

INTEVAC INC

FORM 10-Q (Quarterly Report)

Filed 08/10/06 for the Period Ending 07/01/06

Address	3560 BASSETT STREET SANTA CLARA, CA, 95054
Telephone	4089869888
CIK	0001001902
Symbol	IVAC
SIC Code	3559 - Special Industry Machinery, Not Elsewhere Classified
Industry	Industrial Machinery & Equipment
Sector	Industrials
Fiscal Year	12/31

INTEVAC INC

FORM 10-Q (Quarterly Report)

Filed 8/10/2006 For Period Ending 7/1/2006

Address	356O BASSETT ST SANTA CLARA, California 95054
Telephone	408-986-9888
CIK	0001001902
Industry	Computer Storage Devices
Sector	Technology
Fiscal Year	12/31

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SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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 July 1, 2006
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 0-26946

INTEVAC, INC.

(Exact name of registrant as specified in its charter)

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

94-3125814
*(IRS Employer
Identification No.)*

3560 Bassett Street
Santa Clara, California 95054
(Address of principal executive office, including Zip Code)

Registrant's telephone number, including area code:
(408) 986-9888

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

On August 4, 2006, 21,111,702 shares of the Registrant's Common Stock, no par value, were outstanding.

INTEVAC, INC.

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PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

INTEVAC, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	July 1, 2006 (Unaudited)	December 31, 2005
(In thousands)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 20,321	\$ 15,255
Short term investments	45,312	34,476
Trade and other accounts receivable, net of allowances of \$87 and \$154 at July 1, 2006 and December 31, 2005	41,558	42,847
Inventories	33,857	24,837
Prepaid expenses and other current assets	2,063	1,814
Deferred tax assets	2,479	—
Total current assets	145,590	119,229
Property, plant and equipment, net	8,853	7,980
Investment in 601 California Avenue LLC	2,431	2,431
Other long term assets	1,437	804
Total assets	<u>\$ 158,311</u>	<u>\$ 130,444</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,639	\$ 7,049
Accrued payroll and related liabilities	6,634	5,509
Other accrued liabilities	5,852	6,182
Customer advances	25,569	23,136
Total current liabilities	49,694	41,876
Other long-term liabilities	933	694
Shareholders' equity:		
Common stock, no par value	99,388	97,165
Additional paid in capital	1,180	—
Accumulated other comprehensive income	301	238
Retained earnings (accumulated deficit)	6,815	(9,529)
Total shareholders' equity	107,684	87,874
Total liabilities and shareholders' equity	<u>\$ 158,311</u>	<u>\$ 130,444</u>

See accompanying notes.

INTEVAC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
AND COMPREHENSIVE INCOME (LOSS)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 1, 2006</u>	<u>July 2, 2005</u>	<u>July 1, 2006</u>	<u>July 2, 2005</u>
	(Unaudited)			
	(In thousands, except per share amounts)			
Net revenues:				
Systems and components	\$ 56,843	\$ 28,545	\$ 104,917	\$ 37,139
Technology development	<u>2,699</u>	<u>1,873</u>	<u>4,245</u>	<u>3,884</u>
Total net revenues	59,542	30,418	109,162	41,023
Cost of net revenues:				
Systems and components	35,838	19,425	67,178	25,821
Technology development	1,909	1,298	2,861	2,792
Inventory provisions	<u>533</u>	<u>34</u>	<u>555</u>	<u>754</u>
Total cost of net revenues	<u>38,280</u>	<u>20,757</u>	<u>70,594</u>	<u>29,367</u>
Gross profit	21,262	9,661	38,568	11,656
Operating expenses:				
Research and development	6,290	3,413	11,851	6,538
Selling, general and administrative	<u>5,004</u>	<u>2,741</u>	<u>10,118</u>	<u>5,932</u>
Total operating expenses	<u>11,294</u>	<u>6,154</u>	<u>21,969</u>	<u>12,470</u>
Operating profit (loss)	9,968	3,507	16,599	(814)
Interest income and other, net	<u>729</u>	<u>423</u>	<u>1,327</u>	<u>854</u>
Income before income taxes	10,697	3,930	17,926	40
Provision for income taxes	<u>1,364</u>	<u>3</u>	<u>1,582</u>	<u>10</u>
Net income	<u>\$ 9,333</u>	<u>\$ 3,927</u>	<u>\$ 16,344</u>	<u>\$ 30</u>
Other comprehensive income:				
Foreign currency translation adjustments	<u>34</u>	<u>(21)</u>	<u>63</u>	<u>(37)</u>
Total comprehensive income (loss)	<u>\$ 9,367</u>	<u>\$ 3,906</u>	<u>\$ 16,407</u>	<u>\$ (7)</u>
Basic income per share:				
Net income	\$ 0.44	\$ 0.19	\$ 0.78	\$ 0.00
Shares used in per share amounts	20,987	20,391	20,910	20,317
Diluted income per share:				
Net income	\$ 0.42	\$ 0.19	\$ 0.75	\$ 0.00
Shares used in per share amounts	21,972	21,144	21,883	20,989

See accompanying notes.

INTEVAC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended	
	July 1, 2006	July 2, 2005
	(Unaudited) (In thousands)	
Operating activities		
Net income	\$ 16,344	\$ 30
Adjustments to reconcile net income to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	1,240	1,049
Inventory provisions	555	754
Equity-based compensation	1,180	—
Loss on disposal of equipment	5	4
Changes in operating assets and liabilities	(3,584)	(10,253)
Total adjustments	(604)	(8,446)
Net cash and cash equivalents provided by (used in) operating activities	15,740	(8,416)
Investing activities		
Purchases of investments	(183,453)	(8,859)
Proceeds from maturities of investments	172,700	18,000
Purchases of leasehold improvements and equipment	(2,196)	(1,462)
Net cash and cash equivalents provided by (used) in investing activities	(12,949)	7,679
Financing activities		
Net proceeds from issuance of common stock	2,223	1,427
Net cash and cash equivalents provided by financing activities	2,223	1,427
Effect of exchange rate changes on cash	52	(56)
Net increase in cash and cash equivalents	5,066	634
Cash and cash equivalents at beginning of period	15,255	17,455
Cash and cash equivalents at end of period	<u>\$ 20,321</u>	<u>\$ 18,089</u>
Supplemental Schedule of Cash Flow Information		
Cash paid for:		
Income taxes	\$ 2,723	\$ 2

See accompanying notes.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Business Activities and Basis of Presentation

We are the world's leading provider of disk sputtering equipment to manufacturers of magnetic media used in hard disk drives and a developer and provider of leading technology for extreme low light imaging sensors, cameras and systems. We operate two businesses: Equipment and Imaging.

Our Equipment business designs, manufactures, markets and services complex capital equipment used in the sputtering, or deposition, of highly engineered thin-films of material onto magnetic disks which are used in hard disk drives. Hard disk drives are the primary storage medium for digital data and function by storing data on magnetic disks. These disks are created in a sophisticated manufacturing process involving a variety of steps, including plating, annealing, polishing, texturing, sputtering and lubrication. We are also utilizing our expertise in complex manufacturing equipment to develop new manufacturing products that address markets outside the disk drive industry.

Our Imaging business develops and manufactures electro-optical sensors, cameras, and systems that permit highly sensitive detection of photons in the visible and near infrared portions of the spectrum, which can be used in applications such as military night vision and extreme low light imaging.

Most of our revenue is derived from our Equipment business, and we expect that the majority of our revenues for the next several years will continue to be derived from our Equipment business.

The financial information at July 1, 2006 and for the three- and six-month periods ended July 1, 2006 and July 2, 2005 is unaudited, but includes all adjustments (consisting only of normal recurring accruals) that we consider necessary for a fair presentation of the financial information set forth herein, in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, it does not include all of the information and footnotes required by U.S. GAAP for annual financial statements. For further information, refer to the Consolidated Financial Statements and footnotes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The results for the three- and six-month periods ended July 1, 2006 are not considered indicative of the results to be expected for any future period or for the entire year.

"Intevac ®," "LIVAR ®," "D-STAR ®," and "200 Lean ®" are trademarks of Intevac, Inc.

2. Concentrations

Historically, a significant portion of our revenues in any particular period has been attributable to sales to a limited number of customers. Our largest customers tend to change from period to period.

We evaluate the collectibility of trade receivables on an ongoing basis and provide reserves against potential losses when appropriate.

3. New Accounting Pronouncements

In March 2004, the Emerging Issues Task Force ("EITF") issued EITF No. 03-01, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," which provides new guidance for assessing impairment losses on debt and equity investments. The new impairment model applies to investments accounted for under the cost or equity method and investments accounted for under FAS 115,

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

“Accounting for Certain Investments in Debt and Equity Securities.” EITF No. 03-01 also includes new disclosure requirements for cost method investments and for all investments that are in an unrealized loss position. In September 2004, the FASB delayed the accounting provisions of EITF No. 03-01; however, the disclosure requirements remain effective and the applicable disclosures have been included in our consolidated financial statements and related notes thereto. We do not expect the adoption of this EITF to have an effect on our consolidated financial position, results of operations and cash flows.

In September 2005, the FASB issued EITF Issue No. 04-13, “Accounting for Purchases and Sales of Inventory with the Same Counterparty” (“EITF 04-13”). The issue provided guidance on the circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single non-monetary transaction within the scope of APB Opinion No. 29, “Accounting for Non-monetary Transactions.” The issue also provided guidance on circumstances under which non-monetary exchanges of inventory within the same line of business should be recognized at fair value. EITF 04-13 is effective for transactions completed in reporting periods beginning after March 15, 2006. The adoption of EITF 04-13 did not have a material impact on our consolidated financial position, results of operations and cash flows.

In July 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” (“FIN 48”). Under FIN 48, companies are required to apply the “more likely than not” threshold to the recognition and derecognition of tax positions. FIN 48 also provides guidance on the measurement of tax positions, balance sheet classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will be effective beginning January 1, 2007. We are currently evaluating the provisions in FIN 48, however, at the present time we do not anticipate that the adoption of FIN 48 will have a material impact on our consolidated financial position, results of operations and cash flows.

4. Inventories

Inventories are priced using standard costs, which approximate cost under the first-in, first-out method and are stated at the lower of cost or market. Inventories consist of the following:

	<u>July 1, 2006</u>	<u>December 31, 2005</u>
	(In thousands)	
Raw materials	\$ 17,234	\$ 15,070
Work-in-progress	13,757	6,303
Finished goods	2,866	3,464
	<u>\$ 33,857</u>	<u>\$ 24,837</u>

Finished goods inventory consists primarily of completed systems at customer sites that are undergoing installation and acceptance testing.

Inventory reserves included in the above numbers were \$9.5 million and \$11.0 million at July 1, 2006 and December 31, 2005, respectively. Each quarter, we analyze our inventory (raw materials, work-in-progress and finished goods) against the forecast demand for the next 12 months. Raw materials with no forecast requirements in that period are considered excess and inventory provisions are established to write those items down to zero net book value. Work-in-progress and finished goods inventories with no forecast requirements in that period are typically written down to the lower of cost or market. During this process, some inventory is identified as having no future use or value to us and is disposed of against the reserves.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table displays the activity in the inventory provision account for the six-month periods ending July 1, 2006 and July 2, 2005:

	Six Months Ended	
	July 1, 2006	July 2, 2005
	(In thousands)	
Beginning balance	\$ 10,988	\$ 9,863
New provisions in cost of sales	555	754
New provisions for refurbishment of consigned products	7	87
Disposals of inventory	(2,058)	—
Miscellaneous adjustments	—	(96)
Ending balance	<u>\$ 9,492</u>	<u>\$ 10,608</u>

5. Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment,” (“SFAS 123(R)”) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including equity awards related to the 2004 Equity Incentive Plan (the “2004 Plan”) and employee stock purchases related to the 2003 Employee Stock Purchase Plan (the “ESPP”) based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB 25”) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (“SAB 107”) relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our Condensed Consolidated Financial Statements as of and for the three and six months ended July 1, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three months and six months ended July 1, 2006 was \$695,000 and \$1.1 million, respectively, which consisted of stock-based compensation expense related to the grant of stock options under the 2004 Plan and stock purchase rights under the ESPP. There was no stock-based compensation expense related to the grant of stock options or stock purchase rights recognized during the three or six months ended July 2, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in our Condensed Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), we accounted for employee equity awards and employee stock purchases using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”). Under the intrinsic value method, no stock-based compensation expense had been recognized in our Condensed Consolidated Statement of Operations because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in our Condensed Consolidated Statement of Operations for the three and six months ended July 1, 2006 included compensation expense for share-based payment awards granted prior to, but not

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). As stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the first six months of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

*Descriptions of Plans**2004 Equity Incentive Plan*

Our 2004 Equity Incentive Plan (the “2004 Plan”) is a broad-based, long-term retention program intended to attract and retain qualified management and technical employees, and align stockholder and employee interests. The 2004 Plan permits the grant of incentive or non-statutory stock options, restricted stock, stock appreciation rights, performance units and performance shares. Option price, vesting period, and other terms are determined by the Administrator of the 2004 Plan, but the option price shall generally not be less than 100% of the fair market value per share on the date of grant. During the six months ended July 1, 2006, we granted 387,000 stock options with an estimated total grant-date fair value of \$4.9 million. Of this amount, we estimated that the stock-based compensation for the awards not expected to vest was \$1.7 million.

2003 Employee Stock Purchase Plan

Our 2003 Employee Stock Purchase Plan (the “ESPP”) provides that eligible employees may purchase our common stock through payroll deductions at a price equal to 85% of the lower of the fair market value at the beginning of the applicable offering period or at the end of each applicable purchase period. Offering periods are generally two years in length, and consist of a series of six-month purchase intervals. Eligible employees may join the ESPP at the beginning of any six-month purchase interval. During the six months ended July 1, 2006, we granted purchase rights with an estimated total grant-date value of \$46,000.

Impact of the Adoption of SFAS 123(R)

The effect of recording stock-based compensation for the three and six-month periods ended July 1, 2006 was as follows:

	Three Months Ended July 1, 2006	Six Months Ended July 1, 2006
Stock-based compensation by type of award:		
Stock options	\$ 552	\$ 896
Employee stock purchase plan	167	283
Amounts capitalized as inventory	(24)	(56)
Total stock-based compensation	695	1,123
Tax effect on stock-based compensation	(61)	(99)
Net effect on net income	634	1,024
Effect on earnings per share:		
Basic	\$ 0.03	\$ 0.05
Diluted	\$ 0.03	\$ 0.04

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Approximately \$56,000 of stock-based compensation was capitalized as inventory at July 1, 2006. No stock-based compensation was capitalized to inventory prior to our adoption of the provisions of SFAS 123(R) in the first quarter of 2006.

Valuation Assumptions

The fair value of share-based payment awards is estimated at the grant date using the Black-Scholes option valuation model. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, and actual employee stock option exercise behavior.

In connection with the adoption of SFAS 123(R), we reassessed our valuation technique and related assumptions. We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), SAB No. 107 and our prior period pro forma disclosures of net earnings, including stock-based compensation expense (determined under a fair value method as prescribed by SFAS 123). The weighted-average estimated value of employee stock options granted during the three and six months ended July 1, 2006 was \$15.93 per share and \$12.65 per share, respectively. The weighted-average estimated fair value of employee stock purchase rights granted pursuant to the ESPP during the six months ended July 1, 2006 was \$5.16 per share. The fair value of each option and employee stock purchase right grant is estimated on the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions:

	<u>Three Months Ended July 1, 2006</u> <u>Stock Options</u>	
Expected volatility		81.71%
Risk free interest rate		5.09%
Expected term of options and purchase rights (in years)		5.76
Dividend yield		None
	<u>Six Months Ended July 1, 2006</u>	
	<u>Stock Options</u>	<u>Employee Stock Purchase Plan</u>
Expected volatility	77.91%	61.47%
Risk free interest rate	4.88%	4.64%
Expected term of options and purchase rights (in years)	4.95	0.5
Dividend yield	None	None

The computation of the expected volatility assumptions used in the Black-Scholes calculations for new grants and purchase rights is based on the historical volatility of our stock price, measured over a period equal to the expected term of the grant or purchase right. The risk-free interest rate is based on the yield available on U.S. Treasury Strips with an equivalent remaining term. The expected life of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards and vesting schedules. The expected life of purchase is the period of time remaining in the current offering period. The dividend yield assumption is based on our history of not paying dividends and the assumption of not paying dividends in the future.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

As the stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the first six months of 2006 is based on awards ultimately expected to vest, such amount has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience.

*Expense Information Under SFAS 123(R)**2004 Equity Incentive Plan*

A summary of activity under the above captioned plan is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	1,867,570	\$ 7.19	7.55	\$ 11,482,717
Options granted	387,000	\$ 19.40		
Options forfeited	(38,760)	\$ 8.06		
Options exercised	(260,700)	\$ 7.18		
Options outstanding at July 1, 2006	1,955,110	\$ 9.59	7.88	\$ 23,781,813
Options exercisable at July 1, 2006	880,234	\$ 7.79	6.93	\$ 12,229,177

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing stock price of \$21.68 as of June 30, 2006, which would have been received by the option holders had all options holders exercised their options as of that date.

The options outstanding and currently exercisable at July 1, 2006 were in the following exercise price ranges:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Shares Outstanding	Weighted Average Remaining Contractual Term (In Years)	Weighted Average Exercise Price	Number Vested and Exercisable	Weighted Average Exercise Price
\$ 2.63 - \$ 3.98	350,140	5.42	\$ 2.88	277,049	\$ 2.80
\$ 3.99 - \$ 6.38	277,970	7.33	\$ 4.55	86,885	\$ 4.77
\$ 6.39 - \$ 7.84	343,550	8.05	\$ 7.57	45,150	\$ 7.20
\$ 7.85 - \$10.01	318,200	8.39	\$ 9.04	202,900	\$ 9.63
\$10.02 - \$15.50	280,250	8.29	\$ 12.60	268,250	\$ 12.62
\$15.50 - \$22.55	385,000	9.67	\$ 19.39	—	\$ —
\$ 2.63 - \$28.55	1,955,110	7.88	\$ 9.59	880,234	\$ 7.79

As of July 1, 2006, the unrecorded deferred stock-based compensation balance related to stock options was \$6.1 million and will be recognized over an estimated weighted average amortization period of 2.0 years. The amortization period is based on the expected term of the option, which is defined as the period from grant date to exercise date.

2003 Employee Stock Purchase Plan

During the six months ended July 1, 2006, 74,491 shares were purchased at an average per share price of \$4.71. At July 1, 2006, there were 472,305 shares available to be issued under the ESPP.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Prior to the Adoption of SFAS No. 123(R)

Prior to the adoption of SFAS No. 123(R), we provided the disclosures required under SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosures." Consistent with the disclosure provisions of SFAS 148, our net loss and basic and diluted loss per share for the three and six months ended July 2, 2005 would have been adjusted to the pro forma amounts indicated below:

	Three Months Ended July 1, 2005	Six Months Ended July 1, 2005
Net income, as reported	\$ 3,927	\$ 30
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(717)	(1,109)
Pro forma net income (loss)	<u>\$ 3,210</u>	<u>\$ (1,079)</u>
Basic income (loss) per share:		
As reported	\$ 0.19	\$ 0.00
Pro forma	\$ 0.16	\$ (0.05)
Diluted income (loss) per share:		
As reported	\$ 0.19	\$ 0.00
Pro forma	\$ 0.15	\$ (0.05)

The weighted-average fair value of stock options granted was \$7.65 and \$6.67 for the three and six months ended July 2, 2005, respectively. The weighted-average fair value of purchase rights granted was \$4.42 for the six months ended July 2, 2005. The fair value of each option grant and purchase right was estimated on the date of grant using the Black-Scholes option valuation model with the following weighted average assumptions:

	Three Months Ended July 2, 2005	Six Months Ended	
		July 2, 2005	July 2, 2005
	Stock Options	Employee Stock Purchase Plan	Stock Options
Expected volatility	91.43%	93.02%	92.65%
Risk free interest rate	3.68%	3.83%	4.32%
Expected term of options and purchase rights (in years)	5.0	1.5	6.6
Dividend yield	None	None	None

Prior to fiscal 2006, the expected forfeitures of employee stock options were accounted for on an as-incurred basis.

6. Warranty

We provide for the estimated cost of warranty when revenue is recognized. Our warranty is per contract terms and for our systems the warranty typically ranges between 12 and 24 months from customer acceptance. During this warranty period any defective non-consumable parts are replaced and installed at no charge to the customer. The warranty period on consumable parts is limited to their reasonable usable life. We use estimated repair or replacement costs along with our actual warranty experience to determine our warranty obligation. We exercise judgment in determining the underlying estimates.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On the condensed consolidated balance sheet, the short-term portion of the warranty is included in other accrued liabilities, while the long-term portion is included in other long-term liabilities.

The following table displays the activity in the warranty provision account for the three and six month periods ending July 1, 2006 and July 2, 2005:

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands)			
Beginning balance	\$ 3,573	\$ 1,011	\$ 3,399	\$ 1,116
Expenditures incurred under warranties	(720)	(263)	(1,844)	(709)
Accruals for product warranties issued during the reporting period	1,102	709	2,077	994
Adjustments to previously existing warranty accruals	89	220	412	276
Ending balance	<u>\$ 4,044</u>	<u>\$ 1,677</u>	<u>\$ 4,044</u>	<u>\$ 1,677</u>

The following table displays the balance sheet classification of the warranty provision account at July 1, 2006 and at December 31, 2005:

	July 1, 2006	December 31, 2005
		(In thousands)
Other accrued liabilities	\$ 3,111	\$ 2,705
Other long-term liabilities	933	694
Total warranty provision	<u>\$ 4,044</u>	<u>\$ 3,399</u>

7. Guarantees

We have entered into agreements with customers and suppliers that include limited intellectual property indemnification obligations that are customary in the industry. These guarantees generally require us to compensate the other party for certain damages and costs incurred as a result of third party intellectual property claims arising from these transactions. The nature of the intellectual property indemnification obligations prevents us from making a reasonable estimate of the maximum potential amount we could be required to pay our customers and suppliers. Historically, we have not made any significant indemnification payments under such agreements, and no amount has been accrued in the accompanying consolidated financial statements with respect to these indemnification obligations.

8. Cash, Cash Equivalents and Investments in Debt Securities

Our investment portfolio consists of cash, cash equivalents and investments in debt securities and municipal bonds. We consider all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Investments in debt securities and municipal bonds consist principally of highly rated debt instruments with maturities generally between one and 25 months.

We account for our investments in debt securities and auction rate securities in accordance with Statement of Accounting Standards No. 115 "Accounting for Certain Investments in Debt and Equity Securities," which requires certain securities to be categorized as either trading, available-for-sale or held-to-maturity. Available-for-sale securities are carried at fair value, with unrealized gains and losses recorded within other comprehensive income (loss) as a separate component of shareholders' equity. Held-to-maturity securities are carried at amortized cost. We have no trading securities. The cost of investment securities sold is determined by the specific identification method. Interest income is recorded using an effective interest rate,

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

with the associated premium or discount amortized to interest income. Realized gains and losses and declines in value judged to be other than temporary, if any, on available-for-sale securities are included in earnings. The table below presents the amortized principal amount, major security type and maturities for our investments in debt securities and auction rate securities.

	<u>July 1, 2006</u>	<u>December 31, 2005</u>
	(In thousands)	
Amortized Principal Amount:		
Debt securities issued by the US government and its agencies	\$ —	\$ 10,991
Auction rate securities	33,700	15,000
Corporate debt securities	11,612	8,485
Total investments in debt securities, all short-term	<u>\$ 45,312</u>	<u>\$ 34,476</u>
Approximate fair value of investments in debt securities	<u>\$ 45,291</u>	<u>\$ 34,408</u>

The decline in the fair value of our investments from the principal amount is attributable to changes in interest rates and not credit quality. In accordance with EITF 03-01, we have the ability and intent to hold these investments until fair value recovers, which may be maturity, and we do not consider these investments to be other-than-temporarily impaired at July 1, 2006.

Cash and cash equivalents represent cash accounts and money market funds. Included in accounts payable are \$4.4 million and \$988,000 of book overdraft at July 1, 2006 and December 31, 2005, respectively.

9. Net Income Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 1, 2006</u>	<u>July 2, 2005</u>	<u>July 1, 2006</u>	<u>July 2, 2005</u>
	(In thousands)			
Numerator:				
Numerator for diluted earnings per share — income available to common stockholders	<u>\$ 9,333</u>	<u>\$ 3,927</u>	<u>\$ 16,344</u>	<u>\$ 30</u>
Denominator:				
Denominator for basic earnings per share — weighted-average shares	20,987	20,391	20,910	20,317
Effect of dilutive securities:				
Employee stock options(1)	985	753	973	672
Dilutive potential common shares	985	753	973	672
Denominator for diluted earnings per share — adjusted weighted-average shares and assumed conversions	<u>21,972</u>	<u>21,144</u>	<u>21,883</u>	<u>20,989</u>

- (1) Potentially dilutive securities, consisting of shares issuable upon exercise of employee stock options and weighted-average unamortized compensation expense, are excluded from the calculation of diluted EPS when their effect is anti-dilutive. The weighted average number of employee stock options excluded for the three-month periods ended July 1, 2006 and July 2, 2005 was 196,000 and 218,313, respectively, and the number of employee stock options excluded for the six-month periods ended July 1, 2006 and July 2, 2005 was 196,640 and 281,522, respectively.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

10. Segment Reporting*Segment Description*

We have two reportable operating segments: Equipment and Imaging. Our reportable segments are business units that offer different products and are each managed separately, under the direction of our Chief Executive Officer. Our Equipment business designs, manufactures, markets and services complex capital equipment that deposits, or sputters, highly engineered thin-films onto magnetic disks used in hard disk drives. Our Imaging business develops and manufactures electro-optical sensors, cameras and systems that permit highly sensitive detection of photons in the visible and near infrared portions of the spectrum, allowing vision in extreme low light situations.

Included in corporate activities are general corporate expenses, less an allocation of corporate expenses to operating units equal to 3% of net revenues. Assets of corporate activities include unallocated cash and short-term investments, deferred income tax assets and other assets.

Segment Profit or Loss and Segment Assets

We evaluate performance and allocate resources based on a number of factors including, profit or loss from operations and future revenue potential. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

Business Segment Net Revenues

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands)			
Equipment	\$ 56,465	\$ 28,337	\$ 104,038	\$ 36,873
Imaging	3,077	2,081	5,124	4,150
Total	<u>\$ 59,542</u>	<u>\$ 30,418</u>	<u>\$ 109,162</u>	<u>\$ 41,023</u>

Business Segment Profit & Loss

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands)			
Equipment	\$ 10,974	\$ 4,672	\$ 19,454	\$ 2,001
Imaging	(1,159)	(1,278)	(3,028)	(2,459)
Corporate activities	153	113	173	(356)
Operating income (loss)	9,968	3,507	16,599	(814)
Interest income and other, net	729	423	1,327	854
Income (loss) before income taxes	<u>\$ 10,697</u>	<u>\$ 3,930</u>	<u>\$ 17,926</u>	<u>\$ 40</u>

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Business Segment Assets

	July 1, 2006	December 31, 2005
	(In thousands)	
Equipment	\$ 76,610	\$ 68,672
Imaging	8,314	7,665
Corporate activities	73,387	54,107
Total	<u>\$ 158,311</u>	<u>\$ 130,444</u>

The portion of our long-lived assets maintained outside of the United States is immaterial.

Geographic Area Net Trade Revenues

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands)			
United States	\$ 8,073	\$ 2,798	\$ 16,629	\$ 9,583
Asia	51,452	27,332	92,516	30,967
Europe	17	288	17	473
Total	<u>\$ 59,542</u>	<u>\$ 30,418</u>	<u>\$ 109,162</u>	<u>\$ 41,023</u>

11. Income Taxes

For the six months ended July 1, 2006, we accrued income tax using an effective tax rate of 8.8% of pretax income. This rate is based on an estimate of our annual tax rate calculated in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes". We have substantial net operating loss and credit carry-forwards, which are being used to limit the taxes paid this year and to reduce our effective tax rate to less than the statutory income tax rates in effect. We expect our effective tax rate to significantly increase after our net operating losses and deferred credits have been fully utilized. Our deferred tax asset is principally offset by a valuation allowance, resulting in a net deferred tax asset of \$2.5 million at July 1, 2006.

For the three months ended July 2, 2005, we accrued income tax using an effective tax rate of 2.5% of pretax income. Our tax rate differs from the applicable statutory rates due to the utilization of net operating loss carry-forwards and deferred credits.

12. Capital Transactions

During the six-month period ending July 1, 2006, we sold stock to our employees under Intevac's Equity Incentive and Employee Stock Purchase Plans. A total of 335,191 shares were issued under these plans, for which Intevac received \$2.2 million.

13. Financial Presentation

Certain prior year amounts in the Condensed Consolidated Financial Statements have been reclassified to conform to 2006 presentation. The reclassifications had no material effect on total assets, liabilities, equity, revenue, net income (loss) or comprehensive income (loss) as previously reported.

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

This Quarterly Report on Form 10-Q contains forward-looking statements, which involve risks and uncertainties. Words such as "believes," "expects," "anticipates" and the like indicate forward-looking statements. These forward looking statements include comments related to our shipments, projected revenue recognition, product costs, gross margin, operating expenses, interest income, cash balances and financial results in 2006; our projected customer requirements for new capacity and for technology upgrades for their installed base of our thin-film disk sputtering equipment, and when, and if, our customers will place orders for these products; Imaging's ability to proliferate its technology into major military weapons programs and to develop and introduce commercial imaging products; and the timing of delivery and/or acceptance of the systems and products that comprise our backlog for revenue. Our actual results may differ materially from the results discussed in the forward-looking statements for a variety of reasons, including those set forth under "Risk Factors" and in other documents we file from time to time with the Securities and Exchange Commission, including Intevac's Annual Report on Form 10-K filed in March 2006, Form 10-Q's and Form 8-K's.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ("US GAAP") requires management to make judgments, assumptions and estimates that affect the amounts reported. Our significant accounting policies are described in Note 2 to the consolidated financial statements included in Item 8 of our Annual Report on Form 10-K. Certain of these significant accounting policies are considered to be critical accounting policies, as defined below.

A critical accounting policy is defined as one that is both material to the presentation of our financial statements and requires management to make difficult, subjective or complex judgments that could have a material effect on our financial conditions and results of operations. Specifically, critical accounting estimates have the following attributes: 1) We are required to make assumptions about matters that are highly uncertain at the time of the estimate; and 2) different estimates we could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on our financial condition or results of operations.

Estimates and assumptions about future events and their effects cannot be determined with certainty. We base our estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. These changes have historically been minor and have been included in the consolidated financial statements as soon as they become known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. Many of these uncertainties are discussed in the section below entitled "Risk Factors." Based on a critical assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that our consolidated financial statements are fairly stated in accordance with US GAAP, and provide a meaningful presentation of our financial condition and results of operation.

We believe the following critical accounting policies affect the more significant judgments and estimates we make in preparing our consolidated financial statements. We also have other key accounting policies and accounting estimates related to the collectibility of trade receivables and prototype product costs. We believe that these other accounting policies and other accounting estimates either do not generally require us to make estimates and judgments that are as difficult or subjective, or are less likely to have a material impact on our reported results of operation for a given period.

Revenue Recognition

Certain of our system sales with customer acceptance provisions are accounted for as multiple-element arrangements. If we have previously met defined customer acceptance levels with the specific type of system,

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then we recognize revenue for the fair market value of the system upon shipment and transfer of title, and recognize revenue for the fair market value of installation and acceptance services when those services are completed. We estimate the fair market value of the installation and acceptance services based on our actual historical experience. For systems that have generally not been demonstrated to meet a particular customer's product specifications prior to shipment, revenue recognition is typically deferred until customer acceptance. For example, while initial shipments of our 200 Lean[®] system were recognized for revenue upon customer acceptance during 2004, revenue was recognized upon shipment for the majority of 200 Leans shipped in 2005. Most of the systems in backlog at July 1, 2006 are for customers where we have met defined customer acceptance levels and we expect to recognize revenue upon shipment for those systems.

In some instances, hardware that is not essential to the functioning of the system may be delivered after acceptance of the system. In these cases, we estimate the fair market value of the non-essential hardware as if it had been sold on a stand-alone basis, and defer recognizing revenue on that value until the hardware is delivered.

In certain cases, we sell limited rights to our intellectual property. Revenue from the sale of any intellectual property license will generally be recognized at the inception of the license term.

We perform best efforts research and development work under various government-sponsored research contracts. These contracts are a mixture of cost-plus-fixed-fee ("CPFF") and firm fixed-price ("FFP"). Revenue on CPFF contracts is recognized in accordance with contract terms, typically as costs are incurred. Revenue on FFP contracts is generally recognized on the percentage-of-completion method based on costs incurred in relation to total estimated costs. Provisions for estimated losses on government-sponsored research contracts are recorded in the period in which such losses are determined.

Inventories

Inventories are priced using standard costs, which approximate first-in, first-out, and are stated at the lower of cost or market. The carrying value of inventory is reduced for estimated excess and obsolescence by the difference between its cost and the estimated market value based on assumptions about future demand. We evaluate the inventory carrying value for potential excess and obsolete inventory exposures by analyzing historical and anticipated demand. In addition, inventories are evaluated for potential obsolescence due to the effect of known and anticipated engineering change orders and new products. If actual demand were to be substantially lower than estimated, additional inventory adjustments would be required, which could have a material adverse effect on our business, financial condition and results of operation. A cost to market reserve is established for work-in-progress and finished goods inventories when the value of the inventory plus the estimated cost to complete exceeds the net realizable value of the inventory.

Warranty

We provide for the estimated cost of warranty when revenue is recognized. Our warranty is per contract terms and for our systems the warranty typically ranges between 12 and 24 months from customer acceptance. We use estimated repair or replacement costs along with our actual warranty experience to determine our warranty obligation. We exercise judgment in determining the underlying estimates. Should actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material adverse effect on our business, financial condition and results of operations.

Income Taxes

We account for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes," ("SFAS 109") which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. Based on our history of losses through 2004, our deferred tax asset was fully offset by a valuation allowance as of December 31, 2005.

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On a quarterly basis, we provide for income taxes based upon an annual effective income tax rate. The effective tax rate is highly dependent upon the geographic composition of worldwide earnings, tax regulations governing each region, net operating loss carry-forwards, availability of tax credits and the effectiveness of our tax planning strategies. We carefully monitor the changes in many factors and adjust our effective income tax rate on a timely basis. If actual results differ from the estimates, this could have a material effect on our business, financial condition and results of operations.

The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material effect on our business, financial condition and results of operations.

Results of Operations

Three Months Ended July 1, 2006 and July 2, 2005

Net revenues

	Three Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Equipment net revenues	\$ 56,465	\$ 28,337	\$ 28,128	99%
Imaging net revenues	3,077	2,081	996	48%
Total net revenues	<u>\$ 59,542</u>	<u>\$ 30,418</u>	<u>\$ 29,124</u>	<u>96%</u>

Net revenues consist primarily of sales of equipment used to manufacture thin-film disks, related equipment and system components, flat panel equipment technology license fees, contract research and development related to the development of electro-optical sensors, cameras and systems and low light imaging products.

The increase in Equipment revenue for the three months ending July 1, 2006 was primarily the result of revenue recognition for eleven 200 Lean systems, and, to a lesser extent, shipment of seven disk lubrication systems and an increase in revenue from disk equipment spare parts. The three months ended July 2, 2005 included six 200 Lean systems and three disk lubrication systems and the sale of a D-STAR[®] flat panel technology license for \$1.5 million. Our outlook for the Equipment business continues to be positive and we expect our revenues will grow relative to 2005.

The slight increase in Imaging revenues was the result of increased revenues from contract research and development, in addition to an increase in product shipments. In 2006, we expect the Imaging business revenue to grow, with increases in both contract research and development revenue and product revenue, although we do not anticipate our Imaging business will be profitable in 2006. Substantial growth in future Imaging revenues is dependent on proliferation of our technology into major military weapons programs, the ability to obtain export licenses for foreign customers, obtaining production subcontracts for these programs, and development and sale of commercial products.

Our backlog of orders at July 1, 2006 was \$96.2 million, as compared to \$84.5 million at December 31, 2005 and \$65.4 million at July 2, 2005. The increase in backlog was primarily the result of orders for disk sputtering systems. We include in backlog the value of purchase orders for our products that have scheduled delivery dates. We do not recognize revenue on this backlog until we have met the criteria contained in our revenue recognition policy, including customer acceptance of newly developed systems.

International sales increased by 86% to \$51 million for the three months ended July 1, 2006 from \$28 million for the three months ended July 2, 2005. International revenues include products shipped to overseas operations of U.S. companies. The increase in international sales was primarily due to an increase in net revenues from disk sputtering systems. Substantially all of our international sales are to customers in Asia. International sales constituted 86% of net revenues for the three months ended July 1, 2006 and 91% of net revenues for the three months ended July 2, 2005.

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Gross margin

	Three Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
Equipment gross margin	36.4%	33.4%	3.0 pts	8.8%
Imaging gross margin	25.4%	9.2%	16.2 pts	175.3%
Total gross margin	35.7%	31.8%	3.9 pts	12.4%

Cost of net revenues consists primarily of purchased materials and costs attributable to contract research and development, and also includes fabrication, assembly, test and installation labor and overhead, customer-specific engineering costs, warranty costs, royalties, provisions for inventory reserves and scrap. Cost of net revenues for the three months ended July 1, 2006 included \$93,000 of equity-based compensation expense.

Equipment gross margin improved during the three months ended July 1, 2006 as compared to the three months ended July 2, 2005. This improvement was due primarily to lower manufacturing costs and higher average selling prices for the 200 Lean systems recognized for revenue in the period relative to the three months ended July 2, 2005. We expect the gross margin for the Equipment business in 2006 to be better than 2005, primarily as a result of cost reduction efforts undertaken on the 200 Lean systems and a higher average selling price for the systems. Gross margins in the Equipment business will vary depending on a number of factors, including product cost, system configuration and pricing, factory utilization, and inventory provisions.

The increase in Imaging gross margin was primarily a result of increased product revenue, which carries a higher gross margin than funded research and development, and a greater percentage of factory overhead absorbed into research and development activities. We expect Imaging gross margin in 2006 to be improved over 2005, due primarily to an increase in both product revenue and fully funded research and development.

Research and development

	Three Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
Research and development expense	\$ 6,290	\$ 3,413	\$ 2,877	84%
% of net revenues	10.6%	11.2%		

Research and development expense consists primarily of prototype materials, salaries and related costs of employees engaged in ongoing research, design and development activities for disk sputtering equipment and Imaging products.

Research and development spending increased in both Equipment and in Imaging during the three months ended July 2, 2006 as compared to the three months ended July 2, 2005. The increase in Equipment was due to spending on the development of a new product line and spending for continuing development of our disk sputtering products. The increase in Imaging was due primarily to increased spending on the development of our commercial Imaging products. Engineering headcount increased from 78 at July 2, 2005 to 107 at July 1, 2006. Included in research and development spending for the three months ended July 1, 2006 was \$328,000 of equity-based compensation expense. We expect that research and development spending will increase significantly in 2006 due primarily to expenditures related to our potential new Equipment product line, the addition of key engineering personnel and equity-based compensation expense.

Research and development expenses do not include costs of \$1.9 million and \$1.3 million for the three-month periods ended July 1, 2006 and July 2, 2005, respectively, which are related to contract research and development and included in cost of net revenues.

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Selling, general and administrative

	Three Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Selling, general and administrative expense	\$ 5,004	\$ 2,741	\$ 2,263	83%
% of net revenues	8.4%	9.0%		

Selling, general and administrative expense consists primarily of selling, marketing, customer support, financial and management costs and also includes production of customer samples, travel, liability insurance, legal and professional services and bad debt expense. All domestic sales and international sales of disk sputtering products in Asia, with the exception of Japan, are typically made by Intevac's direct sales force, whereas sales in Japan of disk sputtering products and other products are typically made by our Japanese distributor, Matsubo, who provides services such as sales, installation, warranty and customer support. We also have subsidiaries in Singapore and in Hong Kong, along with field offices in Japan and in Shenzhen, China to support our disk equipment customers in Asia.

The increase in selling, general and administrative spending in the three months ended July 1, 2006 as compared to the three months ended July 2, 2005 was primarily the result of increases in costs related to business development, customer service and support in the Equipment business and provisions for employee profit sharing and bonus plans. Included in selling, general and administrative spending for the three months ended July 1, 2006 was \$274,000 of equity-based compensation expense. Our selling, general and administrative headcount increased from 52 at July 2, 2005 to 66 at July 1, 2006. We expect that selling, general and administrative expenses will increase in 2006 over the amount spent in 2005 due primarily to a projected increase in costs related to customer service and support for the Equipment business, the addition of key business development personnel and stock-based compensation expense.

Interest income and other, net

	Three Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Interest income and other, net	\$ 729	\$ 423	\$ 306	72%

Interest income and other, net consists primarily of interest and dividend income on investments and foreign currency gains and losses. The increase in the three months ended July 1, 2006 was driven by higher interest rates on our investments and a higher average invested balance.

Provision for income taxes

	Three Months Ended		Change Over Prior Period	
	July 1, 2005	July 2, 2006	Amount	%
	(In thousands, except percentages)			
Provision for income taxes	\$ 1,364	\$ 3	\$ 1,361	45,367%

For the three months ended July 1, 2006, we accrued income tax using an effective tax rate of 12.8% of pretax income. This rate is based on an estimate of our annual tax rate calculated in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes". We have substantial net operating loss and credit carry-forwards, which are being used to limit the taxes paid this year and to reduce our effective tax rate to less than the statutory income tax rates in effect. We expect our effective tax rate to significantly increase after our net operating losses and deferred credits have been fully utilized. Our deferred tax asset is principally offset by a valuation allowance, resulting in a net deferred tax asset of \$2.5 million at July 1, 2006.

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For the three months ended July 2, 2005, we accrued income tax using an effective tax rate of 2.5% of pretax income. Our tax rate differs from the applicable statutory rates due to the utilization of net operating loss carry-forwards and deferred credits.

Six Months Ended July 1, 2006 and June 2, 2005

Net revenues

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Equipment net revenues	\$ 104,038	\$ 36,873	\$67,165	182%
Imaging net revenues	5,124	4,150	974	23%
Total net revenues	<u>\$ 109,162</u>	<u>\$ 41,023</u>	<u>\$68,139</u>	166%

The increase in Equipment revenue was the result of higher sales of disk sputtering systems and spare parts. The increase in Imaging revenues was the result of higher sales from development contracts from military and government markets.

International sales increased by 194% to \$92.5 million for the six months ended July 1, 2006 from \$31.4 million for the six months ended July 2, 2005. The increase in international sales was due to higher shipments of disk sputtering systems to customers in Asia. International sales constituted 85% of net revenues for the six months ended July 1, 2006 and 77% of net revenues for the six months ended July 2, 2005. International revenues include products shipped to overseas operations of US companies.

Gross margin

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
Equipment gross margin	35.8%	30.2%	5.6 pts	18.7%
Imaging gross margin	25.7%	12.1%	13.6 pts	112.7%
Total gross margin	<u>35.3%</u>	<u>28.4%</u>	6.9 pts	24.4%

Gross margin for the six months ended July 1, 2006 increased relative to the comparable 2005 period primarily due to lower manufacturing costs and higher average selling prices for the 200 Lean system in the Equipment division. In addition, the increase in Imaging was primarily a result of increased product revenue, which carries a higher gross margin than funded research and development, and a greater percentage of factory overhead absorbed into research and development activities. Cost of net revenues for the six months ended July 1, 2006 included \$139,000 of equity-based compensation expense.

Gross margin for the six months ended July 2, 2005 was favorably impacted by \$908,000 of flat panel equipment related activities. The \$908,000 included \$1.5 million of gross profit from the technology license sale less \$592,000 for costs related to obtaining final customer acceptance of a flat panel manufacturing system shipped in 2003. Gross margin for the six months ended July 2, 2005 was adversely impacted by the recognition of revenue on a 200 Lean system that was built early in 2004, prior to the completion of a number of cost reduction activities.

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Research and development

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Research and development expense	\$ 11,851	\$ 6,538	\$ 5,313	81%
% of net revenues	10.9%	15.9%		

Research and development spending increased in both Equipment and in Imaging during the six months ended July 2, 2006 as compared to the six months ended July 2, 2005. The increase in Equipment was due to spending on the development of a new product line and spending for continuing development of our disk sputtering products. The increase in Imaging was due primarily to spending on the development of our commercial Imaging products. Included in research and development spending for the six months ended July 1, 2006 was \$532,000 of equity-based compensation expense.

Research and development expenses do not include costs of \$2.9 million and \$2.8 million, respectively, for the six-month periods ended July 1, 2006 and July 2, 2005 related to Imaging contract research and development. These expenses are included in cost of net revenues.

Selling, general and administrative

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Selling, general and administrative expense	\$ 10,118	\$ 5,932	\$ 4,186	71%
% of net revenues	9.3%	14.5%		

The increase in selling, general and administrative expense for the six months ending July 1, 2006 was primarily the result of increases in costs related to business development, customer service and support in the Equipment business and provisions for employee profit sharing and bonus plans. Included in selling, general and administrative spending for the six months ended July 1, 2006 was \$452,000 of equity-based compensation expense.

Interest income and other, net

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Interest income and other, net	\$ 1,327	\$ 854	\$ 473	55%

Interest income and other, net in both 2006 and 2005 consisted primarily of interest and dividend income on investments. The increase in the six months ended July 1, 2006 was driven by higher interest rates on our investments and a higher average invested balance.

Provision for income taxes

	Six Months Ended		Change Over Prior Period	
	July 1, 2006	July 2, 2005	Amount	%
	(In thousands, except percentages)			
Provision for income taxes	\$ 1,582	\$ 10	\$ 1,572	15,720%

For the six months ended July 1, 2006, we accrued income tax using an effective tax rate of 8.8% of pretax income. This rate is based on an estimate of our annual tax rate calculated in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes".

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Income tax expense for the six months ending July 2, 2005 consists of a 2.5% provision on net pretax income, minimum Franchise Tax payment of \$2,400 to the State of California and a \$7,000 accrual related to a claim we received from the California Franchise Tax Board.

Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including equity awards related to the 2004 Equity Incentive Plan ("employee equity awards") and employee stock purchases related to the 2003 Employee Stock Purchase Plan ("employee stock purchases") based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123 (R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our Condensed Consolidated Financial Statements as of and for the three and six months ended July 1, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

During the three and six months ended July 1, 2006, we recorded stock-based compensation expense related to stock options of \$552,000 and \$896,000 respectively. As of July 1, 2006, the unrecorded deferred stock-based compensation balance related to stock options was \$6.1 million and will be recognized over an estimated weighted average amortization period of 2.0 years.

The compensation cost associated with the employee stock purchase plan for the three and six months ended July 1, 2006 was \$167,000 and \$283,000 respectively. There were 74,491 shares purchased under the employee stock purchase plan during the six months ended July 1, 2006.

Approximately \$24,000 and \$56,000 of stock-based compensation was capitalized as inventory at the three- and six-month periods ended July 1, 2006. No stock-based compensation was capitalized to inventory prior to our adoption of the provisions of SFAS 123(R) in the first quarter of 2006.

Liquidity and Capital Resources

During the first six months of 2006, cash, cash equivalents and short-term investments increased by \$15.9 million, from \$49.7 million at December 31, 2005 to \$65.6 million as of July 1, 2006.

Operating activities provided cash of \$15.7 million during the six months ended July 1, 2006. The cash provided was due primarily to net income, adjusted to exclude the effect of non-cash charges including depreciation and equity-based compensation. This was partially offset by increases in inventory and other prepaid expenses. Accounts receivable totaled \$41.6 million at July 1, 2006 compared to \$42.8 million at December 31, 2005. Net inventories increased by \$9.6 million during the six months ended July 1, 2006 due to increases in both raw materials and work-in -progress, which will be used to support the July 1, 2006 backlog. Accounts payable totaled \$11.6 million at July 1, 2006 compared to \$7.0 million at December 31, 2005. The increase of \$4.6 million relates to the increase in inventory purchases and the general growth of our business. Accrued payroll and related liabilities increased by \$1.1 million during the six months ended July 1, 2006 due primarily to increases in headcount and accruals for bonuses and employee profit sharing. Other accrued liabilities totaled \$6.8 million at July 1, 2006 compared to \$6.9 million at December 31, 2005. The minimal net decrease relates to decreases in income and sales tax accruals and deferred income, partially offset by an increase in accruals for warranty obligations. Customer advances increased by \$2.4 million during the six months ended July 1, 2006. The increase was due to advances billed or received for orders that will be shipped during the balance of 2006 and in 2007.

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Investing activities in the first six months of 2006 used cash of \$12.9 million. Purchases of short-term investments, net of proceeds from sales and maturities, totaled \$10.7 million. Capital expenditures for the six months ended July 1, 2006 were \$2.2 million.

Financing activities provided cash of \$2.2 million during the six months ended July 1, 2006 due to the sale of Intevac common stock to our employees through our employee benefit plans.

We have generated operating income each of the last five quarters, after incurring annual operating losses from 1997 thru 2004. We believe an upturn in demand for the type of disk manufacturing equipment we produce is continuing, and we expect our Equipment business to be profitable again in 2006.

We believe that our existing cash, cash equivalents and short-term investments, combined with the cash we anticipate generating from operating activities will be sufficient to meet our cash requirements for the foreseeable future. We intend to undertake approximately \$7.0 million in capital expenditures during the remainder of 2006.

Contractual Obligations

In the normal course of business, we enter into various contractual obligations that will be settled in cash. These obligations consist primarily of operating lease and purchase obligations. The expected future cash flows required to meet these obligations as of July 1, 2006 are shown in the table below.

	Total	Payments Due by Period			
		<1 Year	1-3 Years (In thousands)	3-5 Years	>5 Years
Operating lease obligations	\$12,151	\$ 3,249	\$ 3,601	\$ 3,713	\$ 1,588
Purchase obligations	23,093	23,093	—	—	—
Total	<u>\$35,244</u>	<u>\$ 26,342</u>	<u>\$ 3,601</u>	<u>\$ 3,713</u>	<u>\$ 1,588</u>

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest rate risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. We place our investments with high quality credit issuers and, by policy, limit the amount of credit exposure to any one issuer. Short-term investments typically consist of investments in commercial paper, auction rate securities and debt instruments issued by the US government and its agencies.

The table below presents principal amounts and related weighted-average interest rates by year of maturity for our investment portfolio at July 1, 2006.

	2006	2007	2008	Beyond	Total	Fair Value
Cash equivalents						
Fixed rate amounts	\$ 9,426	—	—	—	\$ 9,426	\$ 9,421
Weighted-average rate	5.12%					
Variable rate amounts	\$ 4,860	—	—	—	\$ 4,860	\$ 4,860
Weighted-average rate	4.88%					
Short-term investments						
Fixed rate amounts	\$ 43,303	\$2,009	—	—	\$ 45,312	\$ 45,291
Weighted-average rate	5.12%	4.8%				
Total investment portfolio	\$ 57,589	\$2,009	—	—	\$ 59,598	\$ 59,572

Due to the short-term nature of our investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates.

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Foreign exchange risk. From time to time, we enter into foreign currency forward exchange contracts to economically hedge certain of our anticipated foreign currency transaction, translation and re-measurement exposures. The objective of these contracts is to minimize the impact of foreign currency exchange rate movements on our operating results. At July 1, 2006, we had no foreign currency forward exchange contracts.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures.

We maintain a set of disclosure controls and procedures that are designed to ensure that information relating to Intevac, Inc. required to be disclosed in periodic filings under Securities Exchange Act of 1934, or Exchange Act, is recorded, processed, summarized and reported in a timely manner under the Exchange Act. In connection with the filing of this Form 10-Q for the quarter ended July 1, 2006, as required under Rule 13a-15(b) of the Exchange Act, an evaluation was carried out under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of July 1, 2006.

Attached as exhibits to this Quarterly Report are certifications of the CEO and the CFO, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (Exchange Act). This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls include components of our internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within our Disclosure Controls, they are included in the scope of our quarterly controls evaluation.

Limitations on the Effectiveness of Controls

Our management, including the CEO and CFO, does not expect that our Disclosure Controls or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of

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compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Changes in internal controls over financial reporting

There were no changes in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

Patent Infringement Complaint against Unaxis

On July 7, 2006, we filed a patent infringement lawsuit against Unaxis USA, Inc. and its affiliates Unaxis Balzers AG and Unaxis Balzers, Ltd. in the United States District Court for the Central District of California. Our lawsuit against Unaxis asserts infringement by Unaxis of United States Patent 6,919,001 that relates to our 200 Lean magnetic media sputtering equipment. Our complaint seeks monetary damages and an injunction that bars Unaxis from making, using, offering to sell, or selling in the United States, or importing into the United States the allegedly infringing product. In the suit, we seek damages and a permanent injunction for infringement of the same patent. We believe we have meritorious claims and we intend to pursue them vigorously.

Other Legal Matters

From time to time, we are involved in claims and legal proceedings that arise in the ordinary course of business. We expect that the number and significance of these matters will increase as our business expands. Any claims or proceedings against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, result in the diversion of significant operational resources, or require us to enter into royalty or licensing agreements which, if required, may not be available on terms favorable to us or at all. We are not presently party to any lawsuit or proceeding that, in our opinion, is likely to seriously harm our business.

Item 1A. *Risk Factors*

Our operating results fluctuate significantly from quarter to quarter, which may cause the price of our stock to decline.

Over the last 10 quarters, our revenues per quarter have fluctuated between \$6.4 million and \$59.5 million. Over the same period our operating income as a percentage of revenues has fluctuated between approximately 18% and (56%) of revenues. We anticipate that our revenues and operating margins will continue to fluctuate. We expect this fluctuation to continue for a variety of reasons, including:

- changes in the demand, due to seasonality, cyclicity and other factors, for the computer systems, storage subsystems and consumer electronics containing disks our customers produce with our systems; and
- delays or problems in the introduction and acceptance of our new products, or delivery of existing products;
- announcements of new products, services or technological innovations by us or our competitors.

Additionally, because our systems are priced in the millions of dollars and we sell a relatively small number of systems, our business is inherently subject to fluctuations in revenue from quarter to quarter due to factors such as timing of orders, acceptance of new systems by our customers or cancellation of those orders. As a result, we believe that quarter-to -quarter comparisons of our revenues and operating results may not be meaningful and that these comparisons may not be an accurate indicator of our future performance. Our

operating results in one or more future quarters may fail to meet the expectations of investment research analysts or investors, which could cause an immediate and significant decline in the trading price of our common shares.

We are exposed to risks associated with a highly concentrated customer base.

Historically, a significant portion of our revenue in any particular period has been attributable to sales of our disk sputtering systems to a limited number of customers. In 2005, one of our customers accounted for 41% of our revenues and four customers, in the aggregate, accounted for 90% of our revenues. These same four customers, in the aggregate, accounted for 93% of our net accounts receivable at December 31, 2005. During 2005, Seagate announced its acquisition of Maxtor. This acquisition will further consolidate our customer base, as they both are included in the four customers with whom our revenues and accounts receivable were heavily concentrated in 2005. Orders from a relatively limited number of magnetic disk manufacturers have accounted for, and likely will continue to account for, a substantial portion of our revenues. The loss of, or delays in purchasing by, any one of our large customers would significantly reduce, or delay, future revenues. The concentration of our customer base may enable customers to demand pricing and other terms unfavorable to us. Furthermore, the concentration of customers can lead to extreme variability in revenue and financial results from period to period. For example, during 2005 revenues ranged between \$10.6 million in the first quarter and \$52.7 million in the fourth quarter. These factors could have a material adverse effect on our business, financial condition and results of operations.

Our long-term revenue growth is dependent on new products. If these new products are not successful, then our results of operations will be adversely affected.

We have invested heavily, and continue to invest, in the development of new products. Our success in developing and selling new products depends upon a variety of factors, including our ability to predict future customer requirements accurately, technological advances, total cost of ownership of our systems, our introduction of new products on schedule, the reception our new products find in the market, our ability to manufacture our products cost-effectively and the performance of our products in the field. Our new product decisions and development commitments must anticipate continuously evolving industry requirements significantly in advance of sales.

The majority of our revenues in the twelve months ended December 31, 2005 was from sales of our 200 Lean disk sputtering system, which was first delivered in December 2003. When first introduced, advanced vacuum manufacturing equipment, such as the 200 Lean, is subject to extensive customer acceptance tests after installation at the customer's factory. These acceptance tests are designed to validate reliable operation to specification in areas such as throughput, vacuum level, robotics, process performance and software features and functionality. These tests are generally more comprehensive for new systems than for mature systems, and are designed to highlight problems encountered with early versions of the equipment. For example, initial builds of the 200 Lean experienced high production and warranty costs in comparison to our more established product lines. Failure to promptly address any of the problems uncovered in these tests could have adverse effects on our business, including rescheduling of backlog, failure to achieve customer acceptance and therefore revenue recognition as anticipated, unanticipated product rework and warranty costs, penalties for non-performance, cancellation of orders, or return of products for credit.

We are making a substantial investment to develop a new manufacturing system to address applications other than magnetic media manufacturing. We have not yet completed a fully functional production system, and do not expect to generate revenue from this product in the next twelve months. We spent \$6.4 million, or 44% of our research and development costs, on this new product in 2005 and expect to significantly increase our level of spending on this project in 2006. We have not developed or sold products for this market previously, and our knowledge of the market and its needs is limited. Failure to correctly assess the size of the market, to successfully develop a product to cost effectively address the market, or to establish effective sales and support of the new product would have a material adverse effect on our future revenues and profits, including loss of the Company's entire investment in the project.

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We are jointly developing a next generation head mounted night-vision system with another defense contractor. This system is planned for sale to the U.S. military and will compete with head-mounted systems developed by our competitors. The US military does not intend to initiate production of this system until 2010. We plan to make a significant investment in this product and cannot be assured when, or if, we will be awarded any production contracts for these night vision systems.

Our LIVAR[®] target identification and low light level camera technologies are designed to offer significantly improved capability to military customers. We are also developing commercial products based on the technology we have developed in our Imaging business. None of our Imaging products are currently being manufactured in high volume, and we may encounter unforeseen difficulties when we commence volume production of these products. Our Imaging business will require substantial further investment in sales and marketing, in product development and in additional production facilities in order to expand our operations. We may not succeed in these activities or generate significant sales of these new products. To date, commercial sales of our commercial Imaging products have not been significant, and we do not expect to realize significant revenues in 2006 from deployment of LIVAR or our other Imaging products.

Failure of any of these new products to perform as intended, to penetrate their markets and develop into profitable product lines or to achieve their production cost objectives, would have a material adverse effect on our business.

Demand for capital equipment is cyclical, which subjects our business to long periods of depressed revenues interspersed with periods of unusually high revenues.

Our Equipment business sells equipment to capital-intensive industries, which sell commodity products such as disk drives. When demand for these commodity products exceeds capacity, demand for new capital equipment such as ours tends to be amplified. Conversely, when supply of these commodity products exceeds demand, the demand for new capital equipment such as ours tends to be depressed. The hard disk drive industry has historically been subject to multi-year cycles because of the long lead times and high costs involved in adding capacity, and to seasonal cycles driven by consumer purchasing patterns, which tend to be heaviest in the third and fourth quarters of each year.

The cyclical nature of the capital equipment industry means that in some years we will have unusually high sales of new systems, and that in other years our sales of new systems will be severely depressed. The timing, length and volatility of these cycles are difficult to predict. These cycles have affected the timing and amounts of our customers' capital equipment purchases and investments in new technology. For example, sales of systems for magnetic disk production were severely depressed from the middle of 1998 until mid-2003. We believe we are currently in a strong upswing in a cycle, but we cannot predict with any certainty how long such an upswing might last.

If the projected growth in demand for hard disk drives does not materialize and our customers do not replace or upgrade their installed base of disk sputtering systems, then future sales of our disk sputtering systems will suffer.

From the middle of 1998 until mid-2003, there was very little demand for new disk sputtering systems, as magnetic disk manufacturers were burdened with over-capacity and were not investing in new disk sputtering equipment. By 2003, however, over-capacity had diminished and sales of our 200 Lean began to increase.

Sales of our equipment for capacity expansions are dependent on the capacity expansion plans of our customers and upon whether our customers select our equipment for their capacity expansions. We have no control over our customers' expansion plans, and we cannot assure you that they will select our equipment if they do expand their capacity. Our customers may not implement capacity expansion plans, or we may fail to win orders for equipment for those capacity expansions, which could have a material adverse effect on our business and our operating results. In addition, some manufacturers may choose to purchase used systems from other manufacturers or customers rather than purchasing new systems from us. Furthermore, if hard disk drives were to be replaced by an alternative technology as a primary method of digital storage, demand for our products would decrease.

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Sales of our 200 Lean disk sputtering systems are also dependent on obsolescence and replacement of the installed base of disk sputtering equipment. If technological advancements are developed that extend the useful life of the installed base of systems, then sales of our 200 Lean will be limited to the capacity expansion needs of our customers, which would significantly decrease our revenue.

Our products are complex, constantly evolving and often must be customized to individual customer requirements.

The systems we manufacture and sell in our Equipment business have a large number of components and are complex, which require us to make substantial investments in research and development. If we were to fail to develop, manufacture and market new systems or to enhance existing systems, that failure would have an adverse effect on our business. We may experience delays and technical and manufacturing difficulties in future introduction, volume production and acceptance of new systems or enhancements. In addition, some of the systems that we manufacture must be customized to meet individual customer site or operating requirements. In some cases, we market and commit to deliver new systems, modules and components with advanced features and capabilities that we are still in the process of designing. We have limited manufacturing capacity and engineering resources and may be unable to complete the development, manufacture and shipment of these products, or to meet the required technical specifications for these products, in a timely manner. Failure to deliver these products on time, or failure to deliver products that perform to all contractually committed specifications, could have adverse effects on our business, including rescheduling of backlog, failure to achieve customer acceptance and therefore revenue recognition as anticipated, unanticipated rework and warranty costs, penalties for non-performance, cancellation of orders, or return of products for credit. In addition, we may incur substantial unanticipated costs early in a product's life cycle, such as increased engineering, manufacturing, installation and support costs, that we may be unable to pass on to the customer and that may affect our gross margins. Sometimes we work closely with our customers to develop new features and products. In connection with these transactions, we sometimes offer a period of exclusivity to these customers.

Our sales cycle is long and unpredictable, which requires us to incur high sales and marketing expenses with no assurance that a sale will result.

The sales cycle for our equipment systems can be a year or longer, involving individuals from many different areas of our company and numerous product presentations and demonstrations for our prospective customers. Our sales process for these systems also includes the production of samples and customization of products for our prospective customers. We do not enter into long-term contracts with our customers and therefore, until an order is actually submitted by a customer, there is no binding commitment to purchase our systems.

Our Imaging business is also subject to long sales cycles because many of our products, such as our LIVAR system, often must be designed into our customers' products, which are often complex state-of-the-art products. These development cycles are often multi-year, and our sales are contingent on our customer successfully integrating our product into their product, completing development of their product and then obtaining production orders for their product from the U.S. Government or its allies.

As a result, we may not recognize revenue from our products for extended periods of time after we have completed development, and made initial shipments of, our products, during which time we may expend substantial funds and management time and effort with no assurance that a sale will result.

We operate in an intensely competitive marketplace, and our competitors have greater resources than we do.

In the market for our disk sputtering systems, we have experienced competition from competitors such as Anelva Corporation, which is a subsidiary of Canon, and Unaxis Holdings, Ltd, each of which has sold substantial numbers of systems worldwide. In the market for our Imaging products, we experience competition from companies such as ITT Industries, Inc. and Northrop Grumman Corporation, the primary

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U.S. manufacturers of Generation-III night vision devices and their derivative products. Our competitors have substantially greater financial, technical, marketing, manufacturing and other resources than we do. We cannot assure you that our competitors will not develop enhancements to, or future generations of, competitive products that offer superior price or performance features. Likewise, we cannot assure you that new competitors will not enter our markets and develop such enhanced products. Moreover, competition for our customers is intense, and our competitors have historically offered substantial pricing concessions and incentives to attract our customers or retain their existing customers.

We experienced significant growth in our business and operations and if we do not appropriately manage this growth and any future growth, our operating results will be negatively affected.

Our business has grown significantly in recent years in both operations and headcount, and continued growth may cause a significant strain on our infrastructure, internal systems and managerial resources. To manage our growth effectively, we must continue to improve and expand our infrastructure, including information technology and financial operating and administrative systems and controls, and continue managing headcount, capital and processes in an efficient manner. Our productivity and the quality of our products may be adversely affected if we do not integrate and train our new employees quickly and effectively and coordinate among our executive, engineering, finance, marketing, sales, operations and customer support organizations, all of which add to the complexity of our organization and increase our operating expenses. We also may be less able to predict and effectively control our operating expenses due to the growth and increasing complexity of our business. In addition, our information technology systems may not grow at a sufficient rate to keep up with the processing and information demands placed on them by a much larger company. The efforts to continue to expand our information technology systems or our inability to do so could harm our business. Further, revenues may not grow at a sufficient rate to absorb the costs associated with a larger overall headcount.

Our future growth may require significant additional resources given that, as we increase our business operations in complexity and scale, we may have insufficient management capabilities and internal bandwidth to manage our growth and business effectively. We cannot assure you that resources will be available when we need them or that we will have sufficient capital to fund these potential resource needs. Also, growth in the number of orders received in our Equipment business may require additional physical space and headcount, and our ability to fulfill such orders may be constrained if we are unable to effectively grow our business. If we are unable to manage our growth effectively or if we experience a shortfall in resources, our results of operations will be harmed.

Our Imaging business depends heavily on government contracts, which are subject to immediate termination and are funded in increments. The termination of or failure to fund one or more of these contracts could have a negative impact on our operations.

We sell many of our Imaging products and services directly to the U.S. government, as well as to prime contractors for various U.S. government programs. Our revenues from government contracts totaled \$6.9 million, \$8.2 million and \$9.4 million in 2005, 2004 and 2003, respectively. Generally, government contracts are subject to oversight audits by government representatives and contain provisions permitting termination, in whole or in part, without prior notice at the government's convenience upon the payment of compensation only for work done and commitments made at the time of termination. We cannot assure you that one or more of the government contracts under which we or our customers operate will not be terminated under these circumstances. Also, we cannot assure you that we or our customers would be able to procure new government contracts to offset the revenues lost as a result of any termination of existing contracts, nor can we assure you that we or our customers will continue to remain in good standing as federal contractors.

Furthermore, the funding of multi-year government programs is subject to congressional appropriations, and there is no guarantee that the U.S. government will make further appropriations. The loss of funding for a government program would result in a loss of anticipated future revenues attributable to that program. That could increase our overall costs of doing business.

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In addition, sales to the U.S. government and its prime contractors may be affected by changes in procurement policies, budget considerations and political developments in the United States or abroad. The influence of any of these factors, which are beyond our control, could also negatively impact our financial condition. We also may experience problems associated with advanced designs required by the government, which may result in unforeseen technological difficulties and cost overruns. Failure to overcome these technological difficulties and the occurrence of cost overruns would have a material adverse effect on our business.

We may not be successful in maintaining and obtaining the necessary export licenses to conduct operations abroad, and the United States government may prevent proposed sales to foreign customers.

Many of our Imaging products require export licenses from United States Government agencies under the Export Administration Act, the Trading with the Enemy Act of 1917, the Arms Export Act of 1976 and the International Trading in Arms Regulations. This limits the potential market for our products. We can give no assurance that we will be successful in obtaining all the licenses necessary to export our products. Recently, heightened government scrutiny of export licenses for products in our market has resulted in lengthened review periods for our license applications. Export to countries which are not considered by the United States Government to be allies is likely to be prohibited, and even sales to U.S. allies may be limited. Failure to obtain, or delays in obtaining, or revocation of previously issued licenses would prevent us from selling our products outside the United States, may subject us to fines or other penalties, and would have a material adverse effect on our business, financial condition and results of operations.

Our sales of disk sputtering systems are dependent on substantial capital investment by our customers, far in excess of the cost of our products.

Our customers must make extremely large capital expenditures in order to purchase our systems and other related equipment and facilities. These costs are far in excess of the cost of our systems alone. The magnitude of such capital expenditures requires that our customers have access to large amounts of capital and that they be willing to invest that capital over long periods of time to be able to purchase our equipment. The magnetic disk manufacturing industry has not made significant additions to its production capacity until recently. Some of our potential customers may not be willing or able to make the magnitude of capital investment required, especially during a downturn in either the overall economy or the hard disk drive industry.

Our stock price is volatile.

The market price and trading volume of our common stock has been subject to significant volatility, and this trend may continue. Over the last 12 months, the closing price of our common stock, as traded on The Nasdaq National Market, fluctuated from a low of \$8.88 to a high of \$30.60 per share. The value of our common stock may decline regardless of our operating performance or prospects. Factors affecting our market price include:

- our perceived prospects;
- hard disk drive market expectations;
- variations in our operating results and whether we achieve our key business targets;
- sales or purchases of large blocks of our stock;
- changes in, or our failure to meet, our revenue and earnings estimates;
- changes in securities analysts' buy or sell recommendations;
- differences between our reported results and those expected by investors and securities analysts;
- announcements of new contracts, products or technological innovations by us or our competitors;

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- market reaction to any acquisitions, joint ventures or strategic investments announced by us or our competitors;
- our high fixed operating expenses, including research and development expenses;
- developments in the financial markets; and
- general economic, political or stock market conditions in the United States and other major regions in which we do business.

For example, in July 2004 when we announced that our gross margin and gross revenue for the year would be under the expectations of investment analysts, our stock price dropped by approximately half. In addition, the general economic, political, stock market and hard drive industry conditions that may affect the market price of our common stock are beyond our control. The market price of our common stock at any particular time may not remain the market price in the future. In the past, securities class action litigation has been instituted against companies following periods of volatility in the market price of their securities. Any such litigation, if instituted against us, could result in substantial costs and a diversion of management's attention and resources.

Changes in tax rates or tax liabilities could affect future results.

As a global company, we are subject to taxation in the United States and various other countries. Significant judgment is required to determine and estimate worldwide tax liabilities. Our future tax rates could be affected by changes in the composition of earnings in countries with differing tax rates, changes in the valuation of our deferred tax assets and liabilities, or changes in the tax laws. Although we believe our tax estimates are reasonable, there can be no assurance that any final determination will not be materially different from the treatment reflected in our historical income tax provisions and accruals, which could materially and adversely affect our results of operations.

At December 31, 2005, due to a history of net operating losses prior to 2005, \$15 million of deferred tax assets have been fully reserved by a valuation allowance. We are projecting an effective tax rate of 8.8% for 2006. This rate assumes the reversal of a portion of the valuation allowance against the deferred tax assets. If we determine that conclusive evidence exists to support additional adjustments to the valuation allowance, or we can reasonably forecast sufficient income to utilize the deferred tax assets, our future effective tax rate will likely increase significantly. An increase in the effective tax rate could have a material adverse effect on our reported earnings and earnings per share.

Our future success depends on international sales and the management of global operations.

In the six months ended July 1, 2006, approximately 85% of our revenues came from regions outside the United States. In 2005, approximately 71% of our revenues came from these regions. We currently have international customer support offices in Singapore, China and Japan. We expect that international sales will continue to account for a significant portion of our total revenue in future years. Certain manufacturing facilities and suppliers are also located outside the United States. Managing our global operations presents challenges including, but not limited to, those arising from:

- varying regional and geopolitical business conditions and demands;
- global trade issues;
- variations in protection of intellectual property and other legal rights in different countries;
- rising raw material and energy costs;
- variations in the ability to develop relationships with suppliers and other local businesses;
- changes in laws and regulations of the United States (including export restrictions) and other countries, as well as their interpretation and application;
- fluctuations in interest rates and currency exchange rates;

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- the need to provide sufficient levels of technical support in different locations;
- political instability, natural disasters (such as earthquakes, hurricanes or floods), pandemics, terrorism or acts of war where we have operations, suppliers or sales;
- cultural differences; and
- shipping delays.

Changes in existing financial accounting standards or practices or taxation rules or practices may adversely affect our results of operations.

Changes in existing accounting or taxation rules or practices, new accounting pronouncements or taxation rules, or varying interpretations of current accounting pronouncements or taxation practice could have a significant adverse effect on our results of operations or the manner in which we conduct our business. Further, such changes could potentially affect our reporting of transactions completed before such changes are effective. For example, in December 2004, the Financial Accounting Standards Board (“FASB”) enacted Statement of Financial Accounting Standards 123 (Revised 2004) (“SFAS 123R”), “Share-Based Payment,” which replaces SFAS No. 123 (“SFAS 123”), “Accounting for Stock-Based Compensation.” SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such compensation expense in our statements of income. We adopted SFAS 123R in the first quarter of fiscal year 2006.

We are required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 and any adverse results from such evaluation could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, our management must perform evaluations of our internal control over financial reporting. Beginning in 2004, our Form 10-K has included a report by management of their assessment of the adequacy of such internal control. Additionally, our independent registered public accounting firm must publicly attest to the adequacy of management’s assessment and the effectiveness of our internal control. Ongoing compliance with these requirements is complex, costly and time-consuming.

In 2004, we were not able to assert, in our management certifications filed with our Annual Report on Form 10-K, that our internal control over financial reporting was effective as of December 31, 2004, as our management identified three material weaknesses in our internal control over financial reporting. This or any future inability to assert that our internal controls over financial reporting are effective for any given reporting period (or if our auditors are unable to attest that our management’s report is fairly stated or if they are unable to express an opinion on the effectiveness of our internal controls), could cause us to lose investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on our stock price.

We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. During the 2004 audit, our external auditors brought to our attention a need to increase the internal controls in certain areas of our operation, including revenue calculations in the Imaging business, determination of inventory reserve requirements, approval of changes to the perpetual inventory and segregation of duties. In 2005, we devoted significant resources to remediation of these and other findings and to improvement of our internal controls. Although we believe that these efforts have strengthened our internal controls and addressed the concerns that gave rise to the material weaknesses previously reported by us, we are continuing to work to improve our internal controls.

Our dependence on suppliers for certain parts, some of them sole-sourced, makes us vulnerable to manufacturing interruptions and delays, which could affect our ability to meet customer demand.

We are a manufacturing business. Purchased parts constitute the largest component of our product cost. Our ability to manufacture depends on the timely delivery of parts, components, and subassemblies from

suppliers. We obtain some of the key components and sub-assemblies used in our products from a single supplier or a limited group of suppliers. If any of our suppliers fail to deliver quality parts on a timely basis, we may experience delays in manufacturing, which could result in delayed product deliveries or increased costs to expedite deliveries or develop alternative suppliers. Development of alternative suppliers could require redesign of our products.

Our business depends on the integrity of our intellectual property rights.

The success of our business depends upon integrity of our intellectual property rights and we cannot assure you that:

- any of our pending or future patent applications will be allowed or that any of the allowed applications will be issued as patents or will issue with claims of the scope we sought;
- any of our patents will not be invalidated, deemed unenforceable, circumvented or challenged;
- the rights granted under our patents will provide competitive advantages to us;
- other parties will not develop similar products, duplicate our products or design around our patents; or
- our patent rights, intellectual property laws or our agreements will adequately protect our intellectual property or competitive position.

Failure to protect our intellectual property rights adequately could have a material adverse effect on our business.

We provide products that are expected to have long useful lives and that are critical to our customers' operations. From time to time, as part of business agreements, we place portions of our intellectual property into escrow to provide assurance to our customers that our technology will be available to them in the event that we are unable to support them at some point in the future.

From time to time, we have received claims that we are infringing third parties' intellectual property rights. We cannot assure you that third parties will not in the future claim that we have infringed current or future patents, trademarks or other proprietary rights relating to our products. Any claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us.

Our success is dependent on recruiting and retaining a highly talented work force.

Our employees are vital to our success, and our key management, engineering and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. The expansion of high technology companies worldwide has increased demand and competition for qualified personnel, and has made companies increasingly protective of prior employees. It may be difficult for us to locate employees who are not subject to non-competition and other restrictions.

Our U.S. operations are located in Santa Clara, California and Fremont, California, where the cost of living and recruiting employees is high. Additionally, our operating results depend, in large part, upon our ability to retain and attract qualified management, engineering, marketing, manufacturing, customer support, sales and administrative personnel. Furthermore, we compete with similar industries, such as the semiconductor industry, for the same pool of skilled employees. If we are unable to retain key personnel, or if we are not able to attract, assimilate or retain additional highly qualified employees to meet our needs in the future, our business and operations could be harmed. Changes we make to our business in response to the adoption of 123R may make this more difficult.

Changes in demand caused by fluctuations in interest and currency exchange rates may reduce our international sales.

Sales and operating activities outside of the United States are subject to inherent risks, including fluctuations in the value of the U.S. dollar relative to foreign currencies, tariffs, quotas, taxes and other market barriers, political and economic instability, restrictions on the export or import of technology, potentially limited intellectual property protection, difficulties in staffing and managing international operations and potentially adverse tax consequences. We earn a significant portion of our revenue from international sales, and there can be no assurance that any of these factors will not have an adverse effect on our ability to sell our products or operate outside the United States.

We currently quote and sell the majority of our products in U.S. dollars. From time to time, we may enter into foreign currency contracts in an effort to reduce the overall risk of currency fluctuations to our business. However, there can be no assurance that the offer and sale of products denominated in foreign currencies, and the related foreign currency hedging activities, will not adversely affect our business.

Our principal competitor for disk sputtering equipment is based in Japan and has a cost structure based on the Japanese yen. Accordingly, currency fluctuations could cause the price of our products to be more or less competitive than our principal competitor's products. Currency fluctuations will decrease or increase our cost structure relative to those of our competitors, which could lessen the demand for our products and affect our competitive position.

We may evaluate acquisition candidates and other diversification strategies.

In the past we have engaged in acquisitions as part of our efforts to expand and diversify our business. For example, our business was initially acquired from Varian Associates in 1991. We also acquired our gravity lubrication and rapid thermal processing product lines in two acquisitions. We sold the rapid thermal processing product line in November 2002. We also acquired our RPC electron beam processing business in late 1997, and subsequently closed this business. We intend to continue to evaluate new acquisition candidates, divestiture and diversification strategies. Any acquisition involves numerous risks, including difficulties in the assimilation of the acquired company's employees, operations and products, uncertainties associated with operating in new markets and working with new customers, and the potential loss of the acquired company's key employees. Additionally, unanticipated expenses, difficulties and consequences may be incurred relating to the integration of technologies, research and development, and administrative and other functions. Any future acquisitions may also result in potentially dilutive issuance of equity securities, acquisition- or divestiture-related write-offs or the assumption of debt and contingent liabilities.

We use hazardous materials and are subject to risks of non-compliance with environmental and safety regulations.

We are subject to a variety of governmental regulations relating to the use, storage, discharge, handling, emission, generation, manufacture, treatment and disposal of toxic or otherwise hazardous substances, chemicals, materials or waste. If we fail to comply with current or future regulations, such failure could result in suspension of our operations, alteration of our manufacturing process, or substantial civil penalties or criminal fines against us or our officers, directors or employees. Additionally, these regulations could require us to acquire expensive remediation or abatement equipment or to incur substantial expenses to comply with them. Failure to properly manage the use, disposal or storage of, or adequately restrict the release of, hazardous or toxic substances could subject us to significant liabilities.

Future sales of shares of our common stock by our officers, directors and affiliates could cause our stock price to decline.

Substantially all of our common stock may be sold without restriction in the public markets, although shares held by our directors, executive officers and affiliates may be subject to volume and manner of sale restrictions. In August 2005, at the request of Redemco LLC, we registered the sale of 2,000,000 shares at any time and in any manner Redemco LLC chooses. As of March 20, 2006, Redemco LLC had sold all these

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2,000,000 shares, and Redemco LLC and its affiliates still owned 1,004,000 shares. Redemco LLC and its affiliates can resell these remaining shares at any time without restrictions. Sales of a substantial number of shares of common stock in the public market by our officers, directors or affiliates or the perception that these sales could occur could materially and adversely affect our stock price and make it more difficult for us to sell equity securities in the future at a time and price we deem appropriate.

Anti-takeover provisions in our charter documents and under California law could prevent or delay a change in control, which could negatively impact the value of our common stock by discouraging a favorable merger or acquisition of us.

Our articles of incorporation authorize our board of directors to issue up to 10,000,000 shares of preferred stock and to determine the powers, preferences, privileges, rights, including voting rights, qualifications, limitations and restrictions of those shares, without any further vote or action by the shareholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that we may issue in the future. The issuance of preferred stock could have the effect of delaying, deterring or preventing a change in control and could adversely affect the voting power of your shares. In addition, provisions of California law and our bylaws could make it more difficult for a third party to acquire a majority of our outstanding voting stock by discouraging a hostile bid, or delaying or deterring a merger, acquisition or tender offer in which our shareholders could receive a premium for their shares or a proxy contest for control of our company or other changes in our management.

We could be involved in litigation.

From time to time we may be involved in litigation of various types, including litigation alleging infringement of intellectual property rights and other claims. For example, we recently filed a patent infringement suit against Unaxis. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms.

Business interruptions could adversely affect our operations.

Our operations are vulnerable to interruption by fire, earthquake, or other natural disaster, quarantines or other disruptions associated with infectious diseases, national catastrophe, terrorist activities, war, disruptions in our computing and communications infrastructure due to power loss, telecommunications failure, human error, physical or electronic security breaches and computer viruses, and other events beyond our control. We do not have a fully implemented detailed disaster recovery plan. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites. Political instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur, and any losses or damages incurred by us could have a material adverse effect on our business and results of operations. For example, we self insure earthquake risks because we believe this is the prudent financial decision based on the high cost of limited coverage available in the earthquake insurance market. An earthquake could significantly disrupt our operations, most of which are conducted in California. It could also significantly delay our research and engineering effort on new products, most of which is also conducted in California. We take steps to minimize the damage that would be caused by an earthquake, but there is no certainty that our efforts will prove successful in the event of an earthquake.

Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds*

None.

Item 3. *Defaults upon Senior Securities*

None.

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Item 4. *Submission of Matters to a Vote of Security-Holders*

Our annual meeting of shareholders was held May 15, 2006. The following actions were taken at this meeting:

	<u>Affirmative Votes</u>	<u>Negative Votes</u>	<u>Votes Withheld</u>	<u>Abstentions and Broker Non-Votes</u>
(a) Election of Directors				
Norman H. Pond	19,296,325	471,708	—	1,156,568
Kevin Fairbairn	19,369,674	398,359	—	1,156,568
David S. Dury	18,814,164	953,869	—	1,156,568
Stanley J. Hill	18,887,373	880,660	—	1,156,568
Robert Lemos	18,664,418	1,103,615	—	1,156,568
Arthur L. Money	14,816,266	4,951,767	—	1,156,568
Ping Yang	19,369,224	398,809	—	1,156,568
(b) Proposal to approve an amendment to the 2004 Equity Incentive Plan to increase the number of shares reserved for issuance thereunder by 800,000	14,492,641	1,519,563	—	3,755,829
(c) Proposal to approve an amendment to the 2003 Employee Stock Purchase Plan to increase the number of shares reserved for issuance thereunder by 400,000 shares	15,499,675	512,329	—	3,756,029
(d) Ratification of Grant Thornton LLP as independent public accountants for the fiscal year ending December 31, 2006	19,670,277	95,565	—	2,191

Item 5. *Other Information*

None.

Item 6. *Exhibits*

The following exhibits are filed herewith:

<u>Number</u>	<u>Exhibit Description</u>
31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to U.S.C. 1350 adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

INTEVAC, INC.

By: /s/ KEVIN FAIRBAIRN

Kevin Fairbairn
President, Chief Executive Officer and Director
(Principal Executive Officer)

Date: August 10, 2006

By: /s/ CHARLES B. EDDY III

Charles B. Eddy III
Vice President, Finance and Administration,
Chief Financial Officer, Treasurer and Secretary
(Principal Financial and Accounting Officer)

Date: August 10, 2006

EXHIBIT INDEX

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32.1	Certification Pursuant to U.S.C. 1350 adopted Pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.

I, Kevin Fairbairn certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Intevac, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2006

/s/ KEVIN FAIRBAIRN

Kevin Fairbairn

President, Chief Executive Officer and Director

I, Charles B. Eddy certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Intevac, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 10, 2006

/s/ CHARLES B. EDDY III

Charles B. Eddy III

Vice President, Finance and Administration,
Chief Financial Officer, Treasurer and Secretary

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Kevin Fairbairn, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Intevac, Inc. on Form 10-Q for the quarterly period ended July 1, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Intevac, Inc.

By: /s/ KEVIN FAIRBAIRN
Name: Kevin Fairbairn
Title: President, Chief Executive Officer and Director

I, Charles B. Eddy III, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Intevac, Inc. on Form 10-Q for the quarterly period ended July 1, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Intevac, Inc.

By: /s/ CHARLES B. EDDY III
Name: Charles B. Eddy III
Title: Vice President, Finance and Administration,
Chief Financial Officer, Treasurer and Secretary

A signed original of this written statement required by Section 906 has been provided to Intevac, Inc. and will be retained by Intevac, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.