

INTEVAC INC

FORM 10-Q (Quarterly Report)

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Address	3560 BASSETT STREET SANTA CLARA, CA, 95054
Telephone	4089869888
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Symbol	IVAC
SIC Code	3559 - Special Industry Machinery, Not Elsewhere Classified
Industry	Industrial Machinery & Equipment
Sector	Industrials
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 October 1, 2005

OR

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

For the transition period from _____ to _____

Commission file number 0-26946

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

On November 6, 2005, 20,628,300 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
(In thousands)

	<u>October 1, 2005</u>	<u>December 31, 2004</u>
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,025	\$ 17,455
Short term investments	41,419	24,579
Trade and other accounts receivable, net of allowances of \$0 and \$217 at October 1, 2005 and December 31, 2004	33,029	4,775
Inventories	32,666	15,375
Prepaid expenses and other current assets	<u>1,334</u>	<u>956</u>
Total current assets	112,473	63,140
Property, plant and equipment, net	6,835	5,996
Long term investments	—	8,052
Investment in 601 California Avenue LLC	2,431	2,431
Other long term assets	<u>503</u>	<u>3</u>
Total assets	<u>\$ 122,242</u>	<u>\$ 79,622</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 10,470	\$ 1,647
Accrued payroll and related liabilities	3,125	1,617
Other accrued liabilities	4,632	2,943
Customer advances	<u>25,605</u>	<u>3,833</u>
Total current liabilities	43,832	10,040
Other long-term liabilities	686	207
Shareholders' equity:		
Common stock, no par value	96,954	94,802
Accumulated other comprehensive income	229	253
Accumulated deficit	<u>(19,459)</u>	<u>(25,680)</u>
Total shareholders' equity	<u>77,724</u>	<u>69,375</u>
Total liabilities and shareholders' equity	<u>\$ 122,242</u>	<u>\$ 79,622</u>

See accompanying notes.

INTEVAC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
(In thousands, except per share amounts)
(Unaudited)

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>
Net revenues:				
Systems and components	\$ 41,862	\$ 32,721	\$ 79,001	\$ 52,540
Technology development	1,645	2,308	5,529	6,688
Total net revenues	<u>43,507</u>	<u>35,029</u>	<u>84,530</u>	<u>59,228</u>
Cost of net revenues:				
Systems and components	29,277	26,322	55,098	39,148
Technology development	1,411	1,972	4,203	5,293
Inventory provisions	(735)	325	19	1,078
Total cost of net revenues	<u>29,953</u>	<u>28,619</u>	<u>59,320</u>	<u>45,519</u>
Gross profit	13,554	6,410	25,210	13,709
Operating expenses:				
Research and development	3,897	2,831	10,435	8,972
Selling, general and administrative	3,746	2,316	9,678	6,709
Total operating expenses	<u>7,643</u>	<u>5,147</u>	<u>20,113</u>	<u>15,681</u>
Operating profit (loss)	5,911	1,263	5,097	(1,972)
Interest expense	(20)	(41)	12	(53)
Interest income and other, net	458	264	1,280	816
Income (loss) before income taxes	6,349	1,486	6,389	(1,209)
Provision for income taxes	158	115	168	103
Net income (loss)	<u>\$ 6,191</u>	<u>\$ 1,371</u>	<u>6,221</u>	<u>\$ (1,312)</u>
Other comprehensive income:				
Foreign currency translation adjustments	13	10	(24)	4
Total comprehensive income (loss)	<u>\$ 6,204</u>	<u>\$ 1,381</u>	<u>\$ 6,197</u>	<u>\$ (1,308)</u>
Basic income (loss) per share:				
Net income (loss)	\$ 0.30	\$ 0.07	\$ 0.30	\$ (0.07)
Shares used in per share amounts	20,567	20,104	20,400	19,617
Diluted income (loss) per share:				
Net income (loss)	\$ 0.29	\$ 0.07	\$ 0.29	\$ (0.07)
Shares used in per share amounts	21,438	20,387	21,138	19,617

See accompanying notes.

INTEVAC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	<u>Nine months ended</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>
Operating activities		
Net income (loss)	\$ 6,221	\$ (1,312)
Adjustments to reconcile net income (loss) to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	1,537	1,691
Inventory provisions	19	1,078
Compensation expense in the form of common stock	19	—
Loss on disposal of equipment	6	1
Changes in operating assets and liabilities	<u>(12,174)</u>	<u>(13,120)</u>
Total adjustments	<u>(10,593)</u>	<u>(10,350)</u>
Net cash and cash equivalents used in operating activities	(4,372)	(11,662)
Investing activities		
Purchases of investments	(44,658)	(37,922)
Proceeds from sales of investments	35,900	6,000
Purchases of leasehold improvements and equipment	<u>(2,414)</u>	<u>(1,371)</u>
Net cash and cash equivalents used in investing activities	(11,172)	(33,293)
Financing activities		
Proceeds from issuance of common stock	2,133	42,582
Payoff of convertible notes due 2004	<u>—</u>	<u>(1,025)</u>
Net cash and cash equivalents provided by financing activities	<u>2,133</u>	<u>41,557</u>
Effect of exchange rate changes on cash	<u>(19)</u>	<u>3</u>
Net decrease in cash and cash equivalents	(13,430)	(3,395)
Cash and cash equivalents at beginning of period	<u>17,455</u>	<u>19,507</u>
Cash and cash equivalents at end of period	<u>\$ 4,025</u>	<u>\$ 16,112</u>
Supplemental Schedule of Cash Flow Information		
Cash paid for:		
Interest	\$ —	\$ 33
Income taxes	\$ 2	\$ 2
Other non-cash changes:		
Inventories transferred to property, plant and equipment	\$ —	\$ 706

See accompanying notes.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Business Activities and Basis of Presentation

We are the world's leading supplier of sputtering equipment used to manufacture magnetic media used in hard disk drives and a developer and provider of advanced 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 that deposits, or sputters, highly engineered thin-films onto magnetic disks 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 thin-film disks are created in a sophisticated manufacturing process involving many steps, including plating, annealing, polishing, texturing, sputtering and lubrication.

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. We currently develop night-vision technology and equipment for military and commercial applications.

The financial information at October 1, 2005 and for the three- and nine-month periods ended October 1, 2005 and September 25, 2004 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, 2004.

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 nine-month periods ended October 1, 2005 are not considered indicative of the results to be expected for any future period or for the entire year.

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.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

3. 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>October 1, 2005</u>	<u>December 31, 2004</u>
	(In thousands)	
Raw materials	\$ 14,590	\$ 5,624
Work-in-progress	10,099	3,496
Finished goods	<u>7,977</u>	<u>6,255</u>
	<u>\$ 32,666</u>	<u>\$ 15,375</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 \$10.1 million and \$9.9 million at October 1, 2005 and December 31, 2004, 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.

During the nine months ended October 1, 2005, \$19,000 was added to inventory reserves based on the quarterly analysis and \$91,000 of inventory was disposed of and charged to the reserve. The \$19,000 of additions was net of the reversal of a \$288,000 lower of cost or market reserve that existed at December 31, 2004. This reserve was reversed when the system was recognized for revenue in the three months ended October 1, 2005. We also added \$133,000 to inventory reserves to provide for the loss or refurbishment of Imaging products consigned to our customers for demonstrations. During the nine months ended September 25, 2004, \$1.1 million was added to inventory reserves based on the quarterly analysis and \$449,000 of inventory was disposed of and charged to the reserve. A system in inventory with a value of \$706,000, net of a \$250,000 reserve, was transferred to fixed assets and capitalized.

4. Employee Stock Plans

At October 1, 2005, we had two stock-based employee compensation plans. We account for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. We plan to adopt the fair value requirements of SFAS No. 123R beginning in 2006.

The following table illustrates the effects on net income (loss) and earnings (loss) per share if Intevac had applied the fair value-recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation", to stock-based employee compensation.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
Net income (loss), as reported	\$ 6,191	\$ 1,371	\$ 6,221	\$ (1,312)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(518)	(47)	(1,627)	(657)
Pro forma net income (loss)	<u>\$ 5,673</u>	<u>\$ 1,324</u>	<u>\$ 4,594</u>	<u>\$ (1,969)</u>
Basic income (loss) per share:				
As reported	\$ 0.30	\$ 0.07	\$ 0.30	\$ (0.07)
Pro forma	\$ 0.28	\$ 0.06	\$ 0.23	\$ (0.10)
Diluted income (loss) per share:				
As reported	\$ 0.29	\$ 0.07	\$ 0.29	\$ (0.07)
Pro forma	\$ 0.26	\$ 0.06	\$ 0.22	\$ (0.10)

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted-average assumptions for grants made in the three- and nine-month periods ended October 1, 2005 and September 25, 2004:

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
Dividend yield	None	None	None	None
Expected volatility	90.20%	95.23%	92.50%	94.68%
Risk free interest rate	4.26%	2.67%	4.32%	2.50%
Expected lives	5.66 years	3.02 years	6.54 years	2.70 years

The weighted-average fair value of stock options granted was \$8.67 and \$6.79 for the three and nine months ended October 1, 2005, respectively, and \$2.59 and \$4.46 for the three and nine months ended September 25, 2004, respectively.

The pro forma net income (loss) and net income (loss) per share data listed above includes expense related to the Employee Stock Purchase Plan ("ESPP"). The fair value of purchase rights granted under the ESPP is estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
Dividend yield	None	None	None	None
Expected volatility	90.20%	95.23%	91.53%	95.23%
Risk free interest rate	3.97%	2.42%	3.90%	2.37%
Expected lives	1.00 year	1.99 years	1.23 years	1.92 years

The weighted-average fair value of purchase rights granted was \$6.00 and \$5.14 for the three and nine months ended October 1, 2005, respectively, and \$2.78 and \$2.95 for the three and nine months ended September 25, 2004, respectively.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

5. Warranty

Our typical warranty is 12 months from customer acceptance. We also sell extended warranties beyond 12 months to our customers. During this warranty period any necessary non-consumable parts are supplied and installed. The warranty period on consumable parts is limited to their reasonable usable life. A provision for the estimated warranty cost is recorded at the time revenue is recognized.

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 nine-month periods ending October 1, 2005 and September 25, 2004:

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
Beginning balance	\$ 1,677	\$ 654	\$ 1,116	\$ 534
Expenditures incurred under warranties	(137)	(277)	(846)	(386)
Accruals for product warranties issued during the reporting period	1,352	1,321	2,346	1,815
Adjustments to previously existing warranty accruals	(64)	(120)	212	(385)
Ending balance	<u>\$ 2,828</u>	<u>\$ 1,578</u>	<u>\$ 2,828</u>	<u>\$ 1,578</u>

The following table displays the balance sheet classification of the warranty provision account at October 1, 2005 and at December 31, 2004:

	October 1, 2005	December 31, 2004
		(In thousands)
Other accrued liabilities	\$ 2,142	\$ 909
Other long-term liabilities	<u>686</u>	<u>207</u>
Total warranty provision	<u>\$ 2,828</u>	<u>\$ 1,116</u>

6. Guarantees

We have entered into agreements with customers and suppliers that include limited intellectual property indemnification obligations that are customary in the industry. These obligations 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.

7. Cash, Cash Equivalents and Investments

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

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

equivalents. Investments in debt securities and municipal bonds consists principally of highly rated debt instruments with maturities generally between one and 25 months.

We account for our investments in debt securities and municipal bonds 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, with the associated premium or discount amortized to interest income. Realized gains and losses are included in earnings. The table below presents the amortized principal amount, major security type and maturities for our investments in debt securities and municipal bonds.

	<u>October 1, 2005</u>	<u>December 31, 2004</u>
	(in thousands)	
Amortized Principal Amount:		
Debt securities issued by US government agencies	\$ 18,411	\$ 28,017
Municipal bonds	15,000	—
Corporate debt securities	8,008	4,614
Total investments	<u>\$ 41,419</u>	<u>\$ 32,631</u>
Short-term investments	\$ 41,419	\$ 24,579
Long-term investments	—	8,052
Total investments	<u>\$ 41,419</u>	<u>\$ 32,631</u>
Approximate fair market value of investments	<u>\$ 41,308</u>	<u>\$ 32,450</u>

Cash and cash equivalents represent cash accounts and money market funds. Included in accounts payable is \$3,443,000 and \$188,000 of book overdraft at October 1, 2005 and December 31, 2004, respectively.

8. Net Income (Loss) Per Share

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>
	(in thousands)			
Numerator:				
Numerator for basic income (loss) per share – income (loss) available to common stockholders	\$ 6,191	\$ 1,371	\$ 6,221	\$ (1,312)
Effect of dilutive securities:				
6 1/2% convertible notes (1)	—	—	—	—
Numerator for diluted income (loss) per share – income (loss) available to common stockholders after assumed conversions	<u>\$ 6,191</u>	<u>\$ 1,371</u>	<u>\$ 6,221</u>	<u>\$ (1,312)</u>

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
Denominator:				
Denominator for basic income (loss) per share – weighted-average shares	20,567	20,104	20,400	19,617
Effect of dilutive securities:				
Employee stock options (2)	871	283	738	—
6 1/2% convertible notes (1)	—	—	—	—
Dilutive potential common shares	<u>871</u>	<u>283</u>	<u>738</u>	<u>—</u>
Denominator for diluted income (loss) per share – adjusted	<u>21,438</u>	<u>20,387</u>	<u>21,138</u>	<u>19,617</u>

- (1) Diluted EPS for the nine-month period ended September 25, 2004 exclude “as converted” treatment of the convertible notes, as their inclusion would be anti-dilutive. The number of “as converted” shares excluded for the nine-month period ended September 25, 2004 was 11,424.
- (2) Potentially dilutive securities, consisting of shares issuable upon exercise of employee stock options, 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 October 1, 2005 and September 25, 2004 was 137,198 and 822,980, respectively, and the number of employee stock options excluded for the nine-month periods ended October 1, 2005 and September 25, 2004 was 233,414 and 1,558,484, respectively.

9. 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, “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 financial statements.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs—an amendment of ARB No. 43”, which is the result of its efforts to converge U.S. accounting standards for inventories with International Accounting Standards. SFAS No. 151 requires idle facility expenses, freight, handling costs, and wasted material (spoilage) costs to be recognized as current-period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not expect the adoption of this statement to have a material impact on our financial statements.

In December 2004, FASB issued SFAS No. 123 (Revised 2004), “Share-Based Payment”. SFAS 123R addresses all forms of share-based payment (“SBP”) awards, including shares issued under certain employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS 123R will require us to expense SBP awards with compensation cost for SBP transactions measured at fair value. Although we are in the process of evaluating the impact of applying the various provisions of SFAS 123R, we expect that this statement will have a material impact on our financial statements. On April 14, 2005, the U.S. Securities and Exchange Commission

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

announced a deferral of the effective date of SFAS 123R until the first interim period beginning after December 15, 2005.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Non-monetary Assets, an amendment of APB No. 29” which requires non-monetary exchanges to be recorded at the fair value of the assets exchanged, with certain exceptions. This standard requires most exchanges of productive assets to be accounted for at fair value, rather than at carryover basis. The provisions of SFAS No. 153 are effective for fiscal years beginning after June 15, 2005. We do not expect the adoption of this statement to have a material impact on our financial statements.

In March 2005, the SEC issued Staff Accounting Bulletin (“SAB”) No. 107. SAB 107 provides guidance related to share-based payment transactions with non-employees, the transition from nonpublic to public entities status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of SFAS 123R in an interim period, capitalization of compensation costs related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS 123R, the modification of employee share options prior to the adoption of SFAS 123R and disclosures in Management’s Discussion and Analysis subsequent to adoption of SFAS 123R. We are currently in the process of assessing the impact of this guidance.

In March 2005, the FASB issued Interpretation No. 47 (“FIN 47”), “Accounting for Conditional Asset Retirement Obligations – An Interpretation of FASB Statement No. 143”, to clarify the requirement to record liabilities stemming from a legal obligation to clean up and retire fixed assets, such as a plant or factory, when an asset retirement depends on a future event. We plan to adopt the FIN 47 in the first quarter of fiscal 2006. We do not expect the application of FIN 47 to have a material effect on our financial statements.

In May 2005, FASB issued SFAS No. 154, “Accounting Changes and Error Corrections.” This new standard replaces APB Opinion No. 20, “Accounting Changes” and FASB Statement No. 3, “Reporting Accounting Changes in Interim Financial Statements.” SFAS 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impractical to do so. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a “restatement.” SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not expect the adoption of this statement to have a material impact on our financial statements.

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 (which are fully offset by a valuation allowance) and other assets.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>
	(in thousands)			
Equipment	\$ 41,519	\$ 32,636	\$ 78,392	\$ 52,192
Imaging	1,988	2,393	6,138	7,036
Total	<u>\$ 43,507</u>	<u>\$ 35,029</u>	<u>\$ 84,530</u>	<u>\$ 59,228</u>

Business Segment Profit & Loss

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>
	(in thousands)			
Equipment	\$ 7,177	1,803	\$ 9,178	\$ 1,123
Imaging	(1,415)	(905)	(3,874)	(2,736)
Corporate activities	149	365	(207)	(359)
Operating income (loss)	5,911	1,263	5,097	(1,972)
Interest expense	(20)	(41)	12	(53)
Interest income	312	173	863	405
Other income and expense, net	146	91	417	411
Income (loss) before income taxes	<u>\$ 6,349</u>	<u>\$ 1,486</u>	<u>\$ 6,389</u>	<u>\$ (1,209)</u>

Business Segment Assets

	<u>October 1, 2005</u>	<u>December 31, 2004</u>
	(in thousands)	
Equipment	\$ 65,500	\$ 19,407
Imaging	7,187	7,135
Corporate activities	49,555	53,080
Total	<u>\$122,242</u>	<u>\$ 79,622</u>

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Geographic Area Net Trade Revenues

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2005	Sept. 25, 2004	Oct. 1, 2005	Sept. 25, 2004
	(in thousands)			
United States	\$ 6,315	\$ 6,086	\$ 15,898	\$ 19,912
Far East	36,971	28,678	67,938	38,771
Europe	221	265	694	545
Total	<u>\$ 43,507</u>	<u>\$ 35,029</u>	<u>\$ 84,530</u>	<u>\$ 59,228</u>

11. Income Taxes

For the three- and nine-month periods ended October 1, 2005, we accrued income tax using an effective tax rate of 2.5% of pretax income. This rate is based on the estimated annual tax rate complying with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes". We also paid the minimum Franchise Tax to the State of California. We recorded \$7,000 of income tax expense during the nine months ended October 1, 2005 related to a claim we received from the California Franchise Tax Board for a portion of income tax credits we claimed in prior years. Our \$17.8 million deferred tax asset is fully offset by a \$17.8 million valuation allowance, resulting in a net deferred tax asset of zero at October 1, 2005.

We did not accrue a tax provision for the three-month period ended September 25, 2004 as the profits for this period were offset by net operating loss carry-forwards. We did not accrue a tax benefit for the nine-month period ended September 25, 2004 due to the inability to realize additional refunds from loss carry-backs. We recorded \$115,000 of income tax expense during the three-month period ended September 25, 2004 related to a claim we received from the California Franchise Tax Board for a portion of income tax credits we claimed in prior years. During the nine-month period ended September 25, 2004, we also recorded a credit to income tax expense related to a revised estimate of 2003 taxes owed by our Singapore subsidiary.

12. Capital Transactions

During the nine-month period ending October 1, 2005, we sold stock to our employees under Intevac's Stock Option and Employee Stock Purchase Plans. A total of 439,381 shares were issued under these plans, for which Intevac received \$2.1 million.

13. Financial Presentation

Certain prior year amounts in the Condensed Consolidated Financial Statements have been reclassified to conform to 2005 presentation.

14. Subsequent Event

On October 27, 2005, the Board of Directors of Intevac, Inc. ("Intevac") approved accelerating the vesting of approximately 306,000 "out-of-the-money" unvested common stock options previously awarded to employees and officers under Intevac's stock option plans. The exercise prices of the accelerated common stock options range from \$9.31 per share to \$15.50 per share and have a weighted average exercise price of \$11.131 per share. The closing price of Intevac's common stock on October 27, 2005 was \$9.06 per share. As a condition to the acceleration of vesting, the holders of the accelerated common stock options are required to refrain from selling any shares acquired upon exercise before the date on which the shares to be sold would otherwise have vested, had the vesting of common stock options not been accelerated. This restriction continues to apply regardless of any termination of the optionees' employment.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The purpose of the acceleration of these common stock options is to eliminate future stock compensation expense that Intevac would otherwise have been required to recognize in its statement of operations with respect to these common stock options after the adoption of Statement of Financial Accounting Standard No. 123R “Share-Based Payment,” in January 2006. SFAS 123R will be effective for Intevac beginning in the first quarter of 2006, and will require that compensation expense associated with stock options be recognized in the statement of operations, rather than as footnote disclosure in its consolidated financial statements. The maximum reduction in future stock compensation expense is estimated to be approximately \$1.5 million, which would have otherwise been recognized beginning in January 2006 through the fourth quarter of 2009. The effect on fiscal 2006 is a reduction in compensation expense of approximately \$798,000. The \$1.5 million of compensation expense was estimated using the Black-Scholes option-pricing model, which is used by Intevac to calculate the fair value of its options in determining the pro forma impact of Statement of Financial Accounting Standards No. 123 “Accounting for Stock-Based Compensation,” for disclosure purposes only.

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 projected shipments, revenue, system revenue recognition, gross margin, operating expenses, interest income, cash balances and improved financial results in 2005; our projected customer requirements for new capacity and technology upgrades for our installed base of thin-film disk manufacturing 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 "Certain Factors Which May Affect Future Operating Results" 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 2005, 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 are 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. These uncertainties are discussed in the section entitled "Certain Factors Which May Affect Future Operating Results." 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, valuation of deferred tax assets 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 would be 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, 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

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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, during the three months ended October 1, 2005 ten 200 Leans were shipped. The fair market value of seven of the 200 Leans was recognized for revenue upon shipment. Installation and acceptance was completed during the quarter on three of these seven 200 Lean systems. Accordingly, the fair market value of installation and acceptance services for these three systems was recognized for revenue. The other three 200 Leans were shipped to customers where we have not yet met defined acceptance levels, and revenue recognition has been deferred until customer acceptance.

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 is typically 12 months from customer acceptance. We also sell extended warranties beyond 12 months to some customers. 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.

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Results of Operations

Three Months Ended October 1, 2005 and September 25, 2004.

Net revenues

	Three months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Equipment net revenues	\$ 41,519	\$ 32,636	\$ 8,883	27%
Imaging net revenues	1,988	2,393	(405)	(17)%
Total net revenues	<u>\$ 43,507</u>	<u>\$ 35,029</u>	<u>\$ 8,478</u>	24%

Net revenues consist primarily of sales of equipment used to manufacture thin-film disks, equipment used to manufacture flat panel displays, 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 October 1, 2005 was primarily the result of a higher average selling price for the seven 200 Lean systems and two MDP-250B systems recognized for revenue in the current quarter and revenue recognition of nine disk lubrication systems and one flat panel manufacturing system. The three months ended September 25, 2004 included customer acceptance of eight 200 Lean systems and the sale of one MDP-250B system. Revenue from disk equipment technology upgrades and spare parts decreased in the three months ending October 1, 2005. As of October 1, 2005, we have orders for eleven 200 Lean systems and four MDP-250B systems. We expect to ship and recognize revenue for twelve to thirteen of these systems in the fourth quarter of 2005.

Imaging revenues decreased to \$2.0 million for the three months ended October 1, 2005 from \$2.4 million for the three months ended September 25, 2004. The decrease in Imaging revenues was the result of decreased revenues from contract research and development. We expect fourth quarter Imaging revenues will be equal to or greater than the third quarter of 2005.

Our backlog of orders at October 1, 2005 was \$65.4 million, unchanged from July 2, 2005 and a significant increase over the backlog at September 25, 2004 of \$16.3 million. The increase in backlog was primarily the result of orders for disk manufacturing systems. We include in backlog the value of purchase orders for our products that have been shipped but not accepted or 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.

International sales increased by 29% to \$37.2 million for the three months ended October 1, 2005 from \$28.9 million for the three months ended September 25, 2004. The increase in international sales was due to higher shipments of disk manufacturing systems. International sales constituted 86% of net revenues for the three months ended October 1, 2005 and 83% of net revenues for the three months ended September 25, 2004. International revenues include products shipped to overseas operations of US companies.

Gross margin

	Three months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Equipment gross margin	32.0%	19.1%	12.9 pts	68%
Imaging gross margin	13.8%	7.7%	6.1 pts	79%
Total gross margin	31.2%	18.3%	12.9 pts	70%

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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.

Equipment margin for the three months ended October 1, 2005 improved significantly due primarily to lower manufacturing costs and a higher average selling price for 200 Lean systems. The flat panel manufacturing system recognized for revenue in the three months ended October 1, 2005 was originally shipped in 2003 and contributed minimal gross profit. Equipment margin for the three months ended September 25, 2004 was adversely impacted by higher than anticipated costs incurred during the rapid production, installation and startup of the initial production run of 200 Lean systems, by costs for scrap, rework and inventory obsolescence, related primarily to design changes on our 200 Lean disk manufacturing system, and by favorable pricing offered to our first 200 Lean customer. Gross margins in the Equipment business vary depending on a number of factors, including product cost, system configuration and pricing, factory utilization, and inventory provisions. We expect the gross margin for the Equipment business to improve in the fourth quarter of 2005 and in 2006.

Imaging margin improved in the three months ended October 1, 2005 due primarily to increased product revenue, which carries a higher gross margin than funded research and development, and to improved absorption of factory overhead. We expect margins in the Imaging business to decline in the fourth quarter of 2005 and then show slow improvement in 2006. The anticipated low margin is the result of cost-shared development programs.

Research and development

	<u>Three months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Research and development expense	\$ 3,897	\$ 2,831	\$ 1,066	38%
% of net revenues	9.0%	8.1%		

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 manufacturing equipment and imaging products. The increase in research and development expense in the three months ended October 1, 2005 was the result of increased spending on both Equipment and Imaging projects and projected provisions for employee profit sharing and bonus plans. We expect research and development expense in the fourth quarter of 2005 and in 2006 to be higher than the current period due to increased spending on both Equipment and Imaging projects and provisions for employee profit sharing and bonus plans.

Research and development expenses do not include costs of \$1.4 million and \$2.0 million, respectively, for the three-month periods ended October 1, 2005 and September 25, 2004 related to Imaging contract research and development. These expenses are included in cost of net revenues.

Selling, general and administrative

	<u>Three months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Selling, general and administrative expense	\$ 3,746	\$ 2,316	\$ 1,430	62%
% of net revenues	8.6%	6.6%		

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. Domestic sales and international sales of disk manufacturing products in the Far East, with the exception of Japan, are typically made by Intevac's direct sales force, whereas sales in Japan of disk manufacturing products and other products are typically made by our Japanese distributor, Matsubo,

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who provides services such as sales, installation, warranty and customer support. We also have a subsidiary in Singapore to support customers in Southeast Asia. We plan to open field offices in China during the fourth quarter of 2005 and in Thailand during the first quarter of 2006.

The increase in selling, general and administrative expense was primarily the result of increases in costs related to customer service and support in the Equipment business and projected provisions for employee profit sharing and bonus plans. We expect selling, general and administrative expense in the fourth quarter of 2005 and in 2006 to be higher than the current period due to increases in costs related to customer service and support in the Equipment business and provisions for employee profit sharing and bonus plans.

Interest expense

	Three months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Interest expense	\$ (20)	\$ (41)	\$ 21	51%

Interest expense in both the three-month periods ended October 1, 2005 and September 25, 2004 related to a claim from the State of California for a portion of income tax credits we claimed in prior years. We had been recording a quarterly estimate of the interest expense related to the claim until the current quarter when the final bill was received from the State and the actual interest was recorded.

Interest income and other, net

	Three months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Interest income and other, net	\$ 458	\$ 264	\$ 194	73%

Interest income and other, net in both 2005 and 2004 consisted primarily of interest and dividend income on investments and foreign currency gains and losses. The increase in the three months ended October 1, 2005 was driven by higher interest rates on our investments and a foreign currency gain.

Provision for income taxes

	Three months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Provision for income taxes	\$ 158	\$ 115	\$ 43	37%

For the three-month period ended October 1, 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. We did not accrue a tax provision for the three-month period ended September 25, 2004, as the profits for this period were offset by net operating loss carry-forwards. We did record, however, \$115,000 of income tax expense during the three-month period ended September 25, 2004 related to a claim we received from the California Franchise Tax Board for a portion of income tax credits we claimed in prior years. Our \$17.8 million deferred tax asset is fully offset by a \$17.8 million valuation allowance, resulting in a net deferred tax asset of zero at October 1, 2005.

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Nine Months Ended October 1, 2005 and September 25, 2004.

Net revenues

	Nine months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Equipment net revenues	\$ 78,392	\$ 52,192	\$ 26,200	50%
Imaging net revenues	6,138	7,036	(898)	(13)%
Total net revenues	<u>\$ 84,530</u>	<u>\$ 59,228</u>	<u>\$ 25,302</u>	43%

The increase in Equipment revenue was the result of higher sales of disk sputtering systems, the sale of a flat panel manufacturing system and the sale of a flat panel equipment technology license. The decrease in Imaging revenues was the result of a reduction in revenues from contract research and development, partially offset by increased revenues from product shipments.

International sales increased by 75% to \$68.6 million for the nine months ended October 1, 2005 from \$39.3 million for the nine months ended September 25, 2004. The increase in international sales was due to increased shipments of disk sputtering systems and the sale of one flat panel manufacturing system. International sales constituted 81% of net revenues for the nine months ended October 1, 2005 and 66% of net revenues for the nine months ended September 25, 2004.

Gross margin

	Nine months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Equipment gross margin	31.2%	24.7%	6.5 pts	26%
Imaging gross margin	12.7%	10.9%	1.8 pts	17%
Total gross margin	29.8%	23.1%	6.7 pts	29%

Equipment gross margin for the nine months ended October 1, 2005 was favorably impacted by lower manufacturing costs and a higher average selling price for 200 Lean systems.

The increase in Imaging margin was due primarily to improved overhead absorption in the nine months ended October 1, 2005.

Research and development

	Nine months ended		Change over prior period	
	Oct. 1, 2005	Sept. 25, 2004	Amount	%
Research and development expense	\$ 10,435	\$ 8,972	\$ 1,463	16%
% of net revenues	12.3%	15.1%		

The increase in research and development expense in the nine months October 1, 2005 was primarily the result of a \$1.2 million increase in spending on Imaging projects related to the development of sensors and cameras for night-vision systems and near infrared commercial applications.

Research and development expenses do not include costs of \$4.2 million or \$5.3 million, respectively, for the nine-month periods ended October 1, 2005 and September 25, 2004 related to Imaging contract research and development. These expenses are included in cost of net revenues.

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Selling, general and administrative

	<u>Nine months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Selling, general and administrative expense	\$ 9,678	\$ 6,709	\$ 2,969	44%
% of net revenues	11.4%	11.3%		

The increase in selling, general and administrative expense for the nine months ending October 1, 2005 was primarily the result of increased costs related to customer service and support in the Equipment business, additional headcount and related expenses in marketing and business development for the Equipment Business, and increased costs related to the 2004 audit of our internal controls.

Interest expense

	<u>Nine months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Interest expense	\$ 12	\$ (53)	\$ 65	n/a

Interest expense in the nine months ended October 1, 2005, included \$26,000 related to a claim from the State of California for a portion of income tax credits we claimed in prior years and a \$38,000 refund of interest we had paid in 2002 and 2004 related to a sales and use tax audit by the State of California Board of Equalization ("BOE"). We executed a settlement agreement with the BOE for a reduction in the amount of tax and interest we owed compared to what we had previously paid in response to the audit. Interest expense in the nine months ended September 25, 2004 included interest payable on our convertible notes that were paid off in March 2004 and interest expense related to a claim from the State of California for a portion of income tax credits we claimed in prior years.

Interest income and other, net

	<u>Nine months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Interest income and other, net	\$ 1,280	\$ 816	\$ 464	57%

Interest income and other, net in both 2005 and 2004 consisted primarily of interest and dividend income on investments. The increase in the nine months ended October 1, 2005 was driven by higher interest rates on our investments and a higher average invested balance.

Provision for income taxes

	<u>Nine months ended</u>		<u>Change over prior period</u>	
	<u>Oct. 1, 2005</u>	<u>Sept. 25, 2004</u>	<u>Amount</u>	<u>%</u>
Provision for income taxes	\$ 168	\$ 103	\$ 65	63%

Income tax expense for the nine months ending October 1, 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. We did not accrue a tax benefit for the nine-month period ended September 25, 2004 due to the inability to realize additional refunds from loss carry-backs. The \$103,000 tax provision in 2004 consists of a \$12,000 credit related to a revised estimate of 2003 taxes owed by our Singapore subsidiary and a \$115,000 accrual related to a claim we received from the California Franchise Tax Board.

Liquidity and Capital Resources

Our operating activities used cash of \$4.4 million during the nine months ended October 1, 2005. The cash used was due primarily to increases in accounts receivable of \$28.3 million and in inventory of \$17.3 million, partially offset by our net profit and increases in customer advances of \$21.8 million and in accounts payable of \$8.8 million. In the nine months ended September 25, 2004, our operating activities used cash of \$11.7 million due primarily to the net loss incurred, increases in inventory and reductions in accounts payable and customer advances, partially offset by decreases in accounts receivable and increases in other accrued liabilities.

Our investing activities used cash of \$11.2 million in the nine months ended October 1, 2005 due primarily to the net purchase of investments. Investing activities in the nine months ended September 25, 2004 used cash of \$33.3 million due primarily to the net purchase of investments.

Our financing activities provided cash of \$2.1 million in the nine months ended October 1, 2005 as a result of the sale of our common stock to our employees through our employee benefit plans. In the nine months ended September 25, 2004, our financing activities provided cash of \$41.6 million due primarily to a public offering of our common stock, for which we received \$41.6 million. We also sold our common stock to our employees through our employee benefit plans. We retired the remaining \$1.0 million of our convertible notes during the nine months ended September 25, 2004.

At October 1, 2005, we had \$4.0 million of cash and cash equivalents and \$41.4 million of short-term investments. We expect our combined cash and investment balances to increase in the fourth quarter of 2005. We intend to undertake approximately \$7 to \$9 million in capital expenditures over the next twelve months.

We have incurred operating losses each year since 1998 and cannot predict with certainty when we will return to operating profitability on an ongoing annual basis. However, based upon our current outlook we expect to be profitable on a consolidated basis in fiscal 2005.

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 October 1, 2005 are shown in the table below.

	<u>Total</u>	<u>< 1 Year</u>	<u>Payments due by period</u> <u>1-3 Years</u> <u>(in thousands)</u>	<u>3-5 Years</u>	<u>> 5 Years</u>
Operating lease obligations	\$ 13,986	\$ 3,522	\$ 4,119	\$ 3,403	\$ 2,942
Purchase obligations	15,918	15,918	—	—	—
Total	<u>\$ 29,904</u>	<u>\$ 19,440</u>	<u>\$ 4,119</u>	<u>\$ 3,403</u>	<u>\$ 2,942</u>

Certain Factors Which May Affect Future Operating Results

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

Over the last 11 quarters, our revenues per quarter have fluctuated between \$43.5 million and \$4.6 million. Over the same period our operating income as a percentage of revenues has fluctuated between approximately 14% and (90%) 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:

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- delays or problems in the introduction and acceptance of our new products, or delivery of existing products;
- changes in the demand, due to seasonality and other factors, for the computer systems, storage subsystems and consumer electronics containing disks our customers produce with our systems; and
- 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. For example, quarterly revenues in our Equipment business fluctuated between \$8.3 million and \$41.5 million in the last four quarters. 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 magnetic media sputtering systems to a limited number of customers. In 2004, Seagate accounted for \$43.4 million, or 62% of our revenue; and Matsubo accounted for \$7.5 million, or 11% of our revenue. 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 potential 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 2004 revenues ranged between \$6.4 million in the first quarter and \$35.0 million in the third quarter. These factors could have a material adverse effect on our business, financial condition and results of operations.

The majority of our future revenue 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, our ability to manufacture our systems cost-effectively and the performance of our systems in the field. Our new product decisions and development commitments must anticipate continuously evolving industry requirements significantly in advance of sales.

For example, the majority of our revenues in the nine months ended October 1, 2005 were from sale of our 200 Lean magnetic media sputtering system, which was first delivered in December 2003. 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. 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 are in the concept and feasibility stage for this new product. We have not

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yet completed a fully working prototype, and do not expect to generate any revenue from this product in the next twelve months. We spent \$975,000, or 8.4% of our research development costs related to the development of this new product in 2004 and expect to significantly increase our level of spending on this project in 2005. Failure to correctly assess the size of the market, or 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.

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 is 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 cannot assure you that we will 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 collect significant revenues in 2005 from deployment of LIVAR or our other Imaging products. Failure of any of these 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. In addition, our disk manufacturing customers are generally more sensitive to the cyclical nature of the hard disk drive industry, because many of their customers have internal magnetic disk manufacturing operations and will cut back their purchases of disks from outside suppliers first in an industry downturn. If we fail to anticipate or respond quickly to the industry business cycle, it could have a material adverse effect on our business.

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, three of our customers announced plans for major capacity expansions, and we shipped our first next generation 200 Lean system. Since then, sales of our 200 Lean have increased.

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

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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.

Sales of our new 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 have a material adverse effect on our operating results.

We have a recent history of significant losses and may not regain annual profitability on a sustained basis. If we do not establish sustained profitable operations in the future, then our share price is likely to decline.

The majority of our revenues and gross profit have historically been derived from sales of disk sputtering equipment. Sales of our disk sputtering equipment were severely depressed from the middle of 1998 until mid-2003. Also, our Imaging business has yet to earn an annual profit. We have experienced an operating loss in each of the last five fiscal years. Our operating loss in 2004 was \$5.2 million, and as of December 31, 2004, we had an accumulated deficit of \$25.7 million. To regain and sustain annual profitability, we will need to increase gross margins and generate and sustain substantially higher revenue while maintaining reasonable cost and expense levels. Based on our current outlook, we expect to be profitable on a consolidated basis in fiscal 2005. But we cannot predict with certainty when we will return to operating profitability on a sustained annual basis. If we fail to attain sustained profitability within the time frame expected by securities analysts or investors, then the market price of our common stock will likely decline.

Recently enacted and proposed changes in securities laws and regulations will increase our costs.

The Sarbanes-Oxley Act of 2002 has required changes in some of our corporate governance, securities disclosure and/or compliance practices. As part of the Act's requirements, the Securities and Exchange Commission has promulgated new rules on a variety of subjects, in addition to other rule proposals, and the NASDAQ Stock Market has enacted new corporate governance listing requirements. These developments have and will continue to increase our accounting and legal compliance costs, and could also expose us to additional liability.

Costs of compliance were significantly larger in 2004 than originally anticipated, and costs of compliance in future periods may continue to be unpredictable, which could have an adverse effect on our financial results. In addition, we were unable to complete the efforts required in order to comply with Section 404 in a timely manner in 2004, which impacted our ability to make a timely filing of our Report on Form 10-K. There can be no guarantee that we will not face similar issues in future filings.

In addition, such developments may make retention and recruitment of qualified persons to serve on our board of directors or executive management more difficult. We continue to evaluate and monitor regulatory and legislative developments and cannot reliably estimate the timing or magnitude of all costs we may incur as a result of the Act or other related legislation or regulation.

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 highly 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. Any of these factors could have a material adverse effect on our business.

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.

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. Up to 1998, we also experienced competition from Ulvac Technologies, Inc. In the market for our Imaging products, we experience competition from companies such as ITT Industries, Inc. and Northrop Grumman Corporation, the primary 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. Accordingly, 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.

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. In 2002, 2003 and 2004, 18%, 26% and 12%, respectively of our consolidated revenues were derived from government contracts. 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

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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. The loss of one or more government contracts by us or our customers could have a material adverse effect on our operating results.

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 and have a material adverse effect on our operating results.

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 (“ITAR”). We can give no assurance that we will be successful in obtaining all the licenses necessary to export our products. Export to countries which are not considered by the United States Government to be allies is also likely to be prohibited. This limits the potential market for our products. 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 past 12 months, the closing price of our common stock, as traded on The Nasdaq National Market, fluctuated from a low of \$5.01 to a high of \$14.94 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;
- variations in our operating results and whether we achieve our key business targets;
- sales or purchases of large blocks of our stock;

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- 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;
- 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.

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

International sales accounted for 68% of total revenues in 2004 and 81% of our revenues during the nine months ended October 1, 2005. We currently have a customer support office in Singapore and are in the process of opening customer support offices in China and Japan. We expect that international sales will continue to account for a significant portion of our total revenue in future years. We market to customers located in the Far East in countries such as China, Japan, Malaysia, Singapore and Taiwan. We are subject to various challenges related to the management of global operations, and international sales are subject to risks including, but not limited to regional economic and political conditions, challenges in staffing and managing foreign operations, changes in currency controls, potentially adverse tax consequences, difference in enforcement of intellectual property rights and fluctuation in interest and currency exchange rates. Any of these factors could have a material adverse effect on our business and operating results.

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 Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." 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 intend to adopt SFAS 123R in the first quarter of fiscal year 2006. The pro forma disclosures, previously permitted under SFAS 123 and adopted by Intevac, no longer will be an alternative to financial statement recognition. Although we have not yet

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determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we expect the adoption to increase our cost of revenues and operating expenses, and the adoption of SFAS 123R could make our net income less predictable in any given reporting period, could change the way we compensate our employees, or may cause other changes in the way we conduct our business.

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 (Section 404), we are required to furnish a report by our management on our internal control over financial reporting. Such report contains, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. The report must also contain a statement that our auditors have issued an attestation report on management's assessment of our internal controls.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a framework for companies to assess and improve their internal control systems. Auditing Standard No. 2 provides the professional standards and related performance guidance for auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404. Management's assessment of internal controls over financial reporting requires management to make subjective judgments, and, particularly because Section 404 and Auditing Standard No. 2 are newly effective, some of the judgments will be in areas that may be open to interpretation. Therefore the report is especially difficult to prepare.

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.

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. Any or all of these factors could have a material adverse effect on our business and operating results.

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;
- any of our patents will not be invalidated, deemed unenforceable, circumvented or challenged;

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- the rights granted under our patents will provide competitive advantages to us;
- any of our pending or future patent applications will issue with claims of the scope that we sought, if at all;
- 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. Any of the foregoing could have a material adverse effect on our business.

Our business is based in Northern California, where operating costs are high and competition for employees is intense.

Our U.S. operations are located in Santa Clara, California and Fremont, California, where the cost of doing business and recruiting employees is high. Failure to manage these costs well could have a material adverse effect on our operating results. 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. Failure to attract and retain qualified personnel could have a material adverse effect on our business.

Business interruptions, such as earthquakes or other natural or man-made disasters, could disrupt our operations and adversely affect our business.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, unauthorized intrusion and other catastrophic events beyond our control. Our contingency plans for addressing these kinds of events may not be sufficient to prevent system failures and other interruptions in our operations that have a material adverse effect on our business. Additionally, our suppliers' suffering similar business interruptions could have an adverse effect on our manufacturing ability. If any natural or man-made disasters do occur, our operations could be disrupted for prolonged periods, which could have a material adverse effect on our business.

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.

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We market to customers located in the Far East in countries such as China, Japan, Malaysia, Singapore and Taiwan.

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 routinely evaluate acquisition candidates and other diversification strategies.

We have completed a number of 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 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. Any of the above factors could have a material adverse effect on our business.

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. Shares held by our directors, executive officers and affiliates are subject to volume and manner of sale restrictions, and as otherwise described in the following sentence. We have an agreement with Foster City LLC and Redemco LLC that gives Foster City and Redemco the right to require us to file a registration statement on Form S-3, registering the resale of all shares of our common stock held by Foster City and Redemco. 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. Sales of a substantial number of shares of common stock in the public market 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.

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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 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.

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 and market auction rate bonds.

The table below presents principal amounts and related weighted-average interest rates by year of maturity for our investment portfolio at October 1, 2005.

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Beyond</u>	<u>Total</u>	<u>Fair Value</u>
			(in thousands)			
Cash equivalents						
Fixed rate amounts	—	—	—	—	—	—
Weighted-average rate						
Variable rate amounts	\$ 2,897	—	—	—	\$ 2,897	\$ 2,897
Weighted-average rate	3.53%					
Short-term investments						
Fixed rate amounts	\$25,458	\$15,961	—	—	\$41,419	\$41,308
Weighted-average rate	3.26%	3.02%				
Long-term investments						
Fixed rate amounts	—	—	—	—	—	—
Weighted average rate						
Total investment portfolio	\$28,355	\$15,961	—	—	\$44,316	\$44,205

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 October 1, 2005, 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 October 1, 2005, 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 October 1, 2005.

Changes in internal controls. In our Management's Report over Internal Controls, which was contained in our Form 10-K for the fiscal year ending December 31, 2004, we reported three material weaknesses and the steps we proposed taking to remediate such weaknesses. As of December 31, 2004, we concluded that we did not maintain effective controls over (1) aspects of the Imaging Business, (2) approval of inventory cycle count adjustments, and (3) documentation related to our quarterly review and approval of excess and obsolete inventory reserves. In the first quarter of 2005, we began efforts to remediate the material weaknesses. Specifically, our evaluation and remediation efforts were as follows:

Imaging Business — We determined during the course of our year-end audit that projected, rather than approved, billing rates were used to calculate revenue for cost-plus-fixed-fee technology development contracts. In addition, journal entries for revenue recognition and the related documentation were not subjected to adequate review and approval.

We also determined during the course of our year-end audit that firm fixed-price technology development contracts were not being accounted for in accordance with U.S. GAAP for firm fixed-price contracts. This would have resulted in an overstatement of revenue and operating profit had it not been discovered prior to the public release of our 2004 earnings.

We also determined during the course of our year-end audit that a receivable greater than one year old had not been reserved as a bad debt. During the fourth quarter of 2004, we implemented a bad debt policy that required receivables aged more than one year to be fully reserved. Our review did not include unbilled receivables and we did not establish the appropriate bad debt reserve. This would have resulted in an understatement of bad debt expense and an overstatement of operating profit had it not been discovered prior to the public release of our 2004 earnings.

To remediate this material weakness, during the first quarter of 2005, we retrained our accounting staff in proper application of revenue recognition policies and implemented policies regarding analyzing contracts for proper revenue recognition accounting. We also changed our process for evaluating accounts receivable to ensure that all balances are reviewed for collectibility on a regular basis. During both the first and second quarters of 2005, we tested the new controls and found them to be working effectively. We believe that this material weakness has been remediated.

Approval of Inventory Cycle Count Adjustments — We routinely cycle count our stockroom inventories and make corrections to our inventory balances as a result of those cycle counts. We determined late in 2004 that the cycle count adjustments were being made, but without written approval by management as required by our internal control policies. Management authorization of cycle count adjustments is necessary to reduce the potential of an employee using a cycle count adjustment to conceal a theft of inventory.

To remediate this material weakness, the requirement for the appropriate management approval of all cycle count adjustments was re-emphasized in December 2004. During the first quarter of 2005, we tested a significant sample of the cycle count adjustments and found them to be properly approved. We believe that this material weakness has been remediated.

Documentation of Excess and Obsolete Inventory Reserve Calculation Review and Approval — We determine, on a quarterly basis, the level of reserves required related to excess and obsolete inventory. Excess and obsolete inventory reserves are an estimate, which requires significant judgment on the part of management. Our Chief Financial Officer reviews and approves these estimates on a quarterly basis. Given the significant nature of the estimate, we determined during the course of our internal controls evaluation that improved documentation of those reviews was needed.

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To remediate this material weakness, we have documented the management review of the quarterly excess and obsolete calculations in each of the last two quarters. We have also performed tests over the calculations surrounding the excess and obsolete requirements and found them to be working properly. We believe that this material weakness has been remediated.

We believe each of the changes discussed above is a change in our internal controls over financial reporting which was identified in connection with the evaluation required by Rule 13(a)-15(d) of the Exchange Act that occurred during our third quarter ended October 1, 2005 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

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.

Date: November 10, 2005

By: /s/ KEVIN FAIRBAIRN
Kevin Fairbairn
President, Chief Executive Officer and Director
(Principal Executive Officer)

Date: November 10, 2005

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)

EXHIBIT TO INDEX

Number	Exhibit Description
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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.

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: November 10, 2005

/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)) 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: November 10, 2005

/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 October 1, 2005 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 October 1, 2005 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.