

ULTRALIFE BATTERIES INC

Form 10-Q

August 09, 2007

Table of Contents

**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 the quarterly period ended June 30, 2007

or

**Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
for the transition period from _____ to _____**

Commission file number 0-20852

ULTRALIFE BATTERIES, INC.

(Exact name of registrant as specified in its charter)

Delaware

16-1387013

(State or other jurisdiction
of incorporation or organization)

(I.R.S. Employer Identification No.)

2000 Technology Parkway, Newark, New York 14513

(Address of principal executive offices)

(Zip Code)

(315) 332-7100

(Registrant's telephone number, including area code)

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

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

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

Large Accelerated Filer Accelerated Filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common stock, \$.10 par value 15,232,437 shares of common stock outstanding, net of 727,250 treasury shares, as of August 4, 2007.

ULTRALIFE BATTERIES, INC.
INDEX

| | Page |
|--|------|
| <u>PART I FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements (Unaudited)</u> | |
| <u>Condensed Consolidated Balance Sheets June 30, 2007 and December 31, 2006</u> | 3 |
| <u>Condensed Consolidated Statements of Operations Three- and six-month periods ended June 30, 2007 and July 1, 2006</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows Six-month periods ended June 30, 2007 and July 1, 2006</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 25 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 37 |
| <u>Item 4. Controls and Procedures</u> | 37 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 39 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 40 |
| <u>Item 6. Exhibits</u> | 40 |
| <u>Signatures</u> | 41 |
| <u>Index to Exhibits</u> | 42 |
| EX-31.1 | |
| EX-31.2 | |
| EX-32 | |

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

ULTRALIFE BATTERIES, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Dollars in Thousands, Except Per Share Amounts)
 (unaudited)

| | June 30, 2007 | December 31, 2006 |
|---|------------------|-------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 553 | \$ 720 |
| Trade accounts receivable (less allowance for doubtful accounts of \$464 at June 30, 2007 and \$447 at December 31, 2006) | 23,190 | 24,197 |
| Inventories | 31,659 | 27,360 |
| Due from insurance company | 849 | 780 |
| Deferred tax asset - current | 82 | 75 |
| Prepaid expenses and other current assets | 1,966 | 2,748 |
| | | |
| Total current assets | 58,299 | 55,880 |
| | | |
| Property, plant and equipment, net | 19,396 | 19,396 |
| | | |
| Other assets: | | |
| Goodwill | 14,460 | 13,344 |
| Intangible assets, net | 7,785 | 9,072 |
| Security deposit | 77 | 66 |
| | 22,322 | 22,482 |
| | | |
| Total Assets | \$ 100,017 | \$ 97,758 |

LIABILITIES AND SHAREHOLDERS EQUITY**Current liabilities:**

| | | |
|---|-----------|-----------|
| Current portion of debt and capital lease obligations | \$ 13,110 | \$ 12,246 |
| Accounts payable | 14,293 | 15,925 |
| Other current liabilities | 9,261 | 9,639 |
| | | |
| Total current liabilities | 36,664 | 37,810 |

Long-term liabilities:

| | | |
|------------------------------------|--------|--------|
| Debt and capital lease obligations | 20,350 | 20,043 |
| Other long-term liabilities | 482 | 316 |
| Total long-term liabilities | 20,832 | 20,359 |

Commitments and contingencies (Note 11)**Shareholders equity:**

| | | |
|--|------------|-----------|
| Preferred stock, par value \$0.10 per share, authorized 1,000,000 shares; none issued and outstanding | | |
| Common stock, par value \$0.10 per share, authorized 40,000,000 shares; issued 15,920,046 at June 30, 2007 and 15,853,306 at December 31, 2006 | 1,586 | 1,578 |
| Capital in excess of par value | 136,071 | 134,736 |
| Accumulated other comprehensive loss | 6 | (321) |
| Accumulated deficit | (92,764) | (94,026) |
| | 44,899 | 41,967 |
| Less Treasury stock, at cost 727,250 shares outstanding | 2,378 | 2,378 |
| Total shareholders equity | 42,521 | 39,589 |
| Total Liabilities and Shareholders Equity | \$ 100,017 | \$ 97,758 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

ULTRALIFE BATTERIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Amounts)
(unaudited)

| | Three-Month Periods Ended | | Six-Month Periods Ended | |
|--|------------------------------|-----------------|----------------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Revenues | \$ 35,196 | \$ 21,393 | \$ 67,516 | \$ 39,712 |
| Cost of products sold | 26,579 | 17,016 | 51,398 | 31,365 |
| Gross margin | 8,617 | 4,377 | 16,118 | 8,347 |
| Operating expenses: | | | | |
| Research and development (including \$256, \$0, \$509 and \$0, respectively, of amortization of intangible assets) | 1,688 | 884 | 3,302 | 1,844 |
| Selling, general, and administrative (including \$294, \$0, \$572 and \$0, respectively, of amortization of intangible assets) | 5,212 | 3,032 | 10,508 | 5,814 |
| Total operating expenses | 6,900 | 3,916 | 13,810 | 7,658 |
| Operating income | 1,717 | 461 | 2,308 | 689 |
| Other income (expense): | | | | |
| Interest income | 18 | 40 | 32 | 85 |
| Interest expense | (604) | (207) | (1,261) | (412) |
| Gain on insurance settlement | | 43 | | 191 |
| Miscellaneous | 167 | 139 | 183 | 147 |
| Income before income taxes | 1,298 | 476 | 1,262 | 700 |
| Income tax provision-current | | 20 | | 24 |
| Income tax provision-deferred | | 347 | | 427 |
| Total income taxes | | 367 | | 451 |
| Net income | \$ 1,298 | \$ 109 | \$ 1,262 | \$ 249 |

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| | | | | | |
|--|----------------|---------|---------|---------|---------|
| Earnings per share | basic | \$ 0.09 | \$ 0.01 | \$ 0.08 | \$ 0.02 |
| Earnings per share | diluted | \$ 0.08 | \$ 0.01 | \$ 0.08 | \$ 0.02 |
| Weighted average shares outstanding | basic | 15,123 | 14,851 | 15,100 | 14,807 |
| Weighted average shares outstanding | diluted | 15,331 | 15,165 | 15,320 | 15,150 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

4

Table of Contents

ULTRALIFE BATTERIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(unaudited)

| | Six-Month Periods Ended | |
|---|-------------------------|-----------------|
| | June 30, 2007 | July 1, 2006 |
| OPERATING ACTIVITIES | | |
| Net income | \$ 1,262 | \$ 249 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of financing fees | 1,916 | 1,817 |
| Amortization of intangible assets | 1,081 | |
| Loss on asset disposal | 6 | |
| Gain on insurance settlement | | (191) |
| Foreign exchange (gain) loss | (153) | (147) |
| Non-cash stock-based compensation | 1,031 | 566 |
| Changes in deferred income taxes | | 427 |
| Changes in operating assets and liabilities, net of effects from the purchase of ABLE and McDowell: | | |
| Accounts receivable | 848 | (1,332) |
| Inventories | (4,282) | 3,455 |
| Prepaid expenses and other current assets | 688 | 1,236 |
| Insurance receivable relating to fires | (49) | 602 |
| Income taxes payable | | 23 |
| Accounts payable and other liabilities | (830) | (2,234) |
| Net cash provided by operating activities | 1,518 | 4,471 |
| INVESTING ACTIVITIES | | |
| Purchase of property and equipment | (1,370) | (651) |
| Payment for purchase of ABLE, net of cash acquired | (1) | (1,946) |
| Payment for purchase of McDowell | (1,500) | |
| Net cash used in investing activities | (2,871) | (2,597) |
| FINANCING ACTIVITIES | | |
| Net change in revolving credit facilities | 1,800 | (525) |
| Proceeds from issuance of common stock | 312 | 555 |
| Principal payments on long-term debt and capital lease obligations | (1,039) | (1,000) |
| Net cash provided by (used in) in financing activities | 1,073 | (970) |
| Effect of exchange rate changes on cash | 113 | 119 |

| | | |
|--|--------|----------|
| Change in cash and cash equivalents | (167) | 1,023 |
| Cash and cash equivalents at beginning of period | 720 | 3,214 |
| Cash and cash equivalents at end of period | \$ 553 | \$ 4,237 |

SUPPLEMENTAL CASH FLOW INFORMATION

| | | |
|--|----------|----------|
| Cash paid for income taxes | \$ | \$ 5 |
| Cash paid for interest | \$ 1,155 | \$ 363 |
| Noncash investing and financing activities: | | |
| Issuance of common stock and stock warrants for purchase of ABLE | \$ | \$ 1,526 |
| Purchase of property and equipment via capital lease payable | \$ 410 | \$ |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

ULTRALIFE BATTERIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollar Amounts in Thousands Except Share and Per Share Amounts)
(unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Ultralife Batteries, Inc. and our subsidiaries have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and adjustments) considered necessary for a fair presentation of the condensed consolidated financial statements have been included. Results for interim periods should not be considered indicative of results to be expected for a full year. Reference should be made to the consolidated financial statements contained in our Form 10-K for the twelve-month period ended December 31, 2006.

The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Our monthly closing schedule is a weekly-based cycle as opposed to a calendar month-based cycle. While the actual dates for the quarter-ends will change slightly each year, we believe that there are not any material differences when making quarterly comparisons.

2. ACQUISITIONS

We have accounted for the following acquisitions in accordance with the purchase method of accounting provisions of Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, whereby the purchase price paid to effect an acquisition is allocated to the acquired tangible and intangible assets and liabilities at fair value.

ABLE New Energy Co., Ltd.

On May 19, 2006, we acquired 100% of the equity securities of ABLE New Energy Co., Ltd. (ABLE), an established manufacturer of lithium batteries located in Shenzhen, China. With more than 50 products, including a wide range of lithium-thionyl chloride and lithium-manganese dioxide batteries and coin cells, this acquisition broadens our expanding portfolio of high-energy power sources, enabling us to further penetrate large and emerging markets such as remote meter reading, RFID (Radio Frequency Identification) and other markets that will benefit from these chemistries. We expect this acquisition will strengthen our global presence, facilitate our entry into the rapidly growing Chinese market, and improve our access to lower material and manufacturing costs.

The initial cash purchase price for ABLE was \$1,896 (net of \$104 in cash acquired), with an additional \$500 cash payment contingent on the achievement of certain performance milestones, payable in separate \$250 increments, when cumulative ABLE revenues from the date of acquisition attain \$5,000 and \$10,000, respectively. The contingent payments will be recorded as an addition to the purchase price when the performance milestones are attained. The equity portion of the purchase price consisted of 96,247 shares of our common stock valued at \$1,000, based on the closing price of the stock on the closing date of the acquisition, and 100,000 stock warrants valued at \$526, for a total equity consideration of \$1,526. The fair value of the stock warrants was estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions as of May 19, 2006 (the date of acquisition):

Table of Contents

| | |
|--|--------|
| Risk-free interest rate | 4.31% |
| Volatility factor | 61.25% |
| Dividends | 0.00% |
| Weighted average expected life (years) | 2.50 |

We have incurred \$59 in acquisition related costs, which are included in the total potential cost of the investment of \$3,981. During the second quarter of 2007, \$1 of additional acquisition costs were incurred, which resulted in an increase of goodwill of \$1.

The results of operations of ABLE and the estimated fair value of assets acquired and liabilities assumed are included in our consolidated financial statements beginning on the acquisition date. The estimated excess of the purchase price over the net tangible and intangible assets acquired of \$2,268 (including \$104 in cash) was recorded as goodwill in the amount of \$1,317. The acquired goodwill has been assigned to the Non-Rechargeable Products segment and is not expected to be deductible for income tax purposes.

The following table represents the final allocation of the purchase price to assets acquired and liabilities assumed at the acquisition date:

ASSETS

Current assets:

| | |
|---|--------|
| Cash and cash equivalents | \$ 104 |
| Trade accounts receivables, net | 318 |
| Inventories | 737 |
| Prepaid expenses and other current expenses | 73 |

| | |
|------------------------------------|-------|
| Total current assets | 1,232 |
| Property, plant and equipment, net | 740 |
| Goodwill | 1,317 |

Intangible assets:

| | |
|---------------------------|-----|
| Trademarks | 90 |
| Patents and technology | 390 |
| Customer relationships | 820 |
| Distributor relationships | 300 |
| Non-compete agreements | 40 |

| | |
|-----------------------|-------|
| Total assets acquired | 4,929 |
|-----------------------|-------|

LIABILITIES

Current liabilities:

| | |
|---------------------------|-------|
| Accounts payable | 1,085 |
| Other current liabilities | 110 |

| | |
|---------------------------|-------|
| Total current liabilities | 1,195 |
|---------------------------|-------|

Long-term liabilities:

| | |
|-----------------------------|----|
| Other long-term liabilities | 65 |
| Deferred tax liability | 84 |

| | |
|---------------------------|-------|
| Total liabilities assumed | 1,344 |
|---------------------------|-------|

Total Purchase Price \$ 3,585

The trademarks intangible asset has an indefinite life and is not being amortized. The intangible assets related to patents and technology, customer relationships and distributor relationships are being amortized as the economic benefits of the intangible assets are being utilized over their weighted-average estimated useful life of eleven years. The non-compete agreements intangible asset is being amortized on a straight-line basis over its estimated useful life of three years.

Table of Contents**McDowell Research, Ltd.**

On July 3, 2006, we finalized the acquisition of substantially all of the assets of McDowell Research, Ltd. (McDowell), a manufacturer of military communications accessories located in Waco, Texas.

Under the terms of the acquisition agreement, the purchase price of approximately \$25,000 consisted of \$5,000 in cash and a \$20,000 non-transferable, subordinated convertible promissory note to be held by the sellers. The purchase price is subject to a post-closing adjustment based on a final valuation of trade accounts receivable, inventory and trade accounts payable that were acquired or assumed on the date of the closing, using a base value of \$3,000. The final net value of these assets, under our contractual obligation under the acquisition agreement, is \$6,389, an increase of \$944 from what was reported for the quarter ended March 31, 2007, resulting in a revised purchase price of approximately \$28,448. The increase of \$944 resulted from final revisions to the asset valuations during the second quarter of 2007, as further described below. A cash payment of \$1,500 was made to the sellers during the first quarter of 2007 and as of June 30, 2007, we have accrued \$1,889 for the remaining final post-closing adjustment of \$3,389. As of December 31, 2006, we had accrued \$3,000 for the post-closing adjustment. The respective accruals for the post-closing adjustment are included in the Other Current Liabilities line on our Consolidated Balance Sheet. The acquisition agreement and the resultant purchase price is subject to the finalization of substantial negotiations with the sellers pertaining to the valuation of trade accounts receivable, inventory, trade accounts payable and other matters related to the acquisition.

The initial \$5,000 cash portion was financed through a combination of cash on hand and borrowing through the revolver component of our credit facility with our primary lending banks, which was amended to accommodate the acquisition of McDowell. The \$20,000 convertible note carries a five-year term, an annual interest rate of 4% and is convertible at \$15 per share into 1.33 million shares of our common stock, with a forced conversion feature, at our option, at any time after the 30-day average closing price of our common stock exceeds \$17.50 per share. The conversion price is subject to adjustment as defined in the subordinated convertible promissory note. Interest is payable quarterly in arrears, with all unpaid accrued interest and outstanding principal due in full on July 3, 2011. In April 2007, in connection with its dissolution, McDowell distributed the convertible note to its members in proportion to their membership interests. There are now six separate convertible notes aggregating \$20,000. We have incurred \$59 in acquisition related costs, which are included in the approximate total cost of the investment of \$28,448.

The results of operations of McDowell and the estimated fair value of assets acquired and liabilities assumed are included in our consolidated financial statements beginning on the acquisition date. The estimated excess of the purchase price over the net tangible and intangible assets acquired of \$15,373 was recorded as goodwill in the amount of \$13,075. The acquired goodwill has been assigned to the Rechargeable Products and the Communications Accessories segments and is expected to be fully deductible for income tax purposes.

As a result of final revisions to the asset valuations during the second quarter of 2007, values assigned to the tangible assets have been revised. The adjustments to the values for tangible assets from those reported for the quarter ended March 31, 2007 were as follows: trade accounts receivable increased by \$238, accounts payable increased \$4 and other current liabilities decreased by \$4. These adjustments, along with the adjustment to the post-closing adjustment noted above, resulted in an increase to goodwill of \$706.

The following table represents the final allocation of the purchase price to assets acquired and liabilities assumed at the acquisition date:

Table of Contents**ASSETS**

Current assets:

| | |
|--|------------|
| Trade accounts receivables, net | \$ 3,532 |
| Inventories | 5,155 |
| Prepaid inventory and other current expenses | 10 |
| Total current assets | 8,697 |
| Property, plant and equipment, net | 397 |
| Goodwill | 13,075 |
| Intangible assets: | |
| Trademarks | 3,000 |
| Patents and technology | 3,201 |
| Customer relationships | 1,990 |
| Non-compete agreements | 166 |
| Total assets acquired | 30,526 |

LIABILITIES

Current liabilities:

| | |
|-----------------------------------|-----------|
| Current portion of long-term debt | 46 |
| Accounts payable | 1,787 |
| Other current liabilities | 208 |
| Total current liabilities | 2,041 |
| Long-term liabilities: | |
| Debt | 37 |
| Total liabilities assumed | 2,078 |

Total Purchase Price \$ 28,448

The trademarks intangible asset has an indefinite life and is not being amortized. The intangible assets related to patents and technology and customer relationships are being amortized as the economic benefits of the intangible assets are being utilized over their weighted-average estimated useful life of thirteen years. The non-compete agreements intangible asset is being amortized on a straight-line basis over its estimated useful life of two years.

In connection with the McDowell acquisition, we entered into an operating lease agreement for real property in Waco, Texas with a partnership that is 50% owned by Thomas Hauke, who joined us as an executive officer following the completion of the McDowell acquisition. The lease term is for one year, with annual rent of \$227, payable in monthly installments. In June 2007, this lease was extended through September 2007. During the first quarter of 2007, Mr. Hauke resigned from his position.

Table of Contents**3. GOODWILL AND OTHER INTANGIBLE ASSETS**

The composition of intangible assets was:

| | | June 30, 2007 Accumulated | |
|--------------------------------|-------------------------|--|----------------|
| | Gross Assets | Amortization | Net |
| Trademarks | \$ 3,095 | \$ | \$3,095 |
| Patents and technology | 3,611 | 1,133 | 2,478 |
| Customer relationships | 2,853 | 978 | 1,875 |
| Distributor relationships | 315 | 88 | 227 |
| Non-compete agreements | 208 | 98 | 110 |
| Total intangible assets | \$10,082 | \$ 2,297 | \$7,785 |

| | | December 31, 2006 Accumulated | |
|--------------------------------|-------------------------|--|----------------|
| | Gross Assets | Amortization | Net |
| Trademarks | \$ 3,090 | \$ | \$3,090 |
| Patents and technology | 3,737 | 619 | 3,118 |
| Customer relationships | 2,940 | 476 | 2,464 |
| Distributor relationships | 300 | 55 | 245 |
| Non-compete agreements | 204 | 49 | 155 |
| Total intangible assets | \$10,271 | \$ 1,199 | \$9,072 |

Amortization expense for intangible assets was \$550 and \$0 for the three-month periods ended June 30, 2007 and July 1, 2006, respectively. Amortization expense for intangible assets was \$1,081 and \$0 for the six-month periods ended June 30, 2007 and July 1, 2006, respectively.

The change in the cost value of total intangible assets is a result of changes in the final valuation of intangible assets in connection with the 2006 acquisitions and the effect of foreign currency translations.

The following table summarizes the goodwill activity by segment for the six months ended June 30, 2007:

| | Non- Rechargeable Products | Rechargeable Products | Communications Accessories | Total |
|--|---|----------------------------------|---------------------------------------|--------------|
| Balance at December 31, 2006 | \$1,239 | \$ 2,421 | \$ 9,684 | \$13,344 |
| Adjustments to purchase price allocation | 78 | 194 | 776 | 1,048 |
| Effect of foreign currency translations | 68 | | | 68 |

| | | | | |
|--------------------------|---------|----------|-----------|----------|
| Balance at June 30, 2007 | \$1,385 | \$ 2,615 | \$ 10,460 | \$14,460 |
|--------------------------|---------|----------|-----------|----------|

10

Table of Contents

The following table summarizes the goodwill activity by segment for the six months ended July 1, 2006:

| | Non- Rechargeable Products | Rechargeable Products | Communications Accessories | Total |
|------------------------------|---|----------------------------------|---------------------------------------|--------------|
| Balance at December 31, 2005 | \$ | \$ | \$ | \$ |
| Acquisition of ABLE | 516 | | | 516 |
| Balance at June 30, 2006 | \$516 | \$ | \$ | \$516 |

4. EARNINGS PER SHARE

Basic earnings per share are calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated by dividing net income by potentially dilutive common shares, which include stock options and warrants.

The computation of basic and diluted earnings per share is summarized as follows:

| | Three-Month Periods Ended | | Six-Month Periods Ended | |
|--|------------------------------|-----------------|----------------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Net Income (a) | \$ 1,298 | \$ 109 | \$ 1,262 | \$ 249 |
| Average Shares Outstanding Basic (b) | 15,123 | 14,851 | 15,100 | 14,807 |
| Effect of Dilutive Securities: | | | | |
| Stock Options / Warrants | 202 | 314 | 215 | 343 |
| Restricted Stock | 6 | | 5 | |
| Convertible Note Payable | | | | |
| Average Shares Outstanding Diluted (c) | 15,331 | 15,165 | 15,320 | 15,150 |
| EPS Basic (a/b) | \$ 0.09 | \$ 0.01 | \$ 0.08 | \$ 0.02 |
| EPS Diluted (a/c) | \$ 0.08 | \$ 0.01 | \$ 0.08 | \$ 0.02 |

We had options and warrants outstanding to purchase 1,593,933 and 1,184,601 shares of common stock at June 30, 2007 and July 1, 2006, respectively, which were not included in the computation of diluted EPS because these securities were anti-dilutive. We also had 1,333,333 and -0- shares of common stock at June 30, 2007 and July 1, 2006, respectively, reserved under a convertible note payable, which were also not included in the computation of diluted EPS because these securities were anti-dilutive. The anti-dilutive securities were due to the exercise and/or conversion prices were greater than the average market price of the common shares.

5. STOCK-BASED COMPENSATION**a. General**

We have various stock-based employee compensation plans. Effective January 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) requiring that compensation cost relating to share-based payment transactions be recognized in the financial statements. The cost is measured at the grant date,

based on the calculated fair value of the

Table of Contents

award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award). We adopted SFAS 123R using the modified prospective method and, accordingly, did not restate prior periods to reflect the fair value method of recognizing compensation cost. Under the modified prospective approach, SFAS 123R applies to new awards, awards that were unvested as of January 1, 2006 and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled.

Our shareholders have approved various equity-based plans that permit the grant of options, restricted stock and other equity-based awards. In addition, our shareholders have approved the grant of options outside of these plans.

Our shareholders approved a 1992 stock option plan for grants to key employees, directors and consultants of ours. The shareholders approved reservation of 1,150,000 shares of Common Stock for grant under the plan. During 1997, the Board of Directors and shareholders approved an amendment to the plan increasing the number of shares of Common Stock reserved by 500,000 to 1,650,000. Options granted under the 1992 plan are either Incentive Stock Options (ISOs) or Non-Qualified Stock Options (NQSOs). Key employees are eligible to receive ISOs and NQSOs; however, directors and consultants are eligible to receive only NQSOs. All ISOs vest at twenty percent per year for five years and expire on the sixth anniversary of the grant date. The NQSOs vest immediately and expire on the sixth anniversary of the grant date. On October 13, 2002, this plan expired and as a result, there are no more shares available for grant under this plan. As of June 30, 2007, there were 50,900 stock options outstanding under this plan.

Effective December 2000, we established the 2000 stock option plan which is substantially the same as the 1992 stock option plan. The shareholders approved reservation of 500,000 shares of Common Stock for grant under the plan. In December 2002, the shareholders approved an amendment to the plan increasing the number of shares of Common Stock reserved by 500,000, to a total of 1,000,000.

In June 2004, the shareholders adopted the Ultralife Batteries, Inc. 2004 Long-Term Incentive Plan (LTIP) pursuant to which we were authorized to issue up to 750,000 shares of Common Stock and grant stock options, restricted stock awards, stock appreciation rights and other stock-based awards. In June 2006, the shareholders approved an amendment to the LTIP, increasing the number of shares of Common Stock by an additional 750,000, bringing the total shares authorized under the LTIP to 1,500,000.

Options granted under the amended 2000 stock option plan and the LTIP are either ISOs or NQSOs. Key employees are eligible to receive ISOs and NQSOs; however, directors and consultants are eligible to receive only NQSOs. Most ISOs vest over a three or five year period and expire on the sixth or seventh anniversary of the grant date. All NQSOs issued to non-employee directors vest immediately and expire on either the sixth or seventh anniversary of the grant date. Some NQSOs issued to non-employees vest immediately and expire within three years; others have the same vesting characteristics as options given to employees. As of June 30, 2007, there were 1,734,131 stock options outstanding under the amended 2000 stock option plan and the LTIP.

On December 19, 2005, we granted the current CEO an option to purchase shares of Common Stock at \$12.96 per share outside of any of our equity-based compensation plans, subject to shareholder approval. Shareholder approval was obtained on June 8, 2006. The option to purchase 48,000 shares of Common Stock becomes exercisable in annual increments of 16,000 shares over a three-year period commencing December 9, 2006. The option expires on June 8, 2013.

Table of Contents

b. Stock Options

In conjunction with SFAS 123R, we recorded compensation cost related to stock options of \$392 and \$813 for the three- and six-month periods ended June 30, 2007, respectively, and \$308 and \$566 for the three- and six-month periods ended July 1, 2006, respectively. As of June 30, 2007, there was \$2,121 of total unrecognized compensation costs related to outstanding stock options, which is expected to be recognized over a weighted average period of 1.54 years.

We use the Black-Scholes option-pricing model to estimate fair value of stock-based awards. The following weighted average assumptions were used to value options granted during the six-month periods ended June 30, 2007 and July 1, 2006:

| | Six-Month Period Ended June 30, 2007 | Six-Month Period Ended July 1, 2006 |
|--|--|--|
| Risk-free interest rate | 4.54% | 4.76% |
| Volatility factor | 57.99% | 60.08% |
| Dividends | 0.00% | 0.00% |
| Weighted average expected life (years) | 3.75 | 3.58 |

We calculate expected volatility for stock options by taking an average of historical volatility over the past five years and a computation of implied volatility. The computation of expected term was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards and vesting schedules. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield in effect at the time of grant.

Stock option activity for the first six months of 2007 is summarized as follows (in thousands, except shares and per share amounts):

| | Number of Shares | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---------------------|---|---|---------------------------------|
| Shares under option at January 1, 2007 | 1,815,471 | \$ 11.03 | | |
| Options granted | 173,500 | 9.70 | | |
| Options exercised | (67,140) | 4.67 | | |
| Options forfeited | (78,300) | 9.80 | | |
| Options expired | (10,500) | 15.16 | | |
| Shares under option at June 30, 2007 | 1,833,031 | \$ 11.17 | 4.52 years | \$2,553 |
| Vested and expected to vest as of June 30, 2007 | 1,756,215 | \$ 11.19 | 4.45 years | \$2,508 |
| Options exercisable at June 30, 2007 | 1,093,137 | \$ 11.71 | 3.62 years | \$1,978 |

The total intrinsic value of options (which is the amount by which the stock price exceeded the exercise price of the options on the date of exercise) exercised during the six-month period ended June 30, 2007 was \$340.

Prior to adopting SFAS 123R, all tax benefits resulting from the exercise of stock options were presented as operating cash flows in the Condensed Statement of Cash Flows. SFAS 123R requires

13

Table of Contents

cash flows from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. We did not record any excess tax benefits in the first six months of 2007 and 2006. Cash received from option exercises under our stock-based compensation plans for the six-month periods ended June 30, 2007 and July 1, 2006 was \$312 and \$555, respectively.

c. Restricted Stock Awards

There were no restricted stock grants awarded during the six-month periods ended June 30, 2007 and July 1, 2006.

The activity of restricted stock grants of common stock for the first six months of 2007 is summarized as follows (dollars in thousands, except per share amounts):

| | Number of Shares | Weighted Average Grant Date Fair Value |
|-------------------------------|---------------------|---|
| Unvested at December 31, 2006 | 72,334 | \$ 10.50 |
| Granted | | |
| Vested | (13,334) | 10.30 |
| Forfeited | | |
| Unvested at June 30, 2007 | 59,000 | \$ 10.55 |

We recorded compensation cost related to restricted stock grants of \$88 and \$218 for the three- and six-month periods ended June 30, 2007, respectively, and \$0 and \$0 for the three- and six-month periods ended July 1, 2006, respectively. As of June 30, 2007, we had \$519 of total unrecognized compensation expense related to restricted stock grants, which is expected to be recognized over the remaining weighted average period of approximately 1.63 years. The total fair value of these grants that vested during the six-month period ended June 30, 2007 was \$128.

6. COMPREHENSIVE INCOME

The components of our total comprehensive income were:

| | Three-Month Periods Ended | | Six-Month Periods Ended | |
|---|------------------------------|-----------------|-------------------------|-----------------|
| | June 30, 2007 | July 1, 2006 | June 30, 2007 | July 1, 2006 |
| Net income (loss) | \$1,298 | \$109 | \$1,262 | \$249 |
| Foreign currency translation adjustments | 213 | 318 | 340 | 370 |
| Change in fair value of derivatives, net of tax | (1) | 11 | (13) | 32 |
| Total comprehensive income | \$1,510 | \$438 | \$1,589 | \$651 |

Table of Contents**7. INVENTORIES**

Inventories are stated at the lower of cost or market with cost determined under the first-in, first-out (FIFO) method. The composition of inventories was:

| | June 30, 2007 | December 31, 2006 |
|--------------------------------|------------------|-------------------------|
| Raw materials | \$21,140 | \$ 14,964 |
| Work in process | 5,850 | 9,061 |
| Finished goods | 6,876 | 4,541 |
| | 33,866 | 28,566 |
| Less: Reserve for obsolescence | 2,207 | 1,206 |
| | \$31,659 | \$27,360 |

8. PROPERTY, PLANT AND EQUIPMENT

Major classes of property, plant and equipment consisted of the following:

| | June 30, 2007 | December 31, 2006 |
|--------------------------------------|------------------|-------------------------|
| Land | \$ 123 | \$ 123 |
| Buildings and leasehold improvements | 4,786 | 4,336 |
| Machinery and equipment | 40,996 | 40,485 |
| Furniture and fixtures | 1,173 | 982 |
| Computer hardware and software | 2,295 | 2,127 |
| Construction in progress | 1,968 | 1,300 |
| | 51,341 | 49,353 |
| Less: Accumulated depreciation | 31,945 | 29,957 |
| | \$19,396 | \$19,396 |

Depreciation expense for property, plant and equipment was \$921 and \$1,855 for the three- and six-month periods ended June 30, 2007, respectively, and \$965 and \$1,783 for the three- and six-month periods ended July 1, 2006, respectively.

9. DEBT

On June 30, 2004, we closed on a \$25,000 credit facility, comprised of a five-year \$10,000 term loan component and a three-year \$15,000 revolving credit component. The facility is collateralized by essentially all of our assets, including all of our subsidiaries. The term loan component is paid in equal monthly installments over five years. The rate of interest, in general, is based upon either a LIBOR rate or Prime, plus a Eurodollar spread (dependent upon a debt to earnings ratio within a predetermined grid). This facility replaced our \$15,000 credit facility that expired on the same date. Availability under the revolving credit component is subject to meeting certain financial covenants, whereas availability under the previous facility was limited by the various asset values. The lenders of the new credit facility are JP Morgan Chase Bank and Manufacturers and Traders Trust Company, with JP Morgan Chase Bank acting as the administrative agent. We are required to meet certain financial covenants, including a debt to earnings

ratio, an EBIT (as defined) to interest expense ratio, and a current assets to total liabilities ratio. In addition, we are required to meet certain non-financial covenants.

On June 30, 2004, we drew down the full \$10,000 term loan. The proceeds of the term loan, to be repaid in equal monthly installments of \$167 over five years, were used for the retirement of outstanding debt and capital expenditures. From June 30, 2004 through August 1, 2004, the interest rate associated with the term loan was based on LIBOR plus a 1.25% Eurodollar spread. On July 1, 2004, we entered into an interest rate swap arrangement in the notional amount of \$10,000 to be effective on August 2, 2004, related to the \$10,000 term loan, in order to take advantage of historically low interest

Table of Contents

rates. We received a fixed rate of interest in exchange for a variable rate. The swap rate received was 3.98% for five years. The total rate of interest paid by us is equal to the swap rate of 3.98% plus the Eurodollar spread stipulated in the predetermined grid associated with the term loan. From August 2, 2004 to September 30, 2004, the total rate of interest associated with the outstanding portion of the \$10,000 term loan was 5.23%. On October 1, 2004, this adjusted rate increased to 5.33%, on January 1, 2005 the adjusted rate increased to 5.73%, on April 1, 2005, the adjusted rate increased to 6.48%, on October 3, 2005, the adjusted rate increased to 6.98%, and on February 14, 2007, the adjusted rate increased to 7.23%, and remains at that rate as of June 30, 2007. Derivative instruments are accounted for in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which requires that all derivative instruments be recognized in the financial statements at fair value. The fair value of this arrangement at June 30, 2007 resulted in an asset of \$57, all of which was reflected as a short-term asset.

Effective July 3, 2006, the banks amended the credit facility to reflect our acquisitions of ABLE and McDowell. As a result, the banks increased the amount of the revolving credit component from \$15,000 to \$20,000, and the financial covenants that we are required to maintain under the facility were revised accordingly. In addition, the revolving credit component of the facility was extended for one additional year.

Effective as of September 30, 2006, we received a waiver letter from the banks concerning our non-compliance with the EBIT (as defined) to interest covenant of the credit facility, as amended. In addition, we received a waiver for a non-financial covenant related to a Change in Control provision, as defined in the credit facility.

Effective February 14, 2007, we entered into Forbearance and Amendment Number Six to the Credit Agreement (*Forbearance and Amendment*) with the banks. The Forbearance and Amendment provides that the banks will forbear from exercising their rights under the credit facility arising from our failure to comply with certain financial covenants in the credit facility with respect to the fiscal quarter ended December 31, 2006. Specifically, we were not in compliance with the terms of the credit facility because we failed to maintain the required debt-to-earnings and EBIT-to-interest ratios provided for in the credit facility. The banks agreed to forbear from exercising their respective rights and remedies under the credit facility until March 23, 2007 (*Forbearance Period*), unless we breach the Forbearance and Amendment or unless another event or condition occurs that constitutes a default under the credit facility. Each bank agreed to continue to make revolving loans available to us during the Forbearance Period. Pursuant to the Forbearance and Amendment, the aggregate amount of the banks' revolving loan commitment was reduced from \$20,000 to \$15,000. During the Forbearance Period, the applicable revolving interest rate and the applicable term interest rate, in each case as set forth in the credit agreement, both shall be increased by 25 basis points. In addition to a number of technical and conforming amendments, the Forbearance and Amendment revised the definition of

Change in Control in the credit facility to provide that the acquisition of equity interests representing more than 30% of the aggregate ordinary voting power represented by the issued and outstanding equity interests of us shall constitute a *Change in Control* for purposes of the credit facility. Previously, the equity interests threshold had been set at 20%.

Effective March 23, 2007, we entered into Extension of Forbearance and Amendment Number Seven to Credit Agreement (*Extension and Amendment*) with the banks. The Extension and Amendment provides that the banks have agreed to extend the Forbearance Period until May 18, 2007. The Extension and Amendment also acknowledged that we continue not to be in compliance with the financial covenants identified above for the fiscal quarter ended December 31, 2006 and did not contemplate being in compliance for the fiscal quarter ending March 31, 2007.

Effective May 18, 2007, we entered into Extension of Forbearance and Amendment Number Eight to Credit Agreement (*Second Extension and Amendment*) with the banks. The Second Extension and Amendment provides that the banks have agreed to extend the Forbearance Period until August 15,

Table of Contents

2007. The Second Extension and Amendment also acknowledged that we continue not to be in compliance with the financial covenants identified above for the fiscal quarter ended March 31, 2007 and did not contemplate being in compliance for the fiscal quarter ending June 30, 2007. Once the Forbearance Period ends, the banks may exercise their rights and remedies under the credit facility without further notice or action. As of June 30, 2007, we were not in compliance with the EBIT-to-interest ratio covenant identified above, and we do not expect to be in compliance with the EBIT-to-interest ratio covenant, as currently stated, for the fiscal quarter ending September 29, 2007.

While we believe relations with our lenders are good and we have received waivers as necessary in the past, there can be no assurance that such waivers can always be obtained. In such case, we believe we have, in the aggregate, sufficient cash, cash generation capabilities from operations, working capital, and financing alternatives at our disposal, including but not limited to alternative borrowing arrangements (e.g. asset secured borrowings) and other available lenders, to fund operations in the normal course and repay the debt outstanding under our credit facility that is subject to the Extension and Amendment.

As of June 30, 2007, we had \$4,167 outstanding under the term loan component of our credit facility with our primary lending bank and \$8,800 was outstanding under the revolver component. As a result of the uncertainty of our ability to comply with the more restrictive financial covenants within the next year, we continued to classify all of the debt associated with this credit facility as a current liability on the Condensed Consolidated Balance Sheet as of June 30, 2007. The revolver arrangement now provides for up to \$15,000 of borrowing capacity, including outstanding letters of credit. At June 30, 2007, we had \$1,440 of outstanding letters of credit related to this facility, as amended May 18, 2007, leaving \$4,760 of additional borrowing capacity. As of August 1, 2007, the \$1,440 letter of credit has expired, providing additional borrowing capacity under the revolver for this amount.

As of June 30, 2007, our wholly-owned U.K. subsidiary, Ultralife Batteries (UK) Ltd., had nothing outstanding under its revolving credit facility with a commercial bank in the U.K. This credit facility provides our U.K. operation with additional financing flexibility for its working capital needs. Any borrowings against this credit facility are collateralized with that company's outstanding accounts receivable balances. There was approximately \$902 in additional borrowing capacity under this credit facility as of June 30, 2007.

10. INCOME TAXES

The asset and liability method, prescribed by SFAS No. 109, *Accounting for Income Taxes*, is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws that may be in effect when the differences are expected to reverse.

For the three- and six-month periods ended June 30, 2007, we recorded no income tax expense, due to the loss reported for U.S. operations during the period. The effective tax rate for the total consolidated company was 0%. The overall effective rate is the result of the combination of income and losses in each of our tax jurisdictions, which is particularly influenced by the fact that we have not recognized a deferred tax asset pertaining to cumulative historical losses for our U.S. operations and our U.K. subsidiary, as management does not believe it is more likely than not that we will realize the benefit of these losses. As a result, there is no provision for income taxes for the U.S. operations or the U.K. subsidiary reflected in the Condensed Consolidated Statements of Operations.

During the fiscal quarter ended December 31, 2006, we recorded a full valuation allowance on our net deferred tax asset, due to the determination that it was more likely than not that we would not be able to utilize these benefits in the future. At June 30, 2007, we continue to recognize a full valuation allowance on our net deferred tax asset, as we believe that it is more likely than not that we will not

Table of Contents

be able to utilize these benefits in the future. We continually monitor the assumptions and performance results to assess the realizability of the tax benefits of the U.S. and U.K. net operating losses and other deferred tax assets.

On January 1, 2007, we adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes: An interpretation of FASB Statement No. 109 (FIN 48). As a result of the adoption of FIN 48 and recognition of the cumulative effect of adoption of a new accounting principle, we recorded no increase in the liability for unrecognized income tax benefits, with no offsetting reduction in retained earnings. There was no adjustment to reflect the net difference between the related balance sheet accounts before applying FIN 48, and then as measured pursuant to FIN 48 s provisions.

The tax years 2003 to 2006 remain open to examination by United States taxing jurisdictions, and for our other major jurisdictions (UK and China), the tax years 2001 to 2006 and 2003 to 2006, respectively, remain open to routine examination by foreign taxing authorities.

We have determined that a change in ownership as defined under Internal Revenue Code Section 382 occurred during the fourth quarter of 2003 and again during the third quarter of 2005. As such, the domestic net operating loss carryforward will be subject to an annual limitation. We believe such limitation will not impact our ability to realize the deferred tax asset. In addition, certain of our NOL carryforwards are subject to U.S. alternative minimum tax such that carryforwards can offset only 90% of alternative minimum taxable income. This limitation did not have an impact on income taxes determined for 2006 and 2007.

11. COMMITMENTS AND CONTINGENCIES

We are subject to legal proceedings and claims that arise in the normal course of business. We believe that the final disposition of such matters will not have a material adverse effect on our financial position, results of operations or cash flows.

As of June 30, 2007, we have made commitments to purchase approximately \$921 of production machinery and equipment.

We estimate future costs associated with expected product failure rates, material usage and service costs in the development of our warranty obligations. Warranty reserves are based on historical experience of warranty claims and generally will be estimated as a percentage of sales over the warranty period. In the event the actual results of these items differ from the estimates, an adjustment to the warranty obligation would be recorded. Changes in our product warranty liability during the first six months of 2007 were as follows:

| | |
|--------------------------------|--------|
| Balance at December 31, 2006 | \$ 522 |
| Accruals for warranties issued | 272 |
| Settlements made | (21) |
| Balance at June 30, 2007 | \$ 773 |

A retail end-user of a product manufactured by one of our customers (the Customer) made a claim against the Customer wherein it asserted that the Customer s product, which is powered by one of our batteries, does not operate according to the Customer s product specification. No claim has been filed against us. However, in the interest of fostering good customer relations, in September 2002, we agreed to lend technical support to the Customer in defense of its claim. Additionally, we assured the Customer that we would honor our warranty by replacing any batteries that might be determined to be defective. Subsequently, we learned that the end-user and the Customer settled the matter. In February 2005, we entered into a settlement agreement with the Customer. Under the terms of the agreement, we

Table of Contents

have agreed to provide replacement batteries for product determined to be defective, to warrant each replacement battery under our standard warranty terms and conditions, and to provide the Customer product at a discounted price for a period of time in recognition of the Customer's administrative costs in responding to the claim of the retail end-user. In consideration of the above, the Customer released us from any and all liability with respect to this matter. Consequently, we do not anticipate any further expenses with regard to this matter other than our obligation under the settlement agreement. Our warranty reserve as of June 30, 2007 includes an accrual related to anticipated replacements under this agreement. Further, we do not expect the ongoing terms of the settlement agreement to have a material impact on our operations or financial condition.

In conjunction with our purchase/lease of our Newark, New York facility in 1998, we entered into a payment-in-lieu of tax agreement, which provides us with real estate tax concessions upon meeting certain conditions. In connection with this agreement, a consulting firm performed a Phase I and II Environmental Site Assessment, which revealed the existence of contaminated soil and ground water around one of the buildings. We retained an engineering firm, which estimated that the cost of remediation should be in the range of \$230. Through June 30, 2007, total costs incurred have amounted to approximately \$164, none of which has been capitalized. In February 1998, we entered into an agreement with a third party which provides that we and this third party will retain an environmental consulting firm to conduct a supplemental Phase II investigation to verify the existence of the contaminants and further delineate the nature of the environmental concern. The third party agreed to reimburse us for fifty percent (50%) of the cost of correcting the environmental concern on the Newark property. We have fully reserved for our portion of the estimated liability. Test sampling was completed in the spring of 2001, and the engineering report was submitted to the New York State Department of Environmental Conservation (NYSDEC) for review. NYSDEC reviewed the report and, in January 2002, recommended additional testing. We responded by submitting a work plan to NYSDEC, which was approved in April 2002. We sought proposals from engineering firms to complete the remedial work contained in the work plan. A firm was selected to undertake the remediation and in December 2003 the remediation was completed, and was overseen by the NYSDEC. The report detailing the remediation project, which included the test results, was forwarded to NYSDEC and to the New York State Department of Health (NYSDOH). The NYSDEC, with input from the NYSDOH, requested that we perform additional sampling. A work plan for this portion of the project was written and delivered to the NYSDEC and approved. In November 2005, additional soil, sediment and surface water samples were taken from the area outlined in the work plan, as well as groundwater samples from the monitoring wells. We received the laboratory analysis and met with the NYSDEC in March 2006 to discuss the results. On June 30, 2006, the Final Investigation Report was delivered to the NYSDEC by our outside environmental consulting firm. In November 2006, the NYSDEC completed its review of the Final Investigation Report and requested additional groundwater, soil and sediment sampling. A work plan to address the additional investigation was submitted to the NYSDEC in January 2007 and was approved in April 2007. Additional investigation work started in May 2007 and we are currently awaiting results and recommendations from our outside environmental consulting firm. The results of the additional investigation requested by the NYSDEC may increase the estimated remediation costs modestly. At June 30, 2007 and December 31, 2006, we had \$22 and \$35, respectively, reserved for this matter.

We have had certain exigent, non-bid contracts with the government, which have been subject to an audit and final price adjustment, which have resulted in decreased margins compared with the original terms of the contracts. As of June 30, 2007, there were no outstanding exigent contracts with the government. As part of its due diligence, the government has conducted post-audits of the completed exigent contracts to ensure that information used in supporting the pricing of exigent contracts did not differ materially from actual results. In September 2005, the Defense Contracting Audit Agency (DCAA) presented its findings related to the audits of three of the exigent contracts, suggesting a potential pricing adjustment of approximately \$1,400 related to reductions in the cost of materials that occurred prior to the final negotiation of these contracts. We have reviewed these audit reports, have submitted our response to these audits and believe, taken as a whole, the proposed audit

Table of Contents

adjustments can be offset with the consideration of other compensating cost increases that occurred prior to the final negotiation of the contracts. While we believe that potential exposure exists relating to any final negotiation of these proposed adjustments, we cannot reasonably estimate what, if any, adjustment may result when finalized. In addition, we have received a request from the Office of Inspector General of the Department of Defense ("DoD IG") seeking certain information and documents relating to our business with the Department of Defense. We are cooperating with the DoD IG inquiry and are furnishing the requested information and documents. At this time we have no basis for assessing whether we might face any penalties or liabilities on account of the DoD IG inquiry. The aforementioned DCAA-related adjustments could reduce margins and, along with the aforementioned DoD IG inquiry, could have an adverse effect on our business, financial condition and results of operations.

We have been able to obtain certain grants/loans from government agencies to assist with various funding needs. In November 2001, we received approval for a \$300 grant/loan from New York State. The grant/loan was to fund capital expansion plans that we expected would lead to job creation. In this case, we were to be reimbursed after the full completion of the particular project. This grant/loan also required us to meet and maintain certain levels of employment. During 2002, since we did not meet the initial employment threshold, it appeared unlikely at that time that we would be able to gain access to these funds. However, during 2006, our employment levels had increased to a level that exceeded the minimum threshold, and we received these funds in April 2007. As this grant/loan requires us to not only meet, but maintain, our employment levels for a pre-determined time period, we currently reflect the funds that we received as a current liability, in the Other Current Liabilities line on our Consolidated Balance Sheet. In the event our employment levels are not maintained at the specified levels at December 31, 2007 and 2008, we may be required to pay back these funds.

From August 2002 through August 2006, we participated in a self-insured trust to manage our workers compensation activity for our employees in New York State. All members of this trust have, by design, joint and several liability during the time they participate in the trust. In August 2006, we left the self-insured trust and have obtained alternative coverage for our workers compensation program through a third-party insurer. In the third quarter of 2006, we confirmed that the trust was in an underfunded position (i.e. the assets of the trust were insufficient to cover the actuarially projected liabilities associated with the members in the trust). In the third quarter of 2006, we recorded a liability and an associated expense of \$350 as an estimate of our potential future cost related to the trust's underfunded status. It is likely, however, that the final amount may be more or less, depending upon the ultimate settlement of claims that remain in the trust for the period of time we were a member. It is likely to take several years before resolution of outstanding workers compensation claims are finally settled. We will continue to review this liability periodically and make adjustments accordingly as new information is collected.

12. BUSINESS SEGMENT INFORMATION

We report our results in four operating segments: Non-Rechargeable Products, Rechargeable Products, Communications Accessories, and Technology Contracts. The Non-Rechargeable Products segment includes: lithium 9-volt, cylindrical and various other non-rechargeable batteries, including seawater-activated. The Rechargeable Products segment includes: our lithium ion and lithium polymer rechargeable batteries and charging systems and accessories, such as cables. In 2006, as a result of the acquisition of McDowell Research, we formed a new segment, Communications Accessories. The Communications Accessories segment includes: power supplies, cables and connector assemblies, RF amplifiers, amplified speakers, equipment mounts, case equipment and integrated communication systems kits. The Technology Contracts segment includes: revenues and related costs associated with various development contracts. We look at our segment performance at the gross margin level, and we do not allocate research and development or selling, general and administrative costs against the segments. All other items that do not specifically relate to these four segments and are not considered in the performance of the segments are considered to be Corporate charges.

Table of Contents**Three-Month Period Ended June 30, 2007**

| | Non- Rechargeable Products | Rechargeable Products | Communications Accessories | Technology Contracts | Corporate | Total |
|-----------------------|---|----------------------------------|---------------------------------------|---------------------------------|------------------|--------------|
| Revenues | \$ 22,808 | \$ 4,561 | \$ 7,688 | \$ 139 | \$ | \$ 35,196 |
| Segment contribution | 6,201 | 943 | 1,451 | 22 | (6,900) | 1,717 |
| Interest expense, net | | | | | (586) | (586) |
| Miscellaneous | | | | | 167 | 167 |
| Income taxes-current | | | | | | |
| Income taxes-deferred | | | | | | |
| Net income | | | | | | \$ 1,298 |
| Total assets | \$ 51,410 | \$ 18,459 | \$ 25,440 | \$ 74 | \$ 4,634 | \$ 100,017 |

Three-Month Period Ended July 1, 2006

| | Non- Rechargeable Products | Rechargeable Products | Communications Accessories | Technology Contracts | Corporate | Total |
|-----------------------|---|----------------------------------|---------------------------------------|---------------------------------|------------------|--------------|
| Revenues | \$ 18,458 | \$ 2,648 | \$ | \$ 287 | \$ | \$ 21,393 |
| Segment contribution | 3,558 | 789 | | 30 | (3,916) | 461 |
| Interest expense, net | | | | | (167) | (167) |
| Miscellaneous | | | | | 182 | 182 |
| Income taxes-current | | | | | (20) | (20) |
| Income taxes-deferred | | | | | (347) | (347) |
| Net income | | | | | | \$ 109 |
| Total assets | \$ 47,160 | \$ 3,883 | \$ | \$ 158 | \$ 30,542 | \$ 81,743 |

Six-Month Period Ended June 30, 2007

| | Non- Rechargeable Products | Rechargeable Products | Communications Accessories | Technology Contracts | Corporate | Total |
|-----------------------|---|----------------------------------|---------------------------------------|---------------------------------|------------------|--------------|
| Revenues | \$ 40,966 | \$ 10,090 | \$ 16,179 | \$ 281 | \$ | \$ 67,516 |
| Segment contribution | 10,749 | 2,305 | 2,971 | 93 | (13,810) | 2,308 |
| Interest expense, net | | | | | (1,229) | (1,229) |
| Miscellaneous | | | | | 183 | 183 |
| Income taxes-current | | | | | | |
| Income taxes-deferred | | | | | | |
| Net income | | | | | | \$ 1,262 |
| Total assets | \$ 51,410 | \$ 18,459 | \$ 25,440 | \$ 74 | \$ 4,634 | \$ 100,017 |

Six-Month Period Ended July 1, 2006

**Non-
Rechargeable Rechargeable Communications Technology**

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| | Products | Products | Accessories | Contracts | Corporate | Total |
|-----------------------|-----------------|-----------------|--------------------|------------------|------------------|--------------|
| Revenues | \$ 34,103 | \$ 5,213 | \$ | \$ 396 | \$ | \$ 39,712 |
| Segment contribution | 6,880 | 1,485 | | (18) | (7,658) | 689 |
| Interest expense, net | | | | | (327) | (327) |
| Miscellaneous | | | | | 338 | 338 |
| Income taxes-current | | | | | (24) | (24) |
| Income taxes-deferred | | | | | (427) | (427) |
| Net income | | | | | | \$ 249 |
| Total assets | \$ 47,160 | \$ 3,883 | \$ | \$ 158 | \$ 30,542 | \$ 81,743 |

21

Table of Contents

13. FIRES AT MANUFACTURING FACILITIES

In May 2004 and June 2004, we experienced two fires that damaged certain inventory and property at our facilities. The May 2004 fire occurred at our Newark facility and was caused by cells that shorted out when a forklift truck accidentally tipped the cells over in an oven in an enclosed area. Certain inventory, equipment and a small portion of the building where the fire was contained were damaged. The June 2004 fire happened at our U.K. location and mainly caused damage to various inventory and the U.K. company's leased facility. The fire was contained mainly in a bunkered, non-manufacturing area designed to store various material, and there was additional smoke and water damage to the facility and its contents. It is unknown how the U.K. fire was started.

The total amount of the two losses and related expenses associated with our owned assets was approximately \$2,000. Of this total, approximately \$450 was related to machinery and equipment, approximately \$750 was related to inventory and approximately \$800 was required to repair and clean up the facilities. The insurance claim related to the fire at our Newark facility was finalized in March 2005. In the first quarter of 2006, we received notice of a final claim settlement for the U.K. facility. As a result of the final settlement for the fire at the U.K. facility, we reflected a gain of \$148 in the first quarter of 2006 related to equipment and inventory damage. In April 2006 we received payment in fina