ACCURAY INC
Form 10-Q
March 15, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 30, 2006

or

o **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: 001-33301

ACCURAY INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**20-8370041**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

1310 Chesapeake Terrace

Sunnyvale, California 94089

(Address of principal executive offices including zip code)

(408) 716-4600

(Registrant s telephone number, including area code)

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

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

As of March 1, 2007, there were 53,326,826 shares of the registrant s Common Stock, par value $0.001 per share, outstanding.

Accuray Incorporated

Form 10-Q for the Quarter Ended December 31, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Accuray Incorporated

Condensed Consolidated Balance Sheets

(in thousands, except share amounts)

	December 31, 2006 (unaudited)	June 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 15,865	$ 27,856
Restricted cash		1
Accounts receivable, net of allowance for doubtful accounts of $20 at December 31, 2006 and June 30, 2006	18,841	11,698
Inventories	14,940	10,100
Prepaid expenses and other current assets	6,456	3,512
Deferred cost of revenue current	10,106	4,810
Total current assets	66,208	57,977
Property and equipment, net	23,440	21,945
Goodwill	4,495	4,495
Intangible assets, net	1,317	1,446
Deferred cost of revenue non-current	46,575	51,778
Other assets	1,688	982
Total assets	$ 143,723	$ 138,623
Liabilities, temporary equity and stockholders equity (deficiency)		
Current liabilities:		
Accounts payable	$ 8,547	$ 4,726
Accrued compensation	7,493	8,561
Other accrued liabilities	5,617	6,494
Customer advances current	13,802	10,338
Deferred revenue current	36,223	31,641
Total current liabilities	71,682	61,760
Long-term liabilities:		
Customer advances non-current	10,601	12,191
Deferred revenue non-current	116,053	118,023
Total liabilities	198,336	191,974
Commitments and contingencies (Note 6)		
Temporary equity		
Redeemable convertible preferred stock, no par value; authorized: 30,000,000 shares; issued and outstanding: 17,419,331 at December 31, 2006 and June 30, 2006 ; liquidation amount: $42,934 and $40,354 at December 31, 2006 and June 30, 2006, respectively.	27,504	27,504
Stockholders equity (deficiency)		
Common stock, no par value; authorized: 70,000,000 shares; issued and outstanding: 16,206,327 and 16,243,150 shares at December 31, 2006 and June 30, 2006, respectively.	12,876	13,276
Additional paid-in capital	30,966	43,988
Notes receivable from stockholders		(206)
Deferred stock-based compensation		(17,272)
Accumulated other comprehensive income	15	
Accumulated deficit	(125,974)	(120,641)
Total stockholders equity (deficiency)	(82,117)	(80,855)
Total liabilities, temporary equity and stockholders equity (deficiency)	$ 143,723	$ 138,623

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

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Accuray Incorporated

Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

(unaudited)

	Three months ended December 31, 2006	Three months ended December 31, 2005	Six months ended December 31, 2006	Six months ended December 31, 2005
Net revenue:				
Products	$ 19,309	$ 7,621	$ 46,076	$ 8,089
Shared ownership programs	2,585	2,031	4,811	3,715
Services	3,661	932	6,630	1,929
Other	792	742	1,601	1,464
Total net revenue	26,347	11,326	59,118	15,197
Cost of revenue:				
Costs of products	7,363	2,809	18,080	3,237
Costs of shared ownership programs	696	699	1,302	1,232
Costs of services	2,960	970	4,629	1,564
Costs of other	626	488	1,102	960
Total cost of revenue	11,645	4,966	25,113	6,993
Gross profit	14,702	6,360	34,005	8,204
Operating expenses:				
Selling and marketing	9,764	6,236	17,294	10,952
Research and development	6,132	4,366	12,314	8,910
General and administrative	6,136	3,605	10,755	6,387
Total operating expenses	22,032	14,207	40,363	26,249
Loss from operations	(7,330)	(7,847)	(6,358)	(18,045)
Other income (expense):				
Interest and other income	167	94	436	208
Interest and other expense	(64)	(109)	(126)	(229)
Loss before provision for income taxes and cumulative effect of change in accounting principle	(7,227)	(7,862)	(6,048)	(18,066)
Provision for income taxes	64	74	123	80
Loss before cumulative effect of change in accounting principle	(7,291)	(7,936)	(6,171)	(18,146)
Cumulative effect of change in accounting principle, net of tax of $0			838	
Net loss	$ (7,291)	$ (7,936)	$ (5,333)	$ (18,146)
Net loss per common share, basic and diluted:				
Loss before cumulative effect of change in accounting principle	$ (0.45)	$ (0.50)	$ (0.38)	$ (1.14)
Cumulative effect of change in accounting principle			0.05	
Basic and diluted net loss per share	$ (0.45)	$ (0.50)	$ (0.33)	$ (1.14)
Weighted average common shares outstanding used in computing net loss per share:				
Basic and diluted	16,209	15,942	16,234	15,881
Cost of revenue, selling and marketing, research and development, and general and administrative expenses include stock-based compensation charges as follows:				
Cost of revenue	$ 232	$ 265	$ 450	$ 419
Selling and marketing	$ 1,007	$ 762	$ 1,656	$ 1,291
Research and development	$ 471	$ 442	$ 920	$ 814
General and administrative	$ 1,164	$ 847	$ 2,062	$ 1,691

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

Accuray Incorporated

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Six months ended December 31, 2006	2005
Cash Flows From Operating Activities		
Net loss	$ (5,333)	$ (18,146)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,794	1,568
Stock-based compensation	5,088	4,214
Provision for bad debts		(44)
Loss on write-down of inventories	284	82
Loss on disposal of fixed assets	131	
Accrued interest expense on note payable		98
Cumulative effect of change in accounting principle	(838)	
Changes in assets and liabilities:		
Accounts receivable	(7,370)	(12,455)
Inventories	(5,124)	(3,221)
Prepaid expenses and other current assets	(2,963)	(1,990)
Deferred cost of revenue	(93)	(14,054)
Other assets	(706)	(66)
Accounts payable	3,862	(389)
Accrued liabilities	(1,945)	5,709
Customer advances	1,874	5,041
Deferred revenue	2,612	40,310
Net cash provided by (used in) operating activities	(7,727)	6,657
Cash Flows From Investing Activities		
Purchases of property and equipment	(4,332)	(5,835)
Restricted cash	1	105
Net cash used in investing activities	(4,331)	(5,730)
Cash Flows From Financing Activities		
Exercise of common stock options for cash	52	223
Exercise of common stock warrants for cash		167
Net cash provided by financing activities	52	390
Effect of exchange rate changes on cash	15	18
Net increase (decrease) in cash and cash equivalents	(11,991)	1,335
Cash and cash equivalents at beginning of period	27,856	17,024
Cash and cash equivalents at end of period	$ 15,865	$ 18,359

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

Accuray Incorporated

Notes to Condensed Consolidated Financial Statements

1. DESCRIPTION OF BUSINESS

Organization

Accuray Incorporated (the Company) was incorporated in California in December 1990 and commenced operations in January 1992. The Company was reincorporated in Delaware in February 2007. The Company designs, develops and sells the CyberKnife system, an image-guided robotic radiosurgery system used for the treatment of solid tumors anywhere in the body.

Subsequent Event - Initial Public Offering

In February 2007, the Company completed its initial public offering (IPO) of common stock in which a total of 18,399,998 shares were sold and issued, including 8,000,000 shares sold by selling stockholders at an issue price of $18.00 per share. The Company raised a total of $187.2 million in gross proceeds from the IPO, or approximately $170.5 million in net proceeds after deducting underwriting discounts and commissions of $13.1 million and estimated other offering costs of approximately $3.6 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding and warrants outstanding automatically converted into 25,186,285 and 495,833 shares of common stock, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

On October 1, 2006, the Company prospectively changed its fiscal calendar to a 52- or 53- week period. The Company s fiscal year ends on the Saturday closest to June 30th, so that in a 52-week period, each fiscal quarter consists of 13 weeks. The additional week in a 53-week year is added to the fourth quarter, making such quarter consist of 14 weeks. Fiscal years 2007 and 2006 are both comprised of 52-weeks. For ease of presentation purposes, the condensed consolidated financial statements and notes refer to December 31, 2006 and 2005 as the quarter ends and June 30, 2006 as its most recent fiscal year end.

Basis of Presentation and Principles of Consolidation

In December 2003, the Company formed a wholly owned subsidiary, Accuray International SARL, headquartered in Geneva, Switzerland. The purpose of Accuray International is to manage the sales, marketing and service activities of Accuray s international subsidiaries. In January 2004, the Company formed a wholly owned subsidiary, Accuray Europe SARL, headquartered in Paris, France. The purpose of Accuray Europe is to market the Company s products in Europe. In January 2005, the Company completed the purchase of the High Energy Systems Division (HES) of American Science and Engineering, Inc. (AS&E) and integrated this operation into the Company s existing manufacturing operation. In October 2005, the Company formed a wholly owned subsidiary, Accuray UK Ltd, headquartered in London, United Kingdom. The purpose of Accuray UK Ltd is to market the Company s products in the United Kingdom and other countries in northern Europe. In December 2005, the Company formed a wholly owned subsidiary, Accuray Asia Limited, headquartered in Hong Kong, SAR. The purpose of Accuray Asia Limited is to market the Company s products in Asia. The condensed consolidated financial statements include the accounts of the subsidiaries, and all inter-company transactions and balances have been eliminated.

The accompanying condensed consolidated balance sheet as of December 31, 2006, the condensed consolidated statements of operations for the three and six months ended December 31, 2006 and 2005, and the condensed consolidated statements of cash flows for the six months ended December 31, 2006 and 2005 and other information disclosed in the related notes are unaudited. The condensed consolidated balance sheet as of June 30, 2006 was derived from the Company s audited consolidated financial statements at that date. The accompanying condensed financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company s Registration Statement on Form S-1 dated February 7, 2007.

The accompanying condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the

Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. The unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to state fairly the Company s consolidated financial position as of December 31, 2006, consolidated results of operations for the three and six months ended December 31, 2006 and 2005 and cash flows for the six months ended December 31, 2006 and 2005. The results for the three and six months ended December 31, 2006 are not necessarily indicative of the results to be expected for the year ending June 30, 2007 or for any other interim period or for any future year. Certain prior period balances have been reclassified to conform with current period presentation.

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. Key estimates and assumptions made by the Company relate to stock-based compensation, allowances, valuation allowances for deferred tax assets, impairment of long-lived assets, goodwill and deferred revenue and costs for services. Actual results could differ from those estimates.

Foreign Currency

The Company s international subsidiaries use their local currencies as their functional currencies. For those subsidiaries, assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expense accounts at average exchange rates during the year. Resulting translation adjustments are recorded directly to accumulated comprehensive income within the statement of stockholders equity (deficiency). Foreign currency transaction gains and losses are included as a component of interest and other income.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. Cash equivalents consist of amounts invested in money market accounts and amounted to $6.4 million and $3.6 million at December 31, 2006 and June 30, 2006, respectively.

Fair Value of Financial Instruments

The carrying values of the Company s financial instruments including cash and cash equivalents, restricted cash, accounts receivable and accounts payable are approximately equal to their respective fair values due to the relatively short-term nature of these instruments.

Concentration of Credit Risk and Other Risks and Uncertainties

The Company s cash and cash equivalents are mainly deposited with one major financial institution. At times, deposits in this institution exceed the amount of insurance provided on such deposits. The Company has not experienced any losses in such accounts and believes that it is not exposed to any significant risk on these balances.

Accounts receivable are typically not collateralized. The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses. Accounts receivable are deemed past due in accordance with the contractual terms of the agreement. Accounts are charged against the allowance for doubtful accounts once collection efforts are unsuccessful. Historically, such losses have been within management s expectations. The Company s allowance for doubtful accounts was approximately $20,000 at both December 31, 2006 and June 30, 2006. For the three months ended December 31, 2006, the Company had five customers that represented approximately 65% of revenue. The Company had no customers that represented greater than 10% of revenue for the six months ended December 31, 2006. For the three and six months ended December 31, 2005, the Company had three customers that represented approximately 67% and 58% of revenue, respectively. At December 31, 2006 and June 30, 2006, the Company had three and two customers that represented approximately 58% and 44% of accounts receivable, respectively.

The Company is subject to risks common to companies in the medical device industry including, but not limited to: new technological innovations, dependence on key personnel, dependence on key suppliers, protection of proprietary technology, compliance with government regulations, uncertainty of widespread market acceptance of products, product liability and the need to obtain additional financing. The Company s products include components subject to rapid technological change. Certain components used in manufacturing have relatively few alternative

sources of supply, and establishing additional or replacement suppliers for such components cannot be accomplished quickly. While the Company has ongoing programs to minimize the adverse effect of such uncertainty and considers technological change in estimating its allowances, uncertainty continues to exist.

The products currently under development by the Company may require clearance by the U.S. Food and Drug Administration (FDA) or other international regulatory agencies prior to commercial sales. There can be no assurance that the Company s products will receive the necessary clearance. If the Company was denied such clearance or such clearance was delayed, it could have a material adverse impact on the Company.

Inventories

Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. Excess and obsolete inventories are written down generally based on historical sales and forecasted demand, as judged by management. The Company determines inventory and product costs through use of standard costs which approximate actual average costs.

Revenue Recognition

Revenue is generated from the sale of products, shared ownership programs, and by providing related services, which include installation services, post-contract customer support (PCS), training and consulting. The Company s products and upgrades to those products include software that is essential to the functionality of the products and accordingly, the Company accounts for the sale of its products pursuant to Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2), as amended.

The Company recognizes product revenues for sales of the CyberKnife system, replacement parts and accessories when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection of the fee is probable and delivery has occurred as prescribed by SOP 97-2. Payments received in advance of product shipment are recorded as customer advances and are recognized as revenue or deferred revenue upon product shipment or installation.

For arrangements with multiple elements, the Company allocates arrangement consideration to services and PCS based upon vendor specific objective evidence (VSOE) of fair value of the respective elements. VSOE of fair value for the services element is based upon the Company s standard rates charged for the services when such services are sold separately or based upon the price established by management having the relevant authority when that service is not yet being sold separately. When contracts contain multiple elements, and VSOE of fair value exists for all undelivered elements, the Company accounts for the delivered elements, principally the CyberKnife system, based upon the residual method as prescribed by SOP No. 98-9, *Modification of SOP No. 97-2 with Respect to Certain Transactions.* If VSOE of fair value does not exist for all the undelivered elements, all revenue is deferred until the earlier of; (1) delivery of all elements, or (2) establishment of VSOE of fair value for all undelivered elements.

For PCS arrangements that include specified or committed upgrades for which the Company has not established VSOE of fair value, all revenue is deferred and accounted for as described above. In fiscal year 2006, the Company began selling PCS contracts that only provide for upgrades when and if they become available. The Company has established VSOE of the fair value of PCS in these circumstances.

For arrangements with multiple elements that include the CyberKnife system, installation services, training services and a PCS service agreement, the Company recognizes the CyberKnife system and installation services revenue following installation and acceptance of the system by application of the residual method as prescribed in SOP No. 98-9 when VSOE of fair value exists for all undelivered elements in the arrangement, including PCS.

Upgrade services revenues relate to the sale of specialized services specifically contracted to provide current technology capabilities for units previously sold through a distributor into the Japan market. The upgrade programs include elements where VSOE of fair value has not been established for the PCS. As a result, associated revenues are deferred and recognized ratably over the term of the PCS arrangement, generally four years.

Service revenue for providing PCS, which includes warranty services, extended warranty services, unspecified when and if available product updates and technical support is deferred and recognized ratably over the service period, generally one year, until no further obligation exists. At the time of sale, the Company provides for the estimated incremental costs of meeting product warranty if the incremental warranty costs are expected to exceed

the related service revenues. Training and consulting service revenues, that are not deemed essential to the functionality of the CyberKnife system, are recognized as such services are performed.

Costs associated with providing PCS and maintenance services are expensed when incurred, except when those costs are related to units where revenue recognition has been deferred. In those cases, the costs are deferred until the recognition of the related revenue and are recognized over the period of revenue recognition.

For all sales, the Company uses either a signed agreement or a binding purchase order as evidence of an arrangement. Sales to third party distributors are evidenced by a distribution agreement governing the relationship together with binding purchase orders on a transaction-by-transaction basis. The Company records revenues from an arrangement with distributors based on a sell-through method where revenue is recognized upon shipment of the product to the end user customer once all revenue recognition criteria are met. These criteria require that persuasive evidence of an arrangement exists, the fees are fixed or determinable, collection of the resulting receivable is probable and there is no right of return.

The Company s agreements with customers and distributors do not contain product return rights.

The Company assesses the probability of collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. The Company generally does not request collateral from its customers. If the Company determines that collection of a fee is not probable, the Company will defer the fee and recognize revenue upon receipt of cash.

The Company also enters into shared ownership programs with certain customers. Under the terms of such programs, the Company retains title to its CyberKnife system, while the customer has use of the product. The Company generally receives a minimum monthly payment and earns additional revenues from the customer based upon their use of the product. The Company may provide unspecified upgrades to the product during the term of each program when and if available. Upfront payments from the customer are deferred and recognized as revenue over the contractual period. Revenues from shared ownership programs are recorded as they become earned and receivable and are included within shared ownership program revenues in the consolidated statements of operations.

The CyberKnife systems associated with the Company s shared ownership programs are recorded within property, plant and equipment and are depreciated over their estimated useful life of ten years. Depreciation and warranty expense attributable to the CyberKnife shared ownership systems are recorded within costs of products. The shared ownership programs typically have a term of five years. During this term the customer has the option to purchase the CyberKnife system at pre-determined prices based on the period the system has been in use and considering the lease payments already received. Revenue from such sales is recorded in accordance with the Company s revenue recognition policy, taking into account the PCS and any other elements that might be purchased as part of the arrangement. As of December 31, 2006, one former shared ownership program customer had purchased a CyberKnife system. The total selling price of $3.5 million was recorded in deferred revenue. As of December 31, 2006, no revenue has been recognized in the consolidated statement of operations from the sale of this system.

Future minimum revenues under the shared ownership arrangements as of December 31, 2006 are as follows (in thousands):

Year ending June 30,	
2007 (remaining six months)	$ 1,564
2008	3,408
2009	3,408
2010	2,868
2011	2,082
2012 and thereafter	860
Total	$ 14,190

Total contingent revenues, included in shared ownership revenue, earned from the CyberKnife systems attributable to the shared ownership programs were $2.0 million and $3.6 million for the three and six months ended December 31, 2006, respectively, and $1.4 million and $2.7 million for the three and six months ended December 31, 2005, respectively.

Deferred Revenue and Deferred Cost of Revenue

Deferred revenue consists of deferred product revenue, deferred shared ownership program revenue, deferred service revenue and deferred other revenue. Deferred product revenue arises from timing differences between the shipment of product and the satisfaction of all revenue recognition criteria consistent with the Company s revenue recognition policy. Deferred shared ownership program revenue results from the receipt of advance monthly minimum lease payments, which will be recognized ratably over the term of the shared ownership program. Deferred service revenue results from the advance payment for services to be delivered over a period of time, usually one year. Service revenue is recognized ratably over the service period. Deferred other revenue results primarily from the Japan upgrade services programs and is due to timing differences between the receipt of cash payments for those upgrades and final delivery to the end user customer. Deferred cost of revenue consists of the direct costs associated with the manufacture of units, direct service costs and deferred costs associated with the Japan upgrade services for which the revenue has been deferred in accordance with the Company s revenue recognition policies. Deferred revenue, and associated deferred cost of revenue, expected to be realized within one year are classified as current liabilities and current assets, respectively.

Impairment of Long-Lived Assets

In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets,* the Company reviews long-lived assets, including property and equipment, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. Under SFAS No. 144, an impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. Impairment, if any, is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. Through December 31, 2006, there have been no such losses.

Stock-Based Compensation

Prior to July 1, 2006, the Company accounted for stock-based employee compensation arrangements in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* (SFAS 148). Under SFAS 123, stock-based compensation expense is measured on the date of grant based on the fair value of the award.

Effective July 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95* (SFAS 123R) using the modified prospective method under which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted or modified after the effective date and (b) based on the previous requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under previous literature.

SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates. Stock-based compensation expense was recorded net of estimated forfeitures for the three and six months ended December 31, 2006 such that expense was recorded only for those stock-based awards that are expected to vest. Prior to the adoption of SFAS 123(R), the Company adjusted stock-based compensation expense at the time forfeitures occurred in accordance with SFAS 123. Upon adoption of SFAS 123(R), the Company recorded a cumulative effect of a change in accounting principle of approximately $838,000, net of tax of $0, to reflect this change in accounting for estimated forfeitures related to periods prior to July 1, 2006. During the three and six months ended December 31, 2006, the Company recognized $2.9 million and $5.1 million, respectively, of stock-based compensation expense for stock options granted to employees.

The impact of adopting SFAS 123R in the three and six months ended December 31, 2006, was as follows (in thousands, except per share amounts):

	Three months ended December 31, 2006 Using Previous Accounting	SFAS 123(R) Adjustments	As Reported	Six months ended December 31, 2006 Using Previous Accounting	SFAS 123(R) Adjustments	As Reported
Loss from operations	$ (7,498)	$ 168	$ (7,330)	$ (6,673)	$ 315	$ (6,358)
Loss before income taxes	(7,395)	168	(7,227)	(6,363)	315	(6,048)
Loss before cumulative effect of a change in accounting principle, net of tax	(7,459)	168	(7,291)	(6,486)	315	(6,171)
Net loss	(7,459)	168	(7,291)	(6,486)	1,153	(5,333)
Basic and diluted earnings per share						
Prior to cumulative effect of a change in accounting principle	$ (0.46)	$ 0.01	$ (0.45)	$ (0.40)	$ 0.02	$ (0.38)
Cumulative effect of a change in accounting principle					0.05	0.05
	$ (0.46)	$ 0.01	$ (0.45)	$ (0.40)	$ 0.07	$ (0.33)

During the three and six months ended December 31, 2006, the estimated fair value of the stock options granted is calculated at the date of grant using the Black-Scholes option pricing model, using fair values of common stock between $12.88 and $14.88 per share. Expected volatility is based on the historical volatility of a peer group of publicly traded companies. The expected term of options is based upon the vesting term of the Company s options (i.e., 25% on the first anniversary of the vesting start date and 36 equal monthly installments thereafter) and on its partial life history. The risk-free rate for the expected term of the option is based on the U.S. Treasury Constant Maturity rate. The following weighted-average assumptions were used during the three and six months ended December 31, 2006:

	Three months ended December 31, 2006	Six months ended December 31, 2006
Risk-free interest rate	5.07 %	4.92 %
Dividend yield		
Weighted average expected life	6.25	6.25
Expected volatility	70.8 %	76.7 %

The Company believes that the fair value of the stock options is more reliably measurable than the fair value of the services received. In connection with the preparation of its financial statements, the Company determined the estimated fair value of its common stock in light of the expected completion of its initial public offering. The Company engaged Cogent Valuation, an unrelated third-party appraisal firm, to assist management in this process by providing a valuation analysis that valued the Company s common stock. During the three and six months ended December 31, 2005, the Company recognized $2.3 million and $4.2 million of stock-based compensation expense, net of reversals for cancellations, respectively, for stock options granted to employees.

The estimated fair value of the stock options granted is calculated at the date of grant using the Black-Scholes option pricing model, as prescribed by SFAS 123, using fair values of common stock between $6.35 and $7.06 per share and the following weighted-average assumptions during the three and six months ended December 31, 2005:

	Three months ended December 31, 2005	Six months ended December 31, 2005
Risk-free interest rate	4.45 %	4.45 %
Dividend yield		
Weighted average expected life	6.25	6.25
Expected volatility	87.6 %	87.6 %

Net Loss Per Common Share

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss by the weighted-average number of dilutive common shares outstanding during the period. Dilutive shares outstanding are calculated by adding to the weighted shares outstanding any common stock equivalents from outstanding stock options and warrants based on the treasury stock method. In periods when net income is reported, the calculation of diluted net income per share typically results in lower earnings per share than is calculated using the basic method. In periods when a net loss is reported, such as the three and six months ended December 31, 2006 and 2005, these potential shares from stock options and warrants are not included in the calculation because they would have an anti-dilutive effect, meaning the loss per share would be reduced. Therefore, in periods when a loss is reported, the calculation of basic and diluted net loss per share results in the same value.

For the three and six months ended December 31, 2006, the basic and diluted net loss per share were based on weighted-average shares of 16,209,175 and 16,234,121, respectively. For the three and six months ended December 31, 2005, the basic and diluted net loss per share were based on weighted-average shares of 15,941,896 and 15,881,437, respectively. The number of anti-dilutive shares excluded from the calculation of diluted net loss per share are as follows:

	Three Months Ended December 31,		**Six Months Ended December 31,**	
	2006	**2005**	**2006**	**2005**
Preferred stock (as if converted)	25,186,285	25,186,285	25,186,285	25,186,285
Options to purchase common stock	9,511,261	7,604,523	8,931,546	7,912,410
Warrants	489,431	449,133	487,792	446,642
	35,186,977	33,239,941	34,605,623	33,545,337

The following table sets forth the basic and diluted per share computations:

	Three Months Ended December 31,		**Six Months Ended December 31,**	
	2006	**2005**	**2006**	**2005**
Numerator:				
Net loss (in thousands)	$ (7,291)	$ (7,936)	$ (5,333)	$ (18,146)
Denominator:				
Basic and diluted weighted average shares of common stock outstanding	16,209,175	15,941,896	16,234,121	15,881,437
Basic and diluted net loss per share:	$ (0.45)	$ (0.50)	$ (0.33)	$ (1.14)

Income Taxes

Deferred tax assets and liabilities are determined based on the differences between financial reporting and tax bases of assets and liabilities, using tax rates expected to be in effect when the differences will reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

Segment Information

The Company has determined that it operates in only one segment in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131) as it only reports profit and loss information on an aggregate basis to its chief operating decision maker. The Company s long-lived assets maintained outside the United States are insignificant.

The following summarizes revenue by geographic region (in thousands):

	Three Months Ended December 31,		**Six Months Ended December 31,**	
	2006	**2005**	**2006**	**2005**
United States	$ 17,433	$ 9,864	$ 38,848	$ 12,242
Europe	7,296	117	11,576	301
Asia (except Japan)	218	100	5,938	155
Japan	1,400	1,245	2,756	2,499
Total	$ 26,347	$ 11,326	$ 59,118	$ 15,197

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not yet determined the impact that adoption of this standard will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* . The standard defines fair value and provides a framework for using fair value to measure assets and liabilities. SFAS No. 157 establishes the principle that fair value should consider characteristics specific to the asset or liability based on the assumptions that market participants would use when pricing the asset or liability. SFAS No. 157 is effective for the Company beginning in fiscal 2008, though early adoption is permitted. The Company has not yet determined the impact that adoption of this standard will have on its consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB No. 108). SAB No. 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying misstatement in the current period. The SEC staff believes that registrants should quantify errors using both an iron curtain and a rollover approach and evaluate whether either approach results in a material misstatement in the reporting fiscal period, when all relevant quantitative and qualitative factors are considered. SAB 108 is effective for fiscal years ending on or after November 15, 2006, with the option for early adoption. The Company does not expect that the adoption of SAB 108 will have a material impact on its results of operations or financial position.

3. BALANCE SHEET COMPONENTS

Accounts receivable, net

Accounts receivable, net consists of the following (in thousands):

	December 31, 2006	June 30, 2006
Accounts receivable	$ 18,181	$ 10,866
Unbilled fees and services	680	852
	18,861	11,718
Less: Allowance for doubtful accounts	(20)	(20)
	$ 18,841	$ 11,698

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market. As of December 31, 2006 and June 30, 2006, inventories consisted of the following (in thousands):

	December 31, 2006	June 30, 2006
Raw materials	$ 5,132	$ 4,447
Work-in-process	6,588	1,559
Finished goods	3,220	4,094
	$ 14,940	$ 10,100

4. GOODWILL AND OTHER PURCHASED INTANGIBLES

Goodwill and other intangible assets with indefinite lives are not amortized in accordance with SFAS 142, *Goodwill and Other Intangible Assets* (SFAS 142). Intangible assets with determinable useful lives are amortized on a straight line basis over their useful lives. SFAS 142 requires that the Company perform an annual test for impairment of intangible assets with indefinite lives, and interim tests if indications of potential impairment exist. The Company performed the annual test for impairment in December 2006 concluding that there was no impairment of goodwill.

The amortization expense relating to intangible assets for the three and six months ending December 31, 2006 was approximately $64,000 and $129,000, respectively. The amortization expense relating to intangible assets for the three and six months ending December 31, 2005 was approximately $59,000 and $235,000, respectively. The following represents the gross carrying amounts and accumulated amortization of amortized intangible assets at December 31, 2006 and June 30, 2006 (in thousands):

	December 31, 2006	June 30, 2006
Complete technology	$ 1,740	$ 1,740
Customer contract / relationship	70	70
	1,810	1,810
Less: Accumulated amortization	(493)	(364)
Intangible assets, net	$ 1,317	$ 1,446

The following table represents the estimated useful life of the intangible assets subject to amortization:

	Years
Amortized intangible assets:	
Complete technology	7.0
Customer contract / relationship	7.0

The estimated future amortization expense of purchased intangible assets as of December 31, 2006, is as follows (in thousands):

Year ending June 30,	
2007 (remaining six months)	$ 130