MERCURY COMPUTER SYSTEMS INC
Form 10-Q
February 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2009

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: 0-23599

MERCURY COMPUTER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

MASSACHUSETTS	**04-2741391**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
201 RIVERNECK ROAD CHELMSFORD, MA	**01824**
(Address of principal executive offices)	**(Zip Code)**

978-256-1300

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 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.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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

Shares of Common Stock outstanding as of February 1, 2010: 23,564,488 shares

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ITEM 1. FINANCIAL STATEMENTS

MERCURY COMPUTER SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	December 31, 2009 (unaudited)	June 30, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 52,197	$ 46,950
Marketable securities	44,444	44,977
Accounts receivable, net of allowance of $375 and $425 at December 31, 2009 and June 30, 2009, respectively	31,239	28,595
Inventory	16,884	16,805
Option to sell auction rate securities at par	4,741	5,030
Prepaid expenses and other current assets	3,184	3,748
Total current assets	152,689	146,105
Property and equipment, net	8,283	7,960
Goodwill	57,653	57,653
Acquired intangible assets, net	2,043	2,911
Other non-current assets	6,058	4,743
Total assets	$ 226,726	$ 219,372
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 5,290	$ 3,770
Accrued expenses	6,498	7,449
Accrued compensation	9,065	9,372
Borrowings under line of credit and current capital lease obligations	32,716	33,408
Income taxes payable	2,959	2,316
Deferred revenues and customer advances	7,314	7,840
Current liabilities of discontinued operations	121	1,234
Total current liabilities	63,963	65,389
Deferred gain on sale-leaseback	7,292	7,870
Other non-current liabilities	1,595	1,076
Total liabilities	72,850	74,335
Commitments and contingencies (Note N)		
Shareholders equity:		
Preferred stock, $.01 par value; 1,000,000 shares authorized; no shares issued or outstanding		
Common stock, $.01 par value; 85,000,000 shares authorized; 22,590,930 and 22,376,069 shares issued and outstanding at December 31, 2009 and June 30, 2009, respectively	226	224
Additional paid-in capital	107,321	104,843
Retained earnings	45,742	39,313
Accumulated other comprehensive income	587	657
Total shareholders equity	153,876	145,037

Total liabilities and shareholders equity	$ 226,726	$ 219,372

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY COMPUTER SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

	Three months ended December 31,		Six months ended December 31,	
	2009	**2008**	**2009**	**2008**
Net revenues	$ 45,158	$ 45,094	$ 92,589	$ 89,934
Cost of revenues	19,293	19,690	39,422	39,603
Gross profit	25,865	25,404	53,167	50,331
Operating expenses:				
Selling, general and administrative	13,485	13,929	24,829	26,014
Research and development	9,901	11,632	20,097	21,883
Impairment of long-lived assets	150		150	
Amortization of acquired intangible assets	434	447	868	1,457
Restructuring	(19)	235	254	474
Total operating expenses	23,951	26,243	46,198	49,828
Income (loss) from operations	1,914	(839)	6,969	503
Interest income	163	686	242	1,681
Interest expense	(113)	(945)	(170)	(1,783)
Other income (expense), net	281	(119)	535	(265)
Income (loss) from continuing operations before income taxes	2,245	(1,217)	7,576	136
Income tax expense	330		1,236	
Income (loss) from continuing operations	1,915	(1,217)	6,340	136
(Loss) income from discontinued operations, net of income taxes	(15)	(15,863)	15	(18,992)
Gain on sale of discontinued operations, net of income taxes	171	16	74	488
Net income (loss)	$ 2,071	$ (17,064)	$ 6,429	$ (18,368)
Basic net earnings (loss) per share:				
Income (loss) from continuing operations	$ 0.08	$ (0.05)	$ 0.28	$ 0.01
(Loss) income from discontinued operations		(0.72)		(0.86)
Gain on sale of discontinued operations	0.01		0.01	0.02
Net income (loss)	$ 0.09	$ (0.77)	$ 0.29	$ (0.83)
Diluted net earnings (loss) per share:				
Income (loss) from continuing operations	$ 0.08	$ (0.05)	$ 0.28	$ 0.01
(Loss) income from discontinued operations		(0.72)		(0.85)
Gain on sale of discontinued operations	0.01			0.02
Net income (loss)	$ 0.09	$ (0.77)	$ 0.28	$ (0.82)
Weighted-average shares outstanding:				

Basic	22,500	22,121	22,450	22,065
Diluted	22,870	22,121	22,806	22,318

The accompanying notes are an integral part of the consolidated financial statements.

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MERCURY COMPUTER SYSTEMS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(unaudited)

	Six Months Ended December 31,	
	2009	**2008**
Cash flows from operating activities:		
Net income (loss)	$ 6,429	$ (18,368)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,346	5,419
Stock-based compensation	2,025	3,984
Impairment of goodwill and long-lived assets	150	14,555
Deferred income taxes	(1,810)	
Non-cash interest		571
Gross tax windfall from stock-based compensation	(614)	(450)
Gain on sale of discontinued operations	(74)	(487)
Other non-cash expenses	(691)	(557)
Changes in operating assets and liabilities:		
Accounts receivable	(2,647)	6,682
Inventory	(77)	3,134
Prepaid expenses and other current assets	818	3,924
Other assets	(30)	400
Accounts payable and accrued expenses	186	(6,815)
Deferred revenues and customer advances	(526)	(4,295)
Income taxes payable	643	(340)
Other non-current liabilities	646	(1,987)
Net cash provided by operating activities	7,774	5,370
Cash flows from investing activities:		
Purchases of marketable securities		(139,726)
Sales and maturities of marketable securities	850	82,098
Purchases of property and equipment	(2,800)	(2,219)
Payments on sale of discontinued operations	(707)	
Payments for acquired intangible assets	(125)	
Proceeds from life insurance policies redemption		831
Net cash used in investing activities	(2,782)	(59,016)
Cash flows from financing activities:		
Proceeds from employee stock plans	823	413
(Payments) borrowings under line of credit	(648)	31,410
Payments of deferred financing activities	(125)	
Gross tax windfall from stock-based compensation	614	450
Repurchases of common stock	(367)	(297)
Payments of capital lease obligations	(45)	(135)
Net cash provided by financing activities	252	31,841
Effect of exchange rate changes on cash and cash equivalents	3	718
Net increase (decrease) in cash and cash equivalents	5,247	(21,087)
Cash and cash equivalents at beginning of period	46,950	59,045

Cash and cash equivalents at end of period	$ 52,197	$ 37,958
Cash paid (received) during the period for:		
Interest	$	$ 1,251
Income taxes, net	2,171	(2,804)
Supplemental disclosures non-cash activities:		
Issuance of restricted stock awards to employees	$ 5,369	$ 26

The accompanying notes are an integral part of the consolidated financial statements.

MERCURY COMPUTER SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

A. Description of Business

Mercury Computer Systems, Inc. (the Company or Mercury) designs, manufactures and markets high-performance embedded, real-time digital signal and image processing systems and software for embedded and other specialized computing markets. The Company s solutions are involved in a wide range of applications, transforming sensor data to information for analysis and interpretation. In military reconnaissance and surveillance platforms, the Company s systems process real-time radar, sonar and signals intelligence data. The Company s systems are also used in semiconductor imaging applications including photomask generation and wafer inspection. The Company also provides radio frequency products for enhanced communications capabilities in military and commercial applications. Additionally, the Company entered the defense prime contracting market space in fiscal 2008 through the creation of its wholly-owned subsidiary, Mercury Federal Systems, Inc. (MFS) to focus on reaching the federal intelligence agencies and homeland security programs. The Company s primary markets are aerospace and defense, specifically in the Intelligence, Surveillance and Reconnaissance (ISR) space, which includes radar, electronic warfare, sonar and electro-optical markets; and commercial markets, which includes homeland security, telecommunications and semiconductor markets.

B. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to the Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures, normally included in annual consolidated financial statements have been condensed or omitted pursuant to those rules and regulations; however, in the opinion of management the financial information reflects all adjustments, consisting of adjustments of a normal recurring nature, necessary for fair presentation. These consolidated financial statements should be read in conjunction with the audited financial statements and related notes for the fiscal year ended June 30, 2009 which are contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC). The results for the three and six months ended December 31, 2009 are not necessarily indicative of the results to be expected for the full fiscal year.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated. The fiscal 2009 consolidated financial statements, excluding the statement of cash flows, were reclassified to reflect the discontinuation and sale of the Biotech business (Biotech), the Visage Imaging (VI) business and the Visualization Sciences Group (VSG) business, in accordance with FASB ASC 360 (FASB ASC 360), *Property, Plant, and Equipment,* previously SFAS No. 144 (see Note P).

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 establishes the *FASB Accounting Standards Codification™* (Codification) as the source of authoritative U.S. GAAP for nongovernmental entities. The Codification does not change U.S. GAAP. Instead, it takes the thousands of individual pronouncements that currently comprise U.S. GAAP and reorganizes them into approximately 90 accounting Topics, and displays all Topics using a consistent structure. Contents in each Topic are further organized first by Subtopic, then Section and finally Paragraph. The Paragraph level is the only level that contains substantive content. Citing particular content in the Codification involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure. FASB suggests that all citations begin with FASB ASC, where ASC stands for *Accounting Standards Codification*. Changes to the ASC subsequent to June 30, 2009 are referred to as Accounting Standards Updates (ASU).

In conjunction with the issuance of SFAS 168, the FASB also issued ASU No. 2009-1, *Topic 105 Generally Accepted Accounting Principles* (ASU 2009-1), which includes SFAS 168 in its entirety as a transition to the ASC. ASU 2009-1 is effective for interim and annual periods ending after September 15, 2009 and will not have an impact on the Company s financial position or results of operations but will change the referencing system for accounting standards.

Certain of the following pronouncements were issued prior to the issuance of the ASC and adoption of the ASUs. For such pronouncements, citations to the applicable Codification by Topic, Subtopic and Section are provided where applicable in addition to the original standard type and number.

Effective July 1, 2009, the Company adopted ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements* (ASU 2009-13), which amends FASB ASC Topic 605, *Revenue Recognition*. ASU 2009-13 amends the FASB ASC to eliminate the residual method of allocation for multiple-deliverable revenue arrangements, and requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. The ASU also establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence if available; (2) third-party evidence if vendor-specific objective evidence is not available; and (3) estimated selling price if neither vendor-specific nor third-party evidence is available. Additionally, ASU 2009-13 expands the disclosure requirements related to a vendor s multiple-deliverable revenue arrangements. This guidance is effective for the Company July 1, 2010; however, the Company has elected to early adopt as permitted by the guidance. As such, the Company will prospectively apply the provisions of ASU 2009-13 to all revenue arrangements entered into or materially modified after July 1, 2009. See Note C for disclosures regarding the adoption of ASU 2009-13.

Effective July 1, 2009, the Company adopted ASU No. 2009-14, *Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14), which amends FASB ASC Topic 985, *Software*. ASU 2009-14 amends the FASB ASC to change the accounting model for revenue arrangements that include both tangible products and software elements, such that tangible products containing both software and non-software components that function together to deliver the tangible product s essential functionality are no longer within the scope of software revenue guidance. This guidance is effective for the Company July 1, 2010, however; the Company has elected to early adopt as permitted by the guidance. As such, the Company will prospectively apply the provisions of ASU 2009-14 to all revenue arrangements entered into or materially modified after July 1, 2009. Such adoption did not have a material impact on the Company s financial position or results of operations.

Effective July 1, 2009, the Company adopted FASB ASC 805, *Business Combinations* (FASB ASC 805 and formerly referred to as SFAS No. 141(R) and SFAS No. 141(R)-1). FASB ASC 805 requires the acquisition method to be applied to all transactions and other events in which an entity obtains control over one or more other businesses, requires the acquirer to recognize the fair value of all assets and liabilities acquired, even if less

than one hundred percent ownership is acquired, and establishes the acquisition date fair value as measurement date for all assets and liabilities assumed. Additionally, FASB ASC 805-20 provides further guidance on the initial recognition and measurement, subsequent measurement and accounting, and discloses assets and liabilities arising from contingencies in business combinations. The guidance within FASB ASC 805 is effective prospectively for any acquisitions made after July 1, 2009. In the period of adoption, the Company had no acquisitions and as such, the adoption did not have a material impact on the Company s financial position or results of operations.

Effective July 1, 2009, the Company adopted FASB Staff Position (FSP) No. 142-3, *Determination of the Useful Life of Intangible Assets*, which was primarily codified into Topic 350 *Intangibles Goodwill and Other* (FASB ASC 350) in the FASB ASC. This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset and requires enhanced related disclosures. FASB ASC 350 improves the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. This guidance must be applied prospectively to all intangible assets acquired as of and subsequent to fiscal years beginning after December 15, 2008. This guidance became effective for the Company on July 1, 2009. Although future transactions involving intangible assets may be affected by this guidance, it did not impact the Company s financial position or results of operations as the Company did not acquire any intangible assets during the three and six months ended December 31, 2009.

Effective July 1, 2009, the Company adopted FSP No. 107-1 and APB Opinion 28-1, *Interim Disclosures about Fair Value of Financial Instruments,* which is now part of FASB ASC 825, *Financial Instruments* (FASB ASC 825). FASB ASC 825 requires disclosures about fair value of financial instruments for interim and annual reporting periods and is effective for interim reporting periods ending after June 15, 2009. Such adoption did not have a material impact on the Company s financial position or results of operations.

Effective June 2009, the Company adopted FASB SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether the date represents the date the financial statements were issued or were available to be issued. In accordance with SFAS 165, the Company has evaluated subsequent events through February 9, 2010, the date of issuance of consolidated financial statements. See Note T for the Company s disclosure of subsequent events during the period from January 1, 2010 to February 9, 2010.

Effective August 2009, the Company adopted FASB ASU No. 2009-05, *Measuring Liabilities at Fair Value* (ASU 2009-05), which amends ASC Topic 820, *Fair Value Measurements and Disclosures*. ASU 2009-05 provides clarification and guidance regarding how to value a liability when a quoted price in an active market is not available for that liability. The changes to the FASB ASC as a result of this update were effective for the Company on October 1, 2009. Such adoption did not have a material impact on the Company s financial position or results of operations.

C. Multiple-Deliverable Arrangements

The Company enters into multiple-deliverable arrangements that may include a combination of hardware components, related integration or other services. These arrangements generally do not include any performance-, cancellation-, termination- or refund-type provisions. Total revenue recognized under multiple-deliverable revenue arrangements in the three and six months ended December 31, 2009 was approximately 52% and 56% of total revenues, respectively. Revenue recognized under multiple-deliverable arrangements in the three and six months ended December 31, 2008 was approximately 67% and 63% of total revenues, respectively. Typically, 80% to 90% of the Company s multiple-deliverable revenue arrangements ship complete within the same quarter.

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Effective July 1, 2009, the Company adopted ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements*, which amends FASB ASC Topic 605, *Revenue Recognition*. ASU 2009-13 eliminates the residual method of allocation for multiple-deliverable revenue arrangements and requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. ASU 2009-13 also establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence if available; (2) third-party evidence if vendor-specific objective evidence is not available; and (3) estimated selling price if neither vendor-specific nor third-party evidence is available. Additionally, ASU 2009-13 expands the disclosure requirements related to a vendor s multiple-deliverable revenue arrangements. This guidance is effective for the Company on July 1, 2010, however, the Company elected to early adopt, as permitted by the guidance. As such, the Company has prospectively applied the provisions of ASU 2009-13 to all revenue arrangements entered into or materially modified after July 1, 2009.

Per the provisions of ASU 2009-13, the Company allocates arrangement consideration to each deliverable in an arrangement based on its relative selling price. The Company determines selling price using vendor specific objective evidence (VSOE), if it exists, otherwise third-party evidence (TPE). If neither VSOE nor TPE of selling price exists for a unit of accounting, the Company uses estimated selling price (ESP). The Company generally expects that it will not be able to establish TPE due to the nature of the markets in which the Company competes, and, as such, the Company typically will determine selling price using VSOE or ESP.

VSOE is generally limited to the price charged when the same or similar product is sold separately or, if applicable, the stated substantive renewal rate in the agreement. If a product or service is seldom sold separately, it is unlikely that the Company can determine VSOE for the product or service. The Company defines VSOE as a median price of recent standalone transactions that are priced within a narrow range, as defined by the Company.

TPE is determined based on the prices charged by competitors of the Company for a similar deliverable when sold separately. As noted above, the Company typically is not able to use TPE as the Company is usually not able to obtain sufficient information on competitor pricing to substantiate TPE.

If the Company is unable to establish selling price using VSOE or TPE, and the order was received or materially modified after the Company s ASU 2009-13 implementation date of July 1, 2009, the Company will use ESP in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact if the product or service were sold by the Company on a standalone basis.

The Company s determination of ESP involves a weighting of several factors based on the specific facts and circumstances of the arrangement. Specifically, the Company considers the cost to produce the deliverable, the anticipated margin on that deliverable, the selling price and profit margin for similar parts, the Company s ongoing pricing strategy and policies (as evident in the price list established and updated by management on a regular basis), the value of any enhancements that have been built into the deliverable and the characteristics of the varying markets in which the deliverable is sold.

Since the adoption of ASU 2009-13 on July 1, 2009, the Company has primarily used its ongoing pricing strategy and policies to determine ESP. The Company has corroborated the ESP determined by ongoing pricing strategy and policies with the cost to produce the deliverable, the anticipated margin on the deliverable, the selling price and profit margin for similar parts and the characteristics of the varying markets in which the deliverables are sold. The Company will determine ESP for deliverables in future agreements based on the specific facts and circumstances of the arrangement.

The Company plans to analyze the selling prices used in its allocation of arrangement consideration at a minimum on an annual basis. Selling prices will be analyzed on a more frequent basis if a significant change in the Company s business necessitates a more timely analysis or if the Company experiences significant variances in its selling prices.

Each deliverable within the Company s multiple-deliverable revenue arrangements is accounted for as a separate unit of accounting under the guidance of ASU 2009-13 if both of the following criteria are met: the delivered item or items have value to the customer on a standalone basis; and for an arrangement that includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. The Company considers a deliverable to have standalone value if the item is sold separately by the Company or another vendor or if the item could be resold by the customer. Further, the Company s revenue arrangements generally do not include a general right of return relative to delivered products.

Deliverables not meeting the criteria for being a separate unit of accounting are combined with a deliverable that does meet that criterion. The appropriate allocation of arrangement consideration and recognition of revenue is then determined for the combined unit of accounting.

As a result of implementing ASU 2009-13, the Company recognized $2,348 and $4,349 in revenue within the ACS business unit in the three months and six months ended December 31, 2009 that would have been deferred under the previous guidance for multiple element arrangements. The Company anticipates that the effect of the adoption of this guidance on subsequent periods will be primarily based on the substance of the arrangements entered into or materially modified after the July 1, 2009 adoption date and the timing of the shipments of the deliverables within these arrangements.

D. Stock-Based Compensation

STOCK OPTION PLANS

The number of shares authorized for issuance under the Company s 2005 Stock Incentive Plan, as amended and restated (the 2005 Plan) is 4,092,264 shares, which will be increased by any future cancellations, forfeitures, expirations or terminations (other than by exercise) under the Company s 1997 Stock Option Plan (the 1997 Plan). On October 21, 2009, the Company s shareholders approved an increase in the number of shares authorized for issuance under the 2005 plan to 4,092,264, an increase of 1,500,000. The 2005 Plan provides for the grant of non-qualified and incentive stock options, restricted stock, stock appreciation rights and deferred stock awards to employees and non-employees. All stock options are granted with an exercise price of not less than 100% of the fair value of the Company s common stock at the date of grant and the options generally have a term of seven years. There were 2,426,017 shares available for future grant under the 2005 Plan at December 31, 2009.

The number of shares authorized for issuance under the 1997 Plan was 8,650,000 shares, of which 100,000 shares could be issued pursuant to restricted stock grants. The 1997 Plan provided for the grant of non-qualified and incentive stock options and restricted stock to employees and non-employees. All stock options were granted with an exercise price of not less than 100% of the fair value of the Company s common stock at the date of grant. The options typically vest over periods of zero to four years and have a maximum term of 10 years. Following shareholder approval of the 2005 Plan on November 14, 2005, the Company s Board of Directors directed that no further grants of stock options or other awards would be made under the 1997 Plan, and the 1997 Plan subsequently expired in June 2007. The foregoing does not affect any outstanding awards under the 1997 Plan, which remain in full force and effect in accordance with their terms.

EMPLOYEE STOCK PURCHASE PLAN

During 1997, the Company adopted the 1997 Employee Stock Purchase Plan (ESPP) and authorized 500,000 shares for future issuance. In November 2006, the Company s shareholders approved an increase in the number of authorized shares under the ESPP to 800,000 shares. On October 21, 2009, the Company s shareholders approved an increase in the number of authorized shares under the ESPP to 1,100,000 shares, an increase of 300,000. Under the ESPP, rights are granted to purchase shares of common stock at 85% of the lesser

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of the market value of such shares at either the beginning or the end of each six-month offering period. The ESPP permits employees to purchase common stock through payroll deductions, which may not exceed 10% of an employee s compensation as defined in the plan. There were 49,511 and 46,220 shares issued under the ESPP during the six months ended December 31, 2009 and 2008, respectively. Shares available for future purchase under the ESPP totaled 298,413 at December 31, 2009.

STOCK OPTION AND AWARD ACTIVITY

The following table summarizes activity of the Company s stock option plans since June 30, 2008:

	Options Outstanding		
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Outstanding at June 30, 2008	**3,732,671**	**$ 16.88**	**6.20**
Grants	558,864	6.68	
Exercises	(21,790)	7.68	
Cancellations(1)	(1,290,074)	19.57	
Outstanding at June 30, 2009	**2,979,671**	**$ 13.87**	**5.69**
Grants	56,000	10.41	
Exercises	(49,342)	8.54	
Cancellations	(221,994)	12.07	
Outstanding at December 31, 2009	**2,764,335**	**$ 14.03**	**5.24**

(1) Options cancelled as part of the Company s shareholder-approved option exchange program, totaling 394,270 options, are included in the cancellation figure.

The following table summarizes the status of the Company s nonvested restricted stock awards since June 30, 2008:

	Nonvested Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at June 30, 2008	**866,123**	**$ 13.18**
Granted(1)	384,445	5.99
Vested	(375,209)	13.48
Forfeited	(209,106)	12.70
Outstanding at June 30, 2009	**666,253**	**$ 8.97**
Granted	541,931	9.91
Vested	(152,417)	12.13
Forfeited	(78,350)	7.65
Outstanding at December 31, 2009	**977,417**	**$ 9.10**

(1)

Awards issued as a result of the Company s shareholder-approved option exchange program, totaling 153,545 awards, at a weighted-average fair value of $8.71, are included in the granted figure.

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STOCK-BASED COMPENSATION ASSUMPTIONS AND EXPENSE

The Company recognized the full impact of its share-based payment plans in the consolidated statements of operations for the three and six months ended December 31, 2009 and 2008 in accordance with FASB ASC 718 (FASB ASC 718), *Compensation Stock Compensation*, previously SFAS No. 123R, and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. Under the fair value recognition provisions of FASB ASC 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the service period. The following table presents share-based compensation expenses included in the Company s consolidated statement of operations:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Cost of revenues	$ 73	$ 141	$ 110	$ 209
Selling, general and administrative	1,318	1,785	1,718	2,515
Research and development	145	413	197	725
Share-based compensation expense before tax	1,536	2,339	2,025	3,449
Income taxes				
Net compensation expense	$ 1,536	$ 2,339	$ 2,025	$ 3,449

The following table sets forth the weighted-average key assumptions and fair value results for stock options granted during the three and six month periods ended December 31, 2009 and 2008:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Weighted-average fair value of options granted	$ 7.17	$ 2.97	$ 7.17	$ 3.57
Option life(1)	5 years	5.5 years	5 years	5.5 years
Risk-free interest rate(2)	2.4%	2.3%	2.4%	2.6%
Stock volatility(3)	87%	57%	87%	57%
Dividend rate	0%	0%	0%	0%

(1) The option life was determined based upon historical option activity.

(2) The risk-free interest rate for each grant is equal to the U.S. Treasury yield curve in effect at the time of grant for instruments with a similar expected life.

(3) The stock volatility for each grant is measured using the weighted average of historical daily price changes of the Company s common stock over the most recent period equal to the expected option life of the grant, the historical short-term trend of the option and other factors, such as expected changes in volatility arising from planned changes in the Company s business operations.

The following table sets forth the weighted-average key assumptions and fair value results for employees stock purchase rights during the three and six month periods ended December 31, 2009 and 2008:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Weighted-average fair value of stock purchase rights granted	$ 3.98	$ 2.94	$ 3.98	$ 2.94
Option life	6 months	6 months	6 months	6 months
Risk-free interest rate	0.3%	2.1%	0.3%	2.1%

Stock volatility	96%	93%	96%	93%
Dividend rate	0%	0%	0%	0%

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E. Net Earnings (Loss) Per Share

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Income (loss) from continuing operations basic	$ 1,915	$ (1,217)	$ 6,340	$ 136
(Loss) income from discontinued operations, net of income taxes	(15)	(15,863)	15	(18,992)
Gain on sale of discontinued operations, net of income taxes	171	16	74	488
Net income (loss)	$ 2,071	$ (17,064)	$ 6,429	$ (18,368)
Shares used in computation of net earnings (loss) per share basic	22,500	22,121	22,450	22,065
Effect of dilutive stock options and restricted stock	370		356	253
Shares used in computation of net earnings (loss) per share diluted	22,870	22,121	22,806	22,318
Net earnings (loss) per share basic				
Income (loss) from continuing operations	$ 0.08	$ (0.05)	$ 0.28	$ 0.01
(Loss) income from discontinued operations		(0.72)		(0.86)
Gain on sale of discontinued operations	0.01		0.01	0.02
Net income (loss)	$ 0.09	$ (0.77)	$ 0.29	$ (0.83)
Net earnings (loss) per share diluted				
Income (loss) from continuing operations	$ 0.08	$ (0.05)	$ 0.28	$ 0.01
(Loss) income from discontinued operations		(0.72)		(0.85)
Gain on sale of discontinued operations	0.01			0.02
Net income (loss)	$ 0.09	$ (0.77)	$ 0.28	$ (0.82)

Weighted average equity instruments to purchase 1,701,110 and 2,048,525 shares of common stock were not included in the calculation of diluted net earnings (loss) per share for the three and six months ended December 31, 2009, respectively, because the equity instruments were anti-dilutive. Weighted average equity instruments to purchase 3,976,988 and 4,070,772 shares of common stock were not included in the calculation of diluted net earnings (loss) per share for the three and six months ended December 31, 2008, respectively, because the equity instruments were anti-dilutive. Additionally, the 4,135,000 shares which represented the securities contingently issuable under the Company s then outstanding Convertible Senior Notes were not included in the diluted net income (loss) per share for the three and six months ended December 31, 2008 because the equity instruments were anti-dilutive. The Convertible Senior Notes were repurchased in full in fiscal 2009.

F. Comprehensive Income (Loss)

Total comprehensive income (loss) was as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2009	2008	2009	2008
Net income (loss)	$ 2,071	$ (17,064)	$ 6,429	$ (18,368)
Other comprehensive (loss) income:				
Foreign currency translation adjustments	(42)	(656)	13	(2,382)
Change in unrealized gain (loss) on marketable securities		4,331	(83)	3,068

Other comprehensive (loss) income	(42)	3,675	(70)	686
Total comprehensive income (loss)	$ 2,029	$ (13,389)	$ 6,359	$ (17,682)

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G. Marketable Securities

The Company s investments consist mainly of student loan auction rate securities (ARS). The ARS securities are all highly rated investments with AAA/Aaa ratings and are supported by the federal government as part of the Federal Family Education Loan Program and by private insurance companies. The ARS investments have contractual terms from 30 to 40 years, but generally have interest rate reset dates that occur every seven to 30 days. The auction mechanism generally allows existing investors to roll over their holdings and continue to own their securities or liquidate their holdings by selling their securities at par value.

Beginning in mid-February 2008, auctions held for the Company s ARS failed. As a result, the Company was not able to access these funds, and therefore, the ARS investments were determined to lack short-term liquidity and were classified as non-current in the consolidated balance sheet. In October 2008, the Company received a rights offering from UBS (the offering) in which the Company elected to participate. By electing to participate in the offering, the Company (1) received the right (put option) to sell these ARS back to UBS at par plus interest, at the Company s sole discretion, during a two-year period beginning on June 30, 2010, and (2) received an option to borrow up to 75% of the fair value of the ARS. Upon borrowing against the ARS, the Company forgoes the interest income on the underlying ARS while the borrowings are outstanding and in return is not charged any interest expense. As the settlement date with UBS is within one year from the December 31, 2009 balance sheet date, and the Company intends to exercise the put option on June 30, 2010, the Company has classified the fair value of the ARS as current marketable securities. Following the fiscal 2010 sale of $850 of securities, the ARS had a par value of approximately $49,200 at December 31, 2009.

At the time of the rights offering, the Company elected to measure the put option under the fair value option of FASB ASC 825-10 (FASB ASC 825-10), *Financial Instruments*, previously SFAS No. 159, and recorded income of $5,030, pre-tax, in fiscal 2009. The Company also transferred these ARS from available-for-sale to trading investment securities. As a result of this transfer, the Company recognized an impairment loss of $5,073, pre-tax, in fiscal 2009. The recording of the put option and the recognition of the impairment loss resulted in an immaterial impact to the consolidated statement of operations for fiscal 2009. The put option will continue to be measured at fair value utilizing Level 3 inputs, as described in FASB ASC 820, (FASB ASC 820), *Fair Value Measurements and Disclosures,* previously SFAS 157, until the earlier of its maturity or exercise (see Note H). Consistent with the ARS, the Company reclassified the put option from a non-current asset to current as of June 30, 2009. In accordance with FASB ASC 820, the Company re-measured the put option at December 31, 2009. The resulting valuation decreased the put option by $120 and $289 during the three and six month periods ended December 31, 2009. The difference between the change in value of the put option and the change in value of the ARS resulted in an immaterial impact to the consolidated statement of operations for the three and six month periods ended December 31, 2009. The following table summarizes the marketable securities of the Company as of December 31, 2009 and June 30, 2009:

	Amortized Cost	Gross Recognized Gains	Gross Recognized Losses	Fair Market Value
Trading Securities				
DECEMBER 31, 2009				
Short-term marketable securities:				
Auction rate securities	$ 49,234	$	$ (4,790)	$ 44,444
JUNE 30, 2009				
Short-term marketable securities:				
Auction rate securities	$ 50,062	$	$ (5,085)	$ 44,977

The Company s investments in marketable securities consisted entirely of auction rate securities with maturities upwards of 40 years; however, as a result of the settlement noted above, the anticipated liquidation of these securities will occur less than one year from December 31, 2009. For the fiscal year ended June 30, 2009, realized gains and losses from the sale of available-for-sale securities were immaterial.

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H. Fair Value of Financial Instruments

The Company measures at fair value certain financial assets and liabilities, including cash equivalents, restricted cash and auction rate securities. FASB ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. These two types of inputs have created the following fair-value hierarchy:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The following table summarizes the fair value measurements as of December 31, 2009, for the Company s financial instruments, including its ARS:

		Fair Value Measurements		
	December 31, 2009	Level 1	Level 2	Level 3
Assets:				
Money market funds	$ 43,449	$ 43,449	$	$
Restricted cash	3,000	3,000		
Auction rate securities	44,444			44,444
Put option to sell auction rate securities	4,741			4,741
Total	$ 95,634	$ 46,449	$	$ 49,185

The fair values of the Company s cash equivalents and restricted cash are determined through market, observable and corroborated sources. The volume and level of activity for these sources has been determined to be sufficient primarily due to the market being active, the quantity of recent transactions, pricing being current and no significant recent increases to certain risk factors, and as such, no adjustments to these sources were needed. The following table is a rollforward of the fair value of the Company s auction rate securities and put option, whose fair values are determined by Level 3 inputs:

	Fair Value
Balance at June 30, 2008	$ 47,231
Recognition of change in put option	5,030
Realized losses included in earnings	(5,073)
Redemption of ARS	(222)
Change in temporary valuation adjustment included in comprehensive income	3,041
Balance at June 30, 2009	$ 50,007
Recognition of change in put option	(289)
Realized gains included in earnings	317
Redemption of ARS	(850)
Balance at December 31, 2009	$ 49,185

The carrying values of the ARS and related put option reflect changes in the fair value of the underlying securities, which is based on Level 3 unobservable inputs. These unobservable inputs consist of fair values that are provided by the Company s broker on a monthly basis, which are corroborated by a discounted cash flow

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analysis that the Company performs. The significant assumptions used by the Company in its analysis include interest rate spreads, credit quality, liquidity premiums and other inputs that are current as of the measurement date, including during periods of market dislocations, such as the recent illiquidity in the ARS market. When performing this analysis the Company notes and analyzes for reasonableness any changes in assumptions. Factors that could cause assumptions to change include fluctuations in consumer confidence, which can vary the Company s credit risk discount factor and cause changes to other rates used in the analysis including the 3-month Libor rate. Since the October 2008 election to participate in the rights offering, there have been no material changes in the assumptions used by the Company in its discounted cash flow analysis.

I. Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market value, and consists of materials, labor and overhead. On a quarterly basis, the Company uses consistent methodologies to evaluate inventory for net realizable value. The Company reduces the value of inventory for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. The excess and obsolete inventory evaluation is based upon assumptions about future demand, product mix and possible alternative uses. Inventory was comprised of the following:

	December 31, 2009	June 30, 2009
Raw materials	$ 5,433	$ 5,991
Work in process	7,595	6,240
Finished goods	3,856	4,574
Total	$ 16,884	$ 16,805

There are no amounts in inventory relating to contracts having production cycles longer than one year.

J. Property and Equipment

Property and equipment consisted of the following:

	December 31, 2009	June 30, 2009
Computer equipment and software	$ 56,709	$ 64,954
Furniture and fixtures	6,790	6,800
Building and leasehold improvements	612	597
Machinery and equipment	2,274	2,084
	66,385	74,435
Less: accumulated depreciation and amortization	(58,102)	(66,475)
	$ 8,283	$ 7,960

In the three months ended December 31, 2009, the Company retired $10,852 of fully depreciated computer equipment and software assets that were no longer in use by the Company. This retirement was part of an on-going effort by the Company to review and identify all assets that are still in use by the Company, and to retire those that are not.

Depreciation and amortization expense related to property and equipment for the three and six months ended December 31, 2009 was $1,222 and $2,476, respectively. Depreciation and amortization expense related to property and equipment for the three and six months ended December 31, 2008 was $1,440 and $2,940, respectively.

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K. Operating Segment, Significant Customers and Geographic Information

Operating segments are defined as components of an enterprise evaluated regularly by the Company s senior management in deciding how to allocate resources and assess performance. Following the discontinuation and sale of the ES/PS businesses, the Biotech business, the VI business and the VSG business, the Company is organized in two business units. These reportable segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company s management structure:

Advanced Computing Solutions (ACS). This business unit is focused on specialized, high performance computing solutions with key market segments, including aerospace and defense, semiconductor, telecommunications and medical diagnostic imaging. This segment also provides software and customized design services to meet the specified requirements of military and commercial applications.

Mercury Federal Systems (MFS). Formerly referred to as the Emerging Business Unit segment, this business unit has historically been focused on the cultivation of new business opportunities that benefit from the Company s capabilities across markets. Following the sale of the Biotech business and the shutdown of the Avionics and Unmanned Systems Group (AUSG) reporting unit, this business unit now solely consists of the Company s wholly-owned subsidiary, Mercury Federal Systems, Inc. As such, beginning in the first quarter of fiscal 2010, this segment was renamed Mercury Federal Systems (MFS) . Current areas of focus include services and support work with federal intelligence agencies and homeland security programs including designing and engineering new ISR capabilities to address present and emerging threats to U.S. forces.

Prior year results have been reclassified for the discontinuation of the VI and VSG operating segments and for the sale of the Biotech business. These operating segments were reclassified into the discontinued operations line items on the consolidated balance sheets and consolidated statements of operations (see Note P).

The accounting policies of the reportable segments are the same as those described in Note B: Summary of Significant Accounting Policies. The profitability measure employed by the Company and its chief operating decision maker for making decisions about allocating resources to segments and assessing segment performance is income (loss) from operations prior to stock compensation expense. As such, stock-based compensation expense has been excluded from each operating segments income (loss) from operations below and reported separately to reconcile the reported segment income (loss) from operations to the consolidated operating income (loss) reported in the consolidated statements of operations. Additionally, asset information by reportable segment is not reported because the Company does not produce such information internally. The following is a summary of the performance of the Company s operations by reportable segment:

	ACS	MFS	Stock Compensation Expense	Eliminations	Total
THREE MONTHS ENDED DECEMBER 31, 2009					
Net revenues to unaffiliated customers	$ 42,081	$ 3,077	$	$	$ 45,158
Intersegment revenues	1,699	266		(1,965)	
Net revenues	43,780	3,343		(1,965)	45,158
Income (loss) from operations	3,088	362	(1,536)		1,914
Depreciation and amortization expense	1,651	7			1,658
THREE MONTHS ENDED DECEMBER 31, 2008					
Net revenues to unaffiliated customers	$ 43,935	$ 1,159	$	$	$ 45,094
Intersegment revenues	55	71		(126)	
Net revenues	43,990	1,230		(126)	45,094
Income (loss) from operations	1,751	(277)	(2,339)	26	(839)
Depreciation and amortization expense	1,880	7			1,887

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	ACS	MFS	Stock Compensation Expense	Eliminations	Total
SIX MONTHS ENDED DECEMBER 31, 2009					
Net revenues to unaffiliated customers	$ 86,440	$ 6,149	$	$	$ 92,589
Intersegment revenues	2,593	336		(2,929)	
Net revenues	89,033	6,485		(2,929)	92,589
Income (loss) from operations	8,694	300	(2,025)		6,969
Depreciation and amortization expense	3,332	14			3,346
SIX MONTHS ENDED DECEMBER 31, 2008					
Net revenues to unaffiliated customers	$ 88,570	$ 1,364	$	$	$ 89,934
Intersegment revenues	55	141		(196)	
Net revenues	88,625	1,505			