

OSI SYSTEMS INC  
Form 10-Q  
January 26, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

---

**FORM 10-Q**

---

(Mark one)

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

For the quarterly period ended December 31, 2010

OR

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

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

Commission File Number 0-23125

---

## OSI SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

---

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

**33-0238801**  
(I.R.S. Employer  
Identification Number)

**12525 Chadron Avenue**

**Hawthorne, California 90250**

(Address of principal executive offices)

**(310) 978-0516**

(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 such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

Edgar Filing: OSI SYSTEMS INC - Form 10-Q

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

As of January 25, 2011, there were 18,932,010 shares of the registrant's common stock outstanding.

---

Table of Contents

OSI SYSTEMS, INC.

INDEX

		PAGE
<b><u>PART I FINANCIAL INFORMATION</u></b>		3
<u>Item 1</u>	<u>Condensed Consolidated Financial Statements</u>	3
	<u>Condensed Consolidated Balance Sheets at June 30, 2010 and December 31, 2010</u>	3
	<u>Condensed Consolidated Statements of Operations for the three and six months ended December 31, 2009 and 2010</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the six months ended December 31, 2009 and 2010</u>	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	19
<u>Item 4</u>	<u>Controls and Procedures</u>	20
<b><u>PART II OTHER INFORMATION</u></b>		21
<u>Item 1</u>	<u>Legal Proceedings</u>	21
<u>Item 1A</u>	<u>Risk Factors</u>	21
<u>Item 6</u>	<u>Exhibits</u>	21
<u>Signatures</u>		22

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share amounts)

	June 30, 2010	December 31, 2010
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 51,989	\$ 35,323
Accounts receivable	132,728	128,376
Other receivables	2,859	3,126
Inventories	125,930	155,115
Deferred income taxes	17,262	16,620
Prepaid expenses and other current assets	18,433	18,658
Total current assets	349,201	357,218
Property and equipment, net	51,515	51,170
Goodwill	63,941	69,778
Intangible assets, net	31,975	33,110
Other assets	16,482	19,018
Total assets	\$ 513,114	\$ 530,294
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities:		
Current portion of long-term debt	\$ 12,743	\$ 754
Accounts payable	49,673	74,144
Accrued payroll and employee benefits	23,953	17,060
Advances from customers	25,325	24,319
Accrued warranties	10,930	12,069
Deferred revenue	7,698	7,526
Other accrued expenses and current liabilities	14,272	14,234
Total current liabilities	144,594	150,106
Long-term debt	23,366	2,775
Other long-term liabilities	31,444	35,387
Total liabilities	199,404	188,268
Commitment and contingencies (Note 7)		
Shareholders' Equity:		
Preferred stock, no par value authorized, 10,000,000 shares; no shares issued or outstanding		
Common stock, no par value authorized, 100,000,000 shares; issued and outstanding, 18,326,133 at June 30, 2010 and 18,853,140 shares at December 31, 2010	244,026	254,764

Edgar Filing: OSI SYSTEMS INC - Form 10-Q

Retained earnings	76,681	89,289
Accumulated other comprehensive loss	(6,997)	(2,027)
Total shareholders' equity	313,710	342,026
Total liabilities and shareholders' equity	\$ 513,114	\$ 530,294

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amount data)

(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	December 31,		December 31,	
	2009	2010	2009	2010
Revenues	\$ 150,621	\$ 169,287	\$ 284,382	\$ 297,740
Cost of goods sold	94,256	109,264	183,550	190,819
Gross profit	56,365	60,023	100,832	106,921
Operating expenses:				
Selling, general and administrative expenses	34,610	33,958	66,890	65,934
Research and development	10,353	11,842	18,342	21,073
Restructuring and other charges	607	903	607	1,159
Total operating expenses	45,570	46,703	85,839	88,166
Income from operations	10,795	13,320	14,993	18,755
Interest and other expense, net	(784)	(506)	(1,389)	(1,096)
Income before provision for income taxes	10,011	12,814	13,604	17,659
Provision for income taxes	3,059	3,596	4,142	5,049
Net income	\$ 6,952	\$ 9,218	\$ 9,462	\$ 12,610
Earnings per share:				
Basic	\$ 0.39	\$ 0.49	\$ 0.54	\$ 0.68
Diluted	\$ 0.39	\$ 0.47	\$ 0.53	\$ 0.65
Shares used in per share calculation:				
Basic	17,643	18,752	17,573	18,592
Diluted	18,014	19,475	17,906	19,289

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

(Unaudited)

	For the Six Months Ended December 31	
	2009	2010
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 9,462	\$ 12,610
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,490	9,206
Stock based compensation expense	2,398	2,752
Recovery of losses on accounts receivable	(521)	(425)
Equity in earnings of unconsolidated affiliates	(323)	(247)
Deferred income taxes	(1,290)	815
Other	80	126
Changes in operating assets and liabilities:		
Accounts receivable	(5,522)	6,632
Other receivables	1,986	(88)
Inventories	19,887	(26,703)
Prepaid expenses and other current assets	(987)	(809)
Accounts payable	(13,429)	23,102
Accrued payroll and related expenses	(2,146)	(7,162)
Advances from customers	9,763	(1,582)
Accrued warranties	121	1,005
Deferred revenue	(1,203)	(621)
Other accrued expenses and current liabilities	(3,378)	863
Net cash provided by operating activities	23,388	19,474
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Acquisition of property and equipment	(6,926)	(4,590)
Acquisition of businesses-net of cash acquired	(3,241)	(5,248)
Acquisition of intangible and other assets	(1,106)	(1,764)
Net cash used in investing activities	(11,273)	(11,602)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net repayments of bank lines of credit	(4,000)	
Payments on long-term debt	(9,450)	(32,490)
Payments of capital lease obligations	(334)	(169)
Proceeds from exercise of stock options and employee stock purchase plan	3,423	7,532
Net cash used in financing activities	(10,361)	(25,127)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	642	589
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,396	(16,666)
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	25,172	51,989
CASH AND CASH EQUIVALENTS - END OF PERIOD	\$ 27,568	\$ 35,323
Supplemental disclosure of cash flow information:		
Interest paid	\$ 1,309	\$ 796
Income taxes paid	\$ 4,549	\$ 3,707

See accompanying notes to condensed consolidated financial statements.



Table of Contents

**OSI SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

*Description of Business*

OSI Systems, Inc., together with its subsidiaries (the Company), is a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. The Company sells its products in diversified markets, including homeland security, healthcare, defense and aerospace.

The Company has three operating divisions: (i) Security, providing security inspection systems and related services; (ii) Healthcare, providing patient monitoring, diagnostic cardiology and anesthesia systems, and related services; and (iii) Optoelectronics and Manufacturing, providing specialized electronic components for the Security and Healthcare divisions as well as for applications in the defense and aerospace markets, among others.

Through its Security division, the Company designs, manufactures, markets and services security and inspection systems worldwide, and provides turnkey security screening solutions. The Security division's products are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband and to screen people. These products and services are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

Through its Healthcare division, the Company designs, manufactures, markets and services patient monitoring, diagnostic cardiology and anesthesia delivery and ventilation systems worldwide primarily under the Spacelabs trade name. These products are used by care providers in critical care, emergency and perioperative areas within hospitals as well as physician offices, medical clinics and ambulatory surgery centers.

Through its Optoelectronics and Manufacturing division, the Company designs, manufactures and markets optoelectronic devices and provides electronics manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, telecommunications, office automation, computer peripherals and industrial automation. This division provides products and services to original equipment manufacturers as well as to the Company's own Security and Healthcare divisions.

*Basis of Presentation*

The condensed consolidated financial statements include the accounts of OSI Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to interim financial reporting guidelines and the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company's management, all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the financial position and the results of operations for the periods presented have been included. These condensed consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the Securities and Exchange Commission on August 27, 2010. The results of operations for the three months and six months ended December 31, 2010, are not necessarily indicative of the operating results to be expected for the full fiscal year or any future periods.

*Per Share Computations*

The Company computes basic earnings per share by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. The Company computes diluted earnings per share by dividing net income available to common shareholders by the sum of the weighted average number of common and dilutive potential common shares outstanding. Potential common shares consist of the shares issuable upon the exercise of stock options or warrants under the treasury stock method. Stock options and warrants to purchase a total of 0.1 million shares of common stock for the six months ended December 31, 2010 were not included in diluted earnings per share calculations because to do so would have been antidilutive, while no options or warrants were excluded from the calculation for the three months ended December 31, 2010. Stock options and warrants

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

### Table of Contents

to purchase a total of 1.1 million and 1.2 million shares of common stock for the three months and six months ended December 31, 2009, were not included in diluted earnings per share calculations because to do so would have been antidilutive. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2009		2010		2009		2010	
Net income available to common shareholders	\$	6,952	\$	9,218	\$	9,462	\$	12,610
Weighted average shares outstanding basic		17,643		18,752		17,573		18,592
Dilutive effect of stock options and warrants		371		723		333		697
Weighted average of shares outstanding diluted		18,014		19,475		17,906		19,289
Basic earnings per share	\$	0.39	\$	0.49	\$	0.54	\$	0.68
Diluted earnings per share	\$	0.39	\$	0.47	\$	0.53	\$	0.65

### *Comprehensive Income*

Comprehensive income is computed as follows (in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2009		2010		2009		2010	
Net income	\$	6,952	\$	9,218	\$	9,462	\$	12,610
Foreign currency translation adjustments		1,371		(1,116)		(205)		3,795
Reversal of losses on derivatives and investments		507		1,046		507		1,064
Other		36		(31)				111
Comprehensive income	\$	8,866	\$	9,117	\$	9,764	\$	17,580

### *Fair Value of Financial Instruments*

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company has determined that all of its marketable securities fall into the Level 1 category, which values assets at the quoted prices in active markets for identical assets; while the Company's derivative instruments fall into the Level 2 category, which values assets and liabilities from observable inputs other than quoted market prices. There were no assets or liabilities for which Level 3 valuation techniques were used and there were no assets and liabilities measured at fair value on a non-recurring basis.

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

The fair values of such assets/ (liabilities) are:

	June 30, 2010		December 31, 2010	
Level 1	\$	5,750	\$	7,096
Level 2		(244)		
Total	\$	5,506	\$	7,096

### *Derivative Instruments and Hedging Activity*

The Company's use of derivatives consists primarily of foreign exchange contracts and interest rate swap agreements. As of December 31, 2010, the Company had no such derivative contracts outstanding.

### *Business Combinations*

During the normal course of business the Company makes acquisitions. In the event that an individual acquisition (or an aggregate of acquisitions) is material, appropriate disclosure of such acquisition activity is disclosed.

Table of Contents*Recent Accounting Updates Not Yet Adopted*

In January 2010, the Financial Accounting Standards Board issued an accounting standards update (ASU) improving disclosures surrounding fair market value measurements. This update requires disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Certain financial assets are measured at fair value on a nonrecurring basis. These assets include equity method investments that are recognized at fair value at the end of the period to the extent that they are deemed to be other-than-temporarily impaired. Non-financial assets such as property plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. This portion of the ASU is effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early application is permitted. The Company has not yet adopted this update and is currently evaluating the impact it may have on its financial condition and results of operations.

**2. Balance Sheet Details**

The following tables provide details of selected balance sheet accounts (in thousands):

	June 30, 2010	December 31, 2010
<b>Accounts receivable</b>		
Trade receivables	\$ 138,734	\$ 133,373
Less: allowance for doubtful accounts	(6,006)	(4,997)
Accounts receivable, net	\$ 132,728	\$ 128,376

	June 30, 2010	December 31, 2010
<b>Inventories, net</b>		
Raw materials	\$ 69,421	\$ 86,575
Work-in-process	20,847	26,671
Finished goods	35,662	41,869
Total	\$ 125,930	\$ 155,115

	June 30, 2010	December 31, 2010
<b>Property and equipment</b>		
Land	\$ 5,078	\$ 5,174
Buildings	8,618	8,761
Leasehold improvements	12,549	12,959
Equipment and tooling	62,861	65,775
Furniture and fixtures	4,753	4,857
Computer equipment	17,738	18,515
Software	13,859	14,369
Total	125,456	130,410
Less: accumulated depreciation and amortization	(73,941)	(79,240)
Property and equipment, net	\$ 51,515	\$ 51,170

**3. Goodwill and Intangible Assets**

The goodwill acquired during the period within the Security, and Optoelectronics and Manufacturing divisions related to acquisitions of businesses that were considered immaterial individually and in the aggregate to the Company. The changes in the carrying value of goodwill for the six month period ended December 31, 2010, are as follows (in thousands):

	Security		Healthcare		Optoelectronics and Manufacturing		Consolidated
Balance as of June 30, 2010	\$	16,566	\$	35,403	\$	11,972	\$ 63,941
Goodwill acquired during the period		3,863				1,599	5,462
Foreign currency translation adjustment		283		92			375
Balance as of December 31, 2010	\$	20,712	\$	35,495	\$	13,571	\$ 69,778

Edgar Filing: OSI SYSTEMS INC - Form 10-Q

Table of Contents

Intangible assets consisted of the following (in thousands):

	Weighted Average Lives	Gross Carrying Value	June 30, 2010		December 31, 2010		Intangibles Net
			Accumulated Amortization	Intangibles Net	Gross Carrying Value	Accumulated Amortization	
Amortizable assets:							
Software development costs	5 years	\$ 11,877	\$ 3,954	\$ 7,923	\$ 12,887	\$ 4,334	\$ 8,553
Patents	9 years	1,630	388	1,242	2,161	418	1,743
Core technology	10 years	2,029	1,094	935	2,082	1,227	855
Developed technology	13 years	17,246	8,942	8,304	18,933	9,931	9,002
Customer relationships/ backlog	7 years	10,437	6,132	4,305	10,453	6,796	3,657
Total amortizable assets		43,219	20,510	22,709	46,516	22,706	23,810
Non-amortizable assets:							
Trademarks		9,266		9,266	9,300		9,300
Total intangible assets		\$ 52,485	\$ 20,510	\$ 31,975	\$ 55,816	\$ 22,706	\$ 33,110

Amortization expense related to intangibles assets was \$2.1 million for each of the six months ended December 31, 2009 and 2010, and \$1.1 million for each of the three months ended December 31, 2009 and 2010. At December 31, 2010, the estimated future amortization expense was as follows (in thousands):

2011 (remaining 6 months)	\$	2,126
2012		4,218
2013		3,926
2014		2,741
2015		1,348
2016		1,467
2017 and thereafter		7,984
Total	\$	23,810

#### 4. Borrowings

On October 15, 2010, the Company entered into a credit agreement with a syndicate of banks for a \$250 million revolving credit facility. This credit agreement replaced the prior agreement described below, which was repaid and terminated simultaneously with the close of the new agreement. The new facility consists of a \$250 million, five-year revolving credit facility, including a \$155 million sub-limit for letters of credit. Borrowings under this facility bear interest, based on the Company's option, at either (i) London Interbank Offered Rate (LIBOR) plus margins that range from 2.00% to 2.50% or (ii) the sum of margins that range from 1.00% to 1.50% and the higher of (a) the bank's prime rate, (b) the Fed Funds rate plus 0.5% or (c) LIBOR plus 1.0%. The margins are determined by the Company's consolidated leverage ratio. The Company's borrowings under the credit agreement are guaranteed by the Company's domestic subsidiaries and are secured by substantially all of

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

the Company's and certain subsidiaries' assets. The agreement contains various representations, warranties, affirmative, negative and financial covenants, and conditions of default customary for financing agreements of this type, including restrictions on the Company's ability to pay cash dividends. As of December 31, 2010, there was no debt outstanding under the revolving credit facility and \$34.0 million was outstanding under the letter-of-credit facility.

Prior to the closing of the aforementioned revolving credit facility, the Company maintained a credit agreement with certain lenders allowing for a \$74.5 million revolving credit facility (including a \$64.5 million sub-limit for letters-of-credit) and an amortizing five-year term loan, which would have matured in July 2012. Borrowings under the agreement bore interest at either (i) LIBOR plus margins that range from 2.00% to 2.50% or (ii) the sum of margins that range from 1.00% to 1.50% and the higher of (a) the bank's prime rate or (b) Fed Funds rate plus 0.5%. The rates were determined based on the Company's consolidated leverage ratio. The Company's borrowings under the credit agreement were guaranteed by the Company's domestic subsidiaries and secured by substantially all of the Company's and certain subsidiaries' assets. The agreement contained various representations, warranties, affirmative, negative and financial covenants, and conditions of default customary for financing agreements of this type, including restrictions on the Company's ability to pay cash dividends.

Several of the Company's foreign subsidiaries maintain bank lines-of-credit, denominated in local currencies, to meet short-term working capital requirements and for the issuance of letters-of-credit. As of December 31, 2010, \$13.5 million was outstanding under

Table of Contents

these letter-of-credit facilities, while no debt was outstanding. As of December 31, 2010, the total amount available under these credit facilities was \$23.4 million, with a total cash borrowing sub-limit of \$4.2 million.

In fiscal 2005, the Company entered into a bank loan of \$5.3 million to fund the acquisition of land and buildings in the U.K. The loan is payable over a 20-year period. The loan bears interest at British pound-based LIBOR plus 1.2%, payable on a quarterly basis. As of December 31, 2010, \$3.0 million remained outstanding under this loan at an interest rate of 1.9% per annum.

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

	<b>June 30,</b>		<b>December 31,</b>
	<b>2010</b>		<b>2010</b>
Five-year term loan due in fiscal 2013	\$ 32,281	\$	
Twenty-year term loan due in fiscal 2024	3,015		2,988
Capital leases	711		541
Other	102		
	<b>36,109</b>		<b>3,529</b>
Less current portion of long-term debt	12,743		754
Long-term portion of debt	\$ 23,366	\$	2,775

**5. Stock-based Compensation**

As of December 31, 2010, the Company maintained an equity participation plan and an employee stock purchase plan.

The Company recorded stock-based-compensation expense in the condensed consolidated statement of operations as follows (in thousands):

	<b>Three Months Ended</b>				<b>Six Months Ended</b>			
	<b>December 31,</b>		<b>December 31,</b>		<b>December 31,</b>		<b>December 31,</b>	
	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>
Cost of goods sold	\$ 68	\$ 82	\$ 140	\$ 170				
Selling, general and administrative	1,147	1,313	2,149	2,469				
Research and development	55	59	109	113				
Total stock-based compensation expense	\$ 1,270	\$ 1,454	\$ 2,398	\$ 2,752				

As of December 31, 2010, total unrecognized compensation cost related to non-vested share-based compensation arrangements granted was approximately \$12.0 million. The Company expects to recognize these costs over a weighted-average period of 2.9 years.

**6. Retirement Benefit Plans**

Edgar Filing: OSI SYSTEMS INC - Form 10-Q

The Company sponsors various retirement benefit plans including qualified and nonqualified defined benefit pension plans for its employees. The components of net periodic pension expense are as follows (in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2009		2010		2009		2010	
Service cost	\$	27	\$	153	\$	34	\$	278
Interest cost		45				86		
Amortization of net loss		80		189		152		223
Net periodic pension expense	\$	152	\$	342	\$	272	\$	501

For the three months ended December 31, 2009 and 2010, the Company made contributions of \$0.1 million and \$0.9 million, respectively to these defined benefit plans. For the six months ended December 31, 2009 and 2010, the Company made contributions of \$0.2 million and \$0.9 million, respectively, to these defined benefit plans.

In addition, the Company maintains various defined contribution plans. For the three months ended December 31, 2009 and 2010, the Company made contributions of \$0.7 million and \$1.0 million, respectively, to these defined contribution plans. For the six months ended December 31, 2009 and 2010, the Company made contributions of \$1.5 million and \$2.4 million, respectively, to these defined contribution plans.

Table of Contents

**7. Commitments and Contingencies**

*Legal Proceedings*

The Company is involved in various claims and legal proceedings arising out of the ordinary course of business. In the Company's opinion after consultation with legal counsel, the ultimate disposition of such proceedings is not likely to have a material adverse effect on its financial position, future results of operations, or cash flows. The Company has not accrued for loss contingencies relating to such matters because the Company believes that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.

*Contingent Acquisition Obligations*

Under the terms and conditions of the purchase agreements associated with certain acquisitions, the Company may be obligated to make additional payments based on the achievement by the acquired operations of certain sales and profitability milestones. Some of the purchase agreements the Company has entered into do not put a cap on the total payments that may be earned, or a deadline for such payments. For acquisitions that occurred prior to fiscal year 2010, which were accounted for under Statement of Financial Accounting Standards 141, Business Combinations, the Company accounts for such contingent payments as an addition to the purchase price of the acquired company. For acquisitions accounted for under Accounting Standards Codification 805, Purchase Price Allocations, (ASC 805), the estimated fair value of these obligations is recorded as a liability in the consolidated balance sheet with subsequent revisions reflected in the consolidated statements of operations. As of June 30, 2010 and December 31, 2010, pursuant to ASC 805, \$5.1 million and \$9.3 million of contingent payment obligations, respectively, are included in other long-term liabilities in the accompanying condensed consolidated balance sheet.

*Environmental Contingencies*

The Company is subject to various environmental laws. The Company's practice is to ensure that Phase I environmental site assessments are conducted for each of its properties in the United States at which the Company manufactures products in order to identify, as of the date of such report, potential areas of environmental concern related to past and present activities or from nearby operations. In certain cases, the Company has conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants.

During one investigation, the Company discovered soil and groundwater contamination at its Hawthorne, California facility. The Company filed the requisite reports concerning this problem with the appropriate environmental authorities in fiscal 2001. The Company has not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. The Company's site was previously used by other companies for semiconductor manufacturing similar to that presently conducted on the site by us, and it is not presently known who is responsible for the contamination or, if required, the remediation. The groundwater contamination is a known regional problem, not limited to the Company's premises or its immediate surroundings.

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

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

The Company has not accrued for loss contingencies relating to the above environmental matters because it believes that, although unfavorable outcomes may be possible, they are not considered by the Company's management to be probable and reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's results of operations, financial position and/or liquidity could be material.

### *Product Warranties*

The Company offers its customers warranties on many of the products that it sells. These warranties typically provide for repairs and maintenance of the products if problems arise during a specified time period after original shipment. Concurrent with the sale of products, the Company records a provision for estimated warranty expenses with a corresponding increase in cost of goods sold. The Company periodically adjusts this provision based on historical and anticipated experience. The Company charges actual expenses of repairs under warranty, including parts and labor, to this provision when incurred.

The following table presents changes in warranty provisions (in thousands):

Table of Contents

	Three Months Ended December 31,				Six Months Ended December 31,			
		2009		2010		2009		2010
Balance at beginning of period	\$	9,507	\$	11,395	\$	10,106	\$	10,930
Additions		1,726		1,832		1,997		2,969
Reductions for warranty repair costs		(1,063)		(1,158)		(1,933)		(1,830)
Balance at end of period	\$	10,170	\$	12,069	\$	10,170	\$	12,069

**8. Income Taxes**

The provision for income taxes is determined using an effective tax rate that is subject to fluctuations during the year as new information is obtained. The assumptions used to estimate the annual effective tax rate includes factors such as the mix of pre-tax earnings in the various tax jurisdictions in which the Company operates, valuation allowances against deferred tax assets, increases or decreases in uncertain tax positions, utilization of research and development tax credits, and changes in or the interpretation of tax laws in jurisdictions where the Company conducts business. The Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of its assets and liabilities along with net operating loss and tax credit carryovers. The Company records a valuation allowance against its deferred tax assets to reduce the net carrying value to an amount that it believes is more likely than not to be realized. When the Company establishes or reduces the valuation allowance against its deferred tax assets, the provision for income taxes will increase or decrease, respectively, in the period such determination is made.

**9. Segment Information**

The Company operates in three identifiable industry segments: (i) Security, providing security and inspection systems, and turnkey security screening solutions; (ii) Healthcare, providing patient monitoring, diagnostic cardiology and anesthesia systems; and (iii) Optoelectronics and Manufacturing, providing specialized electronic components for affiliated end-products divisions, as well as for applications in the healthcare, defense and aerospace markets, among others. The Company also has a Corporate segment that includes executive compensation and certain other general and administrative expenses. Interest expense and certain expenses related to legal, audit and other professional service fees, are not allocated to industry segments. Both the Security and Healthcare divisions comprise primarily end-product businesses whereas the Optoelectronics and Manufacturing division comprises businesses that primarily supply components and subsystems to original equipment manufacturers, including to the businesses of the Security and Healthcare divisions. All intersegment sales are eliminated in consolidation.

Table of Contents

The following table presents segment information (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2010	2009	2010
<b>Revenues by Segment:</b>				
Security division	\$ 59,092	\$ 76,703	\$ 106,427	\$ 127,800
Healthcare division	57,048	55,799	104,010	101,723
Optoelectronics and Manufacturing division, including intersegment revenues	43,663	47,682	89,454	89,593
Intersegment revenues elimination	(9,182)	(10,897)	(15,509)	(21,376)
<b>Total</b>	<b>\$ 150,621</b>	<b>\$ 169,287</b>	<b>\$ 284,382</b>	<b>\$ 297,740</b>
<b>Revenues by Geography:</b>				
North America	\$ 110,841	\$ 123,094	\$ 206,916	\$ 220,098
Europe	35,545	34,010	66,080	55,074
Asia	13,417	23,079	26,895	43,944
Intersegment revenues elimination	(9,182)	(10,896)	(15,509)	(21,376)
<b>Total</b>	<b>\$ 150,621</b>	<b>\$ 169,287</b>	<b>\$ 284,382</b>	<b>\$ 297,740</b>
<b>Operating income (loss) by Segment:</b>				
Security division	\$ 4,134	\$ 7,004	\$ 6,102	\$ 9,115
Healthcare division	5,808	5,664	7,303	8,262
Optoelectronics and Manufacturing division	3,257	4,270	6,718	7,691
Corporate	(2,689)	(3,072)	(5,969)	(5,248)
Eliminations (1)	285	(546)	839	(1,065)
<b>Total</b>	<b>\$ 10,795</b>	<b>\$ 13,320</b>	<b>\$ 14,993</b>	<b>\$ 18,755</b>

	June 30,	December 31,
	2010	2010
<b>Assets by Segment:</b>		
Security division	\$ 221,019	\$ 244,919
Healthcare division	138,739	141,432
Optoelectronics and Manufacturing division	85,170	100,318
Corporate	72,731	49,235
Eliminations (1)	(4,545)	(5,610)
<b>Total</b>	<b>\$ 513,114</b>	<b>\$ 530,294</b>

(1) Eliminations within operating income primarily reflect the change in the elimination of intercompany profit in inventory not-yet-realized; while the eliminations in assets reflect the amount of intercompany profits in inventory as of the balance sheet date. Such intercompany profit will be realized when inventory is shipped to the external customers of the Security and Healthcare divisions.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

To

### Cautionary Statement

*Certain statements contained in this quarterly report on Form 10-Q that are not related to historical results, including, without limitation, statements regarding our business strategy, objectives and future financial position, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and involve risks and uncertainties. These forward-looking statements may be identified by the use of forward-looking terms such as anticipate, believe, expect, may, could, likely to, should, or will, or by discussions of strategy that involve predictions which are based upon a number of future conditions that ultimately may prove to be inaccurate. Statements in this quarterly report on Form 10-Q that are forward-looking are based on current expectations and actual results may differ materially. Forward-looking statements involve numerous risks and uncertainties described in this quarterly report on Form 10-Q, our Annual Report on Form 10-K and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. Such factors, of course, do not include all factors that might affect our business and financial condition. Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, such assumptions could prove to*

Table of Contents

*be inaccurate and actual results could differ materially from those expressed in or implied by the forward-looking statements. All forward-looking statements contained in this quarterly report on Form 10-Q are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Our critical accounting policies are detailed in our Annual Report on Form 10-K for the year ended June 30, 2010.

**Recent Accounting Pronouncements**

We describe recent accounting pronouncements in Item 1 Condensed Consolidated Financial Statements Notes to Condensed Consolidated Financial Statements.

**Executive Summary**

We are a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. We sell our products and provide related services in diversified markets, including homeland security, healthcare, defense and aerospace. We have three operating divisions: (i) Security; (ii) Healthcare; and (iii) Optoelectronics and Manufacturing.

*Security Division.* Through our Security division, we design, manufacture, market and service security and inspection systems, and provide turnkey security screening solutions worldwide for sale primarily to U.S. federal, state and local government agencies as well as to foreign customers. These products and services are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband as well as to screen people. Revenues from our Security division accounted for 43% and 37% of our total consolidated revenues for the six months ended December 31, 2010 and 2009, respectively.

As a result of the terrorist attacks of September 11, 2001, and subsequent attacks in other locations worldwide, security and inspection products have increasingly been used at a wide range of facilities other than airports, such as border crossings, railway stations, seaports, cruise line terminals, freight forwarding operations, government and military installations and nuclear facilities.

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

*Healthcare Division.* Through our Healthcare division, we design, manufacture, market and service patient monitoring, diagnostic cardiology and anesthesia systems for sale primarily to hospitals and medical centers. Our products monitor patients in critical, emergency and perioperative care areas of the hospital and provide such information, through wired and wireless networks, to physicians and nurses who may be at the patient's bedside, in another area of the hospital or even outside the hospital. Revenues from our Healthcare division accounted for 34% and 37% of our total consolidated revenues for the six months ended December 31, 2010 and 2009, respectively.

The healthcare markets in which we operate are highly competitive. We believe that our customers choose among competing products on the basis of product performance, functionality, value and service. We also believe that the worldwide economic slowdown has caused some hospitals and healthcare providers to delay purchases of our products and services. During this period of uncertainty, we anticipate lower sales of patient monitoring, diagnostic cardiology and anesthesia systems products than we have historically experienced, resulting in a negative impact on our sales. We cannot predict when the markets will recover and therefore when this period of delayed and diminished purchasing will end. A prolonged delay could have a material adverse effect on our business, financial condition and results of operations.

*Optoelectronics and Manufacturing Division.* Through our Optoelectronics and Manufacturing division, we design, manufacture and market optoelectronic devices and value-added manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, computed tomography, fiber optics, telecommunications, office automation, computer peripherals and industrial automation. We also provide our optoelectronic devices and value-added manufacturing services to our own Security and Healthcare divisions. External revenues from our Optoelectronics and Manufacturing division accounted for 23% and 26% of our total consolidated revenues for the six months ended December 31, 2010 and 2009, respectively.

Table of Contents**Results of Operations**

*Three Months Ended December 31, 2010 Compared to Three Months Ended December 31, 2009.*

**Net Revenues**

The table below and the discussion that follows are based upon the way in which we analyze our business. See Note 9 to the condensed consolidated financial statements for additional information about our business segments.

(in millions)	Q2 2010	% of Net Sales	Q2 2011	% of Net Sales	\$ Change	% Change
Security division	\$ 59.1	39%	\$ 76.7	45%	\$ 17.6	30%
Healthcare division	57.0	38%	55.8	33%	(1.2)	(2)%
Optoelectronics and Manufacturing division	43.7	29%	47.7	28%	4.0	9%
Intersegment revenues	(9.2)	(6)%	(10.9)	(6)%	(1.7)	18%
Total revenues	\$ 150.6	100%	\$ 169.3	100%	\$ 18.7	12%

Net revenues for the three months ended December 31, 2010, increased \$18.7 million, or 12%, to \$169.3 million, from \$150.6 million for the comparable prior-year period.

Revenues for the Security division for the three months ended December 31, 2010, increased \$17.6 million, or 30%, to \$76.7 million, from \$59.1 million for the comparable prior-year period. The increase was attributed to: (i) a \$15.9 million, or 35% increase in equipment sales mainly driven by a \$12.2 million increase in our baggage and parcel inspection, hold baggage screening and people screening equipment, as well as a \$1.9 million increase in cargo and vehicle inspection equipment; and (ii) a \$1.7 million or 13% increase in revenue related to contracts to service such equipment. The increase in service revenue was due to the growing installed equipment base, from which we derive service revenues as warranty periods expire.

Revenues for the Healthcare division for the three months ended December 31, 2010, decreased \$1.2 million, or 2%, to \$55.8 million, from \$57.0 million for the comparable prior-year period. The decrease was primarily attributable to a \$1.1 million decrease in cardiology product revenues.

Revenues for the Optoelectronics and Manufacturing division for the three months ended December 31, 2010, increased by \$4.0 million, or 9%, to \$47.7 million, from \$43.7 million for the comparable prior-year period. This increase was primarily the result of a \$6.9 million increase in commercial optoelectronics sales due to both a \$5.2 million growth in sales to external customers as well as \$1.7 million growth in intersegment sales, primarily to our Security division partially offset by expected decreases in contract manufacturing sales of \$2.9 million primarily due to the winding down of a defense-industry related contract. Included in this total revenue amount for the three months ended December 31, 2010, the Optoelectronics and Manufacturing division recorded intersegment sales of \$10.9 million, compared to \$9.2 million in the comparable

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

prior-year period as previously noted. Such intersegment sales are eliminated in consolidation.

### Gross Profit

(in millions)	Q2 2010	%	of Net Sales	Q2 2011	%	of Net Sales
Gross profit	\$ 56.4	37.4%		\$ 60.0	35.4%	

Gross profit increased \$3.6 million, or 6%, to \$60.0 million for the three months ended December 31, 2010, from \$56.4 million for the comparable prior-year period as a result of a 12% increase in revenue. Such increase was offset by a 2% reduction in our gross margin due primarily to less favorable product mix of sales as sales within our Healthcare division, which historically generates the highest gross margin across the three divisions, declined relative to our Security and Optoelectronics and Manufacturing divisions.

### Operating Expenses

(in millions)	Q2 2010	%	of Net Sales	Q2 2011	%	of Net Sales	\$ Change	% Change
Selling, general and administrative	\$34.6	23.0%		\$34.0	20.1%		\$(0.6)	(2)%
Research and development	10.4	6.9%		11.8	7.0%		1.4	13%
Restructuring and other charges	0.6	0.4%		0.9	0.5%		0.3	50%
Total operating expenses	\$45.6	30.3%		\$46.7	27.6%		\$1.1	2%

**Selling, general and administrative expenses.** Selling, general and administrative expenses consist primarily of compensation paid

Table of Contents

to sales, marketing and administrative personnel, professional service fees and marketing expenses. For the three months ended December 31, 2010, SG&A expenses decreased by \$0.6 million, or 2%, to \$34.0 million, from \$34.6 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses were 20.1% for the three months ended December 31, 2010, compared to 23.0% for the comparable prior-year period. This reduction in spending was a result of cost containment initiatives undertaken throughout the Company to better leverage our cost structure.

**Research and development.** Research and Development expenses include research related to new product development and product enhancement expenditures. For the three months ended December 31, 2010, such expenses increased \$1.4 million, or 13%, to \$11.8 million, from \$10.4 million for the comparable prior-year period. As a percentage of revenues, R&D expenses were 7.0% for the three months ended December 31, 2010, compared to 6.9% for the comparable prior-year period. This increase in R&D expenses for the three month period ended December 31, 2010, resulted from an increase in R&D investment in our Security and Healthcare divisions in support of new product introductions.

**Restructuring and other charges.** In response to the challenging worldwide economic conditions, we continued to optimize our cost structure during the second quarter of fiscal 2011. In conjunction with these efforts, we incurred non-recurring restructuring and other charges of \$0.2 million in our Healthcare division for employee severance during the three months ended December 31, 2010, as well as charges of \$0.7 million in our Corporate segment related to costs associated with the termination and repayment of our prior credit facility as compared to incurring total restructuring charges of \$0.6 million for the comparable prior-year period.

**Other Income and Expenses**

(in millions)	Q2 2010	% of Net Sales	Q2 2011	% of Net Sales	\$ Change	% Change
Interest and other expense, net	\$ 0.8	0.5%	\$ 0.5	0.3%	\$ (0.3)	(38)%

**Interest and other expense, net.** For the three months ended December 31, 2010, interest and other expense, net, decreased due to lower levels of borrowing as a result of the pay down of debt from the generation of cash flow from operations.

**Income taxes.** For the three months ended December 31, 2010, our income tax provision was \$3.6 million, compared \$3.1 million for the comparable prior-year period. Our effective tax rate for the three months ended December 31, 2010 was 28.1%, compared to 30.6% in the comparable prior-year period. Our provision for income taxes is dependent on the mix of income from U.S. and foreign locations due to tax rate differences among such countries as well as due to the impact of permanent taxable differences.

*Six Months Ended December 31, 2010 Compared to Six Months Ended December 31, 2009.*

**Net Revenues**

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

The table below and the discussion that follows are based upon the way in which we analyze our business. See Note 9 to the condensed consolidated financial statements for additional information about our business segments.

(in millions)	YTD Q2 2010	% of Net Sales	YTD Q2 2011	% of Net Sales	\$ Change	% Change
Security division	\$ 106.4	37%	\$ 127.8	43%	\$ 21.4	20%
Healthcare division	104.0	37%	101.7	34%	(2.3)	(2)%
Optoelectronics and Manufacturing division	89.5	31%	89.6	30%	0.1	%
Intersegment revenues	(15.5)	(5)%	(21.4)	(7)%	(5.9)	(38)%
<b>Total revenues</b>	<b>\$ 284.4</b>	<b>100%</b>	<b>\$ 297.7</b>	<b>100%</b>	<b>\$ 13.3</b>	<b>5%</b>

Net revenues for the six months ended December 31, 2010, increased \$13.3 million, or 5%, to \$297.7 million from \$284.4 million for the comparable prior-year period.

Revenues for the Security division for the six months ended December 31, 2010, increased \$21.4 million or 20%, to \$127.8 million, from \$106.4 million for the comparable prior-year period. The increase was attributed to: (i) an \$18.6 million, or 23% increase in equipment sales mainly driven by a \$19.1 million increase in our baggage and parcel inspection, hold baggage screening and people screening equipment; and (ii) a \$2.8 million or 11% increase in revenue related to contracts to service such equipment. The increase in service revenue was due to the growing installed equipment base, from which we derive service revenues as warranty periods expire.

Table of Contents

Revenues for the Healthcare division for the six months ended December 31, 2010, decreased \$2.3 million, or 2%, to \$101.7 million, from \$104.0 million for the comparable prior-year period. The decrease was primarily due to: (i) a \$2.3 million decrease in patient monitoring revenues mainly in North America; and (ii) a \$1.0 million decrease in cardiology product revenues. These decreases were partially offset by a \$1.3 million increase in anesthesia revenues.

Revenues for the Optoelectronics and Manufacturing division for the six months ended December 31, 2010, were virtually unchanged at \$89.6 million as compared to \$89.5 million for the comparable prior-year period. This was due to a \$12.1 million increase in commercial optoelectronic revenues both due to growth in revenue to external customers as well as due to growth in intersegment sales, primarily to the Security division, offset by a \$12.0 million decrease in contract manufacturing mainly driven by the expected winding down of a large defense-industry related contract. Included in this total revenue amount for the six months ended December 31, 2010, the Optoelectronics and Manufacturing division recorded intersegment sales of \$21.4 million, compared to \$15.5 million in the comparable prior-year period. Such intersegment sales are eliminated in consolidation.

**Gross Profit**

(in millions)	YTD Q2 2010		% of Net Sales	YTD Q2 2011		% of Net Sales
Gross profit	\$	100.8	35.4%	\$	106.9	35.9%

Gross profit increased \$6.1 million, or 6%, to \$106.9 million for the six months ended December 31, 2010, from \$100.8 million for the comparable prior-year period. The gross margin increased to 35.9%, from 35.4% over the comparable prior-year period. The increase in gross margin was attributable to manufacturing efficiencies gained through facility consolidation and operational improvement initiatives partially offset by a less favorable mix of product sales as sales within our Healthcare division have declined relative to our Security and Optoelectronics and Manufacturing divisions, and our Healthcare division has historically realized the highest gross margin among our three divisions.

**Operating Expenses**

(in millions)	YTD Q2 2010	% of Net Sales	YTD Q2 2011	% of Net Sales	\$ Change	% Change
Selling, general and administrative	\$ 66.9	23.5%	\$ 65.9	22.1%	\$ (0.9)	(1)%
Research and development	18.3	6.4%	21.1	7.1%	2.8	15%
Restructuring and other charges	0.6	0.2%	1.1	0.4%	0.5	83%
Total operating expenses	\$ 85.8	30.1%	\$ 88.1	29.6%	\$ 2.4	3%

**Selling, general and administrative expenses.** For the six months ended December 31, 2010, SG&A expenses decreased by \$0.9 million, or 1%, to \$65.9 million, from \$66.8 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses were 22.1% for the six months ended December 31, 2010, compared to 23.5% for the comparable prior-year period. This reduction in spending was a result of our ongoing company-wide cost containment initiatives and due to restructuring activities that were most heavily focused on our Healthcare

division.

**Research and development.** R&D expenses include research related to new product development and product enhancement expenditures. For the six months ended December 31, 2010, such expenses increased \$2.8 million, or 15%, to \$21.1 million, from \$18.3 million for the comparable prior-year period. As a percentage of revenues, research and development expenses were 7.1% for the six months ended December 31, 2010, compared to 6.4% for the comparable prior-year period. The increase in R&D expenses for the six month period ended December 31, 2010, primarily resulted from an increase in R&D investment in our Security and Healthcare divisions, in support of new product introductions.

**Restructuring and other charges.** In response to the worldwide economic downturn, we initiated an aggressive cost-cutting plan in the first half of fiscal 2009 to reduce our fixed cost structure. During the six months ended December 31, 2010, we continued this effort to further increase our operating efficiencies. In conjunction with these efforts, we incurred non-recurring restructuring and other charges of \$0.4 million in our Healthcare division for employee severance and \$0.7 million in our Corporate segment related to costs associated with the termination and repayment of our prior credit facility as compared to incurring restructuring charges of \$0.6 million for the comparable prior-year period.

#### Other Income and Expenses

(in millions)	YTD Q2 2010		YTD Q2 2011		\$ Change		% Change		
		% of Net Sales		% of Net Sales					
Interest and other expense, net	\$	1.4	0.5%	\$	1.1	0.4%	\$	(0.3)	(21)%

Table of Contents

**Interest and other expense, net.** For the six months ended December 31, 2010, interest and other expense, net decreased by \$0.3 million, to \$1.1 million from \$1.4 million for the comparable prior-year period, primarily due to lower levels of borrowing as a result of the pay down of debt from the generation of cash flow from operations.

**Income taxes.** For the six months ended December 31, 2010, our income tax provision was \$5.1 million, compared to \$4.1 million for the comparable prior-year period. Our effective tax rate for the six months ended December 31, 2010, was 28.6%, compared to 30.5% in the comparable prior-year period. Our provision for income taxes is dependent on the mix of income from U.S. and foreign locations due to tax rate differences among such countries as well as due to the impact of permanent taxable differences.

**Liquidity and Capital Resources**

To date, we have financed our operations primarily through cash flow from operations, proceeds from equity issuances and our credit facilities. Cash and cash equivalents totaled \$35.3 million at December 31, 2010, a decrease of \$16.7 million from \$52.0 million at June 30, 2010. As further discussed below, the principal use of cash during the six-months ended December 31, 2010 was the early pay down of a \$32.5 million term loan associated with the termination of our prior credit facility. The changes in our working capital and cash and cash equivalent balances during the six months ended are described below.

(in millions)	June 30, 2010	December 31, 2010	% Change
Working capital	\$ 204.6	\$ 207.1	1%
Cash and cash equivalents	52.0	35.3	(32)%

*Working Capital.* Working capital increased primarily due to: (i) a \$29.2 million increase in inventory mainly in our Security division, to support anticipated growth in shipments; (ii) a \$12.0 million decrease in the current portion of long term debt due to the repayment and termination of our former credit agreement, simultaneously with our entering into a new \$250 million credit agreement in October 2010 and (iii) a \$6.9 million decrease in accrued payroll and other benefits. These increases to working capital were partially offset by: (i) a \$24.5 million increase in accounts payable, driven in part by the increase in inventory as previously noted; (ii) a \$16.7 million decrease in cash and cash equivalents mainly driven by the repayment of our debt facility; and (iii) a \$4.4 million decrease in accounts receivable.

(in millions)	YTD Q2 2010	YTD Q2 2011	\$ Change
Cash provided by operating activities	\$ 23.4	\$ 19.5	\$ (3.9)
Cash used in investing activities	(11.3)	(11.6)	(0.3)
Cash used in financing activities	(10.4)	(25.1)	(14.7)

*Cash Provided by Operating Activities.* Cash flows from operating activities can fluctuate significantly from period to period, as net income, tax timing differences, customer collections, vendor payments and other items can significantly impact cash flows. Net cash provided by operations for the six months ended December 31, 2010 was \$19.5 million, a decrease of \$3.9 million from the \$23.4 million provided in the comparable prior-year period. This reduction in net cash provided was primarily due to the changes in working capital in the current-year period versus the prior-year period resulting in: (i) a \$46.6 million increase in the change in inventory, reflecting the build-up of inventory primarily in our Security division to support growth as well as due to improvements realized in our prior fiscal year due to inventory reduction initiatives, (ii) an

## Edgar Filing: OSI SYSTEMS INC - Form 10-Q

\$11.3 million decrease in cash received as advances from customers, and (iii) a \$5.0 million decrease in the change in accrued payroll and related expenses. These unfavorable changes in cash flow were partially offset by the following favorable changes in working capital: (i) a \$36.5 million increase in cash from accounts payable, (ii) a \$12.2 million increase in cash from accounts receivables reflecting strong receivables collections efforts, (iii) \$4.2 million in increases in cash from other accrued expenses and current liabilities and (iv) an increase in our net income of \$6.5 million for the six months ended December 31, 2010, after giving consideration to non-cash operating items including depreciation and amortization, stock-based compensation, deferred taxes and provision for losses on accounts receivable, among others, for both periods.

*Cash Used in Investing Activities.* Net cash used in investing activities was \$11.6 million for the six months ended December 31, 2010, compared to \$11.3 million for the six months ended December 31, 2009. During the six months ended December 31, 2010, we invested \$4.6 million in capital expenditures as compared to \$6.9 million during the comparable prior-year period. During the six months ended December 31, 2010, we also paid \$5.2 million for the acquisitions of businesses as compared to the \$3.2 million we paid to acquire a business in the comparable prior-year period.

Table of Contents

*Cash Used in Financing Activities.* Net cash used in financing activities was \$25.1 million for the six months ended December 31, 2010, compared to \$10.4 million for the six months ended December 31, 2009. During the six months ended December 31, 2010, we entered into a new credit facility with a syndicate of banks for a \$250 million revolving credit facility. In connection with this new credit facility, we repaid \$32.5 million in term loans to terminate our existing credit facility. We received \$7.5 million in proceeds from the exercise of stock options and the purchase of stock under our employee stock purchase plan which partially offset the debt payments. In the prior-year period, we paid down our revolving lines of credit by \$4.0 million, our term loan by \$9.5 million, and made payments of \$0.3 million on our capital leases. We received \$3.4 million in proceeds from the exercise of stock options and the purchase of stock under our employee stock purchase plan in the prior period.

**Borrowings**

Outstanding lines of credit and current and long-term debt totaled \$3.5 million at December 31, 2010, a decrease of \$32.6 million from \$36.1 million at June 30, 2010. See Note 4 to the condensed consolidated financial statements for further discussion.

**Stock Repurchase Program**

Our Board of Directors has authorized a stock repurchase program under which we can repurchase up to 3,000,000 shares of our common stock. During the six months ended December 31, 2010, we did not repurchase any shares under this program, and 711,205 shares were available for additional repurchase under the program as of December 31, 2010.

**Dividend Policy**

We have never paid cash dividends on our common stock and have no plans to do so in the foreseeable future.

**Contractual Obligations**

We presented our contractual obligations in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010. Except as discussed below, there have been no significant changes in those obligations during the first six months of fiscal 2011.

As a result of current and prior-year acquisitions, we may have payment obligations based on the achievement by the acquired operations of certain sales and profitability milestones. Some of the purchase agreements we have entered into do not include a cap on the total payments that may be earned, or a deadline for such payments. For acquisitions accounted for under Statement of Financial Accounting Standards 141, Business Combinations, we account for any such contingent payments as an addition to the purchase price of the acquired company. For acquisitions accounted for under ASC 805, the estimated fair value of these obligations will be recorded as a liability in the consolidated balance

sheet with subsequent revisions reflected in the consolidated statements of operations. As of December 31, 2010, pursuant to ASC 805, \$9.3 million of contingent payment obligations are included in other long-term liabilities in the accompanying condensed consolidated balance sheet.

**Off Balance Sheet Arrangements**

As of December 31, 2010, we did not have any significant off balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

For the six months ended December 31, 2010, no material changes occurred with respect to market risk as disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

**Market Risk**

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

## Table of Contents

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

## **Foreign Currency**

We maintain the accounts of our operations in each of the following countries in the following currencies: Finland, France, Germany, Italy and Greece (Euros), Singapore (Singapore dollars and U.S. dollars), Malaysia (Malaysian ringgits), United Kingdom (U.K. pounds), Norway (Norwegian kroners), India (Indian rupees), Indonesia (Indonesian rupiah), Hong Kong (Hong Kong dollars), China (Chinese yuan), Canada (Canadian dollars), Australia (Australian dollars) and Cyprus (Cypriot pounds). Foreign currency financial statements are translated into U.S. dollars at period-end rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. We include gains and losses resulting from foreign currency transactions in income, while we exclude those resulting from translation of financial statements from income and include them as a component of accumulated other comprehensive income (AOCI). Transaction gains and losses, which were included in our condensed consolidated statement of operations, amounted to a gain of \$0.1 million as compared to a loss of \$0.5 million during the three months ended December 31, 2010 and 2009, respectively. For the six months ended December 31, 2010 and 2009, we incurred losses of \$1.0 million and \$0.6 million, respectively. Furthermore, a 10% appreciation of the U.S. dollar relative to each of the local currencies would have resulted in a net increase in our operating income of approximately \$2 million in the second quarter of fiscal 2011. Conversely, a 10% depreciation of the U.S. dollar relative to each of the local currencies would have resulted in a net decrease in our operating income of approximately \$2 million in the second quarter of fiscal 2011.

## **Use of Derivatives**

Our use of derivatives consists primarily of foreign exchange contracts and interest rate swap agreements. As discussed in Note 1 to the condensed consolidated financial statements, we had no such derivative contracts outstanding as of December 31, 2010.

## **Importance of International Markets**

International markets provide us with significant growth opportunities. However, the following events, among others, could adversely affect our financial results in subsequent periods: periodic or prolonged economic downturns in different regions of the world, changes in trade policies, tariffs and other laws and wars and other forms of political instability. We continue to perform ongoing credit evaluations of our customers financial condition and, if deemed necessary, we require advance payments for sales. We monitor economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future. Due to our overseas investments and the necessity of dealing in local currencies in many foreign business transactions, we are at risk with respect to foreign currency fluctuations.

## **Inflation**

We do not believe that inflation had a material impact on our results of operations during the three and six months ended December 31, 2010.

**Interest Rate Risk**

We classify all highly liquid investments with maturity of three months or less as cash equivalents and record them in the balance sheet at fair value.

**Item 4. Controls and Procedures**

*(a) Evaluation of Disclosure Controls and Procedures*

As of December 31, 2010, the end of the period covered by this report, our management, including our Chief Executive Officer and our Chief Financial Officer, reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended). Such disclosure controls and procedures are designed to ensure that material information we must disclose in this report is recorded, processed, summarized and filed or submitted on a timely basis. Based upon that evaluation our management, Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of December 31, 2010.

*(b) Changes in Internal Control over Financial Reporting*

Table of Contents

There were no changes in the Company's internal control over financial reporting during the second quarter of fiscal 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved in various claims and legal proceedings which have been previously disclosed in our quarterly and annual reports. The results of such legal proceedings cannot be predicted with certainty. Should we fail to prevail in any of these legal matters or should several of these legal matters be resolved against us in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

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

**Item 1A. Risk Factors**

The discussion of our business and operations in this Quarterly Report on form 10-Q should be read together with the risk factors contained in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the Securities and Exchange Commission, which describe various risks and uncertainties to which we are or may become subject.

**Item 6. Exhibits**

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, in the City of Hawthorne, State of California on the 26th day of January 2011.

**OSI SYSTEMS, INC.**

By: /s/ Deepak Chopra  
Deepak Chopra  
President and Chief Executive Officer

By: /s/ Alan Edrick  
Alan Edrick  
Executive Vice President and  
Chief Financial Officer