GSI LUMONICS INC
Form 10-K/A
June 30, 2003

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

Form 10-K/A
Amendment No. 3

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2002

Commission File No. 000-25705

GSI Lumonics Inc.
(Exact name of registrant as specified in its charter)

New Brunswick, Canada *(State or other jurisdiction of incorporation or organization)*	**98-0110412** *(I.R.S. Employer Identification No.)*
39 Manning Road **Billerica, Massachusetts, USA** *(Address of principal executive offices)*	**01821** *(Zip Code)*

(978) 439-5511

(Registrant s telephone number, including area code)

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) 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 such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES þ NO o

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. þ

The aggregate market value of the Registrant s common shares held by non-affiliates of the Registrant, based on the closing price of the common shares on The NASDAQ Stock Market® on the last business day of the Registrant s most recently completed second fiscal quarter (June 28, 2002) was approximately $261,848,010 (assumes officers, directors, and all shareholders beneficially owning 5% or more of the outstanding common shares are affiliates).

There were approximately 40,806,464 of the Registrant s common shares, no par value, issued and outstanding on June 26, 2003.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12-b-2 of the Securities Exchange Act of 1934). YES þ NO o

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As used in this report, the terms we, us, our, GSI Lumonics and the company mean GSI Lumonics Inc. and its subsidiaries, unless the context indicates another meaning.

Unless otherwise noted, all dollar amounts in this report are expressed in United States dollars.

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EXPLANATORY NOTE

In accordance with Rule 12b-15 under the Securities Exchange Act of 1934, as amended, we are filing this Amendment No. 3 on Form 10-K/ A in response to comments received from the staff of the Securities and Exchange Commission in connection with their review of our proxy circular-prospectus contained in the Registration Statement on Form S-4 of GSLI Corp. Our Annual Report on Form 10-K for the fiscal year ended December 31, 2002 was filed on March 31, 2003 and on May 21, 2003 we filed an Amendment No. 2 on Form 10-K/ A in response to an earlier round of comments from the staff of the Securities and Exchange Commission.

In this filing we have specifically amended and restated Items 7 and 8 of Part II and Item 15 of Part IV (to reflect recently filed reports on Form 8-K and the inclusion of an updated consent of Ernst & Young LLP). Please note that we have not been requested to, and we are not, restating our financial results. The only changes made to Item 8 have been to notes 10, 11, 13 and 15 to the consolidated financial statements but, for ease of reference and consistency of presentation, we have elected to restate Item 8 in its entirety in this report.

This report speaks as of the original filing date of our Annual Report on Form 10-K (March 31, 2003) and, except as indicated below, has not been updated to reflect events occurring subsequent to that date. All information contained in this and our previous filings is subject to updating and supplementing as provided in our periodic reports filed with the Securities and Exchange Commission.

PART I

Item 1. ***Business of GSI Lumonics Inc.***

The text appearing under the heading Recent Developments is deleted in its entirety and replaced with the following:

Recent Developments

On March 31, 2003, our wholly-owned subsidiary GSLI Corp filed with the Securities and Exchange Commission a registration statement on Form S-4 containing a joint proxy circular-prospectus of the company and GSLI Corp which included a proposal to approve a plan of arrangement, the principal effect of which would be to restructure the company as a publicly traded United States domiciled corporation. Subsequently, GSLI Corp filed a series of amendments to the registration statement in response to comments received from the Securities and Exchange Commission and, on June 27, 2003, the registration statement was declared effective by the Securities and Exchange Commission.

A special meeting at which shareholders and optionholders of the company will be asked to vote on the plan of arrangement, originally scheduled to be held on Thursday, July 24, 2003, will now be held at 10:00 a.m. on Monday, August 4, 2003 at the Renaissance Bedford Hotel in Bedford, Massachusetts.

The foregoing discussion is qualified by and subject to the more detailed information on the plan of arrangement, including the applicable reasons, mechanics, effects and risks associated therewith, contained in the registration statement on Form S-4 filed by GSLI Corp with the Securities and Exchange Commission.

PART II

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

You should read this discussion together with the consolidated financial statements and other financial information included in this report. This report contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those indicated in the forward-looking statements. Please see the Special Note Regarding Forward Looking Statements elsewhere in this report.

Overview

We design, develop, manufacture and market components, lasers and laser-based advanced manufacturing systems as enabling tools for a wide range of applications. Our products allow customers to meet demanding manufacturing specifications, including device complexity and miniaturization, as well as advances in materials and process technology. Major markets for our products include the medical, automotive, semiconductor and electronics industries. In addition, we sell our products and services to other markets such as light industrial and aerospace.

We completed a merger of equals with General Scanning, Inc. on March 22, 1999. The merger transaction has been accounted for as a purchase for accounting purposes and, accordingly, the operations of General Scanning, Inc. have been included in the consolidated financial statements from the date of merger.

Results of Operations. The following table sets forth items in the consolidated statement of operations as a percentage of sales for the periods indicated:

	Year Ended December 31,		
	2002	**2001**	**2000**
Sales	100.0%	100.0%	100.0%
Cost of goods sold	69.1	65.4	64.8
Gross profit	30.9	34.6	35.2
Operating expenses:			
Research and development	12.9	10.3	9.1
Selling, general and administrative	34.9	29.8	23.5
Amortization of purchased intangibles	3.2	2.1	1.3
Restructuring	4.0	1.2	2.7
Other	(0.6)	(0.1)	(0.8)
Operating expenses	54.4	43.3	35.8
Loss from operations	(23.5)	(8.7)	(0.6)
Gain (loss) on sale of assets and investments		(1.9)	20.5
Other income (expense)	(0.3)		
Interest income, net	1.3	1.7	0.9
Foreign exchange transaction gains (losses)	(0.5)	(0.1)	(0.8)
Income (loss) before income taxes	(23.0)	(9.0)	20.0
Income tax provision (benefit)	(5.6)	(3.1)	7.9
Net income (loss)	(17.4)%	(5.9)%	12.1%

Commencing in the first quarter of 2002, we classified service sales support and service management costs as selling, general and administrative expenses. The table above reflects the reclassification of service sales support and service management costs from cost of goods sold to selling, general and administrative expense for 2000 and 2001 to be comparative with the current period. The change was made to properly classify costs that we believed should be classified as selling, general and administrative costs rather than cost of sales. The primary components of the costs reclassified were the general management of the company s service organization, which included the vice president of that organization and management employees worldwide who report to him, sales and marketing activities for service products, training development and order entry support. The company continues to reflect all direct field costs for services as well as technical support costs in cost of sales.

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Business Environment and Restructurings

Several significant markets for our products have been in severe decline for the past two years. Our sales of systems for semiconductor and electronics applications and precision optics for telecommunications have declined. From 2000 through 2002, the company faced a 57% decline in revenues and responded by streamlining operations to reduce fixed costs. This decline continues to the present and is due to the downturn in general economic conditions, combined with our customers current excess of manufacturing capacity and their customers excess inventories of semiconductor and electronic components.

In response to the business environment, we have undertaken to restructure our operations in an effort to bring costs in line with our expectations for sales of systems for the semiconductor and telecommunications markets. Our emphasis has predominantly been on consolidation of operations at various locations and reducing overhead. The company expects to incur additional restructuring charges in the first three quarters of 2003 as it continues to reduce and consolidate operations around the world.

2000

During fiscal 2000, the company took total restructuring charges of $15.1 million, $12.5 million of which resulted from the company s determination to exit the high powered laser product line that was produced in its Rugby, United Kingdom facility. The $12.5 million charge consisted of $1 million to accrue employee severance for approximately 50 employees; $3.8 million for reduction and elimination of the company s United Kingdom operation and worldwide distribution system related to high power laser systems; and $7.7 million for excess capacity at three leased facilities in the United States and Germany where high power laser systems operations were conducted. The provisions for lease costs at our Livonia and Farmington Hills, Michigan facilities and in Germany related primarily to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. Additionally, for our Farmington Hills, Michigan and Maple Grove, Minnesota facilities, we accrued an anticipated loss on our contractual obligations to guarantee the value of the buildings. This charge was estimated as the excess of our cost to purchase the buildings over their estimated fair market value. The company also recorded a non-cash write-down of land and building in the United Kingdom of $2 million, based on market assessments as to the net realizable value of the facility. Included in the expected savings in earnings and cash on an annual go forward basis was approximately $1.1 million related to salaries and benefits of employees terminated in the company s Rugby, United Kingdom manufacturing facility as part of the elimination of this product line. In addition, the company recorded in cost of goods sold a reserve of $8.5 million for raw materials, work-in-process, equipment, parts and demo equipment inventory that related to the high power laser product line in its Rugby, United Kingdom facility and other locations that supported this product line.

The remaining restructuring charge for fiscal 2000, $0.6 million of compensation expense, resulted from the acceleration of options upon the sale of our Life Sciences business and MPG product line during that year.

Also during fiscal 2000, the company reversed a provision of $5 million originally recorded at the time of the 1999 merger of General Scanning, Inc. and Lumonics Inc. At the time the $5 million provision was recorded, the company intended to close its Rugby, United Kingdom facility and transfer those manufacturing activities to its Kanata, Ontario facility. As plans evolved, the company realized that it would cost too much to move the manufacturing and decided to not go through with its original plan. Thus, the company reversed the $5 million that had initially been recorded for this proposed restructuring.

Cumulative cash draw-downs of $6 million, a reversal of $0.5 million recorded in the fourth quarter of 2001 for anticipated restructuring costs that will not be incurred and a non-cash draw-down of $2.6 million have been applied against the total fiscal 2000 provision of $15.1 million, resulting in a remaining balance at December 31, 2002 of $6 million. All actions relating to the 2000 restructuring charge have been completed. The $6 million accrual remaining at December 31, 2002 for the Farmington Hills, Michigan and the Maple Grove, Minnesota facilities is expected to be used during 2003 at the end of the lease terms to offset the anticipated loss on these leases upon purchase and eventual resale of the buildings.

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2001

In the fourth quarter of fiscal 2001, to further reduce capacity in response to declining sales, the company determined that the remaining functions located in its Farmington Hills, Michigan facility should be integrated with its Wilmington, Massachusetts facility and that its Oxnard, California facility should be closed. In addition, the company determined to integrate its Bedford, Massachusetts facility with its Billerica, Massachusetts manufacturing facility. The company took total restructuring charges of \$3.4 million. The \$3.4 million charge consisted of \$0.9 million to accrue employee severance for approximately 35 employees at the Farmington Hills, Michigan and Oxnard, California locations; \$1.8 million for excess capacity at five leased locations in the United States, Canada and Germany; and \$0.7 million for write-down of leasehold improvements and certain equipment associated with the exiting of leased facilities located in Bedford, Massachusetts. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. The expected effects of the 2001 restructuring were to better align our ongoing expenses and cash flows in light of reduced sales. The company anticipated savings of approximately \$2.4 million on an annual basis related to salaries and benefits of employees terminated at these facilities in connection with this restructuring.

Cumulative cash draw-downs of approximately \$2.4 million and non-cash draw-downs of \$0.7 million have been applied against the provision, resulting in a remaining provision balance of \$0.3 million as at December 31, 2002. The restructuring is complete, except for costs that are expected to be paid on the leased facilities in Munich, Germany (lease expiration January 2013), Oxnard, California (expected payment March 2003) and Nepean, Ontario (lease expiration January 2006).

2002

Two major restructuring plans were initiated in 2002, as the company continued to adapt to a lower level of sales. In the first quarter of 2002, the company made a determination to reduce fixed costs by transferring manufacturing operations at its Kanata, Ontario facility to other manufacturing facilities. Associated with this decision, the company incurred restructuring costs in the first, second and fourth quarters of 2002. At this time, the company believes that all cost associated with the closure of this facility have been recorded, as noted below.

During the first quarter of 2002, the company consolidated its electronics systems business from its facility in Kanata, Ontario into the company s existing systems manufacturing facility in Wilmington, Massachusetts and transferred its laser business from the company s Kanata, Ontario facility to its existing facility in Rugby, United Kingdom. The company then closed its Kanata, Ontario facility. The company took a total restructuring charge of \$2.7 million related to these activities in the first quarter of 2002. The \$2.7 million charge consisted of \$2.2 million to accrue employee severance and benefits for approximately 90 employees; \$0.3 million for the write-off of furniture, equipment and system software; and \$0.2 million for plant closure and other related costs. Future expense and cash outflow associated with the termination of the 90 employees will be avoided, improving income before tax and cash flow by approximately \$1.2 million per quarter. During the second quarter of fiscal 2002, the company recorded additional restructuring charges of \$1.4 million related to cancellation fees on contractual obligations of \$0.3 million, an aggregate write-down of land and building in Kanata, Ontario and Rugby, United Kingdom of \$0.8 million and leased facility costs of \$0.3 million at the Farmington Hills, Michigan and Oxnard, California locations. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. The write-downs of the land and building brings the properties offered for sale in line with market values and the recording of these write-downs has no effect on cash.

The second major restructuring plan in 2002 related to the refocusing of our Nepean, Ontario operations on the custom optics business as a result of the telecom industry s severe downturn. The company s executive team approved a plan to reduce capacity at its Nepean, Ontario facility and the company recorded a pre-tax restructuring charge of \$2.3 million in the fourth quarter of 2002 which included \$0.6 million to accrue employee severance and benefits for approximately 41 employees. Future expense and cash outflow associated with the 41 terminated employees will be avoided, improving quarterly income before tax and cash flow by approximately \$0.5 million per quarter. The company also wrote-off approximately \$0.2 million of excess fixed

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assets and wrote-down one of the Nepean, Ontario buildings by $0.2 million to its estimated fair market value. Additionally, the company continued to evaluate accruals made in prior restructurings and we recorded charges of approximately $0.8 million for an adjustment to earlier provisions for leased facilities in the United States and Germany. Specifically, the $0.8 million in adjustments in the fourth quarter of 2002 related to earlier provisions for the leased facilities in Munich, Germany, Maple Grove, Minnesota and Farmington Hills, Michigan. We had originally estimated our restructuring reserve of $0.5 million based upon the assumption that we would have subleased the Munich, Germany facility in 2003. We had received information from a real estate broker that the commercial office market in Munich, Germany had softened and that we would not recover our full lease rate when we finally sublease the building. As such we recorded an additional provision of $0.5 million to cover a longer anticipated time required to sublease the space and to reflect the likelihood of subleasing at less than our existing lease rates. For the Maple Grove, Minnesota facility, we had subleased the entire building through January 2003. We had anticipated that we would find a buyer for this building by January 2003 and exercise our option to purchase the building and not have to pay the remaining lease costs. As this did not happen, we accrued the contractual lease costs through the end of the lease in June 2003, which are $0.2 million. Similarly for the Farmington Hills, Michigan facility, we had anticipated selling the building sooner, but as this did not occur by the end of 2002, we accrued the costs for the unused space through the end of the lease in June 2003, which are $0.1 million. The company also took a further write-down of $0.3 million on the buildings in Kanata, Ontario and Rugby, United Kingdom and a $0.1 million write-off for fixed assets in Kanata, Ontario and a $0.1 million for the Maple Grove, Minnesota and Farmington Hills, Michigan facilities.

At December 31, 2002, the net book value of two facilities, one in Kanata, Ontario and the other in Nepean, Ontario, were reclassified as held for sale and included in other assets.

Cumulative cash draw-downs of approximately $2.1 million and non-cash draw-downs of $1.8 million have been applied against the provisions taken in 2002, resulting in a remaining provision balance of $2.5 million at December 31, 2002. For severance related costs associated with these two restructuring actions, the actions are complete and the company does not anticipate taking additional restructuring charges and expects to finalize payment in 2003. The company will continue to evaluate the fair value of the buildings and fixed assets that were written down. The restructuring accrual is expected to be completely utilized during January 2013 at the end of the lease term for the Munich, Germany facility. The company estimated the restructuring charge for the Munich, Germany facility based on contractual payments required on the lease for the unused space, less what is expected to be received for subleasing. Because this is a long term lease that extends until 2013, the company will draw-down the amount accrued over the life of the lease. Future sublease market conditions may require the company to make further adjustments to this restructuring reserve.

The result of this restructuring activity was the establishment of our three new primary business segments: Components, Lasers and Laser Systems. In addition, improved working capital management provided substantially reduced investment in receivables and inventories.

2002 Compared to 2001

Sales by Segment. The following table sets forth sales in millions of dollars by our business segments for 2002 and 2001. The information was not available and impracticable to obtain to reclassify 2000 results into these new segments. In 2000, there were other businesses and product lines that were subsequently divested or discontinued that do not conform to the new segments, as such the information would not be comparable. Information for 2000 by segment is not presented.

	2002 Sales	2001 Sales
Components	$ 70.5	$ 88.7
Lasers	23.7	39.1
Laser Systems	65.9	124.0
Other and intra-segment eliminations	(1.0)	(3.9)
Total	$ 159.1	$ 247.9

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Sales for 2002 decreased by $88.8 million or 36% compared to 2001. The divestiture and discontinuation of product lines accounted for $12 million of this reduction. But, the primary reason for the decline remains the deep recession in the market for semiconductor and electronic capital equipment and optical telecommunications components, which began midway through 2001. Sales have now stabilized at a level of approximately $40 million per quarter since the third quarter of 2001.

Sales in the Components segment decreased in 2002 by $18.2 million compared to 2001. The weakness in the telecommunications market sector was the primary cause for the decline. Sales from the product lines linked to that sector accounted for a combined $9.6 million in sales reduction. Other factors were a $6.1 million reduction in the Optical Scanning product line affected by the downturn of the semiconductor industry and the market for laser ophthalmology equipment and $1.8 million decline in our GMAX product line affected by a slow down in Europe and North America. Discontinued product lines contributed another $0.7 million in sales decrease against 2001.

Sales in the Lasers segment declined by $15.4 million or 39% below 2001 results. The decline was due to a combination of repositioning the business out of high power automotive lasers into lower power lasers for medical and other markets, as well as the introduction of a new family of products. Our JK series and Excimer laser product lines accounted for $10.8 million or 70% of the sales decline in this segment against 2001. Excimer laser sales declined as a result of the collapse of the telecommunications market. Discontinued product lines accounted for $1.4 million of the 2002 sales decline.

The sales of Laser Systems have suffered the most with a $58.1 million or 47% decline from 2001. Our Trim & Test, WaferMark and DrillStar product line sales decreased by a combined $57.9 million primarily due to lower volume reflecting the downturn in the global semiconductor, electronics and telecom industries. These factors were partially offset by market acceptance of our Memory Repair product line, sales of which increased by $10.9 million in 2002 from 2001. Discontinued and divested product lines accounted for $10 million of the 2002 sales decline.

Sales by Region. We distribute our systems and services via our global sales and service network and through third-party distributors and agents. Our sales territories are divided into the following regions: the United States; Canada; Latin and South America; Europe, consisting of Europe, the Middle East and Africa; Japan; and Asia-Pacific, consisting of ASEAN countries, China and other Asia-Pacific countries. Sales are attributed to these geographic areas on the basis of the bill to customer location. Not infrequently, equipment is sold to large international companies, which may be headquartered in Asia-Pacific, but the sales of our systems are billed and shipped to locations in the United States. These sales are therefore reflected in United States totals in the table below. The following table shows sales in millions of dollars to each geographic region for 2002, 2001 and 2000.

	2002		2001		2000	
	Sales	**% of total**	**Sales**	**% of total**	**Sales**	**% of total**
United States	$ 94.7	59%	$119.3	48%	$177.8	48%
Canada	1.9	1	11.4	5	20.2	5
Latin and South America	1.2	1	0.9		5.5	1
Europe	25.8	16	50.7	20	72.0	19
Japan	23.5	15	41.0	17	58.2	16
Asia-Pacific, other	12.0	8	24.6	10	40.2	11
Total	$159.1	100%	$247.9	100%	$373.9	100%

The significant downturn in economic conditions that commenced in 2001, especially in the global semiconductor, electronics and telecom industries, continues to impact sales in all of our geographic regions. The 2002 sales decline of 20.6% in the United States was not as marked as the percent decline in other regions, because there was a relatively moderate sales decline of 23% in the Components segment, which is predominately in the United States, and there was a $6.4 million sales increase in the United States in

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Memory Repair over 2001. Sales from the Components segment and Memory Repair accounted for respectively $52.7 million or 56%, and $12.5 or 13% of the sales recorded in the United States in 2002. Other products sold in the United States recorded a combined 40% decline in 2002. The decline in Canada in 2002 compared to 2001 relate primarily to the downturn of the optics and telecommunication market sectors. Europe, Japan and Asia Pacific all suffered from the downturn in the semiconductor and electronics markets. In 2000, all geographic regions had relatively strong sales. This was especially true for Japan and Asia Pacific, which experienced recovery in 2000 after the financial crisis and economic downturn of the 1990s.

Backlog. We define backlog as unconditional purchase orders or other contractual agreements for products for which customers have requested delivery within the next twelve months. Backlog was $42 million at December 31, 2002, compared to $50 million at December 31, 2001 and $119 million at December 31, 2000.

Gross Profit. Gross profit was 30.9% in 2002 and 34.6% in 2001. Gross profit as a percentage of sales in 2002 decreased compared to 2001 primarily as a result of fixed costs representing a larger percentage of cost of sales in 2002 as compared to 2001. When sales dropped dramatically, fixed costs as a percentage of sales increased. Fixed costs for manufacturing and service were 18.1% of sales in 2002 versus 14.6% in 2001. These fixed costs of sales were higher, year over year, as a percentage of sales, despite decreasing by $7.4 million, or 20%, from 2001 to 2002, because sales in the same period decreased by 36%. Fixed costs are not variable to sales and we cannot quickly reduce these expenses. Major items in fixed costs are salaries and benefits for non-direct labor, facility and occupancy costs (rent and buildings that are under long term contracts) and depreciation expense (which is spread over the life of the assets). We have tried through restructurings to reduce fixed costs over time, but we cannot reduce fixed costs as a one-for-one match to sales declines in any particular period. To the extent that we cannot reduce these fixed costs in the future at the same rate as any reduction in sales, we could experience lower margins. Favorable fluctuations as a percentage of sales in cost of materials (3%) and other costs of sales (1%) were offset by unfavorable fluctuations as a percentage of sales in direct service cost (3%) and inventory provision (1%).

Although the number of competitors in our marketplace remained relatively constant, demand for our products, particularly products in the markets served by our Laser Systems segment, decreased in 2002 from 2001. As a result, we faced increased competition for fewer potential sales. In an effort to reduce some of our slower moving inventory, we reduced prices on some of our products, primarily in lines in which the company does not expect to focus significant resources in the future. We anticipate that pricing pressure will continue in the future and that such pressure will continue to affect sales particularly in our Laser Systems segment. To attempt to improve our gross profit as a percentage of sales in the future, we have taken steps to reduce our fixed manufacturing costs and to add technology features to some of our products that, as a result, we believe may command a premium price, although no assurances can be given that we will be successful in improving or preventing a future decline in our gross profit percentage.

As a policy, we review inventory values, based on expected future usage, to ensure that inventory is recorded at the lower of cost or net realizable values. The company establishes a reserve in the event of excess inventory. In 2002, as sales declined, the company established additional inventory reserves for potential excess and obsolete inventory. The majority of these reserves were in our Laser Systems and Lasers segments. The company has initiated programs to try to sell this inventory and believes that, based on the stabilization of sales since the third quarter of 2001, the current inventory provisions are adequate, although no assurances can be given that such provisions will be adequate or that the markets that our products serve will not further deteriorate.

Commencing in the first quarter of 2002, we classified service sales support and service management costs as selling, general and administrative expenses. In prior years, we classified these costs as cost of goods sold. As such we have reclassified in the comparative statement of operations $5.3 million in 2002 and $5.1 million in 2001 from cost of goods sold to selling, general and administrative expenses. The reclassification was prepared on a consolidated basis only and is not available by segment.

Research and Development Expenses. Research and Development (R&D) expenses for 2002 were 12.9% of sales or $20.4 million, compared to 10.3% of sales or $25.6 million in 2001.

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The R&D expenses in the Components segment were $4.4 million in 2002 compared to $6.3 million in 2001. The decrease in R&D expenses of $1.9 million in 2002 is due primarily to a $1.3 million reduction in projects related to the telecommunications market.

The R&D expenses in the Lasers segment were $2.8 million in 2002 compared to $3 million in 2001. The modest reduction in R&D spending in 2002 in spite of lower sales confirm the company s commitment to grow the equipment sales in this segment.

The R&D expenses in the Laser Systems segment were $12.4 million in 2002 compared to $16.4 million in 2001. The decrease of $4 million in 2002 reflects the completion of major projects and the impact of initiatives undertaken by the company to focus our spending on key potential growth areas.

R&D expenses for $0.8 million in 2002 compared to none in 2001 were recorded at the corporate level. These expenses are mostly in support of our patent application management. In 2001 similar expenses were recorded at the factory level.

Selling, General and Administrative Expenses. Selling, General and Administrative (SG&A) expenses decreased by $18.3 million to $55.5 million or 34.9% of sales in 2002 compared to $73.8 million or 29.8% of sales in 2001. There was a 31% reduction in SG&A headcount from December 31, 2001 to December 31, 2002. SG&A cost reductions, however, did not decline during 2002 proportionately as much as our sales, resulting in an increase in SG&A as a percentage of sales ratio from 2001 to 2002. Of the total decrease in SG&A expenses from 2001 to 2002, $9 million or 49% of the decrease is attributable to reduced personnel costs, such as salaries and benefits, as a result of the reductions in headcount made during 2002 and mandatory shutdown days. Also, as a result of decreased hiring, recruiting expenses decreased by $0.5 million. Lower commissions as a result of lower sales accounted for $1.9 million or 10% of decrease in SG&A expenses from 2001 to 2002. Lower occupancy costs as a result of reductions in operating locations accounted for $1.3 million or 8% of the decrease in SG&A spending year over year. Reductions in spending on consultants and temporary employees accounted for $1.2 million or 6% of the decrease in SG&A expenses from 2001 to 2002. Lower spending on travel related expenses accounted for $1 million or 5% of the decrease in SG&A expenses. Although legal expenses decreased by $0.9 million from 2001 to 2002, they were still approximately $2.5 million for the year ended 2002, as a result of expenses associated with the defense of two lawsuits that were settled in 2002. The balance of the decrease in SG&A expenses from 2002 to 2001 of approximately $2.5 million was in a variety of areas as a result of cost cutting measures that were implemented.

As noted above, in 2002 service sales support and service management costs were reclassified to selling, general and administrative expenses from cost of goods sold. As this was done on a consolidated basis, it is not possible to breakdown SG&A expenses by segment.

Amortization of Purchased Intangibles. Amortization of purchased intangibles was $5.1 million in 2002 compared to $5.2 million in 2001. This slight decrease in the amortization in 2002 as compared to 2001 is due to the write-down of certain intangibles that occurred at the end of 2001.

Restructuring. As described above and in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, we recorded restructuring charges of $6.4 million in the year then ended and of $2.9 million in the year ended December 31, 2001.

Other. Other includes a net benefit of $0.7 million from settlement of two lawsuits during 2002 and royalty income of $0.3 million. As more fully described in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, during the fourth quarter of 2001, the company recorded a reduction of purchased intangibles related to technologies no longer a part of the business in the amount of $1.8 million. Also, during 2001, the company recorded a benefit of $0.3 million related to royalties earned on the divested OLT precision alignment system product line. The company also adjusted a $19 million provision originally recorded the first quarter of fiscal 1999 related to litigation and recorded a benefit of $1.6 million when the litigation was settled.

Loss from Operations. The following table sets forth loss from operations in thousands of dollars by our business segments for the years ended December 31, 2002 and 2001.

	Year Ended December 31,	
	2002	2001
Profit (loss) from operations before income taxes		
Components	$ 16,763	$ 18,603
Lasers	(5,010)	4,425
Laser Systems	(18,732)	(23,712)
Total by segment	(6,979)	(684)
Unallocated amounts:		
Corporate expenses	19,754	12,983
Amortization of purchased intangibles	5,135	5,226
Restructuring and other	5,427	2,782
Loss from operations	$ (37,295)	$ (21,675)

Gain (loss) on Sale of Assets and Investments. During 2001, we sold our investment in shares of PerkinElmer, Inc. for a loss of $4.8 million. There were no such items in 2002.

Interest Income. Interest income was $2.7 million in 2002 compared to $5.1 million in 2001. The decrease in interest income in 2002 was due to continuous declines in interest rates.

Interest Expense. Interest expense was $0.7 million in 2002 compared to $0.9 million in 2001. The decrease in interest expense in 2002 was due to lower balances of debt in 2002 than 2001. By the end of December 2002, the company had no bank debt.

Other Expense. In 2002, we recorded a write-down of approximately $0.6 million related to an investment in OpNet Partners, L.P. See note 10 to the audited consolidated financial statements.

Income Taxes. The effective tax rate for 2002 was 24.5% of income before taxes, compared to an effective tax rate of 34.6% for 2001. Our tax rates in 2002 and 2001 reflect the fact that we do not recognize the tax benefit from losses in certain countries where future use of the losses is uncertain and other non-deductible costs. The company believes it is more likely than not that the remaining deferred tax assets will be realized principally through future taxable income and carry backs to taxable income in prior years. If the company does not return to profitability, we may be at risk to take further write-downs in our deferred tax assets.

Net Income (Loss). As a result of the forgoing factors, net loss during 2002 was $27.7 million, compared with a net loss of $14.7 million in 2001.

2001 Compared to 2000

Sales. The total sales in 2001 of $247.9 million were $126 million or 34% below the total sales in 2000. The divestitures of the LaserDyne, Custom Systems, Life Sciences, Metrology and Xymark product lines accounted for $42.8 million or 34% of the decline. The discontinuation of the AM Series and other product lines accounted for $35.2 million or 28% of the decline. We expect that sales from these divested and discontinued product lines will be negligible going forward. The balance of the 2001 sales decline as compared to the prior year was primarily due to the significant downturn in the markets we serve, especially in the semiconductor and electronics markets.

Gross Profit. Gross profit was 34.6% in 2001 and 35.2% in 2000. Gross profit in 2001 decreased compared to 2000 as a result of the economic downturn and fixed manufacturing and service overhead costs, which were not reflective of the lower sales volumes during the period. This was partially offset by lower inventory loss provisions in 2001 compared to 2000. In the fourth quarter of 2000, the company wrote off

$8.5 million of AM series inventory related to high power lasers for the auto industry that we discontinued and evaluated other inventory that resulted in a $10.5 million increase in inventory provision.

Research and Development Expenses. Research and Development (R&D) expenses were 10.3% of sales or $25.6 million in 2001 and 9.1% of sales or $33.9 million in 2000. During 2001 and 2000, R&D activities focused on products targeted at the electronics, semiconductor and telecommunications markets. The spending reduction in 2001 compared to 2000 is due primarily to a decision to focus R&D spending on core technologies combined with the divestitures of certain product lines in the second half of 2000 as well as Laserdyne and Custom Systems in 2001.

Selling, General and Administrative Expenses. Selling, General and Administrative (SG&A) expenses decreased to $73.8 million or 29.8% of sales in 2001 compared to $87.5 million or 23.5% of sales in 2000. The quarterly spending rate in 2001 was $3.5 million lower in the fourth quarter of 2001 compared to the first quarter due to the impact of lower sales, discontinued product lines, cost reduction measures and mandatory factory shut down days.

Amortization of Purchased Intangibles. Amortization of purchased intangibles increased to $5.2 million in 2001 from $4.9 million in 2000. The increase in amortization from 2000 to 2001 is a result of amortizing intangible assets acquired from the acquisition of General Optics, which was partially offset by a reduction in amortization due to the sale of Life Sciences in October 2000.

Restructuring. As described above and in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, we recorded restructuring charges of $2.9 million in the year ended December 31, 2001 and $10.1 million in the year ended December 31, 2000.

Gain (loss) on Sale of Assets and Investments. During 2001, we sold our investment in shares of PerkinElmer, Inc. for a loss of $4.8 million. During 2000, we sold the net assets of the Life Sciences business for a non-operating gain of $73.1 million and the operating assets of other product lines including View Engineering metrology product line, fiber-optics operations in Phoenix, Arizona and package coding product line in Hull, United Kingdom for a net gain of $1.3 million. We also sold two facilities in the United States for a net gain of $2.4 million.

Interest Income. Interest income was $5.1 million in 2001 and $4.8 million in 2000. The increase in interest income in 2001 was due to an increased average cash and investment balance compared to 2000 and due to the sale of the company s holding of PerkinElmer, Inc. stock and reinvestment of proceeds into short-term investments.

Interest Expense. Interest expense was $0.9 million in 2001 compared to $1.5 million in 2000. The decrease in interest expense in 2001 was due to lower balances of debt in 2001 as compared to 2000.

Income Taxes. The effective tax rate for 2001 was 34.6% of income before taxes, compared to an effective tax rate of 39.5% for 2000. Our tax rates in 2001 and 2000 reflect the fact that we do not recognize the tax benefit from losses in certain countries where future use of the losses is uncertain and other non-deductible costs.

Net Income (Loss). As a result of the forgoing factors, net loss during 2001 was $14.7 million, compared with a net income of $45.4 million in 2000.

Critical Accounting Policies and Estimates

Our consolidated financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operations.

Revenue Recognition. We recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, risk of loss has passed to the customer and collection of the resulting receivable is probable. We design, market and sell our products as standard configurations. Accordingly, customer acceptance provisions for standard configurations are generally based on seller-specified criteria, which we demonstrate prior to shipment. Revenue on new products is deferred until we have established a track record of customer acceptance on these new products. When customer-specified objective criteria exist, revenue is deferred until customer acceptance if we cannot demonstrate the system meets these specifications prior to shipment. Should management determine that these customer acceptance provisions are not met for certain future transactions, revenue recognized for any reporting period could be affected.

Stock Based Compensation. We recognize compensation expense for stock options under the intrinsic value method, as allowed in APB 25. At this time, the company does not intend to include stock based compensation expense directly in the results of operations, except as required under APB 25, but to disclose the pro-forma effects of stock based compensation in the notes to the financial statements. If the accounting rules change to require the expensing of all stock based compensation, then our results of operations would be lower. See note 7 to the financial statements for the disclosure of the effects of stock based compensation.

Allowance for Doubtful Accounts. 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. We write down inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. Sales volumes have been adversely impacted by the general economic downturn, and the semiconductor, electronics and telecommunication industries downturn in particular, and inventory has been affected accordingly. We have been implementing a program to reduce our inventory to desired levels. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

The company has in place policies to review inventory values to ensure that inventory is recorded at the lower of cost or net realizable values. The company regularly reviews inventory values based on expected future usage. If, using our best judgment and based on information available, there is excess inventory, the company will establish a reserve. As the sales demand for the company s products declines, the company establishes additional inventory reserves for potential excess and obsolete inventory. Historically, the majority of these reserves have been in product lines associated with our Laser and Laser Systems segments. The company has initiated programs to try to sell this inventory or to dispose of it, and believes that the current inventory provisions are adequate. The company does not realize significant proceeds or margins on the sale or other disposition of this inventory. Most of the inventory reserves we took in 2002 were indirectly related to the restructuring actions. The same root cause of lower demand for and sales of our products, which caused us to evaluate the inventory that we had on hand and to make adjustments in value as appropriate, also initiated management s decisions that restructuring actions were necessary to bring costs in line with sales.

In general, after the company establishes a reserve on inventory, various options are reviewed before a decision is made to dispose of the written-down excess inventory. The company may decide to keep the inventory to support anticipated sales, which may be outside the time frames of our reserve policy. We will review to see if the inventory can be used in other product lines or in research and development efforts. The company will determine if there is an outside market to which the parts can be moved, such as a scrap vendor. Much of our reserved inventory is highly customized and can not be sold for scrap or used in other products, and is ultimately disposed of for insignificant proceeds. Disposal of inventory is made after all other options for use of the written-down inventory have been exhausted.

Net inventory provisions included in cost of goods sold were $20.8 million in fiscal 2000 and $3.7 million in each of fiscal 2001 and fiscal 2002.

In 2000, the company recorded inventory provisions on various product lines, in addition to the $8.5 million charge specifically relating to the high powered laser product line and described under the heading Business Environment and Restructurings above, of approximately $12.3 million. There were many reasons for recording these provisions, including but not limited to: (i) ensuring compliance with internal company policies on valuing inventory and providing for reserves for excess and obsolescence; (ii) providing for

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inventory on products that were eliminated or planned to be eliminated in the near future; and (iii) providing for inventory where future sales forecasts had been reduced.

In 2001, the majority of the $3.7 million in inventory provisions recorded were in the product lines affected by the downturn in the semiconductor markets. These were not related to a specific restructuring action.

In 2002, the company continued to evaluate the inventory provisions as sales did not recover as anticipated in the semiconductor and telecom industries. We recorded approximately $3.7 million in inventory provisions. Only $0.3 million was identified as part of the restructuring plan for the company s Kanata, Ontario operations and was recorded in cost of goods sold.

Warranties. We provide for the estimated costs of product warranties at the time revenue is recognized. Our estimate of costs to service the warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, revisions to the estimated warranty liability would be required.

Restructuring. During fiscal year 2002, 2001 and 2000, we recorded significant reserves in connection with our restructuring program. These reserves include estimates pertaining to employee separation costs and the settlements of contractual obligations resulting from our actions. Some of these accruals relate to costs of excess leased facilities that are under long-term leases. Our estimate of the reserve is based on estimates of market value of leased buildings, where we have made residual value guarantees, or of office rental rates in the future in various markets and the time required to sublease the space, both of which are subject to many variables, such as economic conditions and amount of space available in the market. Additionally, our restructuring reserve includes estimates to reduce owned buildings to market value. We are trying to sell these buildings, but there are many factors that could affect the fair market value or final value that we receive in any sale, as such there may be adjustments to our reserves. Although we do not anticipate significant changes, the actual costs may differ from these estimates.

Deferred Taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets totaling $17.2 million within our December 31, 2002 consolidated balance sheet, after providing a valuation allowance of $22.6 million, as presented in note 9 to the consolidated financial statements.

We assess the likelihood that our deferred tax assets will be recovered. To the extent that we believe that future recovery is not likely, we must establish a valuation allowance. To the extent we establish or increase a valuation allowance, we must include an expense within the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. The company has provided a valuation allowance against losses in the parent company and subsidiaries with an inconsistent history of taxable income and loss due to the uncertainty of their realization. In addition, the company has provided a valuation allowance on foreign tax credits, due to the uncertainty of generating foreign earned income to claim the tax credits. In the event that actual results differ from our estimates of future taxable income, or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could impact our financial position and results of operations.

Intangible Assets. In assessing the recoverability of our intangible assets, we must make assumptions regarding estimated future operating results, cash flows, planned uses of technology and other factors to determine the fair value of the respective assets. During the fourth quarter of 2002, we reviewed the intangible assets for potential impairment, and determined that there was no adjustment needed. During the fourth quarter of 2001, we determined that the carrying value of our intangible assets was no longer fully recoverable based on these factors. As a result, we recognized an impairment charge of $1.8 million in 2001. If our estimates or their related assumptions change in the future, we may require adjustments to the carrying value of the remaining assets.

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Pension Plan. The company s United Kingdom subsidiary maintains a defined benefit pension plan, whose membership was closed effective 1997. At year-end 2002, because of significant declines in the stock market and low interest rates, the market value of the plan assets was approximately $5 million less than the projected benefit obligation.

The accounting rules applicable to our pension plan require amounts recognized in financial statements be determined on an actuarial basis, rather than as contributions are made to the plan. A significant element in determining our pension income or pension expense is the expected return on plan assets. We have assumed, based on the type of securities in which the plan assets are invested and the long-term historical returns of these investments, that the long-term expected return on pension assets will be 7% and its assumed discount rate will be 6%. Given our pension plan s current under-funded status, absent improved market conditions, we will be required to increase cash contributions to our pension plan in future years. Further declines in the stock market and lower rates of return could increase our required contributions.

Since the market value of our pension assets at year-end 2002 was less than the accumulated pension benefit obligation, the company rec