esi®

# 2007 Annual Report

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## TO OUR SHAREHOLDERS:

Fiscal 2007 proved to be an exciting and successful year for ESI. Our on-going commitment to investing in research and development resulted in the launch of cutting-edge products and expanded applications throughout the year. Our focus on growth, combined with driving operational excellence throughout the organization, resulted in the strongest fiscal results for ESI since 2001.

Our success in 2007 was the result of developing our semiconductor, interconnect, and component inspection markets. The semiconductor and component groups reported the highest revenue levels since 2001 and 2002, respectively, while our interconnect segment achieved the highest revenue levels on record. These results are evidence that our strategy of investing in product development, while maintaining a strong customer focus, provides solutions that are aligned with the needs of our customers.

While achieving success in our core business, we entered into negotiations to purchase New Wave Research (NWR) during the fourth quarter. Following the evaluation of the company and its strategic fit with ESI, we completed the acquisition of NWR shortly after the close of fiscal 2007. The purchase of NWR is a major step in furthering our goal of creating a broad portfolio of photonic micro-engineering applications that leverage our core competencies and target growing adjacent markets. We believe the purchase of NWR will complement our existing development efforts and play a key role in the profitable growth of ESI in the future.

### Growth and Operational Excellence Delivers Strongest Results Since 2001

ESI exhibited very strong year-over-year growth in fiscal 2007. Revenue for the year closed at $250.8 million, up 21% from $207.0 million in 2006. Operating income, at $24.2 million, was more than double the amount recorded in the prior year. Net orders for the year reached $275.3 million, up 29% over the prior year, while net income was up 13% compared to 2006. We ended the year with our strongest order backlog since 2004, driven by large capacity orders for systems in all three of our product segments.

A contributing factor to our on-going success is our flexible operating model, which allowed us to respond quickly to evolving market forces. Implemented over the last few years, this effort entailed improving such key success parameters as on-time delivery, cycle-time reduction, and production expenses. The activities in this area resulted in improvements in on-time delivery, from an already outstanding 98% in 2006 to a nearly perfect 99% in 2007. In addition, average production cycle times dropped eight days when compared to 2006 through efficiencies achieved in manufacturing. Finally, production expenses, as a percentage of revenue, declined two percentage points during the year despite a significantly higher unit volume compared to 2006. While we are pleased with these results, we remain committed to achieving additional improvements and efficiencies to maximize our margins going forward.

In addition to increased internal efficiencies in North America, we are pursuing a program to develop off-shore manufacturing capabilities. Our first effort in this area was the transfer of production of one of our systems to a contract manufacturer in Singapore. Under this model, our off-shore manufacturing partner provides major sub-assemblies to on-site ESI personnel, who then perform final assembly and testing. The ability to leverage the purchasing resources and logistics of a large contract manufacturer, while maintaining the high standards for quality that our customers demand, is expected to result in savings to ESI going forward. The financial impact of this effort will expand as more systems are moved to off-shore manufacturing in the future.

Our focus on operational excellence has given us the ability to consistently generate positive cash flow from operations. The growth in cash over the last several years enabled ESI to implement a stock repurchase program in 2007. Authorized by our board of directors in Q4, the plan provides for the repurchase of up to $50 million of ESI's Common Stock over a nine month period. Investment in ESI stock demonstrates our faith in the fundamental strength of the company while raising the underlying value of our outstanding shares and providing a positive return to our shareholders.

### Achievements in Research and Development Drive Growth

A key goal for ESI is to build a portfolio of applications that leverage our core competencies of laser-material interactions, automation and parts handling, and robust system design. Focusing on these areas allows us to continue to build on our pattern of growth and strengthen our position as a premier provider of photonic micro-engineering solutions.

In 2007, we introduced the latest version of our 9830 single beam infrared (IR) memory repair tool, the 9830HD, which provides significant throughput and accuracy advantages over earlier versions. The 9830HD is a key example of our focus on continued improvements to our product lines which extend their lifecycles and provide strong returns for our investment in engineering.

In addition to improving our existing products, another major objective for R&D is to develop new products that expand our capabilities and enhance our portfolio of photonic solutions. For the semiconductor market, we successfully shipped our first dual-beam memory repair tool, the 9850 IR, in 2007. This system, which utilizes a patented optical design to split a laser beam, enables significant throughput advantages over a single beam system. The improved cost-of-ownership for those customers who require significant increases in productivity resulted in several large follow-up orders for this product during the year.

For the passive market, we announced a beta evaluation of our new high capacitance tester, the 3550, to a major multi-layer ceramic capacitor (MLCC) manufacturer in Japan. This product, which was officially released in early fiscal 2008, represents a major breakthrough in passive components testing. With the ability to accurately test and sort over half a million parts per hour, the 3550's throughput is at least two to three times greater than any other product in the market. The productivity gains that can be achieved with this system are expected to expand our market share by creating opportunities with companies that currently build their own test equipment.

## Strategic Investments Target New and Emerging Technology Areas

External investment is essential to broadening ESI's market reach, and provides access to promising new technologies. In early 2007, we led a funding round and joined the board of OmniGuide, which makes a proprietary flexible fiber cable that allows transmission of CO2 laser energy used in minimally invasive micro-surgery. Later in the year, we led a funding round and joined the board of another emerging company, Axsun Technologies, a manufacturer of micro-spectrometers. This product is used for industrial process spectroscopy, targeting the pharmaceutical, homeland security and optical communications markets. We foresee exciting potential opportunities to leverage these new technologies in both medical and industrial photonic applications in the future.

In addition to external investments in emerging technologies in 2007, we completed construction of a state-of-the-art cleanroom at ESI headquarters in Portland, Oregon. The new facility's manufacturing capabilities will enable us to develop solutions with compelling yield advantages for our customers, while addressing their evolving requirements for leading-edge solutions. Combined with the existing cleanroom that was constructed in 2004, we believe these two facilities will significantly enhance the development efforts that are crucial to remaining a technology leader in the markets we serve.
To aid in the exploration of new technologies, we formed a scientific advisory board (SAB) in 2007. The SAB brings together leading scientists and researchers to share their insights on emerging technologies and our development of innovative photonic solutions. Comprised of experts from fields such as photonics, semiconductor manufacturing process, MEMS, and laser and optics, the SAB will help to validate that our efforts in research and development will produce tangible results in the form of new profitable technologies.

## Partnering with Customers Results in Key Wins

During the year, we spent considerable effort to ensure our thorough understanding of global market forces and the needs of our customers. As evidence of our success in 2007 we announced several major orders from customers worldwide, a number of which included early adopters of our newest systems.

The Semiconductor group achieved the highest revenue level for this segment since 2001. The success of the single beam IR products continued in 2007 with key business wins for our 9830 IR system at ProMOS and Winbond in Taiwan. In addition to single beam systems, we shipped our first 9850 dual-beam IR tool to Hynix in China. This system was quickly accepted into production and we subsequently received multiple follow-on orders for this product. Adoption of our patented ultraviolet (UV) technology continues to move forward in Taiwan with repeat orders for the 9835 UV system by both Inotera and Nanya during the year.

In the passive components segment, we received a large order from Samsung Electro-Mechanics Company in Korea for our Model 3352 test system for MLCCs. This purchase opened up a key captive segment of the market with this customer. In Japan, a major MLCC manufacturer placed an order for multiple Model 3340 testers, providing further penetration of the Japanese market. These key wins, coupled with repeat orders from existing customers in Asia, resulted in the strongest year of revenue for this segment since 2002.

Strong demand produced the highest annual revenue for our interconnect products group on record. The majority of growth in this segment resulted from orders for our flex packaging tool, Model 5330, in Asia. For IC packaging, key wins in North America at Endicott Interconnect Technologies and in Korea to a major IC manufacturer for our Model 5650 resulted in further penetration in the packaging market. An additional achievement during 2007 was the shipment of our 600th Interconnect system to Stevenage in the UK, proving our long-term commitment to growth and innovation in this segment.

## People Are Key to Success

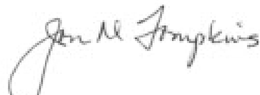
Jon D. Tompkins and Nicholas Konidaris

ESI remains committed, even as we increase our global focus, to maintaining a strong presence in our community by contributing to the local economy. We are very proud that ESI was named mid/small-cap company of the year at the 2006 Oregon Technology Awards. Key criteria guiding our selection included measurable employee satisfaction, significant technology development, and strong performance.

Our people continue to be the cornerstone of our success. Over the years, we have fostered a culture of innovation and entrepreneurial growth that was a key factor in the success of fiscal 2007. This same spirit will enable us to continue executing on our plans for growth and provide us with many more successful years.

We close a very strong fiscal 2007 with a suite of new products and applications that we expect will fuel growth in the years to come. We are excited by the prospects for 2008 and look forward to another year of success and profitability.

Sincerely,



Nicholas Konidaris
President and CEO

Jon D. Tompkins
Chairman of the Board

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**WASHINGTON, D. C. 20549**

# FORM 10-K

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

For the Fiscal Year Ended: June 2, 2007

OR

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

Commission File Number: 0-12853

# ELECTRO SCIENTIFIC INDUSTRIES, INC.
**(Exact name of registrant as specified in its charter)**

| **Oregon** | **93-0370304** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **13900 N.W. Science Park Drive, Portland, Oregon** | **97229** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**Registrant's telephone number, including area code: 503-641-4141**

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

Securities registered pursuant to Section 12(g) of the Act:
**Common Stock, without par value**
**Preferred Stock Purchase Rights**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the Registrant is not required to file reports pursuant Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

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

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.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the last sales price ($19.46) as reported by the NASDAQ National Market System, as of the last business day of the Registrant's most recently completed second fiscal quarter (December 3, 2006) was $567,342,444.

The number of shares outstanding of the Registrant's Common Stock as of August 10, 2007 was 28,178,577 shares.

**Documents Incorporated by Reference**

The Registrant has incorporated into Part III of this Form 10-K, by reference, portions of its Proxy Statement for its 2007 Annual Meeting of Shareholders.

**ELECTRO SCIENTIFIC INDUSTRIES, INC.**
**2007 FORM 10-K ANNUAL REPORT**
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## PART I

### *Item 1. Business*

This annual report on Form 10-K contains forward-looking statements that are subject to risks and uncertainties. Actual results may differ materially from the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under the caption "Factors That May Affect Future Results" included within "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations."

### Where You Can Find More Information

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 as amended (Exchange Act). You can inspect and copy our reports, proxy statements, and other information filed with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, D.C 20549. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. The SEC maintains an Internet site at *www.sec.gov* where you can obtain most of our SEC filings. We also make available, free of charge on our website at *www.esi.com*, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after they are filed electronically with the SEC. The information found on our website is not part of this Form 10-K. You can also obtain copies of these reports by contacting Investor Relations at (503) 641-4141.

### Fiscal Year

Our fiscal year consists of 52 or 53 weeks ending on the Saturday nearest May 31. Accordingly, fiscal 2007 ended on June 2, 2007, fiscal 2006 ended on June 3, 2006 and fiscal 2005 ended on May 28, 2005 and those fiscal years contained 52 weeks, 53 weeks and 52 weeks, respectively. All references to years relate to fiscal years unless otherwise noted.

On July 3, 2007, our Board of Directors approved a change in the Company's reporting periods that results in a fiscal year end on the Saturday nearest March 31. Accordingly, fiscal year 2008 will consist of approximately a ten month period containing 43 weeks ending on March 29, 2008.

### Business Overview

Electro Scientific Industries, Inc. and its subsidiaries (ESI) provide high-technology manufacturing systems to the global electronics market, including advanced laser-based systems that are used to microengineer semiconductor device features in high-volume production environments. Our customers are primarily manufacturers of semiconductors, passive electronic components and electronic interconnect devices. Our equipment enables these manufacturers to achieve yield and productivity gains in their manufacturing processes that can be critical to their profitability. The components and devices manufactured by our customers are used in a wide variety of end products in the computer, consumer electronics, communications and automotive industries. ESI was founded in 1944 and is headquartered in Portland, Oregon.

We are a leading supplier of advanced photonic microengineering systems that allow electronics manufacturers to physically alter select device features during high-volume production in order to heighten performance and boost production yields of semiconductor devices, advanced semiconductor packaging, flex circuits and passive electronic components and circuitry. Photonic microengineering comprises a set of precise fine-tuning processes (laser trimming, link cutting and via drilling) that require application-specific laser systems able to meet semiconductor and microelectronics manufacturers' exacting performance and productivity requirements. Additionally, we produce high-speed test, inspection and termination equipment used in the high-volume production of multi-layer ceramic capacitors (MLCCs) and other passive components.

**Electronics Industry Overview**

The electronics market continues to be driven by demand for advanced features and improved functionality for consumer items. The market for consumer-oriented electronics such as smart phones, computers, handheld devices, digital video recorders, digital cameras and high-definition televisions have developed rapidly as increasingly affordable products have been introduced that are smaller, lighter and more portable. In addition, most automobile manufacturers now include electronic ignition, fuel injection, anti-lock brakes, and other electronic safety and sensor systems as standard equipment, replacing components that in the past were predominantly mechanical or hydraulic.

The increasing demand for electronic products has been accompanied by the need for faster, smaller, more complex, less expensive and higher-quality electronic devices and circuits. To achieve these performance and size improvements, electronic device manufacturers are increasing the circuit densities in these devices and tuning them to precise electrical values. Manufacturers of cellular telephones, for example, must use miniaturized circuits to accommodate the size limitations of their finished products. These circuits must also be tuned to operate within precise frequency specifications, enabling the existing wireless frequency bands to accommodate more users without interchannel interference.

Smaller and lighter requirements also decrease the physical dimensions used in electronic interconnections within the electronic device, its surrounding package and the high-density interconnect (HDI) circuit board on which it is mounted. Higher operating speeds of computers and communications products also require more input and output channels within these packages and between the packages and the HDI circuit board.

The highly competitive consumer markets for electronic products drive the demand for lower-cost devices and components. Electronic devices and components are produced in large unit volumes, and their production and testing is highly automated, utilizing a variety of manufacturing equipment. Manufacturers continually seek to reduce costs by improving the throughput, yield and quality of device and component production. These manufacturers are also developing new materials to improve performance and reduce costs of their devices. These ongoing changes challenge equipment suppliers to continually innovate new manufacturing process solutions and equipment.

For example, semiconductor device manufacturers are continuing the transition from 200mm and smaller silicon wafers to 300mm wafers, which can accommodate a significantly higher number of electronic devices. In addition, increasing circuit densities enable more devices to be produced on a silicon wafer by reducing the size of each device on the wafer. Together, larger wafers and smaller device designs significantly reduce the cost of semiconductor devices. Increasing circuit densities which result from shrinking line widths and faster operating speeds require the use of materials such as copper to create these miniaturized and higher performance electronic circuits.

To improve production yield, or the number of functioning devices produced per silicon wafer, device manufacturers are utilizing advanced systems, such as our laser memory repair products, to boost final yields in the manufacture of devices. This includes dynamic random access memory (DRAM), NAND flash memory and non-memory devices, such as logic with embedded memory and high-end electronic game chips.

As semiconductor manufacturers move toward higher densities and more complex architectures, machine vision has also emerged as a critical technology. Machine vision is an enabling technology in the semiconductor manufacturing process that allows manufacturers to achieve increased equipment speed with fewer errors. Moreover, machine-vision technology is proving to be integral to applications such as wafer identification. As the increased functionality of next-generation chips continues to drive up total wafer cost, the need to accurately track and identify wafers will become even more critical to chip manufacturers' bottom lines.

Variations of these advanced technologies and manufacturing processes that are routinely used in semiconductor fabs are increasingly being employed in the production of passive components, HDI circuit boards

and advanced semiconductor packages. An example is the use of machine vision in passive component inspection. As device sizes grow ever smaller and critical dimensions of the electrical contacts become more precise, machine vision, incorporated with high-speed handling and real-time software, allows for inspection of MLCCs at over 50,000 parts per hour. The previous technique utilized human inspection at a much slower rate with poorer inspection results.

**Our Solutions**

We believe our products address the needs of electronics manufacturers by providing them with a high return on their investment due to measurable production benefits, including improved yield, increased throughput, higher performance, smaller component size, greater reliability and enhanced flexibility. We typically design our production systems to be easily upgraded, enabling them to accommodate the next generation of technology and giving customers the flexibility to add capacity or improve product performance at a reasonable incremental cost.

Our core technology strengths include a deep understanding of laser/materials interaction, laser beam positioning, high-speed motion control systems, small parts handling systems, image processing and optical character recognition and systems engineering. We combine this technology expertise in unique and innovative ways with a thorough understanding of our customers' processes and objectives to develop new and improved products.

Our customers manufacture semiconductors, passive components and electronic interconnect devices—which, in turn, serve a wide range of electronic applications. The largest end-market applications for electronic devices and circuits that are produced using our systems are:

- Computers;
- Telecommunications;
- Consumer electronics; and
- Automotive electronics.

**Our Strategy**

***Focus on businesses where we are a market leader***

We intend to expand the application of our existing technologies to grow our overall market opportunity serving manufacturers in semiconductor, advanced semiconductor packaging and passive components – all markets in which we currently maintain a leadership position. We also intend to maintain our market leadership by developing new products that have higher performance, greater throughput and enhanced reliability, thereby lowering the effective cost of ownership to our customers.

***Develop new high-value businesses***

We plan to leverage expertise in our core technologies, technology integration and customer collaboration to develop innovative solutions that will enable us to grow into attractive new markets through internal or external business development.

***Invest in research and development to maintain our technological leadership***

We intend to further develop our technology leadership by maintaining a significant level of investment in research and development. Our key technological capabilities include laser/materials interaction, high-speed motion control systems, small parts handling systems and image processing and optical character recognition. We consider our continuing ability to develop intellectual property to be an important component of our future success.

*Increase the value of our products to global customers*

We are focused on improving the yield, throughput and productivity of our customers by utilizing our technology, global infrastructure, customer service and ability to integrate multiple technologies. We work with our market-leading customers to whom we supply equipment, and have created high-level and multi-disciplinary management and employee teams to define and produce the next generation manufacturing systems. This requires confidential interaction between the customer and ESI, sharing technology, product and production roadmaps often looking out over a three- to five-year period. Embracing the industry trend toward true globalization of our business has enabled us to elevate our presence in key world markets, particularly Asia-Pacific.

**Our Products**

We operate within one segment, high technology manufacturing equipment, which is composed of products grouped according to our three key target markets: semiconductors, passive components and electronic interconnect. Net sales by group, as a percentage of total sales, were as follows (in thousands):

| | 2007 | | 2006 | | 2005 | |
|---|---|---|---|---|---|---|
| **Semiconductor** | $145,381 | 58.0% | $126,682 | 61.2% | $138,574 | 59.4% |
| **Passive Components** | 63,093 | 25.2 | 46,305 | 22.4 | 61,001 | 26.1 |
| **Electronic Interconnect** | 42,350 | 16.8 | 34,019 | 16.4 | 33,796 | 14.5 |
| | $250,824 | 100.0% | $207,006 | 100.0% | $233,371 | 100.0% |

**Semiconductor Group**

*Semiconductor Yield-Improvement Systems*

Our yield-improvement product line is designed to cost-effectively meet the production challenges faced by semiconductor manufacturers, including shrinking circuit sizes, material changes and increased wafer sizes. As circuit densities in semiconductor memory devices such as DRAM have increased, manufacturers have built redundant cells into their memory designs and connected them with small electrical links on the device surface. During the manufacturing process, wafers with millions of individual memory cells are tested to identify defective cells. Our laser systems are then used to cut links that reprogram the device to disconnect the paths to defective portions of the memory device and replace them with functional redundant cells, driving post-repair yield improvements for our customers.

Our semiconductor link-processing equipment is primarily used in the manufacture of DRAMs, logic integrated circuits (IC), analog ICs and NAND flash memory devices.

Our 98XX Series systems are designed specifically for the 300mm wafer processing market, but can also handle 200mm wafers. The 9835 is the world's first single-beam ultraviolet (UV) laser fuse processing tool and it delivers class-leading spot size with greater depth of focus for processing future generations of ICs. With the recent introduction of the dual-beam 9850 system, ESI provides significant throughput increases compared to a single beam repair tool. The 9850 can be configured for use in either infrared (IR) or UV laser fuse processes. These high-performance systems deliver increased manufacturing productivity and minimize capital requirements.

*Machine-Vision Systems*

Our machine-vision subsystems are a key module integrated into our systems. Our machine-vision sub-systems are predominantly sold to original equipment manufacturers (OEMs) for incorporation into electronics-manufacturing equipment, performing alignment, identification, part placement, die and wire bonding and other functions.

In addition to alignment and inspection applications we also provide a wafer identification tool that is sold to both OEMs and chipmakers. Our Bullet™ wafer-identification (ID) reader combines the industry's smallest read head with ESI's patented telecentric lighting technology, enabling the Bullet to identify any kind of wafer by reading all types of ID marks—from hard scribe marks to super-soft marks used in new and emerging optical character recognition wafer-tracking applications. As the increased functionality of next-generation chips continues to drive up total wafer cost, the need to accurately track and identify each wafer will be critical to a chip manufacturer's bottom line.

***Thin Film Trimming***

Our Model 2100 thin-film-on-silicon (TFOS) trimming system continues to gain market traction. Over the past year, multiple leading analog IC makers placed repeat orders to increase their installed base of these tools. This system uses our patented 1.3-micron wavelength trimming process to deliver, in a small footprint, superior throughput and yield compared to traditional 1.0-micron laser-based TFOS systems.

**Passive Components Group**

We design and manufacture products that combine high-speed, small parts handling technology with real-time control systems to provide highly automated, cost-effective solutions for manufacturers of MLCCs and other passive components such as capacitor arrays, inductors, resistors, varistors and hybrid circuits. These components, produced in quantities of hundreds of billions of units per year, process analog, digital and high-frequency signals in nearly all electronic products.

- Multilayer Ceramic Test Systems: These products employ high-speed handling and positioning techniques to precisely load, test and sort MLCCs based on their electrical energy storage capacity, or capacitance, and their electrical energy leakage, or dissipation factor.
- Termination Systems: These products apply a conductive material to the ends of ceramic capacitors permitting connection of the device in a circuit on a high-density printed wiring board. The latest addition to this line is the Model 753 array termination system, which features ESI's patented "Soft Grip" diamond belt for greatly improved productivity.
- Visual Inspection Systems: These systems perform six-sided automated inspection of MLCCs and arrays for dimensional criteria and defects.
- Consumable Products: We also produce consumables, such as carrier plates and termination belts, both of which are used to hold MLCCs in the manufacturing process.
- Circuit Fine-Tuning Systems: We design and manufacture application-specific laser systems that adjust the electrical performance of a hybrid circuit, or an electronic assembly containing many circuits, by removing a precise amount of material from one or more circuit components.

**Electronic Interconnect Group**

Our laser microvia engineering systems are targeted at applications that require the highest accuracy and smallest via dimensions to create electrical connections between layers in high-density circuit boards, flexible circuits and IC packages. Our microvia drilling technology addresses the rapidly changing applications in IC packages, multichip modules and HDI circuit boards. Our UV laser processing systems employ state-of-the-art technology in lasers, optics and motion control. Our products include single-beam and multi-beam systems that produce very high quality vias (holes) with the best-in-class placement accuracy for improved yield of packages and substrates.

- Our 5300 Series single-head laser drills utilize lasers to drill via holes as small as 25 microns (by comparison, a human hair is approximately 100 microns in diameter) in a wide variety of materials, including epoxy, resins and resin-coated copper.

- Our ICP5650 employs our high-repetition UV laser to perform high-quality, high-volume drilling of blind microvias in electronic packages. The ICP5650 can produce more than 60,000 high-quality microvias per minute on chip-scale substrates, flip-chip ball-grid arrays and other advanced IC packages.

**Customers**

Our top ten customers for fiscal 2007, 2006 and 2005 accounted for approximately 62%, 55%, and 51%, respectively, of total net sales, with two customers, Samsung and Hynix, accounting for approximately 34%, 25% and 21% of total net sales in fiscal 2007, 2006 and 2005, respectively. Except for a distributor in Japan, Canon Sales, which accounted for an additional 10% of total net sales in fiscal 2006, no other customer in 2007, 2006 or 2005 accounted for more than 10% of total net sales. These high-volume customers purchase products from all three of our product groups.

Geographic sales, based on the location of the end user, were as follows (in thousands):

| | 2007 | | 2006 | | 2005 | |
|---|---|---|---|---|---|---|
| **Asia** | $187,228 | 74.6% | $155,959 | 75.3% | $180,378 | 77.3% |
| **Americas** | 40,987 | 16.3 | 36,351 | 17.6 | 35,277 | 15.1 |
| **Europe** | 22,609 | 9.1 | 14,696 | 7.1 | 17,716 | 7.6 |
| | $250,824 | 100.0% | $207,006 | 100.0% | $233,371 | 100.0% |

**Long-Lived Assets**

Long-lived assets, exclusive of marketable securities and deferred tax assets, by geographic area were as follows at June 2, 2007 and June 3, 2006 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| United States | $62,635 | $51,680 |
| Asia | 9,430 | 9,286 |
| Europe | 136 | 134 |
| | $71,931 | $61,100 |

**Sales, Marketing and Service**

We sell our products worldwide through direct sales and service offices, a franchised distributor, value-added resellers and independent representatives located around the world. ESI has direct sales and service personnel in Oregon, Texas and several other states; Tokyo, Oita and Nagoya, Japan; Seoul, Korea; Kao Hsiung and Hsin Chu, Taiwan; Singapore; Shanghai, China; Munich, Germany; West Sussex, England; Kirkcaldy, Scotland; and Graz, Austria. We serve selected customers in the United States, South America, Europe, Israel and additional countries through manufacturers' representatives. Canon Sales is a distributor for our Semiconductor Group in Japan.

We have a substantial base of installed products in use by leading worldwide electronics manufacturers. We emphasize strong working relationships with these customers to meet their needs for additional systems and to facilitate the successful development and sale of new products to these customers.

We generally maintain service personnel wherever we have a significant installed base. We offer a variety of warranty, maintenance and parts replacement programs.

## Backlog

Backlog consists of purchase orders for products, spare parts and service that we expect to ship or perform within twelve months. Backlog does not include deferred revenue. Backlog was $56.7 million at June 2, 2007 compared to $50.0 million at June 3, 2006. The stated backlog is not necessarily indicative of sales for any future period nor is a backlog any assurance that we will realize a profit from filling the orders.

## Research, Development and Technology

We believe that our ability to compete effectively depends, in part, on our ability to maintain and expand our expertise in core technologies and product applications. The primary emphasis of our research and development is to advance our capabilities in:

- Lasers and laser/material interaction;
- High-speed, micron-level motion control systems;
- Precision optics;
- High-speed, small parts handling;
- Image processing and optical character recognition;
- Real-time production-line electronic measurement;
- Real-time operating systems; and
- Systems integration.

Our research and development expenditures for fiscal years 2007, 2006 and 2005 were $37.7 million (15.0% of net sales), $33.8 million (16.3% of net sales) and $28.0 million (12.0% of net sales), respectively.

## Competition

Our markets are dynamic, cyclical and highly competitive. The principal competitive factors in our markets are product performance, ease of use, cost of ownership, reliability, service, technical support, a product improvement path, price, established relationships with customers, product familiarity and proprietary technology. We believe that our products compete favorably with respect to these factors. Some of our competitors have greater financial, engineering and manufacturing resources and larger distribution networks than we do. Some of our customers develop, or have the ability to develop, manufacturing equipment similar to our products. Competition in our markets may intensify and our technological advantages may be reduced or lost as a result of technological advances by competitors or customers or changes in electronic device processing technology.

The principal competitor for our semiconductor group is GSI Group. Cognex is our principal competitor in the field of machine vision. Our electronic interconnect group competes with laser systems provided by Hitachi Via Mechanics, Mitsubishi Electric and Sumitomo. For the passive component group, our competitors include Tokyo Weld, Kanebo, Humo, All Ring Tech and GSI Group as well as component manufacturers that develop systems for internal use. See discussion of a patent infringement action that ESI has brought against All Ring Tech in Part I, Item 3, “Legal Proceedings.”

## Manufacturing and Supply

Our production facilities are located in Portland and Klamath Falls, Oregon. The manufacturing operations located in Portland consist of electronic subassembly and final system assembly for all products, except as described in the next paragraph and passive component consumable products, which are produced in our facility in Klamath Falls.

We use qualified manufacturers to supply many components and sub-system modules of our products. In addition, we utilize a major global contract manufacturer in Asia to complete final assembly for certain systems. Our systems use high-performance computers, peripherals, lasers and other components from various suppliers. Some of the components we use are obtained from a single source or a limited group of suppliers. An interruption in the supply of a particular component could require substitutions that would have a temporary adverse impact on us. We believe our relationships with our suppliers are good.

**Patents and Other Intellectual Property**

We have a policy of seeking patents, when appropriate, on inventions relating to new products and improvements that are discovered or developed as part of our ongoing research, development and manufacturing activities. We own 111 United States patents and 210 patents issued outside of the United States. Additionally, as of June 2, 2007, we had 81 patent applications pending in the United States and 183 patent applications pending outside of the United States. Although our patents are important, we believe that the success of our business also depends on the technical competence and innovation of our employees.

We rely on copyright protection for our proprietary software. We also rely upon trade secret protection for our confidential and proprietary information. Others may independently develop substantially equivalent proprietary information and techniques, and we may be unable to meaningfully protect our trade secrets.

**Employees**

As of June 2, 2007, we employed 585 people. Many of our employees are highly skilled, and our success will depend in part upon our ability to attract and retain such employees, who are in great demand. We have never had a work stoppage or strike, and no employees are represented by a labor union or covered by a collective bargaining agreement. We consider our employee relations to be good.

***Item 1A. Risk Factors***

**Factors That May Affect Future Results**

The statements contained in this report that are not statements of historical fact, including without limitation statements containing the words “believes,” “expects” and similar words, constitute forward-looking statements that are subject to a number of risks and uncertainties. From time to time we may make other forward-looking statements. Investors are cautioned that such forward-looking statements are subject to an inherent risk that actual results may materially differ. The following information highlights some of the factors that could cause actual results to differ materially from the results expressed or implied by our forward-looking statements. Forward-looking statements should be considered in light of these factors. Factors that may result in such variances include, but are not limited to, the following:

***The industries that comprise our primary markets are volatile and unpredictable.***

Our business depends upon the capital expenditures of manufacturers of components and circuitry used in wireless communications, computers and other electronic products. In the past, the markets for electronic devices have experienced sharp downturns. During these downturns, electronics manufacturers, including our customers, have delayed or canceled capital expenditures, which has had a negative impact on our financial results. In the event of a downturn, we will not be able to assure you when demand for our products will increase or that demand will not decrease. Even if demand for our products does increase, there may be significant fluctuations in our profitability and net sales.

During any downturn, it will be difficult for us to maintain our sales levels. As a consequence, to maintain profitability we will need to reduce our operating expenses. For example, in December 2004 we announced an operational restructuring and reduction in force to reduce our expenses in connection with the most recent

downturn. Our ability to quickly reduce operating expenses is dependent upon the nature of the actions we take to reduce expense and our subsequent ability to implement those actions and realize expected cost savings. Additionally, we may be unable to defer capital expenditures and we will need to continue to invest in certain areas such as research and development. An economic downturn may also cause us to incur charges related to impairment of assets and inventory write-offs and we may also experience delays in payments from our customers, which would have a negative effect on our financial results.

In addition, because we derive a substantial portion of our revenue from the sale of a relatively small number of products, the timing of, or changes to, orders by our customers may also cause our order levels and results of operations to fluctuate between periods, perhaps significantly. For example, in the second quarter of fiscal 2007, a customer requested that the Company convert part of a previous order for UV-based semiconductor systems to IR-based systems and to postpone shipment of additional UV-based systems, which resulted in approximately $18 million being removed from backlog. Accordingly, order levels or results of operations for a given period may not be indicative of order levels or results of operations for following periods.

***Delays in manufacturing, shipment or customer acceptance of our products could substantially decrease our sales for a period.***

We depend on manufacturing flexibility to meet the changing demands of our customers. Any significant delay or interruption in receiving raw materials or in our manufacturing operations as a result of software deficiencies, natural disasters, or other causes could result in reduced manufacturing capabilities or delayed product deliveries, any or all of which could materially and adversely affect our results of operations.

We also have an arrangement with a contract manufacturer in Singapore to complete the manufacture of certain of our products. Any significant interruption in this contract manufacturer’s ability to provide manufacturing services to us as a result of contractual disputes with us or another party, labor disruptions, natural disasters, delay or interruption in the receipt of inventory or other causes could result in reduced manufacturing capabilities or delayed deliveries for certain of our products, any or all of which could materially and adversely affect our results of operations

In addition, we derive a substantial portion of our revenue from the sale of a relatively small number of products. Consequently, shipment and/or customer acceptance delays, including acceptance delays related to new product introductions or customizations, could significantly impact recognition of revenue and could be further magnified by announcements from us or our competitors of new products and technologies, which announcements could cause our customers to defer purchases of our systems, change existing orders or purchase products from our competitors. Any of these delays could result in a material adverse change in our results of operations for any particular period.

***Failure of critical suppliers of parts, components and manufacturing equipment to deliver sufficient quantities to us in a timely and cost-effective manner could negatively affect our business.***

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers for those materials. We generally do not have guaranteed supply arrangements with our suppliers. We seek to reduce the risk of production and service interruptions and shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, some key parts are available only from a single supplier or a limited group of suppliers in the short term. Operations at our suppliers’ facilities are subject to disruption for a variety of reasons, including changes in business relationships, competitive factors, work stoppages, and fire, earthquake, flooding or other natural disasters. Such disruption could interrupt our manufacturing. Our business may be harmed if we do not receive sufficient parts to meet our production requirements in a timely and cost-effective manner.

***We depend on a few significant customers and we do not have long-term contracts with any of our customers.***

Our top ten customers for fiscal 2007 accounted for approximately 62% of total net sales in fiscal 2007, with two customers each accounting for more than 10% of total net sales in fiscal 2007. In addition, none of our customers has any long-term obligation to continue to buy our products or services, and any customer could delay, reduce or cease ordering our products or services at any time.

***Our markets are subject to rapid technological change, and to compete effectively we must continually introduce new products that achieve market acceptance.***

The markets for our products are characterized by rapid technological change and innovation, frequent new product introductions, changes in customer requirements and evolving industry standards. Our future performance will depend on the successful development, introduction and market acceptance of new and enhanced products that address technological changes as well as current and potential customer requirements. The introduction by us or by our competitors of new and enhanced products may cause our customers to defer, change or cancel orders for our existing products, which may harm our operating results. In the past we have also experienced delays in new product development. Similar delays may occur in the future. We also may not be able to develop the underlying core technologies necessary to create new products and enhancements or, where necessary, to license these technologies from others.

Product development delays may result from numerous factors, including:

- Changing product specifications and customer requirements;
- Difficulties in hiring and retaining necessary technical personnel;
- Difficulties in reallocating engineering resources and overcoming resource limitations;
- Difficulties with contract manufacturers;
- Changing market or competitive product requirements; and
- Unanticipated engineering complexities.

The development of new, technologically advanced products is a complex and uncertain process, requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully, if at all, or on a timely basis. Further, we cannot assure you that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technological changes or emerging industry standards. Any failure to respond to technological change that may render our current products or technologies obsolete could significantly harm our business.

***We acquire inventory based upon projected demand. If these projections are incorrect we may carry inventory that cannot be used, which may result in significant charges for excess and obsolete inventory.***

Our business is highly competitive and one factor on which we compete is the ability to ship products on the schedule required by customers. In order to facilitate timely shipping, management forecasts demand, both in type and amount of products, and these forecasts are used to determine our inventory to be purchased. Certain types of inventory, including lasers and optical equipment, are particularly expensive and can only be used in the production of a single type of product. If actual demand is lower than forecast with respect to the type or amount of products actually ordered, or both, our inventory levels may increase. As a result, there is a risk that we may have to incur material accounting charges for excess and obsolete inventory if inventory cannot be used, which could negatively affect our financial results.

***Our ability to reduce costs is limited by our need to invest in research and development.***

Our industry is characterized by the need for continued investment in research and development. Because of intense competition in the industries in which we compete, if we were to fail to invest sufficiently in research and development, our products could become less attractive to potential customers, and our business and financial condition could be materially and adversely affected. As a result of our need to maintain our spending levels in this area, our operating results could be materially harmed if our net sales fall below expectations. In addition, as a result of our emphasis on research and development and technological innovation, our operating costs may increase in the future, and research and development expenses may increase as a percentage of total operating expenses and as a percentage of net sales.

***We are exposed to the risks that others may violate our proprietary rights, and our intellectual property rights may not be well protected in foreign countries.***

Our success is dependent upon the protection of our proprietary rights. In the high technology industry, intellectual property is an important asset that is always at risk of infringement. We incur substantial costs to obtain and maintain patents and defend our intellectual property. For example, we have initiated litigation alleging that certain parties have violated various patents of ours, such as the action we initiated in Taiwan against All Ring Tech Co., Ltd. in August 2005. We rely upon the laws of the United States and of foreign countries in which we develop, manufacture or sell our products to protect our proprietary rights. However, these proprietary rights may not provide the competitive advantages that we expect or other parties may challenge, invalidate or circumvent these rights.

Further, our efforts to protect our intellectual property may be less effective in some foreign countries where intellectual property rights are not as well protected as in the United States. Many U.S. companies have encountered substantial problems in protecting their proprietary rights against infringement in foreign countries. If we fail to adequately protect our intellectual property in these countries, it could be easier for our competitors to sell competing products in foreign countries, which could result in reduced sales and gross margins.

***We may be subject to claims of intellectual property infringement.***

Several of our competitors hold patents covering a variety of technologies, applications and methods of use similar to some of those used in our products. From time to time, we and our customers have received correspondence from our competitors claiming that some of our products, as used by our customers, may be infringing one or more of these patents. Competitors or others have in the past and may in the future assert infringement claims against our customers or us with respect to current or future products or uses, and these assertions may result in costly litigation or require us to obtain a license to use intellectual property rights of others. If claims of infringement are asserted against our customers, those customers may seek indemnification from us for damages or expenses they incur.

If we become subject to infringement claims, we will evaluate our position and consider the available alternatives, which may include seeking licenses to use the technology in question or defending our position. These licenses, however, may not be available on satisfactory terms or at all. If we are not able to negotiate the necessary licenses on commercially reasonable terms or successfully defend our position, our financial condition and results of operations could be materially and adversely affected.

***Our business is highly competitive, and if we fail to compete effectively, our business will be harmed.***

The industries in which we operate are highly competitive. We face substantial competition from established competitors, some of which have greater financial, engineering, manufacturing and marketing resources than we do. If we are unable to compete effectively with these companies, our market share may decline and our business could be harmed. Our competitors can be expected to continue to improve the design and performance of their products and to introduce new products. New companies may enter the markets in which we compete, or industry consolidation may occur, further increasing competition in those markets. Furthermore, our technological advantages may be reduced or lost as a result of technological advances by our competitors.

Our competitors' greater resources in the areas described above may enable them to:

- Better withstand periodic downturns;
- Compete more effectively on the basis of price and technology; and
- More quickly develop enhancements to and new generations of products.

We believe that our ability to compete successfully depends on a number of factors, including:

- Performance of our products;
- Quality of our products;
- Reliability of our products;
- Cost of using our products;
- The ability to upgrade our products;
- Consistent availability of critical components;
- Our ability to ship products on the schedule required;
- Quality of the technical service we provide;
- Timeliness of the services we provide;
- Our success in developing new products and enhancements;
- Our understanding of the needs of our customers;
- Existing market and economic conditions; and
- Price of our products as compared to our competitors' products.

We may not be able to compete successfully in the future, and increased competition may result in price reductions, reduced profit margins and loss of market share.

***The loss of key personnel, including our Chief Financial Officer, or our inability to attract, retain and assimilate sufficient numbers of managerial, financial, engineering and other technical personnel could have a material effect upon our results of operations.***

Our continued success depends, in part, upon key managerial, financial, engineering and technical personnel as well as our ability to continue to attract, retain and assimilate additional personnel. The loss of key personnel could have a material adverse effect on our business or results of operations. We may not be able to retain our key managerial, financial, engineering and technical employees. For example, on July 30, 2007 we announced that our Chief Financial Officer will be leaving on September 29, 2007. We have not identified a new Chief Financial Officer at this time. Attracting qualified personnel may be difficult and our efforts to attract and retain these personnel may not be successful. In addition, we may not be able to assimilate qualified personnel, including any new members of senior management, which could disrupt our operations.

***Our worldwide direct sales and service operations and our overseas research and development facility expose us to employer-related risks in foreign countries.***

We have established direct sales and service organizations throughout the world. We have also established a research and development facility in China. Having overseas employees involves certain risks. We are subject to compliance with the labor laws and other laws governing employers in the countries where our operations are located and as a result we may incur additional costs to comply with these local regulations. Additionally, we may encounter labor shortages or disputes that could inhibit our ability to effectively sell, market and service our products. If we cannot effectively manage the risks related to employing persons in foreign countries, our operating results could be adversely affected.

***We recently completed an acquisition and may make acquisitions in the future, and these acquisitions may subject us to risks associated with integrating these businesses into our current business.***

We recently completed the acquisition of New Wave Research, Incorporated and in the future we may make acquisitions of, or significant investments in, other businesses with complementary products, services or technologies.

Acquisitions, including the acquisition of New Wave Research, involve numerous risks, many of which are unpredictable and beyond our control, including:

- Difficulties and increased costs in connection with integration of the personnel, operations, technologies and products of acquired companies;
- Diversion of management's attention from other operational matters;
- The potential loss of key employees of acquired companies;
- Lack of synergy, or inability to realize expected synergies, resulting from the acquisition;
- Acquired assets becoming impaired as a result of technological advancements or worse-than-expected performance by the acquired company;
- Difficulties establishing satisfactory internal controls at acquired companies; and
- Incurring liabilities for which we may not be indemnified in full or at all.

Our inability to effectively manage these acquisition risks could materially and adversely affect our business, financial condition and results of operations and could cause us not to realize the anticipated benefits of an acquisition on a timely basis or at all. In addition, if we issue equity securities to pay for an acquisition the ownership percentage of our existing shareholders would be reduced and the value of the shares held by our existing shareholders could be diluted. If we use cash to pay for an acquisition the payment could significantly reduce the cash that would be available to fund our operations or to use for other purposes. In addition, the accounting for acquisitions, including the New Wave Research acquisition, could result in significant charges resulting from amortization of intangible assets related to such acquisitions. We may make strategic investments in development stage companies, which investments are subject to a high degree of risk, and therefore it is possible that we could lose our entire investment.

***We are exposed to the risks of operating a global business, including risks associated with exchange rate fluctuations, legal and regulatory changes and the impact of regional and global economic disruptions.***

International shipments accounted for 84% of net sales in fiscal 2007, with 75% of our net sales to customers in Asia. We expect that international shipments will continue to represent a significant percentage of net sales in the future. We also have an arrangement with a contract manufacturer in Singapore to complete the manufacture of certain of our products. Our non-U.S. sales, purchases and operations, including contract manufacturing, are subject to risks inherent in conducting business abroad, many of which are outside our control, including the following:

- Periodic local or geographic economic downturns and unstable political conditions;

- Price and currency exchange controls;
- Fluctuation in the relative values of currencies;
- Difficulties protecting intellectual property;
- Local labor disputes;
- Shipping delays and disruptions;
- Increases in shipping costs, caused by increased fuel costs or otherwise, which we may not be able to pass on to our customers;
- Unexpected changes in trading policies, regulatory requirements, tariffs and other barriers; and
- Difficulties in managing a global enterprise, including staffing, collecting accounts receivable, managing suppliers, distributors and representatives, and repatriation of earnings.

Our business and operating results are subject to uncertainties arising out of the possibility of regional or global economic disruptions (including those resulting from natural disasters and outbreaks of infectious disease), the economic consequences of military action or terrorist activities and associated political instability, and the impact of heightened security concerns on domestic and international travel and commerce. In particular, due to these uncertainties we are subject to:

- The risk that future tightening of immigration controls may adversely affect the residence status of non-U.S. engineers and other key technical employees in our U.S. facilities or our ability to hire new non-U.S. employees in such facilities;
- The risk of more frequent instances of shipping delays; and
- The risk that demand for our products may not increase or may decrease.

***We have previously reported a material weakness in our internal control over financial reporting and if additional material weaknesses are discovered in the future, our internal controls over financial reporting could be adversely affected.***

In connection with our management's assessment of the effectiveness of our internal control over financial reporting as of March 3, 2007, we concluded that, as of March 3, 2007, our disclosure controls and procedures were not effective in ensuring accurate reporting of financial information due to a material weakness in our processes, procedures and controls related to the review and analysis of inventory cost variances resulting from certain inventory transactions. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected.

This material weakness resulted in a revision to our previously reported consolidated condensed financial statements as of and for the three months ended September 2, 2006 as reported in our Quarterly Report on Form 10-Q. We have taken the steps necessary to remediate this material weakness. The controls implemented to remediate this material weakness were tested and we concluded that they were operating effectively at June 2, 2007. The identification of one or more additional material weaknesses, could result in material misstatements in our financial reports and could lead us or our auditors to conclude that we do not have effective controls over financial reporting as required under Section 404 of the Sarbanes-Oxley Act. This may negatively impact the market's view of our control environment and, potentially, our stock price.

***Our reported results of operations have been materially and adversely affected by our adoption of SFAS 123R.***

Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), was effective in our first quarter of fiscal 2007, and resulted in recognition of substantial compensation expense

relating to our stock incentive plan and employee stock purchase plan. We previously used the intrinsic value method to measure compensation expense for stock-based awards to our employees. Under that standard, we generally did not recognize compensation expense related to stock option grants or the discounts we provide under our employee stock purchase plan. Under the new rules, we are required to adopt a fair value-based method for measuring the compensation expense related to employee stock awards. Pre-tax stock compensation expense increased by $1.6 million in fiscal 2007 as a result of the adoption of SFAS 123R. Total pre-tax stock-based compensation in fiscal 2007 was $2.9 million. Future results of operations may be materially and adversely affected by the expense recorded in accordance with SFAS 123R on future grants of stock awards. Additionally, tax expense treatment under SFAS 123R does not provide for recording of deferred taxes consistent with the timing of recording stock-based compensation expense for incentive stock options. As such, the impact of non-compensatory plans may increase our effective tax rate.

***Our tax rates are subject to fluctuation, which could impact our financial position, and our estimates of tax liabilities may be subject to audit, which could result in additional assessments.***

Our effective tax rates are subject to fluctuation as the income tax rates for each year are a function of: (a) taxable income levels the effects of a mix of profits (losses) earned by ESI and our subsidiaries in numerous tax jurisdictions with a broad range of income tax rates, (b) our ability to utilize recorded deferred tax assets, (c) taxes, interest or penalties resulting from tax audits, (d) the magnitude of various credits and deductions as a percentage of total taxable income and (e) changes in tax laws or the interpretation of such tax laws. Changes in the mix of these items may cause our effective tax rates to fluctuate between periods, which could have a material adverse effect on our financial position.

We are subject to income taxes in both the United States and numerous foreign jurisdictions. During the ordinary course of business there are transactions and calculations for which the ultimate tax determination is uncertain. Significant judgment is exercised in determining our world wide provisions for income taxes. Furthermore, we are occasionally under audit by tax authorities. Although we believe our tax estimates are reasonable, the final outcome of tax audits and examinations and the impact of changes in tax laws or the interpretation of tax laws could result in material differences from what is reflected in historical income tax accruals. For example, in the third quarter of fiscal 2006, a significant tax benefit was recorded upon the reversal of accrued income taxes due to the statutory closure of returns for various open tax years. In addition, we recorded an additional $1.0 million of income taxes payable in the fourth quarter of fiscal 2007 due to new technical guidance from the Internal Revenue Service regarding foreign sales and leasing income. If additional taxes are assessed as a result of an examination, a material effect on our financial results, tax positions or cash flows could occur in the period or periods in which the determination is made.

## *Item 2. Properties*

Our executive and administrative offices, as well as our system manufacturing facilities, are located in a four-building complex with 258,500 square feet of space on 15 acres in Portland, Oregon. Our passive component consumable products are manufactured at a 53,000 square foot plant on 31 acres in Klamath Falls, Oregon. We own all of these buildings. We believe the productive capacity of these facilities to be adequate and suitable for the requirements of our business for the foreseeable future.

We lease other office and service space in various locations throughout the United States and in six foreign countries.

We do not expect compliance with federal, state and local provisions which have been enacted or adopted related to the discharge of materials into the environment, or otherwise relating to protection of the environment, to have a material effect on our capital expenditures, earnings or competitive position.

### *Item 3. Legal Proceedings*

In August 2005, we commenced a proceeding in the Kaohsiung District Court of Taiwan (the Court) directed against All Ring Tech Co., Ltd. (All Ring) of Taiwan. We alleged that All Ring's Capacitor Tester Model RK-T6600 (the Capacitor Tester) infringes our Taiwan Patent No. 207469, entitled "Circuit Component Handler" (the 207469 patent). This patent corresponds to our U.S. Patent No. 5,842,579. The patented technology is used in the Model 3340 Multifunction MLCC Tester. The Court issued a Provisional Attachment Order in August 2005 and All Ring filed a bond with the Court to obtain relief from the attachment of its assets. In July 2007, the Court issued a second Provisional Attachment Order, and approximately US$6.0 million was frozen in All Ring's accounts.

In October 2005, the Court executed a Preliminary Injunction Order that prohibits All Ring from manufacturing, selling, offering for sale or using the Capacitor Tester until final judgment is entered in the formal patent infringement action. Pursuant to the Court's orders, we were required to post a Taiwan dollar security bond which is valued at approximately US$6.9 million and included in other assets on our consolidated balance sheet at June 2, 2007. On June 13, 2007, we posted an additional bond amount of US $2.1 million related to the second Provisional Attachment Order.

In October 2005, we filed a formal patent infringement action against All Ring in the Court. In May 2006, after all parties filed briefs on the topic, the Court appointed an expert to conduct a patent infringement assessment. The Court-appointed expert has completed the assessment of the Capacitor Tester and concluded that it infringes every claim of the 207469 patent.

In November 2005, All Ring filed a cancellation action against our 207469 patent in the Taiwan Intellectual Property Office (the IPO). On July 5, 2007, the IPO issued a notice requiring us to cancel two of our claims in the 207469 patent. No other claims of the patent have been rejected. We intend to vigorously pursue our patent infringement claims against All Ring and defend against the cancellation action.

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

No matters were submitted to a vote of our security holders during the quarter ended June 2, 2007.

## PART II

### *Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities*

### Common Stock Prices/Dividends

Our common stock trades on the NASDAQ Global Market under the symbol ESIO. The following table shows, for the fiscal quarters indicated, the high and low closing sale prices for the common stock as reported on the NASDAQ Global Market.

| Fiscal 2007 | High | Low |
|---|---|---|
| Quarter 1 | $20.40 | 17.33 |
| Quarter 2 | 22.34 | 19.17 |
| Quarter 3 | 22.87 | 18.69 |
| Quarter 4 | 21.24 | 18.61 |

| Fiscal 2006 | High | Low |
|---|---|---|
| Quarter 1 | $22.11 | $17.18 |
| Quarter 2 | 24.74 | 20.75 |
| Quarter 3 | 26.64 | 23.38 |
| Quarter 4 | 25.84 | 19.50 |

We have not paid any cash dividends on our common stock during the last two fiscal years. We intend to retain any earnings for our business and do not anticipate paying any cash dividends in the foreseeable future. The number of shareholders of record at August 10, 2007 was 661.

### Share Repurchase Transactions

On March 9, 2007, the Board of Directors authorized the repurchase of up to $50 million in shares of our outstanding common stock during the nine-month period beginning April 17, 2007. The authority will be exercised from time to time as market conditions warrant through transactions in the open market or in negotiated transactions with brokers or shareholders. During the fourth quarter of fiscal 2007, we repurchased 504,000 shares at an average price of $20.70. The following table sets forth information about the share repurchase transactions in accordance with SEC Regulation S-K, Item 703:

| Period | (a) Total Number of Shares (or Units) Purchased | (b) Average Price Paid per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| 4/1/07 to 5/5/07 | 210,000 | $20.89 | 210,000 | $45,614,081 |
| 5/6/07 to 6/2/07 | 294,000 | $20.56 | 294,000 | $39,569,613 |
| Total | 504,000 | $20.70 | 504,000 | $39,569,613 |

Disclosures related to securities authorized for issuance under our Equity Compensation Plans are incorporated by reference into Item 12 of this annual report on Form 10-K from our Proxy Statement for our 2007 annual meeting.

*Item 6. Selected Financial Data*

| (in thousands, except per share amounts) | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| **Statement of Operations Data** | | | | | |
| Net sales | $250,824 | $207,006 | $233,371 | $207,242 | $136,885 |
| Provision (benefit) for income taxes | 11,103 | (1,536) | 6,437 | (9,308) | (29,135) |
| Net income (loss) [1, 2, 3, 4, 5] | 23,524 | 20,823 | 19,837 | 11,887 | (50,086) |
| Net income (loss) per share—basic [1, 2, 3, 4, 5] | 0.81 | 0.72 | 0.70 | 0.42 | (1.81) |
| Net income (loss) per share—diluted [1, 2, 3, 4, 5] | 0.80 | 0.72 | 0.69 | 0.42 | (1.81) |
| **Balance Sheet Data** | | | | | |
| Cash, cash equivalents and marketable and restricted securities | $228,691 | $229,332 | $218,901 | $332,754 | $308,252 |
| Working capital | 321,531 | 302,184 | 275,701 | 369,941 | 340,162 |
| Net property, plant and equipment | 43,859 | 43,338 | 32,959 | 33,531 | 36,592 |
| Total assets | 465,668 | 437,465 | 403,557 | 537,186 | 502,598 |
| Long-term debt | — | — | — | 142,759 | 141,891 |
| Shareholders' equity | 408,330 | 388,167 | 357,155 | 326,813 | 310,317 |

1. Fiscal 2007 includes a pretax gain for an insurance recovery of $1.3 million on fire-damaged demonstration systems and a pretax gain of $1.0 million for an insurance settlement related to the shareholder and derivative lawsuits. Due to the adoption of SFAS No. 123R, fiscal 2007 included an additional $1.6 million in pretax stock compensation expense.
2. Fiscal 2006 includes a $5.9 million reduction in accrued income taxes due to the statutory closure of various tax years.
3. Fiscal 2005 includes pretax charges of approximately $4.1 million for the redemption of our 4 ¼% convertible subordinated notes due 2006 and $2.2 million resulting from the settlement and related legal costs for a patent infringement lawsuit. See Notes 15 and 19.
4. Fiscal 2004 includes a pretax charge of $3.8 million for the estimated settlement of the class action and derivative lawsuits. See Note 15.
5. Fiscal 2003 includes a pretax charge of $10.1 million related to the write-down of our Klamath Falls passive components consumable manufacturing site and related equipment and a parcel of land in Taiwan.

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

**Overview**

Electro Scientific Industries, Inc. and its subsidiaries (ESI) provide high-technology manufacturing equipment to the global electronics market, including advanced laser systems that are used to microengineer electronic device features in high-volume production environments. Our customers are primarily manufacturers of semiconductors, passive components and electronic interconnect devices. Our equipment enables these manufacturers to achieve the yield and productivity gains in their manufacturing processes that can be critical to their profitability. The components and devices manufactured by our customers are used in a wide variety of end products in the computer, consumer electronics and communications industries.

We supply advanced laser microengineering systems that allow electronics manufacturers to physically alter select device features during high-volume production in order to heighten performance and boost production yields of semiconductor devices, passive components and circuitry, high-density interconnect (HDI) circuit boards and advanced semiconductor packaging. Laser microengineering comprises a set of precise fine-tuning processes (laser trimming, link processing and via drilling) that require application-specific laser systems able to meet semiconductor and microelectronics manufacturers' exacting performance and productivity requirements.

Additionally, we produce high speed test, inspection and termination equipment used in the high volume production of multi-layer ceramic capacitors (MLCC) and other passive components, as well as original equipment manufacturer machine vision products.

Fiscal 2007 reflected strong demand for our products stimulated by industry strength and successful introduction of new products. Orders of $275.3 million in fiscal 2007 increased 29% compared to orders of $213.8 million in fiscal 2006. The increase compared to prior year was driven by growing demand in all three of our product groups.

Orders for our semiconductor group products increased by 23%, with customers continuing to ramp capacity to meet end-market demand for DRAM driven by innovations in personal computer technology, mobile communications and next-generation game consoles. Demand remains strong for our IR-based link-processing systems and the customer base for our UV-based DRAM link-processing systems is growing. During the year, we successfully introduced a dual beam IR-based repair system and an enhanced single beam IR-based repair system that uses a 100 KHz, 1.0um wavelength laser, providing increased yield and throughput.

Passive component group orders increased 45% compared to the prior fiscal year, reflecting continued strength and stability in the MLCC manufacturing market and our continued penetration into the Japanese MLCC market. This market continues to be positively impacted by demand for leading edge consumer products such as handheld devices, multi-core PC processors, flat panel displays and high definition televisions.

Electronic interconnect group orders increased 28% in fiscal 2007 compared to fiscal 2006, representing the strongest year on record for this product group. The growth in orders is the result of our continued expansion in the flex-circuit and IC packaging segments of this market and our ability to introduce new applications for our technology.

Fiscal 2007 shipments of $250.4 million increased $43.4 million or 21% compared to $207.0 million in fiscal 2006, primarily due to increased semiconductor and passive component group shipments. Backlog was $56.7 million at the close of fiscal 2007, compared to $50.0 million at the end of fiscal 2006, representing an increase of 14%.

Gross margins were 43.4% on net sales of $250.8 million in fiscal 2007 compared to 44.2% on net sales of $207.0 million in fiscal 2006. Net operating expenses increased $4.7 million from $79.8 million in fiscal 2006 to $84.5 million in fiscal 2007, which included the favorable impact of $2.3 million in insurance recoveries.

Operating income increased to $24.2 million in fiscal 2007, compared to operating income of $11.7 million in fiscal 2006, primarily due to increased gross profit. Non-operating income increased to $10.4 million from $7.6 million, primarily due to increased investment yields. Offsetting these impacts, the provision for income taxes increased by $12.6 million compared to fiscal 2006 resulting in net income of $23.5 million in fiscal 2007, compared to $20.8 million in fiscal 2006.

On July 3, 2007, the Board of Directors approved a change in reporting periods that will result in a financial year-end on the Saturday nearest March 31. Prior to this change, ESI's fiscal year-end occurred on the Saturday nearest May 31. This change was implemented to align ESI's reporting periods with peer companies. This change will be effective for fiscal 2008, which will represent approximately a ten month period ending on March 29, 2008. Financial releases and SEC filings for interim periods ending during fiscal 2008 will cover the periods ending September 29, 2007 and December 29, 2007.

On July 5, 2007, we announced an agreement to acquire New Wave Research, Incorporated (NWR), a developer and manufacturer of high-end laser-based systems and components based in Fremont, California. We purchased NWR for approximately $45.4 million in cash, representing a $36 million base price plus an amount approximately equal to NWR's cash and cash equivalents at closing. This transaction closed on July 20, 2007.

Excluding the impact of the acquisition of NWR, for the upcoming four-month reporting period we expect shipments and revenue to be approximately $85 to $95 million. The gross margin percentage is expected to be approximately flat compared to the 46.4% recorded in the fourth quarter of fiscal 2007. Operating expenses are expected to range from $30 to $31 million for the four-month period. We estimate net interest and other income will be slightly less than $3 million. The effective tax rate is anticipated to be approximately 36%.

We believe the addition of NWR will contribute an additional $7 to $8 million in revenue from the closing date of July 20, 2007 through the period ending September 29, 2007. Associated gross margin for NWR is expected to be in the range of 45-50% and operating expenses are expected to be approximately 40% of revenue, excluding integration costs and purchase accounting adjustments. The impact of purchase accounting adjustments to our consolidated financial results will not be finalized until the end of the reporting period and is not currently estimable.

### Results of Operations

The following table sets forth results of operations data as a percentage of net sales.

| | Fiscal 2007 | Fiscal 2006 | Fiscal 2005 |
|---|---|---|---|
| **Net sales** | 100.0% | 100.0% | 100.0% |
| **Cost of sales** | 56.6 | 55.8 | 52.1 |
| **Gross margin** | 43.4 | 44.2 | 47.9 |
| **Selling, service and administration** | 19.6 | 22.2 | 22.1 |
| **Research, development and engineering** | 15.0 | 16.3 | 12.0 |
| **Patent infringement settlement and related legal fees** | — | — | 1.0 |
| **Insurance recoveries** | (0.9) | — | — |
| **Operating income** | 9.7 | 5.7 | 12.8 |
| **Total other income (expense), net** | 4.1 | 3.7 | (1.5) |
| **Income before taxes** | 13.8 | 9.4 | 11.3 |
| **Income tax provision (benefit)** | 4.4 | (0.7) | 2.8 |
| **Net income** | 9.4% | 10.1% | 8.5% |

### Fiscal Year 2007 Compared to Fiscal Year 2006

*Net Sales*

Certain information regarding our net sales by product group is as follows (net sales in thousands):

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Net Sales | Percent of Total Net Sales | Net Sales | Percent of Total Net Sales |
| **Semiconductor (SG)** | $145,381 | 58.0% | $126,682 | 61.2% |
| **Passive Components (PCG)** | 63,093 | 25.2 | 46,305 | 22.4 |
| **Electronic Interconnect (EIG)** | 42,350 | 16.8 | 34,019 | 16.4 |
| | $250,824 | 100.0% | $207,006 | 100.0% |

Net sales for fiscal 2007 increased $43.8 million or 21.2% to $250.8 million compared to $207.0 million in fiscal 2006. Each product group reflected strong increases in net sales, increasing 14.8%, 36.3% and 24.5% for SG, PCG and EIG, respectively.

The $18.7 million increase in SG revenue in fiscal 2007 compared to the prior fiscal year was due primarily to an increase in sales of our dual beam IR-based tool and our new UV-based tool, partially offset by a decrease in system sales volumes of our single beam IR-based memory link processing tools.

The increase of $16.8 million in fiscal 2007 PCG sales compared to fiscal 2006 was driven by strong demand for our electrical test systems as manufacturers sought to build production capacity for multi-layer ceramic capacitor (MLCC) components. End-market demand for MLCC products has increased for wireless handsets, dual core microprocessors, flat panel displays and automotive electronics.

EIG sales levels increased by $8.3 million in fiscal 2007 compared to prior year. The increase was due to higher sales volumes of our single-head UV micro-via drilling systems for flex circuits, many of which are now included in cell phones, digital cameras and notebook PCs. Sales volume also increased for our dual-head IC packaging tool, which offers improved cost-of-ownership, yield and performance compared to our earlier models.

***Gross Profit***

Gross profit was $108.8 million (43.4% of net sales) in fiscal 2007 compared to $91.5 million (44.2% of net sales) in fiscal 2006. Despite volume-based manufacturing efficiencies on shipments that increased by 21% compared to the prior year, our gross margin rates were lower in fiscal 2007 compared to the prior year primarily due to changes in product sales mix, both among our product groups and among products within the product groups. The semiconductor group comprises our highest-margin products. Compared to the prior year, that group's revenue decreased by 3% as a percentage of total net sales with the offsetting increase primarily in the PCG group products, which are lower margin products.

***Operating Expenses***

*Selling, Service and Administration Expenses*

The primary items included in selling, service and administration expenses are labor and other employee-related expenses, travel expenses, professional fees, commissions and facilities costs. Selling, service and administration expenses were $49.1 million (19.6% of net sales) in fiscal 2007, an increase of $3.1 million compared to $46.0 million (22.2% of net sales) in fiscal 2006. The net increase was primarily due to $4.7 million in increased compensation costs. A portion of employee compensation costs for those directly engaged in ERP development was capitalized during fiscal 2006. As such, those capitalized costs were excluded from operating expenses for fiscal 2006. Additionally, we incurred higher share-based compensation costs in fiscal 2007 related to the adoption of SFAS 123R and higher variable incentive compensation costs due to increased business levels. These increases were partially offset by both lower professional fees and reduced legal fees related to the All Ring patent litigation.

*Research, Development and Engineering Expenses*

Expenses associated with research, development and engineering totaled $37.7 million (15.0% of net sales) for fiscal 2007, representing a $3.9 million increase from expenses of $33.8 million (16.3% of net sales) for fiscal 2006. The increase in research and development is primarily attributable to an increase in compensation costs due to 12% higher average headcount in fiscal 2007 compared to fiscal 2006, higher variable incentive compensation and higher share-based compensation costs related to the adoption of SFAS 123R. Other spending increases included professional services for patent registration and maintenance fees as well as an increase in funding for development projects and new technical capabilities. We will continue to emphasize research and development investments in the coming year in order to drive product innovation, new product offerings and penetration into emerging growth markets.

*Insurance Recoveries*

In the first quarter of fiscal 2007, we received a $1.3 million insurance recovery for demonstration systems that were destroyed in a fire at a customer's plant. We recorded a gain on the recovery as the book value of the assets had previously been written off.

In the second quarter of fiscal 2007, we recorded a gain of $1.0 million for an insurance settlement related to the shareholder and derivative lawsuits filed in 2003.

***Other Income***

Other income increased by $2.8 million to $10.4 million in fiscal 2007 compared to $7.6 million in fiscal 2006. The increase was primarily due to a rise in interest income of $2.3 million due to higher investment yields, which increased from an annualized effective year-to-date yield of 4.6% at the end of fiscal 2006 to 5.2% at the end of fiscal 2007. Weighted average invested assets in fiscal 2007 decreased to $222.9 million, compared to $225.2 million for fiscal 2006, which partially offset the increased investment yields. The increase in income due to rising market interest rates was also partially offset by a decrease in net interest income related to taxes refunds. During fiscal 2007, we received net interest income related to various income and property tax refunds and payments totaling $0.4 million, compared to $0.7 million for the prior fiscal year.

Our investment income in fiscal 2008 is expected to decrease due to the use of investment assets to purchase NWR and the remaining shares authorized under our repurchase program further described in the discussion of "Financial Condition and Liquidity" below. Future investment income levels will depend on our ability to generate and invest cash and obtain favorable returns on our investment assets.

***Income Taxes***

The income tax provision recorded for fiscal 2007 was $11.1 million on pre-tax income of $34.6 million, reflecting an effective rate of 32%. The fiscal 2007 income tax provision increased $12.6 million compared to the income tax benefit of $1.5 million on pre-tax income of $19.3 million in fiscal 2006, reflecting an effective tax benefit rate of 8%. The increase in the income tax provision was due both to the increase in taxable income and changes in the effective tax rate due to discrete income tax expense or benefit items recorded in fiscal 2007 and fiscal 2006. The fiscal 2007 income tax provision reflected a $1.0 million increase to income taxes payable related to a revision in Internal Revenue Service technical guidance. Comparatively, the income tax benefit for fiscal 2006 included a $5.9 million reduction in accrued income taxes due to the statutory closure of various tax years.

In October 2003 the Internal Revenue Service (IRS) began an audit of the tax years ending in 1996 through 2003. During fiscal 2005 we reached an agreement with the IRS on the tax return years under review. The examination process required a special report to be submitted by the IRS for congressional approval from the Joint Committee on Taxation. In fiscal 2006, we received notice from the IRS that the Joint Committee's review was completed without exception. As a result, we received approximately $7.2 million in tax refunds relating to those years in fiscal 2006. Additionally, we are subject to numerous ongoing state and foreign tax audits. Although the final outcome of these audits are uncertain, based on currently available information, management believes the ultimate resolutions will not have a materially adverse effect on our financial position or results of operations.

***Net Income***

As a result of the factors discussed above, net income in fiscal 2007 was $23.5 million, or $0.81 per basic and $0.80 per diluted share, compared to fiscal 2006 net income of $20.8 million, or $0.72 per basic and diluted share.

**Fiscal Year 2006 Compared to Fiscal Year 2005**

***Net Sales***

Net sales for fiscal 2006 decreased $26.4 million or 11.3% to $207.0 million compared to $233.4 million in fiscal 2005. The annual decrease reflected the industry environment at the beginning of fiscal 2006, in which we

experienced softened demand for our products. Over the course of fiscal 2006, however, demand for our products increased. Shipments in the first half of fiscal 2006 were $93.4 million, compared to shipments in the latter half of fiscal 2006 of $113.6 million. As a result, total net sales increased sequentially each quarter in fiscal 2006, from $44.5 million in the first quarter to $57.9 million in the fourth quarter.

Net sales by product group were as follows (net sales in thousands):

| | 2006 | | 2005 | |
|---|---|---|---|---|
| | **Net Sales** | **Percent of Total Net Sales** | **Net Sales** | **Percent of Total Net Sales** |
| **Semiconductor (SG)** | $126,682 | 61.2% | $138,574 | 59.4% |
| **Passive Components (PCG)** | 46,305 | 22.4 | 61,001 | 26.1 |
| **Electronic Interconnect (EIG)** | 34,019 | 16.4 | 33,796 | 14.5 |
| | $207,006 | 100.0% | $233,371 | 100.0% |

During fiscal 2006, net sales decreased in our SG and PCG product groups, while EIG remained stable compared to fiscal 2005. SG sales decreased $11.9 million or 8.6% from the prior fiscal year, as demand peaked for semiconductor products in the first half of fiscal 2005, and decreased thereafter consistent with the industry demand cycle. Net sales of SG products began to increase again in the latter half of fiscal 2006 and approached levels experienced in the first half of fiscal 2005 due primarily to increased unit sales of IR based systems as well as demand for our new UV based memory-link processing system.

PCG sales in fiscal 2006 decreased $14.7 million or 24.1% compared to the prior year. In the first quarter of fiscal 2005, PCG sales reached a four-quarter peak at approximately $21 million. Subsequently, PCG quarterly net sales decreased sequentially for the remainder of fiscal 2005 and somewhat stabilized over the first three quarters of fiscal 2006 in a range of $9 million to $12 million per quarter. In the fourth quarter of fiscal 2006, PCG net sales increased to $14 million due to a doubling in unit sales as compared to the first three quarters combined.

EIG sales remained stable at $34.0 million in fiscal 2006 compared to $33.8 million in fiscal 2005.

***Gross Profit***

Gross profit was $91.5 million (44.2% of net sales) for fiscal 2006 compared to $111.8 million (47.9% of net sales) for fiscal 2005. Overall gross margin rates declined 3.7 percentage points, resulting from lower overhead absorption per unit on reduced shipments, a shift in product sales mix within our product groups, competitive pricing pressure, an unfavorable margin impact from the sale of previous generation EIG product and the impact of information systems and technology costs related to the implementation of a new ERP system, as discussed below.

***Operating Expenses***

Included in fiscal 2006 operating expenses are charges related to our implementation of a new ERP system. All business functions were allocated service charges according to the function's derived benefit. Total ERP implementation expenses, net of capitalizable costs, were $3.1 million, of which $1.0 million is in included in cost of goods sold, $1.1 million is included in research and development expenses and $0.9 million is included in selling, service and administration costs. The ERP implementation expenses were primarily incurred in the second half of fiscal 2006.

*Selling, Service and Administration Expenses*

| (in thousands) | 2006 | 2005 |
|---|---|---|
| Selling, service and administration | $45,955 | $51,618 |
| Included in totals above: | | |
| Legal and professional fees—securities litigation and derivative lawsuits | 240 | 795 |
| Restructuring and cost management plans | — | 642 |
| Impact of special charges | $ 240 | $ 1,437 |

Selling, service and administration expenses were $46.0 million (22.2% of net sales) in fiscal 2006, a decrease of $5.7 million compared to $51.6 million (22.1% of net sales) in fiscal 2005. The primary items included in selling, service and administration expenses are labor, commissions and other employee-related expenses, travel expenses, professional fees and facilities costs.

Fiscal 2005 expenses of $51.6 million included $0.6 million in expenses related to our fiscal 2005 restructuring and cost management plans, consisting primarily of employee severance and related costs. Additionally, selling, service and administration expenses for fiscal 2006 and fiscal 2005 included $0.2 million and $0.8 million, respectively, in legal and professional fees related to the class action securities litigation and derivative lawsuits.

Selling, service and administration costs in fiscal 2006 included $0.9 million in costs related to the ERP implementation. Exclusive of the impact of the ERP implementation costs of $0.9 million in fiscal 2006 and special charges in fiscal 2006 and fiscal 2005 as detailed above, selling, service and administration expenses decreased by $5.4 million, primarily resulting from reduced compensation and commission expenses, decreased liability insurance premiums and a reduction in various professional service costs.

*Research, Development and Engineering Expenses*

Expenses associated with research, development and engineering totaled $33.8 million (16.3% of net sales) for fiscal 2006, representing a $5.8 million increase from expenses of $28.0 million (12.0% of net sales) for fiscal 2005. Research, development and engineering expenses in fiscal 2006 included $1.1 million in costs related to the ERP implementation and fiscal 2005 expenses included $0.3 million related to our fiscal 2005 restructuring plan. Exclusive of the impact of those charges, the $5.0 million increase in research and development is primarily attributable to increased investment in funding for development projects, new technical capabilities and initiatives, including an increase in compensation costs due to a higher average headcount in fiscal 2006 compared to fiscal 2005. Other spending increases included professional services for patent registration and maintenance fees as well as an increase in subcontracted services and materials used in research and development activities. We will continue to emphasize research and development investments in the coming year in order to drive product innovation, new product offerings and penetration into emerging growth markets.

***Other Income (Expense)***

Interest income was $8.5 million in fiscal 2006 compared to $6.5 million in fiscal 2005. The increase of $2.0 million is due primarily to increased investment yields as a result of rising market interest rates, partially offset by lower average invested asset balances compared to fiscal 2005, due to the liquidation of certain marketable securities in March 2005 to fund the redemption of $145.0 million in Convertible Notes.

Interest expense decreased $5.3 million to $0.2 million in fiscal 2006 compared to $5.5 million in fiscal 2005 due to the redemption of the Convertible Notes in the fourth quarter of fiscal 2005. As a result of the redemption of the Convertible Notes, we recorded charges totaling $4.1 million in fiscal 2005, comprised of a redemption premium of $2.5 million and a non-cash charge of $1.6 million for unamortized debt issuance costs.

### *Income Taxes*

The income tax benefit for fiscal 2006 was $1.5 million on pre-tax income of $19.3 million, compared to the income tax expense in the prior fiscal year of $6.4 million on pretax income of $26.3 million. The effective tax rate for fiscal 2006 was a benefit of 8% compared to a provision of 24% in fiscal 2005. The tax benefit in fiscal 2006 resulted from a $5.9 million reduction in accrued income taxes due to the statutory closure of various tax years, partially offset by income tax expense of $3.7 million and other discrete income tax expense items totaling $0.7 million.

In October 2003 the Internal Revenue Service (IRS) began an audit of the tax years ending in 1996 through 2003. During fiscal 2005 we reached an agreement with the IRS on the tax return years under review. The examination process required a special report to be submitted by the IRS for congressional approval from the Joint Committee on Taxation. In fiscal 2006, we received notice from the IRS that the Joint Committee's review was completed without exception. As a result, we received approximately $7.2 million in tax refunds relating to those years. Additionally, we are subject to numerous ongoing state and foreign tax audits. Although the final outcome of these audits are uncertain, based on currently available information, management believes the ultimate resolutions will not have a materially adverse effect on our financial position or results of operations.

### *Net Income*

As a result of the factors discussed above, net income was $20.8 million, or $0.72 per basic and diluted share, compared to fiscal 2005 net income of $19.8 million, or $0.70 per basic and $0.69 per diluted share.

## Restructuring and Cost Management Plans

In response to the economic climate and resulting cyclical fluctuations in demand for our products, we initiated restructuring and other cost management plans in fiscal 2005 and the preceding fiscal years.

### *Fiscal year 2005 restructuring plan*

In the third quarter of fiscal 2005, we initiated a restructuring plan designed to streamline our technology development efforts and enhance our customer-centric focus through several actions, including centralizing our research, development and engineering function, creating a technical marketing solutions group and creating a customer-centric manufacturing organization. In conjunction with the restructuring, 57 positions were eliminated in our U.S. operations, impacting all employee groups. Ongoing annual savings were offset by increased research and development spending in fiscal 2006. We started fiscal 2005 with 623 employees and ended the year with 563 employees, representing a net decrease of 60 employees during fiscal 2005. The restructuring actions were completed in early January 2005 and we incurred and paid approximately $1.2 million in charges related to the fiscal 2005 restructuring plan during the third quarter of fiscal 2005. These amounts are included in the consolidated statement of operations for fiscal 2005 as follows (in thousands):

| For the year ended May 28, 2005: | Cost of Goods Sold | Selling, Service and Administration | Research, Development and Engineering | Total |
|---|---|---|---|---|
| Severance and other employee-related charges . . . | $311 | $642 | $271 | $1,224 |
| | $311 | $642 | $271 | $1,224 |

## Financial Condition and Liquidity

At June 2, 2007, our principal sources of liquidity consisted of cash, cash equivalents and marketable securities of $228.7 million and accounts receivable of $55.7 million. At June 2, 2007, we had a current ratio of 6.6 and no long-term debt. Working capital increased by $19.3 million to $321.5 million at June 2, 2007 from $302.2 million at June 3, 2006.

On July 5, 2007, we announced an agreement to acquire NWR which was completed on July 20, 2007. We purchased NWR for approximately $45.4 million in cash, representing a $36 million base price plus an amount approximately equal to NWR's cash and cash equivalents at closing.

On March 9, 2007, the Board of Directors authorized the repurchase of up to $50 million in shares of our outstanding common stock during the nine-month period beginning April 17, 2007. The authority will be exercised from time to time as market conditions warrant through transactions in the open market or in negotiated transactions with brokers or shareholders. At the end of fiscal 2007, we had funded approximately $9.8 million of the share repurchases. We believe that our existing cash, cash equivalents and marketable securities are adequate to fund our operations, the acquisition of NWR and share repurchase transactions for at least the next twelve months.

Cash flows from operating activities totaled $23.7 million in fiscal 2007. Cash totaling $38.1 million was provided by net income adjusted for non-cash items. Other significant items generating or consuming cash flows from operations in fiscal 2007 included increases in receivables, inventories and payables and accrued liabilities.

Net trade receivables were $55.7 million at June 2, 2007 compared to $48.0 million at June 3, 2006, an increase of $7.7 million. The increase is primarily due to higher shipments late in the fourth quarter of fiscal 2007 resulting from increased sales volume. Days sales outstanding decreased to 71 days at the end of fiscal 2007, compared to 76 days at the end of fiscal 2006 as a higher percentage of shipments in the fourth quarter of fiscal 2007 had standard payment terms that resulted in improved collection periods.

Inventories increased $17.1 million to $81.0 million at June 2, 2007 compared to $63.8 million at June 3, 2006. The increase is comprised primarily of $8.2 million in additions to raw materials and purchased parts and an increase of $9.7 in work-in-process (WIP) inventories. These increases were driven by inventory build at the end of fiscal 2007 to support the ramp in anticipated shipments for the subsequent quarter due to increased orders and due to quantity purchases for certain high volume systems. WIP inventories at June 2, 2007 also included $2.9 million of engineering inventory for new product development.

Payables and accrued liabilities were $45.0 million at June 2, 2007 compared to $36.0 million at June 3, 2006, an increase of $9.0 million. The increase is primarily due to a rise of $2.5 million in trade accounts payable driven by raw materials purchases, an increase of $2.9 million in payroll liabilities and an increase of $3.9 million in income taxes payable. These increases to payables and current liabilities were offset by a $0.3 million decrease in other operating accruals.

Cash provided by investing activities totaled $2.8 million for the fiscal 2007. We generated a net $21.5 million in cash and cash equivalents through the maturity and sale of investments in our portfolio of marketable securities offset by certain reinvestments. Capital expenditures totaled $8.4 million during this period and were principally comprised of costs related to a major refurbishment of research and development clean rooms and laboratories, and computer hardware, software and ERP-related costs. During fiscal 2007, we invested $6.0 million in a Series D Preferred Stock financing of OmniGuide, Inc. and $5.0 million in a Series D Preferred Stock financing of Axsun Technologies, Inc., which are classified as other assets on the consolidated balance sheet as of June 2, 2007. Included in cash flow from investing activities was a $1.3 million insurance recovery received in fiscal 2007 for damaged demonstration systems. The acquisition of NWR which was agreed to on July 4, 2007 and completed on July 20, 2007 was financed with cash on hand. As of June 2, 2007, we had no material contractual commitments for future capital expenditures.

Cash flows used in financing activities totaled $6.0 million. Cash flows provided by financing activities were comprised of $3.3 million in proceeds from the exercise of stock options and other employee stock plan purchases and $0.5 million related to associated income tax benefits realized in fiscal 2007. These cash inflows were offset by $9.8 million in cash used to settle repurchase transactions for 504,000 shares of ESI common stock pursuant to the share repurchase program discussed above.

A summary of our contractual commitments and obligations as of June 2, 2007 is as follows (in thousands):

| Contractual Obligation | Payments Due By Period Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
|---|---|---|---|---|---|
| Purchase commitments | $46,126 | $46,126 | $— | $— | $— |
| Derivative financial instruments, net | 5,550 | 5,550 | — | — | — |
| Operating leases | 1,291 | 739 | 546 | 6 | — |
| | $52,967 | $52,967 | $546 | $ 6 | $— |

Derivative financial instruments represent various forward exchange contracts to hedge foreign currency transactions. Amounts are presented above in U.S. dollars, translated at the exchange rate on June 2, 2007 and are a net presentation of amounts expected to be received and paid upon settlement of these contracts.

### Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Our estimates are based on historical experience and on various assumptions that we believe to be reasonable under the circumstances. These estimates form the basis for judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Refer to Part II, Item 8. Note 1—Summary of Significant Accounting Policies, in the Notes to Consolidated Financial Statements for additional information.

Our critical accounting policies and estimates include the following:

- Revenue recognition;
- Inventory write-downs;
- Product warranty reserves;
- Allowance for doubtful accounts;
- Stock-based compensation;
- Deferred taxes and tax reserves;
- Loss contingencies;
- Valuation of cost method investments; and
- Long-lived asset valuations.

#### *Revenue Recognition*

We recognize revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, “Revenue Recognition” (SAB 104). Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. Title and risk of loss generally pass to the customer at the time of delivery of the product to a common carrier. Revenue is recognized upon such delivery, provided that fulfillment of acceptance criteria can be demonstrated prior to shipment. Where the acceptance criteria cannot be demonstrated prior to shipment, or in the case of substantially new products, revenue is deferred until acceptance has been received. For multiple element arrangements, the fair values of any undelivered elements are deferred until the elements are delivered and acceptance criteria are met. Installation services are not essential to the functionality of the delivered equipment and installation revenue is deferred until installation is complete. Historically, neither the costs of installation accrued nor the fair value of installation service revenue deferred has been significant.

Revenues associated with sales to customers under local contracts in Japan are recognized upon title transfer, which generally occurs upon customer acceptance. On sales to our distributor in Japan, where title transfers to the distributor generally upon shipment, revenue recognition is subject to our standard revenue recognition policy. We have no distributor relationships outside of Japan.

Revenues related to spare parts and consumable sales are generally recognized upon shipment. Revenues related to maintenance and service contracts are recognized ratably over the duration of the contracts.

Revenues are difficult to predict, due in part to our reliance on customer acceptance for a portion of our revenues. Any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in future operating losses.

***Inventory Write-downs***

We regularly evaluate the value of our inventory based on a combination of factors including, but not limited to, the following: forecasted sales or usage, historical usage rates, estimated service period, product end-of-life dates, estimated current and future market values, service inventory requirements and new product introductions. Purchasing requirements and alternative uses for the inventory are explored within these processes to mitigate inventory exposure. Raw materials with quantities in excess of forecasted usage are reviewed quarterly for obsolescence by our engineering and operating personnel. Raw material obsolescence write-downs are typically caused by engineering change orders or product end-of-life adjustments in the market. Finished goods are reviewed quarterly by product marketing and operating personnel to determine if inventory carrying costs exceed market selling prices. When necessary, we record inventory write-downs as an increase to cost of sales based on the above factors and take into account worldwide quantities and demand into our analysis. If circumstances related to our inventories change, our estimates of the value of inventory could materially change.

***Product Warranty Reserves***

We evaluate obligations related to product warranties quarterly. A standard one-year warranty is provided on most products. Warranty charges are comprised of costs to service the warranty, including labor to repair the system and replacement parts for defective items, as well as other costs incidental to the repairs. Warranty charges are recorded net of any cost recoveries resulting from either successful repair of damaged parts or from warranties offered by our suppliers for defective components. Using historical data, we estimate average warranty cost per system or part type and record the provision for such charges as an element of cost of goods sold upon recognition of the related revenue. Additionally, the overall warranty accrual balance is separately analyzed using the remaining warranty periods outstanding on systems and items under warranty, and any resulting changes in estimates are recorded as an adjustment to cost of sales upon shipment. If circumstances change, or if a material change in warranty-related incidents occurs, the estimate of the warranty accrual could change significantly. Accrued product warranty is included on the consolidated balance sheets as a component of accrued liabilities. Our warranty expense in fiscal 2007 totaled $6.5 million.

***Allowance for Doubtful Accounts***

Credit limits are established by reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of the customer to establish and modify their credit limits. On certain foreign sales, we require letters of credit. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer's account becomes past due, we talk with the customer to determine the cause. If we determine that the customer will be unable to fully meet its financial obligation to us, such as in the case of a bankruptcy filing or other material events impacting its business, we record a specific reserve for bad debt to reduce the related receivable to the amount we expect to recover given all information then available. If circumstances related to specific customers change, our estimates of the recoverability of receivables could materially change. We record estimated bad debt expense as an increase to selling, service and administration expenses. At June 2, 2007, our allowance for doubtful accounts totaled $0.6 million and our bad debt expense in fiscal 2007 was $0.1 million.

### *Stock-Based Compensation*

On June 4, 2006, we adopted SFAS 123R which requires the measurement and recognition of compensation expense for all share-based payment awards granted to our employees and directors, including employee stock options, non-vested stock and purchases under the employee stock purchase plan, based on the estimated fair value of the award on the grant date. Upon the adoption of SFAS 123R, we maintained our method of valuation for stock option awards using the Black-Scholes valuation model, which has historically been used for the purpose of providing pro-forma financial disclosures in accordance with SFAS No. 123.

The use of the Black-Scholes valuation model to estimate the fair value of stock option awards requires us to make assumptions regarding the risk-free interest rate, expected dividend yield, expected term and expected volatility over the expected term of the award. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates based on our historical data, but these estimates involve inherent uncertainties and the application of expense could be materially different in the future.

Compensation expense is only recognized on awards that ultimately vest. Therefore, we have reduced the compensation expense to be recognized over the vesting period for anticipated future forfeitures. Forfeiture estimates are based on historical forfeiture patterns. We will update our forfeiture estimates quarterly and recognize any changes to accumulated compensation expense in the period of change. If actual forfeitures differ significantly from our estimates, our results of operations could be materially impacted.

### *Deferred Taxes and Tax Reserves*

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those assets and liabilities are expected to be recovered or settled. Under SFAS No. 109 "Accounting for Income Taxes," the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. When management determines that it is more likely than not that a deferred tax asset will not be fully realized, a valuation allowance is established to reduce deferred tax assets to the amount expected to be realized. Should management's assumptions and expectations be inaccurate, our results of operations and financial condition could be adversely affected in future periods. At June 2, 2007, our net deferred tax assets totaled $20.8 million, which included a valuation allowance of $6.6 million.

We are subject to income taxes in the United States and in numerous foreign jurisdictions and in the ordinary course of business, there are transactions and calculations where the ultimate tax determination is uncertain. We have reserves for taxes to address potential exposures related to tax positions that could be challenged by taxing authorities, even though the Company believes that the positions taken on previously filed tax returns are appropriate. Tax reserves are reviewed as warranted and adjusted as events occur that affect the Company's potential liability for additional taxes.

### *Loss Contingencies*

Where we can make a reasonable estimate of the liability relating to pending litigation, we record a liability. As additional information becomes available, we assess the potential liability and revise estimates as appropriate. Because of uncertainties relating to litigation, however, the amount of our estimates could be wrong. Moreover, plaintiffs may not specify an amount of damages sought.

### *Valuation of Cost Method Investments*

Minority equity investments include $6.0 million invested in a Series D Preferred Stock financing for OmniGuide, Inc., representing an 11% interest, and $5.0 million invested in a Series D Preferred Stock financing for Axsun Technologies, Inc., representing a 14.5% interest. These investments are accounted for as cost method investments as specified by Accounting Principles Board Opinion (APB) No. 18, "The Equity Method of Accounting for Investments in Common Stock." In accordance with EITF 03-1, "The Meaning of Other-Than-

Temporary Impairment and Its Application to Certain Investments," at each reporting period end, we determine whether events or circumstances have occurred that are likely to have a significant adverse effect on the fair value of the investments. If there are no identified events or circumstances that may have a significant adverse effect on the fair value of the investments, the fair value of the investments are not calculated as it is not practicable to do so in accordance with SFAS No. 107, "Disclosures about Fair Value of Financial Instruments." As of June 2, 2007, management was not aware of any events or circumstances that indicated the investments were impaired, therefore the full carrying value of $11,000,000 was included in other assets in the consolidated balance sheet.

***Long-lived Asset Valuations***

Long-lived assets, principally property and equipment and identifiable intangibles held and used by us are reviewed for impairment whenever events or circumstances indicate that the carrying amount of assets may not be recoverable in accordance with SFAS No. 144. We evaluate recoverability of assets to be held and used by comparing the carrying amount of an asset to estimated future net undiscounted cash flows to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets.

## ***Item 7A. Quantitative and Qualitative Disclosures About Market Risk***

***Interest Rate Risk***

As of June 2, 2007, our investment portfolio includes marketable debt securities of $127.7 million. These securities are subject to interest rate risk and will decline in value if interest rates increase. These securities are classified as Securities Available for Sale; therefore, the impact of interest rate changes is reflected as a separate component of shareholders' equity. Due to the short duration of our investment portfolio, an immediate 10% change in interest rates would not have a material effect on the fair value of our invested assets; however, our interest income on invested assets over a 12-month period would change by approximately $1 million.

***Foreign Currency Exchange Rate Risk***

We have limited involvement with derivative financial instruments and do not use them for trading purposes. We do, however, use derivatives to manage well-defined foreign currency risks. We enter into forward exchange contracts to hedge forecasted Japanese sales commitments and the value of accounts receivable primarily denominated in Japanese yen and other material non-functional currency monetary asset and liability balances. The effect of an immediate 10% change in exchange rates on the forward exchange contracts and the underlying hedged positions would not be material to our financial position or the results of our operations.

The table below summarizes, by major currency, the notional amounts of our forward exchange contracts in U.S. dollars as of June 2, 2007 and June 3, 2006. The "bought" amounts represent the net U.S. dollar equivalents of commitments to purchase foreign currencies, and the "sold" amounts represent the net U.S. dollar equivalent of commitments to sell foreign currencies. The foreign currency amounts have been translated into a U.S. dollar equivalent value using the exchange rate at the reporting date.

| | Bought (Sold) (in thousands) | |
|---|---|---|
| **Foreign Currency** | **2007** | **2006** |
| Japanese Yen | $(4,514) | $(7,467) |
| Taiwan Dollar | (2,685) | (3,369) |
| Euro | 2,776 | 3,565 |
| British Pound | 2,191 | 855 |
| Korean Won | 7,782 | 6,097 |

***Item 8. Financial Statements and Supplementary Data***

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of
Electro Scientific Industries, Inc.:

We have audited the accompanying consolidated balance sheets of Electro Scientific Industries, Inc. (an Oregon corporation) and subsidiaries as of June 2, 2007 and June 3, 2006, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended June 2, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements 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 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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro Scientific Industries, Inc. and subsidiaries as of June 2, 2007 and June 3, 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended June 2, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, effective June 4, 2006, Electro Scientific Industries, Inc. adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Electro Scientific Industries, Inc.'s internal control over financial reporting as of June 2, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated August 13, 2007 expressed an unqualified opinion on management's assessment of, and effective operation of, internal control over financial reporting.

/s/ KPMG LLP
Portland, Oregon
August 13, 2007

**ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**As of June 2, 2007 and June 3, 2006**
**(in thousands)**

| | 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $100,462 | $ 79,961 |
| Marketable securities | 124,607 | 140,106 |
| Total cash and securities | 225,069 | 220,067 |
| Trade receivables, net of allowances of $626 and $689 | 55,722 | 47,978 |
| Inventories | 80,981 | 63,834 |
| Shipped systems pending acceptance | 1,817 | 3,941 |
| Deferred income taxes, net | 9,504 | 9,682 |
| Prepaid and other current assets | 5,776 | 5,980 |
| Total current assets | 378,869 | 351,482 |
| Long-term marketable securities | 3,622 | 9,265 |
| Property, plant and equipment, net | 43,859 | 43,338 |
| Deferred income taxes, net | 11,246 | 15,618 |
| Other assets | 28,072 | 17,762 |
| Total assets | $465,668 | $437,465 |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 13,826 | $ 11,272 |
| Accrued liabilities | 31,222 | 24,705 |
| Deferred revenue | 12,290 | 13,321 |
| Total current liabilities | 57,338 | 49,298 |
| Commitments and Contingencies (Notes 12 and 15) | | |
| Shareholders' equity: | | |
| Preferred stock, without par value; 1,000 shares authorized; no shares issued | — | — |
| Common stock, without par value; 100,000 shares authorized; 28,766 and 29,051 issued and outstanding | 162,719 | 166,459 |
| Retained earnings | 245,546 | 222,022 |
| Accumulated other comprehensive income (loss) | 65 | (314) |
| Total shareholders' equity | 408,330 | 388,167 |
| Total liabilities and shareholders' equity | $465,668 | $437,465 |

See accompanying Notes to Consolidated Financial Statements.

**ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**For the years ended June 2, 2007, June 3, 2006 and May 28, 2005**
**(in thousands, except per share data)**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Net sales | $250,824 | $207,006 | $233,371 |
| Cost of sales | 142,054 | 115,518 | 121,541 |
| Gross profit | 108,770 | 91,488 | 111,830 |
| Operating expenses: | | | |
| Selling, service and administration | 49,119 | 45,955 | 51,618 |
| Research, development and engineering | 37,703 | 33,837 | 28,027 |
| Patent infringement settlement and related legal fees | — | — | 2,240 |
| Insurance recoveries | (2,287) | — | — |
| | 84,535 | 79,792 | 81,885 |
| Operating income | 24,235 | 11,696 | 29,945 |
| Interest income | 10,769 | 8,494 | 6,535 |
| Interest expense | (58) | (208) | (5,471) |
| Redemption charges—convertible subordinated notes | — | — | (4,149) |
| Other expense, net | (319) | (695) | (586) |
| | 10,392 | 7,591 | (3,671) |
| Income before income taxes | 34,627 | 19,287 | 26,274 |
| Provision for (benefit from) income taxes | 11,103 | (1,536) | 6,437 |
| Net income | $ 23,524 | $ 20,823 | $ 19,837 |
| Net income per share—basic | $ 0.81 | $ 0.72 | $ 0.70 |
| Net income per share—diluted | $ 0.80 | $ 0.72 | $ 0.69 |
| Weighted average number of shares—basic | 29,125 | 28,823 | 28,434 |
| Weighted average number of shares—diluted | 29,379 | 29,078 | 28,572 |

See accompanying Notes to Consolidated Financial Statements.

**ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME**
**For the years ended June 2, 2007, June 3, 2006 and May 28, 2005**
**(in thousands)**

| | Common Stock | | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|
| | Shares | Amount | | | |
| **Balance at May 29, 2004** | 28,175 | $147,054 | $181,362 | $(1,603) | 326,813 |
| Stock Plans: | | | | | |
| Employee stock plans | 440 | 9,141 | — | — | 9,141 |
| Tax benefit of stock options exercised | — | 172 | — | — | 172 |
| Comprehensive income: | | | | | |
| Net income | — | — | 19,837 | — | 19,837 |
| Net unrealized gain on securities, net of tax | — | — | — | 615 | 615 |
| Net unrealized gain on derivative instruments, net of tax | — | — | — | 23 | 23 |
| Cumulative translation adjustment, net of tax | — | — | — | 554 | 554 |
| Annual comprehensive income | | | | | 21,029 |
| **Balance at May 28, 2005** | 28,615 | 156,367 | 201,199 | (411) | 357,155 |
| Stock Plans: | | | | | |
| Employee stock plans | 436 | 8,462 | — | — | 8,462 |
| Tax benefit of stock options exercised | — | 1,630 | — | — | 1,630 |
| Comprehensive income: | | | | | |
| Net income | — | — | 20,823 | — | 20,823 |
| Net unrealized loss on securities, net of tax | — | — | — | (141) | (141) |
| Net unrealized gain on derivative instruments, net of tax | — | — | — | 31 | 31 |
| Cumulative translation adjustment, net of tax | — | — | — | 207 | 207 |
| Annual comprehensive income | | | | | 20,920 |
| **Balance at June 3, 2006** | 29,051 | $166,459 | $222,022 | $ (314) | $388,167 |
| Share repurchases | (504) | (10,430) | | | (10,430) |
| Stock Plans: | | | | | |
| Employee stock plans | 219 | 6,202 | — | — | 6,202 |
| Tax benefit of stock options exercised | — | 488 | — | — | 488 |
| Comprehensive income: | | | | | |
| Net income | — | — | 23,524 | — | 23,524 |
| Net unrealized gain on securities, net of tax | — | — | — | 380 | 380 |
| Net unrealized loss on derivative instruments, net of tax | — | — | — | (21) | (21) |
| Cumulative translation adjustment, net of tax | — | — | — | 208 | 208 |
| Annual comprehensive income | | | | | 24,091 |
| Adjustment for adoption of SFAS No. 158, net of tax | — | — | — | (188) | (188) |
| **Balance at June 2, 2007** | 28,766 | $162,719 | $245,546 | $ 65 | $408,330 |

See accompanying Notes to Consolidated Financial Statements.

**ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the years ended June 2, 2007, June 3, 2006 and May 28, 2005**
**(in thousands)**

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | $ 23,524 | $ 20,823 | $ 19,837 |
| Adjustments to reconcile net income to cash provided by operating activities: | | | |
| Depreciation and amortization | 8,370 | 7,914 | 8,286 |
| Stock based compensation | 2,884 | 1,353 | 1,691 |
| Write-off of unamortized debt issuance costs | — | — | 1,590 |
| Loss on disposal of property and equipment | 2 | 79 | 430 |
| Provision for (recovery of) doubtful accounts | 103 | (153) | 211 |
| Tax benefit of stock options exercised | — | 1,630 | 172 |
| Insurance recovery on fire-damaged equipment | (1,287) | — | — |
| Deferred income taxes | 4,516 | 2,451 | 5,841 |
| Changes in operating accounts: | | | |
| (Increase) decrease in trade receivables | (8,085) | (11,329) | 16,895 |
| Increase in inventories | (16,343) | (3,709) | (5,279) |
| Decrease in shipped systems pending acceptance | 2,124 | 73 | 377 |
| (Increase) decrease in prepaid and other current assets | 82 | 6,532 | (1,477) |
| Increase (decrease) in accounts payable and accrued liabilities | 8,884 | 2,506 | (23,025) |
| Increase (decrease) in deferred revenue | (1,031) | 335 | 1,001 |
| Net cash provided by operating activities | 23,743 | 28,505 | 26,550 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Purchase of property, plant and equipment | (8,407) | (18,293) | (4,710) |
| Proceeds from sales of property, plant and equipment | 6 | — | 95 |
| Insurance recovery on fire-damaged equipment | 1,287 | — | — |
| Proceeds from the sale of assets held for sale | — | — | 2,361 |
| Maturity of restricted investments | — | — | 6,251 |
| Purchase of securities | (619,884) | (688,226) | (428,265) |
| Proceeds from sales of securities and maturing securities | 641,406 | 696,302 | 517,438 |
| Omniguide and Axsun equity investments | (11,000) | — | — |
| Increase in other assets | (652) | (6,750) | (848) |
| Net cash provided by (used in) investing activities | 2,756 | (16,967) | 92,322 |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Redemption of convertible subordinated notes | — | — | (145,000) |
| Share repurchases | (9,804) | — | — |
| Tax benefits realized from stock options exercised | 488 | — | — |
| Proceeds from exercise of stock options and stock plans | 3,318 | 7,109 | 7,084 |
| Net cash provided by (used in) financing activities | (5,998) | 7,109 | (137,916) |
| **NET CHANGE IN CASH AND CASH EQUIVALENTS** | 20,501 | 18,647 | (19,044) |
| **CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD** | 79,961 | 61,314 | 80,358 |
| **CASH AND CASH EQUIVALENTS AT END OF PERIOD** | $ 100,462 | $ 79,961 | $ 61,314 |
| **SUPPLEMENTAL CASH FLOW INFORMATION** | | | |
| Cash paid for interest | $ — | $ (104) | $ (7,516) |
| Cash (paid for) received from income taxes, net | (1,999) | 6,708 | (3,296) |

See accompanying Notes to Consolidated Financial Statements.

## ELECTRO SCIENTIFIC INDUSTRIES, INC.
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### *Principles of Consolidation and Nature of Operations*

The accompanying consolidated financial statements include the accounts of Electro Scientific Industries, Inc. and its subsidiaries, all of which are wholly owned (collectively, the Company). All material intercompany accounts and transactions have been eliminated. The Company designs and manufactures high-technology manufacturing equipment for the global electronics market, including advanced laser systems that are used to microengineer electronic device features in high-volume production environments. The Company's customers are primarily manufacturers of semiconductors, passive electronic components and electronic interconnect devices. Principal products include:

- laser manufacturing systems for semiconductor yield improvement;
- production, test and inspection equipment for the manufacture of passive components;
- laser micro-via drilling systems used to process high-density interconnect (HDI) circuit boards, flexible circuits, and electronic packages; and
- machine vision systems.

The Company serves the global electronics market from its headquarters in Portland, Oregon and through subsidiaries located in the United States, Europe and Asia.

#### *Fiscal Year*

The Company's fiscal year consists of 52 or 53 weeks ending on the Saturday nearest May 31. Accordingly, fiscal 2007 ended on June 2, 2007, fiscal 2006 ended on June 3, 2006 and fiscal 2005 ended on May 28, 2005 and those fiscal years contained 52 weeks, 53 weeks and 52 weeks, respectively. All references to years relate to fiscal years unless otherwise noted.

On July 3, 2007, the Company's Board of Directors approved a change in the Company's reporting periods that results in a fiscal year end on the Saturday nearest March 31. Accordingly, the Company's fiscal year 2008 will consist of approximately a ten month period containing 43 weeks ending on March 29, 2008.

#### *Reclassifications*

Certain reclassifications have been made in the accompanying consolidated financial statements for 2006 to conform to the 2007 presentation.

#### *Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ from those estimates. Management believes that the estimates used are reasonable. Significant estimates made by management include: inventory write-downs; allowances for uncollectible trade accounts receivables; valuation of minority equity investments; long-lived asset valuations; product warranty reserves; loss contingency reserves; revenue recognition; stock compensation valuation, and income tax benefits, expenses and deferred taxes.

### *Risks and Uncertainties*

The Company uses financial instruments that potentially subject it to concentrations of credit risk. Such instruments include cash equivalents, marketable securities available for sale, trade receivables and financial instruments used in hedging activities. The Company invests cash in cash deposits, money market funds, commercial paper, certificates of deposit and readily marketable debt securities. Investments are placed with high credit quality financial institutions and the credit exposure from any one institution or instrument is minimized. To date, the amounts of losses experienced on these investments have not been material.

The Company sells a significant portion of its products to a small number of large electronics manufacturers. In fiscal 2007, ten customers accounted for approximately 62% of total net sales. Two customers accounted for a cumulative 34%, 25% and 21% of total net sales in fiscal 2007, 2006 and 2005, respectively. One other customer accounted for an additional 10% of total net sales in 2006. No other customer accounted for more than 10% of total net sales in 2007 and 2005. The Company's operating results could be adversely affected if the financial condition and operations of these key customers decline.

The Company's net investment exposure in foreign subsidiaries translated into U.S. Dollars using the period-end exchange rates at June 2, 2007, was approximately $35 million. The potential loss in fair value resulting from a hypothetical 10% adverse change in foreign exchange rates would be approximately $3.5 million at June 2, 2007. The Company has no plans of liquidating any of its foreign subsidiaries, and therefore, foreign exchange rate gains or losses on foreign investments are reflected as a cumulative translation adjustment and do not affect our results of operations.

The Company's operations involve a number of other risks and uncertainties including but not limited to those relating to the cyclicality of the electronics market, the availability of materials provided by suppliers, the effect of general economic conditions, rapid changes in technology and international operations.

### *Cash Equivalents and Marketable Securities*

All highly liquid investments with a maturity of 90 days or less at the date of purchase are considered to be cash equivalents. Short-term marketable securities have maturities of less than one year or are subject to immediate pre-payment or call provisions. Marketable securities consist primarily of marketable debt securities and are classified as "available for sale" and recorded at fair market value. Unrealized gains and losses on marketable securities are recorded as a component of accumulated other comprehensive income within shareholders' equity. To determine whether any existing impairment is considered other-than-temporary and an impairment loss is required to be recognized in the consolidated statement of operations, the Company evaluates its marketable securities based on the nature of the investments and the Company's ability to hold the securities until the securities are no longer carrying an unrealized loss. The Company determined that there was no other-than-temporary impairment as of June 2, 2007. See Note 3.

### *Accounts Receivable and Allowance for Doubtful Accounts*

Trade accounts receivable are stated at the amount the Company expects to collect and do not bear interest. Credit limits are established by reviewing the financial history and stability of each customer. Where appropriate, the Company obtains credit rating reports and financial statements of the customer to establish or modify their credit limits. On certain foreign sales, letters of credit are required. The collectibility of trade receivable balances is regularly evaluated based on a combination of factors such as customer credit-worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If it is determined that a customer will be unable to fully meet its financial obligation, such as in the case of a bankruptcy filing or other material events impacting its business, a specific reserve for bad debt is recorded to reduce the related receivable to the amount expected to be recovered.

***Inventories***

Inventories are principally valued at standard costs, which approximate the lower of cost (first-in, first-out) or market. Costs utilized for inventory valuation purposes include material, labor and manufacturing overhead. See Note 4.

***Shipped Systems Pending Acceptance***

Shipped systems pending acceptance relate to systems that have been ordered and shipped to the customer, but have been deferred in accordance with the Company's revenue recognition policy. Shipped systems pending acceptance are recognized as cost of sales once all criteria for revenue recognition have been met and revenue is recorded. Shipped systems pending acceptance are valued at standard costs, which approximate the lower of cost (first-in, first-out) or market. Costs utilized in the valuation of shipped systems pending acceptance include material, labor and manufacturing overhead and exclude costs of installation.

***Property, Plant and Equipment***

Property, plant and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance, repairs and minor improvements are charged to expense as incurred. Major improvements and additions are capitalized. When assets are sold or retired, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is included as a component of operating expenses. See Note 5.

***Costs of Computer Software for Internal Use***

Costs incurred related to the implementation of an enterprise resource planning (ERP) system are accounted for in accordance with Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (SOP 98-1). Computer software costs are capitalized according to the criteria specified by SOP 98-1, including external direct costs of materials and services consumed in obtaining and developing internal-use computer software and payroll and related costs for employees who are directly associated with the implementation project to the extent of the time spent directly on the project. See Note 5.

***Long-Lived Asset Impairment***

Long-lived assets, principally property, equipment and identifiable intangibles are reviewed for impairment whenever events or circumstances indicate that the carrying amount of assets may not be recoverable in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The Company evaluates recoverability of assets to be held and used by comparing the carrying amount of an asset to estimated future net undiscounted cash flows generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. The Company determined that there was no impairment as of June 2, 2007. See Notes 5 and 6.

***Other Assets***

Other assets include goodwill, patents, consignment and demonstration (demo) equipment, minority equity investments and long-term deposits.

The Company accounts for goodwill pursuant to SFAS No. 142, "Goodwill and Other Intangible Assets," which requires that goodwill no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of SFAS No. 142. Goodwill was tested for impairment in the fourth quarter of fiscal 2007 utilizing a fair value comparison method that considered the Company's market capitalization and it was determined that there was no impairment as of June 2, 2007.

The Company's intangible assets with estimable useful lives, which consist primarily of patents, are accounted for in accordance with SFAS No. 142 and are amortized over their estimated useful lives of 17 years.

Consigned, demo and training equipment are recorded at the lower of standard costs or estimated market values, until the assets are sold. These assets are also reviewed quarterly for impairment.

Minority equity investments include $6.0 million invested in a Series D Preferred Stock financing for OmniGuide, Inc., representing an 11% interest, and $5.0 million invested in a Series D Preferred Stock financing for Axsun Technologies, Inc., representing a 14.5% interest. These investments are accounted for as cost method investments as specified by Accounting Principles Board Opinion (APB) No. 18, "The Equity Method of Accounting for Investments in Common Stock." In accordance with EITF 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," at each reporting period end, the Company determines whether events or circumstances have occurred that are likely to have a significant adverse effect on the fair value of the investments. If there are no identified events or circumstances that may have a significant adverse effect on the fair value of the investments, the fair value of the investments are not calculated as it is not practicable to do so in accordance with SFAS No. 107, "Disclosures about Fair Value of Financial Instruments." As of June 2, 2007, management was not aware of any events or circumstances that indicated the investments were impaired, therefore the full carrying value of $11,000,000 was included in other assets in the consolidated balance sheet. See Note 6.

### *Fair Value of Financial Instruments*

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to the short maturities of these financial instruments. Marketable securities are recorded at fair market value based on quoted market prices for those investments at each period end.

### *Derivative Financial Instruments*

The Company's primary objective for holding derivative financial instruments is to manage currency risk. In accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," the Company's accounting policies for these instruments are based on whether they meet the Company's criteria for designation as hedging transactions, either as cash flow or fair value hedges. A hedge of the exposure to variability in the cash flows of an asset or a liability, or of a forecasted transaction, is referred to as a cash flow hedge. A hedge of the exposure to changes in fair value of an asset or a liability, or of an unrecognized firm commitment, is referred to as a fair value hedge. The criteria for designating a derivative as a hedge include the instrument's effectiveness in risk reduction and, in most cases, a one-to-one matching of the derivative instrument to its underlying transaction. See Note 11 for further detail on cash flow and remeasurement hedge contracts as of June 2, 2007 and June 3, 2006.

### *Revenue Recognition*

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition" (SAB 104). Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. Title and risk of loss generally pass to the customer at the time of delivery of the product to a common carrier. Revenue is recognized upon such delivery, provided that fulfillment of acceptance criteria can be demonstrated prior to shipment. Where the acceptance criteria cannot be demonstrated prior to shipment, or in the case of substantially new products, revenue is deferred until acceptance has been received. For multiple element arrangements, the fair value of any undelivered elements is deferred until the elements are delivered and acceptance criteria are met. Installation services are not essential to the functionality of the delivered equipment and installation revenue is deferred until installation is complete. Neither the costs of installation accrued nor the fair value of installation service revenue deferred has been significant.

Revenues associated with sales to customers under local contracts in Japan are recognized upon title transfer, which generally occurs upon customer acceptance. On sales to the Company's distributor in Japan, where title transfers to the distributor generally upon shipment, revenue recognition is subject to our standard revenue recognition policy. The Company has no distributor relationships outside of Japan.

Revenues related to spare parts and consumable sales are generally recognized upon shipment. Revenues related to maintenance and service contracts are recognized ratably over the duration of the contracts.

***Product Warranty***

The Company evaluates obligations related to product warranties quarterly. A standard one-year warranty from the date of acceptance is provided on most products. Warranty charges are comprised of costs to service the warranty, including labor to repair the system and replacement parts for defective items, as well as other costs incidental to the repairs. Warranty charges are recorded net of any cost recoveries resulting from either successful repair of damaged parts or from warranties offered by the Company's suppliers for defective components. Using historical data, the Company estimates average warranty cost per system or part type and records the provision for such charges as an element of cost of goods sold upon recognition of the related revenue. Additionally, the overall warranty accrual balance is separately analyzed using the remaining warranty periods outstanding on systems and items under warranty, and any resulting changes in estimates are recorded as an adjustment to cost of sales. If circumstances change, or if a material change in warranty-related incidents occurs, the estimate of the warranty accrual could change significantly. Accrued product warranty is included on the consolidated balance sheets as a component of accrued liabilities. See Note 10.

***Research and Development***

Research and development costs, which include labor and related employee expenses, patent maintenance fees, project materials, project subcontractors, depreciation of engineering equipment, building costs and other administration expenses, are expensed as incurred as research, development and engineering expense in the consolidated statements of operations.

***Taxes on Unremitted Foreign Income***

Under APB No. 23, "Accounting for Income Taxes—Special Areas," the Company is required to provide for deferred taxes on the undistributed earnings of a subsidiary which is included in consolidated income of the parent, except to the extent that the income is intended to be indefinitely reinvested or remitted in a tax-free liquidation.

The Company provides for income taxes on its foreign subsidiaries' results based on their effective income tax rates in each respective jurisdiction. Additional U.S. income tax expense is recorded on the unremitted foreign earnings, including any estimated withholding taxes, as if those earnings were repatriated to the U.S. parent company.

***Comprehensive Income***

SFAS No. 130, "Reporting Comprehensive Income," establishes standards for the reporting and presentation of comprehensive income and its components in financial statements. Comprehensive income includes net income and "other comprehensive income," which includes charges or credits to equity that are not the result of transactions with shareholders. Comprehensive income within these consolidated financial statements includes cumulative foreign currency translation adjustments, unrealized gains and losses on securities available for sale and certain gains or losses on foreign currency forward contracts.

### *Net Income per Share*

Basic earnings per share (EPS) and diluted EPS are computed using the methods prescribed by SFAS No. 128, "Earnings per Share." Basic EPS is computed utilizing the weighted average number of shares outstanding during the period. Diluted EPS also considers common stock equivalents, such as stock options and stock awards, to the extent that they are not antidilutive. See Note 13.

### *Stock-Based Compensation Plans*

Prior to June 4, 2006, the Company used the intrinsic value method under APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations to account for stock options and unvested stock awards issued to its employees under its stock option plans, which are described more fully in Note 17. On June 4, 2006, the Company adopted the provisions of SFAS No. 123(R), "Share-Based Payment," (SFAS 123R), requiring the Company to recognize expense related to the fair value of its stock-based compensation awards. The Company has elected to use the modified prospective transition method as permitted by SFAS 123R and therefore financial statement amounts for the prior periods presented in this Form 10-K have not been restated to reflect the fair value method of expensing stock-based compensation. Additionally, stock-based compensation expense under SFAS 123R includes expense for unvested stock-based payment awards granted prior to June 3, 2006 based on the grant date fair value determined in accordance with the provisions of SFAS 123, "Accounting for Stock-Based Compensation." The Company uses the Black-Scholes model to estimate the fair value of all stock-based compensation awards on the date of grant, except for unvested stock awards which are valued at the fair market value on the date of award. The Company recognizes the compensation expense for options and unvested stock awards on a straight-line basis over the requisite service period of each award.

Prior to the adoption of SFAS 123R, disclosures were provided of net income and net income per share as if the fair value of stock-based awards to employees had been applied. This pro forma information for the fiscal 2006 and fiscal 2005 is as follows (in thousands, except per share data):

| | 2006 | 2005 |
|---|---|---|
| Net income, as reported | $ 20,823 | $ 19,837 |
| Add—Stock-based employee compensation expense included in reported net income, net of related tax effects | 866 | 1,082 |
| Deduct—Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effect | (11,993) | (20,859) |
| Net income, pro forma | $ 9,696 | $ 60 |
| Net income per share—basic, as reported | $ 0.72 | $ 0.70 |
| Net income per share—diluted, as reported | $ 0.72 | $ 0.69 |
| Net income per share—basic, pro forma | $ 0.34 | $ 0.00 |
| Net income per share—diluted, pro forma | $ 0.33 | $ 0.00 |

As further described in Note 17, the Compensation Committee of the Board of Directors accelerated the vesting of certain stock options during fiscal 2005 and fiscal 2006. The total pro forma stock-based employee compensation expense for fiscal 2006 of $12.0 million includes $10.5 million for options that were granted in fiscal 2006 and fully vested during the fiscal year. The total pro forma stock-based employee compensation expense of $20.9 million for fiscal 2005 includes $4.0 million resulting from the January 25, 2005 acceleration and $10.1 million resulting from the June 28, 2004 acceleration.

The following table presents the impact of the adoption of SFAS 123R on selected items from the Company's consolidated financial statements for fiscal year 2007 (in thousands, except per share data):

| | As reported under SFAS 123(R) | If reported under APB 25 |
|---|---|---|
| Consolidated Statements of Operations: | | |
| Operating income | $24,235 | $25,879 |
| Income before income taxes | 34,627 | 36,271 |
| Net income | 23,524 | 24,853 |
| Basic earnings per share | $ 0.81 | $ 0.85 |
| Diluted earnings per share | $ 0.80 | $ 0.85 |
| Consolidated Statements of Cash Flows: | | |
| Net cash provided by operating activities | $23,743 | $24,231 |
| Net cash used by financing activities | $ (5,998) | $ (6,486) |

Stock-based compensation was included in our consolidated statements of operations as follows (in thousands):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Cost of sales | $ 509 | $ 112 | $ — |
| Selling, service, and administration | 1,665 | 1,057 | 1,640 |
| Research, development, and engineering | 710 | 184 | 51 |
| Stock-based compensation expense before income taxes | 2,884 | 1,353 | 1,691 |
| Income tax benefit | (1,040) | (487) | (609) |
| Total stock-based compensation expense after income taxes | $ 1,844 | $ 866 | $1,082 |

The total amount of cash received from the exercise of stock options in the year ended June 2, 2007 was $0.8 million. The total amount of cash received from the ESPP purchases in fiscal 2007 was $2.5 million. For the year ended June 2, 2007, there was $0.5 million in tax benefit realized from the exercise of stock options and ESPP purchases. Upon exercise of stock options, the Company issues new shares of common stock from its authorized shares.

The Company has elected to adopt the alternative transition method provided in FASB Staff Position (FSP) No. FAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards" (FSP 123R-3) for calculating the tax effects of stock-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the APIC pool related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R.

As of June 2, 2007, no stock-based compensation costs were capitalized and the Company had $5.3 million of total unamortized stock-based compensation costs, net of estimated forfeitures, to be recognized over a weighted average period of 2.1 years.

The Black-Scholes option pricing model is utilized to determine the fair value of options granted. The following weighted average assumptions were used in calculating the fair value during the periods presented:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Risk-free interest rate | 4.55% | 4.33% | 3.83% |
| Expected dividend yield | 0% | 0% | 0% |
| Expected lives | 4.6 years | 4.9 years | 5.7 years |
| Expected volatility | 49% | 56% | 65% |

Options were granted to members of the Scientific Advisory Board during fiscal 2007. Since these are non-employee options, the valuation will not be final until the vesting date, February 16, 2009. As such, these options are revalued at the end of each reporting period. The expense for these non-employee options was estimated for fiscal 2007 based on the following assumptions:

| | 2007 |
|---|---|
| Risk-free interest rate | 4.50% |
| Expected dividend yield | 0% |
| Expected lives | 10 years |
| Expected volatility | 58.7% |

The following weighted average assumptions were made in calculating the fair value of all shares issued under the ESPP during the periods presented:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Risk-free interest rate | 4.93% | 4.44% | 2.33% |
| Expected dividend yield | 0% | 0% | 0% |
| Expected lives | 1.1 years | 1.1 years | 1.2 years |
| Expected volatility | 33% | 38% | 54% |

The risk-free rates used are based on the U.S. Treasury yields over the expected terms. The expected term and forfeiture estimates for stock options are based on an analysis of actual exercise behavior. The expected term for options granted to members of the Scientific Advisory Board is based on the contractual life of the option as required by EITF 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." The expected term for the ESPP is the weighted average length of the purchase periods. The Company uses its historical volatility over the estimated expected term as the expected volatility.

***Segment Reporting***

The Company complies with SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No. 131, which is based on a management approach to segment reporting, establishes requirements to report selected segment information quarterly and to report annually entity-wide disclosures about products, major customers and the geographies in which the entity holds material assets and reports revenue. An operating segment is defined as a component that engages in business activities whose operating results are reviewed by the chief operating decision maker and for which discrete financial information is available. Based on the provisions of SFAS No. 131, the Company has determined that it operates in one segment. The Company manages its resources and assesses its performance on an enterprise-wide basis. The Company's product groups qualify for aggregation under SFAS No. 131 due to their similarities in customer base, economic characteristics, nature of products and services, and procurement, manufacturing and distribution processes.

***Employee Benefit Plans***

The Company has an employee savings plan under the provisions of Section 401(k) of the Internal Revenue Code. Contributions to the plan by the Company were $1.1 million, $0.9 million and $0.9 million for fiscal 2007, 2006 and 2005, respectively.

The Company has defined benefit retirement plans at certain of its foreign subsidiaries. During fiscal 2007, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)" and has recorded the effects of adopting SFAS No. 158 with an adjustment to accumulated other comprehensive income. The adoption of SFAS No. 158 did not materially impact the Company's consolidated financial position and results of operations.

## NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN 48). This pronouncement prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect of FIN 48 on its consolidated financial statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force (EITF) Issue No. 06-03, "How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (that is, Gross Versus Net Presentation)" (EITF 06-03). The EITF reached a consensus that the presentation of taxes on either a gross or net basis is an accounting policy decision that requires disclosure. EITF 06-03 is effective for our fiscal year beginning June 3, 2007. Sales tax amounts collected from customers have been recorded on a net basis. The adoption of EITF 06-03 will not have any effect on our financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 does not impose fair value measurements on items not already accounted for at fair value; rather it applies, with certain exceptions, to other accounting pronouncements that either require or permit fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact, if any, of adopting SFAS 157 on its financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159)," which permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the impact that the elective adoption of SFAS 159 may have on our results of operations or financial position.

## NOTE 3. MARKETABLE SECURITIES

The Company accounts for marketable securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Except as described below, marketable securities are classified as available for sale and, accordingly, they are recorded on the consolidated balance sheets at fair value with unrealized gains and losses reported as a component of accumulated other comprehensive income within shareholders' equity. All investments in marketable debt securities are high credit quality securities.

In fiscal 2007, the Company established a trust account to fund its liability under a non-qualified deferred compensation (NQDC) plan. Investments held in the trust are comprised primarily of mutual funds and a cash equivalent option. The Company holds invested assets in the trust in accordance with NQDC plan participant elections. Participants may change their investment elections at any time and the Company classifies mutual fund trust assets as trading securities included in current assets, with changes in the market value of the securities recorded as a component of non-operating income. There were no material unrealized gains or losses on the NQDC trust asset investments in fiscal 2007. Trust assets included in marketable securities at June 2, 2007 totaled $0.5 million.

Proceeds from the sales and maturities of available for sale securities were $641.4 million, $696.3 million and $517.4 million during fiscal 2007, 2006 and 2005, respectively. There were no sales of available for sale securities in fiscal 2007. Net losses on sales during fiscal 2006 and 2005 were $0.1 million and $0.2 million, respectively. For purpose of determining gross realized gains and losses, the cost of securities sold is based on specific identification. Net unrealized holding gains (losses) on available for sale securities in the tax-effected amounts of $0.4 million, ($0.1 million) and $0.6 million for fiscal 2007, 2006 and 2005, respectively, have been included in accumulated other comprehensive income.

During fiscal 2005, the Company generated cash from sales of available for sale securities totaling $188.2 million. These sales transactions were entered into primarily to fund the redemption of the convertible subordinated notes.

Certain information regarding marketable securities at June 2, 2007 and June 3, 2006 is as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Fair market value of debt securities: | | |
| Federal government and government agency | $100,199 | $121,616 |
| Corporate | 27,514 | 27,755 |
| Total | $127,713 | $149,371 |
| Fair market value of NQDC trust securities | $ 516 | $ — |
| Net unrealized gain (loss) on available for sale securities | $ 187 | $ (412) |
| Maturity information: | | |
| Less than one year | $124,607 | $140,106 |
| One to three years | 3,622 | 9,265 |
| Total | $128,229 | $149,371 |

**NOTE 4. INVENTORIES**

The components of inventories at June 2, 2007 and June 3, 2006 are as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Raw materials and purchased parts | $50,021 | $41,830 |
| Work-in-process | 19,170 | 9,498 |
| Finished goods | 11,790 | 12,506 |
| | $80,981 | $63,834 |

**NOTE 5. PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment consisted of the following as of June 2, 2007 and June 3, 2006 (in thousands):

| | Estimated Useful Lives | 2007 | 2006 |
|---|---|---|---|
| Land | n/a | $ 3,047 | $ 3,047 |
| Buildings and improvements | 3 to 40 years | 37,884 | 33,228 |
| Machinery and equipment | 3 to 10 years | 35,903 | 33,453 |
| Computer equipment and software | 1 to 7 years | 25,726 | 24,772 |
| | | 102,560 | 94,500 |
| Less accumulated depreciation and amortization | | (58,701) | (51,162) |
| | | $ 43,859 | $ 43,338 |

Depreciation and amortization expense totaled $8.2 million, $7.6 million and $7.2 million in fiscal 2007, 2006 and 2005, respectively.

Costs related to the implementation of an ERP system that met the criteria for capitalization under SOP 98-1 totaled $0.8 million in fiscal 2007 and $10.9 million in fiscal 2006.

## NOTE 6. OTHER ASSETS

Other assets consisted of the following as of June 2, 2007 and June 3, 2006 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Goodwill | $ 1,442 | $ 1,442 |
| Patents, net | 188 | 249 |
| Consignment and demo equipment | 7,516 | 8,335 |
| Minority equity investments | 11,000 | — |
| Other | 7,926 | 7,736 |
| | $28,072 | $17,762 |

See Note 1 for discussion of minority equity investments.

Other assets include a Taiwan dollar security bond posted with the Kaohsiung Court in Taiwan related to the Company's filing of a patent infringement suit against All Ring Tech Co., Ltd. in that jurisdiction. This deposit is valued at $6.9 million and $7.2 million at June 2, 2007 and June 3, 2006, respectively, and will be held by the court pending final resolution of the matter. See Note 15.

Amortization expense totaled $0.2 million, $0.3 million and $0.4 million in fiscal 2007, 2006 and 2005, respectively.

## NOTE 7. INCOME TAXES

The Company accounts for income taxes under the asset and liability method prescribed by SFAS No. 109, "Accounting for Income Taxes." Under this method, deferred income taxes are recognized for the future tax consequences attributable to temporary differences between the financial statement and tax balances of existing assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those assets and liabilities are expected to be recovered or settled. Under SFAS No. 109, the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. When management determines that it is more likely than not that a deferred tax asset will not be fully realized, a valuation allowance is established to reduce deferred tax assets to the amount expected to be realized.

Net deferred tax assets at June 2, 2007 and June 3, 2006 consisted of the following (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Deferred tax assets: | | |
| Receivable and inventory valuation | $ 3,950 | $ 5,371 |
| Payroll-related accruals | 383 | 336 |
| Product warranty costs | 1,401 | 1,278 |
| Deferred revenue | 3,356 | 3,212 |
| Property, plant and equipment | 638 | — |
| Other comprehensive (gains) losses | (49) | 179 |
| Other accrued liabilities | 3,710 | 2,099 |
| Tax loss and credit carryforwards | 14,876 | 19,309 |
| Total deferred tax assets | 28,265 | 31,784 |
| Deferred tax liabilities | (880) | (352) |
| Valuation allowance | (6,635) | (6,132) |
| Net deferred tax asset | $20,750 | $25,300 |

The net increase in the valuation allowance was $0.5 million, $2.6 million and $1.0 million during fiscal 2007, fiscal 2006 and fiscal 2005, respectively. The Company believes it is more likely than not that the net deferred tax assets of $20.8 million reflected on the June 2, 2007 consolidated balance sheet will be realized based on future forecasts of taxable income over a relatively short time horizon. The Company believes that its valuation allowance of $6.6 million on deferred tax assets is adequate, although a change to the valuation allowance against the deferred tax assets in future periods may be recorded if its future forecasts of taxable income are not achieved.

As of June 2, 2007 the Company had approximately $14.9 million in tax assets resulting from federal, state and foreign net operating losses and tax credits. A detailed breakdown of the net operating loss carryforwards (tax-effected) and tax credits at June 2, 2007 and June 3, 2006 are as follows (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Federal net operating losses | $ 2,316 | $ 5,064 |
| State net operating losses | 3,052 | 3,509 |
| Foreign net operating losses and credits | 1,455 | 2,013 |
| Federal and state research credits | 6,724 | 7,555 |
| Federal minimum tax credit | 1,243 | 1,168 |
| Federal capital losses | 86 | — |
| | $14,876 | $19,309 |

The federal operating losses of $2.3 million were acquired as part of prior acquisitions and expire on various dates through 2012. If any of the valuation allowance related to the acquired federal operating losses is subsequently recognized, the benefit will be recorded as a reduction to goodwill in accordance with SFAS No. 109. The state operating losses of $3.1 million expire on various dates through 2024. The foreign tax credits expire on various dates through 2016. The federal and most of the state research credits expire on various dates through 2027. Certain state research credits and the minimum tax credits are available indefinitely.

These tax losses and credits are subject to certain limitations caused by the change in ownership. Accordingly, their utilization in future periods may be restricted. As such some of these losses may not be realizable and valuation allowances of $6.6 million and $6.1 million have been recorded as of June 2, 2007 and June 3, 2006, respectively.

The components of income before income taxes and the provision for (benefit from) income taxes are as follows, all from continuing operations (in thousands):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Income before income taxes: | | | |
| Domestic | $30,213 | $16,274 | $22,141 |
| Foreign | 4,414 | 3,013 | 4,133 |
| Total income before income taxes | $34,627 | $19,287 | $26,274 |
| Provision for (benefit from) income taxes: | | | |
| Current: | | | |
| U.S. federal and state | $ 5,565 | $ (5,163) | $ (941) |
| Foreign | 1,216 | 1,054 | 1,985 |
| | 6,781 | (4,109) | 1,044 |
| Deferred | 4,322 | 2,573 | 5,393 |
| Total provision for (benefit from) income taxes | $11,103 | $ (1,536) | $ 6,437 |

The tax benefit related to stock option exercises has been recorded as an increase to common stock rather than a reduction to the provision for income taxes in accordance with SFAS No. 109.

A reconciliation of the Company's effective tax rate to the United States federal statutory income tax rate is as follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| U.S. federal statutory income tax rate | 35.0% | 35.0% | 35.0% |
| State income taxes, net of federal benefit | 0.9 | 5.0 | 1.4 |
| Tax credits | (5.5) | (5.8) | (6.7) |
| Export tax incentives | (3.6) | (12.3) | (13.4) |
| Non-U.S. income taxed at different rates | 2.3 | (0.8) | 4.4 |
| Changes in accrued taxes | 4.0 | (30.9) | — |
| Other, net | (1.0) | 1.8 | 3.8 |
| | 32.1% | (8.0)% | 24.5% |

In October 2003 the Internal Revenue Service (IRS) began an audit of the Company's tax years ending in 1996 through 2003. During fiscal 2005 the Company and the IRS reached agreement on the tax return years under review. The examination process requires a special report to be submitted by the IRS for congressional approval from the Joint Committee on Taxation. In fiscal 2006, the Company received notice from the IRS that the Joint Committee's review was completed without exception. As a result, in fiscal 2006 the Company received approximately $7.2 million in tax refunds and recorded a $5.9 million reversal of previously accrued income taxes relating to those years. Additionally, the Company is subject to numerous ongoing state and foreign tax audits. Although the final outcome of these audits are uncertain, based on currently available information management believes the ultimate resolutions will not have a materially adverse effect on the Company's financial position or results of operations.

The Company is subject to income taxes in the United States and in numerous foreign jurisdictions. In the ordinary course of business, there are transactions and calculations where the ultimate tax determination is uncertain. The Company has reserves for taxes to address potential exposures related to tax positions that could be challenged by taxing authorities, even though the Company believes that the positions taken on previously filed tax returns are appropriate. Tax reserves are reviewed as warranted and adjusted as events occur that affect the Company's potential liability for additional taxes.

## NOTE 8. ACCRUED LIABILITIES

Accrued liabilities consist of the following at June 2, 2007 and June 3, 2006 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| Payroll-related | $11,391 | $ 8,445 |
| Product warranty | 3,893 | 3,716 |
| Income taxes payable | 8,718 | 4,846 |
| Other | 7,220 | 7,698 |
| | $31,222 | $24,705 |

See Note 10 for discussion of the accrual for product warranty.

### NOTE 9. DEFERRED REVENUE

The following is a reconciliation of the changes in deferred revenue for fiscal years 2007 and 2006 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| **Beginning of fiscal year** | $ 13,321 | $ 12,986 |
| Revenue deferred | 26,521 | 23,425 |
| Revenue recognized | (27,552) | (23,090) |
| **End of fiscal year** | $ 12,290 | $ 13,321 |

### NOTE 10. PRODUCT WARRANTY

The following is a reconciliation of the changes in the aggregate product warranty accrual for fiscal years 2007, 2006 and 2005 (in thousands):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| **Beginning of fiscal year** | $ 3,716 | $ 3,625 | $ 4,720 |
| Warranty charges incurred, net | (6,080) | (5,617) | (6,198) |
| Provision for warranty charges | 6,257 | 5,708 | 5,103 |
| **End of fiscal year** | $ 3,893 | $ 3,716 | $ 3,625 |

Warranty charges incurred include labor charges and replacement parts for system repairs under warranty and are recorded net of any cost recoveries resulting from either successful repair of damaged parts or from warranties offered by the Company's suppliers for defective components. The provision for warranty charges reflects the revised estimate of future anticipated net warranty costs to be incurred for all products under warranty at fiscal year end and is recorded as an adjustment to cost of sales.

### NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. It does, however, use derivatives to manage well-defined foreign currency risks. The Company enters into forward exchange contracts to hedge forecasted Japanese sales commitments and the value of accounts receivable primarily denominated in Japanese yen and other material non-functional currency monetary asset and liability balances. Foreign exchange contracts have gains and losses that are recognized at the end of each fiscal period. Such gains and losses have been immaterial to the results of operations and are typically offset by the corresponding changes to the related underlying transactions. Cash flows from derivative financial instruments are classified in the same category as the cash flows from the items being hedged.

In accordance with SFAS No. 133, hedges of anticipated transactions are designated and documented at inception as "cash flow hedges" and are evaluated for effectiveness, excluding time value, on a monthly basis. As a result, the forward contracts designated by the Company to hedge forecasted Japanese sales denominated in yen are cash flow hedges. The critical terms of the forward contract, such as amount and timing, are matched to the forecasted sale. The effectiveness of the cash flow hedge is determined by comparing the change in value of the anticipated transaction to the change in value of the related forward contracts, excluding time value. The effective portion of the hedge is accumulated in other comprehensive income and any ineffectiveness along with the time value change in the instrument is recognized immediately in other income and expense. Other comprehensive income associated with the hedges of forecasted sales is reclassified to revenue upon revenue recognition. As of June 2, 2007, the Company had no outstanding forward exchange contracts that were designated as cash flow hedges in accordance with SFAS No. 133.

In addition to "cash flow hedges", the Company uses "remeasurement hedges" to hedge non-functional currency monetary assets and liabilities held outside the U.S. These non-functional currency monetary balances are reviewed monthly and, if material, are hedged using the local functional currency value at the current month balance sheet rate. Forward contracts are one month in duration and at the settlement of the contract, any resulting gains or losses are reflected in other income and expense.

At June 2, 2007 and June 3, 2006 the Company had net forward exchange contracts to purchase (sell) foreign currencies totaling $5.6 million and ($0.3 million), respectively. In general, these contracts mature in less than one year and the counterparties are large, highly rated banks; therefore, the Company believes that the risk of loss as a result of nonperformance by the banks is minimal. The use of derivatives has not had, and is not expected to have, a significant effect on financial position or the results of operations.

The table below summarizes, by major currency, the notional amounts of forward exchange contracts in U.S. dollars as of June 2, 2007 and June 3, 2006. The "bought" amounts represent the net U.S. dollar equivalents of commitments to purchase foreign currencies, and the "sold" amounts represent the net U.S. dollar equivalent of commitments to sell foreign currencies. The foreign currency amounts have been translated into a U.S. dollar equivalent value using the exchange rate as of June 2, 2007 and June 3, 2006.

| | Bought (Sold) (in thousands) | |
|---|---|---|
| **Foreign Currency** | **2007** | **2006** |
| Japanese Yen | $(4,514) | $(7,467) |
| Taiwan Dollar | (2,685) | (3,369) |
| Euro | 2,776 | 3,565 |
| British Pound | 2,191 | 855 |
| Korean Won | 7,782 | 6,097 |

## NOTE 12. COMMITMENTS AND CONTINGENCIES

The Company leases certain equipment, automobiles and office space under operating leases, which are non-cancelable and expire on various dates through fiscal 2011. The aggregate minimum commitment for rentals under operating leases beyond June 2, 2007 is as follows (in thousands):

| **Fiscal** | |
|---|---|
| 2008 | $ 739 |
| 2009 | 395 |
| 2010 | 151 |
| 2011 | 6 |
| Thereafter | — |
| Total minimum lease payments | $1,291 |

Rental expense for all operating leases was $0.9 million, $0.9 million and $0.9 million in fiscal 2007, 2006 and 2005, respectively. In addition to the operating lease commitments detailed above, the Company had firm purchase order commitments in the ordinary course of business, which are primarily for inventories, totaling $46.1 million at June 2, 2007.

In the normal course of business, the Company indemnifies customers with respect to certain matters. The Company has agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from other third party claims that our products, when used for their intended purposes, infringe the intellectual property rights of such other third parties. To date, the Company has not recorded any material charges related to this indemnification.

## NOTE 13. EARNINGS PER SHARE

Following is a reconciliation of weighted average shares outstanding used in the calculation of basic and diluted earnings per share for fiscal 2007, 2006 and 2005 (in thousands, except per share amounts):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Weighted average shares outstanding—basic | 29,125 | 28,823 | 28,434 |
| Effect of dilutive stock options and awards | 254 | 255 | 138 |
| Weighted average shares outstanding—diluted | 29,379 | 29,078 | 28,572 |

In fiscal 2007, 2006 and 2005, there were approximately 3,373,000, 2,600,000 and 3,306,000 antidilutive common stock equivalents related to employee stock options and awards that were excluded from the diluted EPS calculations because inclusion would have had an antidilutive effect.

## NOTE 14. SHARE REPURCHASE PROGRAM

On March 9, 2007, the Company's Board of Directors authorized the repurchase of up to $50 million in shares of the Company's outstanding common stock during the nine-month period beginning April 17, 2007. The authority is to be exercised from time to time as market conditions warrant through transactions in the open market or in negotiated transactions with brokers or shareholders. During the fourth quarter of fiscal 2007, 504,000 shares were repurchased at a total purchase price of $10.4 million. Cash used to settle the repurchase transactions as of June 2, 2007 totaled $9.8 million and is reflected as a component of cash used in financing activities in the consolidated statements of cash flows. Accrued liabilities include $0.6 million for amounts owed on the unsettled repurchase transactions as of June 2, 2007.

## NOTE 15. LEGAL MATTERS

*All Ring Patent Infringement Prosecution*

In August 2005, the Company commenced a proceeding in the Kaohsiung District Court of Taiwan (the Court) directed against All Ring Tech Co., Ltd. (All Ring) of Taiwan. The Company alleged that All Ring's Capacitor Tester Model RK-T6600 (the Capacitor Tester) infringes ESI's Taiwan Patent No. 207469, entitled "Circuit Component Handler" (the 207469 patent). This patent corresponds to ESI's U.S. Patent No. 5,842,579. The patented technology is used in the Model 3340 Multifunction MLCC Tester. The Court issued a Provisional Attachment Order in August 2005 and All Ring filed a bond with the Court to obtain relief from the attachment of its assets. In July 2007, the Court issued a second Provisional Attachment Order, and approximately US$6.0 million was frozen in All Ring's accounts.

In October 2005, the Court executed a Preliminary Injunction Order that prohibits All Ring from manufacturing, selling, offering for sale or using the Capacitor Tester until final judgment is entered in the formal patent infringement action. Pursuant to the Court's orders, the Company was required to post with the Court a Taiwan dollar security bond, which is valued at approximately US$6.9 million and is included in other assets on the Company's consolidated balance sheets. An additional bond amount of US$2.1 million was posted in fiscal 2008 on June 13, 2007 related to the second Provisional Attachment Order.

In October 2005, ESI filed a formal patent infringement action against All Ring in the Court. In May 2006, after all parties filed briefs on the topic, the Court appointed an expert to conduct a patent infringement assessment. The Court-appointed expert has completed the assessment of the Capacitor Tester and concluded that it infringes every claim of the 207469 patent.

In November 2005, All Ring filed a cancellation action against ESI's 207469 patent in the Taiwan Intellectual Property Office (the IPO). On July 5, 2007, the IPO issued a notice requiring the Company to cancel two of the claims in the 207469 patent. No other claims of the patent have been rejected. The Company intends to vigorously pursue its patent infringement claims against All Ring and defend against the cancellation action.

*Patent Infringement Settlement*

On October 29, 2004, the Company entered into a settlement and license agreement with Cognex Corporation (Cognex) resolving a lawsuit filed by Cognex on February 14, 2001 in the United States District Court for the District of Massachusetts (Cognex Corporation v. Electro Scientific Industries, Inc. No. 01-10287 WGY). The lawsuit, which alleged that the Company's CorrectPlace product and some of its predecessors infringed United States Patent 5,371,690 owned by Cognex, was dismissed with prejudice on November 1, 2004. Under the settlement agreement, Cognex has granted the Company a license to the patent in dispute as well as certain covenants not to sue under various other surface mount placement equipment-related patents, and as consideration for the license the Company agreed to pay Cognex an undisclosed license fee. As a result of the settlement, the Company recorded a charge to operations of $2.2 million in fiscal 2005, consisting of $1.8 million related to the settlement payment along with approximately $0.4 million in related legal fees.

In addition to the legal matters described above, in the ordinary course of business the Company is involved in various other legal matters, either asserted or unasserted, and investigations. In the opinion of management, ultimate resolution of these matters will not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

## NOTE 16. SHAREHOLDER RIGHTS PLAN

The Company renewed its Shareholder Rights Plan in May 1999 and accordingly declared a dividend distribution of one Right for each outstanding share of common stock, payable to holders of record on June 4, 1999. On March 1, 2001, the Rights Agreement was amended and restated appointing Mellon Investor Services as the Rights Agent, successor to First Chicago Trust Company of New York. Under certain conditions, each right may be exercised to purchase 1/100 of a share of Series A No Par Preferred Stock at a purchase price of $270, subject to adjustment. The Rights are not presently exercisable and will only become exercisable following the occurrence of certain specified events. Generally, the Rights become exercisable after a person or group acquires or commences a tender offer that would result in beneficial ownership of 15 percent or more of outstanding common stock. In addition, the Rights become exercisable if any party becomes a beneficial owner of 10 percent or more of outstanding common stock and is determined by the Board of Directors to be an adverse party. If a person or group acquires 15 percent of outstanding common stock or the Board of Directors declares a person to be an Adverse Person, each Right will be adjusted to entitle its holder to receive, upon exercise, common stock, or, in certain circumstances, other assets of the Company having a value equal to twice the exercise price of the Right. If, after the Rights become exercisable, the Company is acquired in a merger or other business combination, each Right will be adjusted to entitle its holder to receive, upon exercise, common stock of the acquiring company having a value equal to twice the exercise price of the Right, depending on the circumstances. The Rights expire on May 7, 2009 and may be redeemed by us for $0.001 per Right. The Rights do not have voting or dividend rights and, until they become exercisable, have no dilutive effect on the Company's earnings.

## NOTE 17. STOCK-BASED COMPENSATION PLANS

In October 2004, the shareholders approved the adoption of the 2004 Stock Incentive Plan (the 2004 Plan) that replaced various stock compensation plans that were previously approved by the shareholders or the Board of Directors (the Replaced Plans), except with respect to options and other awards previously outstanding. Outstanding options and awards remained subject to the terms of the Replaced Plans under which they were originally granted. At that time, the shareholders also approved the reservation of 3,000,000 shares of common stock for issuance under the 2004 Plan. These shares are in addition to any shares of common stock that, at the time the 2004 Plan, was approved by shareholders, were available for grant under the Replaced Plans or that may subsequently become available for grant under any of the Replaced Plans through the expiration, termination, forfeiture or cancellation of grants. In January 2005, the Board of Directors approved certain amendments to the 2004 Plan. These amendments prohibit option grants with an exercise price less than fair market value, require that time-based restricted stock awards have a minimum vesting period of at least three years, with the subject

shares vesting no more quickly than one-third annually over the three-year period, and expressly prohibit the reservation of additional shares under the 2004 Plan without shareholder approval. In April 2005, the Board of Directors approved another amendment to the 2004 Plan extending the period during which an option may be exercised following termination of employment or service if an optionee dies within the 90-day exercise period following termination.

The 2004 Plan allows for grants of stock options, stock bonuses (including restricted stock units), restricted stock and performance-based awards. Stock options outstanding under the 2004 Plan and the Replaced Plans vest over variable periods determined at the grant date, generally with terms of immediate vesting or up to four years, and expire ten years from the date of grant. Certain options granted in fiscal 2006 vested immediately or prior to the end of the fiscal year with sale restrictions. Options issued under the 2004 Plan and the Replaced Plans are exercisable at prices not less than fair market value on the date of the grant. The 2004 Plan prohibits repricing of options granted without prior shareholder approval. Restricted stock grants issued under the Replaced Plans vest based on certain performance criteria that are tied to the Company's results of operations and/or length of service. Certain restricted stock units awarded under the 2004 Plan vest based on performance criteria that are tied to the Company's results of operations, personal performance criteria, and, in certain cases, length of service.

During fiscal 2005, the Company granted two options to purchase 25,000 and 50,000 shares, respectively, to certain key executives. During fiscal 2007, the Company granted an option to purchase 100,000 shares to another key executive and options to purchase an aggregate of 25,000 shares to members of the Scientific Advisory Board. The Board of Directors authorized these grants as inducements for joining the Company and the grants were not made under a shareholder approved plan. The exercise price for each option grant is the fair market value of the Company's stock on the date of the grant. Options granted to the key executives become exercisable with respect to 25 percent of the underlying shares each year over four years. Options granted to members of the Scientific Advisory Board become exercisable on February 16, 2009.

In September 1990, the shareholders approved the adoption of the 1990 Employee Stock Purchase Plan, as amended in September 1998, October 2003 and October 2004 (the ESPP), pursuant to which 1,900,000 shares of common stock have been reserved for issuance to participating employees. Eligible employees may elect to contribute up to 15 percent of their base wage and any commissions during each pay period. The ESPP provides for separate overlapping 24-month offerings starting every three months. Each offering has eight purchase dates occurring every three months on designated dates. The offerings under the ESPP commence on January 15, April 15, July 15 and October 15 of each calendar year. Any eligible employee may participate in only one offering at a time and may purchase shares only through payroll deductions permitted under the ESPP. At the end of each three-month purchase period, the purchase price is determined and the accumulated funds are used to automatically purchase shares of common stock. The purchase price per share is equal to 85 percent of the lower of the fair market value of the common stock on (a) the first day of the offering period or (b) the date of purchase. The ESPP also provides that if the fair market value of the common stock on the first day of the new offering period is less than or equal to the fair market value of the common stock on the first date of any ongoing offering, employees participating in any such ongoing offering will be automatically withdrawn from it and enrolled in the new offering.

On January 25, 2005, the Compensation Committee of the Board of Directors (the Compensation Committee) accelerated the vesting, effective immediately, of all the Company's unvested stock options awarded to employees, other than those awarded to the President and Chief Executive Officer at his time of hire (which are discussed in the next paragraph), having an exercise price greater than $20.24. Except as noted in the following paragraph, no options were accelerated for members of the Board of Directors. The closing price of the Company's common stock on the NASDAQ National Market on January 25, 2005 was $17.14. As a result of the acceleration, options to acquire approximately 220,000 shares of the Company's common stock, which otherwise would have vested from time to time over the following 42 months, became immediately exercisable. No compensation expense has been recorded in the consolidated statements of operations related to this modification as the market price of the common stock on the date of the modification was lower than the exercise price of the accelerated options.

On January 25, 2005, the Compensation Committee accelerated the vesting of 315,000 shares of the Company's common stock subject to an option granted to Nicholas Konidaris, the Company's President and Chief Executive Officer, so that the option became fully exercisable on August 26, 2005. The option has an exercise price of $25.71. Under the terms of the original option agreement, 105,000 shares would have vested on each of January 7, 2006, January 7, 2007 and January 7, 2008. For book reporting purposes, the Company accelerated approximately $1.5 million of unamortized expense related to this award ratably from the date of change over the reduced vesting period, which ended August 26, 2005. This expense would otherwise have been expensed ratably through December 2007. Additionally, a stock option granted to Mr. Konidaris to purchase 40,000 shares of the Company's common stock was accelerated effective January 25, 2005. The option had an exercise price of $25.50. Under the terms of the original option agreement, 10,000 shares would have vested on each of July 13, 2005, July 13, 2006, July 13, 2007 and July 13, 2008. In connection with both of these accelerations, Mr. Konidaris agreed that the shares underlying the accelerated options may not be sold by him until the dates those shares would otherwise have been vested under the terms of the original option agreements.

On June 28, 2004, the Compensation Committee of the Board of Directors approved an acceleration of the vesting of those employee stock options, excluding stock options granted to the Board of Directors and President and Chief Executive Officer, with an option price equal to or greater than the closing sale price of $23.38 per share on that date, as reported on the NASDAQ National Market. Options to purchase approximately 1.2 million shares of stock with varying remaining vesting schedules were subject to the acceleration provision and became immediately exercisable. No compensation expense was recorded in the consolidated statements of operations related to this modification as the market price of the common stock on the date of the modification was lower than the exercise price of the accelerated options.

The acceleration of the stock option vesting schedules in fiscal 2005 and fiscal 2006 reduced the amortization of the Company's stock option compensation expense for fiscal 2007.

At June 2, 2007, the Company had 9,227,654 shares of its common stock reserved for issuance under all of the above plans combined. Of those shares, 4,515,616 are subject to issuance under currently outstanding stock options and stock awards and 4,712,038 shares are available for future grants. The weighted-average fair-value of stock-based compensation awards, including stock option awards granted and vested during the period, unvested stock awards granted during the period and the intrinsic value of stock options exercised during the period were (in thousands, except per share data):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Stock Option Awards: | | | |
| Grant date fair value per share | $ 9.85 | $ 10.57 | $ 12.04 |
| Total fair value of options granted | $1,990 | $14,147 | $10,790 |
| Total fair value of options vested | $1,039 | $29,900 | $10,487 |
| Total intrinsic value of options exercised | $ 288 | $ 2,009 | $ 1,795 |
| Unvested Stock Awards | | | |
| Grant date fair value per share | $18.95 | $ 20.13 | $ 24.04 |
| Total fair value of awards granted | $2,128 | $ 674 | $ 2,752 |
| Employee Stock Purchase Plan | | | |
| Grant date fair value per share | $ 6.09 | $ 6.88 | $ 6.43 |
| Total grant date fair value | $3,377 | $ 492 | $ 2,205 |

Information with respect to stock option activity is as follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (thousands) |
|---|---|---|---|---|
| **Outstanding as of June 3, 2006** | 4,340,517 | $25.27 | | |
| Granted | 202,000 | $20.21 | | |
| Exercised | (52,597) | $14.82 | | |
| Expired or forfeited | (197,498) | $28.10 | | |
| **Outstanding as of June 2, 2007** | 4,292,422 | $25.03 | 6.22 | $3,727 |
| **Vested and expected to vest as of June 2, 2007** | 4,262,034 | $25.06 | 6.20 | $3,695 |
| **Exercisable as of June 2, 2007** | 4,022,922 | $25.39 | 6.05 | $3,399 |

Information with respect to unvested stock awards activity is as follows:

| | Shares | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (thousands) |
|---|---|---|---|---|
| **Outstanding as of June 3, 2006** | 111,220 | $22.48 | | |
| Awarded | 117,974 | $18.95 | | |
| Vested | (2,000) | $19.83 | | |
| Forfeited | (4,000) | $18.76 | | |
| **Outstanding as of June 2, 2007** | 223,194 | $20.01 | 2.27 | $4,625 |

**NOTE 18. GEOGRAPHIC AND PRODUCT INFORMATION**

Net sales by product type were as follows (in thousands):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Semiconductor Group (SG) | $145,381 | $126,682 | $138,574 |
| Passive Components Group (PCG) | 63,093 | 46,305 | 61,001 |
| Electronic Interconnect Group (EIG) | 42,350 | 34,019 | 33,796 |
| | $250,824 | $207,006 | $233,371 |

Sales by geographic area, based on the location of the end user, were as follows (in thousands):

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Asia | $187,228 | $155,959 | $180,378 |
| Americas | 40,987 | 36,351 | 35,277 |
| Europe | 22,609 | 14,696 | 17,716 |
| | $250,824 | $207,006 | $233,371 |

Long-lived assets, exclusive of marketable securities and deferred tax assets, by geographic area were as follows at June 2, 2007 and June 3, 2006 (in thousands):

| | 2007 | 2006 |
|---|---|---|
| United States | $62,365 | $51,680 |
| Asia | 9,430 | 9,286 |
| Europe | 136 | 134 |
| | $71,931 | $61,100 |

**NOTE 19. CONVERTIBLE SUBORDINATED NOTES**

In December 2001 and January 2002, the Company sold $150 million aggregate principal amount of 4 ¼% convertible subordinated notes (the Convertible Notes) due in December 2006 in a private offering. The Company received proceeds, net of the initial purchaser's discount, from these sales of approximately $145.5 million. As discussed below, the Company repurchased or redeemed the aggregate principal amount prior to May 28, 2005.

Interest of $3.1 million was due semi-annually on each June 21 and December 21. Interest expense in the accompanying consolidated statements of operations also included accretion of underwriting discounts and debt issuance costs of $0.7 million in fiscal 2005. Principal was originally due at maturity on December 21, 2006. In accordance with the terms of the Convertible Note indenture, the Company was required to place $18.2 million in trust. This restricted investment was invested in treasury bills and was sufficient to satisfy the first six interest payments due through December 2004 under the terms of the indenture. The Convertible Notes were convertible into shares of common stock at a conversion price of $38.00 per share, subject to adjustment in certain circumstances.

In fiscal 2003, the Company repurchased $5.0 million principal amount of the Convertible Notes in the open market. In the fourth quarter of fiscal 2005, the Company redeemed the remaining $145.0 million aggregate principal amount of the Convertible Notes. In accordance with the terms of the Convertible Note indenture, the redemption price was 101.70% of the principal amount of the Convertible Notes, plus accrued and unpaid interest to the redemption date. In connection with the redemption, the Company recorded expenses of approximately $4.1 million in the fourth quarter of fiscal 2005, consisting of the redemption premium, a non-cash charge for unamortized debt issuance costs of approximately $1.6 million and other related costs.

**NOTE 20. RESTRUCTURING AND COST MANAGEMENT PLANS**

The following table reflects changes in accruals related to restructuring and cost management activities, which are reflected in the "other" component of accrued liabilities in the accompanying consolidated balance sheets, for the three years ended June 2, 2007 (in thousands):

| | Balances at May 29, 2004 | Expenses Charged to Accruals | Amounts Paid | Balances at May 28, 2005 |
|---|---|---|---|---|
| Facility consolidation costs | $451 | — | (98) | $353 |
| Severance and other employee-related costs | $— | 1,224 | (1,224) | $— |

| | Balances at May 28, 2005 | Expenses Charged to Accruals | Amounts Paid | Balances at June 3, 2006 |
|---|---|---|---|---|
| Facility consolidation costs | $353 | — | (105) | $248 |

| | Balances at June 3, 2006 | Expenses Charged to Accruals | Amounts Paid | Balances at June 2, 2007 |
|---|---|---|---|---|
| Facility consolidation costs | $248 | (127) | (121) | $— |

Of the approximately $1.2 million of expenses charged in fiscal 2005, $0.3 million was included in cost of goods sold, $0.6 million was included in selling, service and administration expenses, and $0.3 million was included in research, development and engineering expenses. In fiscal 2007, $0.1 million of amounts accrued in excess of amounts paid for facility consolidation costs was recorded as a reduction to selling, service and administration expenses.

***Fiscal year 2005 restructuring plan***

In December 2004, the Company initiated a restructuring plan designed to streamline its technology development efforts and enhance customer-centric focus. This was accomplished through several actions, including centralizing research, development and engineering functions, creating a technical marketing solutions group and creating a customer-centric manufacturing organization. In conjunction with the restructuring, 57 positions in the U.S. operations were eliminated, impacting all employee groups. The restructuring actions were completed in early January 2005 and approximately $1.2 million in charges related to the plan were incurred and paid in fiscal 2005.

## NOTE 21. SUBSEQUENT EVENTS

On July 20, 2007, the Company completed its acquisition of New Wave Research, Incorporated, a California corporation (“NWR”). NWR is a developer and manufacturer of high-end laser-based systems and components based in Fremont, California. The acquisition was made pursuant to an Agreement and Plan of Merger dated July 4, 2007. In the merger Neptune Merger Corp., a wholly-owned subsidiary of the Company, merged with and into NWR, and as a result, NWR became the surviving corporation and a wholly-owned subsidiary of the Company. NWR was purchased for approximately $45.4 million in cash, representing a $36 million base price plus an amount approximately equal to NWR’s cash and cash equivalents at closing. The Company financed the acquisition with cash on hand. The Company is still in the process of determining the purchase price allocation.

In accordance with the on-going share repurchase plan discussed in Note 14, the Company repurchased approximately 702,000 shares of its outstanding common stock between June 3, 2007 and August 10, 2007 at a total purchase price of $15.2 million.

## NOTE 22. QUARTERLY FINANCIAL INFORMATION (Unaudited)

| | *1st Quarter* | *2nd Quarter* | *3rd Quarter* | *4th Quarter* |
|---|---|---|---|---|
| | *(in thousands, except per share data)* | | | |
| ***Year ended June 2, 2007*** | | | | |
| Net sales | $60,368 | $59,301 | $59,411 | $71,744 |
| Gross profit | 26,265 | 24,274 | 24,955 | 33,276 |
| Operating expenses[1] | 20,068 | 20,640 | 21,004 | 22,823 |
| Provision for income taxes | 2,807 | 2,123 | 1,012 | 5,161 |
| Net income | 6,202 | 3,789 | 5,634 | 7,899 |
| Basic net income per share | 0.21 | 0.13 | 0.19 | 0.27 |
| Diluted net income per share | 0.21 | 0.13 | 0.19 | 0.27 |
| ***Year ended June 3, 2006*** | | | | |
| Net sales | $44,508 | $48,643 | $55,937 | $57,918 |
| Gross profit | 19,647 | 21,168 | 24,897 | 25,776 |
| Operating expenses | 18,906 | 19,348 | 19,995 | 21,543 |
| Provision for (benefit from) income taxes[2] | 635 | 902 | (3,656) | 583 |
| Net income | 1,347 | 3,188 | 10,357 | 5,931 |
| Basic net income per share | 0.05 | 0.11 | 0.36 | 0.20 |
| Diluted net income per share | 0.05 | 0.11 | 0.35 | 0.20 |

The sum of the quarterly EPS data presented in the table above for fiscal 2007 and 2006 does not equal annual results due to the varying impacts of dilutive securities to the annual versus the quarterly EPS calculations (see Note 13) and due to rounding.

1 In the first quarter of fiscal 2007, the Company recorded a gain for an insurance recovery of $1.3 million on fire-damaged demonstration systems. In the second quarter of fiscal 2007, the Company recorded a gain of $1.0 million for an insurance settlement related to the shareholder and derivative lawsuits.

2 The third and fourth quarters of fiscal 2006 include $5.3 million and $0.6 million, respectively, for reductions in accrued income taxes due to the statutory closure of various tax years.

### *Revision of Results of Operations for the First Quarter of Fiscal 2007*

During the third quarter of fiscal 2007, we identified adjustments which impacted the results of operations in the first quarter of fiscal 2007. We have determined that those adjustments were not material to the results of the first quarter of fiscal 2007, but the impact of recording those adjustments would be material to the results of operations for the third quarter of fiscal 2007. As such, we revised the results of operations for the first quarter of fiscal 2007 for these immaterial corrections. These adjustments are included in the results of operations for fiscal 2007. The results of operations for the first quarter of fiscal 2007 have been revised as shown below.

| | Three months ended September 2, 2006 | | |
|---|---|---|---|
| (in thousands, except per share amounts) | As Reported | Adjustment | As Revised |
| **Consolidated Condensed Statement of Operations:** | | | |
| Net sales | $60,164 | $ 204 | $60,368 |
| Cost of sales | 32,883 | 1,220 | 34,103 |
| Gross profit | 27,281 | (1,016) | 26,265 |
| Selling, service and administration | 12,158 | (107) | 12,051 |
| Research, development and engineering | 9,304 | — | 9,304 |
| Insurance recovery | (1,287) | — | (1,287) |
| Operating income | 7,106 | (909) | 6,197 |
| Interest and other income, net | 2,910 | (98) | 2,812 |
| Income before income taxes | 10,016 | (1,007) | 9,009 |
| Provision for income taxes | 3,244 | (437) | 2,807 |
| Net income | $ 6,772 | $ (570) | $ 6,202 |
| Net income per share—basic and diluted | $ 0.23 | $ (0.02) | $ 0.21 |

As shown in the table above, the revisions to the first quarter of fiscal year 2007 include the following:

- Increase in net sales of $0.2 million related to deferral of the fair value of certain undelivered elements and the timing of recording credit memos issued to certain customers;
- Increase in cost of sales of $1.2 million primarily related to inaccurate inventory transactions recorded within the new enterprise resource planning (ERP) system and, to a lesser degree, late freight and duty invoices received from an offshore service provider;
- Decrease in variable expenses included in selling, service and administration of $0.1 million resulting from the above adjustments;
- Decrease in other income of $0.1 million due to revised net foreign exchange loss; and
- Net decrease in tax expense of $0.4 million resulting from the above revisions.

### *Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

### *Item 9A. Controls and Procedures*

Attached to this annual report as exhibits 31.1 and 31.2 are the certifications of our President and Chief Executive Officer (CEO) and our Chief Financial Officer (CFO) required by Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certifications). This "Controls and Procedures" section of our annual report on Form 10-K is our disclosure of the conclusions of our management, including our CEO and our CFO, regarding the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report based on management's evaluation of those disclosure controls and procedures. This section of the Annual Report on Form 10-K should be read in conjunction with the Section 302 Certifications for a more complete understanding of the topics presented.

#### *(a) Evaluation of Disclosure Controls and Procedures*

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. This controls evaluation was performed under the supervision and with the participation of management, including our President and CEO and CFO. Disclosure controls are procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 (the Exchange Act), such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission (the SEC). Disclosure controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our quarterly evaluation of disclosure controls includes an evaluation of some components of our internal control over financial reporting. We also perform a separate annual evaluation of internal control over financial reporting for the purpose of providing the management report below.

The evaluation of our disclosure controls included a review of their objectives and design, the Company's implementation of the controls and the effect of the controls on the information generated for use in this Annual Report on Form 10-K. In the course of the controls evaluation, we determined that process improvements were required to strengthen control procedures and confirmed that the appropriate actions were undertaken. This type of evaluation is performed on a quarterly basis so that the conclusions of management, including the CEO and CFO, concerning the effectiveness of the disclosure controls can be reported in our periodic reports on Form 10-Q and Form 10-K. Many of the components of our disclosure controls are also evaluated on an ongoing basis by our finance organization. The overall goals of these various evaluation activities are to monitor our disclosure controls and to modify them as necessary. We intend to maintain the disclosure controls as dynamic systems that we adjust as circumstances merit.

Based on the controls evaluation, our CEO and CFO have concluded that, subject to the limitations noted in (c) below, as of the end of the period covered by this Form 10-K, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the SEC, and that material information relating to the Company is made known to management, including the CEO and the CFO, particularly during the time when our periodic reports are being prepared.

#### *(b) 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 Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of June 2, 2007 based on the guidelines

established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, our management has concluded that our internal control over financial reporting was effective as of June 2, 2007.

Management's assessment of the effectiveness of our internal control over financial reporting as of June 2, 2007 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report in (e) below.

***(c) Limitations on Effectiveness of Controls***

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

***(d) Changes in Internal Control***

During the preparation of the financial statements for the third quarter of fiscal 2007, we discovered deficiencies in our internal controls, specifically controls related to the review and analysis of inventory cost variances resulting from certain transactions and determined that a material weakness in internal controls existed at March 3, 2007. This control weakness resulted from an incomplete understanding of our ERP system configuration with respect to costing certain components of inventory. This control weakness could have resulted in a material misstatement of the results of operations in fiscal 2007 if it had remained undetected.

Upon discovery of the errors, we formed a cross-functional team that undertook a review of inventory cost variances to ensure that these amounts were properly recorded and presented in our financial statements. Additionally, a complete physical inventory count of work-in-process, finished goods and demonstration systems in other assets was performed and reconciled to the corresponding perpetual inventory records and general ledger accounts.

In addition to performing the detailed physical inventory counts and review of inventory cost variances, we have undertaken personnel training to improve our business processes and execution of key controls. We also retained ERP consultants to assist us in improving our underlying business transaction processing and reporting to more effectively utilize the capabilities of our ERP system. These improvements enabled timely and accurate evaluations of inventory cost variances as of June 2, 2007.

***(e) Report of Independent Registered Public Accounting Firm***

The Board of Directors and Shareholders of
Electro Scientific Industries, Inc.:

We have audited management's assessment, included in the accompanying *Management's Report on Internal Control Over Financial Reporting*, that Electro Scientific Industries, Inc. (an Oregon Corporation) and subsidiaries maintained effective internal control over financial reporting as of June 2, 2007, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Electro Scientific Industries, Inc.'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 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 generally accepted accounting principles. 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 Electro Scientific Industries, Inc. maintained effective internal control over financial reporting as of June 2, 2007, is fairly stated, in all material respects, based on the criteria established in *Internal Control–Integrated Framework* issued by the COSO. Also, in our opinion, Electro Scientific Industries, Inc. maintained, in all material respects, effective internal control over financial reporting as of June 2, 2007, based on criteria established in *Internal Control–Integrated Framework* issued by the COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Electro Scientific Industries, Inc. and subsidiaries as of June 2, 2007 and June 3, 2006, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended June 2, 2007, and our report dated August 13, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Portland, Oregon
August 13, 2007

### *Item 9B. Other Information*

None.

## PART III

### *Item 10. Directors, Executive Officers and Corporate Governance*

The information required by this item, including information about the Company's audit committee, is included under the headings "Proposal 1: Election of Directors," "Board Committees", "Executive Officers" and "Section 16(a) Beneficial Ownership Reporting Compliance" in our Proxy Statement for our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

The Company has adopted the ESI Code of Conduct, a code of ethics and business practices with which every person who works for the Company is expected to comply. In addition, the Company has adopted a Code of Ethics for Financial Managers with which all financial employees are expected to comply. The ESI Code of Conduct and Code of Ethics for Financial Managers are publicly available on the Company's website under "Governance" in the Investors Section (at *http://www.esi.com/esi/investors*). This website address is intended to be an inactive, textual reference only; none of the material on this website is part of this report. If any waiver is granted, including any implicit waiver, from a provision of the ESI Code of Conduct or the Code of Ethics to the Company's executive officers, controller or directors, the Company will disclose the nature of such waiver on that website or in a report on Form 8-K.

### *Item 11. Executive Compensation*

The information required by this item is included under the headings "Board Compensation," "Executive Compensation," "Potential Payments Upon Termination or Change in Control," "Compensation Discussion and Analysis," "Compensation Committee Report" and "Compensation Committee Interlocks and Insider Participation" in our Proxy Statement for our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

### *Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters*

Certain information required by this item is included under the headings "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information" in our Proxy Statement for our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

### *Item 13. Certain Relationships and Related Transactions, and Director Independence*

The information required by this item is included under "Certain Relationships and Related Transactions" and "Corporate Governance Guidelines and Independence" in our Proxy Statement for our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

### *Item 14. Principal Accounting Fees and Services*

The information required by this item is included under "Principal Accounting Fees and Services" in our Proxy Statement for our 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

## PART IV

### *Item 15. Exhibits and Financial Statement Schedules*

### (a)(1) and (a)(2) Financial Statements and Schedules

The Consolidated Financial Statements, together with the reports thereon of our independent registered public accounting firm, are included on the pages indicated below:


| | Page |
|---|---|
| Report of Independent Registered Public Accounting Firm | 32 |
| Consolidated Balance Sheets as of June 2, 2007 and June 3, 2006 | 33 |
| Consolidated Statements of Operations for the fiscal years ended June 2, 2007, June 3, 2006 and May 28, 2005 | 34 |
| Consolidated Statements of Shareholders' Equity and Comprehensive Income for the fiscal years ended June 2, 2007, June 3, 2006 and May 28, 2005 | 35 |
| Consolidated Statements of Cash Flows for the fiscal years ended June 2, 2007, June 3, 2006 and May 28, 2005 | 36 |
| Notes to Consolidated Financial Statements | 37 |


There are no schedules required to be filed herewith.

### (a)(3) Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index. An asterisk (*) beside the exhibit number indicates the exhibits containing a management contract, compensatory plan or arrangement, which are required to be identified in this report.

| Exhibit No. | |
|---|---|
| 3.1 | Restated Articles of Incorporation. Incorporated by reference to Exhibit 3-A of the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1991. |
| 3.2 | Articles of Amendment of Third Restated Articles of Incorporation. Incorporated by reference to Exhibit 3-B of the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1999. |
| 3.3 | Articles of Amendment of Third Restated Articles of Incorporation. Incorporated by reference to Exhibit 3 of the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended December 2, 2000. |
| 3.4 | 2004 Restated Bylaws, as amended. Incorporated by reference to Exhibit 3.1 of the Company's Current Report on form 8-K filed on October 21, 2004 (the "October 21 8-K"). |
| 4.1 | Amended and Restated Rights Agreement, dated as of March 1, 2001, between the Company and Mellon Investor Services, relating to rights issued to all holders of Company common stock. Incorporated by reference to Exhibit 4-A of the Company's Annual Report on Form 10-K for the fiscal year ended June 2, 2001. |
| 10.1* | ESI 1983 Stock Option Plan, as amended. Incorporated by reference to Exhibit 10-E of the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1986. |
| 10.2* | ESI 1989 Stock Option Plan, as amended. Incorporated by reference to Exhibit 10-B of the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1997. |
| 10.3* | 1996 Stock Incentive Plan. Incorporated by reference to Exhibit 10-E of the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1997. |

| Exhibit No. | |
|---|---|
| 10.4* | 2000 Stock Option Plan. Incorporated by reference to Exhibit 10-F of the Company's Annual Report on Form 10-K for the fiscal year ended June 3, 2000. |
| 10.5* | 2000 Stock Option Incentive Plan. Incorporated by reference to Appendix A of the Company's definitive Proxy Statement for its 2000 Annual Meeting of Shareholders. |
| 10.6* | Employment Agreement between the Company and Nicholas C. Konidaris, dated January 7, 2004. Incorporated by reference to Exhibit 10.1 to the Company's previously filed Quarterly Report on Form 10-Q for the quarter ended February 28, 2004, as filed on April 6, 2004. |
| 10.7* | Amendment No. 1 to Employment Agreement between the Company and Nicholas Konidaris, dated as of January 25, 2005. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 31, 2005 (the "January 31 8-K"). |
| 10.8* | Amendment No. 1 to Stock Option Agreement between the Company and Nicholas Konidaris, dated as of January 25, 2005. Incorporated by reference to Exhibit 10.2 of the January 31 8-K. |
| 10.9* | Form of Amendment No. 1 to Stock Option Agreement between the Company and Nicholas Konidaris dated as of January 25, 2005. Incorporated by reference to Exhibit 10.3 of the January 31 8-K. |
| 10.10* | Form of Amendment No. 1 to Stock Option Agreement between the Company and Nicholas Konidaris dated as of January 25, 2005. Incorporated by reference to Exhibit 10.4 of the January 31 8-K. |
| 10.11* | Form of Restricted Stock Units Award Agreement between the Company and Nicholas Konidaris, dated as of January 25, 2005. Incorporated by reference to Exhibit 10.6 of the January 31 8-K. |
| 10.12* | Offer Letter to Tom Wu, dated December 12, 2005. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 19, 2006. |
| 10.13* | 2004 Stock Incentive Plan. Incorporated by reference to Exhibit 10.18 of the Company's Annual Report on Form 10-K filed July 27, 2005. |
| 10.14* | 2005 Restated Deferred Compensation Plan. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed August 22, 2006. |
| 10.15* | Form of Notice of Grant of Stock Options and Option Agreement and related Option Terms and Conditions (Incentive Stock Options). Incorporated by reference to Exhibit 10.3 in the October 21 8-K. |
| 10.16* | Form of Notice of Grant of Stock Options and Option Agreement and related Option Terms and Conditions (Non-Qualified Stock Options). Incorporated by reference to Exhibit 10.4 in the October 21 8-K. |
| 10.17* | Form of Notice of Grant of Stock Options and Option Agreement and related Terms and Conditions (non-directors) (for awards made on July 20, 2005). Incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed July 26, 2005. |
| 10.18* | Form of Notice of Grant of Stock Options and Option Agreement and related Terms and Conditions (directors) (for awards made on July 20, 2005). Incorporated by reference to Exhibit 10.3 of the Company's Current Report on Form 8-K filed July 26, 2005. |
| 10.19* | Form of Performance Based Restricted Stock Units Award Agreement (for awards made prior to July 19, 2006). Incorporated by reference to Exhibit 10.5 of the January 31 8-K. |
| 10.20* | Form of Restricted Stock Units Award Agreement (for awards made prior to July 19, 2006). Incorporated by reference to Exhibit 10.7 of the January 31 8-K. |
| 10.21* | Form of Notice of Grant of Stock Options and Option Agreement and related Option Terms and Conditions (Non-Qualified Stock Options granted to Non-Directors) (for awards made on May 24, 2006). Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on May 30, 2006. |

| Exhibit No. | |
|---|---|
| 10.22* | Form of Notice of Grant of Stock Options and Option Agreement and related Option Terms and Conditions (Non-Qualified Stock Options granted to Directors) (for awards made in May 2006). Incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on May 30, 2006. |
| 10.23* | Form of Restricted Stock Unit Agreement between the Company and Nicholas Konidaris dated as of October 4, 2006. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed October 11, 2006. |
| 10.24* | Form of Change in Control Agreement between the Company and each of Thomas Wu, Robert DeBakker and John Metcalf. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed September 26, 2006. |
| 10.25* | Form of Restricted Stock Unit Agreement (for awards made on or after July 19, 2006). Incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed July 25, 2006. |
| 10.26* | Form of Performance-Based Restricted Stock Unit Agreement (for awards made on or after July 19, 2006). Incorporated by reference to Exhibit 10.3 of the Company's Current Report on Form 8-K filed July 25, 2006. |
| 10.27* | Offer Letter to John Metcalf, dated July 7, 2006. Incorporated by reference to Exhibit 10.5 of the Company's Current Report on Form 8-K filed July 25, 2006. |
| 10.28* | Fiscal 2007 Annual Executive Team Bonus Plan Summary. Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed July 25, 2006. |
| 10.29* | Form of Restricted Stock Unit Agreement for directors. Incorporated by reference to Exhibit 10.4 of the Company's Current Report on Form 8-K filed July 25, 2006. |
| 21 | Subsidiaries of the Company |
| 23 | Consent of Independent Registered Public Accounting Firm |
| 24.1 | Power of Attorney for Frederick Ball |
| 24.2 | Power of Attorney for Richard J. Faubert |
| 24.3 | Power of Attorney for Barry L. Harmon |
| 24.4 | Power of Attorney for W. Arthur Porter |
| 24.5 | Power of Attorney for Gerald F. Taylor |
| 24.6 | Power of Attorney for Keith L. Thomson |
| 24.7 | Power of Attorney for Jon D. Tompkins |
| 24.8 | Power of Attorney for Robert R. Walker |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 14, 2007

ELECTRO SCIENTIFIC INDUSTRIES, INC.

By: /s/ NICHOLAS KONIDARIS

**Nicholas Konidaris**
***President and Chief Executive Officer***

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on August 14, 2007.

| Signature | Title |
|---|---|
| /s/ NICHOLAS KONIDARIS<br>**Nicholas Konidaris** | President, Chief Executive Officer and Director (Principal Executive Officer) |
| /s/ JOHN METCALF<br>**John Metcalf** | Senior Vice President of Administration, Chief Financial Officer and Corporate Secretary (Principal Financial Officer) |
| /s/ KERRY MUSTOE<br>**Kerry Mustoe** | Vice President, Corporate Controller, and Chief Accounting Officer (Principal Accounting Officer) |
| *FREDERICK A. BALL<br>**Frederick Ball** | Director |
| *RICHARD J. FAUBERT<br>**Richard J. Faubert** | Director |
| *BARRY L. HARMON<br>**Barry L. Harmon** | Director |
| *W. ARTHUR PORTER<br>**W. Arthur Porter** | Director |
| *GERALD F. TAYLOR<br>**Gerald F. Taylor** | Director |
| *KEITH L. THOMSON<br>**Keith L. Thomson** | Director |
| *JON D. TOMPKINS<br>**Jon D. Tompkins** | Chairman of the Board |
| *ROBERT R. WALKER<br>**Robert R. Walker** | Director |

* By: /s/ JOHN METCALF

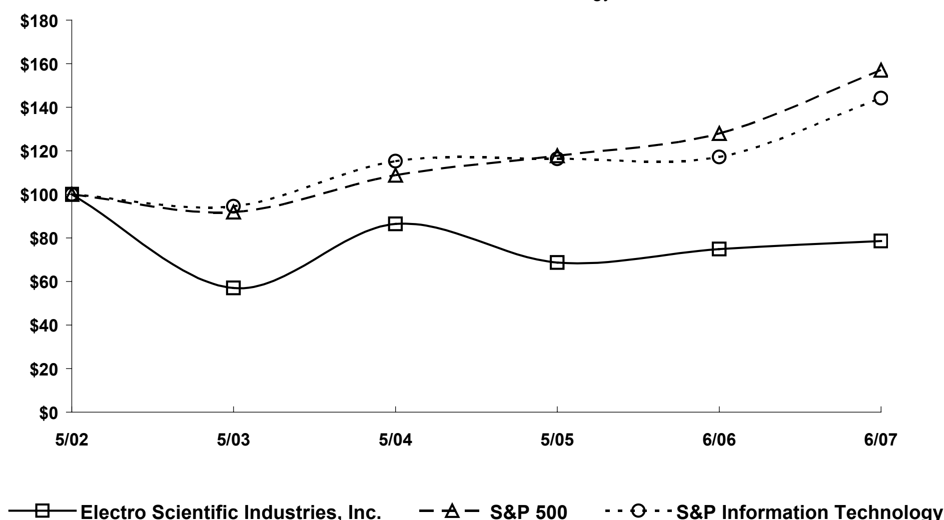
**John Metcalf, *Attorney-in-fact***

## PERFORMANCE GRAPH

*The following graph of stock performance is provided in this Annual Report pursuant to rules of the Securities and Exchange Commission. It was not included in our Annual Report on Form 10-K.*

The graph assumes that $100.00 was invested on May 31, 2002, in Electro Scientific Industries, Inc. Common Stock, the S&P 500 Index and the S&P Information Technology Index, and that all dividends were reinvested.

Historical stock price performance should not be relied upon as indicative of future stock price performance.




### Cumulative Total Return

| | 5/02 | 5/03 | 5/04 | 5/05 | 6/06 | 6/07 |
|---|---|---|---|---|---|---|
| Electro Scientific Industries, Inc. | 100.00 | 57.06 | 86.46 | 68.74 | 74.92 | 78.60 |
| S&P 500 | 100.00 | 91.94 | 108.79 | 117.75 | 127.92 | 157.08 |
| S&P Information Technology | 100.00 | 94.48 | 115.24 | 116.29 | 117.14 | 144.11 |

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*The information contained above under the caption "Performance Graph" shall not be deemed to be "soliciting material" or to be "filed" with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates it by reference into such filing.*

## EXECUTIVE STAFF

Nick Konidaris
President & Chief Executive Officer

John Metcalf
Senior Vice President,
Administration & Chief Financial Officer

Kerry Mustoe
Vice President of Finance, Corporate Controller,
Chief Accounting Officer

Robert M. DeBakker
Vice President, Worldwide Operations

Steven L. Harris
Vice President, Research, Development &
Engineering

Ian Corr
Vice President, Customer Service

Sri Srinivas
Vice President of Marketing

Tom Wu
Vice President of Sales

## BOARD OF DIRECTORS

Jon D. Tompkins
Chairman of the Board
Retired Chairman of the Board KLA-Tencor

Nick Konidaris
President & Chief Executive Officer

Frederick A. Ball
Senior Vice President &
Chief Financial Officer BigBand Networks

Richard J. Faubert
President & CEO AmberWave Systems

Barry L. Harmon
Retired President & Chief Executive Officer ESI

W. Arthur Porter
Vice President for Technology Development
University of Oklahoma

Gerald F. Taylor
Retired Senior Vice President & Chief Financial
Officer
Applied Materials, Inc.

Keith L. Thomson
Retired Vice President Intel Corporation

Robert R. Walker
Retired Chief Financial Officer Agilent
Technologies, Inc

## STOCK LISTING

NASDAQ: ESIO (Common)

## INVESTOR INQUIRES

Investors seeking financial information about ESI can access investor relations information at www.esi.com/esi/investors.

Additional questions should be addressed to:

Chris Butterfield
Director, Investor Relations
ESI
13900 NW Science Park Drive
Portland, OR 97229-5497
503.672.5760
butterfieldc@esi.com

## STOCK TRANSFER AGENT AND REGISTRAR

BNY Mellon Shareowner Services
480 Washington Boulevard
Jersey City, NJ 07310-1900

## SHAREHOLDER INQUIRES

Contact Mellon Shareowner Services:

Mail: BNY Mellon Shareowner Services
480 Washington Boulevard
Jersey City, NJ 07310-1900

Phone: 800.522.6645
TDD for Hearing Impaired: 800.231.5469
Foreign Shareholders: 201.329.8660
TDD Foreign Shareholders: 201.329.8354
www.melloninvestor.com

## ANNUAL MEETING

2:00 p.m. Pacific Time
Thursday, October 25, 2007

ESI Worldwide Headquaters
13900 NW Science Park Drive
Portland, OR 97229-5497

Phone: 503.641.4141
Fax: 503.671.5571
E-mail: info@esi.com

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esi Better Performance. Better Yields.

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