OSI SYSTEMS INC
Form 10-K
September 13, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2007

OR

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

For the transition period from _____ to _____

Commission File Number 0-23125

OSI SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California	33-0238801
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
12525 Chadron Avenue, Hawthorne, California	90250
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number, Including Area Code: (310) 978-0516

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, no par value

(Title of Class)

Securities registered pursuant to Section 12(g) of the Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes: ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes: ¨ No x

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: x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The aggregate market value of the registrant s voting and non-voting common stock held by non-affiliates computed by reference to the price at which the common stock was last sold as on December 29, 2006, the last business day of the registrant s most recently completed second fiscal quarter was $350,799,358.

The number of shares outstanding of the registrant s common stock as of September 10, 2007 was 17,136,488.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders (to be filed subsequently) are incorporated by reference into Part III.

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PART I

Forward Looking Statements

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements relate to expectations concerning matters that are not historical facts. Words such as projects, believes, anticipates, plans, expects, intends, may, will, would, will be, will continue, will likely result and similar words and expressions are intended to identify forward-looking statements. We believe that the expectations reflected in the forward-looking statements are reasonable, but those expectations may not prove to be correct. Important factors that could cause our actual results to differ materially from those expectations are disclosed in this report, including, without limitation, those described in Part I, Item 1, Business, Part I, Item 1A, Risk Factors and Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation as well as elsewhere in this report and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. Such factors, of course, do not include all factors that might affect our business and financial condition. Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, such assumptions could prove to be inaccurate and actual results could differ materially from those expressed in or implied by the forward-looking statements. All forward-looking statements contained in this report are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 1. BUSINESS

General

OSI Systems, Inc. and its subsidiaries is a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. We sell our products in diversified markets, including homeland security, healthcare, defense and aerospace. Our company was incorporated in 1987 in California. Our principal office is located at 12525 Chadron Avenue, Hawthorne, California 90250.

We have three operating divisions: (a) Security, providing security and inspection systems; (b) Healthcare, providing patient monitoring, diagnostic cardiology and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for affiliated end-products divisions, as well as for applications in the defense and aerospace markets, among others.

In our Security division, we design, manufacture and market security and inspection systems worldwide to end users under the Rapiscan Systems trade name. Rapiscan Systems products are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband, and to screen people. These products are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold (checked) baggage screening and people screening.

In our Healthcare division, we design, manufacture and market patient monitoring, diagnostic cardiology and anesthesia systems worldwide to end users primarily under the Spacelabs trade name. These products are used by care providers in critical care, emergency and perioperative areas within hospitals as well as physicians offices, medical clinics and ambulatory surgery centers. We also offer centralized cardiac safety core lab services in connection with clinical trials by or on behalf of pharmaceutical companies and clinical research organizations.

In our Optoelectronics and Manufacturing division, we design, manufacture and market optoelectronic devices and value-added manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, computed

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tomography (CT), fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We sell our optoelectronic devices under the OSI Optoelectronics trade name and perform our value-added manufacturing services under the OSI Electronics trade name. We provide our optoelectronic devices and value-added manufacturing services to original equipment manufacturers, as well as to our own Security and Healthcare divisions. Our Optoelectronics and Manufacturing division also designs, manufactures and markets weapons simulation systems under the OSI Defense Systems trade name, toll and traffic management systems under the OSI LaserScan trade name and peripheral bone densitometers and ultrasound bone sonometers under the Osteometer trade name.

In fiscal 2007, revenues from the Security division amounted to $186.6 million, or approximately 35% of our revenues; revenues from the Healthcare division amounted to $233.2 million, or approximately 44% of our revenues; and revenues from the Optoelectronics and Manufacturing division amounted to $112.5 million, or approximately 21% of revenues. Additional information concerning reporting segments is available in Note 16 to our Consolidated Financial Statements.

Industry Overview

We sell our security and inspection systems and patient monitoring, diagnostic cardiology and anesthesia systems primarily to end-users, while we design and manufacture our optoelectronic devices and value-added subsystems primarily for original equipment manufacturers.

Security. A variety of technologies are currently used worldwide in security and inspection applications, including computed tomography, transmission and backscatter x-ray, metal detection, trace detection and x-ray, gamma-ray and neutron analysis. We believe that the market for security and inspection products will continue to be affected by the threat of terrorist incidents and by new government mandates and appropriations for security and inspection products in the United States and internationally.

The September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon using hijacked airliners led to nationwide shifts in transportation and facilities security policies. Shortly following these attacks, Congress passed the Aviation and Transportation Security Act and integrated many U.S. security-related agencies, including the Federal Aviation Administration, into the U.S. Department of Homeland Security. Under its directive from Congress, the U.S. Department of Homeland Security has since undertaken numerous initiatives to prevent terrorists from entering the country, hijacking airliners, and obtaining and trafficking in weapons of mass destruction and their components, to secure sensitive U.S. technologies and to identify and screen high-risk cargo containers before they are loaded onto vessels destined for the U.S., among others. These projects, known, for example, as the Strategic Border Initiative, the Customs-Trade Partnership Against Terrorism and the U.S. Customs and Border Protection Container Security Initiative, have resulted in an increased demand for security and inspection products both in the United States and other nations.

Projects underway in the United States, such as the U.S. Customs and Border Protection Container Security Initiative and the Customs-Trade Partnership Against Terrorism, have created a ripple effect in other areas of the world because they call on other nations to bolster their port security strategies, including acquiring or improving their security and inspection equipment. The international market for non-intrusive inspection equipment, therefore, continues to expand as countries that ship goods directly to the United States are required to improve their security infrastructure.

The U.S. Congress recently passed legislation that mandated the inspection of international maritime cargo destined for the United States, domestic civil aviation cargo, and for radiological and nuclear threats in cargo entering the United States. Certain of our cargo and vehicle inspection systems are already being used internationally and by the U.S. government to comply with these mandates.

Furthermore, the U.S. Department of Homeland Security s Science and Technology Directorate has supported the development of new security inspection technologies and products. Our Security division

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participates in a number of such research and development efforts, including projects to develop new technologies for radiation and nuclear materials detection, aviation screening and suicide bomber detection. The Science and Technology Directorate has also initiated programs for the development of technologies capable of protecting highways, railways and waterways from terrorist attack.

In addition to these homeland protection activities, the U.S. Department of Defense has also begun to invest more heavily in technologies and services that screen would-be attackers before they are able to harm U.S. and allied forces.

Similar initiatives by international organizations such as the European Union have also resulted in a growing worldwide demand for airline, cargo, port and border inspection technologies. For example, the European Union is expected to issue uniform performance standards for people, cargo, mail and parcel and hold baggage screening systems as well as new directives related specifically to maritime security. We anticipate that the promulgation of these new standards will establish performance baselines against which our Security division will be able to direct certain of its research and development spending and market its products to customers located in the European Union.

As a result of these and other changes, sales of our security and inspection products have grown as compared to pre-September 11, 2001 levels. Major international projects recently installed or currently underway include system installations in Hong Kong, India, Jamaica, Malaysia, Mexico, Romania, South Korea and Taiwan, among others. These sites contain various cargo inspection product offerings, including mobile, fixed and relocatable high-energy x-ray, mobile gamma-ray and hybrid x-ray/thermo neutron analysis scanning systems. We anticipate that there may be growing demand from governments and commercial enterprises for increasingly sophisticated solutions to screening vehicles, trucks, ocean-going cargo, rail cars and air pallet containers.

Healthcare. Healthcare is a rapidly growing sector throughout most of the world and especially in many Asian and Latin American economies. In much of the developed world, including in the United States and Europe, an aging population is also fueling growth.

Many factors such as a nursing shortage in the United States and Europe, stricter government requirements affecting the staffing and accountability and shrinking reimbursements from health insurance organizations are forcing healthcare providers to do more with less. Our Healthcare division designs, manufactures and markets products that respond to these new economic forces by helping hospitals reduce costs while maintaining or improving the quality of care their physicians and nurses are able to deliver.

We are a global manufacturer and distributor of patient monitoring and clinical networking solutions for use primarily in hospitals. We design, manufacture and market patient monitoring solutions for critical, emergency and perioperative care areas of the hospital, wired and wireless networks, ambulatory blood pressure monitors and medical data services, all aimed at providing caregivers with timely patient information. By making critical patient information more readily accessible both inside and outside the hospital, delays in decision-making can be reduced, length of stay can be shortened and treatment errors can be minimized.

In February 2005, we acquired Blease Medical, a global manufacturer and distributor of anesthesia delivery systems, ventilators and vaporizers. We sell these products primarily to hospitals for use in operating rooms and anesthesia induction areas as well as in magnetic resonance imaging (MRI) facilities. In addition, as pharmaceutical companies develop new anesthesia agents for the worldwide market, or as generic alternatives to patented anesthesia formulas become available, we work closely with them to support their new product introductions. As a result, we also sell systems and components, such as anesthesia vaporizers and ventilators, directly to pharmaceutical companies and other manufacturers of anesthesia delivery systems.

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In July 2006, we acquired Del Mar Reynolds, a global manufacture and distributor of cardiac monitoring systems, including Holter recorders, ECG, stress systems and related software and services to hospitals. The acquired operations also included a core laboratory business that provides clinical trial services to pharmaceutical companies and to clinical research organizations. These operations have since been integrated into the Healthcare division s diagnostic cardiology and clinical trial services businesses.

This division has grown from approximately $11 million in annual revenues in fiscal 2003 to approximately $233 million in fiscal 2007, primarily as a result of the acquisitions of Spacelabs Medical, Blease Medical and Del Mar Reynolds. During fiscal 2006, we formed Spacelabs Healthcare, Inc. to serve as a holding company for all of the business operations of our Healthcare division and then completed an initial public offering of approximately 20% of Spacelabs Healthcare s total issued and outstanding shares. The newly issued shares began trading on the Alternative Investment Market (AIM), a market administered by the London Stock Exchange, on October 31, 2005 under the ticker symbol SLAB. During fiscal 2007, we repurchased shares of Spacelabs Healthcare at a cost of $4.5 million. As of June 30, 2007, we owned approximately 84% of Spacelabs Healthcare.

Optoelectronics and Manufacturing. Our optoelectronic devices are used in a wide variety of applications such as satellites, laser guidance systems, range finders, computer peripherals and other applications that require the conversion of optical signals into electronic signals. Because optoelectronic devices and value-added subsystems can be used in a wide variety of measurement control and monitoring applications, they are also used in a broad array of industrial applications and are key components in the telecommunications and fiber optics industries. Historically, we have offered value-added manufacturing services to purchasers of our optoelectronic devices, including to our Security and Healthcare divisions. More recently, however, we have begun to expand such services by providing complete turn-key and box-build manufacturing services, in which we can design, acquire materials, produce, test and supply electronic systems and components to purchasers of optoelectronic devices and to others.

We believe that recent advances in technology and reductions in the cost of key components of optoelectronic systems, including computer processing power and memory, have broadened the market by enabling the use of optoelectronic devices in a greater number of applications. In addition, we see a trend among original equipment manufacturers to increasingly outsource the design and manufacture of optoelectronic devices as well as value-added subsystems to fully-integrated, independent manufacturers, like us, who may have greater specialization, broader expertise and the flexibility to respond in shorter time periods than most original equipment manufacturers can accomplish in-house. We believe that our level of vertical integration, substantial engineering resources, expertise in the use and application of optoelectronic technology and low-cost international manufacturing operations enable us to compete effectively in the market for optoelectronic devices and for value-added manufacturing services.

We have also penetrated several related markets that depend on our optoelectronic technologies and electronics manufacturing capabilities. For example, we sell a series of high-speed photodetectors for use in fiber optic systems such as Gigabit Ethernet, Fiber Channel and other telecommunication and data communication applications. Through system engineering, product development, rapid prototyping and volume manufacturing, we develop, manufacture and market laser-based weapons simulation systems for defense and homeland security applications. Products include tactical engagement simulation systems, small arms transmitters, controller guns and a variety of targeting systems. We also develop, manufacture and sell laser-based remote sensing devices that are used to detect and classify vehicles in toll and traffic management systems.

Growth Strategy

We believe that one of our primary competitive strengths is our expertise in the cost-effective design and manufacture of specialized electronic systems and components for critical applications. As a result, we have leveraged, and intend to continue to leverage, such expertise and capacity to gain price, performance and agility advantages over our competitors in the security, healthcare and optoelectronics fields, and to translate such

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advantages into profitable growth in those fields. At the same time, we continually seek to identify new markets in which our core expertise and capacity will provide us with competitive advantages. Key elements of this strategy include:

Capitalizing on Global Reach. We operate from locations in North America, Asia and Europe. We view our international operations as providing an important strategic advantage over competitors. First, international manufacturing facilities allow us to take advantage of competitive labor rates and favorable tax regulations in order to be a low cost producer. Second, our international offices strengthen our sales and marketing efforts and our ability to service and repair our systems by providing direct access to growing foreign markets and to our existing international customer base. Third, multiple manufacturing locations allow us to reduce delivery times to our global customer base. In the future, we intend to develop new sources of manufacturing and sales capabilities to maintain and enhance the benefits of our international presence.

Capitalizing on Vertical Integration. Our vertical integration provides several advantages in each of our divisions. These advantages include reduced manufacturing and delivery times, lower costs due to our access to competitive international labor markets, direct sourcing of raw materials and quality control. We also believe that we offer significant added value to our customers by providing a full range of vertically-integrated services including component design and customization, subsystem concept design and application engineering, product prototyping and development, efficient pre-production and short-run and high volume manufacturing. We believe that our vertical integration differentiates us from many of our competitors and provides value to our customers who can rely on us to be an integrated supplier. We intend to continue to leverage our vertically integrated services to create greater value for our customers in the design and manufacture of our products.

Capitalizing on the Growing Market for Security and Inspection Systems. Heightened attentiveness to terrorist and other security threats may continue to drive growth in the market for security and inspection systems, not only in transportation security, but in facilities security and event security. In addition, the trend toward increased international transportation of goods may result in growth in the market for cargo inspection systems that are capable of screening shipping containers for contraband and assisting customs officials in the verification of shipping manifests. Package screening by freight forwarders also represents a potential growing sector, as new regulations in Europe require such screening and awareness of the need for such screening grows in the U.S. We intend to continue to expand our sales and marketing efforts both domestically and internationally, and to capitalize on opportunities to replace, service and upgrade existing security installations. We also intend to continue to develop new security and inspection technologies, such as our real time tomography products, and may enhance and expand our current product offerings through selective acquisitions to better address new applications and security industry demands.

Improving and Complementing Existing Medical Technologies. We develop and market patient monitoring systems and diagnostic cardiology products, anesthesia delivery systems, ventilators and vaporizers that utilize patient monitoring technologies. As a result, we are able to market and sell many of our product offerings through shared sales channels and distribution networks. Our efforts to improve our existing medical technologies are focused on making patient information available to care providers both at the bedside as well as in other parts or even away from the hospital, thereby reducing time demands on physicians and nurses, enabling more rapid treatment decisions and improving patient care. Overall, our efforts at improving our existing medical diagnostic and anesthesia delivery technologies will also continue to concentrate on the development of devices that make it possible for institutions from large hospitals to small clinics and physicians offices to obtain accurate, precise, reliable and cost-effective results.

Selectively Entering New Markets. We intend to continue to selectively enter new markets that complement our existing capabilities in the design, development and manufacture of specialized electronic systems and components for critical applications such as security and inspection and patient monitoring, diagnostic cardiology and anesthesia systems. We believe that by manufacturing end products that rely on our

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existing technological capabilities, we will leverage our integrated design and manufacturing infrastructure to capture greater margins and to build a larger presence in new end markets that present attractive competitive dynamics. We intend to achieve this strategy through internal growth and through selective acquisitions.

Acquiring New Technologies and Companies. Our success depends in part on our ability to continually enhance and broaden our product offerings in response to changing technologies, customer demands and competitive pressures. We have developed expertise in our various lines of business and other areas through internal research and development efforts as well as through selective acquisitions. As a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications, we have, since our inception as a company, looked for acquisition opportunities to broaden our technological expertise and capabilities, lower our manufacturing costs or facilitate our entry into new markets. The following are recent acquisitions we have made:

In March 2004, we completed the acquisition of Spacelabs Medical based in Issaquah, Washington, from Instrumentarium Corporation, now a subsidiary of General Electric Company. The acquisition price was approximately $47.9 million in cash (net of cash acquired), including acquisition costs. In March 2007, we settled a dispute with General Electric Company regarding the purchase and received $15 million. The receipt of this amount from General Electric Company has been recorded as Other Income in our Consolidated Statement of Operations for the fiscal ended June 30, 2007. Spacelabs is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors and medical data services. These are areas in which we had considerable interest as they represented a natural extension of our engineering and manufacturing expertise and would add to our presence in the medical device industry.

In June 2004, we purchased a 75% equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems and in December 2004 we acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest, we have agreed to make certain royalty payments based on sales of CXR s products. In March 2006, our Security division received its first contract for such a system, known as the Rapiscan RTT120 CT. The system is still under development and subject to the inherent risks and uncertainties of product development. There is still no assurance of the successful completion of development, timely or otherwise, or of the characteristics of any final product, or whether such final product will achieve certification by regulatory authorities.

In February 2005, we acquired Blease Medical based in Chesham, United Kingdom. We paid $9.3 million in cash (net of cash acquired), including acquisition costs. Furthermore, during the three years following the close, contingent consideration is payable based on Blease s net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately $12.5 million as of June 30, 2007). The acquisition of Blease expands the portfolio of products offered by our patient monitoring, diagnostic cardiology and anesthesia systems companies, enabling us to develop and market products for the perioperative market.

In July 2006, we acquired the Del Mar Reynolds Cardiac division of Ferraris Group PLC. Pursuant to the terms of the acquisition agreement, we made an initial cash payment of $25.9 million, subject to a working capital adjustment and to an adjustment of plus or minus $1.9 million based upon revenue and earnings results for Del Mar Reynolds for the 13-month period ending September 30, 2006. In September 2006, Ferraris Group PLC paid $1.7 million in connection with the working capital adjustment and in November 2006 it paid an additional $1.9 million as a result of the failure of Del Mar Reynolds to meet certain revenue and earnings results for the 13-month period ending September 30, 2006. This acquisition broadened the portfolio of products that we are able to offer the hospital market, especially in Germany and the United Kingdom, with the addition of cardiac monitoring systems, as well as a core laboratory business that provides clinical trial services to pharmaceutical companies and to clinical research organizations. The results of operations for Del Mar Reynolds have been included in our Consolidated Financial Statements as of the date of acquisition.

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Products and Technology

We design, develop, manufacture and sell products ranging from complex security and inspection systems to patient monitoring, diagnostic cardiology and anesthesia systems to discrete optoelectronic devices and value-added subsystems.

***Security and Inspection Systems*.** We design, manufacture and market security and inspection systems worldwide to end users under the Rapiscan Systems name. Rapiscan Systems products are used to inspect baggage, cargo, people, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials. Rapiscan Systems products fall into four categories: baggage and parcel inspection, cargo and vehicle inspection, hold (checked) baggage screening and people screening.

As a result of the terrorist attacks of September 11, 2001, and subsequent attacks in other worldwide locations, security and inspection products have increasingly been used at a wide range of facilities other than airports, such as border crossings, railway stations, seaports, cruise line terminals, government and military installations and nuclear facilities. As a result of the additional markets, we have successfully diversified our sales channels for security and inspection products.

Many of our security and inspection systems in each of the baggage and parcel inspection, cargo and vehicle inspection, hold baggage screening and people screening product categories combine the use of x-ray technology with our optoelectronics capabilities. For example, some of our products include dual- or multi-energy x-ray technology with computer software enhanced imaging technology to facilitate the detection of materials such as explosives, weapons, narcotics, currency or other contraband. While all x-ray systems produce a two-dimensional image of the contents of the inspected object, the dual-energy x-ray systems also measure the x-ray absorption of the inspected object s contents at two x-ray energies to determine the atomic number, mass and other characteristics of the object s contents. The various organic and inorganic substances in the inspected object appear to operators of the inspection systems in various colors and this visual information can be used to identify and differentiate the inspected materials. Our baggage and parcel inspection, cargo and vehicle inspection and hold baggage screening inspection systems range in size from compact tabletop systems to large systems comprising entire buildings in which trucks, shipping containers or pallets are inspected.

Our cargo and vehicle inspection applications, in which trucks, shipping containers, pallets and other large objects can be inspected, are designed in various configurations, including fixed-site, gantry, relocatable, portal and mobile systems. These products are primarily used to verify the contents of trucks or cargo containers and to detect the presence of contraband. They offer significant improvements over past methods of cargo screening, such as manual searches, as our cargo systems are faster, more thorough and do not subject the cargo to pilferage. Entire shipping containers or trucks containing densely packed goods can be screened rapidly.

Many of our cargo and vehicle inspection systems utilize ionizing radiation, such as high-energy x-ray or gamma-ray beams, in conjunction with digital imaging equipment to non-intrusively inspect objects and present images to an inspector, showing shapes, sizes, locations and relative densities of the contents. Many of these systems, such as the Rapiscan Eagle, which was designed and developed under contract with U.S. Customs and Border Protection and the U.S. Department of Defense, have been built to meet specific customer inspection requirements.

Other cargo and vehicle inspection products automatically and non-intrusively detect chemical signatures indicating the presence of explosives and other contraband through the use of pulsed fast neutron and thermal neutron technologies, as opposed to ionizing radiation. Pulsed fast neutron and thermal neutron technologies permit the operator to inspect cargo, vehicles and containers based on the distinctive chemical composition of explosives, drugs or other contraband.

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Our Security division is the only competitor in the market offering x-ray, gamma-ray and neutron-based material specific technologies. As a result, we believe that we offer the broadest technology platform in the cargo and vehicle inspection systems industry. This broad platform also permits us to offer customers hybrid solutions utilizing two or more of the technologies together, thereby optimizing flexibility, performance and cost to meet the customer s unique application requirements. Cargo and vehicle inspection systems recently installed or currently underway include system installations in the United States, China, Hong Kong, India, Malaysia, Mexico, Romania, South Korea and Taiwan, among others.

Our Security division also offers people screening products such as a line of Metor brand walk-through metal detection products for use at security checkpoints at airports, amusement parks, banks, courthouses, government buildings, sports arenas and other venues and the Rapiscan Secure 1000 personnel screener, which uses extremely low dose backscatter x-ray imaging to detect contraband and weapons concealed underneath clothing and hair. The Rapiscan Secure 1000 provides enhanced screening compared to metal detectors as it displays anomalies caused by very small amounts of metal as well as non-metallic items. As a result, the Rapiscan Secure 1000 can simultaneously locate and detect conventional metal weapons, as well as ceramic knives, explosives, illicit drugs, precious metals, cameras, recording devices and other contraband or security threats.

The following table sets forth certain information related to the standard security and inspection products that we currently offer. We do, however, also customize our standard products to suit specific applications and customer requirements.

PRODUCT LINE	PRODUCT NAME / PRODUCT FAMILY	TECHNOLOGY	MARKET SEGMENT
Baggage and Parcel Inspection	Rapiscan 500/600 series x-ray systems	Single and Dual-energy x-ray	Checkpoint inspection at airports, prisons, border crossings and government buildings; postal facilities for mail screening
Cargo and Vehicle Inspection	Rapiscan Eagle	High energy x-ray	Cargo and vehicle inspection at airports, border crossings and sea ports
	Rapiscan VEDS	Thermal Neutron Analysis	
	Rapiscan GaRDS	Gamma ray	
	Rapiscan PFNA	Pulsed Fast Neutron Analysis	
Hold Baggage Screening	Rapiscan MVXR 5000	Multi-view, dual energy x-ray	Baggage inspection at airports
	Rapiscan XRD 1000	Dual energy x-ray diffraction	
People Screening	Metor series of metal detectors	Metal detectors	Checkpoint inspection at airports, border crossings, stadiums, prisons and government facilities

Rapiscan Secure 1000

X-ray Backscatter

Patient Monitoring, Diagnostic Cardiology and Anesthesia Systems. Our Healthcare businesses design, manufacture and market their products worldwide to end users primarily under the Spacelabs trade name.

Spacelabs products include Ultraview SL patient monitors, which are used primarily in perioperative, critical care and emergency care environments. We also offer patient monitors for virtually all applications in the hospital, including neonatal, pediatric and adult critical and emergency care, as well as anesthesia and sub-acute care. Our patient monitoring systems comprise monitors and central nursing stations connected via hardwired or

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wireless networks, as well as stand-alone monitors where the patient data can be transported physically from one monitor to another as the patient is moved. This ensures that hospital staff can access patient data where and when it is required. In addition, these products are designed with an open architecture to interact with hospital information systems. WinDNA, based on Citrix thin client technology, is a feature of many of these products which allows clinicians to view and control Microsoft Windows applications on the patient monitor s display, eliminating the need for separate terminals in the patient s room. Attending nurses can thereby check laboratory results and other reports, enter orders, review protocols and do charting right at the patient s bedside. Inputs can be made using a mouse, keyboard and touchscreen.

In December 2006, we introduced the mCare 300 Vital Signs Monitor, for instant access to essential patient data. The portable unit offers electrocardiograph, respiration, SpO2 (Pulse Oximetry), non-invasive blood pressure and temperature monitoring, along with an easy-to-use touchscreen interface. The mCare 300 is primarily marketed for use in low- to mid-acuity care environments where simplicity and portability are important.

For electrocardiograph monitoring or multiparameter monitoring of ambulatory patients, we offer a digital telemetry system. The system operates in government-protected bands (608 and 614 MHz and 1.4GHz), not used for private land mobile radio, business radio services or broadcast analog and digital television. The Spacelabs Ultraview Digital Telemetry solution comprises a lightweight and compact transmitter that enables monitoring of heart rate, ST segment, arrhythmia and continuous SpO2 (Pulse Oximetry). The multiparameter transmitter also integrates with the Spacelabs Ultralite ambulatory blood pressure monitor for the transmission of non-invasive blood pressure values to a central station or a multi-disclosure and information system.

We are also a world leader in ambulatory blood pressure monitoring, which is a routine procedure in many European countries and is increasingly being used in the United States. Many physicians are using ambulatory blood pressure monitoring to detect white coat hypertension, a condition in which people experience elevated blood pressure in the doctor s office, but not in their daily lives. Ambulatory blood pressure monitoring is also used to adjust drug therapies for hypertensive patients. It is estimated that as many as 20% of the patients that are diagnosed with hypertension based on blood pressure measurements taken in their physicians offices are not actually hypertensive. Ambulatory blood pressure monitoring helps improve diagnostic accuracy and minimize the associated costs of treatment.

In July 2006, our Healthcare division completed the acquisition of the Del Mar Reynolds Cardiac division of Ferraris Group PLC, in significant part for the purpose of augmenting the division s diagnostic cardiology product offerings. Del Mar Reynolds has been developing cardiac monitoring systems, including Holter systems and recorders, for over 40 years. Its Pathfinder and Impresario lines of Holter analyzers offer users interactive control with advanced diagnostic parameters. Its Lifecard and Aria recorders are worn by patients for up to seven days in order capture heart arrhythmias that may occur in a patient only a few times per week. Patients that may be experiencing even less frequent heart arrhythmias wear its CardioCall product, which stays with the patient over several weeks and transmits its findings over the phone to a receiving station in the hospital. In addition to these products, Del Mar Reynolds also offers other diagnostic cardiology products such as the Voyager electrocardiogram series; CardioDirect and CH2000 stress test systems.

Our anesthesia delivery and ventilation group designs and manufactures anesthesia delivery systems, anesthesia vaporizers and ventilators. Our Focus, Genius and recently-launched BleaseSirius anesthesia delivery systems provide flexible anesthesia solutions for most operating room environments, anesthesia induction areas, day surgery units, magnetic resonance imaging facilities and other areas where the administration of anesthesia is required. Its Datum anesthesia vaporizers and its line of anesthesia ventilators are also designed to be compatible with the anesthesia delivery systems of several other manufacturers. At the forefront in anesthesia ventilation, this group recognized the needs of clinicians and the clinical benefits of allowing patients to breathe without the assistance of a ventilator (*i.e.*, on their own) as much as possible while

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undergoing anesthesia. As a result, in 1999, this group became the first to offer ventilators that allowed patients to breathe spontaneously while under anesthesia with the respiratory support of the ventilator used only when necessary to overcome the effects of general anesthesia. In addition, by incorporating spirometry loops into its ventilators, which produce graphical displays about the adequacy and state of a patient s ventilation, clinicians were able to carefully monitor their patients and ensure the efficacy of the mode of ventilation provided.

In fiscal 2007, we added seven new ventilators to our existing product line, each of which enables clinicians to enhance control over the delivery of ventilation and more finely tune their requirements to a surgical procedure and the individual characteristics of a patient by actively controlling flow into and out of the ventilation drive system, throughout the entire respiratory cycle. In addition, each of these new ventilators works in conjunction with a large 8.4 inch touchscreen display. This screen, in conjunction with our proprietary Touch and Trak user interface is easy to use, allowing clinicians to focus greater attention on other aspects of patient care. In fiscal 2007, we launched the BleaseSirius anesthesia delivery systems along with these new ventilators in the United States.

The following table sets forth a description of the more significant healthcare products that we currently offer:

PRODUCT LINE	PRODUCT NAME / PRODUCT FAMILY	MARKET SEGMENT
Anesthesia Delivery and Ventilation	700 and 900 series Ventilators	Ambulatory surgery centers
	BleaseSirius	Operating rooms
	Datum Vaporizer	
	Focus	
	Genius	
Patient Monitoring and Connectivity	Ambulatory Blood Pressure Monitors	All hospital care areas
	mCare 3000	Outpatient surgery centers
	MOM (Maternal Obstetrical Monitors)	Physician offices
	Ultraview / Ultraview SL	
Diagnostic Cardiology	ARIA	All hospital cardiology care areas
	CardioCall	Physician offices
	LifeCard	
	Voyager	
	Stress Testing Systems	

Optoelectronic Devices and Manufacturing Services. Optoelectronic devices generally consist of both active and passive components. Active components sense light of varying wavelengths and convert the light detected into electronic signals, whereas passive components amplify, separate or reflect light. The active components we manufacture consist of silicon, gallium arsenide and indium gallium arsenide photodetectors. Passive components include lenses, prisms, filters, mirrors and other precision optical products that are used by us in the manufacture of our

optoelectronic products or are sold to others for use in telescopes, laser printers, copiers, microscopes and other detection and vision equipment. The devices we manufacture are both standard products and products customized for specific applications and are offered either as components or as subsystems.

We have recently developed two-dimensional back-illuminated detector technology for security, healthcare and industrial CT applications. This technology overcomes the limitations of conventional detectors by providing finer detector pitch density. This is used in high-resolution multi-slice CT scanners and other applications requiring improved image resolution.

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In addition to the manufacture of standard and original equipment manufacturer products, we also specialize in designing and manufacturing customized value-added subsystems for use in a wide range of products and equipment. An optoelectronic subsystem typically consists of one or more optoelectronic devices that are combined with other electronic components and packaging for use in an end product. The composition of a subsystem can range from a simple assembly of various optoelectronic devices that are incorporated into other subsystems (for example, a printed circuit board containing our optoelectronic devices) to complete end-products (for example, pulse oximetry equipment). Furthermore, we have expanded our electronics design and manufacturing capabilities both in the United States and in Asia with enhanced, RoHS-compliant, box-build manufacturing services and PC board assembly capabilities utilizing state-of-the-art automated surface mount technology lines. As a result, we now offer electronics manufacturing services for data and signal processing, amplifier and processor boards for medical equipment, musical tuning and studio hardware, motor controls, power supplies, and several other industrial applications that do not utilize optoelectronic devices.

Markets, Customers and Applications

Security and Inspection Products. Most security and inspection products were developed in response to civilian airline hijackings. Consequently, a significant portion of our security and inspection products have been and continue to be sold for use at airports. Recently, however, our security and inspection products have been used for security purposes at locations in addition to airports, such as courthouses, office buildings, mailrooms, schools, prisons, high-profile locations such as Buckingham Palace, the Kremlin and the Vatican and for high-profile events such as the Olympic Games and the Goodwill Games. Furthermore, as terrorist attacks such as the March 2004 bombings of passenger trains at Atocha railway station in Madrid and the July 2005 bombings of the London underground and commuter bus systems continue to occur, overall transportation and travel industry demands have increased, resulting in heightened attention for our security and inspection products. In addition, our security and inspection products are increasingly being used for non-security purposes, such as for cargo inspection to detect narcotics and contraband and to verify manifests, prevention of pilferage at semiconductor manufacturing facilities, quality assurance and the detection of gold and currency.

Our customers include, among many others, the U.S. Transportation Security Administration, U.S. Customs and Border Protection, U.S. Department of Defense and Federal Bureau of Prisons, in the United States, as well as Heathrow and Gatwick Airports in the United Kingdom, Chek Lap Kok Airport in Hong Kong, Ben Gurion International Airport in Israel and the Malaysian Airport Board in Malaysia.

Patient Monitoring, Diagnostic Cardiology and Anesthesia Systems. Our patient monitoring, diagnostic cardiology and anesthesia systems are manufactured and distributed globally for use in critical care, emergency and perioperative areas within hospitals as well as physicians offices, medical clinics and ambulatory surgery centers. We also provide wired and wireless networks and clinical information access solutions, ambulatory blood pressure monitors and medical data services.

We have sold these products to organizations such as Albany Medical Center in Albany, Children s Hospitals and Clinics of Minnesota, New York and Tulane University Hospital and Clinic in New Orleans, Louisiana, Schüchtermannklinik in Germany, LKW Villach in Austria and Universitätsspital Zürich in Switzerland, among many other organizations, including Premier, Inc., a hospital and healthcare system alliance with approximately 1,500 affiliated hospitals and other healthcare sites.

Optoelectronic Devices and Electronics Manufacturing Services. Our optoelectronic devices and value-added subsystems are used in a broad range of products by a variety of customers. For example, they are utilized by customers in the following market segments: aerospace and avionics; analytical and medical imaging; fiber optics and telecommunications; gaming; homeland security; healthcare; military and weapons simulation; office automation; and toll and traffic management. Major customers in these segments include: Honeywell, Raytheon, Phillips Medical, JDS Uniphase, Bally Gaming, Gilardoni, Heidenhain, Smiths Medical, Somanetics, Lockheed Martin, Xerox and Florida Department of Transportation, among others.

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Marketing, Sales and Service

We market and sell our security and inspection products worldwide through a direct sales and marketing staff of approximately 70 employees located in North America, Europe, Asia and Australia, in addition to an expansive global network of independent and specialized sales representatives. This sales staff is supported by a service organization located primarily in North America, Europe and Asia, as well as a global network of independent distributors. We also support these sales and customer relations efforts by providing operator training, computerized training and testing equipment, in-country service support, software upgrades and service training for customer technicians.

We market and sell our patient monitoring, diagnostic cardiology and anesthesia systems worldwide through a direct sales and marketing staff of approximately 260 sales personnel and 260 service personnel located in North America, Europe and Asia, in addition to a global network of independent distributors. We also support these sales and customer service efforts by providing operator in-service training, software updates and upgrades and service training for customer biomedical staff and distributors.

We market and sell our optoelectronic devices and value-added manufacturing services, through both a direct sales and marketing staff of approximately 40 employees located in North America, Europe and Asia, and indirectly through a global network of independent sales representatives and distributors. We also maintain a worldwide network of independent sales representatives and distributors. Our sales staff is supported by an applications engineering group whose members are available to provide technical support, which includes designing applications, providing custom tooling and process integration and developing products that meet customer defined specifications.

We consider our maintenance service operations to be an important element of our business. After the expiration of our standard product warranty periods, we are sometimes engaged by our customers to provide maintenance services for our security and inspection products through annual maintenance contracts. We provide a variety of service and support options for our patient monitoring, diagnostic cardiology and anesthesia systems customers, ranging from complete on-site repair and maintenance service and telephone support to parts exchange programs for customers with the internal expertise to perform a portion of their own service needs. We believe that our international maintenance service capabilities allow us to be competitive in selling our security and inspection systems as well as our patient monitoring, diagnostic cardiology and anesthesia systems. Furthermore, we believe that as the installed base of both our security and inspection systems and patient monitoring, diagnostic cardiology and anesthesia systems increases, revenues generated from such annual maintenance service contracts and from the sale of replacement parts will increase.

Research and Development

Our security and inspection systems are primarily designed at our facilities in the United States and internationally in Finland, Malaysia, India and the United Kingdom. These products include mechanical, electrical, analog electronic, digital electronic and software subsystems, which are all designed by us. In addition to product design, we provide system integration services to integrate our products into turnkey systems at the customer site. We support cooperative research projects with government agencies and, on occasion, provide contract research for our customers and government agencies.

Our patient monitoring, diagnostic cardiology and anesthesia systems are primarily designed at our facilities in the United States and internationally in Malaysia and the United Kingdom. Such systems include mechanical, electrical, digital electronic and software subsystems, all of which are designed by us. We are also currently involved, both in the United States and internationally, in several research projects aimed at improving our medical systems and at expanding our current product line.

Our optoelectronic devices and value-added subsystems are primarily designed and engineered at our facilities in the United States and internationally in India, Malaysia, Norway and Singapore. We engineer and

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manufacture subsystems to solve the specific application needs of our original equipment manufacturer customers. In addition, we offer entire subsystem design and manufacturing solutions. We consider our engineering personnel to be an important extension of our core sales and marketing efforts.

In addition to close collaboration with our customers in the design and development of our current products, we maintain an active program for the development and introduction of new products, enhancements and improvements to our existing products, including the implementation of new applications of our technology. We seek to further enhance our research and development program and consider such program to be an important element of our business and operations. As of June 30, 2007, we engaged approximately 490 full-time engineers, technicians and support staff. Our research and development expenses were $30.6 million in fiscal 2005, $35.9 million in fiscal 2006 and $44.4 million in fiscal 2007. We intend to continue to invest in our research and development efforts in the future.

Manufacturing and Materials

We currently manufacture our security and inspection systems in the United States, and internationally in India, Finland, Malaysia and the United Kingdom. We currently manufacture our patient monitoring, diagnostic cardiology and anesthesia systems in California and Washington, and internationally in India, Malaysia, Singapore and the United Kingdom. We currently manufacture our optoelectronic devices and value-added subsystems in the United States and internationally in India, Indonesia, Malaysia and Norway. Most of our high volume, labor intensive manufacturing and assembly is performed at our facilities in Indonesia and Malaysia. Since most of our customers currently are located in the United States, Europe and Asia, our ability to assemble products in these markets and provide follow-on service from offices located in these regions is an important component of our global strategy.

Our global manufacturing organization has expertise in optoelectronic, microelectronic and integrated value-added assemblies for commercial, medical, aerospace and defense industry applications. Our manufacturing includes silicon wafer processing and fabrication, optoelectronic device assembly and screening, thin and thick film microelectronic hybrid assemblies, surface mounted and thru-hole printed circuit board electronic assemblies and value-added services, including complete turn-key and box-build manufacturing. We outsource certain manufacturing operations, including certain sheet metal fabrication and plastic components. The manufacturing process for components and subsystems consists of manual tasks performed by skilled technicians as well as automated tasks.

The principal raw materials and subcomponents used in producing our security and inspection systems consist primarily of x-ray generators, linear accelerators, detectors, data acquisition and computing devices, conveyor systems and video monitors. A large portion of the optoelectronic devices, subsystems and circuit card assemblies used in our inspection and detection systems are manufactured in-house. The x-ray generators and certain metal enclosures used in our baggage and parcel inspection systems are also manufactured in-house, while the x-ray generators and linear accelerators used in our cargo and vehicle inspection systems are purchased from unaffiliated third party providers. We purchase the x-ray tubes, computer hardware and certain standard mechanical parts and some of our metal enclosures from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our patient monitoring, diagnostic cardiology and anesthesia systems consist of printed circuit boards, housings, mechanical assemblies, pneumatic devices, cables, filters and packaging materials. We purchase certain devices, including computers, peripheral accessories and remote displays from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our optoelectronic devices and value-added subsystems consist of silicon wafers, electronic components, light emitting diodes, scintillation crystals,

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passive optical components, printed circuit boards, and packaging materials. The silicon-based optoelectronic devices manufactured by us are critical components in most of our products and subsystems. We purchase silicon wafers and other electronic components from unaffiliated third party providers.

For cost, quality control and efficiency reasons, we generally purchase raw materials and subcomponents only from single vendors with whom we have ongoing relationships. We do, however, qualify second sources for most of our raw materials and critical components, or have identified alternate sources of supply. We purchase the materials pursuant to purchase orders placed from time to time in the ordinary course of business. Although to date none of our divisions has experienced any significant shortages or material delays in obtaining any of its raw materials or subcomponents, it is possible that they may face such shortages or delays in one or more materials in the future.

Patents, Trademarks, Tradenames and Licenses

Trademarks and Tradenames. We have used, registered and applied to register certain trademarks and service marks to distinguish our products, technologies and services from those of our competitors in the United States and in foreign countries. We enforce our trademark, service mark and trade name rights in the United States and abroad.

Patents. We hold a number of U.S. and foreign patents relating to various aspects of our security and inspection products, patient monitoring, diagnostic cardiology and anesthesia systems and optoelectronic devices and subsystems. Our current patents will expire at various times between 2007 and 2025. However, it remains possible that pending patent applications or other applications that may be filed may not result in issued patents. In addition, issued patents may not survive challenges to their validity. Although we believe that our patents have value, our patents, or any additional patents that may be issued in the future, may not be able to provide meaningful protection from competition.

Licenses. Our Security, Healthcare and Optoelectronics and Manufacturing divisions have each entered into a variety of license arrangements under which they are permitted to manufacture, market, sell and/or service various types of software, data, equipment, components and enhancements to our own proprietary technology.

We believe that our trademarks and tradenames, patents and licenses are important to our business. The loss of some of our trademarks, patents or licenses might have a negative impact on our financial results and operations. However, we operate in a competitive environment with a known customer base and rely mainly on providing our customers with quality products and services to ensure continuing business. Thus, with the exception of the loss of either the Spacelabs® or Rapiscan® trademarks, the impact of the loss of any single trademark, patent or license would not likely have a material adverse effect on our business. We consider the Spacelabs® trademark an important asset and have registered it in approximately forty countries. In addition, following the re-branding of our Security division under the Rapiscan Systems name, we have instituted a similar registration program for the Rapiscan® trademark.

Regulation of Medical Products

The patient monitoring, diagnostic cardiology and anesthesia systems we manufacture and market are subject to regulation by numerous federal government agencies, principally the U.S. Food and Drug Administration (FDA) and by certain state and foreign authorities. They are also subject to various U.S. and foreign electrical safety standards.

The FDA has broad regulatory powers with respect to pre-clinical and clinical testing of new medical products and the manufacturing, marketing and advertising of medical products. It requires that all medical devices introduced into the market be preceded either by a pre-market notification clearance order under section 510(k) of the Food, Drug and Cosmetic Act, or an approved pre-market approval application. A 510(k) pre-market notification clearance order indicates that the FDA agrees with an applicant s determination that the

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product for which clearance has been sought is substantially equivalent to another legally marketed medical device. The clearance of a pre-market approval application, on the other hand, indicates that the FDA has determined that the device has been proven, through the submission of clinical trial data and manufacturing quality assurance information, to be safe and effective for its labeled indications. The process of obtaining 510(k) clearance typically takes between three and six months, but can take substantially longer. The pre-market approval application review process, on the other hand, can last more than a year. To date, all of the patient monitoring, diagnostic cardiology and anesthesia systems we manufacture and sell in the United States have required only 510(k) pre-market notification clearance.

Such regulatory approvals, when granted, may entail limitations on the indicated uses for which a product may be marketed, and such product approvals, once granted, may be withdrawn if problems occur after initial marketing. Manufacturers of FDA-regulated products are subject to pervasive and continuing governmental regulation, including extensive recordkeeping requirements and reporting of adverse experiences associated with product manufacture and use. Compliance with these requirements is costly, and failure to comply can result in, among other things, fines, total or partial suspension of production, product recalls, failure of the FDA to review pending marketing clearances or approval applications, withdrawal of marketing clearances or approvals or even criminal prosecution.

We are also subject to regulation in the foreign countries in which we manufacture and market our patient monitoring, diagnostic cardiology and anesthesia systems. For example, the commercialization of medical devices in the European Union is regulated under a system that presently requires all medical devices sold in the European Union to bear the CE mark an international symbol of adherence to quality assurance standards. Our manufacturing facilities in Hawthorne, California; Issaquah, Washington; and in Chesham and Hertford in the United Kingdom are all certified to the International Organization for Standardization s ISO 13485 standard for medical device companies. They are also certified to the requirements of the European Medical Device Directive 93/42 EEC, which allows them to self-certify that newly manufactured products can bear the CE mark.

We believe we are in material compliance with all applicable federal, state and foreign regulations regarding the manufacture and sale of our patient monitoring, diagnostic cardiology and anesthesia delivery systems. Such regulations and their enforcement do, however, constantly change, and we cannot predict what effect, if any, such changes may have on our businesses in the future.

Environmental Regulations

We are subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances that have been released on or in our facilities or that have been disposed of off-site as waste. Such laws may impose liability without regard to whether we knew of, or caused, the release of such hazardous substances. We have conducted Phase I environmental site assessments for each of our properties in the United States at which we manufacture products. The purpose of each such report is to identify, as of the date of such report, potential areas of environmental concern related to past and present activities or from nearby operations. In certain cases, we have conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants. We believe that we are currently in compliance with all material environmental regulations in connection with our manufacturing operations, and that we have obtained all material environmental permits necessary to conduct our business. The amount of hazardous substances and wastes produced and generated by us may increase in the future depending on changes in our operations. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing process or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

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During one such investigation, we discovered soil and groundwater contamination at our Hawthorne, California facility. We filed the requisite reports concerning this problem with the appropriate environmental authorities in fiscal 2001. We have not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. We also have notified the prior owners of the facility and the present owners and tenants of adjacent properties concerning the problem and have requested from such parties agreements to toll of the statute of limitations with respect to actions against such parties with respect to the contamination in order that we may focus our attention on resolution of the contamination problem. Our site was previously used by other companies for semiconductor manufacturing similar to that presently conducted on the site by us, and it is not presently known who is responsible for the contamination or, if required, the remediation. The groundwater contamination is a known regional problem, not limited to our premises or our immediate surroundings.

We have also been informed of soil and groundwater evaluation efforts at a facility that our Ferson Technologies subsidiary previously leased in Ocean Springs, Mississippi. Ferson Technologies occupied the facility between 1993 and 2003. We believe that the owner and previous occupants of the facility have primary responsibility for any remediation that may be required and have an agreement with the facility s owner under which the owner is responsible for remediation of pre-existing conditions. However, as site evaluation efforts are still in progress, and may be for some time, we are unable at this time to ascertain whether Ferson Technologies bears any exposure for remediation costs under applicable environmental regulations.

Competition

The markets in which we operate are highly competitive and characterized by evolving customer needs and rapid technological change. We compete with a number of other manufacturers, some of which have significantly greater financial, technical and marketing resources than we have. In addition, these competitors may have the ability to respond more quickly to new or emerging technologies, adapt more quickly to changes in customer requirements, have stronger customer relationships, have greater name recognition and may devote greater resources to the development, promotion and sale of their products than we do. As a result, we may not be able to compete successfully against designers and manufacturers of specialized electronic systems and components, broadly speaking, or more specifically within the markets for security and inspection systems, patient monitoring, diagnostic cardiology and anesthesia systems, or optoelectronic devices. Future competitive pressures may materially and adversely affect our business, financial conditions and results of operations.

In the security and inspection market, competition is based primarily on such factors as product performance, functionality and quality, the overall cost effectiveness of the system, prior customer relationships, technological capabilities of the products, price, local market presence and breadth of sales and service organization. We believe that our principal competitors in the market for security and inspection products are the Security and Detection Systems division of L-3 Communications Corporation, the Smiths Detection division of Smiths Group plc, American Science and Engineering, Inc., GE Infrastructure, Security, a division of the General Electric Company, Science Applications International Corporation, Control Screening L.L.C., CEIA SpA, Garrett Electronics, Inc. and Nuctech Company Limited. Competition could result in price reductions, reduced margins and loss of market share. In the airline and airport security and inspection market, particularly in the upgrade and replacement market, we also compete for potential customers based on existing relationships between our competitors and the customers. Certain of our competitors have established strong relationships with airlines, airports and other transportation security authorities. Although we also have established relationships with a number of airport and airline customers, we may not be able to compete successfully in the future with existing competitors or new entrants. In the cargo and vehicle inspection systems market, we compete for potential customers based on price, performance and the ability to design both standard and customized products. Several of our competitors have operated in this area for longer than we have. However, due to our recent successes in designing and delivering high-energy x-ray and gamma-ray systems, we believe that we have demonstrated an ability to compete effectively. Additionally, although our competitors in the cargo and vehicle inspection market each offer products in competition with one or more of our products, our ability to supply

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high-energy x-ray, gamma-ray and thermal neutron analysis systems means that we offer among the widest array of solutions available from a single supplier. This variety of technologies also permits us to offer unique hybrid systems to our customers that utilize two or more of these technologies, thereby optimizing flexibility, performance and cost to meet the customer s unique application requirements.

In the patient monitoring, diagnostic cardiology and anesthesia systems delivery market, competition is also based on a variety of factors including product performance, functionality, value and breadth of sales and service organization. We believe that our principal competitors in the market for patient monitoring, diagnostic cardiology and anesthesia systems are Cardiac Science Corporation, Criticare Systems, Inc., Mortara Instrument, Philips Medical Systems, GE Healthcare, Dräger Medical, Datascope Corp., Nihon Kohden Corporation, Mindray Medical International, Penlon Limited, Nellcor, a division of Tyco Healthcare and Schiller. Competition could result in price reductions, reduced margins and loss of our market share. We believe that our patient monitoring products are easier to use than the products of many of our competitors because we offer a consistent user interface throughout many of our product lines. Finally, while some of our competitors are also beginning to introduce portal technology, which allows remote access to data from the bedside monitor, central station or other point of care, we believe that our competing technologies are superior in bringing instant access to labs, radiology and charting at the point of care. Although we have established relationships with a number of large hospitals, we may not be able to successfully compete in the future with existing competitors or with new entrants.

In the optoelectronic devices and subsystems market, competition for optoelectronic devices and value-added subsystems is based primarily on such factors as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support and on the ability to provide fully integrated services from application development and design through production. We believe that our major competitors in the optoelectronic device market are PerkinElmer, Inc. and Hamamatsu Corporation. Because we specialize in custom subsystems requiring a high degree of engineering expertise, we believe that we generally do not compete to any significant degree with any other large United States, European or Asian manufacturers of standard optoelectronic components. Competition in the extensive electronic manufacturing services market ranges from multinational corporations with sales in excess of several billions of dollars, to large regional competitors and to small local assembly companies. In our experience, the original equipment manufacturers to whom we provide such services prefer to engage companies that offer both local and lower-cost off-shore facilities. As a result, our primary domestic competition for these services is located in Southern California and in New England, where our U.S. facilities are also located. Such competition includes CTS, Sigmatron International, Sanmina-SCI, Senior Systems Technology, and Benchmark Electronics, among others. In addition, our high-volume, low-cost contract manufacturing locations in Southeast Asia compete with other manufacturers in the same region.

Backlog

We measure our backlog as orders for which purchase orders or contracts have been signed, but which have not yet been shipped and for which revenues have not yet been recognized.

We ship most of our baggage and parcel inspection, hold (checked) baggage screening, people screening, patient monitoring, diagnostic cardiology and anesthesia systems and optoelectronic devices and value-added subsystems within one to several months after receiving an order. However, such shipments may be delayed for a variety of reasons, including any special design or engineering requirements of the customer. In addition, large orders of security and inspection products (more than ten machines) typically require greater lead-times.

Certain of our cargo and vehicle inspection and hold (checked) baggage screening systems may require several months to several years lead-time. We have experienced some significant shipping delays associated with our cargo and vehicle inspection systems. Such delays can occur for many reasons, including: (i) additional time necessary to conduct inspections at the factory before shipment; (ii) a customer s need to engage in time-

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consuming special site preparation to accommodate the system, over which we have no control or responsibility; (iii) additional fine tuning of such systems once they are installed; (iv) design or specification changes by the customer; and (v) delays originating from other contractors on the project.

As of June 30, 2007, our consolidated backlog totaled approximately $209 million, compared to approximately $147 million as of June 30, 2006 and approximately $95 million at June 30, 2005. Sales orders underlying our backlog are firm orders. However, from time to time, we may agree to permit the cancellation of an order. Variations in the size of orders, product mix, or delivery requirements, among other factors, may result in substantial fluctuations in backlog from period to period. Backlog as of any particular date should not be relied upon as indicative of our revenues for any future period and cannot be considered a meaningful indicator of our performance on an annual or quarterly basis.

Employees

As of June 30, 2007, we employed approximately 3,480 people, of whom 1,840 were employed in manufacturing, 480 were employed in engineering or research and development, 370 were employed in finance and administration, 380 were employed in sales and marketing and 410 were employed in service capacities. Of the total employees, approximately 1,480 were employed in North America and South America, 1,450 were employed in Asia and 550 were employed in Europe. Many of our employees in Europe have statutory collective bargaining rights. We have never experienced a work stoppage or strike, and management believes that its relations with employees are good.

Available Information

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended. Therefore, we file periodic reports, proxy statements and other information with the Securities and Exchange Commission. Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the Securities and Exchange Commission at 100 F Street, N.E., Washington, D.C. 20549 or by calling 1-202-551-8090. In addition, the Securities and Exchange Commission maintains an Internet website (http://www.sec.gov) that contains reports, proxy statements and other information that issuers are required to file electronically.

Our Internet address is: http://www.osi-systems.com. We make available, free-of-charge through our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended and reports filed pursuant to Section 16 of the Securities Exchange Act of 1934, as amended. We do so as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the Securities and Exchange Commission.

ITEM 1A. RISK FACTORS

Fluctuations in our operating results may cause our stock price to decline.

Given the nature of the markets in which we participate, we cannot always reliably predict future revenues and profitability. Changes in competitive, market and economic conditions may cause us to adjust our operations. A high proportion of our costs are fixed, due in part to our significant sales, research and development and manufacturing costs. Thus, small declines in revenue could disproportionately affect our

operating results. Factors that may affect our operating results and the market price of our Common Stock include:

demand for and market acceptance of our products;

competitive pressures resulting in lower selling prices;

adverse changes in the level of economic activity in regions in which we do business;

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low or fluctuating levels of political stability in regions in which we do business;

adverse changes in industries, such as semiconductors and electronics, on which we are particularly dependent;

changes in the portions of our revenue represented by various products and customers;

delays or problems in the introduction of new products;

the announcement or introduction of new products, services or technological innovations by our competitors;

variations in our product mix;

the timing and amount of our expenditures in anticipation of future sales;

exchange rate fluctuations;

increased costs of raw materials or supplies;

changes in the volume or timing of product orders;

timing of completion of acceptance testing of some of our products;

natural disasters; and

changes in general economic factors.

We face aggressive competition in many areas of business. If we do not compete effectively, our business will be harmed.

We encounter aggressive competition from numerous competitors in many areas of our business. In the security and inspection and patient monitoring, diagnostic cardiology and anesthesia systems markets, competition is based primarily on such factors as product performance, functionality and quality, cost, prior customer relationships, technological capabilities of the product, price, certification by government authorities, local market presence and breadth of sales and service organization. In the optoelectronic devices and electronics manufacturing markets competition is based primarily on factors such as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support and on the ability to provide fully-integrated services from application development and design through volume subsystem production. We may not be able to compete effectively with all of our competitors. To remain competitive, we must develop new products and enhance our existing products and services in a timely manner. We anticipate that we may have to adjust prices of many of our products to stay competitive. In addition, new competitors may emerge, and entire product lines or service offerings may be threatened by new technologies or market trends that reduce the value of these product lines or service offerings.

The September 11, 2001 terrorist attacks and the creation of the U.S. Department of Homeland Security have increased financial expectations that may not materialize.

The September 11, 2001 terrorist attacks and the subsequent creation of the U.S. Department of Homeland Security have created increased interest in our security and inspection systems. However, we are not certain whether the level of demand will continue to be as high as it is now. We do not know what solutions will continue to be adopted by the U.S. Department of Homeland Security and whether our products will be a part of those solutions. Additionally, should our products be considered as a part of the future security solutions, it is unclear what the level may be and how quickly funding to purchase our products may be made available. These factors may adversely impact us and create unpredictability in revenues and operating results.

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If operators of our security and inspection systems fail to detect weapons, explosives or other devices that are used to commit a terrorist act, we could be exposed to product liability and related claims for which we may not have adequate insurance coverage.

Our business exposes us to potential product liability risks that are inherent in the development, manufacturing, sale and service of security inspection systems as well as in the provision training of our customers in the use and operation of such systems. Our customers use our security and inspection systems to help them detect items that could be used in performing terrorist acts or other crimes. Some of our security and inspection systems require that an operator interpret an image of suspicious items within a bag, parcel, container or other vessel. Others signal to the operator that further investigation is required. In either case, the training, reliability and competence of the customer s operator are crucial to the detection of suspicious items.

Security inspection systems that signal to the operator that further investigation is required are sometimes referred to in the security industry as automatic detection systems. Such systems utilize software algorithms to interpret data produced by the system and to signal to the operator when a dangerous object may be present. Such algorithms are probabilistic in nature and are also subject to significant technical limitations. Nevertheless, if such a system were to fail to signal to an operator when an explosive or other contraband was in fact present, resulting in significant damage, we could become the subject of significant product liability claims.

Furthermore, security inspection by technological means is always circumstance and application-specific. In addition, our security and inspection systems are not designed to work under all circumstances. We test the reliability of our security and inspection systems during both their development and manufacturing phases. We also perform such tests if we are requested to perform installation, warranty or post-warranty servicing. However, our security inspection systems are advanced mechanical and electronic devices and therefore can malfunction. In addition, there are also many other factors beyond our control that could lead to liability claims should an act of terrorism occur. The September 11, 2001 and 1993 World Trade Center bombing attacks, and the potential for future attacks, have caused commercial insurance for such threats to become extremely difficult to obtain. It is very likely that, should we be found liable following a major act of terrorism, the insurance we currently have in place would not fully cover the claims for damages.

Our patient monitoring, diagnostic cardiology and anesthesia systems could give rise to product liability claims that could materially and adversely affect our financial condition and results of operations.

The development, manufacturing and sale of medical devices expose us to significant risk of product liability claims and, sometimes, product failure claims. We face an inherent business risk of financial exposure to product liability claims if the use of our medical devices results in personal injury or death. Substantial product liability litigation currently exists within the medical device industry. Some of our patient monitoring, diagnostic cardiology and anesthesia systems businesses have, in the past, been subject to product liability claims and/or product recalls. To date, no such claim or recall has had a significant impact on our operations. Future product liability claims may exceed the limits of our insurance coverages or such insurance may not continue to be available to us on commercially reasonable terms, or at all. Consequently, a product liability claim or other claim with respect to uninsured liabilities, or in excess of insured liabilities, could have a material adverse effect on our business, financial condition, operating results and cash flows.

Our revenues are dependent on orders of security and inspection systems and patient monitoring, diagnostic cardiology and anesthesia systems, which may have lengthy and unpredictable sales cycles.

Sales of security and inspection systems often depend upon the decision of governmental agencies to upgrade or expand existing airports, border crossing inspection sites, seaport inspection sites and other security installations. Sales outside of the United States of our patient monitoring,

diagnostic cardiology and anesthesia systems depend in significant part on the decision of governmental agencies to build new medical facilities or to expand or update existing medical facilities. Accordingly, a significant portion of our sales of security and inspection systems and our patient monitoring, diagnostic cardiology and anesthesia systems is often subject to

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delays associated with the lengthy approval processes that typically accompany such capital expenditures. During these approval periods, we expend significant financial and management resources in anticipation of future orders that may not occur. If we fail to receive an order after expending such resources, such failure could have a material adverse effect on our business, financial condition and results of operations.

If we do not introduce new products in a timely manner, our products could become obsolete and our operating results would suffer.

We sell many of our products in industries characterized by rapid technological changes, frequent new product and service introductions and evolving industry standards and customer needs. Without the timely introduction of new products and enhancements, our products could become technologically obsolete over time, in which case our revenue and operating results would suffer. The success of our new product offerings will depend upon several factors, including our ability to:

- accurately anticipate customer needs;
- innovate and develop new technologies and applications;
- successfully commercialize new technologies in a timely manner;
- price our products competitively and manufacture and deliver our products in sufficient volumes and on time; and
- differentiate our offerings from our competitors offerings.

Some of our products are used by our customers to develop, test and manufacture their products. We therefore must anticipate industry trends and develop products in advance of the commercialization of our customers products. In developing any new product, we may be required to make a substantial investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

Interruptions in our ability to purchase raw materials and components may adversely affect our profitability.

We purchase certain raw materials and subcomponents from third parties pursuant to purchase orders placed from time to time. Purchase order terms range from three months to one year at fixed costs, but we do not have guaranteed long-term supply arrangements with our suppliers. Any material interruption in our ability to purchase necessary raw materials or subcomponents could have a material adverse effect on our business, financial condition and results of operations.

We may not be able to successfully implement our acquisitions strategy, integrate acquired businesses into our existing business or make acquired businesses profitable.

One of our strategies is to supplement our internal growth by acquiring businesses and technologies that complement or augment our existing product lines. This growth has placed, and may continue to place, significant demands on our management, working capital and financial resources. We may be unable to identify or complete promising acquisitions for many reasons, including:

- competition among buyers;
- the need for regulatory approvals, including antitrust approvals; and
- the high valuations of businesses.

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Some of the businesses we may seek to acquire may be marginally profitable or unprofitable. For these acquired businesses to achieve acceptable levels of profitability, we must improve their management, operations, products and market penetration. We may not be successful in this regard and may encounter other difficulties in integrating acquired businesses into our existing operations.

To finance our acquisitions, we may have to raise additional funds, through either public or private financings. We may be unable to obtain such funds or may be able to do so only on unfavorable terms.

Our acquisition and alliance activities could disrupt our ongoing business.

We intend to continue to make investments in companies, products and technologies, either through acquisitions, investments or alliances. Acquisition and alliance activities often involve risks, including: (i) difficulty in assimilating the acquired operations and employees; (ii) difficulty in managing product co-development activities with our alliance partners; (iii) difficulty in retaining the key employees of the acquired operation; (iv) disruption of our ongoing business; (v) inability to successfully integrate the acquired technologies and operations into our businesses and maintain uniform standards, controls, policies and procedures; and (vi) lacking the experience necessary to enter into new product or technology markets successfully. In addition, from time to time, our competitors acquire or enter into exclusive arrangements with companies with whom we do business or may do business in the future. Reductions in the number of partners with whom we may do business in a particular context may reduce our ability to enter into critical alliances on attractive terms or at all, and the termination of an existing alliance by a business partner may disrupt our operations.

Economic, political and other risks associated with international sales and operations could adversely affect our sales.

In fiscal 2005, revenues from shipments made outside of the United States accounted for approximately 40% of our revenues, 42% in fiscal 2006 and 47% in fiscal 2007. Of the revenues generated during fiscal 2007 from shipments made to customers outside of the United States, 20% represented sales made by subsidiaries based in United States to foreign customers, and the balance represented sales generated by foreign subsidiaries. Since we sell certain of our products worldwide, our businesses are subject to risks associated with doing business internationally. We anticipate that revenues from international operations will continue to represent a substantial portion of our total revenue. In addition, many of our manufacturing facilities, and therefore employees, suppliers, real property, capital equipment, cash and other assets are located outside the United States. Accordingly, our future results could be harmed by a variety of factors, including:

- changes in foreign currency exchange rates;
- changes in a country s or region s political or economic conditions, particularly in developing or emerging markets;
- longer payment cycles of foreign customers and difficulty of collecting receivables in foreign jurisdictions;
- trade protection measures and import or export licensing requirements;
- differing legal and court systems;

differing tax laws and changes in those laws;

difficulty in staffing and managing widespread operations;

differing labor laws and changes in those laws;

differing protection of intellectual property and changes in that protection; and

differing regulatory requirements and changes in those requirements.

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Others may allege that our products infringe on their intellectual property rights, and resulting claims against us could be costly and prevent us from making or selling certain products.

Third parties may seek to claim that our products and operations infringe their patent or other intellectual property rights. In addition, we may find it necessary to initiate litigation in order to protect our patent or other intellectual property rights. Under either circumstance, we may incur significant expenses. In addition, claims of third parties against us could result in awards of substantial damages or court orders that could effectively prevent us from making, using or selling our products in the United States or abroad.

Our competitors may seek to challenge the intellectual property rights on which some of our new and more promising products are based.

As we introduce any new and potentially promising product, companies possessing competing technologies may be motivated to assert infringement claims in order to delay or diminish potential sales and challenge our right to market such product. Lengthy and costly litigation may be necessary in order to defend against these claims.

Our ongoing success is dependent upon the continued availability of certain key employees.

We are dependent in our operations on the continued availability of the services of our employees, many of whom are individually key to our current and future success, and the availability of new employees to implement our growth plans. In particular, we are dependent upon the services of Deepak Chopra, our Chairman of the Board of Directors, President and Chief Executive Officer. We entered into a 5-year employment agreement with Mr. Chopra, which expires July 18, 2010 and we maintain a $13.0 million policy of key man life insurance on the life of Mr. Chopra. The market for skilled employees is highly competitive, especially for employees in technical fields. While our compensation programs are intended to attract and retain the employees required for it to be successful, ultimately, we may not be able to retain the services of all of our key employees or a sufficient number to execute on our plans. In addition, we may not be able to continue to attract new employees as required.

Substantial government regulation in the United States and abroad may restrict our ability to sell our patient monitoring, diagnostic cardiology and anesthesia systems.

The FDA and comparable regulatory authorities in foreign countries extensively and rigorously regulate our patient monitoring, diagnostic cardiology and anesthesia systems, including related development activities and manufacturing processes. In the United States, the FDA regulates the introduction of medical devices as well as the manufacturing, labeling and record-keeping procedures for such products. We are required to:

- obtain clearance before we can market and sell medical devices;
- satisfy content requirements applicable to our labeling, sales and promotional materials;

comply with manufacturing and reporting requirements; and

undergo rigorous inspections.

Our future products may not obtain FDA clearance on a timely basis, or at all. Our patient monitoring, diagnostic cardiology and anesthesia systems must also comply with the laws and regulations of foreign countries in which we develop, manufacture and market such products. In general, the extent and complexity of medical device regulation is increasing worldwide. This trend is likely to continue and the cost and time required to obtain marketing clearance in any given country may increase as a result. Our products may not obtain any necessary foreign clearances on a timely basis, or at all.

Once any of our patient monitoring, diagnostic cardiology and anesthesia systems is cleared for sale, regulatory authorities may still limit the use of such product, prevent its sale or manufacture or require a recall or

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withdrawal of such product from the marketplace. Following initial clearance from regulatory authorities, we continue to be subject to extensive regulatory requirements. Government authorities can withdraw marketing clearance due to our failure to comply with regulatory standards or due to the occurrence of unforeseen problems following initial clearance. Ongoing regulatory requirements are wide-ranging and govern, among other things:

- annual inspections to retain a CE mark for sale of products in the European Union;
- product manufacturing;
- supplier substitution;
- product changes;
- process modifications;
- medical device reporting; and
- product sales and distribution.

Our failure to comply with environmental regulations may create significant environmental liabilities and force us to modify our manufacturing processes.

We are subject to various foreign and U.S. federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances or wastes that have been or are being disposed of offsite as wastes or that have been or are being released on or in our facilities. Such laws may impose liability without regard to whether we knew of, or caused, the release of such hazardous substances or wastes. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing processes, or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

We may be exposed to potential risks relating to our internal controls over financial reporting and our ability to have our independent registered public accounting firm attest to these controls.

As directed by the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission adopted rules requiring public companies to include in their annual reports an assessment of the effectiveness of the company s internal controls over financial reporting. In addition, the independent registered public accounting firm auditing a public company s financial statements must attest to and report on management s assessment of the effectiveness of the company s internal controls over financial reporting, as well as the operating effectiveness of the company s internal controls over financial reporting. We evaluate our internal controls over financial reporting in order to allow our management to report on, and our independent registered public accounting firm to attest to, our internal controls.

We expect to continue to expend significant resources in complying with the documentation and testing procedures required by the Sarbanes-Oxley Act of 2002. However, there will remain an ongoing risk that we will not comply with all of its requirements.

If our independent registered public accounting firm differs from us in its interpretation of the requirements imposed on us by the Sarbanes-Oxley Act of 2002, or if it is not satisfied with our internal controls over financial reporting or with the level at which such controls are documented, operated or reviewed, we may be delayed in filing reports with the Securities and Exchange Commission, our independent registered public accounting firm may decline to attest to our management s assessment or it may issue a qualified report. In addition, if our independent registered public accounting firm is unable to rely on our internal controls over financial reporting in connection with its audit of our financial statements and if it is unable to devise alternative procedures in order to satisfy itself as to the material accuracy of our financial statements and related disclosures, it is possible that we could receive a qualified or adverse audit opinion in connection with those financial statements.

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Accordingly, we may not receive a favorable report from our independent registered public accounting firm regarding our internal controls over financial reporting and the operating effectiveness of our internal controls over financial reporting. If we identify material weaknesses in our internal controls over financial reporting that we cannot remediate in a timely manner or if we receive an adverse report from our independent registered public accounting firm with respect to our internal controls over financial reporting, investors and others may lose confidence in the reliability of our financial statements and the market for our Common Stock could be adversely affected.

Our operations are subject to certain risks and uncertainties associated with the listing in the United Kingdom of common stock of Spacelabs Healthcare.

Since October 2005, a minority interest in Spacelabs Healthcare, a holding company composed of the business operations of our Healthcare division, has been listed on the AIM of the London Stock Exchange (Ticker: SLAB). The value of these shares, and consequently the value of the shares in Spacelabs Healthcare that we retained following the placing, is subject to stock price fluctuations as well as fluctuations in the British pound, the currency in which the shares trade. A downturn in the performance of equity markets in the United Kingdom generally, or on the AIM specifically, could depress the value of the Spacelabs Healthcare shares that we own.

We receive significant amounts of research and development funding for our security and inspection systems from government grants and contracts, but we may not continue to receive comparable levels of funding in the future.

The U.S. government currently plays an important role in funding the development of certain of our security and inspection systems and sponsoring their deployment at airports, ports and border crossings. However, in the future, additional research and development funds from the government may not be available to us. If the government fails to continue to sponsor our technologies we may have to expend more resources on product development or cease development of certain technologies, which could adversely affect our business. In addition, any future grants to our competitors may improve their ability to develop and market competing products and cause our customers to delay purchase decisions, which could harm our ability to market our products.

Our Articles of Incorporation and other agreements contain provisions that could discourage a takeover.

Our Articles of Incorporation authorize our Board of Directors to issue up to 10,000,000 shares of Preferred Stock in one or more series, to fix the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued shares of Preferred Stock, to fix the number of shares constituting any such series and to fix the designation of any such series, without further vote or action by shareholders. The terms of any series of Preferred Stock, which may include priority claims to assets and dividends and special voting rights, could adversely affect the rights of the holders of our Common Stock and thereby reduce the value of our Common Stock. We have no present plans to issue shares of Preferred Stock. The issuance of Preferred Stock, coupled with the concentration of ownership in the directors and executive officers, could discourage certain types of transactions involving an actual or potential change in control of our company, including transactions in which the holders of Common Stock might otherwise receive a premium for their shares over then current prices, otherwise dilute the rights of holders of Common Stock and may limit the ability of such shareholders to cause or approve transactions which they may deem to be in their best interests, all of which could have a material adverse effect on the market price of our Common Stock. We have in place a stockholder rights plan, adopted in 2000, under which our shareholders are entitled to purchase shares of Preferred Stock under certain circumstances. The stockholder rights plan may have the effect of impeding or preventing certain types of transactions involving a change in control of our company that could be beneficial to the shareholders.

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Our Articles of Incorporation limit the liability of our directors, which may limit the remedies we or our shareholders have available.

Our Articles of Incorporation provide that, pursuant to the California Corporations Code, the liability of our directors for monetary damages shall be eliminated to the fullest extent permissible under California law. This is intended to eliminate the personal liability of a director for monetary damages in an action brought by us, or in our right for breach of a director s duties to us or our shareholders and may limit the remedies available to us or our shareholders. This provision does not eliminate the directors fiduciary duty and does not apply to liabilities for: (i) acts or omissions that involve intentional misconduct or a knowing and culpable violation of law; (ii) acts or omissions that a director believes to be contrary to the best interests of our company or our shareholders or that involve the absence of good faith on the part of the director; (iii) any transaction from which a director derived an improper personal benefit; (iv) acts or omissions that show a reckless disregard for the director s duty to the our company or our shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director s duties, of a risk of serious injury to our company or our shareholders; (v) acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director s duty to our company or our shareholders; (vi) certain transactions or the approval of transactions in which a director has a material financial interest; and (vii) expressly imposed by statute for approval of certain improper distributions to shareholders or certain loans or guarantees.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of June 30, 2007, we owned five facilities. Three are located in Hawthorne, California (combined, approximately 88,000 square feet) and are primarily used by our Optoelectronics and Manufacturing division for administrative, manufacturing, engineering, sales and marketing functions. They also constitute our corporate headquarters. We also own one building in Salfords, England (approximately 59,000 square feet), which is used by our Security and Healthcare divisions for manufacturing, engineering, sales and marketing functions. Additionally we own a facility in Ocean Springs, Mississippi (approximately 19,000 square feet), which is used by our Security and Optoelectronics and Manufacturing divisions for manufacturing, engineering, sales and marketing functions.

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As of June 30, 2007, we leased all of our other facilities. The following table lists our principal physical properties (*i.e.*, facilities greater than 50,000 square feet):

Location	Description of Facility	Approximate Square Footage	Expiration
Camarillo, California	Manufacturing, engineering, sales and marketing and service for our Optoelectronics and Manufacturing division	60,000	2010
Torrance, California	Manufacturing, engineering, sales and marketing and service for our Security division	91,900	2012
North Andover, Massachusetts	Manufacturing, engineering, sales and marketing and service for our Optoelectronics and Manufacturing division	71,717	2010
Issaquah, Washington (1)	Manufacturing, engineering, sales and marketing and service for our Healthcare division	202,600	2014
Hyderabad, India (2)	Manufacturing and engineering for our Security, Healthcare and Optoelectronics and Manufacturing divisions	52,100	2009
Johor Bahru, Malaysia (3)	Manufacturing, engineering sales and service for our Security and Optoelectronics and Manufacturing divisions	93,000	2007

(1) The lease of the 202,600 square foot facility in Issaquah, Washington is composed of two leases in the same facility. One is a 107,000 square foot facility lease and the other is a 95,600 square foot facility lease. Both leases expire in December 2014.

(2) The lease of the 52,100 square foot facility in Hyderabad, India is composed of four leases in the same or in nearby facilities: (i) a 19,800 square foot facility lease that expires in 2009; (ii) a 19,600 square foot facility lease that expires in 2009; (iii) a 6,400 square foot facility lease that expires in 2009; (iv) and a 6,300 square foot facility that expires in 2009.

(3) The lease of the 93,000 square foot facility in Johor Bahru, Malaysia is composed of two leases in nearby facilities: (i) a 76,000 square foot facility lease that expires in December 2007 and (ii) a 17,000 square foot facility lease that expires in January 2008. We expect that both the 76,000 square foot facility and 17,000 square foot facility leases will be renewed on similar terms.

We believe that our facilities are in good condition and are adequate to support our operations for the foreseeable future. We currently anticipate that we will be able to renew the leases that are scheduled to expire in the next few years on terms that are substantially the same as those currently in effect. However, even if we were not able to renew one or more of the leases, we believe that suitable substitute space is available to relocate any of the facilities. Accordingly, we do not believe that our failure to renew any of the leases that are scheduled to expire in the next few years will have a material adverse effect on our operations.

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ITEM 3. LEGAL PROCEEDINGS

In November 2002, L-3 Communications Corporation brought suit against us in the District Court for the Southern District of New York seeking a declaratory judgment that L-3 Communications Corporation had not breached its obligations to us concerning the acquisition of PerkinElmer s Security Detection Systems Business. We asserted counterclaims against L-3 Communications Corporation for, among other things, fraud and breach of fiduciary duty. On May 24, 2006, the jury in the case returned a verdict in our favor and awarded us $125 million in damages. The jury found that L-3 Communications Corporation had breached its fiduciary duty to us and had committed fraud. The jury awarded us $33 million in compensatory damages and $92 million in punitive damages. In addition, the jury also found that we had breached a confidentiality agreement and awarded L-3 Communications Corporation nominal damages of one dollar. Final judgment has been entered and the judgment is currently under appeal.

We have previously disclosed a lawsuit, filed in March 2004 in the 285th Judicial District Court in Bexar County, Texas by certain individuals, naming us and our Spacelabs Medical subsidiary, as well as a hospital located in Bexar County, Texas, in a petition, claiming that the individuals suffered injuries in March 2003 caused, in part, by a defective monitoring system manufactured by Spacelabs Medical. We have also previously disclosed a lawsuit, filed in April 2004 in the 21st Judicial District Court, Parish of Tangipahoa, Louisiana by certain individuals, naming our Spacelabs Medical subsidiary, as well as several other defendants, in a petition that alleges, among other things, that a product possibly manufactured by Spacelabs Medical failed to properly monitor a hospital patient thereby contributing to the patient s death in November 2001. We do not presently consider either of these legal proceedings to be material to our business and therefore will no longer disclose information about them in the reports that we file with the Securities and Exchange Commission.

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

In accordance with Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, we have not accrued for loss contingencies relating to the above matters because we believe that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to us, the impact on our results of operations, financial position and/or liquidity could be material.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Stock Market and Other Information

Our Common Stock is traded on The NASDAQ Global Market under the symbol OSIS.

The following table sets forth the high and low sale prices of a share of our Common Stock as reported by The NASDAQ Global Market on a quarterly basis for the fiscal years ended June 30, 2006 and June 30, 2007. The prices shown reflect inter-dealer prices, without retail markup, markdown or commission and may not necessarily represent actual transactions.

2006:	High	Low
Quarter ended September 30, 2005	$ 18.44	$ 14.41
Quarter ended December 31, 2005	$ 19.34	$ 14.60
Quarter ended March 31, 2006	$ 23.34	$ 18.13
Quarter ended June 30, 2006	$ 21.38	$ 16.60

2007:	High	Low
Quarter ended September 30, 2006	$ 19.96	$ 17.01
Quarter ended December 31, 2006	$ 21.74	$ 18.53
Quarter ended March 31, 2007	$ 27.97	$ 20.09
Quarter ended June 30, 2007	$ 29.80	$ 25.56

As of September 10, 2007, there were approximately 91 holders of record of our Common Stock. This number does not include beneficial owners holding shares through nominees or in street name.

Dividend Policy

We have not paid any cash dividends since the consummation of our initial public offering in 1997 and anticipate that we will retain any available funds for use in the operation of our business. We do not currently intend to pay any cash dividends in the foreseeable future. Our Board of Directors will determine the payment of future cash dividends, if any. Certain of our current bank credit facilities restrict the payment of cash dividends and future borrowings may contain similar restrictions.

Issuer Purchases of Equity Securities

In March 1999, our Board of Directors authorized a stock repurchase program for the repurchase of up to 2 million shares of our Common Stock. In September 2004, we increased the number of shares available for repurchase under the stock repurchase program by 1 million shares. At June 30, 2007, 1,330,973 shares were available for repurchase under the program. The following table summarizes the stock repurchase activity for the three months ended June 30, 2007:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased under the Plans or Programs
April 1, 2007 to April 30, 2007				1,330,923
May 1, 2007 to May 31, 2007				1,330,973
June 1, 2007 to June 30, 2007				1,330,973
Total				1,330,973

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Equity Compensation Plans

The following table provides information concerning our equity compensation plans as of June 30, 2007.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders (1)	1,332,129	$ 18.63	552,963
Equity participation plans not approved by security holders			
Total	1,332,129	$ 18.63	552,963

(1) Includes shares of our Common Stock issuable upon exercise of options from our 2006 Equity Participation Plan.

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Performance Graph

The graph below compares the cumulative total shareholder return for the period beginning on the market close on the last trading day before the beginning our fifth preceding fiscal year through and including the end of our last completed fiscal year, with (a) The NASDAQ Global Market Index and (b) a peer group of publicly-traded issuers with which we have generally competed.

The peer group includes the following companies: American Science & Engineering (AMEX Symbol: ASE), Analogic Corporation (NASDAQ Symbol: ALOG), Criticare Systems, Inc. (AMEX Symbol: CMD) and Datascope Corporation (NASDAQ Symbol: DSCP).

The graph assumes that $100.00 was invested on June 30, 2002 in (a) our Common Stock, (b) The NASDAQ Global Market Index and (c) the companies comprising the peer group described above (weighted according to each respective issuer s stock market capitalization at the beginning of each period for which a return is indicated). The graph assumes that all dividends were reinvested. Historical stock price performance is not necessarily indicative of future stock price performance.

Comparison of Five Year Cumulative Total Return

Assumes Initial Investment of $100

June 2002 through June 2007

Among OSI Systems, Inc.,

The NASDAQ Composite Index And A Peer Group

The following table provides the same information in tabular form as of June 30,:

	2002	2003	2004	2005	2006	2007
OSI Systems, Inc.	100.00	79.07	100.50	79.63	89.61	137.92
The NASDAQ Composite Index	100.00	108.29	139.82	140.70	151.54	183.10
Peer Group	100.00	98.37	111.42	132.02	134.83	174.68

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ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth our selected consolidated financial data as of and for each of the five fiscal years ended June 30, 2007 and is derived from our Consolidated Financial Statements. The Consolidated Financial Statements as of June 30, 2006 and 2007, and for each of the years in the three-year period ended June 30, 2007, are included elsewhere in this report. The following data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operation and the Consolidated Financial Statements and Notes thereto included elsewhere in this report.

	Year Ended June 30,				
	2003	2004	2005	2006	2007
	(in thousands, except earnings per share data)				
Consolidated Statements of Operations Data(1):					
Revenues	$ 182,644	$ 247,069	$ 385,041	$ 452,686	$ 532,284
Cost of goods sold	122,661	163,712	243,415	276,025	354,067
Gross profit	59,983	83,357	141,626	176,661	178,217
Operating expenses:					
Selling, general and administrative	29,160	54,161	116,245	138,428	149,201
Research and development	8,865	14,638	30,537	35,839	44,446
Impairment, restructuring and other charges		1,061		800	26,071
Other operating expenses		1,104	1,824	623	658
Total operating expenses	38,025	70,964	148,606	175,690	220,376
Income (loss) from operations	21,958	12,393	(6,980)	971	(42,159)
Other income (expense):					
Other	(274)	129	(182)	824	15,766
Interest expense	(380)	(283)	(807)	(1,558)	(4,544)
Interest income	1,166	863	196	267	475
Income (loss) before income taxes and minority interest	22,470	13,102	(7,773)	504	(30,462)
Provision (benefit) for income taxes	6,521	3,316	(5,309)	1,090	(12,876)
Income (loss) before minority interest	15,949	9,786	(2,464)	(586)	(17,586)
Minority interest	(156)	170	69	(1,772)	(1,172)
Net income (loss)	$ 15,793	$ 9,956	$ (2,395)	$ (2,358)	$ (18,758)
Net income (loss) available to common shareholders diluted	$ 15,793	$ 9,956	$ (2,502)	$ (2,738)	$ (18,815)
Basic earnings (loss) per common share	$ 1.13	$ 0.68	$ (0.15)	$ (0.14)	$ (1.11)
Diluted earnings (loss) per common share	$ 1.09	$ 0.65	$ (0.15)	$ (0.17)	$ (1.12)
Weighted average shares outstanding diluted	14,513	15,236	16,223	16,517	16,844

	Year Ended June 30,				
	2003	2004	2005	2006	2007
	(in thousands)				
Consolidated Balance Sheet Data(1):					
Cash and cash equivalents	$ 94,246	$ 39,879	$ 14,623	$ 13,799	$ 15,980

Working capital	141,916	147,543	130,375	162,156	158,741
Total assets	229,538	331,801	347,120	403,498	451,483
Long-term debt	1,838	32	4,852	5,483	25,709
Total debt	4,463	2,553	21,103	17,591	48,228
Total shareholders equity	180,399	227,482	223,627	248,947	247,212

(1) Results of operations for the fiscal years 2004 through 2007, and our financial position as of June 30, 2004, 2005, 2006 and 2007 incorporate the effect of several acquisitions, including that of Spacelabs Medical.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Overview

We are a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. We sell our products in diversified markets, including homeland security, healthcare, defense and aerospace. We have three operating divisions: (a) Security, providing security and inspection systems; (b) Healthcare, providing patient monitoring, diagnostic cardiology and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for affiliated end-products divisions, as well as for applications in the defense and aerospace markets, among others.

Security Division. Through our Security division, we design, manufacture and market security and inspection systems worldwide for sale primarily to U.S. and foreign government agencies. These products are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband as well as to screen people. Revenues from our Security division accounted for 35% of our total consolidated revenues for fiscal 2007.

Following the September 11, 2001 terrorist attacks, U.S. Government spending for the development and acquisition of security and inspection systems increased in response to the attacks and has continued at high levels during its global war on terrorism. This spending has had a favorable impact on our business. However, future levels of such spending could decrease as a result of changing budgetary priorities or could shift to products that we do not provide. Additionally, competition for contracts has become more intense in recent years as new competitors and technologies have entered this market.

Healthcare Division. Through our Healthcare division, we design, manufacture and market patient monitoring, diagnostic cardiology and anesthesia systems for sale primarily to hospitals and medical centers. Our products monitor patients in critical, emergency and perioperative care areas of the hospital and provide such information, through wired and wireless networks, to physicians and nurses who may be at the patient s bedside, in another area of the hospital or even outside the hospital. Revenues from our Healthcare division accounted for 44% of our total consolidated revenues for fiscal 2007.

The healthcare markets in which we operate are highly competitive. We believe that our customers choose among competing patient monitoring, diagnostic cardiology and anesthesia products on the basis of product performance, functionality, value and service. We also believe that price has become an important factor in hospital purchasing decisions because of pressures they are facing to cut costs.

Optoelectronics and Manufacturing Division. Through our Optoelectronics and Manufacturing division, we design, manufacture and market optoelectronic devices and value-added manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, CT, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We also provide our optoelectronic devices and value-added manufacturing services to our own Security and Healthcare divisions. Revenues from our Optoelectronics and Manufacturing division accounted for approximately 21% of our total consolidated revenues for fiscal 2007.

Despite the overall growth in revenues that we experienced, our operating losses for fiscal 2007 grew in comparison to the prior year period, primarily as a result of: (i) a $21.5 million charge associated with the impairment of certain intangible and fixed assets; (ii) $10.3 million of inventory charges following a review of our product portfolio; (iii) $4.5 million of restructuring charges primarily related to the consolidation of

several manufacturing processes and facilities among each of our three operating divisions and corporate; (iv) a $0.6 million charge for in-process research and development related to our acquisition of Del Mar Reynolds; (v) lower sales of patient monitors in North America by our Healthcare division (such monitors generally carry a higher gross margin than many of our other products); and (vi) cost overruns in certain long-term contracts for weapons simulation systems sold by our Optoelectronics and Manufacturing division.

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During fiscal 2007, we undertook a review of our global operations as part of our on-going efforts to integrate recent acquisitions and rationalize our overall cost structure. The review resulted in the implementation of cost-cutting measures during the second half of fiscal 2007 resulting in approximately $17 million of pre-tax annualized cost savings, including a reduction of approximately 8% of our global workforce and the consolidation of multiple facilities. The full year beneficial impact of these cost savings is expected to be realized in fiscal 2008.

Acquisitions. An active acquisition program is an important element of our corporate strategy. In the last three fiscal years, we have invested approximately $35 million, in the aggregate, to acquire companies, product lines, and technologies. We believe that our acquisition program supports our long-term strategic direction, strengthens our competitive position, expands our customer base and provides greater scale to increase our investment in research and development to accelerate innovation, grow our earnings and increase stockholder value. We expect to continue to acquire companies, products, services and technologies. See Note 2 of our Notes to Consolidated Financial Statements for additional information related to our recent acquisitions.

In the third quarter of fiscal 2005, we acquired Blease Medical, a global manufacturer and distributor of anesthesia delivery systems, ventilators and vaporizers. In the first quarter of fiscal 2007, we acquired Del Mar Reynolds, a global manufacturer and distributor of cardiac monitoring systems, as well as an operation that provides contract manufacturing services. The acquisition of businesses affects the comparability of financial results between fiscal periods. As a result, we have quantified, where appropriate, the impact of the businesses that we have recently acquired.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based on our Consolidated Financial Statements, which have been prepared in conformity with accounting principles generally accepted in the United States. Our preparation of these Consolidated Financial Statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. As a result, actual results may differ from such estimates. Our senior management has reviewed these critical accounting policies and related disclosures with the Audit Committee of our Board of Directors. The following summarizes our critical accounting policies and significant estimates used in preparing our Consolidated Financial Statements:

Revenue Recognition. We recognize revenue upon shipment of products when title and risk of loss passes, and when terms are fixed and collection is probable. In accordance with the terms of Staff Accounting Bulletin No. 104, Revenue Recognition and Emerging Issues Task Force 00-21 Revenue Arrangements with Multiple Deliverables, where installation services, if provided, are essential to the functionality of the equipment, we defer the portion of revenue for the sale attributable to installation until we have completed the installation. When terms of sale include subjective customer acceptance criteria, we defer revenue until the acceptance criteria are met. Concurrent with the shipment of the product, we accrue estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not the customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of the revenue that we recognize. Critical judgments also include estimates of warranty reserves, which are established based on historical experience and knowledge of the product.

We undertake projects that include the design, development and manufacture or fabrication of large, complex cargo and vehicle inspection systems that are specially customized to our customers specifications or that involve fixed-site construction. We record sales under such contracts under the percentage-of-completion method in accordance with Statement of Position No. 81-1 Accounting for Performance of Construction-Type

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and Certain Production-Type Contracts. We record costs and estimated revenues as we perform work based on the percentage that incurred costs bear to estimated total costs, utilizing the most recent estimates of costs. If our current contract estimate indicates a loss, we make a provision for the total anticipated loss in the current period. Critical estimates made by management related to revenue recognition under the percentage-of-completion method include the estimation of costs at completion and the determination of the overall margin rate on the specific project.

We recognize revenues from separate service maintenance contracts ratably over the term of the agreements. For other services, we recognize service revenues as we perform the services. Deferred revenue for services arises from advance payments received from customers for services not yet performed. We record billed shipping and handling fees as revenue and the associated costs as cost of goods sold.

Allowance for Doubtful Accounts. The allowance for doubtful accounts involves estimates based on management s judgment, review of individual receivables and analysis of historical bad debts. We monitor collections and payments from our customers and we maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory. Inventory is stated at the lower of cost or market. Cost is determined on the first-in, first-out method. We write down inventory for slow-moving and obsolete inventory based on assessments of future demands, market conditions and customers who may be experiencing financial difficulties. If these factors were to become less favorable than those projected, additional inventory write-downs could be required.

Deferred Tax Asset Valuation Allowance. We record a valuation allowance to reduce our deferred tax assets when it is more likely than not, based upon currently available evidence and other factors, that we will not realize some portion or all of our deferred tax assets. We base our determination of the need for a valuation allowance on an on-going evaluation of past and current evidence, including, among other things, historical earnings, estimates of future earnings, the backlog of customer orders and the expected timing of deferred tax asset reversals. We charge or credit adjustments to the valuation allowance to income tax expense in the period in which we make these determinations. If we determine that we will be able to realize our deferred tax assets in the future in excess of its net recorded amount, then we make an adjustment to our deferred tax assets to increase net income in the period that we make this determination. Likewise, if we determine that we will not be able to realize all or part of our net deferred tax assets in the future, then we establish a valuation allowance for the deferred tax asset and reduce net income in the period that we make this determination.

Business Combinations. In accordance with business combination accounting, we allocate the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed as well as to in-process research and development based on their estimated fair values. We engage third-party appraisal firms to assist management in determining the fair values of certain assets acquired and liabilities assumed in material transactions. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. Management makes estimates of fair value based upon assumptions believed to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies and is inherently uncertain.

Other significant estimates associated with the accounting for acquisitions include restructuring costs. Restructuring costs are primarily composed of severance costs, costs of consolidating facilities and contract termination costs. Restructuring expenses are based upon plans that have been committed to by management, but which are subject to refinement. Estimated restructuring expenses may change as management executes the plan. Decreases to the cost estimates of executing the plans associated with pre-merger activities of the companies we acquire are recorded as an adjustment to goodwill indefinitely, whereas increases to the estimates are recorded as an adjustment to goodwill during the purchase price allocation period (generally within one year of the acquisition date) and as operating expenses thereafter.

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For a given acquisition, we may identify certain pre-acquisition contingencies. If, during the purchase price allocation period, we are able to determine the fair value of a pre-acquisition contingency, we will include that amount in the purchase price allocation. If, as of the end of the purchase price allocation period, we are unable to determine the fair value of a pre-acquisition contingency, we will evaluate whether to include an amount in the purchase price allocation based on whether it is probable that a liability had been incurred and whether an amount can be reasonably estimated. With the exception of unresolved tax matters, after the end of the purchase price allocation period, any adjustment to amounts recorded for a pre-acquisition contingency will be included in our operating results in the period in which the adjustment is determined.

Impairment of Long-Lived Assets. We test goodwill for impairment at the reporting unit level at least annually and more frequently upon the occurrence of certain events. For purposes of testing for goodwill impairment, we have determined that we have five reporting units, consisting of the Security division, the Optoelectronics and Manufacturing division and three reporting units within the Healthcare division. We test goodwill for impairment annually during the second fiscal quarter using a two-step process. First, we determine if the carrying amount of any of the reporting units exceeds its fair value. We use a discounted cash flows method to make this determination for our Security and Optoelectronics and Manufacturing divisions and we use a market value method for our Healthcare division (based on the market price of the Healthcare division s publicly traded stock). If these methods indicate a potential impairment of goodwill associated with the respective reporting unit, we then compare the implied fair value of the goodwill associated with the respective reporting unit to its carrying amount to determine if there is an impairment loss. We performed this annual impairment test for goodwill during the second quarter of fiscal 2007 and concluded that there was no impairment of goodwill.

We evaluate long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment is considered to exist if the total estimated future cash flows on an undiscounted basis are less than the carrying amount of the assets. If an impairment does exist, we measure the impairment loss and record it based on discounted estimated future cash flows. In estimating future cash flows, we group assets at the lowest level for which there are identifiable cash flows that are largely independent of cash flows from other asset groups. Our estimate of future cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors.

During the second quarter of fiscal 2007, we recognized non-cash impairment charges totaling $21.5 million relating to software development costs, core technology, developed technology, customer relationships/backlog and fixed assets. Of the $21.5 million impairment charge, $21.3 million was recognized within the Security division and $0.2 million was recognized within the Optoelectronics and Manufacturing division. See Note 8 to the Consolidated Financial Statements for additional information about these impairment charges.

Stock-Based Compensation Expense. Effective July 1, 2005, we adopted SFAS 123(R), Share-Based Payment (SFAS 123(R)), using the modified prospective approach and therefore have not restated results for prior periods. Under this approach, awards that are granted, modified or settled after July 1, 2005 have been and will be measured and accounted for in accordance with SFAS 123(R). Unvested awards that were granted prior to July 1, 2005 will continue to be accounted for in accordance with SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123 (SFAS 148), except that compensation cost will be recognized in our results of operations. Pursuant to the provisions of SFAS 123(R), we record stock-based compensation as a charge to earnings net of the estimated impact of forfeited awards. As such, we recognize stock-based compensation cost only for those stock-based awards that are estimated to ultimately vest over their requisite service period, based on the vesting provisions of the individual grants.

Prior to the adoption of SFAS 123(R), we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to

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Employees, and related interpretations and chose to adopt the disclosure-only provisions of SFAS 123, as amended by SFAS 148. Under this approach, we disclosed the cost of stock option grants and discounts offered under our Employee Stock Purchase Plan based on the vesting provisions of the individual grants, but did not charge it to expense.

The process of estimating the fair value of stock-based compensation awards and recognizing stock-based compensation cost over their requisite service period involves significant assumptions and judgments. We estimate the fair value of stock option awards on the date of grant using the Black-Scholes option-valuation model which requires that we make certain assumptions regarding: (i) the expected volatility in the market price of our common stock; (ii) dividend yield; (iii) risk-free interest rates; and (iv) the period of time employees are expected to hold the award prior to exercise (referred to as the expected holding period). In addition, SFAS 123(R) requires us to estimate the expected impact of forfeited awards and recognize stock-based compensation cost only for those awards expected to vest. If actual forfeiture rates differ materially from our estimates, stock-based compensation expense could differ significantly from the amounts we have recorded in the current period. We periodically review actual forfeiture experience and revise our estimates, as necessary. We recognize the cumulative effect on current and prior periods of a change in the estimated forfeiture rate as compensation cost in earnings in the period of the revision. As a result, if we revise our assumptions and estimates, our stock-based compensation expense could change materially in the future. See Note 10 (Stock-based Compensation) to the Consolidated Financial Statements for a further discussion of stock-based compensation.

Legal and Other Contingencies. We are currently involved in various claims and legal proceedings. Each fiscal quarter, we review the status of each significant legal dispute to which we are a party and assess our potential financial exposure, if any. If the potential financial exposure from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and revise our estimates accordingly. Such revisions in the estimates of the potential liabilities could have a material impact on our results of operations and financial position.

Net Revenues

The table below and the discussion that follows are based upon the way we analyze our business. See Note 16 to the Consolidated Financial Statements for additional information about business segments.

	2005	% of Net Sales	2006	% of Net Sales	2007	% of Net Sales	2005-2006 % Change	2006-2007 % Change
	(Dollars in millions)							
Security	$ 123.2	32%	$ 135.1	30%	$ 186.6	35%	10%	38%
Healthcare	195.7	51%	220.6	49%	233.2	44%	13%	6%
Optoelectronics / Manufacturing	84.6	22%	125.9	28%	150.5	28%	49%	20%
Intercompany Revenue	(18.5)	(5)%	(28.9)	(7)%	(38.0)	(7)%	57%	31%
Total Sales	$ 385.0		$ 452.7		$ 532.3		18%	18%

Fiscal 2007 Compared with Fiscal 2006. Net revenues for fiscal 2007, increased $79.6 million, or 18%, to $532.3 million from $452.7 million for the comparable prior-year period.

Revenues for the Security division for fiscal 2007, increased $51.5 million, or 38%, to $186.6 million, from $135.1 million for the comparable prior-year period. The increase was primarily attributable to a $28.1 million, or 26%, increase in sales of baggage and parcel inspection and people screening systems, and a $23.4 million, or 81%, increase in sales of cargo and vehicle inspection systems.

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Revenues for the Healthcare division for fiscal 2007, increased $12.6 million, or 6%, to $233.2 million, from $220.6 million for the comparable prior-year period. The increase was primarily attributable to the inclusion of $28.4 million of revenues from Del Mar Reynolds, a business that we acquired in July 2006, partially offset by a decline in patient monitoring sales of $13.6 million and a decline in anesthesia delivery sales of approximately $0.8 million.

Revenues for the Optoelectronics and Manufacturing division for fiscal 2007, increased $15.5 million, or 16%, to $112.5 million, from $97.0 million for the comparable prior-year period, net of intercompany eliminations. The increase was primarily attributable to an increase in commercial optoelectronic sales of $6.9 million and an increase in contract manufacturing sales of $6.9 million due primarily to the inclusion of revenues from a small acquisition in July 2006. In addition, for fiscal 2007, the division recorded intercompany sales of $38.0 million, compared to $28.9 million in the comparable prior-year period. Such sales, which are made to the Security and Healthcare divisions, are eliminated in consolidation.

Fiscal 2006 Compared with Fiscal 2005. Net revenues for fiscal 2006, increased $67.7 million, or 18%, to $452.7 million from $385.0 million for the comparable prior-year period.

Revenues for the Security division for fiscal 2006, increased $11.9 million, or 10%, to $135.1 million, from $123.2 million for the comparable prior-year period. The increase was primarily attributable to an $11.5 million, or 12%, increase in revenues in our baggage, parcel inspection and people screening product lines, and a $0.4 million, or 1%, increase in revenues from the cargo and vehicle inspection product lines.

Revenues for the Healthcare division for fiscal 2006, increased $24.9 million, or 13%, to $220.6 million from $195.7 million for the comparable prior-year period. The increase was primarily attributable to higher patient monitoring sales as well as to the inclusion of a full year of revenues from Blease, a company we acquired in February 2005. The increase in revenues was partially offset by a decline in sales of pulse oximetry products.

Revenues for the Optoelectronics and Manufacturing division for fiscal 2006 increased $30.9 million, or 47%, to $97.0 million, from $66.1 million for the comparable prior-year period net of intercompany eliminations. The increase was primarily attributable to higher contract manufacturing and commercial optoelectronic sales, partially offset by a decline in sales of defense optoelectronics. In addition, during fiscal 2006, the division recorded intercompany sales of $28.9 million, compared to $18.4 million in the comparable prior-year period.

Gross Profit

Our gross profit is affected by a number of factors, including product mix, unit volumes, pricing, competition, new product introductions, capacity utilization, new manufacturing programs, inventory obsolescence and the expansion and consolidation of manufacturing facilities. As a result, our gross profit varies from period to period. The following table provides a summary of our gross profit:

	2005	% of Net Sales	2006	% of Net Sales	2007	% of Net Sales
	(Dollars in millions)					
Gross profit	$ 141.6	36.8%	$ 176.6	39.0%	$ 178.2	33.5%

Fiscal 2007 Compared with Fiscal 2006. Gross profit increased $1.6 million, or 1%, to $178.2 million for fiscal 2007, from $176.6 million for the comparable prior-year period. The gross margin decreased to 33.5%, from 39.0% over the same period. This decrease was partially attributable to the recording of $10.3 million of inventory charges during fiscal 2007, following a global review of operations during which we determined that certain finished goods inventory values, primarily associated with cargo and vehicle inspection products developed by our Security division, were impaired. These inventory charges reduced our gross margin by 1.9%. The decline in gross margin was also attributable to: (i) lower gross margins within our Security division due to

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an increase in sales of cargo and vehicle inspection products that were sold at lower gross margins than our baggage and parcel inspection and people screening systems, but which we expect to sell at higher gross margins when future repeat sales result in greater operating efficiencies; (ii) reduced patient monitoring systems sales by our Healthcare division (such sales generally carry higher gross margins than many of our other products); (iii) growth in sales of contract manufacturing services and commercial optoelectronic products by our Optoelectronic and Manufacturing division (such products and services generally carry lower gross margins than the products and services of the other divisions); and (iv) cost overruns incurred during the performance of certain long-term contracts for the development and manufacture of weapons simulation systems by our Optoelectronics and Manufacturing division.

Fiscal 2006 Compared with Fiscal 2005. Our gross profit increased $35.0 million, or 25%, to $176.6 million for fiscal 2006, from $141.6 million for the comparable prior-year period. Our gross margin increased to 39.0%, from 36.8% in the comparable prior-year period. The increase in gross margin was primarily attributable to: (i) improved gross margins in the Security division due to favorable changes in the product mix and increased sales; and (ii) increased sales of patient monitoring systems by our Healthcare division, which resulted in improved gross margins as the division was able to leverage its fixed cost structure coupled with successful cost reduction initiatives.

Operating Expenses

	2005	% of Net Sales	2006	% of Net Sales	2007	% of Net Sales	2005-2006 % Change	2006-2007 % Change
	(Dollars in millions)							
Selling, general and administrative	$ 116.2	30.2%	$ 138.4	30.6%	$ 149.2	28.0%	19%	8%
Research and development	30.6	7.9%	35.9	7.9%	44.4	8.4%	17%	24%
Impairment, restructuring and other charges			0.8	0.2%	26.1	4.9%	NM%	NM%
Other operating expenses	1.8	0.5%	0.6	0.2%	0.7	0.1%	(67)%	%
Total operating expenses	$ 148.6	38.6%	$ 175.7	38.9%	$ 220.4	41.4%	18%	25%

Selling, general and administrative

Fiscal 2007 Compared with Fiscal 2006. Selling, general and administrative (SG&A) expenses consisted primarily of compensation paid to sales, marketing and administrative personnel, professional service fees and marketing expenses. For fiscal 2007, SG&A expenses increased by $10.8 million, or 8%, to $149.2 million from $138.4 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses for fiscal 2007 decreased to 28.0%, from 30.6% in the comparable prior-year period. The increase in SG&A expenses in 2007, over the comparable prior-year period, was primarily attributable to: (i) approximately $13.5 million in increased Healthcare division spending primarily due to spending in support of Del Mar Reynolds, a business that we acquired in July 2006, and (ii) an increase of $4.3 million to support the growth in the Optoelectronic and Manufacturing division. This increase in SG&A expenses was partially offset by a $5.7 million reduction in legal expenses as we concluded during fiscal 2007 certain litigation matters involving Science Applications International Corporation and the General Electric Corporation as well as reductions in the level of litigation activity associated with an ongoing lawsuit with L-3 Communications Corporation.

Fiscal 2006 Compared with Fiscal 2005. For fiscal 2006, SG&A expenses increased by $22.2 million, or 19%, to $138.4 million from $116.2 million for the comparable prior-year period. As a percentage of revenues, SG&A expenses in fiscal 2006 increased to 30.6%, from 30.2% in the comparable prior-year period. The increase in SG&A expenses in fiscal 2006 over the comparable prior-year period was primarily attributable to: (i) a $5.1 million increase in spending on legal fees primarily in support of ongoing litigation with L-3 Communications Corporation and

with Science Applications International Corporation; (ii) a $3.3 million increase in corporate administrative spending to support the overall growth of our businesses; (iii) a foreign

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currency exchange loss of $1.8 million, compared to a foreign currency exchange loss of $0.2 million for the comparable prior-year period; (iv) the recognition of $4.5 million in stock compensation expense under SFAS 123(R) which was adopted on July 1, 2005 related to employee stock options and employee stock purchases; (v) a $2.6 million increase due to the inclusion of the SG&A expenses of Blease for a full year; and (vi) and an increase of approximately $6.9 million in general sales and administrative support costs to support the growth in all three of our business segments. The increase in SG&A expenses was partially offset by the impact of a net decrease in the amount of bad debt expense recorded for a previously disclosed international receivable for our cargo and vehicle inspection product line of approximately $1.7 million as compared with an amount expensed in fiscal 2005.

Research and development

Our Security and Healthcare divisions have historically invested substantial amounts in research and development. We intend to continue this trend in future years; although, specific programs may or not may not continue to be funded and funding levels may fluctuate.

Fiscal 2007 Compared with Fiscal 2006. Research and development expenses include research related to new product development and product enhancement expenditures. For fiscal 2007, such expenses increased by $8.5 million, or 24%, to $44.4 million, from $35.9 million for the comparable prior-year period. As a percentage of revenues, research and development expenses were 8.4% fiscal 2007, compared to 7.9% for the comparable prior-year period. The increase in research and development expenses was primarily attributable to: (i) incremental spending of approximately $6.6 million by our Healthcare division primarily incurred in connection with support of Del Mar Reynolds (a business acquired in July 2006) and in support of next generation patient monitoring products; and (ii) increased investment by our Security division of $3.0 million, primarily to support new hold (checked) baggage screening products. These increases were partially offset by a $1.0 million reduction in Optoelectronic and Manufacturing division spending.

Fiscal 2006 Compared with Fiscal 2005. For fiscal 2006, research and development expenses increased by $5.3 million, or 17%, to $35.9 million, from $30.6 million for the comparable prior-year period. As a percentage of revenues, research and development expenses were 7.9% in fiscal 2006, compared to 7.9% in the comparable prior-year period. The increase in research and development expenses was primarily attributable to: (i) incremental spending of approximately $2.5 million by our Healthcare division to ramp up for the development of next generation patient monitoring products; (ii) $2.4 million in increased spending by our Security division primarily to support the development of hold (checked) baggage screening products; and (iii) the recognition of $0.5 million in stock compensation expense under SFAS 123(R) related to employee stock options and employee stock purchases, which we adopted on July 1, 2005.

Impairment, Restructuring, and Other Charges

In fiscal 2007, we initiated a series of restructuring activities, which were intended to realign our global capacity and infrastructure with demand by our customers and thereby improve our operational efficiency. These activities included reducing excess workforce and capacity, consolidating and relocating certain manufacturing facilities and reviewing the value of certain technologies and product lines. Impairment, restructuring and other charges primarily include employee severance, costs related to facilities that are no longer in use and the impairment of certain intangible and fixed assets. The overall impact of the restructuring activities is that we lower costs and better utilize our overall existing manufacturing capacity. This enhances our ability to improve operating margins and to retain and expand existing relationships with customers and attract new business. We may utilize similar measures in the future to realign our operations to further increase our operating efficiency, which may materially affect our results of operations in the future.

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Fiscal 2007 Compared with Fiscal 2006. During fiscal 2007, as part of a global review of our operations, we assessed the value of certain technologies and product lines. As a result of this assessment, we recorded charges of $31.8 million. This amount consists of (i) $21.5 million of asset impairment of certain identifiable intangible and fixed assets, and (ii) $10.3 of inventory charges, primarily related to finished goods inventory. Of the $21.5 million of impairment charges related to intangible and fixed assets, $21.3 million was recorded within our Security division and $0.2 million was recorded within our Optoelectronics and Manufacturing division. Of the $10.3 million of impairment charges related to inventory, $9.9 million was recorded within our Security division and $0.4 million was recorded within our Optoelectronics and Manufacturing division. We have reflected such inventory charges in cost of goods sold in our Consolidated Financial Statements. Additionally, we incurred $4.5 million of restructuring charges related to headcount reductions, office closures, and similar termination issues. Of the $4.5 million of restructuring costs, $1.8 million was recorded within our Healthcare division, $1.9 million within our Security division, $0.6 million within our Optoelectronics and Manufacturing division and $0.2 million within the corporate segment. In fiscal 2006, restructuring charges totaled $0.8 million associated with the consolidation of certain facilities.

Other Operating Expenses

In July 2006, our Healthcare division completed the acquisition of the Del Mar Reynolds Cardiac division of Ferraris Group PLC. In connection with this acquisition, our Healthcare division entered into retention bonus agreements with key personnel and recognized approximately $0.6 million of other operating expenses during fiscal 2007. In March 2004, we completed the acquisition of Spacelabs. As a result of the acquisition, we assumed management retention bonus agreements for key personnel of Spacelabs. These retention bonuses vested over a two year period. We recorded retention expense of $1.8 million and $0.6 million for the years ended June 30, 2005 and 2006, respectively. As of June 30, 2007, we had no further obligations under these retention bonus agreements.

Other Income and Expenses

	2005	% of Net Sales	2006	% of Net Sales	2007	% of Net Sales	2005-2006 % Change	2006-2007 % Change
				(Dollars in millions)				
Other income		%	0.8	0.1%	15.8	3.0%	NM%	NM%
Write down of equity investments	(0.2)	(0.1)%		%		%	NM%	NM%
Interest income	0.2	0.1%	0.3	%	0.5	0.1 %	36%	67%
Interest expense	(0.8)	(0.2)%	(1.6)	(0.3)%	(4.6)	(0.9)%	93%	188%
Total non-operating income (expense)	$ (0.8)	(0.2)%	$ (0.5)	(0.2)%	$ 11.7	2.2%	NM%	NM%

Other Income

In fiscal 2007, we received $15.0 million from General Electric Corporation in settlement of a dispute associated with our acquisition in fiscal 2004 of Spacelabs Medical, and a $0.8 million payment in settlement of a dispute with a competitor of our Optoelectronics and Manufacturing division.

In fiscal 2006, we entered into a $25.4 million foreign currency forward contract to buy British pounds in anticipation of the Del Mar Reynolds acquisition. Consistent with SFAS 133, Accounting for Derivative Instruments and Hedging Activities, we concluded that this contract did not qualify for hedge accounting treatment and should be booked as an unrealized gain as of June 30, 2006. The amount of the unrealized gain was $0.5 million. In July 2006, the Del Mar Reynolds acquisition was completed and the foreign currency forward contract settled, resulting in a fiscal 2007 loss of $0.1 million. In fiscal 2005, no other income was recognized.

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Interest Expense

Fiscal 2007 Compared to Fiscal 2006. In fiscal 2007, we incurred interest expense of $4.6 million, compared to $1.6 million in fiscal 2006. The increase was primarily attributable to increases in borrowings used to fund our acquisition of Del Mar Reynolds in July 2006 and to fund working capital requirements.

Fiscal 2006 Compared to Fiscal 2005. In fiscal 2006, we incurred interest expense of $1.6 million, compared to $0.8 million in fiscal 2005. The increase in expense was primarily attributable to an increase in borrowings in fiscal 2006 to support our working capital requirements and rising interest rates.

Provision (Benefit) for Income Taxes

The effective tax rate for a particular period varies depending on the mix of income earned in various tax jurisdictions that apply a broad range of income tax rates, income tax credits, changes in previously established valuation allowances for deferred tax assets based upon our current analysis of the realizability of these deferred tax assets, the level of non-deductible expenses as well as tax holidays granted to certain of our international subsidiaries.

Fiscal 2007 Compared to Fiscal 2006. In fiscal 2007, we recorded an income tax benefit of $12.9 million or 42.3% of our pre-tax loss, compared to $1.1 million of income tax expense or 216.3% of pre-tax income in fiscal 2006. The change in the effective tax rate was primarily attributable to (i) additional research and development tax credits in fiscal 2007 and (ii) the repatriation of dividend income from certain of our foreign subsidiaries in fiscal 2006, which did not occur in fiscal 2007.

Fiscal 2006 Compared to Fiscal 2005. In fiscal 2006, we recorded income tax expense of $1.1 million, or 216.3% of pre-tax income, compared to $5.3 million of income tax benefit, or (68.3%) of pre-tax loss in fiscal 2005. The increase in the effective tax rate was primarily attributable to (i) the inclusion of incentive stock options expense in total compensation expense due to the adoption of SFAS 123(R) in fiscal 2006, which does not qualify for a tax deduction resulting in a 146.4% increase to our effective tax rate and (ii) the repatriation of dividend income from Malaysia which qualified for an 85% exemption from federal income taxes which resulted in a 71.3% increase to our effective tax rate.

Liquidity and Capital Resources

To date, we have financed our operations primarily through cash flow from operations, proceeds from equity issuances and our credit facilities. Cash and cash equivalents totaled $16.0 million at June 30, 2007, an increase of $ 2.2 million from $13.8 million at June 30, 2006. The changes in our working capital and cash and cash equivalent balances are described below.

	2005	2006	2007	2005-2006	2006-2007

				% Change	% Change
			(Dollars in millions)		
Working capital	$ 130.4	$ 162.2	$ 158.7	24%	-2%
Cash and cash equivalents	14.6	13.8	16.0	-5%	16%

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Working Capital

The decrease in working capital in fiscal 2007 was primarily due to increases in customer advances, trade payables and borrowings under lines of credit, which were partially offset by growth in our accounts receivable as a result of our strong sales in the fourth quarter. The increase in working capital in fiscal 2006 was primarily due to the $26.3 million of cash received from the initial public offering in October 2005 of a minority interest in Spacelabs Healthcare and to the increases in accounts receivable and inventory to support our growth, which was partially offset by increased trade payables.

				2005-2006	2006-2007
	2005	2006	2007	% Change	% Change
			(Dollars in millions)		
Cash used in operating activities	$ (12.9)	$ (12.2)	$ (2.3)	-5%	-81%
Cash used in investing activities	(29.6)	(16.3)	(30.2)	-45%	85%
Cash provided by financing activities	16.0	26.7	35.8	67%	34%

Cash Used in Operating Activities.

Cash flows from operating activities can fluctuate significantly from period to period as net income (loss), tax timing differences, and other items can significantly impact cash flows. Our largest source of operating cash flows is cash collections from our customers following the sale of our products and services. Our primary uses of cash for operating activities are for purchasing inventory in support of the products that we sell, personnel related expenditures, facilities costs and payments for general operating matters.

Fiscal 2007 Compared with Fiscal 2006. Cash used in operating activities decreased $9.9 million in fiscal 2007 compared to fiscal 2006, primarily as a result of reduced growth in accounts receivables and inventory due to the additional emphasis placed upon working capital management. This improvement in working capital management was partially offset by lower net income before non-cash charges.

Fiscal 2006 Compared with Fiscal 2005. Cash used in operating activities decreased $0.7 million in fiscal 2006 compared to fiscal 2005. Non-cash expenses for depreciation and amortization and stock based compensation increased $8.9 million but were partially offset by the increased use of cash to support operating assets and liabilities in connection with our 18% revenue growth in fiscal 2006.

Cash Used in Investing Activities

The changes in cash flows from investing activities primarily relate to acquisitions as well as to capital expenditures and other assets to support our growth.

Fiscal 2007 Compared with Fiscal 2006. Cash flows used in investing activities increased $13.9 million in fiscal 2007 primarily due to (i) increases in acquisitions of $22.8 million primarily associated with the Del Mar Reynolds transaction in July 2006 and (ii) the buyback of subsidiary stock of $4.5 million. Such changes were partially offset by a $15.0 million payment from General Electric Corporation in settlement

of a dispute associated with our acquisition of Spacelabs Medical in fiscal 2004 as well as a $0.8 million reduction in capital expenditures in the normal course of business.

Fiscal 2006 Compared with Fiscal 2005. Cash flows used in investing activities decreased $13.3 million in fiscal 2006 compared to fiscal 2005 primarily due to the change in acquisition activity in fiscal 2006, as compared to fiscal 2005, when we acquired Blease Medical Holding Limited for approximately $9.3 million (net of cash acquired). In addition, capital expenditures and intangible and other assets purchases decreased approximately $1.8 million in the normal course of business.

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Cash Provided by Financing Activities

The changes in cash flows from financing activities primarily relate to borrowings and payments under debt obligations to the issuance of and/or repurchase of our stock and to the exercise activity in our stock options warrants and employee stock purchase plan.

Fiscal 2007 Compared with Fiscal 2006. Cash flows provided by financing activities increased $9.1 million in fiscal 2007 primarily due to (i) an increase in long-term debt of $19.4 million which was primarily utilized to fund the acquisition of Del Mar Reynolds, (ii) an increase in borrowings under bank lines of credit of $10.8 million to support working capital requirements and (iii) an increase in proceeds from the exercise of stock options, warrants and employee stock purchase plan of $3.5 million primarily related to the exercise of stock options. This increase in cash flows from financing activities in fiscal 2007 was partially offset by cash proceeds of $26.3 million received from the initial public offering of a minority interest in Spacelabs Healthcare in fiscal 2006 as compared to no such public offering in fiscal 2007.

Fiscal 2006 Compared with Fiscal 2005. Cash provided by financing activities increased $10.7 million in fiscal 2006 primarily driven by (i) the $26.3 million of cash received from the initial public offering in fiscal 2006 of a minority interest in Spacelabs Healthcare, (ii) there were no stock repurchases in fiscal 2006 compared to $3.8 million in fiscal 2005, and (iii) a $2.0 million increase in proceeds from the exercise of stock options, warrants and employee stock purchase plan. These increases were partially offset by a reduction in net borrowings of approximately $21.4 million in fiscal 2006 as a result of the cash received from the issuance of Spacelabs stock.

Borrowings

In July 2007, we entered into a Credit Agreement with Wachovia Bank, N.A., as administrative agent for several lending banks and other financial institutions. This credit agreement provides us with (a) a $44.75 million revolving loan, including letter-of-credit and swingline loan subfacilities and (b) a $44.75 million term loan which is repayable over the term of the agreement. The term of the agreement expires on July 26, 2012. Interest on borrowings under the credit agreement varies, depending on factors such as our consolidated leverage ratio and compliance with certain financial covenants, but will accrue at either (a) the London interbank offered rate, plus between 2% and 2.5% or (b) the bank s prime rate, plus between 1% and 1.5%. Under the credit agreement, our accessible borrowing availability may be limited, depending, at various times during the term of the agreement, on our accounts receivable, finished goods inventory, raw materials inventory and indebtedness incurred by our foreign-based subsidiaries. Accessible borrowing availability is also subject to our compliance with certain customary covenants, including financial covenants. Under the credit agreement, we may also have the ability to increase the size of the combined facility to up to $100 million and, upon repayment of the entire term loan, to increase the size of the revolving loan to up to $100 million assuming that we are able to find a lender willing to finance such incremental amounts. Our obligations under the credit agreement are secured by all of our U.S. assets, including all of the equity that we hold in our U.S.-based subsidiaries, plus 65% of the equity that we hold in certain of our significant foreign subsidiaries. In addition, our U.S.-based subsidiaries guaranty our obligations under the credit agreement.

Prior to our entry into this credit agreement with Wachovia Bank, we had previously maintained a credit agreement with Bank of the West. Our credit agreement with Bank of the West provided us with a $35 million senior revolving line of credit, including a letter of credit and foreign exchange facility, each of which was secured by substantially all of our U.S. assets, including our stock ownership of Spacelabs Healthcare. Prior to our entry into the credit agreement with Wachovia Bank, our Healthcare division also maintained a credit agreement with Bank of the West, which provided for a $10 million senior revolving line of credit, including a letter-of-credit and foreign exchange facility, and a $27.4 million loan to fund the purchase of the Del Mar Reynolds cardiology division of Ferraris Group PLC. As of June 30, 2007, $7.5 million was outstanding under the revolving line-of-credit of our credit agreement with Bank of the West and $8.6 million was issued and

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outstanding under the letter-of-credit facility of our credit agreement with Bank of the West. In addition, as of June 30, 2007, our Healthcare division had $9.3 million outstanding under its revolving line-of-credit and $21.8 million outstanding under its term loan with Bank of the West.

Simultaneous with our entry into the credit agreement with Wachovia Bank, we terminated our credit agreement with Bank of the West and our Healthcare division also terminated its credit agreement with Bank of the West. As a result, no amounts are outstanding under either agreement.

As of June 30, 2007, several of our foreign subsidiaries maintained bank lines-of-credit, denominated in local currencies, to meet short-term working capital requirements and for the issuance of letters of credit. The total amount of these credit facilities was $36.3 million with a total cash borrowing sub limit of $10.8 million, of which nothing was outstanding at June 30, 2007. The weighted average interest rate of these facilities was 7.1% at June 30, 2007. We have guaranteed a portion of these credit facilities.

We believe that cash from operations, existing cash and lines of credit will be sufficient to meet our cash requirements for the next twelve months.

Other Contractual Obligations and Commitments

Under the terms and conditions of the purchase agreements associated with the following acquisitions, we may be obligated to make additional payments:

In August 2002, we purchased a minority equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems. In June 2004, we increased our equity interest in CXR to approximately 75% and in December 2004 we acquired the remaining 25%. As compensation to the selling shareholders for this remaining interest we have agreed, for a period of 18 years, to make certain royalty payments based on sales of CXR s products. As of June 30, 2007, no royalty payments had been earned.

In November 2002, we acquired all of the outstanding capital stock of Ancore Corporation (since renamed Rapiscan Systems Neutronics and Advanced Technologies Corporation), a Santa Clara, California based company. During the five years following the acquisition, contingent consideration is payable based on the sales of certain of its products. The contingent consideration is capped at $34.0 million. As of June 30, 2007, no earn-out payments had been earned.

In January 2004, we completed the acquisition of Advanced Research & Applications Corp. (since renamed Rapiscan Systems High Energy Inspection Corporation), a privately held company located in Sunnyvale, California. During the seven years following the acquisition, contingent consideration is payable based on its net revenues, provided certain requirements are met. The contingent consideration is capped at $30.0 million. As of June 30, 2007, no earn out payments had been earned.

In February 2005, we completed the acquisition of Blease. During the three years following the acquisition, contingent consideration is payable based on Blease s net revenues, provided certain requirements are met. The contingent consideration is capped at £6.25 million (approximately $12.5 million as of June 30, 2007). As of June 30, 2007, no earn-out payments had been earned.

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The following is a summary of our contractual obligations and commitments at June 30, 2007 (in thousands):

	Payments Due by Period				
	Total	Less than 1 year	2-3 years	4-5 years	After 5 years
Total debt (excluding capital lease obligations) (1)	$ 44,893	$ 21,111	$ 8,516	$ 11,448	$ 3,818
Capital lease obligations	$ 3,334	$ 1,408	$ 1,216	$ 710	$
Operating leases	$ 55,798	$ 12,074	$ 18,804	$ 13,139	$ 11,781
Purchase obligations	$ 68,978	$ 61,200	$ 7,774	$ 4	$
Defined benefit plan obligation	$ 4,177	$ 286	$ 343	$ 978	$ 2,570
Total contractual obligations	$ 177,180	$ 96,079	$ 36,863	$ 26,279	$ 18,169
Other Commercial Commitments letters of credit	$ 21,008	$ 12,919	$ 6,986	$ 1,043	$ 60

(1) We have presented the outstanding balance of $16.8 million on bank lines of credit at June 30, 2007, as due within less than one year in order to conform to the classification in the accompanying Consolidated Financial Statements. In addition, our total debt obligations exclude interest costs due to their variable nature.

Stock Repurchase Program

Our Board of Directors has authorized a stock repurchase program under which we may repurchase up to 3,000,000 shares of our Common Stock. During fiscal 2007, we did not repurchase any shares under this program. As of June 30, 2007, 1,330,973 shares were available for additional repurchase under the program. We retire the treasury shares as they are repurchased and record them as a reduction in the number of shares of Common Stock issued and outstanding in our Consolidated Financial Statements.

Off Balance Sheet Arrangements

As of June 30, 2007, we had no off balance sheet arrangements other than those previously disclosed as defined in Item 303(a)(4) of Regulation S-K.

New Accounting Pronouncements

For information with respect to new accounting pronouncements and the impact of these pronouncements on our Consolidated Financial Statements, see Note 1 to Consolidated Financial Statements.

Related-Party Transactions

In 1994, we, together with an unrelated company, formed ECIL-Rapiscan Security Products Limited, a joint venture organized under the laws of India. We own a 36% interest in the joint venture, our chairman and chief executive officer owns a 10.5% interest, and the president of Rapiscan Systems owns a 4.5% ownership interest. Our initial investment was $0.1 million. For the years ended June 30, 2005, 2006 and 2007 our equity earnings in the joint venture amounted to $0.2 million, $0.4 million and $0.3 million, respectively. We, our chairman and chief executive officer, and the president of Rapiscan Systems collectively control less than 50% of the board of directors voting power in the joint venture. As a result, we account for the investment under the equity method of accounting. The joint venture was formed for the purpose of the manufacture, assembly, service and testing of security and inspection systems and other products. Some of our subsidiaries are suppliers to the joint venture partner, which in turn manufactures and sells the resulting products. Sales to the joint venture partner for the fiscal years ended June 30, 2005, 2006, and 2007 were approximately $0.2 million, $0.1 million and $0.5 million, respectively.

We have contracted with entities owned by members of our Board of Directors to provide messenger services, auto rental and printing services. Included in cost of sales and selling, general and administrative expenses for the fiscal years ended June 30, 2005, 2006 and 2007, are approximately $60,000, $60,000 and $50,000, respectively, for messenger service and auto rental; and $70,000, $80,000 and $50,000, respectively, for printing services.

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UNAUDITED QUARTERLY RESULTS

The following tables present unaudited quarterly financial information for the four quarters ended June 30, 2006 and 2007 (in thousands, except per share data):

	Quarter Ended			
	September 30, 2005	December 31, 2005	March 31, 2006	June 30, 2006
	(Unaudited)			
Revenues	$ 101,870	$ 117,138	$ 108,092	$ 125,586
Costs of goods sold	64,917	71,999	65,019	74,090
Gross profit	36,953	45,139	43,073	51,496
Operating expenses:				
Selling, general and administrative expenses	33,415	33,515	33,805	37,693
Research and development	8,731	8,700	8,851	9,557
Impairment, restructuring and other charges	800			
Other operating expenses	521	51	51	
Total operating expenses	43,467	42,266	42,707	47,250
Income (loss) from operations	(6,514)	2,873	366	4,246
Other income		349		475
Interest income (expense) net	(531)	(330)	(145)	(285)
Income (loss) before provision for income taxes and minority interest	(7,045)	2,892	221	4,436
Provision (benefit) for income taxes	(2,856)	1,861	(820)	2,905
Minority interest		(946)	(30)	(796)
Net income (loss)	$ (4,189)	$ 85	$ 1,011	$ 735
Basic earnings (loss) per common share	$ (0.26)	$ 0.01	$ 0.06	$ 0.04
Diluted earnings (loss) per common share	$ (0.26)	$ 0.00	$ 0.06	$ 0.04

	Quarter Ended			
	September 30, 2006	December 31, 2006	March 31, 2007	June 30, 2007
	(Unaudited)			
Revenues	$ 115,529	$ 137,458	$ 126,498	$ 152,799
Costs of goods sold	77,032	98,177	82,562	96,296
Gross profit	38,497	39,281	43,936	56,503
Operating expenses:				
Selling, general and administrative expenses	36,370	37,961	36,199	38,671
Research and development	10,819	11,215	11,390	11,022
Impairment, restructuring and other charges		21,543	2,226	2,302
Other operating expenses	219	329	110	

Total operating expenses	47,408	71,048	49,925	51,995
Income (loss) from operations	(8,911)	(31,767)	(5,989)	4,508
Other income (loss)	(74)	74	15,772	(6)
Interest expense net	(873)	(1,172)	(1,154)	(870)
Income (loss) before provision for income taxes and minority interest	(9,858)	(32,865)	8,629	3,632
Provision (benefit) for income taxes	(3,179)	(12,106)	3,678	(1,269)
Minority interest	638	146	(1,338)	(618)
Net income (loss)	$ (6,041)	$ (20,613)	$ 3,613	$ 4,283
Basic earnings (loss) per common share	$ (0.36)	$ (1.23)	$ 0.21	$ 0.25
Diluted earnings (loss) per common share	$ (0.36)	$ (1.23)	$ 0.21	$ 0.24

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

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

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

Foreign Currency

We maintain the accounts of our operations in each of the following countries in the following currencies: Singapore (Singapore dollars), Malaysia (Malaysian ringgits), United Kingdom (U.K. pounds), Norway (Norwegian kroners), India (Indian rupees), Indonesia (Indonesian rupiah), Hong Kong (Hong Kong dollars), China (Chinese renminbi), Canada (Canadian dollars), Australia (Australian dollars) and Cyprus (Cypriot pounds). We maintain the accounts of our operations in Finland, France, Germany, Italy and Greece in euros. Foreign currency financial statements are translated into U.S. dollars at fiscal year end rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. We include gains and losses resulting from foreign currency transactions in income, while we exclude those resulting from translation of financial statements from income and include them as a component of accumulated other comprehensive income (AOCI). Transaction gains and losses which were included in our consolidated statement of operations amounted to a loss of approximately $0.2 million, a loss of approximately $1.8 million and a gain of approximately $0.4 million, for the fiscal years ended June 30, 2005, 2006 and 2007, respectively.

Use of Derivatives

We may, from time to time, purchase foreign exchange contracts, in order to attempt to reduce foreign exchange transaction gains and losses, or enter into interest rate swaps. As of June 30, 2006, we had a $25.4 million foreign currency forward contract outstanding to buy U.K. pounds in anticipation of the Del Mar Reynolds acquisition. Transaction gains during the year ended June 30, 2006 included a $0.5 million gain related to this contract. In July 2006, we completed the Del Mar Reynolds acquisition and the foreign currency forward contract settled, resulting in a fiscal 2007 loss of $0.1 million related to this contract. There were no foreign exchange contracts or interest rate swaps outstanding as of June 30, 2007.

Importance of International Markets

International markets provide us with significant growth opportunities. However, the following events, among others, could adversely affect our financial results in subsequent periods: periodic economic downturns in different regions of the world, changes in trade policies or tariffs, civil or military conflict and other political instability. For fiscal 2007, overall foreign currency fluctuations relative to the U.S. dollar had an immaterial effect on our consolidated revenues and results of operations. Despite changes in monetary policy in Malaysia, including the de-pegging of the Malaysian ringgit to the U.S. dollar, we believe that our foreign currency exposure in Malaysia will not be significant in the foreseeable future. We continue to perform ongoing credit evaluations of our customers financial condition and, if deemed necessary, we require advance payments for sales. We monitor economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future. Due to our overseas investments and the necessity of dealing with local currencies in our foreign business transactions, we are at risk with respect to foreign currency fluctuations.

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Inflation

We do not believe that inflation has had a material impact on our results of operations.

Interest Rate Risk

All highly liquid investments with maturity of three months or less are classified as cash equivalents and recorded in the balance sheet at fair value. Short-term investments are comprised of high-quality marketable securities.

The principal maturity and estimated value of our long-term debt exposure as of June 30, 2006 are as follows (in thousands):

	Maturity							
	2007	2008	2009	2010	2011	2012 and thereafter	Total	Fair Value
Secured long term loan and capital lease obligations	$ 1,251	$ 625	$ 654	$ 402	$ 265	$ 3,537	$ 6,734	$ 6,734
Average interest rate	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	

The principal maturity and estimated value of our long-term debt exposure as of June 30, 2007 are as follows (in thousands):

	Maturity							
	2008	2009	2010	2011	2012	2013 and thereafter	Total	Fair Value
Secured long term loans and capital lease obligations	$ 5,744	$ 5,181	$ 4,551	$ 4,630	$ 7,529	$ 3,818	$ 31,453	$ 31,453
Average interest rate	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

We make reference here to the Index to Consolidated Financial Statements that appears on page F-1 of this report. The Report of Independent Registered Public Accounting Firm from Deloitte & Touche LLP, the Report of Independent Registered Public Accounting Firm from Moss Adams LLP, the Consolidated Financial Statements and the Notes to Consolidated Financial Statements listed in the Index to Consolidated Financial Statements, which appear beginning on page F-2 of this report, are incorporated by reference into this Item 8.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of June 30, 2007, the end of the period covered by this report, our management, including our Chief Executive Officer and our Chief Financial Officer, reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended). Such disclosure controls and procedures are designed to ensure that material information we must disclose in this report is recorded, processed, summarized and filed or submitted on a timely basis. Based upon that evaluation our management, Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of June 30, 2007.

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Management s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including the Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on that evaluation, management concluded that our internal control over financial reporting was effective as of June 30, 2007.

Moss Adams LLP, an independent registered public accounting firm that audited the financial statements included in this report, has issued its attestation report, which appears below, on our management s assessment of our internal controls over financial reporting.

Changes in Internal Control over Financial Reporting

As reported in Item 9A of our Annual Report on Form 10-K for fiscal 2006, we determined that the following material weaknesses in internal control over financial reporting existed as of June 30, 2006:

1) In our testing of information technology controls, we determined that controls over systems change management, program development, end-user computing, and systems access and related monitoring were inadequately designed and implemented. In assessing these control deficiencies, we determined that there was an incomplete adoption of recognized industry standards resulting in the lack of a comprehensive internal control framework over information technology; a lack of adequate oversight by experienced managers knowledgeable and fully engaged with the design and implementation of effective information technology controls; a lack of a comprehensive training program related to information technology controls supporting our internal controls over financial reporting; and that the evaluation and testing of information technology controls was insufficient and was conducted by personnel who lacked the competency needed to fully evaluate this area.

2) In our overall testing of internal controls, we determined that there was a weakness in the monitoring and oversight component of our control environment. We found that there was insufficient and inappropriate verification of the performance of certain review controls and inadequacies in the documentation supporting those controls. Although we did not identify an error in financial reporting as a result of these observations, we determined that a material weakness in our monitoring and oversight controls is evident. Therefore, we determined that the design and operation of our control environment did not sufficiently promote effective internal control over financial reporting.

During fiscal 2007, we dedicated substantial resources to strengthen our internal controls, including upgrading the talent and technical capabilities of individuals within the finance and information technology functions by hiring credentialed professionals from outside of our company. In addition, we took the actions described below to address such material weaknesses. These actions also serve as additional procedures and analyses to ensure that our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. We implemented the following measures:

Evaluated the adequacy of our personnel overseeing information technology controls and the testing of those controls;

Developed a training program for our personnel overseeing information technology controls and the testing of those controls;

Adopted a widely-recognized standard for information technology controls to supplement our existing internal control framework and evaluated and enhanced our existing processes and controls in adopting that standard;

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Evaluated and improved our information technology policies and procedures, specifically with regard to systems change management, program development, end-user computing, and access controls and related monitoring;

Developed and implemented a global information technology strategic plan; and

Implemented additional monitoring and oversight procedures over the compilation of journal entries and financial reporting.

Other than the changes discussed above, there have been no changes in our internal control over financial reporting that occurred that have materially affected or are reasonably likely to materially affect our internal control over financial reporting. Our management has discussed these issues and remediation efforts in detail with the Audit Committee of our Board of Directors.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of OSI Systems, Inc.:

Hawthorne, California

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting that OSI Systems, Inc. and subsidiaries, (the Company) maintained effective internal control over financial reporting as of June 30, 2007, based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the capitalize company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that OSI Systems, Inc. and subsidiaries maintained effective internal control over financial reporting as of June 30, 2007, is fairly stated, in all material respects, based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Also in our opinion, OSI Systems, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of June 30, 2007, based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule of OSI Systems, Inc. and subsidiaries as of and for the year ended June 30, 2007, and our report dated September 11, 2007 expressed an unqualified opinion on those consolidated financial statements and financial statement schedule.

MOSS ADAMS LLP

Los Angeles, California

September 11, 2007

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ITEM 9B. OTHER INFORMATION

Entry into Material Definitive Agreements

On September 10, 2007, we entered into change-of-control agreements with each of Deepak Chopra, our President and Chief Executive Officer, Ajay Mehra, our Executive Vice President and the President of our Security Division and Victor Sze, our Executive Vice President and General Counsel. Under the terms of each of such agreements, if the employee is not retained or leaves our company for good reason following a change-of-control event involving our company, the employee would be entitled to receive an amount equal to 12 months of his then-current base salary, plus an amount equal to 50% of any bonus that he received during the prior year. In addition, any previously granted, but unvested stock options held by such employee would be deemed fully vested and exercisable by such employee. Each of such agreements is set forth in its entirety as exhibits 10.23, 10.24 and 10.25 of this Report.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which Proxy Statement is anticipated to be filed with the Securities and Exchange Commission within 120 days of June 30, 2007.

ITEM 11. EXECUTIVE COMPENSATION

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which Proxy Statement is anticipated to be filed with the Securities and Exchange Commission within 120 days of June 30, 2007.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which Proxy Statement is anticipated to be filed with the Securities and Exchange Commission within 120 days of June 30, 2007.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which Proxy Statement is anticipated to be filed with the Securities and Exchange Commission within 120 days of June 30, 2007.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2007 Annual Meeting of Shareholders, which Proxy Statement is anticipated to be filed with the Securities and Exchange Commission within 120 days of June 30, 2007.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

1. *Financial Statements*. Please see the accompanying Index to Consolidated Financial Statements, which appears on page F-1 of the report. The Report of Independent Registered Public Accounting Firm, the Consolidated Financial Statements and the Notes to Consolidated Financial Statements listed in the Index to Consolidated Financial Statements, which appear beginning on page F-2 of this report, are incorporated by reference into Item 8 above.

2. *Financial Statement Schedules*.

Schedule II Valuation and Qualifying Accounts

No other financial statement schedules are presented as the required information is either not applicable or included in the Consolidated Financial Statements or notes thereto.

(b) *Exhibits*. The exhibits listed on the accompanying Exhibit Index immediately following the signature page are filed as part of, or are incorporated by reference into, this report.

(c) *Financial Statement Schedules*. Reference is made to Item 15(a)(2) above.

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OSI SYSTEMS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of OSI Systems, Inc.:

We have audited the accompanying consolidated balance sheets of OSI Systems, Inc. and Subsidiaries as of June 30, 2006 and 2007, and the related consolidated statements of operations, shareholders equity and cash flows for the two years ended June 30, 2006 and 2007. Our audits also included the financial statement schedule listed in the index at Item 15 in Schedule II. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of OSI Systems, Inc. and Subsidiaries as of June 30, 2006 and 2007, and the consolidated results of its operations and cash flows for the years ended June 30, 2006 and 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 15 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standard No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an Amendment of FASB Statements No. 87, 88, 106 and 132(R), which changed the Company s method of accounting for pension and postretirement benefits as of June 30, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of OSI Systems, Inc. and Subsidiaries internal control over financial reporting as of June 30, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated September 11, 2007 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

MOSS ADAMS LLP
Los Angeles, California
September 11, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of OSI Systems, Inc.:

Hawthorne, California

We have audited the accompanying consolidated statements of operation, shareholders equity and cash flows of OSI Systems, Inc. and subsidiaries (the Company) for the year ended June 30, 2005. Our audit also included the financial statement schedule listed in the index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements referred to above present fairly, in all material respects, the results of its operations and its cash flows for the year ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

DELOITTE & TOUCHE LLP

Los Angeles, California

September 28, 2005

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OSI SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2006	2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 13,799	$ 15,980
Accounts receivable	119,419	140,483
Other receivables	4,495	5,770
Inventories	120,604	120,174
Deferred income taxes	13,752	20,265
Prepaid expenses and other current assets	11,655	11,967
Total current assets	283,724	314,639
Property and equipment, net	42,521	48,051
Goodwill	29,066	50,286
Intangible assets, net	44,046	28,476
Other assets	4,141	10,031
Total assets	$ 403,498	$ 451,483
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Bank lines of credit	$ 10,857	$ 16,775
Current portion of long-term debt	1,251	5,744
Accounts payable	54,282	60,524
Accrued payroll and related expenses	14,244	15,937
Deferred income taxes	2,186	1,968
Advances from customers	2,961	16,734
Accrued warranties	7,224	7,443
Deferred revenue	9,314	7,548
Other accrued expenses and current liabilities	19,249	23,225
Total current liabilities	121,568	155,898
Long-term debt	5,483	25,709
Deferred rent	5,379	5,174
Accrued pension	2,280	1,836
Deferred income taxes	7,504	4,093
Other long-term liabilities	2,606	2,746
Total liabilities	144,820	195,456
Minority interest	9,731	8,815
Commitment and contingencies (Note 12)		
Shareholders Equity:		
Preferred stock, no par value authorized, 10,000,000 shares; no shares issued or outstanding		
Common stock, no par value authorized, 100,000,000 shares; issued and outstanding, 16,598,361 and 17,086,989 shares at June 30,2006 and 2007, respectively	193,698	207,260

Retained earnings	50,208	31,450
Accumulated other comprehensive income	5,041	8,502
Total shareholders equity	248,947	247,212
Total liabilities and shareholders equity	$ 403,498	$ 451,483

See accompanying notes to Consolidated Financial Statements.

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OSI SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except earnings per share data)

	Year Ended June 30,		
	2005	2006	2007
REVENUES	$ 385,041	$ 452,686	$ 532,284
COST OF GOODS SOLD	243,415	276,025	354,067
GROSS PROFIT	141,626	176,661	178,217
OPERATING EXPENSES:			
Selling, general and administrative expenses	116,245	138,428	149,201
Research and development	30,537	35,839	44,446
Impairment, restructuring, and other charges		800	26,071
Other operating expenses	1,824	623	658
Total operating expenses	148,606	175,690	220,376
INCOME (LOSS) FROM OPERATIONS	(6,980)	971	(42,159)
OTHER INCOME (EXPENSE):			
Other income (expense)	(182)	824	15,766
Interest income	196	267	475
Interest expense	(807)	(1,558)	(4,544)
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES AND MINORITY INTEREST	(7,773)	504	(30,462)
PROVISION (BENEFIT) FOR INCOME TAXES	(5,309)	1,090	(12,876)
MINORITY INTEREST	69	(1,772)	(1,172)
NET LOSS	$ (2,395)	$ (2,358)	$ (18,758)
LOSS PER SHARE:			
Basic	$ (0.15)	$ (0.14)	$ (1.11)
Diluted	$ (0.15)	$ (0.17)	$ (1.12)
SHARES USED IN PER SHARE CALCULATION:			
Basic	16,223	16,517	16,844
Diluted	16,223	16,517	16,844

See accompanying notes to Consolidated Financial Statements.

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OSI SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

FOR THE THREE YEARS ENDED JUNE 30, 2007

(in thousands, except share data)

	Common			Accumulated Other Comprehensive		
	Number of Shares	Amount	Retained Earnings	(Loss) Income	Comprehensive (Loss) Income	Total
BALANCE June 30, 2004	16,213,428	$ 170,129	$ 54,961	$ 2,392	$	$ 227,482
Exercise of stock options	201,899	1,492				1,492
Tax benefit of stock options exercised		905				905
Shares purchased under employee stock purchase program	42,439	701				701
Stock repurchased and retired	(264,527)	(3,821)				(3,821)
Comprehensive loss:						
Net loss			(2,395)		(2,395)	(2,395)
Other comprehensive income translation adjustment				(660)	(660)	(660)
Unrealized gain on securities net of tax				108	108	108
Minimum pension liability adjustment net of tax				(185)	(185)	(185)
Comprehensive loss					$ (3,132)	
BALANCE June 30, 2005	16,193,239	169,406	52,566	1,655		223,627
Exercise of stock options	246,025	1,652				1,652
Tax benefit of stock options exercised		133				133
Shares purchased under employee stock purchase program	74,250	1,229				1,229
Exercise of stock warrants	84,847	1,273				1,273
Stock buy back of subsidiary		(10)				(10)
Stock compensation expense		5,354				5,354
Issuance of subsidiary stock		18,715				18,715
Deferred tax on issuance of subsidiary stock		(4,054)				(4,054)
Comprehensive income:						
Net loss			(2,358)		(2,358)	(2,358)
Other comprehensive loss translation adjustment				3,352	3,352	3,352
Reclassification of unrealized gain on securities net of tax				(108)	(108)	(108)
Minimum pension liability adjustment net of tax				142	142	142
Comprehensive income					$ 1,028	
BALANCE June 30, 2006	16,598,361	193,698	50,208	5,041		248,947
Exercise of stock options	411,157	6,277				6,277
Tax benefit of stock options exercised		844				844

Shares purchased under employee stock purchase program	77,471	1,173				1,173
Stock compensation expense		5,268				5,268
Comprehensive loss:						
Net loss			(18,758)		(18,758)	(18,758)
Other comprehensive income translation adjustment				4,405	4,405	4,405
Impact from implementation of SFAS 158 and minimum pension liability adjustment net of tax				(944)	(944)	(944)
Comprehensive loss					$ (15,297)	
BALANCE June 30, 2007	17,086,989	$ 207,260	$ 31,450	$ 8,502		$ 247,212

See accompanying notes to Consolidated Financial Statements.

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OSI SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended June 30,		
	2005	**2006**	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (2,395)	$ (2,358)	$ (18,758)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	10,636	14,190	17,828
Settlement of Spacelabs purchase dispute			(15,000)
Stock based compensation expense		5,354	5,268
Provision for losses on accounts receivable	4,005	2,792	1,862
Minority interest in net income (loss) of subsidiary	(69)	1,771	825
Equity in (earnings) losses of unconsolidated affiliates	(213)	(432)	11
Tax effect of stock option benefit	905	133	844
Deferred income taxes	(3,368)	(3,704)	(22,682)
Impairment, restructuring and other charges		800	22,163
Impairment of equity investments	182		