CYANOTECH CORP
Form 10-Q
November 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For Quarterly Period Ended September 30, 2016

Or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Transition Period From to

Commission File Number 0-14602

CYANOTECH CORPORATION

(Exact name of registrant as specified in its charter)

NEVADA	**91-1206026**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

73-4460 Queen Kaahumanu Hwy. #102, Kailua-Kona, HI 96740

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

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

Number of common shares outstanding as of November 10, 2016:

Title of Class	**Shares Outstanding**
Common stock - $0.02 par value	5,668,881

CYANOTECH CORPORATION

FORM 10-Q

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PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands except per share amounts)

(Unaudited)

	September 30, 2016	**March 31, 2016**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,055	$ 1,240
Accounts receivable, net of allowance for doubtful accounts of $49 at September 30, 2016 and $136 at March 31, 2016	3,053	2,983
Inventories, net	7,459	7,856
Deferred tax assets	74	74
Prepaid expenses and other current assets	761	502
Total current assets	13,402	12,655
Equipment and leasehold improvements, net	17,145	17,796
Other assets	374	392
Total assets	$ 30,921	$ 30,843
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$ 611	$—
Current maturities of long-term debt	605	574
Customer deposits	50	117
Accounts payable	4,184	4,000
Accrued expenses	1,503	1,430
Total current liabilities	6,953	6,121
Long-term debt, net	6,549	6,790
Deferred tax liabilities	74	74
Deferred rent	38	30
Total liabilities	13,614	13,015

Commitments and contingencies		
Stockholders' equity:		
Preferred stock of $0.01 par value, authorized 10,000,000 shares; no shares issued and outstanding	—	—
Common stock of $0.02 par value, shares authorized 50,000,000; 5,668,881 shares issued and outstanding at September 30, 2016 and 5,599,797 shares at March 31, 2016	113	112
Additional paid-in capital	31,656	31,585
Accumulated deficit	(14,462)	(13,869)
Total stockholders' equity	17,307	17,828
Total liabilities and stockholders' equity	$ 30,921	$ 30,843

See Accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
NET SALES	$9,862	$8,516	$17,184	$16,110
COST OF SALES	5,977	5,416	10,478	10,086
Gross profit	3,885	3,100	6,706	6,024
OPERATING EXPENSES:				
General and administrative	2,032	1,486	3,739	2,696
Sales and marketing	1,470	1,616	3,025	3,348
Research and development	152	166	318	343
Gain on disposal of equipment and leasehold improvements	(16)	(29)	(13)	(29)
Total operating expenses	3,638	3,239	7,069	6,358
Income (loss) from operations	247	(139)	(363)	(334)
Interest expense, net	(122)	(51)	(253)	(75)
Income (loss) before income taxes	125	(190)	(616)	(409)
INCOME TAX EXPENSE (BENEFIT)	26	(204)	(24)	(318)
NET INCOME (LOSS)	$99	$14	$(592)	$(91)
NET INCOME (LOSS) PER SHARE:				
Basic	$0.02	$0.00	$(0.10)	$(0.02)
Diluted	$0.02	$0.00	$(0.10)	$(0.02)
SHARES USED IN CALCULATION OF NET INCOME (LOSS) PER SHARE:				
Basic	5,657	5,568	5,645	5,566
Diluted	5,727	6,047	5,645	5,566

See Accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Six Months Ended September 30,	
	2016	**2015**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(592)	$(91)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Gain on disposal of equipment and leasehold improvements	(13)	(29)
Depreciation and amortization	1,007	637
Amortization of debt issue costs and other assets	28	29
Share based compensation expense	215	324
Provision for doubtful accounts	(87)	22
Deferred income tax benefit	—	(338)
Net (increase) decrease in assets:		
Accounts receivable	17	(990)
Inventories	397	(491)
Prepaid expenses	(259)	(146)
Other assets	—	39
Net increase (decrease) in liabilities:		
Customer deposits	(67)	66
Accounts payable	184	1,068
Accrued expenses	73	36
Deferred rent	8	(1)
Net cash provided by operating activities	911	135
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from restricted cash	—	486
Investment in equipment and leasehold improvements	(277)	(3,214)
Net cash used in investing activities	(277)	(2,728)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short term notes payable	600	500
Net draw down on line of credit	611	—
Payment of short term notes payable	(600)	(500)
Proceeds from long-term debt, net of costs	—	2,580
Capitalized leases	(35)	(174)
Payments for debt issuance costs	—	94

Principal payments on long-term debt	(252)	(122)
Payments in stock withheld for tax payment on issuance	(147)	—
Proceeds from stock options exercised	4	51
Net cash provided by financing activities	181	2,429
Net increase (decrease) in cash and cash equivalents	815	(164)
Cash and cash equivalents at beginning of period	1,240	2,226
Cash and cash equivalents at end of period	$2,055	$2,062
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$213	$180
Income taxes	$—	$21

See Accompanying Notes to Condensed Consolidated Financial Statements.

CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2016

(Unaudited)

1.BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X of the Securities and Exchange Commission (SEC). These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. The Condensed Consolidated Balance Sheet as of March 31, 2016 was derived from the audited consolidated financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company’s audited consolidated financial statements for the year ended March 31, 2016, contained in the Company’s annual report on Form 10-K as filed with the SEC on June 23, 2016.

The accompanying condensed consolidated financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. (“Nutrex Hawaii” or “Nutrex”, collectively the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of any contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the periods reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Recent Accounting Pronouncements

In August 2016, FASB issued Accounting Standards Update ("ASU") 2016-15, "*Statement of Cash Flows (Topic 230)*: *Classification of Certain Cash Receipts and Cash Payments*" ("ASU No. 2016-15"). This ASU clarifies and provides specific guidance on eight cash flow classification issues that are not currently addressed by current GAAP and thereby reduces the current diversity in practice. ASU No. 2016-15 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017, with early application permitted. This guidance is applicable to the Company's fiscal year beginning March 1, 2018. The Company does not anticipate that this guidance will have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "*Compensation – Stock Compensation (Topic 718)*: *Improvements to Employee Share-Based Payment Accounting*" (*"*ASU No. 2016-09*")*. This ASU makes several modifications to Topic 718 related to the accounting for forfeitures, employer tax withholding on share-based compensation, and the financial statement presentation of excess tax benefits or deficiencies. ASU No. 2016-09 also clarifies the statement of cash flows presentation for certain components of share-based awards. The standard is effective for interim periods beginning after December 15, 2016, with early adoption permitted. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-08, *"Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)"* ("ASU No. 2016-08"), which clarified the revenue recognition implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, *"Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing",* which clarified the revenue recognition guidance regarding the identification of performance obligations and the licensing implementation. In May 2016, the FASB issued ASU No. 2016-12, *"Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients",* which narrowly amended the revenue recognition guidance regarding collectability, noncash consideration, presentation of sales tax and transition. ASU No. 2016-08, ASU No. 2016-10 and ASU No. 2016-12 are effective during the same period as ASU No. 2014-09, *Revenue from Contracts with Customers*, which is effective for annual reporting period beginning after December 15, 2017, with the option to adopt one year earlier. The Company does not intend to adopt the new guidance early and is in the process of evaluating the effect that the adoption of ASU No. 2016-08, ASU No. 2016-10 and ASU No. 2016-12 will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, "*Leases (Topic 842)" (*"ASU No. 2016-02"): The principle objective of ASU No. 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet. ASU No. 2016-02 continues to retain a distinction between finance and operating leases but requires lessees to recognize a right-of-use asset representing its right to use the underlying asset for the lease term and a corresponding lease liability on the balance sheet for all leases with terms greater than twelve months. ASU No. 2016-02 is effective for fiscal years and interim periods beginning after December 15, 2018. Early adoption of ASU No. 2016-02 is permitted. Entities are required to apply the amendments at the beginning of the earliest period presented using a modified retrospective approach. The Company is currently assessing the impact that this standard may have on its consolidated financial statements and related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, "*Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes"*. This guidance simplifies the presentation of deferred income taxes and requires that deferred tax assets and liabilities be classified as noncurrent in the classified statement of financial position. This guidance is effective for the Company as of March 31, 2018 and is not expected to have a material impact on the consolidated financial statements as the guidance only changes the classification of deferred income taxes.

In August 2015, the FASB issued ASU 2015-14, *"Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date"*, which defers the effective date of ASU 2014-09 by one year to December 15, 2017 for interim and annual reporting periods beginning after that date, and permitted early adoption of the standard, but not before the original effective date. The Company expects to adopt this guidance when effective and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, *"Inventory: Simplifying the Measurement of Inventory"*, that requires inventory not measured using either the last in, first out (LIFO) or the retail inventory method to be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable cost of completion, disposal, and transportation. The new standard will be effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and will be applied prospectively. Early adoption is permitted. The Company is evaluating the impact that this standard will have on its consolidated financial statements and related disclosures.

In April 2015, the FASB issued ASU No. 2015-03, "*Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*", which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the debt liability rather than as an asset. ASU 2015-03 is effective for fiscal years beginning after December 15, 2015. The Company adopted this standard on a retroactive basis on June 30, 2016 and prior period amounts have been reclassified to conform to the current period presentation. As of September 30, 2016 and March 31, 2016, net debt issuance costs of $285,000 and $304,000, respectively, were reclassified in the Condensed Consolidated Balance Sheet from non-current other assets to non-current portion of long term debt.

Other recently issued accounting pronouncements did not or are not believed by management to have a material impact on the Company's present or future financial statements.

2. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out method. Inventories consist of the following:

	September 30, 2016	March 31, 2016
	(in thousands)	
Raw materials	$445	$375
Work in process	3,565	3,782
Finished goods (1)	3,302	3,543
Supplies	147	156
Inventories, net	$7,459	$7,856

(1) Net of reserve for obsolescence of $8,000 at September 30, 2016 and March 31, 2016, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Non-inventoriable fixed costs of $ 73,000 and $101,000 were charged to cost of sales for the three and six months ended September 30, 2016, respectively. $83,000 of non-inventoriable fixed costs and $225,000 of extraction operations start-up costs were charged to cost of sales for the three months ended September 30, 2015. $395,000 of extraction operations start-up costs and $127,000 of non-inventoriable fixed costs were charged to cost of sales for the six months ended September 30, 2015.

3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS, NET

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives for equipment and furniture and fixtures, or the shorter of the land lease term or estimated useful lives for leasehold improvements as follows:

	Years		
Equipment	3	to	10
Furniture and fixtures	3	to	7
Leasehold improvements	10	to	25

Equipment and leasehold improvements consist of the following:

	September 30, 2016	**March 31, 2016**
	(in thousands)	
Equipment	$17,418	$17,040
Leasehold improvements	13,887	13,797
Furniture and fixtures	376	354
	31,681	31,191
Less accumulated depreciation and amortization	(14,985)	(14,067)
Construction-in-progress	449	672
Equipment and leasehold improvements, net	$17,145	$17,796

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of September 30, 2016. The Company recognized a gain on disposal of assets in the amount of $16,000 and $13,000 for the three and six months ended September 30, 2016, respectively. The Company recognized a gain on disposal of assets in the amount of $29,000 and $29,000 for the three and six months ended September 30, 2015, respectively.

The Company has no capitalized interest for the three and six months ended September 30, 2016. $78,000 and $137,000 of interest was capitalized for the three and six month period ended September 30, 2015, respectively.

4.NOTES PAYABLE

Line of Credit

On August 30, 2016, the Revolving Credit Agreement (the “Credit Agreement”), which the Company and First Foundation Bank (“the Bank”) entered into on June 3, 2016, became effective after the Company and the Bank received the necessary approvals from the State of Hawaii to secure the lien on the Company’s leasehold property in Kona. The Credit Agreement allows the Company to borrow up to $2,000,000 on a revolving basis. Borrowings under the Credit Agreement bear interest at the Wall Street Journal prime rate + 2%, floating. The Credit Agreement’s initial term expires on August 30, 2017, and the term may be extended at the Bank’s sole discretion. The Credit Agreement includes various covenants as defined in the Credit Agreement. The Credit Agreement also contains standard acceleration provisions in the event of a default by the Company. Proceeds from the revolving line were used to repay a $600,000 short-term loan from First Foundation Bank. At September 30, 2016, the Company had borrowed $611,000 and had $1,389,000 available on the line.

The Credit Agreement grants the Bank the following security interests in the Company’s property: (a) a lien on the Company’s leasehold interest in its Kona facility; (b) an assignment of the Company’s interest in leases and rents on its Kona facility; and (c) a security interest in all fixtures, furnishings and equipment related to or used by the Company at the Kona facility. Each security interest is further subject to the terms of the Credit Agreement.

5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	September 30, 2016	March 31, 2016
	(in thousands)	
Wages, bonus and profit sharing	$836	$972
Legal	386	95
Use tax	141	140
Customer rebates	—	74
Rent and utilities	66	49
Other expenses	74	100
Total accrued expenses	$1,503	$1,430

6. LONG-TERM DEBT

Long-term debt consists of the following:

	September 30, 2016	March 31, 2016
	(in thousands)	
Long-term debt	$7,439	$7,668
Less current maturities	(605)	(574)
Long-term debt, excluding current maturities	6,834	7,094

8,686

Total Revenues	232,525	194,040	150,848
Costs, Expenses and Other (Income) Expense			
Cost of goods sold	131,858	105,636	79,960
Contract research and development	7,129	6,787	7,135
Internal research and development	6,894	5,847	4,965
Selling, general and administrative	48,084	43,306	35,105
Interest expense	1,790	945	412
Other (income) expense net	(2,195)	(261)	2
Goodwill impairment charge	17,630		

Total Costs, Expenses and Other (Income) Expense		211,190		162,260		127,579
Earnings Before Income Taxes		21,335		31,780		23,269
Income taxes		10,541		8,525		6,747
Net Earnings	$	10,794	$	23,255	$	16,522
Basic Earnings Per Share	$	0.37	$	0.80	$	0.58
Diluted Earnings Per Share	$	0.36	$	0.78	$	0.56

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(1) *As restated to reflect the modified retrospective application of the fair value recognition provisions of SFAS 123(R) Share-Based Payment. See Note A.*

See Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(000)	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Total
Balance July 1, 2003	30,538	$ 39,430	$ 930	$ 73,071	(2,138)	$ (1,910)	$ 111,521
Cumulative share-based compensation expense		3,180		(3,180)			
Cumulative SFAS 123(R) deferred tax asset adjustment		698					698
Balance July 1, 2003 Restated[1]	30,538	$ 43,308	$ 930	$ 69,891	(2,138)	$ (1,910)	$ 112,219
Shares issued under stock option plans	502	1,302					1,302
Shares issued to acquire Laser Power Corporation	2	11					11
Net earnings				16,522			16,522
Payment for redemption of Shareholder Rights Plan				(141)			(141)
Other comprehensive income, net of tax			151				151
Income tax benefit for options exercised		1,686					1,686
Share-based compensation expense		815					815
FAS 123(R) deferred tax asset		301					301
Balance June 30, 2004 Restated[1]	31,042	$ 47,423	$ 1,081	$ 86,272	(2,138)	$ (1,910)	$ 132,866
Shares issued under stock option plans	308	1,291					1,291
Net earnings				23,255			23,255
Purchase of treasury stock					(11)	(182)	(182)
Other comprehensive loss, net of tax			(450)				(450)
Income tax benefit for options exercised		1,497					1,497
Share-based compensation expense		1,588					1,588
FAS 123(R) deferred tax asset		606					606
Balance June 30, 2005 Restated[1]	31,350	$ 52,405	$ 631	$ 109,527	(2,149)	$ (2,092)	$ 160,471
Shares issued under stock option plans	278	1,415					1,415
Net earnings				10,794			10,794
Purchase of treasury stock					(283)	(5,221)	(5,221)
Treasury stock under deferred compensation arrangements					(55)	(590)	(590)
Other comprehensive income, net of tax			111				111
Share-based compensation expense		2,407					2,407
Excess tax benefit under SFAS 123(R)		1,204					1,204
Balance June 30, 2006	31,628	$ 57,431	$ 742	$ 120,321	(2,487)	$ (7,903)	$ 170,591

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(1) As restated *to reflect the modified retrospective application of the fair value recognition provisions of SFAS 123(R) Share-Based Payment. See Note A.*

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Year Ended June 30, ***($000)***	**2006**	**2005**[1]	**2004**[1]
Net earnings	$ 10,794	$ 23,255	$ 16,522
Other comprehensive income (loss):			
Foreign currency translation adjustments, net of income taxes of $41, $(165) and $62, respectively	111	(450)	151
Comprehensive Income	$ 10,905	$ 22,805	$ 16,673

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(1) As retrospectively adjusted to reflect the modified retrospective application of the fair value recognition provisions of SFAS 123(R) Share-Based Payment. See Note A.

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended June 30, *($000)*	**2006**	**2005**	**2004**
Cash Flows from Operating Activities			
Net earnings	$ 10,794	$ 23,255	$ 16,522
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation	14,279	11,501	8,987
Amortization	1,505	1,204	646
Goodwill impairment charge	17,630		
Share-based compensation expense	2,407	2,170	1,148
(Gain) loss on foreign currency remeasurements and transactions	(683)	(106)	105
Net loss on disposal or writedown of assets	101	92	159
Deferred income taxes	(2,944)	(562)	(502)
Excess tax benefits from share-based compensation expense	(1,204)		
Other	277	(157)	(100)
Increase (decrease) in cash from changes in:			
Accounts receivable	(5,358)	(5,762)	(3,388)
Inventories	(3,082)	(11,329)	(3,373)
Accounts payable	219	(1,825)	2,258
Income taxes payable	2,584	1,886	4,004
Deferred revenue	2,229	229	3
Other operating net assets	2,034	(1,984)	3,930
Net cash provided by operating activities	40,788	18,612	30,399
Cash Flows from Investing Activities			
Additions to property, plant & equipment	(15,624)	(17,656)	(12,729)
Purchases of businesses	(1,678)	(29,743)	(3,754)
Investment in unconsolidated business		(217)	
Dividends from unconsolidated business	23	10	8
Note purchase agreement		(2,000)	
Disposals of property, plant and equipment	25	142	
Net cash used in investing activities	(17,254)	(49,464)	(16,475)
Cash Flows from Financing Activities			
Proceeds from short-term borrowings	2,500	18,900	4,000
Payments on short-term borrowings	(12,400)	(9,425)	(5,500)
Proceeds from long-term borrowings		30,000	
Payments on long-term borrowings	(3,801)	(10,000)	(6,923)
Proceeds from exercise of stock options	1,402	1,291	1,313
Purchases of treasury stock	(5,221)	(182)	
Payment for redemption of Shareholder Rights Plan			(141)
Excess tax benefits from share-based compensation expense	1,204		
Net cash (used in) provided by financing activities	(16,316)	30,584	(7,251)
Effect of exchange rate changes on cash and cash equivalents	(2,008)	260	(573)
Net increase (decrease) in cash and cash equivalents	5,210	(8)	6,100
Cash and Cash Equivalents			
Beginning of year	21,675	21,683	15,583

End of year	$ 26,885	$ 21,675	$ 21,683
Non-cash transactions: Additions to property, plant and equipment included in accounts payable	$ 280	$ 1,485	$

(1) *As restated to reflect the modified retrospective application of the fair value recognition provisions of SFAS 123(R) Share-Based Payment. See Note A.*

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note A NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS II-VI Incorporated and subsidiaries (the Company) develops, manufactures and markets infrared and near-infrared laser optical elements, military infrared optical components, x-ray and gamma-ray sensors, single crystal silicon carbide (SiC) substrates and thermoelectric cooling and power generation solutions. The Company markets its products in the United States through its direct sales force and worldwide through its wholly- or majority-owned subsidiaries, distributors and agents.

The Company uses certain uncommon materials and compounds to manufacture its products. Some of these materials are available from only one proven outside source. The continued high quality of these materials is critical to the stability of the Company s manufacturing yields. The Company has not experienced significant production delays due to a shortage of materials. However, the Company does occasionally experience problems associated with vendor supplied materials not meeting specifications for quality or purity. A significant failure of the Company s suppliers to deliver sufficient quantities of necessary high-quality materials on a timely basis could have a material adverse effect on the Company s results of operations.

PRINCIPLES OF CONSOLIDATION The consolidated financial statements include the accounts of the Company. All intercompany transactions and balances have been eliminated.

FOREIGN CURRENCY TRANSLATION For II-VI Singapore Pte., Ltd. and its subsidiaries, and the Company s majority-owned subsidiary II-VI LOT Suisse S.a.r.l., the functional currency is the U.S. dollar. Gains and losses on the remeasurement of the local currency financial statements are included in net earnings. Foreign currency remeasurement gains were $2.8 million, $0.2 million and $0.5 million for the years ended June 30, 2006, 2005 and 2004, respectively. The increase in the foreign currency remeasurement gain during fiscal year 2006 was due to the Singapore dollar strengthening against the U.S. dollar.

For all other foreign subsidiaries, the functional currency is the local currency. Assets and liabilities of those operations are translated into U.S. dollars using period-end exchange rates while income and expenses are translated using the average exchange rates for the reporting period. Translation adjustments are recorded as accumulated other comprehensive income within shareholders equity in the accompanying consolidated balance sheets.

CASH AND CASH EQUIVALENTS The Company considers highly liquid investment instruments with an original maturity of three months or less to be cash equivalents. The majority of cash and cash equivalents is invested in investment grade money market type instruments. Cash of foreign subsidiaries is on deposit at banks in Singapore, China, Germany, Japan, Belgium, the Netherlands, Switzerland, the United Kingdom and Vietnam.

ACCOUNTS RECEIVABLE AND WARRANTY RESERVE The Company establishes an allowance for doubtful accounts based on historical experience.

The Company factored a portion of the accounts receivable due to its Japan subsidiary during each of the years ended June 30, 2006 and 2005. Factoring is done with large banks in Japan. During the years ended June 30, 2006 and 2005, $4.8 million and $6.6 million respectively, of accounts receivable had been factored. As of June 30, 2006 and 2005, $0.5 million and $0.6 million, respectively, was included in Other Accrued Liabilities representing the Company s obligation to the bank for these receivables factored with recourse.

The Company records a warranty reserve as a charge against earnings based on a percentage of sales utilizing actual returns over the last twelve months. The following table summarizes the change in the carrying value of the Company s warranty reserve as of and for the years ended June 30, 2006, 2005 and 2004.

Year Ended June 30, ***($000)***	**2006**	**2005**	**2004**
Balance Beginning of Year	$ 962	$ 552	$ 504
Expense and writeoffs, net	(22)	194	48
Other[1]		216	
Balance End of Year	$ 940	$ 962	$ 552

[1] The component of Other relates to the warranty reserve from the acquisition of Marlow Industries, Inc. in December 2004 (see Note C).

INVENTORIES Inventories are valued at the lower of cost or market, with cost determined on the first-in, first-out basis. Inventory costs include material, labor and manufacturing overhead. The Company records a slow moving inventory reserve as a charge against earnings for all products on hand more than twelve months to eighteen months depending on the products that have not been sold to customers or cannot be further manufactured for sale to alternative customers. An additional reserve is recorded for product on hand that is in excess of product sold to customers over the same periods noted above. Inventories are net of reserves totaling $2.5 million and $1.4 million at June 30, 2006 and 2005, respectively.

PROPERTY, PLANT AND EQUIPMENT Property, plant and equipment are carried at cost or fair market value upon acquisition. Major improvements are capitalized, while maintenance and repairs are generally expensed as incurred. The Company reviews its property, plant and equipment and other long-lived assets for impairment whenever events or circumstances indicate that the carrying amounts may not be recoverable. Depreciation for financial reporting purposes is computed primarily by the straight-line method over the estimated useful lives of the assets. Depreciable useful lives range from 2 to 20 years.

GOODWILL The excess purchase price over the net assets of businesses acquired is reported as goodwill in the accompanying consolidated balance sheets. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and Other Intangible Assets , the Company tests goodwill for impairment at least annually or when events or changes in circumstances indicate that goodwill might be impaired.

INVESTMENT In July 2001, the Company acquired for $1.7 million a 25% ownership interest in 5NPlus, Inc., a supplier to the Company. In July 2002, the Company increased its ownership interest to 33% as a result of a loan conversion to equity in accordance with the original purchase agreement in the amount of $0.4 million. In April 2005, the Company increased its ownership to approximately 36% as a result of acquiring a pro-rata ownership percentage of an exiting shareholder for $0.2 million. This investment is accounted for under the equity method of accounting.

At June 30, 2006 and 2005, the Company had outstanding notes receivable of approximately $0.4 million and $0.5 million, respectively, from equipment and supply agreements with this supplier. Payments on these notes are made quarterly with interest calculated at up to the Canadian Prime Rate plus 1.50% on the unpaid balance. For the years ended June 30, 2006, 2005 and 2004, the Company purchased $1.2 million, $1.0 million and $0.3 million, respectively, of raw materials each year from this supplier. The Company s pro rata share of the earnings from this investment and the interest received from these agreements were approximately $0.2 million, $0.2 million and $0.1 million for the years ended June 30, 2006, 2005 and 2004, respectively.

INTANGIBLES Intangible assets are carried at cost or fair market value upon acquisition. Finite-lived intangible assets are amortized for financial reporting purposes using the straight-line method over the estimated useful lives of the assets ranging from 3 years to 20 years. Indefinite-lived intangible assets are not amortized but tested annually for impairment.

OTHER ASSETS In April 2005, the Company entered into a $2.0 million note purchase agreement with SemiSouth Laboratories, Inc. (SemiSouth), a customer and supplier of the Company. Under the terms of the agreement, the note receivable accrues interest at Prime plus 1.00% per annum paid quarterly. The note receivable matures April 4, 2010. The note purchase agreement contains a conversion feature that permits the Company to convert the note receivable into common shares of SemiSouth at certain times upon certain situations through the maturity date.

ACCRUED BONUSES AND PROFIT SHARING CONTRIBUTION The Company records bonus and profit sharing estimates as a charge against earnings based on a formula percentage of the Company s operating income.

These estimates are adjusted to actual based on final results of operations achieved during the fiscal year. Partial bonus amounts may be paid on an interim basis, and the remainder is paid after the fiscal year end after the final determination of the applicable percentage or amounts.

INCOME TAXES Deferred income tax assets and liabilities are determined based on the differences between the consolidated financial statement and tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount more likely than not to be realized. Annual tax provisions include amounts considered sufficient to pay assessments that may result from examinations of prior year tax returns; however, the amount ultimately paid upon resolution of issues raised may differ from the amounts accrued.

REVENUE RECOGNITION The Company considers the provisions of Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition* (SAB 104), which superseded SAB 101. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is established or determinable and collectibility is probable. Revenue, for all business segments, other than for contract research and development, is recognized from the sale of products at the point of passage of title, which is generally at the time of shipment.

The Company performs research and development under contract agreements with customers based on cost plus fixed fee, cost reimbursable or fixed fee terms. These contracts generally require the Company to produce and provide developmental materials and/or products to those customers. Revenues from cost plus fixed fee and cost reimbursable contracts are recognized as costs are incurred.

The Company follows the guidelines of Statement of Position 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts for its fixed fee contracts. Revenue and profits on each fixed fee contract are accounted for using the percentage-of-completion method of accounting, whereby revenue and profits are recognized throughout the performance period of the contract. Percentage-of-completion is determined by relating the actual cost of work performed to date to the estimated total cost for each contract. The estimated total cost for each contract is periodically reevaluated and revised, when necessary, throughout the life of the contract. Losses on contracts are recorded in full when identified.

SHIPPING AND HANDLING COSTS Shipping and handling costs billed to customers are included in revenues. Shipping and handling costs incurred by the Company are included in selling, general and administrative expenses in the accompanying consolidated statements of earnings. Total shipping and handling costs included in revenues and in selling, general and administrative expenses was $0.3 million for the year ended June 30, 2006 and $0.2 million for each of the years ended June 30, 2005 and 2004.

RESEARCH AND DEVELOPMENT Internal research and development costs and costs not related to customer and government funded research and development contracts are expensed as incurred.

SHARE-BASED COMPENSATION The Company adopted SFAS No. 123 (revised 2004), (SFAS 123R) Share-Based Payment, effective July 1, 2005. SFAS 123R requires the recognition of the fair value of stock compensation in net earnings. The Company recognizes the share-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. Prior to July 1, 2005, the Company followed Accountings Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for its share-based compensation.

The Company elected the modified retrospective transition method for adopting SFAS 123R. Under this method, all prior period financial statements were restated effective July 1, 2005 to recognize share-based compensation cost in the amounts previously reported in the Notes to Consolidated Financial Statements. The Consolidated Balance Sheet at June 30, 2005 has been restated for the modified retrospective adoption of SFAS 123R resulting in a $7.2 million increase in common stock, a $5.6 million reduction in retained earnings and a $1.6 million increase in deferred tax asset.

Under the provisions of SFAS 123R, the Company recorded $2.4 million, $2.2 million and $1.1 million in share-based compensation expense in its Consolidated Statements of Earnings for the fiscal years ended June 30, 2006, 2005 and 2004, respectively. The share-based compensation expense is allocated approximately 35% to cost of goods sold and 65% to selling, general and administrative expense in the Consolidated Statements of Earnings based upon the employee classification of the grantee. The Company utilized the Black-Scholes valuation model for estimating the fair value of the share-based compensation expense. During the fiscal years ended June 30, 2006, 2005 and 2004, the weighted-average fair value of options granted under the stock option plan was $10.96, $11.21 and $7.84, respectively, per option using the following assumptions:

	Year Ended June 30, 2006	Year Ended June 30, 2005	Year Ended June 30, 2004
Risk free interest rate	4.52%	3.84%	3.53%
Expected volatility	59%	64%	64%
Expected life of options	6.39 years	6.36 years	7.11 years
Dividend yield	none	none	none

The risk-free interest rate is derived from the average U.S. Treasury Note rate during the period, which approximates the rate in effect at the time of grant related to the expected life of the options. The risk free interest rate shown above is the weighted average rate for all options granted during the fiscal year. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options. The expected life calculation is based on the observed time to post-vesting exercise and/or forfeitures of options by our employees. The dividend yield of zero is based on the fact the Company has never paid cash dividends and has no intention to pay cash dividends in the future. The estimated annualized forfeitures are based on the Company s historical experience of option pre-vesting cancellations and are estimated at a rate of 22%. Under the provisions of SFAS 123R, the Company will record additional expense in future periods if the actual forfeiture rate is lower than estimated, and will record a recovery of expense in future periods if the actual forfeitures are higher than estimated.

DERIVATIVE INSTRUMENTS The Company, from time to time, purchases foreign currency forward exchange contracts, primarily in Japanese Yen, that permit it to sell specified amounts of these foreign currencies expected to be received from its export sales for pre-established U.S. dollar amounts at specified dates. These contracts are entered into to limit transactional exposure to changes in currency exchange rates of export sales transactions in which settlement will occur in future periods and which otherwise would expose the Company, on the basis of its aggregate net cash flows in respective currencies, to foreign currency risk.

The Company recorded these contracts with a notional amount of approximately $4.9 million and $3.0 million as of June 30, 2006 and 2005, respectively, which approximated the fair value of these contracts on the statement of financial position. The Company records the change in the fair value of these contracts in the results of operations as they occur. The change in the fair value of these contracts increased net earnings by $0.1 million for the year ended June 30, 2005. The impact in fiscal years ended June 30, 2006 and 2004 was insignificant.

WORKERS COMPENSATION The Company is self-insured for certain losses related to workers compensation. Additionally, third-party insurance is obtained to limit our exposure to these claims. When estimating the self-insurance liability, the Company considers a number of factors, including historical claims experience, demographic and severity factors and valuations provided by independent third party consultants. Periodically, management reviews its assumptions and the valuations to determine the adequacy of the self-insurance liability.

COMPREHENSIVE INCOME Comprehensive income is a measure of all changes in shareholders equity that result from transactions and other economic events of the period other than transactions with owners. Accumulated other comprehensive income is a component of shareholders equity and consists of accumulated foreign currency translation adjustments of $0.7 million and $0.6 million, net of income taxes of $0.3 million and $0.2 million, as of June 30, 2006 and 2005, respectively.

FAIR VALUE OF FINANCIAL INSTRUMENTS EXCLUDING DERIVATIVE INSTRUMENTS The following methods and assumptions were used to estimate the fair value of financial instruments:

Cash and Cash Equivalents The carrying amount approximates fair value because of their short maturities.

Debt Obligations The fair values of debt obligations are estimated based upon market values of similar issues. The fair values and carrying amounts of the Company s debt obligations are approximately equivalent.

ESTIMATES The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

RECENTLY ISSUED FINANCIAL ACCOUNTING STANDARDS In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections a Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48) which clarifies the accounting for uncertainty in tax positions taken or expected to be taken in a tax return, including issues relating to financial statement recognition and measurement. FIN 48 provides that the tax effects from an uncertain tax position can be recognized in the financial statements only if the position is more-likely-than-not of being sustained if the position were to be challenged by a taxing authority. The assessment of the tax position is based solely on the technical merits of the position, without regard to the likelihood that the tax position may be challenged. If an uncertain tax position meets the more-likely-than-not threshold, the largest amount of tax benefit that is greater than 50 percent likely of being recognized upon ultimate settlement with the taxing authority, is recorded. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on the consolidated financial statements for the fiscal year ending June 30, 2008.

RECLASSIFICATIONS Certain amounts from prior years have been reclassified to conform to the 2006 presentation.

Note B STOCK SPLIT

On February 17, 2005, the Company s Board of Directors declared a two-for-one stock split, in the form of a stock dividend, of the Company s common stock for shareholders of record on March 2, 2005. The stock split was distributed on March 22, 2005 issuing one additional share of common stock for every share of common stock held. The applicable share and per share data for all periods included herein have been restated to give effect to this stock split.

Note C ACQUISITIONS

II-VI Deutschland GmbH

In July 2005, the Company exercised its call option and purchased the remaining 25% interest of II-VI Deutschland GmbH from L.O.T.-Oriel Laser Optik GmbH & Co. KG (L.O.T.) for $1.7 million. In connection with the purchase of the remaining 25% interest, the Company received a three year non-compete agreement from L.O.T. The purchase price was allocated $1.6 million to goodwill and $0.1 million to the non-compete agreement.

Marlow Industries, Inc.

In December 2004, the Company acquired all the outstanding shares of Marlow Industries, Inc. (Marlow) for approximately $29.7 million net of cash acquired of $2.9 million and including transaction costs of approximately $0.3 million. The financial results of Marlow are included since the date of acquisition, in the Consolidated Statements of Earnings.

This acquisition was accounted for using the purchase method in accordance with SFAS No. 141, Business Combinations. Accordingly, the Company recorded the net assets at their estimated fair values. The following table presents allocation of the purchase price to the assets acquired and liabilities assumed at the date of acquisition ($000 s).

Assets	
Accounts receivable, net	$ 4,664
Inventories	4,350
Deferred income taxes	1,889
Prepaid and other current assets	23
Property, plant, and equipment	8,149
Intangible assets	11,650
Goodwill	10,019
Other assets	93
Total assets acquired	$ 40,837
Liabilities	
Accounts payable	$ 2,036
Other accrued liabilities	3,923
Deferred income taxes	5,128
Other liabilities	7
Total liabilities assumed	$ 11,094
Net assets acquired	$ 29,743

Of the $11.7 million of acquired intangible assets, $6.0 million was assigned to a registered tradename that is not subject to amortization. Acquired patents totaled $2.9 million and are amortized over a period ranging from 1.5 years to 8.5 years. Customer list acquired totaled $2.3 million and is amortized over 9.5 years and the remaining non-compete agreement of $0.5 million is amortized over 3 years.

During the fiscal year ended June 30, 2006, the Company finalized its accounting for the acquisition of Marlow in accordance with SFAS No. 141, Business Combinations and recorded an adjustment to goodwill relating to a change in deferred income tax liability.

The following unaudited pro-forma consolidated results of operations have been prepared as if the acquisition of Marlow had occurred at July 1, 2003, the beginning of the Company s fiscal year 2004 ($000 except per share).

	Year Ended June 30, 2005	Year Ended June 30, 2004
Net Revenues	$ 205,288	$ 173,046
Net Earnings	$ 22,659	$ 14,320
Basic earnings per share	$ 0.78	$ 0.50
Dilutive earnings per share	$ 0.76	$ 0.49

The pro-forma results are not necessarily indicative of what actually would have occurred if the transaction had taken place at the beginning of the period, are not intended to be a projection of future results and do not reflect any cost savings that might be achieved from the combined operations.

Note D CONTRACT RECEIVABLES

The components of contract receivables, which are a component of accounts receivable, net, were as follows:

June 30, *($000)*	**2006**	**2005**
Billed		
Completed Contracts	$ 25	$ 883
Contracts in Progress	1,656	953
	1,681	1,836
Unbilled	2,159	2,323
	$ 3,840	$ 4,159

Note E INVENTORIES

The components of inventories were as follows:

June 30, *($000)*	**2006**	**2005**
Raw materials	$ 16,120	$ 16,396
Work in process	17,388	16,409
Finished goods	14,946	12,111
	$ 48,454	$ 44,916

Note F PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at cost or valuation consist of the following:

June 30, *($000)*	**2006**	**2005**
Land and land improvements	$ 1,884	$ 1,842
Buildings and improvements	47,319	35,614
Machinery and equipment	97,264	87,943
Construction in progress	4,334	13,412
	150,801	138,811
Less accumulated depreciation	(73,088)	(60,911)
	$ 77,713	$ 77,900

Depreciation expense was $14.3 million, $11.5 million and $9.0 million for the years ended June 30, 2006, 2005 and 2004, respectively.

Capitalized interest expense associated with the construction of buildings and improvements was $0.1 million for the years ended June 30, 2006 and 2005 and was insignificant for the year ended June 30, 2004.

Note G GOODWILL AND INTANGIBLE ASSETS

Goodwill represents the excess of the cost over the net tangible and identifiable intangible assets of acquired businesses. Identifiable intangible assets acquired in business combinations are recorded based upon fair market value at the date of acquisition.

Changes in the carrying amount of goodwill are as follows:

Year Ended June 30, *($000)*	**2006**	**2005**
Balance Beginning of Year	$ 39,537	$ 28,987
Goodwill impairment charge Exotic Electro-Optics	(17,630)	
Goodwill acquired II-VI Deutschland GmbH	1,609	
Goodwill acquired Marlow Industries, Inc.	(303)	10,322
Goodwill acquired II-VI LOT Suisse S.a.r.l.		228
Foreign currency translation II-VI Deutschland GmbH	80	
Balance End of Year	$ 23,293	$ 39,537

In accordance with SFAS No. 142, Goodwill and Intangible Assets, the Company reviews, the recoverability of goodwill at least annually and any time business conditions indicate a potential change in recoverability. During the fourth quarter of fiscal 2006, the Company conducted its annual impairment tests of its reporting units utilizing a combination of valuation techniques including the discounted cash flow approach and the market multiple approach. The results of these impairment tests indicated that the Company s Exotic Electro-Optics reporting unit s goodwill was impaired. The Company recorded approximately $17.6 million of goodwill impairment charges in the Consolidated Statements of Earnings associated with the goodwill of Exotic Electro-Optics.

In connection with the remaining 25% acquisition of II-VI Deutschland GmbH in July 2005, the Company recorded the excess purchase price over the net assets of the business acquired as goodwill in the accompanying Consolidated Balance Sheets based on the purchase price allocation.

In connection with the acquisition of Marlow in December 2004, the Company recorded the excess purchase price over the net assets of the business acquired as goodwill in the accompanying Consolidated Balance Sheet based on the purchase price allocation. The Company finalized its accounting for the acquisition of Marlow during the fiscal year ended June 30, 2006 in accordance with SFAS No. 141, Business Combinations and recorded an adjustment to goodwill relating to a change in deferred income tax liability.

During the year ended June 30, 2005, the Company finalized its accounting for the acquisition of II-VI LOT Suisse S.a.r.l., (II-VI LOT Suisse) in accordance with SFAS No. 141, Business Combinations and recorded an adjustment to goodwill relating to a change in deferred income tax liability.

The gross carrying amount and accumulated amortization of the Company s intangible assets other than goodwill as of June 30, 2006 and 2005 were as follows:

	June 30, 2006			**June 30, 2005**		
($000)	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Book Value**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Book Value**
Patents	$ 5,506	$ (1,777)	$ 3,729	$ 5,506	$ (1,151)	$ 4,355
Trademark	7,491	(441)	7,050	7,491	(367)	7,124
Customer Lists	5,863	(1,973)	3,890	5,742	(1,356)	4,386
Other	1,348	(1,049)	299	1,275	(808)	467
Total	$ 20,208	$ (5,240)	$ 14,968	$ 20,014	$ (3,682)	$ 16,332

Amortization expense recorded on the intangible assets for the years ended June 30, 2006, 2005 and 2004 was $1.5 million, $1.2 million and $0.6 million, respectively. In connection with the acquisition of Marlow, the Company completed its valuation of certain identifiable intangible assets in accordance with SFAS No. 141, during the year end

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June 30, 2005. The Company recognized approximately $11.7 million of identifiable intangibles as a result of the valuation. The carrying amount of the acquired trade name with an indefinite life not amortized but tested annually for impairment totaled $6.0 million. The Company completed its impairment test of the acquired trade name with an indefinite life in the fourth quarter of fiscal 2006. Based on the results of the test the trade name was not impaired at June 30, 2006. Included in the gross carrying amount and accumulated amortization of the Company s customer list component of intangible assets and goodwill is the effect of the foreign currency translation of the portion relating to the Company s German distributor. The estimated amortization expense for existing intangible assets for each of the five succeeding years is as follows:

Year Ending June 30, *($000)*	
2007	$ 1,326
2008	1,215
2009	1,116
2010	1,116
2011	1,116

Note H DEBT

The components of debt were as follows:

June 30, *($000)*	**2006**	**2005**
Line of credit, interest at the LIBOR rate, as defined plus 0.75%	$ 2,000	$ 11,900
Term loan, interest at the LIBOR rate, as defined plus 0.75% payable in quarterly installments through October 2009	26,250	30,000
Pennsylvania Industrial Development Authority (PIDA) term note, interest at 3.00%, payable in monthly installments through October 2011	303	354
Yen denominated term note, interest at the Japanese Yen Base Rate, as defined, plus 1.49%, principal payable in full in September 2007	2,614	2,727
Total debt	31,167	44,981
Current portion of long-term debt	(7,553)	(3,801)
Long-term debt	$ 23,614	$ 41,180

The Company has a $60.0 million secured credit facility. The facility has a five-year term through December 2009 and contains a term loan in the original amount of $30.0 million and a $30.0 million line of credit. The facility is collateralized by a pledge of 65% of the stock of certain of the Company s foreign subsidiaries. Additionally, the facility is subject to certain restrictive covenants, including those relating to minimum net worth, leverage and consolidated debt service coverage. The facility has an interest rate range of LIBOR plus 0.75% to LIBOR plus 1.50%. Principal payments of $1.9 million under the term loan are payable in quarterly installments through October 2009. The weighted average interest rate of borrowings under the credit agreements was 4.8% and 3.4% for the fiscal years ended June 30, 2006 and 2005, respectively. The Company had available $27.4 million and $17.6 million under its line of credit as of June 30, 2006 and 2005, respectively.

At June 30, 2006 and 2005, total outstanding letters of credit supported by the credit facility were $0.6 million and $0.5 million, respectively.

The Company has a 300 million Yen loan. This loan matures in September 2007. Interest is at a rate equal to the Japanese Yen Base Rate, as defined in the loan agreement, plus 1.49%. The Japanese Yen Base Rate was 0.16% at June 30, 2006 and 0.07% at June 30, 2005.

The Company has a line of credit facility with a Singapore bank which permits maximum borrowings in the local currency of approximately $0.4 million for the fiscal years ended June 30, 2006 and 2005. Borrowings are payable upon demand with interest being charged at the rate of 1.00% above the bank s prevailing prime lending rate. The interest rate was 5.3% at June 30, 2006 and 2005. At June 30, 2006 and 2005 there were no outstanding borrowings under this facility.

The aggregate annual amounts of principal payments required on the long-term debt are as follows:

Year Ending June 30, *($000)*	
2007	$ 7,553
2008	10,169
2009	7,556
2010	5,808
2011	60
Thereafter	21

Interest and commitment fees paid during the years ended June 30, 2006, 2005 and 2004 totaled approximately $1.6 million, $1.0 million and $0.5 million, respectively.

Note I INCOME TAXES

The components of income tax expense were as follows:

Year Ended June 30, *($000)*	**2006**	**2005**	**2004**
Current:			
Federal	$ 9,723	$ 5,514	$ 3,217
State	948	661	787
Foreign	2,814	2,912	3,245
Total Current	$ 13,485	$ 9,087	$ 7,249
Deferred:			
Federal	$ (2,556)	$ (488)	$ 357
State	(120)	(31)	(220)
Foreign	(268)	(43)	(639)
Total Deferred	$ (2,944)	$ (562)	$ (502)
Total Income Tax Expense	$ 10,541	$ 8,525	$ 6,747

Principal items comprising deferred income taxes were as follows:

June 30, *($000)*	**2006**	**2005**
Deferred income tax assets and (liabilities) current		
Inventory capitalization	$ 4,149	$ 4,005
Non-deductible accruals	1,008	925
Accrued employee benefits	1,894	1,524
Net-operating loss carryforward current portion	516	500

Other	(6)	6
Deferred income taxes current	$ 7,561	$ 6,960
Deferred income tax assets and (liabilities) long-term		
Prepaid taxes	$ 523	$ 392
Net-operating loss and credit carryforwards	1,219	1,365
Share-based compensation expense	2,450	1,605
Valuation allowance	(1,445)	(1,147)
Deferred income tax asset long-term	$ 2,747	$ 2,215
Tax over book accumulated depreciation	$ (6,472)	$ (8,083)
Intangible assets	(4,394)	(4,876)
Deferred income tax liability long-term	$ (10,866)	$ (12,959)
Net deferred income taxes long-term	$ (8,119)	$ (10,744)

The reconciliation of income tax expense at the statutory federal rate to the reported income tax expense is as follows:

Year Ended June 30, *($000)*	**2006**	**%**	**2005**	**%**	**2004**	**%**
Taxes at statutory rate	$ 7,467	35	$ 11,123	35	$ 7,911	34
Increase (decrease) in taxes resulting from:						
State income taxes net of federal benefit	544	3	442	1	467	2
Extraterritorial income exclusion	(853)	(4)	(885)	(3)	(763)	(3)
Taxes on non U.S. earnings	(4,074)	(19)	(2,505)	(7)	(422)	(2)
Reduction of provision recorded in prior years					(761)	(3)
Goodwill impairment charge	6,171	29				
Section 965 dividend repatriation	305	1				
Other	981	4	350	1	315	1
	$ 10,541	49	$ 8,525	27	$ 6,747	29

During the years ended June 30, 2006, 2005, and 2004, cash paid by the Company for income taxes was $10.8 million, $6.9 million, and $3.3 million, respectively.

Earnings before income taxes of our non-U.S. operations for June 30, 2006, 2005 and 2004 was $18.1 million, $15.0 million and $12.8 million, respectively. The Company has not recorded deferred income taxes applicable to undistributed earnings of foreign subsidiaries that are indefinitely reinvested outside the United States. If the earnings of such foreign subsidiaries were not indefinitely reinvested, an additional deferred tax liability of approximately $11.4 million and $15.3 million would have been required as of June 30, 2006 and 2005, respectively.

It is the Company s intention to permanently reinvest undistributed earnings of its foreign subsidiaries beyond the repatriated amount; therefore, no provision has been made for future income taxes on the undistributed of foreign subsidiaries, as they are considered indefinitely reinvested.

The American Jobs Creation Act of 2004 (the Act) was enacted in October of 2004. The Act provided for a temporary incentive for U.S. multinational corporations to repatriate accumulated income earned abroad by providing an 85% exclusion from taxable income for certain dividends from controlled foreign corporations. As a result of this special temporary tax incentive and pursuant to the provisions of the Act, the Company repatriated $5.5 million during the year ended June 30, 2006 and recorded tax expense of $0.3 million in connection with such repatriation.

The Company s Vietnam subsidiary operates under a tax holiday and does not pay income taxes. This subsidiary is tax exempted for four years from the first year profits are achieved.

The sources of differences resulting in deferred income tax expense (benefit) and the related tax effect of each were as follows:

Year Ended June 30, *($000)*	**2006**	**2005**	**2004**
Depreciation and amortization	$ (1,738)	$ 11	$ 540
Inventory capitalization	(190)	(350)	(1,779)
Net operating loss and credit carryforwards net of valuation allowances	350	550	1,342
Share-based compensation expense	(866)	(582)	(330)
Other	(500)	(191)	(275)
	$ (2,944)	$ (562)	$ (502)

As of June 30, 2006, the Company had federal and state net operating loss carryforwards of $2.1 million and $2.2 million, respectively. The net operating loss carryforwards will begin to expire in 2024 and 2010, respectively. For the years ended June 30, 2006, 2005 and 2004, the Company utilized $1.5 million, $1.6 million and $1.9 million of net operating losses, respectively, to reduce current taxable income.

Note J EARNINGS PER SHARE

The following table sets forth the computation of earnings per share for the periods indicated. Weighted average shares issuable upon the exercise of stock options that were not included in the calculation because they were antidilutive were immaterial for all periods presented.

Year Ended June 30, *(000 except per share data)*	**2006**	**2005**	**2004**
Net earnings	$ 10,794	$ 23,255	$ 16,522
Divided by:			
Weighted average common shares outstanding	29,211	29,103	28,634
Basic earnings per common share	$ 0.37	$ 0.80	$ 0.58
Net earnings	$ 10,794	$ 23,255	$ 16,522
Divided by:			
Weighted average common shares outstanding	29,211	29,103	28,634
Dilutive effect of stock options	690	806	802
Dilutive weighted average common shares outstanding	29,901	29,909	29,436
Diluted earnings per common share	$ 0.36	$ 0.78	$ 0.56

Note K OPERATING LEASES

The Company leases certain property under operating leases that expire at various dates through the year ending June 30, 2014. Future rental commitments applicable to the operating leases at June 30, 2006 are as follows:

Year Ending June 30, *($000)*	
2007	$ 1,958
2008	1,361
2009	1,168
2010	835
2011	328
Thereafter	168

Rent expense was approximately $2.2 million, $1.7 million and $1.3 million for the years ended June 30, 2006, 2005 and 2004, respectively.

Note L SHARE-BASED COMPENSATION PLANS

On August 13, 2005, the Board of Directors adopted the II-VI Incorporated 2005 Omnibus Incentive Plan (the Plan). The Plan was approved by the shareholders of the Company on November 4, 2005, and consequently, no further stock option grants will be made under the predecessor plan. The Plan provides for the grant of non-qualified stock options, stock appreciation rights, restricted shares, deferred shares and performance units shares may be issued to employees, officers, directors and consultants of the Company. The maximum number of shares of the Company s common stock authorized for issuance under the Plan shall not in the aggregate exceed 1,800,000 shares of common stock authorized plus any shares under the predecessor plan which were outstanding as of November 4, 2005, that expire or terminate without being exercised. All options to purchase shares of common stock granted under the Plan had been at market price at the date of grant. Generally, twenty percent of the options may be exercised one year from the date of grant with comparable annual increases on a cumulative basis each year thereafter. The stock option plan also had vesting provisions predicated upon the death, retirement or disability of the optionee. As of June 30, 2006, there were 1,738,120 shares available under the Plan.

During the fiscal year 2006, the Company issued performance shares under the Plan to certain executive officers for the performance period January 2006 to June 2006. The awards were intended to provide continuing emphasis on specified financial performance goals that the Company considers being important contributors to long-term

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shareholder value. The awards were payable only if the Company achieved specified levels of revenue and cash flows from operations for the performance periods. Included in the $2.4 million share-based compensation expense for the year ended June 30, 2006 was $0.4 million of expense attributable to the performance shares. The performance shares compensation expense was calculated based on the number of shares earned multiplied by the stock price at the date the performance plan was established. There were no performance shares issued for the fiscal years ended June 30, 2005 and 2004.

The Company had a stock option plan, the II-VI Incorporated Stock Option Plan of 2001, under which stock options had been granted by the Board of Directors to directors, officers and key employees, with 7,740,000 shares of common stock reserved for use under this plan. All options to purchase shares of common stock granted under the Stock Option Plan of 2001 had been at market price at the date of grant. Generally, twenty percent of the options may be exercised one year from the date of grant with comparable annual increases on a cumulative basis each year thereafter. The stock option plan also had vesting provisions predicated upon the death, retirement or disability of the optionee. All stock options expire 10 years after the grant date.

Stock option activity relating to the plans during the years ended June 30, 2006, 2005 and 2004 were as follows:

Options		**Number of Shares Subject to Option**		**Weighted Average Exercise Price**
Outstanding	July 1, 2003	2,220,562	$	4.91
Granted		209,500	$	11.95
Exercised		(502,402)	$	2.58
Forfeited		(50,460)	$	7.69
Outstanding	June 30, 2004	1,877,200	$	6.24
Granted		709,250	$	17.87
Exercised		(308,692)	$	4.19
Forfeited		(29,920)	$	11.06
Outstanding	June 30, 2005	2,247,838	$	10.12
Granted		269,500	$	18,02
Exercised		(278,250)	$	5.07
Forfeited		(47,160)	$	14.69
Outstanding	June 30, 2006	2,191,928	$	11.64
Exercisable	June 30, 2006	1,039,308	$	7.62
Exercisable	June 30, 2005	1,007,738	$	5.47
Exercisable	June 30, 2004	1,105,614	$	4.65

Outstanding and exercisable options at June 30, 2006 were as follows:

	Options Outstanding				**Options Exercisable**		
Range of Exercise Prices	**Number of Shares**	**Weighted Average Remaining Contractual Life in Years**		**Weighted Average Exercise Price**	**Number of Shares**		**Weighted Average Exercise Price**
$1.89-$4.38	255,548	2.05	$	2.96	255,548	$	2.96
$5.00-$7.87	510,250	4.59	$	6.36	365,290	$	6.24
$8.00-$11.20	390,220	5.77	$	8.92	243,940	$	8.15
$11.50-$16.88	494,110	7.94	$	15.98	119,870	$	15.30

$16.99-$21.77	541,800	8.43	$	18.70	54,660	$	19.36
	2,191,928	6.21	$	11.64	1,039,308	$	7.62

Note M SEGMENT AND GEOGRAPHIC REPORTING

The Company reports its segments using the management approach model for segment reporting. The management approach model is based on the way a company s management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure or any other manner in which management segregates a company.

The Company s reportable segments offer similar products to different target markets. The segments are managed separately due to the production requirements and facilities that are unique to each segment. The Company has the following reportable segments: Infrared Optics, which is the Company s infrared optics and material products businesses and remaining corporate activities, primarily corporate assets and capital expenditures; Near-Infrared Optics, which is the Company s VLOC subsidiary, and the China and Vietnam near-infrared operations; Military Infrared Optics, which is the Company s Exotic Electro-Optics subsidiary; and the Compound Semiconductor Group, which is the aggregation of the Company s Marlow subsidiary, the eV PRODUCTS division, the Wide Bandgap Materials (WBG) group and the Advanced Material Development Center (AMDC) group, (which is responsible for the corporate research and development activities).

The Infrared Optics segment is divided into the geographic locations in the United States, Singapore, China, Germany, Switzerland, Japan, Belgium and the United Kingdom. An Executive Vice-President of the Company directs the segment, while each geographic location is directed by a general manager, and is further divided into production and administrative units that are directed by managers. The Infrared Optics segment designs, manufactures and markets optical and electro-optical components and materials sold under the II-VI brand name and used primarily in high-power CO_2 lasers.

The Near-Infrared Optics segment is located in the United States, China, Vietnam, Germany, Japan and the U.K. The Near-Infrared Optics segment is directed by a general manager. The Near-Infrared Optics segment is further divided into production and administrative units that are directed by managers. The Near-Infrared Optics segment designs, manufactures and markets near-infrared and visible-light products for industrial, scientific, military and medical instruments and laser gain material and products for solid-state YAG, YLF lasers and UV filter components.

The Military Infrared Optics segment is located in the United States. The Military Infrared Optics segment is directed by a general manager with oversight by a Corporate Vice-President. The Military Infrared Optics segment is further divided into production and administrative units that are directed by managers. The Military Infrared Optics segment designs, manufactures and markets infrared products for military applications under the Exotic Electro-Optics brand name.

The Compound Semiconductor Group is located in the United States, the United Kingdom, Japan, China and Vietnam. The Compound Semiconductor Group segment is directed by a Corporate Vice-President. Marlow designs and manufacturers thermoelectric cooling and power generation solutions for use in defense and space, telecommunications, medical, consumer and industrial markets. eV PRODUCTS division manufactures and markets solid-state x-ray and gamma-ray sensor materials and products for use in medical, security monitoring, industrial, environmental and scientific applications. WBG group manufactures and markets single crystal silicon carbide substrates for use in solid-state lighting, wireless infrastructure, radio frequency (RF) electronics and power switching industries. AMDC group directs the corporate research and development initiatives.

The accounting policies of the segments are the same as those of the Company. Substantially all of the Company s corporate expenses are allocated to the segments. The Company evaluates segment performance based upon reported segment earnings or loss, which is defined as earnings before income taxes, interest and other income or expense. Inter-segment sales and transfers have been eliminated.

The following table summarizes selected financial information of the Company s operations by segment:

($000)	**Infrared Optics**	**Near-Infrared Optics**	**Military Infrared Optics**	**Compound Semiconductor Group**	**Eliminations**	**Total**
2006						
Revenues	$ 120,414	$ 33,968	$ 29,384	$ 48,759		$ 232,525
Inter-segment revenues	312	570	326	3,232	(4,440)	
Segment earnings (loss)	34,505	2,084	(17,520)	1,861		20,930
Interest expense						(1,790)
Other income, net						2,195
Earnings before income taxes						21,335
Depreciation and amortization	5,939	2,789	1,809	5,247		15,784
Segment assets	129,970	35,771	21,281	63,274		250,296
Expenditures for property, plant and equipment	6,101	3,178	1,044	4,096		14,419
Equity investment				2,437		2,437
Goodwill	7,433	1,927	3,914	10,019		23,293
2005						
Revenues	$ 101,295	$ 33,917	$ 27,310	$ 31,518		$ 194,040
Inter-segment revenues	532	3,990	413	2,918	(7,853)	
Segment earnings (loss)	30,578	2,317	1,046	(1,477)		32,464
Interest expense						(945)
Other income, net						261
Earnings before income taxes						31,780
Depreciation and amortization	4,774	2,602	1,682	3,647		12,705
Segment assets	117,611	30,332	42,943	61,792		252,678
Expenditures for property, plant and equipment	12,364	3,277	821	2,679		19,141
Equity investment				2,249		2,249
Goodwill	5,744	1,927	21,544	10,322		39,537
2004						
Revenues	$ 87,652	$ 25,786	$ 25,322	$ 12,088		$ 150,848
Inter-segment revenues	1,432	2,453	167	37	(4,089)	
Segment earnings (loss)	22,416	2,350	886	(1,969)		23,683
Interest expense						(412)
Other expense, net						(2)
Earnings before income taxes						23,269
Depreciation and amortization	4,175	2,296	1,450	1,712		9,633

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Geographic information for revenues, based on country of origin, and long-lived assets which include property, plant and equipment, goodwill and other intangibles, net of related depreciation and amortization, follows:

Year Ended June 30, *($000)*		**Revenues**	
	2006	**2005**	**2004**
United States	$ 156,190	$ 131,690	$ 100,001
Non-United States:			
Japan	23,619	19,947	16,310
Germany	23,135	19,069	17,677
Switzerland	9,776	7,948	3,946
United Kingdom	9,519	7,543	3,031
Singapore	6,114	4,494	7,339
Belgium	4,097	3,336	2,524
China	75	13	20
Total Non - United States	76,335	62,350	50,847
	$ 232,525	$ 194,040	$ 150,848

June 30, *($000)*	**Long-Lived Assets**	
	2006	**2005**
United States	$ 102,517	$ 124,898
Non-United States:		
Singapore	3,233	2,711
Vietnam	3,098	2,327
Germany	2,993	1,372
China	2,852	1,060
Switzerland	960	947
Belgium	286	277
Japan	26	163
United Kingdom	9	14
Total Non - United States	13,457	8,871
	$ 115,974	$ 133,769

Note N EMPLOYEE BENEFIT PLANS

Eligible employees of the Company participate in a profit sharing retirement plan. Contributions to the plan are made at the discretion of the Company s board of directors and were $2.6 million, $2.1 million and $2.1 million for the years ended June 30, 2006, 2005 and 2004, respectively.

The Company has an employee stock purchase plan available for employees who have completed six months of continuous employment with the Company. The employee may purchase the common stock at 5% below the prevailing market price. The amount of shares which may be bought by an employee during each fiscal year is limited to 10% of the employee s base pay. This plan, as amended, limits the number of shares of common stock available for purchase to 800,000 shares. There were 355,897 and 370,896 shares of common stock available for purchase under the plan at June 30, 2006 and 2005, respectively.

The Company has no program for post-retirement health and welfare or post employment benefits.

The II-VI Incorporated Deferred Compensation Plan (the Compensation Plan) is designed to allow officers and key employees of the Company to defer receipt of compensation into a trust fund for retirement purposes. The Compensation Plan is a nonqualified, defined contribution employees retirement plan. At the Company s discretion, the Compensation Plan may be funded by the Company making contributions based on compensation deferrals, matching contributions and discretionary contributions. Compensation deferrals will be based on an election by the participant to defer a percentage of compensation under the Compensation Plan. All assets in the Compensation Plan

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are subject to claims of the Company s creditors until such amounts are paid to the Compensation Plan participants. Employees of the Company made contributions to the Compensation Plan in the amount of approximately $0.3 million, $0.4 million and $0.5 million for the years ended June 30, 2006, 2005, and 2004, respectively.

Note O COMMITMENTS AND CONTINGENCIES

The Company has purchase commitments for materials and supplies as part of the ordinary conduct of business. A few of the commitments are long-term and are based on minimum purchase requirements. Due to the proprietary nature of some of the Company s materials and processes, certain contracts may contain penalty provisions for early termination. The Company does not believe that a material amount of penalties is reasonably likely to be incurred under these commitments based upon historical experience and current expectation. Future purchases under these commitments are as follows:

Year Ending June 30, ***($000)***	
2007	$ 5,984
2008	976
2009	269
2010	157

Note P STOCK REPURCHASE PROGRAM

On May 18, 2005, the Board of Directors authorized the Company to purchase up to 500,000 shares of its common stock. The repurchase program calls for shares to be purchased in the open market or in private transactions from time to time. The Company may suspend or discontinue this purchase program at any time. Shares purchased by the Company will be retained as treasury stock and will be available for general corporate purposes. The Company expects the repurchase of shares to at least partially offset the dilutive effect of the issuance of shares from the Company s stock option plan. The following are share repurchases under the Stock Repurchase Program ($000 except share data).

Period	**Total Number of Shares Purchased**	**Total Amount of Shares Purchased**
Year Ended June 30, 2005	11,000	$ 182
Year Ended June 30, 2006	283,100	5,221
	294,100	$ 5,403

SCHEDULE II

II-VI INCORPORATED AND SUBSIDIARIES

VALUATION AND QUALIFYING ACCOUNTS

YEARS ENDED JUNE 30, 2004, 2005, AND 2006

(IN THOUSANDS OF DOLLARS)

	Balance at Beginning of Year	Additions Charged to Expense	Charged to Other Accounts	Deduction from Reserves	Balance at End of Year
YEAR ENDED JUNE 30, 2004:					
Allowance for doubtful accounts	$ 762	$ 107	$	$ 78[1]	$ 791
Warranty reserves	$ 504	$ 48	$	$	$ 552
Other[2]	$ 210	$	$	$ 200	$ 10
YEAR ENDED JUNE 30, 2005:					
Allowance for doubtful accounts	$ 791	$ 162	$ 113[3]	$ 250[1]	$ 816
Warranty reserves	$ 552	$ 218	$ 217[3]	$ 25	$ 962
Other[2]	$ 10	$	$	$	$ 10
YEAR ENDED JUNE 30, 2006:					
Allowance for doubtful accounts	$ 816	$ 395	$ 7[3]	$ 104[1]	$ 1,114
Warranty reserves	$ 962	$	$	$ 22	$ 940
Other[2]	$ 10	$	$	$	$ 10

1 Uncollectible accounts written off, net of recovery

2 Primarily relates to the closing of manufacturing operations in Mexico and the costs related to consolidating several of the Company s European distribution arrangements.

3 Primarily relates to the allowance for doubtful accounts and warranty return reserves from the acquisition of Marlow Industries, Inc. and foreign currency translations from the Company s foreign subsidiaries.

QUARTERLY FINANCIAL DATA (unaudited)

FISCAL 2006

QUARTER ENDED *($000 except per share data)*	**September 30, 2005**	**December 31, 2005**	**March 31, 2006**	**June 30, 2006**
Net revenues	$ 54,391	$ 53,827	$ 59,363	$ 64,944
Cost of goods sold	32,303	33,371	35,055	38,258
Internal research and development	1,911	1,966	1,604	1,413
Selling, general and administrative	11,499	11,301	11,212	14,072
Interest expense	405	450	458	477
Other (income) net	(1,297)	(101)	(164)	(633)
Goodwill impairment charge				17,630
Earnings (loss) before income taxes	9,570	6,840	11,198	(6,273)
Income taxes	2,821	1,660	3,748	2,312
Net earnings (loss)	$ 6,749	$ 5,180	$ 7,450	$ (8,585)
Basic earnings (loss) per share	$ 0.23	$ 0.18	$ 0.25	$ (0.29)
Diluted earnings (loss) per share	$ 0.23	$ 0.17	$ 0.25	$ (0.29)

FISCAL 2005

QUARTER ENDED *($000 except per share data)*	**September 30, 2004**[(1)]	**December 31, 2004**[(1)]	**March 31, 2005**[(1)]	**June 30, 2005**[(1)]
Net revenues	$ 40,507	$ 43,213	$ 53,313	$ 57,007
Cost of goods sold	22,941	24,221	32,467	32,794
Internal research and development	1,048	1,584	1,410	1,805
Selling, general and administrative	9,220	10,134	11,080	12,872
Interest expense	63	88	421	373
Other expense (income) net	(491)	(203)	(16)	449
Earnings before income taxes	7,726	7,389	7,951	8,714
Income taxes	2,087	1,995	2,146	2,297
Net earnings	$ 5,639	$ 5,394	$ 5,805	$ 6,417
Basic earnings per share	$ 0.19	$ 0.19	$ 0.20	$ 0.22
Diluted earnings per share	$ 0.19	$ 0.18	$ 0.19	$ 0.22

(1) *As restated to reflect the modified retrospective application of the fair value recognition provisions of SFAS 123(R) Share-Based Payment.*

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company s management evaluated, with the participation of Carl J. Johnson, the Company s Chairman and Chief Executive Officer, and Craig A. Creaturo, the Company s Chief Financial Officer and Treasurer the effectiveness of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this annual report on Form 10-K. The Company s disclosure controls were designed to provide reasonable assurance that information required to be disclosed in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. It should be noted that the design of any system of controls 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, regardless of how remote. However, the controls have been designed to provide reasonable assurance of achieving the controls stated goals. Based on that evaluation, Messrs. Johnson and Creaturo concluded that the Company s disclosure controls and procedures were not effective for the reasons discussed below and in the Report of Management set forth under Item 8 above.

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 Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. See the Report of Management which is set forth under Item 8 above and is incorporated herein by reference.

Attestation Report of the Registered Public Accounting Firm

Our management s assessment of the effectiveness of our internal control over financial reporting as of June 30, 2006 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included in Item 8.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company s internal controls over financial reporting that occurred during our most recent quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting other than the material weakness noted in the Report of Management which is included under Item 8.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information set forth above in Part I under the caption Executive Officers of the Registrant is incorporated herein by reference. The other information required by this item is incorporated herein by reference to the information set forth under the captions Election of Directors, Corporate Governance Matters-Code of Business Conduct and Ethics, Meetings and Committees of the Board of Directors and Other Matters - Section 16(a) Beneficial Ownership Reporting Compliance in the Company s definitive proxy statement for the 2006 Annual Meeting of Shareholders filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the information set forth in the second paragraph under the caption Meetings and Committees of the Board of Directors and the information set forth under the caption Executive Compensation and Other Information in the Company s definitive proxy statement for the 2006 Annual Meeting of Shareholders filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

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

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	2,191,928	$ 11.64	1,738,120
Equity compensation plans not approved by security holders	0	0	0
Total	2,191,928	$ 11.64	1,738,120

The other information required by this item is incorporated herein by reference to the information set forth under the caption Principal Shareholders in the Company s definitive proxy statement for the 2006 Annual Meeting of Shareholders filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated herein by reference to the information set forth under the caption Meetings and Committees of the Board of Directors in the Company s definitive proxy statement for the 2006 Annual Meeting of Shareholders filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the information set forth under the caption Ratification of Independent Registered Public Accounting Firm in the Company s definitive proxy statement for the 2006 Annual Meeting of Shareholders filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Financial Statements

The financial statements are set forth under Item 8 of this annual report on Form 10-K.

(2) Schedules

Schedule II Valuation and Qualifying Accounts for each of the three years in the period ended June 30, 2006 is set forth under Item 8 of this annual report on Form 10-K.

Financial statements, financial statement schedules and exhibits not listed have been omitted where the required information is included in the consolidated financial statements or notes thereto, or is not applicable or required.

(3) Exhibits.

Exhibit Number	**Description of Exhibit**	
3.01	Amended and Restated Articles of Incorporation of II-VI Incorporated	Incorporated herein by reference is Exhibit 3.01 to II-VI s Current Report on Form 8-K filed on November 12, 2004.
3.02	Amended and Restated By-Laws of II-VI Incorporated	Incorporated herein by reference is Exhibit 3.02 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 2002.
10.01	II-VI Incorporated Amended and Restated Employees Stock Purchase Plan	Incorporated herein by reference is Exhibit 10.04 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.02	First Amendment to the II-VI Incorporated Amended and Restated Employees Stock Purchase Plan	Incorporated herein by reference Exhibit 10.01 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended March 31, 1996.
10.03	II-VI Incorporated Amended and Restated Employees Profit-Sharing Plan and Trust Agreement, as amended	Incorporated herein by reference is Exhibit 10.05 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.04	Form of Representative Agreement between II-VI and its foreign representatives	Incorporated herein by reference is Exhibit 10.15 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.05	Form of Employment Agreement*	Incorporated herein by reference is Exhibit 10.16 to II-VI s Registration Statement No. 33-16389 on Form S-1.

10.06	Description of Management-By- Objective Plan*	Incorporated herein by reference is Exhibit 10.09 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 1993.
10.07	Trust Under the II-VI Incorporated Deferred Compensation Plan*	Incorporated herein by reference is Exhibit 10.13 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 1996.
10.08	Description of Bonus Incentive Plan*	Incorporated herein by reference is Exhibit 10.14 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 1996.
10.09	Amended and Restated II-VI Incorporated Deferred Compensation Plan*	Incorporated herein by reference is Exhibit 10.01 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 1996.
10.10	II-VI Incorporated Stock Option Plan of 2001*	Incorporated herein by reference is Exhibit 4.1 to II-VI s Registration Statement No. 333-74682 on Form S-8.
10.11	Example Form of Stock Option Agreement under the II-VI Incorporated Stock Option Plan of 2001*	Incorporated herein by reference is Exhibit 10.17 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 2004.
10.12	II-VI Incorporated Arrangement for Director Compensation*	Incorporated herein by reference is Exhibit 10.1 to II-VI s Current Report on Form 8-K filed on March 2, 2005.
10.13	II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit A to II-VI s Definitive Proxy Statement on Schedule 14A filed on September 26, 2005.
10.14	Form of Nonqualified Stock Option under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.01 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 2005.
10.15	Form of Restricted Share Award under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.02 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 2005.
10.16	Form of Deferred Share Award under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.03 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 2005.
10.17	Form of Performance Unit Award under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.04 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 2005.

10.18	Form of Stock Appreciation Rights Award under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.05 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended December 31, 2005.
10.19	Form of Performance Share Award under the II-VI Incorporated 2005 Omnibus Incentive Plan*	Incorporated herein by reference to Exhibit 10.01 to II-VI s current report on Form 8-K filed on February 16, 2006.
21.01	List of Subsidiaries of II-VI Incorporated	Filed herewith.
23.01	Consent of Deloitte & Touche LLP	Filed herewith.
31.01	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, and Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.
31.02	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, and Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.
32.01	Certification of the Chief Executive Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. § 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith.
32.02	Certification of the Chief Financial Officer pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. § 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith.

* Denotes management contract or compensatory plan, contract or arrangement.

The Registrant will furnish to the Commission upon request copies of any instruments not filed herewith which authorize the issuance of long-term obligations of the Registrant not in excess of 10% of the Registrant s total assets on a consolidated basis.

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.

	II-VI INCORPORATED
Date: September 11, 2006	By: /s/ Carl J. Johnson Chairman 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 and on the dates indicated.

	Principal Executive Officer:	
Date: September 11, 2006	By:	/s/ Carl J. Johnson Carl J. Johnson Chairman, Chief Executive Officer and Director
	Principal Financial and Accounting Officer:	
Date: September 11, 2006	By:	/s/ Craig A. Creaturo Craig A. Creaturo Chief Financial Officer and Treasurer
Date: September 11, 2006	By:	/s/ Francis J. Kramer Francis J. Kramer President, Chief Operating Officer and Director
Date: September 11, 2006	By:	/s/ Joseph J. Corasanti Joseph J. Corasanti Director
Date: September 11, 2006	By:	/s/ Thomas E. Mistler Thomas E. Mistler Director
Date: September 11, 2006	By:	/s/ Duncan A.J. Morrison Duncan A. J. Morrison Director
Date: September 11, 2006	By:	/s/ RADM Marc Y.E. Pelaez RADM Marc Y. E. Pelaez (retired) Director
Date: September 11, 2006	By:	/s/ Peter W. Sognefest Peter W. Sognefest Director

EXHIBIT INDEX

3.01	Amended and Restated Articles of Incorporation of II-VI Incorporated	Incorporated herein by reference is Exhibit 3.01 to II-VI s Current Report on Form 8-K filed on November 12, 2004.
3.02	Amended and Restated By-Laws of II-VI Incorporated	Incorporated herein by reference is Exhibit 3.02 to II-VI s Annual Report on Form 10-K for the fiscal year ended June 30, 2002.
10.01	II-VI Incorporated Amended and Restated Employees Stock Purchase Plan	Incorporated herein by reference is Exhibit 10.04 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.02	First Amendment to the II-VI Incorporated Amended and Restated Employees Stock Purchase Plan	Incorporated herein by reference Exhibit 10.01 to II-VI s Quarterly Report on Form 10-Q for the Quarter Ended March 31, 1996.
10.03	II-VI Incorporated Amended and Restated Employees Profit-Sharing Plan and Trust Agreement, as amended	Incorporated herein by reference is Exhibit 10.05 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.04	Form of Representative Agreement between II-VI and its foreign representatives	Incorporated herein by reference is Exhibit 10.15 to II-VI s Registration Statement No. 33-16389 on Form S-1.
10.05	Form of Employment Agreement*	Incorporated herein by reference is Exhibit 10.16 to II-VI s Registration Statement No. 33-16389 on Form S-1.
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