Lenders, and no single or partial exercise by the Lenders of any right, power or remedy shall preclude other or further exercise thereof or any exercise of any other rights, powers or remedies.

14(d) Entire Agreement. This Agreement and the documents and agreements referred to herein embody the entire agreement and understanding between the parties hereto and supersede all prior agreements and understandings relating to the subject matter hereof and thereof.

14(e) Survival. All representations, warranties, covenants and agreements herein contained on the part of the Company shall survive the termination of this Agreement and shall be effective until the Obligations are paid and performed in full or longer as expressly provided herein.

14(f) Notices. All notices given by any party to the others shall be in writing unless otherwise provided for herein, delivered by facsimile transmission, by personal delivery or by overnight courier, addressed to the party as set forth on Annex 2 attached hereto, as such Annex 2 may be amended from time to time. Any party may change the address to which notices are to be sent by notice of such change to each other party given as provided herein. Such notices shall be effective on the date received.

14(g) Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California without giving effect to its choice of law rules.

14(h) Assignments, Participations, Etc.

(1) Any Lender may at any time, with the consent of the Agent and, but only so long as there does not exist an Event of Default, the Company (which consent shall not be unreasonably withheld by the Company), assign and delegate to one or more financial institutions (each an "Assignee") all, or any ratable part of all, of the Loans and the other rights and obligations of such Lender hereunder in a minimum amount of \$5,000,000.00; provided, however, that the Company and the Agent may continue to deal solely and directly with such Lender in connection with the interest so assigned to an Assignee until (i) written notice of such assignment, together with payment instructions, addresses and related information with respect to the Assignee, shall have been given to the Company and the Agent by such Lender and the Assignee; (ii) such Lender and its Assignee shall have delivered to the Company and the Agent an Assignment and Acceptance Agreement; and (iii) the Assignee has paid to the Agent a processing fee in the amount of \$3,500.00. From and after the date that the Agent notifies the assignor Lender that it has received an executed Assignment and Acceptance Agreement, (y) the Assignee thereunder shall be a party hereto and, to the extent that rights and obligations hereunder and under the other Loan Documents have been

assigned to it pursuant to such Assignment and Acceptance Agreement, shall have the rights and obligations of a Lender under the Loan Documents, and (z) the assignor Lender shall, to the extent that rights and obligations hereunder and under the other Loan Documents have been assigned by it pursuant to such Assignment and Acceptance Agreement, relinquish its rights and be released from its obligations under the Loan Documents. Upon the effective date of such assignment, this Agreement and the other Loan Documents shall be deemed to be amended to the extent, but only to the extent, necessary to reflect the addition of the Assignee and the resulting adjustment of the Percentage Share arising therefrom.

(2) Any Lender may at any time sell to one or more financial institutions or other Persons (each a "Participant") participating interests in any Loans, the funding commitment of that Lender and the other interests of that Lender (the "originating Lender") hereunder and under the other Loan Documents; provided, however, that (i) the originating Lender's obligations under this Agreement shall remain unchanged, (ii) the originating Lender shall remain solely responsible for the performance of such obligations, (iii) the Company and the Agent shall continue to deal solely and directly with the originating Lender in connection with the originating Lender's rights and obligations under this Agreement and the other Loan Documents, (iv) following such sale that Lender shall continue to hold for its own account a Percentage Share of the Aggregate Credit Limit of not less than \$5,000,000.00 and (v) the terms of any documentation governing such participation shall not provide for such Participant to have any voting rights on any amendments to the Credit Agreement or other Loan Documents other than any such amendment which purports to (A) forgive principal of, or interest on any Loan, (B) postpone any date fixed for the payment of principal of or interest on, any Loan, (C) decrease the rates at which interest or fees are payable under the Credit Agreement or (D) release all or substantially all of the Collateral.

(3) Notwithstanding any other provision contained in this Agreement or any other Loan Document to the contrary, any Lender may assign all or any portion of the Loans held by it to any Federal Reserve Lender or the United States Treasury as collateral security pursuant to Regulation A of the Board of Governors of the Federal Reserve System and any Operating Circular issued by such Federal Reserve Lender.

14(i) Counterparts. This Agreement and the other Loan Documents may be executed in any number of counterparts, all of which together shall constitute one agreement.

14(j) Sharing of Payments. If any Lender shall receive and retain any payment, whether by setoff, application of deposit balance or security, or otherwise, in respect of the Obligations in excess of such Lender's Percentage Share thereof, then such Lender shall purchase from the other Lenders for cash and at face value and without recourse, such participation in the Obligations held by them as shall be necessary to cause such excess payment to be shared ratably as aforesaid with each of them; provided, that if such excess payment or part thereof is thereafter recovered from such purchasing Lender, the related purchases from the other Lenders shall be rescinded ratably and the purchase price restored as to the portion of such excess payment so recovered, but without interest. Each Lender is hereby authorized by the Company to exercise any and all rights of setoff, counterclaim or bankers' lien against the full amount of the Obligations, whether or not held by such Lender. Each Lender hereby agrees to exercise any such rights first against the Obligations and only then to any other Indebtedness of the Company to such Lender.

14(k) Consent to Jurisdiction. ANY LEGAL ACTION OR PROCEEDING WITH RESPECT TO THIS AGREEMENT OR ANY OTHER LOAN DOCUMENT MAY BE BROUGHT IN THE COURTS OF THE STATE OF CALIFORNIA OR OF THE UNITED STATES FOR THE CENTRAL DISTRICT OF CALIFORNIA, AND BY EXECUTION AND DELIVERY OF THIS AGREEMENT, EACH OF THE COMPANY, THE AGENT AND THE LENDERS CONSENTS, FOR ITSELF AND IN RESPECT OF ITS PROPERTY, TO THE NON-EXCLUSIVE JURISDICTION OF THOSE COURTS. EACH OF THE COMPANY, THE AGENT AND THE LENDERS IRREVOCABLY WAIVES ANY OBJECTION, INCLUDING ANY OBJECTION TO THE LAYING OF VENUE OR BASED ON THE GROUNDS OF FORUM NON CONVENIENS, WHICH IT MAY NOW OR HEREAFTER HAVE TO THE BRINGING OF ANY ACTION OR PROCEEDING IN SUCH JURISDICTION IN RESPECT OF THIS AGREEMENT OR ANY DOCUMENT RELATED HERETO. THE COMPANY, THE AGENT AND THE LENDERS EACH WAIVE PERSONAL SERVICE OF ANY SUMMONS, COMPLAINT OR OTHER PROCESS, WHICH MAY BE MADE BY ANY OTHER MEANS PERMITTED BY CALIFORNIA LAW.

14(l) Waiver of Jury Trial. THE COMPANY, THE LENDERS AND THE AGENT EACH WAIVE THEIR RESPECTIVE RIGHTS TO A TRIAL BY JURY OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF OR RELATED TO THIS AGREEMENT, THE OTHER LOAN DOCUMENTS, OR THE TRANSACTIONS CONTEMPLATED HEREBY OR THEREBY, IN ANY ACTION, PROCEEDING OR OTHER LITIGATION OF ANY TYPE BROUGHT BY ANY OF THE PARTIES AGAINST ANY OTHER PARTY OR ANY PARTICIPANT OR ASSIGNEE, WHETHER WITH RESPECT TO CONTRACT CLAIMS, TORT CLAIMS, OR OTHERWISE. THE COMPANY, THE LENDERS AND THE AGENT EACH AGREE THAT ANY SUCH CLAIM OR CAUSE OF ACTION SHALL BE TRIED BY A COURT TRIAL WITHOUT A JURY. WITHOUT LIMITING THE FOREGOING, THE PARTIES FURTHER AGREE THAT THEIR RESPECTIVE RIGHT TO A TRIAL BY JURY IS WAIVED BY OPERATION OF THIS SECTION AS TO ANY ACTION, COUNTERCLAIM OR OTHER PROCEEDING WHICH SEEKS, IN WHOLE OR IN PART, TO CHALLENGE THE VALIDITY OR ENFORCEABILITY OF THIS AGREEMENT OR THE OTHER LOAN DOCUMENTS OR ANY PROVISION HEREOF OR THEREOF. THIS WAIVER SHALL APPLY TO ANY SUBSEQUENT AMENDMENTS, RENEWALS, SUPPLEMENTS OR MODIFICATIONS TO THIS AGREEMENT AND THE OTHER LOAN DOCUMENTS.

14(m) Indemnity. Whether or not the transactions contemplated hereby are consummated, the Company shall indemnify and hold the Agent and each Lender and each of their respective officers, directors, employees, counsel, agents and attorneys-in-fact (each, an "Indemnified Person") harmless from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, charges, expenses and disbursements (including reasonable attorney's fees and expenses, including the documented cost of internal counsel) of any kind or nature whatsoever which may at any time (including at any time following repayment of the Loans and the termination, resignation or replacement of the Agent or replacement of any Lender) be imposed on, incurred by or asserted against any such Person in any way relating to or arising out of this Agreement or any document contemplated by or referred to herein, or the transactions contemplated hereby, or any action taken or omitted by any such Person under or in connection with any of the foregoing, including with respect to any investigation, litigation or proceeding (including any insolvency proceeding or appellate proceeding) related to or arising out of this Agreement, the Loans or any Letter of Credit issued hereunder, or the use of the proceeds thereof, whether or not any Indemnified Person is a party thereto (all the foregoing, collectively, the "Indemnified Liabilities"); provided, however, that the Company shall have no

obligation hereunder to any Indemnified Person with respect to Indemnified Liabilities resulting from the gross negligence or willful misconduct of such Indemnified Person. The agreements in this Paragraph 14(m) shall survive payment of all other Obligations and the termination of this Agreement.

14(n) Marshalling; Payments Set Aside. Neither the Agent nor the Lenders shall be under any obligation to marshal any assets in favor of the Company or any other Person or against or in payment of any or all of the Obligations. To the extent that the Company makes a payment or payments to the Agent or the Lenders (through the Agent), or the Agent on behalf of the Lenders enforces their Liens or exercise their rights of set-off, and such payment or payments or the proceeds of such enforcement or set-off or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside or required (including pursuant to any settlement entered into by the Agent in its discretion) to be repaid to a trustee, receiver or any other party in connection with any insolvency proceeding, or otherwise, then (1) to the extent of such recovery the obligation or part thereof originally intended to be satisfied shall be revived and continued in full force and effect as if such payment had not been made or such enforcement or set-off had not occurred, and (2) each Lender severally agrees to pay to the Agent upon demand its ratable share of the total amount so recovered from or repaid by the Agent.

14(o) Set-off. In addition to any rights and remedies of the Lenders provided by law, if an Event of Default exists, each Lender is authorized at any time and from time to time, without prior notice to the Company, any such notice being waived by the Company to the fullest extent permitted by law, to set off and apply any and all deposits (general or special, time or demand, provisional or final) at any time held by, and other indebtedness at any time owing to, such Lender to or for the credit or the account of the Company against any and all Obligations owing to such Lender, now or hereafter existing, irrespective of whether or not the Agent or such Lender shall have made demand under this Agreement or any Loan Document and although such Obligations may be contingent or unmatured. Each Lender agrees promptly to notify the Company and the Agent after any such set-off and application made by such Lender; provided, however, that the failure to give such notice shall not affect the validity of such set-off and application.

14(p) Severability. The illegality or unenforceability of any provision of this Agreement or any other Loan Document or any instrument or agreement required hereunder or thereunder shall not in any way affect or impair the legality or enforceability of the remaining provisions hereof or thereof.

14(q) No Third Parties Benefited. This Agreement and the other Loan Documents are made and entered into for the sole protection and legal benefit of the Company, the Lenders and the Agent, and their permitted successors and assigns, and no other Person shall be a direct or indirect legal beneficiary of, or have any direct or indirect cause of action or claim in connection with, this Agreement or any of the other Loan Documents. Neither the Agent nor any Lender shall have any obligation to any Person not a party to this Agreement or other Loan Documents.

14(r) Judgment Currency. If for the purposes of obtaining judgment in any court it is necessary to convert a sum due from the Company hereunder in the currency expressed to be payable herein (the "specified currency") into another currency, the parties hereto agree, to the fullest extent that they may effectively do so, that the rate of exchange used shall be that at which in accordance with normal banking procedures the Agent could purchase the specified currency with such other currency at the Agent's main office on the Business Day preceding that on which final, non-appealable judgment is given. The obligations of the Company in respect of any sum due to any Lender or the Agent hereunder shall, notwithstanding any judgment in a currency other than the specified currency, be discharged only to the extent that on the Business Day following receipt by such Lender or the Agent (as the case may be)



of any sum adjudged to be so due in such other currency such Lender or the Agent (as the case may be) may in accordance with normal, reasonable banking procedures purchase the specified currency with such other currency. If the amount of the specified currency so purchased is less than the sum originally due to such Lender or the Agent, as the case may be, in the specified currency, the Company agrees, to the fullest extent that it may effectively do so, as a separate obligation and notwithstanding any such judgment, to indemnify such Lender or the Agent, as the case may be, against such loss, and if the amount of the specified currency so purchased exceeds (a) the sum originally due to any Lender or the Agent, as the case may be, in the specified currency and (b) any amounts shared with other Lenders as a result of allocations of such excess as a disproportionate payment to such Lender under terms of this Agreement, such Lender or the Agent, as the case may be, agrees to remit such excess to the Company.

15. Definitions. For purposes of this Agreement, the terms set forth below shall have the following meanings:

“Acquisition” shall mean any transaction, or any series of related transactions, consummated on or after the Effective Date, by which the Company or any of its Domestic Subsidiaries: (a) acquires any going business or all or substantially all of the assets of any firm, corporation or limited liability company, or division thereof, whether through purchase of assets, merger or otherwise or (b) directly or indirectly acquires (in one transaction or as the most recent transaction in a series of transactions) at least a majority (in number of votes) of the securities of a corporation which have ordinary voting power for the election of directors (other than securities having such power only by reason of the happening of a contingency) or a majority (by percentage or voting power) of the outstanding ownership interests of a partnership or limited liability company.

“Acquisition Facility Credit Limit” shall mean \$20,000,000.00.

“Acquisition Loan” shall have the meaning given such term in Paragraph 4(a) above.

“Adjusted EBITDA” shall mean:

(a) for any measurement date on or prior to June 30, 2005, four (4) times EBITDA for the three (3) month period ending June 30, 2005;

(b) for any measurement date after June 30, 2005 and on or prior to September 30, 2005, two (2) times EBITDA for the six (6) month period ending September 30, 2005;

(c) for any measurement date after September 30, 2005 and on or prior to December 31, 2005, the quotient of (i) four (4) times EBITDA for the nine (9) month period ending December 31, 2005 divided by (ii) three (3); and

(d) for any measurement date after December 31, 2005, EBITDA for the four (4) fiscal quarters most recently ended.

“Affiliate” shall mean, as to any Person, any other Person directly or indirectly controlling, controlled by or under direct or indirect common control with, such Person. “Control” as used herein means with respect to any business entity the power to direct the management and policies of such business entity.

“Agent” shall have the meaning given such term in the introductory paragraph hereof and shall include any successor to BOW as the initial “Agent” hereunder.

“Aggregate Credit Limit” shall mean \$50,000,000.00, as such amount may be increased or decreased by the mutual written agreement of the Agent, the Company and one hundred percent (100%) of the Lenders.

“Agreed Currencies” shall mean (a) Dollars, (b) so long as such currencies remain Eligible Currencies, Australian Dollars, British Pounds Sterling, Canadian Dollars, Danish Kroners, Euros, Japanese Yen, New Zealand Dollars, Norwegian Kroners, Singapore Dollars, Swiss Francs, Swedish Kroners, and (c) any other Eligible Currency which the Company requests the Agent to include as an Agreed Currency hereunder and which is acceptable to all of the Lenders. For the purposes of this definition, each of the specific currencies referred to in clause (b), above, shall mean and be deemed to refer to the lawful currency of the jurisdiction referred to in connection with such currency, *e.g.*, “Australian Dollars” means the lawful currency of Australia.

“Agreement” shall mean this Agreement, as the same may be amended, extended or replaced from time to time.

“Anti-Terrorism Order” means Executive Order No. 13,224, 66 Fed. Reg. 49,079 (2001) issued by the President of the United States of America (Executive Order Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism).

“Applicable L/C Fee Percentage” shall mean the percentage amount calculated in accordance with the Pricing Matrix.

“Applicable LIBO Rate” shall mean, with respect to any LIBO Rate Loan for the Interest Period applicable to such LIBO Rate Loan, the rate per annum (rounded upward, if necessary, to the next higher 1/16 of one percent) calculated as of the first day of such Interest Period in accordance with the following formula:

$$\text{Applicable LIBO Rate} = \frac{\text{LR}}{1 - \text{LRP}} + \text{ALS}$$

where

LR = LIBO Rate

LRP = LIBOR Reserve Percentage

ALS = Applicable LIBOR Spread

“Applicable LIBOR Spread” shall mean the percentage amount calculated in accordance with the Pricing Matrix.

“Applicable Prime Rate” shall mean a floating rate per annum equal to the daily average Prime Rate on each day of the applicable calculation period plus the Applicable Prime Rate Spread.

“Applicable Prime Rate Spread” shall mean the percentage amount calculated in accordance with the Pricing Matrix.

“Approximate Equivalent Amount” of any currency with respect to any amount of Dollars shall mean the Equivalent Amount of such currency with respect to such amount of Dollars on or as of such date, rounded up to the nearest amount of such currency as determined by the Agent from time to time.

“Assignee” shall have the meaning given such term in Paragraph 14(h)(1) above.

“Assignment and Acceptance Agreement” shall mean an agreement in the form of that attached hereto as Exhibit E.

“Business Day” shall mean (a) with respect to any borrowing, payment or rate selection of Loans funded in any Agreed Currency, any day other than a Saturday, a Sunday or a day on which banks in Los Angeles, California, Chicago, Illinois or New York, New York are authorized or obligated to close their regular banking business, on which interbank wire transfers can be made on the Fedwire system and dealings in Dollars and the other Agreed Currencies are carried on in the London interbank market, and (b) for all other purposes, any day other than a Saturday, a Sunday or a day on which banks in Los Angeles, California, Chicago, Illinois or New York, New York are authorized or obligated to close their regular banking business.

“Capital Expenditures” shall mean, for any period, the aggregate of all expenditures by the Company and its Subsidiaries for the acquisition or leasing of fixed or capital assets or additions to equipment (including replacements, capitalized repairs and improvements during such period) which should be capitalized under GAAP on a consolidated balance sheet of the Company and its Subsidiaries, less net proceeds from sales of fixed or capital assets received by the Company or any of its Subsidiaries during such period.

“Change of Control” shall mean:

(a) As to the Company: (1)(a) the sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or more related transactions, of all or substantially all of the properties and assets of the Parent and its Subsidiaries taken as a whole to any “person” (as such term is used in Section 13(d)(3) of the Exchange Act), (2) the adoption of a plan relating to the liquidation or dissolution of the Company, (3) the consummation of any transaction or other event (including, without limitation, any merger or consolidation) the result of which is that any “person” (as defined above) becomes the “beneficial owner” (as such term is defined in Rule 13d-3 and Rule 13d-5 under the Exchange Act), directly or indirectly, of more than thirty five percent (35%) of the voting shares or economic value of the Stock of the Company,

(b) As to any Domestic Subsidiary, if the Company shall cease to own one hundred percent (100%) of the outstanding capital stock of such Person, directly or indirectly through other Domestic Subsidiaries,

(c) As to any Foreign Subsidiary, if the Company shall cease to own one hundred percent (100%) of the outstanding capital stock of such Foreign Subsidiary, directly or indirectly through other Subsidiaries, or

(d) If Deepak Chopra shall cease to be actively involved in the day to day management of the business of the Company and its Subsidiaries.

“Collateral” shall have the meaning given such term in the Security Agreement and the Guarantor Security Agreements, as applicable.

“Commonly Controlled Entity” of a Person shall mean a Person, whether or not incorporated, which is under common control with such Person within the meaning of Section 411(c) of the Internal Revenue Code.

“Company” shall have the meaning given such term in the preamble hereto.

“Compliance Certificate” shall mean a certificate in the form of that attached hereto as Exhibit F.

“Computation Date” shall have the meaning given such term in Paragraph 5(l)(5) above.

“Contact Office” shall mean the office of the Agent located at 300 South Grand Avenue, Suite 700, Los Angeles, California 90071 or such other office as the Agent may notify the Company and the Lenders from time to time in writing.

“Contractual Obligation” as to any Person shall mean any provision of any security issued by such Person or of any agreement, instrument or undertaking to which such Person is a party or by which it or any of its property is bound.

“Credit Event” shall mean the funding, continuation or conversion of any Loan or the issuance of any Letter of Credit.

“Debt” of any Person shall mean: (a) liabilities for borrowed money; (b) liabilities for the deferred purchase price of property acquired by such Person (excluding accounts payable arising in the ordinary course of business but including, without limitation, all liabilities created or arising under any conditional sale or other title retention agreement with respect to any such property); (c) capitalized lease obligations; (d) all liabilities for borrowed money secured by any lien with respect to any property owned by such Person (whether or not it has assumed or otherwise become liable for such liabilities); (e) liabilities with respect to letters of credit, foreign exchange transactions and net exposure in respect to interest rate swaps, currency swaps and similar obligations; and (f) any guaranty or other contingent liability of such Person with respect to liabilities described in subparagraphs (a) through (e) above.

“Domestic Subsidiary” shall mean any Subsidiary of the Company which is not a Foreign Subsidiary.

“Dollar Amount” shall mean, with respect to any amount of currency, (a) the amount of such currency if such currency is Dollars or (b) the equivalent in such currency of such amount of Dollars if such currency is any currency other than Dollars, calculated according to the Agent’s customary procedures.

“Dollars” and “\$” shall mean the lawful currency of the United States of America.

“EBITDA” shall mean, with respect to any specified fiscal period, the Company’s (a) consolidated net earnings (or loss) for such period, minus (b) the sum of, for such period, (1) extraordinary gains and (2) interest income, plus (c) the sum of, for such period, (1) interest expense, (2) net income tax expense, (3) depreciation and amortization, (4) non-cash stock option expenses, (5) non-cash, non-recurring expenses and (6) up to \$1,500,000 of cash restructuring expenses incurred prior to March 31, 2006, in each case as determined in accordance with GAAP.

“Effective Date” shall mean the date on which all conditions precedent to the occurrence of the first Credit Event set forth in Paragraph 8(a) above have been met to the satisfaction of the Agent and the Lenders.

“Effective Tangible Net Worth” shall mean for any Person at any date the sum of (a) Tangible Net Worth plus (b) Subordinated Debt.

“Eligible Currency” shall mean any currency other than Dollars (a) that is readily available, (b) that is freely traded, (c) in which deposits are customarily offered to banks in the London interbank market, (d) which is convertible into Dollars in the international interbank market and (e) as to which an Equivalent Amount may be readily calculated. If, after the designation by the Agent of any currency as an Agreed Currency, (x) currency control or other exchange regulations are imposed in the country in which such currency is issued with the result that different types of such currency are introduced, (y) such currency is, in the determination of the Agent, no longer readily available or freely traded or (z) in the determination of the Agent, an Equivalent Amount of such currency is not readily calculable, the Agent shall promptly notify the Lenders and the Company, and such currency shall no longer be an Agreed Currency until such time as Agent and all of the Lenders agree to reinstate such currency as an Agreed Currency.

“Environmental Claims” shall mean all claims, however asserted, by any governmental authority or other person alleging potential liability or responsibility for violation of any Environmental Law or for release or injury to the environment or threat to public health, personal injury (including sickness, disease or death), property damage, natural resources damage, or otherwise alleging liability or responsibility for damages (punitive or otherwise), cleanup, removal, remedial or response costs, restitution, civil or criminal penalties, injunctive relief, or other type of relief, resulting from or based upon (i) the presence, placement, discharge, emission or release (including intentional and unintentional, negligent and non-negligent, sudden or non-sudden, accidental or non-accidental placement, spills, leaks, discharges, emissions or releases) of any Hazardous Materials at, in, or from property owned, operated or controlled by the Company or any of its Subsidiaries, or (ii) any other circumstances forming the basis of any violation, or alleged violation, of any Environmental Law.

“Environmental Laws” shall mean all federal, state or local laws, statutes, common law duties, rules, regulations, ordinances and codes, together with all administrative orders, directed duties, requested, licenses, authorizations and permits of, and agreements with, any governmental authorities, in each case relating to environmental, health, safety and land use matters; including the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (“CERCLA”), the Clean Air Act, the Federal Water Pollution Control Act of 1972, the Solid Waste Disposal Act, the Federal Resource Conservation and Recovery Act, the Toxic Substances Control Act, the Emergency Planning and Community Right-to-Know Act, the California Waste Control Law, the California Solid Waste Management, Resource, Recovery and Recycling Act, the California Water Code and the California Health and Safety Code.

“Environmental Permits” shall have the meaning given such term in Paragraph 9(p) above.

“Equivalent Amount” of any currency with respect to any amount of Dollars at any date shall mean the equivalent in such currency of such amount in Dollars, calculated according to the Agent’s customary procedures.

“ERISA” shall mean the Employee Retirement Income Security Act of 1974, as the same may from time to time be supplemented or amended.

“Event of Default” shall have the meaning given such term in Paragraph 12 above.

“Euro” shall mean the euro referred to in Council Regulation (EC) No. 1103/97 dated June 17, 1997 passed by the Council of the European Union, or, if different, the then lawful currency of the member states of the European Union that participate in the third stage of Economic and Monetary Union.

“Exchange Act” shall mean the Securities Exchange Act of 1934, as in effect from time to time.

“Existing Additional Company Collateral Documents” shall have the meaning given such term in Paragraph 7(a) above.

“Existing Additional Guarantor Collateral Documents” shall have the meaning given such term in Paragraph 7(b) above.

“Existing Credit Agreement” shall have the meaning given such term in Recital A above.

“Existing Guarantors” shall mean those Domestic Subsidiaries of the Company listed on Annex 4 attached hereto.

“Existing Guaranty” shall have the meaning given such term in Paragraph 7(a) above.

“Existing Security Agreement” shall have the meaning given such term in Paragraph 7(a) above.

“Foreign Subsidiary” shall mean any Subsidiary of a Person which Subsidiary is not organized in the United States of America.

“Funded Debt” shall mean for any Person at any date of calculation the aggregate amount of Indebtedness of such Person which has actually been funded and is outstanding at such time, whether or not such amount is due and payable on such date and including, without limitation, the aggregate amount available for drawing under outstanding letters of credit on which such Person is the account party.

“Funding Account” shall mean account no. 752-04010 maintained in the Company’s name with the Agent or such other account or accounts as the Agent and the Company may from time to time agree.

“FX Obligations” shall have the meaning given such term in Paragraph 3 above.

“FX Provider” shall have the meaning given such term in Paragraph 3 above.

“FX Transaction” shall mean any transaction between the BOW and the Company or a Guarantor pursuant to which the FX Lender has agreed to sell to or to purchase from the Company or such Guarantor a foreign currency which BOW regularly trades of an agreed amount at an agreed price in Dollars or such other agreed upon foreign currency, deliverable and payable on an agreed date.

“GAAP” shall mean generally accepted accounting principles in the United States of America in effect from time to time.

“Governmental Authority” shall mean any nation or government, any state or other political subdivision thereof, or any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government.

“Guarantor” shall mean any of the Existing Guarantors and any Domestic Subsidiary executing a Guaranty following the Effective Date as required pursuant to Paragraph 7(d) above.

“Guarantor Security Agreement” shall mean each of the Existing Guarantor Security Agreements, as amended and reaffirmed by the Master Reaffirmation of Guaranties and Guarantor Security Agreements, and each security agreement executed and delivered in the future pursuant to Paragraph 7(d) above, as the same may be amended, extended and replaced from time to time.

“Guaranty” shall mean each of the Existing Guaranties, as amended and reaffirmed by the Master Reaffirmation of Guaranties and Guarantor Security Agreements, and each guaranty executed and delivered in the future pursuant to Paragraph 7(d) above, as the same may be amended, extended and replaced from time to time.

“Hazardous Materials” shall mean:

(a) “Hazardous substances,” “hazardous wastes,” “hazardous materials,” or “toxic substances,” as defined in any of the Hazardous Material Laws;

(b) Any pollutant or contaminant, or hazardous, dangerous or toxic chemical, material, waste or substance (“pollutant”) which Hazardous Material Laws prohibit, limit or otherwise regulate as to use, exposure, release, generation, manufacture, sale, transport, handling, storage, treatment, reuse, presence, disposal or recycling;

(c) Petroleum, crude oil or any fraction of petroleum or crude oil;

(d) Any radioactive material, including any source, special nuclear or by-product material, as defined at 42 U.S.C. §2011 et seq., and amendments thereto and reauthorizations thereof;

(e) Asbestos-containing materials in any form or condition; and

(f) Polychlorinated biphenyls.

“Indebtedness” of any Person shall mean all items of indebtedness which, in accordance with GAAP and practices, would be included in determining liabilities as shown on the liability side of a statement of condition of such Person as of the date as of which indebtedness is to be determined, including, without limitation, all obligations for money borrowed and capitalized lease obligations, and shall also include all indebtedness and liabilities of others assumed or guaranteed by such Person or in respect of which such Person is secondarily or contingently liable (other than by endorsement of instruments in the course of collection) whether by reason of any agreement to acquire such indebtedness or to supply or advance sums or otherwise.

“Interest Period” shall mean with respect to any Loan which is being maintained as a LIBO Rate Loan, the period commencing on the date such Loan is advanced and ending one, two, three or six months thereafter, as designated in the related Loan Request; provided, however, that (a) any Interest Period which would otherwise end on a day which is not a LIBOR Business Day shall be extended to the next succeeding LIBOR Business Day unless by such extension it would fall in another calendar month, in which case such Interest Period shall end on the immediately preceding LIBOR Business Day, (b) any Interest Period which begins on a day for which there is no numerically corresponding day in the calendar month in which such Interest Period is to end shall, subject to the provisions of clause (a) above, end on the last day of such calendar month, and (c) no Interest Period shall end after the regularly scheduled Revolving Loan Maturity Date.

“Interim Date” shall mean March 31, 2005.

“Investment” shall mean, with respect to any Person, any investment by such Person in any other Person (including Affiliates) in the form of loans, guarantees, advances, or capital contributions (excluding (a) commission, travel, and similar advances to officers and employees of such Person made in the ordinary course of business, and (b) bona fide accounts receivable arising in the ordinary course of business consistent with past practice), purchases or other acquisitions of Indebtedness, Stock, or assets or business of such other Person, and any other items that are or would be classified as investments on a balance sheet prepared in accordance with GAAP.

“L/C Documents” shall mean any and all documents, instruments and agreements as the L/C Issuing Bank may require be delivered to it as a condition precedent to the issuance by the L/C Issuing Bank of a Letter of Credit.

“L/C Drawing” shall mean any drawing under a Letter of Credit.

“L/C Issuing Bank” shall mean that Lender which has agreed, with the consent of the remaining Lenders, to issue the Letters of Credit, with the initial L/C Issuing Bank being BOW.

“Lender Account Control Agreement” shall have the meaning given such term in Paragraph 7(d)(3) above.

“Lending Installation” means, with respect to a Lender or the Agent, the office, branch, subsidiary or affiliate of such Person with respect to each Agreed Currency listed on Annex 6 or otherwise selected by such Lender or the Agent pursuant to Paragraph 5(l).

“Letter of Credit” shall have the meaning given such term in Paragraph 3(a) above, and shall include, without limitation, the Pre-Existing Letters of Credit.

“Letter of Credit Application” shall mean an application for the issuance of a Letter of Credit in form satisfactory to the L/C Issuing Bank.

“Leverage Ratio” shall mean, as of any date of determination, the ratio of the Company’s consolidated Funded Debt to the Company’s consolidated Adjusted EBITDA.

“LIBO Rate” shall mean, with respect to any LIBO Rate Loan for any Interest Period:

(a) If such LIBO Rate Loan is to be funded in Dollars, the rate per annum determined by the Agent to be the rate as of approximately 11:00 a.m. (London time) on the date that is two LIBOR Business Days prior to the beginning of the relevant Interest Period quoted as the British Bankers Association Interest Settlement Rate for deposits in Dollars (as set forth in any service selected by the Agent which has been nominated by the British Bankers’ Association as an authorized information vendor for purpose of displaying such rates) for a period equal to such Interest Period, and

(b) If such LIBO Rate Loan is to be funded in an Agreed Currency other than Dollars, the rate per annum determined by the Agent in accordance with its customary practices on the date that is two LIBOR Business Days prior to the beginning of the relevant Interest Period for deposits in such Agreed Currency for a period equal to such Interest Period in a recognized market trading such Agreed Currency;



provided, however, that, to the extent that an interest rate is not ascertainable pursuant to the foregoing provisions of this definition, the “LIBO Rate” shall be the interest rate per annum determined by the Agent to be in its reasonable business judgment as an equivalent rate.

“LIBO Rate Loans” shall mean Loans outstanding hereunder at such time as they are made and/or being maintained at a rate of interest based upon the LIBO Rate.

“LIBOR Business Day” shall mean a Business Day upon which commercial banks in London, England are open for domestic and international business.

“LIBOR Reserve Percentage” shall mean with respect to an Interest Period for a LIBO Rate Loan, the maximum aggregate reserve requirement (including all basic, supplemental, marginal and other reserves and taking into account any transitional adjustments) which is imposed under Regulation D on liabilities applicable to such LIBO Rate Loan.

“Lien” shall mean any security interest, mortgage, pledge, lien, claim on property, charge or encumbrance (including any conditional sale or other title retention agreement), any lease in the nature thereof, and the filing of or agreement to give any financial statement under the Uniform Commercial Code of any jurisdiction.

“Loan Documents” shall mean this Agreement, the Security Documents, the Guaranties, the Letters of Credit, the Letter of Credit Applications and other L/C Documents, the FX Applications, and each other document, instrument or agreement executed by the Company and/or any Guarantor in connection herewith or therewith, as any of the same may be amended, extended or replaced from time to time.

“Loan Request” shall mean a request for a Loan by the Company to the Agent in the form of Exhibit G hereto, duly executed on behalf of the Company by a Responsible Officer.

“Loans” shall mean, collectively, Revolving Loans and Acquisition Loans.

“Majority Lenders” shall mean the Lenders holding not less than fifty one percent (51%) of the Percentage Shares; provided, however, that at any time during which the number of Lenders hereunder are less than three, the term “Majority Lenders” shall mean one hundred percent (100%) of the Lenders.

“Master Reaffirmation of Guaranties and Guarantor Security Agreements” shall have the meaning given such term in Paragraph 7(b) above.

“Material Adverse Effect” shall mean a material adverse change in, or a material adverse effect upon, any of: (a) the operations, business, properties, condition (financial or otherwise) or prospects of the Company; (b) a material impairment of the ability of the Company or any Guarantor to perform under any Loan Document to which it is party and to avoid any Event of Default; or (c) a material adverse effect upon the legality, validity, binding effect or enforceability of any Loan Document or the perfection or priority of the Lender’s security interest in the Collateral.

“Material Foreign Subsidiary” shall mean, at any date, any Foreign Subsidiary that has assets the net book value of which constitutes five percent (5%) or more of the Company’s consolidated net book value, in each case based upon the Company’s most recent annual or quarterly financial statements delivered to the Agent pursuant to Paragraph 10(a) above.

“Multiemployer Plan” as to any Person shall mean a Plan of such Person which is a multiemployer plan as defined in Section 4001(a)(3) of ERISA.

“National Currency Unit” shall mean the unit of currency (other than a Euro unit) of each member state of the European Union that participates in the third stage of Economic and Monetary Union.

“Notice of Conversion/Continuation” shall mean a request to the Agent by the Company in the form of Exhibit H hereto, duly executed on behalf of the Company by a Responsible Officer.

“Obligations” shall mean any and all debts, obligations and liabilities of the Company to the Lenders (whether now existing or hereafter arising, voluntary or involuntary, whether or not jointly owed with others, direct or indirect, absolute or contingent, liquidated or unliquidated, and whether or not from time to time decreased or extinguished and later increased, created or incurred), arising out of or related to the Loan Documents and including, without any limitation, any obligations of the Company to any Lender with respect to any Swap Agreement related to the Obligations and the FX Obligations.

“Outstanding” shall mean with respect to Letters of Credit, any Letter of Credit which has not been canceled, expired unutilized or fully drawn upon and reference to the “amount” of any Outstanding Letter of Credit shall be deemed to mean the amount available for drawing thereunder.

“Participant” shall have the meaning given such term in Paragraph 14(b)(2) above.

“PBGC” shall mean the Pension Benefit Guaranty Corporation established pursuant to Subtitle A of Title IV of ERISA and any successor thereto.

“Percentage Share” shall mean, for any Lender at any date that percentage agreed to by such Lender in writing, with the initial Percentage Shares of the Lenders being set forth on Annex 5 attached hereto.

“Permitted Acquisitions” shall mean an Acquisition by the Company or any of its Subsidiaries which satisfies each of the following conditions:

(a) Both before and after giving effect to such Acquisition, no Potential Default and no Event of Default exists or would exist upon the consummation thereof, both on an actual and a pro forma basis;

(b) The Company shall have provided Agent and the Lenders with written confirmation, supported by reasonably detailed calculations, that on a pro forma basis, created by adding the combined financial projections of the Company and its Subsidiaries, on a consolidated basis (including the combined financial projections of any other Person or assets that were the subject of a prior Permitted Acquisition not already reflected on the financial projections most recently delivered to Agent for the Company), to the consolidated financial projections of the Person to be acquired (or the financial projections related to the assets to be acquired) pursuant to the proposed Acquisition (adjusted to eliminate expense items that would not be incurred and to include income items that would be

recognized, in each case, if the combination had been accomplished at the beginning of the relevant period; such eliminations and inclusions to be mutually agreed upon by the Company and Agent), the Company and its Subsidiaries will be in compliance with all financial covenants set forth in Paragraph 11(i) above for the twelve (12) months following the proposed date of consummation of such proposed Acquisition, together with copies of all such financial projections of the Person or Person whose assets are being acquired;

(c) The Acquisition shall be of a Person engaged in, or assets used in, the same, similar or a complimentary business to that of the Company and/or any of its Subsidiaries;

(d) Without the prior written consent of the Lenders, the aggregate consideration paid by the Company or any of its Affiliates in connection with such Acquisition, including, without limitation, all deferred payments and projected earn-out payments, does not exceed (1) \$20,000,000.00 in the aggregate for any one such Acquisition or (2) \$20,000,000.00 in the aggregate for all such Acquisitions made during any fiscal year of the Company;

(e) The Agent shall be satisfied that all acts necessary to perfect the Agent's Liens granted pursuant to the Security Agreement or the Guarantor Security Agreements, as applicable, in the assets or Stock being purchased in connection with such Acquisition have been taken and that if the Acquisition involves the formation or Acquisition of a Subsidiary, such Subsidiary will, promptly following the consummation of such acquisition, deliver the Security Documents required pursuant to Paragraph 7(d) above and such Supplemental Collateral Documents as the Agent may require;

(f) The Company shall have updated the schedules and annexes hereto and to each of the other Loan Documents (to the extent permitted by the terms hereof and thereof), as applicable; provided, that in no event may any schedule be updated in a manner that would reflect or evidence a Potential Default or Event of Default;

(g) The Agent shall have reviewed and approved the Acquisition or other purchase documentations therefor;

(h) Such Acquisition has been duly authorized by all necessary corporate or other organizational requirements of the Company and its Subsidiaries, as applicable; and

(i) Such Acquisition is consensual and will have been approved by the board of directors of the Person whose Stock or assets are proposed to be acquired upon consummation thereof.

"Permitted Investments" shall mean any Investment made by the Company or any of its Subsidiaries, which

(a) Satisfies each of the following conditions:

(1) At the time of such Investment, no Potential Default and no Event of Default exists, or would exist upon the consummation thereof, both on an actual and a pro forma basis;

(2) Such Investment is made in connection with the consummation of a Permitted Acquisition or to acquire a non-controlling interest in a Person engaged in the same, similar or a complimentary business to that of the Company and/or any of its Subsidiaries for purposes of acquiring research and development technology or related products;

(3) Without the prior written consent of the Majority Lenders, such Investment, when aggregated with all other Permitted Investments made in any fiscal year of the Company, does not exceed \$5,000,000.00; and

(4) The Agent shall be satisfied that all acts necessary to perfect the Agent's Liens in any Stock acquired pursuant to such Investment have been taken; or

(b) Constitutes a loan or advance to a director, officer or other employee of the Company or any of its Domestic Subsidiaries made in the normal course of business which loan or advance, when taken together with all other such loans and advances outstanding does not exceed \$1,000,000.00 in the aggregate.

"Person" shall mean any corporation, legally recognized entity, natural person, firm, joint venture, partnership, limited liability company, trust, unincorporated organization, government or any department or agency of any government.

"Plan" shall mean as to any Person, any pension plan that is covered by Title IV of ERISA and in respect of which such Person or a Commonly Controlled Entity of such Person is an "employer" as defined in Section 3(5) of ERISA.

"Potential Default" shall mean an event which but for the lapse of time or the giving of notice, or both, would constitute an Event of Default.

"Pre-Existing Letters of Credit" shall have the meaning given such term in Paragraph 3(i) above.

"Pricing Matrix" shall mean the matrix attached hereto as Annex 3.

"Prime Rate" shall mean the fluctuating per annum rate announced from time to time by the Agent in Los Angeles, California, as its "Prime Rate". The Prime Rate is a rate set by the Agent based upon various factors including the Agent's costs and desired return, general economic conditions, and other factors, and is used as a reference point for pricing some loans, which may be priced at, above or below the Prime Rate.

"Prime Rate Loans" shall mean Loans hereunder during such time as they are made and/or being maintained at a rate of interest based upon the Prime Rate.

"Property" shall mean, collectively and severally, any and all real property, including all improvements and fixtures thereon, owned or occupied by the Company or any of its Subsidiaries.

"Reaffirmation of Security Agreement" shall have the meaning given such term in Paragraph 7(a) above.

"Regulation D" shall mean Regulation D of the Board of Governors of the Federal Reserve System (12 C.F.R. § 221), as the same may from time to time be amended, supplemented or superseded.

"Regulation U" shall mean Regulation U of the Board of Governors of the Federal Reserve System (12 C.F.R. § 221), as the same may from time to time be amended, supplemented or superseded.

“Reportable Event” shall mean a reportable event as defined in Title IV of ERISA, except actions of general applicability by the Secretary of Labor under Section 110 of ERISA.

“Requirements of Law” shall mean as to any Person the Certificate of Incorporation and ByLaws or other organizational or governing documents of such Person, and any law, treaty, rule or regulation, or a final and binding determination of an arbitrator or a determination of a court or other Governmental Authority, in each case applicable to or binding upon such Person or any of its property or to which such Person or any of its property is subject.

“Responsible Financial Officer” shall mean as to any Person, the chief financial officer, treasurer, assistant treasurer, comptroller, controller, or any other senior officer of such Person having the same general duties and responsibilities of any of the foregoing.

“Revolving Facility Credit Limit” shall mean \$50,000,000.00.

“Revolving Loan” shall have the meaning given such term in Paragraph 1(a) above.

“Revolving Loan Maturity Date” shall mean the earlier of: (a) May 18, 2008, as such date may be extended from time to time in writing by one hundred percent (100%) of the Lenders, in their sole discretion, and (b) the date the Lenders terminate their obligation to make further Loans hereunder pursuant to Paragraph 12 above.

“Security Agreement” shall mean the Existing Security Agreement, as amended and reaffirmed by the Reaffirmation of Security Agreement and as further amended, extended and replaced from time to time.

“Security Documents” shall mean the Security Agreement, the Existing Additional Company Collateral Documents, the Guarantor Security Agreements, the Existing Additional Guarantor Collateral Documents, the Supplemental Collateral Documents and any document, instrument, or agreement executed and/or delivered from time to time, whether prior to or following the Effective Date, in connection with any of the foregoing.

“Single Employer Plan” shall mean as to any Person any Plan of such Person which is not a Multiemployer Plan.

“Statement Date” shall mean June 30, 2004.

“Stock” shall mean all shares, options, warrants, interests, participations, or other equivalents (regardless of how designated) of or in a Person, whether voting or nonvoting, including common stock, preferred stock, or any other equity security.

“Subordinated Debt” shall mean Indebtedness subordinated to the Obligations pursuant to a written subordination agreement in form and substance acceptable to the Agent, in its sole and absolute discretion.

“Subsidiary” shall mean with respect to any Person, any other Person with respect to which more than fifty percent (50%) of the voting Stock (as of any date of determination) able to elect or appoint the applicable governing body of such other Person is owned by such Person, either directly or through Subsidiaries (irrespective of whether or not at the time of determination any other class or classes of such Person’s Stock shall have or might have voting power by reason of the happening of any contingency).

“Supplemental Collateral Documents” shall have the meaning given such term in Paragraph 7(d)(4) above.

“Swap Agreement” shall mean an interest rate swap agreement on the International Swap Dealers Association, Inc. (“ISDA”) Master Agreement form and subject to the terms and conditions therein with schedules and confirmations attached (such agreement, together with all confirmations incorporated therein, and all amendments, modifications, supplements, riders, exhibits, schedules and attachments thereto.

“Tangible Net Worth” shall mean for any Person at any time of determination, total assets (exclusive of equity investments in Subsidiaries and other Persons, notes receivable from Affiliates, goodwill, patents, trademarks, trade names, organization expense, treasury stock, unamortized debt discount and premium, deferred charges and other like intangibles and leasehold improvements) less Total Liabilities at such time.

“Total Liabilities” shall mean for any Person at any time of determination, all liabilities of such Person which in accordance with GAAP would be shown on the liability side of a balance sheet of such Person, determined in accordance with GAAP, but including in any event the maximum amount available for drawing under all Outstanding Letters of Credit and excluding Subordinated Debt.

[Signature Page Following]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the day and year first above written.

OSI SYSTEMS, INC., a California corporation

By: \_\_\_\_\_

Anuj Wadhawan, Chief Financial Officer

BANK OF THE WEST, as Agent

By \_\_\_\_\_

Chuck Weerasooriya, Vice President

BANK OF THE WEST, as L/C Issuing Bank and sole initial Lender

By \_\_\_\_\_

Shikha Rehman, Vice President

## ANNEXES, SCHEDULES, AND EXHIBITS TO CREDIT AGREEMENT

### Annexes

Annex 1	Revolving Loans, Letters of Credit and Unrepaid L/C Drawings Outstanding Under Existing Credit Agreement
Annex 2	Schedule of Addresses for Notice, Etc.
Annex 3	Pricing Matrix
Annex 4	Schedule of Existing Guarantors
Annex 5	Schedule of Percentage Shares
Annex 6	Lending Installations

### Schedules

Schedule 9(f)	Schedule of Material Litigation
Schedule 9(i)	Schedule of Subsidiaries
Schedule 9(o)	Schedule of Federally Registered Patents, Copyrights and Trademarks

### Exhibits

Exhibit A	Form of Reaffirmation of Security Agreement
Exhibit B	Form of Master Reaffirmation of Guaranties and Guarantor Security Agreements
Exhibit C	INTENTIONALLY OMITTED
Exhibit D	Form of Officer's Certificate
Exhibit E	Form of Assignment and Acceptance Agreement
Exhibit F	Form of Compliance Certificate
Exhibit G	Form of Loan Request
Exhibit H	Form of Notice of Conversion/Continuation



## CODE OF ETHICS AND CONDUCT

### We Comply with the Law

As officers, directors, and/or employees of a global company, each of us must comply with the letter and spirit of every applicable local, state, federal, and foreign law or regulation. Violations of these laws can be extremely costly to us and can subject us to criminal penalties. Each of us is responsible for understanding the laws and regulations that relate to our job. Certain laws demand the attention of all employees, officers, and directors. These include the following.

- **Securities Laws** – You may not buy, sell, or recommend to others OSI Systems, Inc. stock or any other company’s stock if you have “material inside information.” Engaging in securities trading while in possession of such information is a violation of both civil and criminal law. Material inside information is any information that, if it were made public, could affect any investor’s decision to buy or sell the stock of a company. All such information should be kept strictly confidential.
- **Antitrust Laws** – Antitrust laws generally prohibit agreements with competitors, suppliers, or customers that constitute unlawful restraint of trade, as well as price discrimination. This is a complex area, and officers, directors, and employees (such as those in sales) whose activities cause them to confront these issues must familiarize themselves with the antitrust laws.
- **Laws Governing International Activities** – If you are involved in international activities, you must be familiar with the Foreign Corrupt Practices Act. This act generally prohibits payments to foreign officials to induce actions by them and requires us to maintain accurate books and records and a system of internal controls. We are prohibited from taking any action in support of an international boycott not sanctioned by the U.S. government. If you are involved in exports, including the transmission of technical data over the Internet or other electronic means, you must be familiar with the export laws and our policies and procedures.
- **Employment Laws** – We are committed to providing a work environment that is free from all forms of discrimination, including sexual harassment and harassment based on race, color, religion, sex, national origin, age, disability, or other protected status. We provide equal opportunity in all of our employment practices and seek to ensure that each one of us is treated with fairness and dignity.
- **Occupational Health and Safety and Environmental Laws** - We are committed to providing a healthy and safe work environment. Each of us must abide by Company standards in safety matters, do our part to maintain a healthy and safe work environment, and take the necessary steps to ensure our own safety and the safety of others. We do not condone, and we will not tolerate, illegal drug use or abuse of alcohol by our employees. We also respect and protect the environment. Therefore, each of us must adhere to environmental laws and regulations.

### We Avoid Conflicts of Interest

A conflict of interest exists when an individual’s duty of undivided commercial loyalty to the Company is or is perceived to be prejudiced by actual or potential personal benefit from another source. Conflicts of interest may result directly through your activities or indirectly through the activities of a family member, a person sharing your household or a person with whom you are associated. Generally, you may not solicit or accept salaries, fees, commissions, or any other type of compensation from any individual or organization that conducts or seeks to conduct business with the Company or one of our competitors, and you may not have a financial or other interest in those who deal with the Company. You may not make a loan or extend credit to or receive a loan or credit from those who deal with the Company. You must not directly or indirectly attempt to influence any decision of the Company in order to derive a personal or financial benefit. In case of doubt, ask.

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### **We Protect Confidential Information**

Data, information and documents pertaining to the Company may be used only in the performance of your duties and may be disclosed or communicated to persons outside of the Company only to the extent that the information is needed by them in connection with their business relations with the Company. Each of you is required to keep this information confidential during our employment with the Company and after your employment terminates. This information includes our design and manufacturing technology, other intellectual property we use, business and financial information pertaining to sales, earnings, balance sheet items, business forecasts, business plans, acquisition strategies, and other information of a confidential nature. Any contact from the media should be referred to the Company's investor relations department or Chief Executive Officer, and none of you should speak with the media.

### **We Do Not Make or Accept Improper Payments or Gifts**

Improper payments include anything of more than nominal value given to any person to obtain preferential treatment for either the Company or an officer, director, or employee. You may not solicit or accept gifts or favors of more than nominal value from persons who deal or seek to deal with the Company. Likewise, you may not give such gifts or favors to these persons.

### **We Do Not Use Company Assets or Funds for Political Contributions**

No person may use funds or assets of the Company to support a political party, committee, or candidate. We will not reimburse officers, directors, or employees for political contributions, and the Company does not make political contributions. If you wish to participate in political activities, you must do so during non-work hours and away from the Company property.

### **We Respect the Company and Each Other**

Respect for the Company means not only avoiding misuse of Company funds and property, it includes identifying misuse and waste by others, creating and maintaining accurate books and records, safeguarding all types of information about the Company, complying with our document retention policy, complying with internal controls and procedures, and avoiding conduct that interferes with our functioning in our position to the best of our ability. Respect for others means respecting their property, their self-esteem, and their contributions to the overall success of the Company.

### **We Acknowledge Special Ethical Obligations for Financial Reporting**

As a public company, it is of critical importance that the Company's filings with the Securities and Exchange Commission be accurate and timely and be prepared in accordance with generally accepted accounting principles. Depending on their position with the Company, employees, officers, or directors may be called upon to provide information to assure that the Company's public reports and other public communications are complete, fair, and understandable. The Company expects all of its personnel to take this responsibility seriously and to provide prompt and accurate answers to inquiries related to its public disclosure requirements. The Chief Executive Officer, Chief Financial Officer, and finance department personnel have a special role both to adhere to these principles themselves and also to insure that a culture exists throughout the Company as a whole that insures the fair and timely reporting of our financial results and condition. The Chief Executive Officer and finance department personnel, in addition to adhering to all other provisions of this Code of Ethics and Conduct, are responsible for promptly bringing to the attention of the Audit Committee any material information of which he or she may become aware that affects the disclosures made by the Company in its public filings or otherwise assisting the Audit Committee in fulfilling its responsibilities as specified in its charter.

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## **Implementation and Reporting Obligations**

Adherence to the Code of Ethics and Conduct is the obligation of each officer, director, and employee. The Company will consistently enforce this Code of Ethics and Conduct through appropriate disciplinary means. Any failure to comply with the Code will not be tolerated and will result in disciplinary action, which may include termination of employment.

In the event any officer, director, or employee believes that the Company has engaged or is about to engage in any activity which violates any foreign, federal, state, or local law, rule or regulation, such officer, director, or employee shall promptly advise the Audit Committee.

Pursuant to procedures adopted by it, the Audit Committee will determine whether violations of the Code of Ethics and Conduct have occurred and, if so, will determine the disciplinary measures to be taken against any director, officer, employee, or agent of the Company who has violated the Code of Ethics and Conduct. Disciplinary measures, which may be invoked at the discretion of the Audit Committee include, but are not limited to, counseling, oral or written reprimands, warnings, probation or suspension without pay, demotions, reductions in salary, termination of employment, and restitution.

The Company will not permit retaliation of any kind on or on behalf of the Company against an officer, director, or employee as a result of good faith reporting or an actual or suspected violation of this Code of Ethics and Conduct or any standard of ethical and lawful conduct. Retaliation is itself a violation of this Code of Ethics and Conduct. Any such retaliation shall be reported using the reporting procedures outlined above.

Persons subject to disciplinary measures include, in addition to each actual violator, others involved in the wrongdoing such as (i) individuals who fail to use reasonable care to detect a violation, (ii) individuals who, if requested to divulge information, withhold material information regarding a violation, and (iii) supervisors who approve or condone violations or attempt to retaliate against those reporting violations or violators.

If you have any questions about the Code of Ethics and Conduct or how it applies to a particular situation, or transaction, you should contact your supervisor or your Human Resources representative.

If you become aware of a situation that you believe may be in conflict with the Code of Ethics and Conduct, you should immediately contact your supervisor or your Human Resources representative. We will keep the information that you provide during an investigation confidential to the greatest extent possible.

## **Amendment and Waiver**

The Code of Ethics and Conduct may not be waived or amended with respect to a director or executive officer, except by the Board of Directors.

## SUBSIDIARIES OF THE COMPANY

Advanced Micro Electronics AS	Horten, Norway
Blease Medical Equipment Limited	Chesham, United Kingdom
Blease Medical Holding Ltd.	Chesham, United Kingdom
Blease Medical Services Limited	Chesham, United Kingdom
Centro Vision, Inc.	Newbury Park, California
Corrigan Canada, Ltd.	Ontario, Canada
CXR Limited	Surrey, United Kingdom
Dolphin Medical, Inc.	Hawthorne, California
Dolphin Medical Pte Ltd.	Singapore
Ferson Technologies, Inc.	Ocean Springs, Mississippi
Metorex Security Products, Inc.	Ewing, New Jersey
Opto Sensors (Malaysia) Sdn. Bhd.	Johor Bahru, Malaysia
Opto Sensors (Singapore) Pte. Ltd.	Singapore
OSI Defense Systems, L.L.C.	Orlando, Florida
OSI Electronics, Inc.	Camarillo, California
OSI Fibercomm, Inc.	Hawthorne, California
OSI Medical (Singapore) Pte. Ltd.	Singapore
OSI Systems Pvt. Ltd.	Secunderabad, India
Osteometer MediTech, Inc.	Hawthorne, California
Rapiscan Asia Pte. Ltd.	Singapore
Rapiscan Consortium (M) Sdn. Bhd.	Johor Bahru, Malaysia
Rapiscan Security Products (U.S.A.), Inc.	Hawthorne, California
Rapiscan Systems, Inc.	Hawthorne, California
Rapiscan Systems High Energy Inspection Corporation	Sunnyvale, California
Rapiscan Systems Holdings, Inc.	Hawthorne, California
Rapiscan Systems Hong Kong Limited	Hong Kong
Rapiscan Systems Limited	Salfords, United Kingdom
Rapiscan Systems Neutronics and Advanced Technologies Corporation	Santa Clara, California
Rapiscan Systems Oy	Finland
RapiTec, Inc.	Upland, California
Spacelabs Healthcare, Inc.	Issaquah, Washington
Spacelabs Medical (Canada) Inc.	Ontario, Canada
Spacelabs Medical Austria GmbH	Vienna, Austria
Spacelabs Medical Finland Oy	Espoo, Finland
Spacelabs Medical Germany GmbH	Dusseldorf, Germany
Spacelabs Medical, Inc.	Issaquah, Washington
Spacelabs Medical SAS	Creteil, France
Spacelabs Medical Trading (Shanghai) Co., Ltd.	Shanghai, China
Spacelabs Medical UK Limited	Chesham, United Kingdom
Spacelabs (Singapore) Pte. Ltd.	Singapore
UDT Sensors, Inc.	Hawthorne, California

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in Registration Statement Nos. 333-106176, 333-122674 and 333-69433 on Form S-8 and in Registration Statements Nos. 333-119704, 333-75228, 333-73618, 333-100791 and 333-101716 of on Form S-3 of our reports dated September 28, 2005, relating to the consolidated financial statements and financial statement schedule of OSI Systems, Inc. and subsidiaries (which report expresses and unqualified opinion and includes an explanatory paragraph relating to the restatement of pro forma stock compensation fair value disclosures) and management's report on the effectiveness of internal controls over financial reporting (which report expresses an adverse opinion on the effectiveness of the Company's internal controls over financial reporting because of material weaknesses), appearing in this Annual Report on Form 10-K of OSI Systems, Inc. and subsidiaries for the year ended June 30, 2005.

/s/ DELOITTE & TOUCHE LLP

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Los Angeles, California  
September 28, 2005

## CERTIFICATION

I, Deepak Chopra, certify that:

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

Date: September 28, 2005

/s/ DEEPAK CHOPRA

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Deepak Chopra  
Chief Executive Officer

# CERTIFICATION

I, Anuj Wadhawan, certify that:

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

Date: September 28, 2005

/s/ ANUJ WADHAWAN

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Anuj Wadhawan  
Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of OSI Systems, Inc. (the "Company") on Form 10-K for the year ended June 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Deepak Chopra, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(a) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(b) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods presented in this Report.

Date: September 28, 2005

/s/ DEEPAK CHOPRA

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Deepak Chopra  
*Chief Executive Officer*



**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of OSI Systems, Inc. (the "Company") on Form 10-K for the year ended June 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Anuj Wadhawan, Chief Financial Officer of the Company, certify, pursuant to 18, U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(a) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(b) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods presented in this Report.

Date: September 28, 2005

/s/ ANUJ WADHAWAN

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Anuj Wadhawan  
*Chief Financial Officer*