TECH OPS SEVCON INC
Form 10-Q
August 09, 2006

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 July 1, 2006

o 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 1-9789

TECH/OPS SEVCON, INC.
(Exact name of registrant as specified in its charter)

Delaware	**04-2985631**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

155 Northboro Road, Southborough, Massachusetts, 01772
(Address of principal executive offices and zip code)

(508) 281 5510
(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 **o**

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 **o** Accelerated Filer **o** Non accelerated filer **x**

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

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

Class	**Outstanding at August 9, 2006**
Common stock, par value $.10	**3,211,051**

TECH/OPS, SEVCON LTD
FORM 10-Q
FOR THE QUARTER ENDED July 1, 2006
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ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS
Tech/Ops Sevcon, Inc. and Subsidiaries

		(in thousands of dollars except per share data)		
		July 1, 2006 (unaudited)		September 30, 2005 (derived from audited statements)
ASSETS				
Current assets:				
Cash and cash equivalents	**$**	**330**	$	1,130
Receivables, net of allowances for doubtful accounts of $ 161 at July 1, 2006 and $144 at September 30, 2005		**6,819**		6,193
Inventories		**5,523**		3,737
Prepaid expenses and other current assets		**1,195**		915
Total current assets		**13,867**		11,975
Property, plant and equipment:				
At cost		**10,308**		9,593
Less: accumulated depreciation and amortization		**7,130**		6,557
Net property, plant and equipment		**3,178**		3,036
Goodwill		**1,435**		1,435
Total assets	**$**	**18,480**	$	16,446
LIABILITIES AND STOCKHOLDERS' INVESTMENT				
Current liabilities:				
Due to banks	**$**	**426**	$	-
Accounts payable		**2,840**		2,599
Dividend payable		**96**		95
Accrued expenses		**2,924**		2,685
Accrued and deferred taxes on income		**427**		445
Total current liabilities		**6,713**		5,824
Deferred taxes on income		**35**		33
Commitments and contingencies				
Stockholder equity				
Preferred stock, par value $.10 per share - authorized - 1,000,000 shares; outstanding - none		**-**		-
Common stock, par value $.10 per share - authorized - 8,000,000 shares; outstanding 3,211,051 shares at July 1, 2006 and 3,172,051 shares at September 30, 2005		**321**		317
Premium paid in on common stock		**4,269**		4,310
Retained earnings		**6,975**		6,394
Unearned compensation on restricted stock		**-**		(180)

Cumulative other comprehensive loss		**167**		(252)
Total stockholder equity		**11,732**		10,589
Total liabilities and stockholder equity	**$**	**18,480**	$	16,446

The accompanying notes are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
Tech/Ops Sevcon, Inc. and Subsidiaries

(in thousands except per share data)

	Three months ended		Nine months ended	
	July 1, 2006	July 2, 2005	**July 1, 2006**	July 2, 2005
Net sales	**$ 9,313**	$ 8,453	**$ 25,696**	$ 24,089
Costs and expenses:				
Cost of sales	**5,761**	5,293	**15,780**	14,961
Selling, research and administrative	**2,968**	2,779	**8,526**	8,442
	8,729	8,072	**24,306**	23,403
Operating income	**584**	381	**1,390**	686
Interest expense	**(13)**	(13)	**(48)**	(41)
Interest income	**1**	1	**3**	3
Foreign currency gain or (loss)	**(8)**	(36)	**(10)**	(20)
Income before income taxes	**564**	333	**1,335**	628
Income taxes	**(195)**	(117)	**(464)**	(220)
Net income	**$ 369**	$ 216	**$ 871**	$ 408
Basic income per share	**$ .12**	$ .07	**$ .28**	$ .13
Fully diluted income per share	**$ .12**	$ .07	**$ .28**	$ .13

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
Tech/Ops Sevcon, Inc. and Subsidiaries

(in thousands of dollars)

	Three months ended		Nine months ended	
	July 1, 2006	July 2, 2005	**July 1, 2006**	July 2, 2005
Net income	**$ 369**	$ 216	**$ 871**	$ 408
Foreign currency translation adjustment	**529**	(568)	**418**	(228)
Changes in fair market value of cash flow hedges	**14**	(3)	**1**	(18)
Comprehensive income (loss)	**$ 912**	$ (355)	**$ 1,290**	$ 162

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

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
Tech/Ops Sevcon, Inc. and Subsidiaries

	(in thousands of dollars) Nine months ended	
	July 1, 2006	July 2, 2005
Cash flow from operating activities:		
Net income	**$ 871**	$ 408
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	**469**	503
Stock-based compensation	**143**	56
Deferred tax benefit	**2**	(1)
Increase (decrease) in cash resulting from changes in operating assets and liabilities:		
Receivables	**(626)**	(171)
Inventories	**(1,786)**	371
Prepaid expenses and other current assets	**(281)**	(270)
Accounts payable	**241**	(468)
Accrued expenses	**239**	248
Accrued and deferred taxes on income	**(18)**	179
Net cash generated from (used by) operating activities	**(746)**	855
Cash flow used by investing activities:		
Acquisition of property, plant and equipment	**(462)**	(345)
Net cash used by investing activities	**(462)**	(345)
Cash flow used by financing activities:		
Dividends paid	**(287)**	(284)
Exercise of stock options	**9**	-
Short-term bank borrowings	**426**	-
Net cash generated from (used by) financing activities	**148**	(284)
Effect of exchange rate changes on cash	**260**	(257)
Net decrease in cash	**(800)**	(31)
Beginning balance - cash and cash equivalents	**1,130**	905
Ending balance - cash and cash equivalents	**$ 330**	$ 874
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	**$ 619**	$ 117
Cash paid for interest	**$ 48**	$ 41
Supplemental disclosure of non-cash financing activity:		
Dividend declared	**$ 96**	$ 95

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

TECH/OPS SEVCON, INC.

Notes to Consolidated Financial Statements - July 1, 2006

(Unaudited)

(1) Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting of only normally recurring accruals) necessary to present fairly the financial position of Tech/Ops Sevcon as of July 1, 2006 and the results of operations and cash flows for the nine months ended July 1, 2006.

The significant accounting policies followed by Tech/Ops Sevcon are set forth in Note 1 to the financial statements in the 2005 Tech/Ops Sevcon, Inc. Annual Report filed on Form 10-K. Other than as set forth below, there have been no changes since the end of fiscal 2005 to the significant accounting policies followed by Tech/Ops Sevcon.

The results of operations for the nine month periods ended July 1, 2006 and July 2, 2005 are not necessarily indicative of the results to be expected for the full year.

(2) New Accounting Pronouncements

The Company adopted the provisions of SFAS #123R "Share-Based Payment" effective at the beginning of fiscal 2006 using the modified prospective application transition method. Under this method the Company incurred expense relating to previously issued stock options of approximately $35,000 in the first nine months of fiscal 2006. There was no similar expense recorded in the first half of 2005 as, during that period, the Company accounted for options under APB #25. The accounting for restricted stock issued in fiscal 2005 was substantially unchanged by the application of SFAS #123R

In July 2006 the Financial Accounting Standards Board (FASB) issued Interpretation #48 "Accounting for Uncertain Tax Positions" which will be effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this interpretation on its financial statements.

(3) Stock-Based Compensation Plans

Under the Company's 1996 Equity Incentive Plan there were 71,000 shares reserved and available for grant at July 1, 2006. Recipients of grants or options must execute a standard form of non-competition agreement. This plan provides for the grant of Restricted Stock, Restricted Stock Units, Options, and Stock Appreciation Rights (SARs). Stock Appreciation Rights may be awarded either separately, or in relation to options granted, and for the grant of bonus shares. Options granted are exercisable at a price not less than fair market value on the date of grant.

SFAS #123 "Accounting for Stock-Based Compensation", as amended by SFAS #148 "Accounting for Stock-Based Compensation - Transition and Disclosure" and replaced by SFAS 123R "Share-Based Payment" defined a fair value based method of accounting for employee stock options or similar equity instruments and encouraged all entities to adopt that method of accounting. However, it also allowed an entity to continue to measure compensation costs using the method of accounting prescribed by APB #25 "Accounting for Stock Issued to Employees", until SFAS #123R became effective in fiscal 2006. Prior to fiscal 2006, the Company accounted for its stock-based compensation plans under APB #25, under which no compensation cost was recognized. The Company has not restated prior periods to reflect this change in accounting. Had compensation cost for these plans been determined consistent with SFAS #123, the Company's net income and earnings per share would have equaled the following pro forma amounts for the respective 2005 periods:

	(in thousands of dollars except per share data)			
		Three months ended July 2, 2005		Nine months ended July 2, 2005
Net income - As reported	$	216	$	408
Stock-based compensation expense determined under fair value method for all option awards (net of tax)		(11)		(39)
Net income - Pro forma	$	205	$	369
Basic net income per share - As reported	$	.07	$	.13
Basic net income per share - Pro forma	$	.07	$	.12
Diluted net income per share - As reported	$	.07	$	.13
Diluted net income per share - Pro forma	$	.07	$	.12

The effects of applying SFAS #123R in this pro forma disclosure are not indicative of future amounts. SFAS #123R does not apply to awards prior to fiscal 1996 and additional awards in future years are anticipated.

The adoption of SFAS #123R reduced net income in the first nine months of fiscal 2006 by $35,000 ($.01 per basic and diluted share). The adoption of this statement had no effect on the statement of cash flows for the nine months ended July 1, 2006.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions.

	2006	2005
Risk-free interest rate	**N/A**	N/A
Expected dividend yield	**N/A**	N/A
Expected life (years)	**N/A**	N/A
Expected volatility	**N/A**	N/A

No options were granted in the first nine months of fiscal 2006 or in fiscal 2005. When options are exercised the Company normally issues new shares.

A summary of option activity for all plans for the nine months ended July 1, 2006 is as follows:

	Options # of shares		Weighted average Exercise Price	Weighted average remaining contractual life (years)		Aggregate Intrinsic Value
Outstanding at September 30, 2005	182,000	$	9.26			
Granted	-					
Exercised	(2,000)	$	4.37			
Cancelled	(8,000)	$	8.46			
Outstanding at July 1, 2006	172,000	$	9.35	3 years	$	132,000

Exercisable at July 1, 2006	118,400	$	10.41	3 years	$ 66,000

The aggregate intrinsic value included in the table above represents the difference between the exercise price of the options and the market price of the Company's common stock for the options that had exercise prices that were lower than the $6.32 market price of the Company's common stock at July 1, 2006. Options for 2,000 shares were exercised during the nine months ended July 1, 2006. The total intrinsic value of options exercised in fiscal 2006 was $3,000 and the proceeds received on the exercise of these options was $9,000. No options were exercised in the first nine months of last fiscal year. At July 1, 2006 there was $75,000 of total unrecognized compensation expense related to options granted under all equity compensation plans. The Company expects to recognize that cost over a weighted average period of 3.3 years.

In December 2005, the Company granted 25,000 shares of restricted stock to three employees which will vest in five equal annual installments providing that the grantee remains an employee of the Company, or as determined by the Compensation Committee. The estimated fair value of the stock on the date of grant was $138,000 based on the fair market value of the stock on date of issue and estimated forfeitures of 4% per year. The estimated forfeitures are based on the historical rate of turnover of the relevant group of employees. This amount was credited to common stock and paid in surplus and the $138,000 was netted off paid in surplus in stockholders equity. This unearned compensation is being charged to income on a straight line basis over the five year period during which the forfeiture conditions lapse. The charge to income for these employee restricted stock grants in the third quarter and first nine months of fiscal 2006 was $7,000 and $14,000 respectively, and the subsequent charge will be approximately $7,000 on a quarterly basis.

In January 2006, the Company granted 12,000 shares of restricted stock to six non-employee directors which will vest on the day before the 2007 annual meeting providing that the grantee remains a director of the Company, or as determined by the Compensation Committee. The estimated fair value of the stock on the date of grant was $69,000 based on the fair market value of the stock on date of issue. This amount was credited to common stock and paid in surplus and the $69,000 was netted off paid in surplus in stockholders equity. This unearned compensation is being charged to income on a straight line basis over the twelve month period during which the forfeiture conditions lapse. The charge to income for these director restricted stock grants in the third quarter and first nine months of fiscal 2006 was $17,000 and $29,000 respectively, and the subsequent charge will be approximately $17,000 on a quarterly basis.

In fiscal 2005 the Company granted 35,000 shares of restricted stock to five employees which will vest in five equal annual installments and 12,000 shares of restricted stock to six non-employee directors which vested on the day before the 2006 annual meeting.

During the restriction period, five years for employees and one year for non-employee directors, ownership of unvested shares cannot be transferred. Restricted stock has the same cash dividend and voting rights as other common stock and is considered to be currently issued and outstanding. For the purposes of calculating average issued shares for earnings per share these shares are only considered to be outstanding when the forfeiture conditions lapse and the shares vest.

Restricted stock activity for the nine months ended July 1, 2006 was as follows:

	Number of shares of Restricted Stock		Weighted Average Grant-Date Fair Value
Non-vested balance as of September 30, 2005	47,000	$	6.18
Granted	37,000	$	5.58
Vested	(19,000)	$	6.64
Forfeited	-		N/A
Non-vested balance as of July 1, 2006	65,000	$	5.70

As of July 1, 2006, there was $288,000 of total restricted stock compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 3.5 years.

The stock-based compensation expense was as follows.

								(in thousands of dollars)
		Three Months ended				Nine Months ended		
		July 1, 2006		July 2, 2005		**July 1, 2006**		July 2, 2005
Stock option expense under SFAS # 123R *	**$**	**13**	$	-	**$**	**36**	$	-
Restricted stock grants:								
Employees		**14**		9		**41**		21
Non-employee directors		**17**		14		**57**		35
Total stock based compensation expense	**$**	**44**	$	23	**$**	**134**	$	56
* Pro-forma expense disclosed for options accounted for under APB#25	**$**	**N/A**	$	11	**$**	**N/A**	$	39

Upon adoption of SFAS 123R on October 1, 2005, Unearned Compensation on Restricted Stock, which amounted to $180,000 at September 30, 2005, was deducted from Premium Paid in on Common stock.

(4) Cash Dividends

On June 13, 2006, the Company declared a quarterly dividend of $.03 per share for the third quarter of fiscal 2006, which was paid on July 13, 2006 to stockholders of record on June 28, 2006. The Company has paid regular quarterly cash dividends since the first quarter of fiscal 1990.

(5) Calculation of Earnings Per Share and Weighted Average Shares Outstanding

Basic and fully diluted earnings per share were calculated as follows:

								(in thousands except per share data)
		Three Months ended				Nine Months ended		
		July 1, 2006		July 2, 2005		**July 1, 2006**		July 2, 2005
Net income	**$**	**369**	$	216	**$**	**871**	$	408
Weighted average shares outstanding - basic		**3,144**		3,125		**3,134**		3,125
Basic income per share	**$**	**.12**	$	.07	**$**	**.28**	$	.13
Common stock equivalents		**30**		24		**22**		26
Weighted average shares outstanding - diluted		**3,174**		3,149		**3,156**		3,151
Diluted income per share	**$**	**.12**	$	.07	**$**	**.28**	$	.13
No of options that are anti-dilutive excluded from calculation of common stock equivalents		**105**		106		**105**		109

(6) Segment information

The Company has two reportable segments: electronic controls and capacitors. The electronic controls segment produces control systems and accessories for battery powered vehicles. The capacitor segment produces electronic components for sale to electronic equipment manufacturers. Each segment has its own management team, manufacturing facilities and sales force.

The significant accounting policies of the segments are the same as those described in note (8) to the 2005 Annual Report filed on Form 10-K. Inter-segment revenues are accounted for at current market prices. The Company evaluates the performance of each segment principally based on operating income. The Company does not allocate income taxes, interest income and expense or foreign currency translation gains and losses to segments. Information concerning operations of these businesses is as follows:

(in thousands of dollars)

	Three months ended July 1, 2006			
	Controls	**Capacitors**	**Corporate**	**Total**
Sales to external customers	**$ 8,901**	**$ 412**	**$ -**	**$ 9,313**
Inter-segment revenues	**-**	**18**	**-**	**18**
Operating income	**726**	**(25)**	**(117)**	**584**
Identifiable assets	**16,992**	**906**	**582**	**18,480**

	Three months ended July 2, 2005			
	Controls	Capacitors	Corporate	Total
Sales to external customers	$ 8,005	$ 448	$ -	$ 8,453
Inter-segment revenues	-	40	-	40
Operating income	427	56	(102)	381
Identifiable assets	14,796	1,010	694	16,500

	Nine months ended July 1, 2006			
	Controls	**Capacitors**	**Corporate**	**Total**
Sales to external customers	**$ 24,503**	**$ 1,193**	**$ -**	**$ 25,696**
Inter-segment revenues	**-**	**53**	**-**	**53**
Operating income (loss)	**1,679**	**(43)**	**(246)**	**1,390**
Depreciation and amortization	**427**	**42**	**-**	**469**
Identifiable assets	**16,992**	**906**	**582**	**18,480**
Capital expenditures	**396**	**24**	**-**	**420**

	Nine months ended July 2, 2005			
	Controls	Capacitors	Corporate	Total
Sales to external customers	$ 22,865	$ 1,224	$ -	$ 24,089
Inter-segment revenues	-	189	-	189
Operating income (loss)	920	36	(270)	686
Depreciation and amortization	463	40	-	503
Identifiable assets	14,796	1,010	694	16,500
Capital expenditures	263	82	-	345

In the controls business segment the revenues were derived from the following products and services.

(in thousands of dollars)

	Three Months ended		Nine Months ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Electronic controllers for battery driven vehicles	**$ 6,260**	$ 5,348	**$ 17,291**	$ 15,906
Accessory and aftermarket products and services	**2,641**	2,657	**7,212**	6,959

Total controls segment revenues	**$**	**8,901**	$	8,005	**$**	**24,503**	$	22,865

(7) Research and Development

The cost of research and development programs is charged against income as incurred and was as follows:

	(in thousands of dollars)			
	Three Months ended		Nine Months ended	
	July 1, 2006	July 2, 2005	**July 1, 2006**	July 2, 2005
Research and Development expense	**$ 919**	$ 879	**$ 2,701**	$ 2,659
Percentage of sales	**9.9%**	10.4%	**10.5%**	11.0%

Research and development expense increased by $42,000 compared to the first nine months of last fiscal year and was 5% higher than last year in the third quarter. Excluding the impact of currency fluctuations, engineering expense increased by 16 % compared to the first nine months of last year. This increase was principally due to increased internal engineering resources devoted to advanced new product development.

(8) Employee Benefit Plans

Tech/Ops Sevcon has defined benefit plans covering the majority of its US and UK employees. There is also a small defined contribution plan. The following table sets forth the components of the net pension cost as defined by SFAS #132R.

	(in thousands of dollars)			
	Three Months ended		Nine Months ended	
	July 1, 2006	July 2, 2005	**July 1, 2006**	July 2, 2005
Service cost	**$ 98**	$ 108	**$ 284**	$ 329
Interest cost	**241**	223	**698**	684
Expected return on plan assets	**(227)**	(209)	**(656)**	(640)
Amortization of transition obligation	**-**	-	**-**	-
Amortization of prior service cost	**14**	13	**40**	39
Recognized net actuarial gain (loss)	**-**	-	**-**	-
Net periodic benefit cost	**126**	135	**366**	412
Net cost of defined contribution plans	**$ 9**	$ 7	**$ 25**	$ 21

Tech/Ops Sevcon contributed $609,000 to its pension plans in the nine months ended July 1, 2006 and presently anticipates contributing a further $175,000 to fund its plans in the remainder of fiscal 2006, for a total contribution of $784,000. In addition employee contributions to the UK plan were $199,000 in the first nine months and are estimated to total $269,000 in fiscal 2006.

(9) Inventories

Inventories were comprised of:

	(in thousands of dollars)	
	July 1, 2006	September 30, 2005
Raw materials	**$ 2,666**	$ 1,596
Work-in-process	**315**	174

Finished goods		**2,542**		1,967
	$	**5,523**	$	3,737

(10) Accrued expenses

Set out below is an analysis of other accrued expenses at July 1, 2006 and September 30, 2005 which shows separately any items in excess of 5% of total current liabilities.

	(in thousands of dollars)			
		July 1, 2006		September 30, 2005
Accrued compensation and related costs	**$**	**1,119**	$	1,101
Warranty reserves		**522**		364
Other accrued expenses		**1,283**		1,220
	$	**2,924**	$	2,685

(11) Warranty reserves

The movement in warranty reserves was as follows:

	(in thousands of dollars)							
	Three Months Ended				Nine Months Ended			
		July 1, 2006		July 2, 2005		July 1, 2006		July 2, 2005
Warranty reserves at beginning of period	**$**	**450**	$	404	**$**	**364**	$	386
Decrease in beginning balance for warranty obligations settled during the period		**(81)**		(64)		**(299)**		(290)
Other changes to pre-existing warranties		**8**		(7)		**55**		5
Net increase in warranty reserves for products sold during the period		**145**		88		**402**		320
Warranty reserves at end of period	**$**	**522**	$	421	**$**	**522**	$	421

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

FORWARD LOOKING STATEMENTS

Statements in this discussion and analysis about the Company’s anticipated financial results and growth, as well as those about the development of its products and markets, are forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from those projected. These include the risks discussed under ‘Risk Factors’ below and throughout this Item 2.

NEW ACCOUNTING PRONOUNCEMENTS

The Company adopted SFAS #123R on October 1, 2006. See Note 2 to Consolidated Financial Statements for a more detailed description of this new accounting pronouncement.

CRITICAL ACCOUNTING ESTIMATES

The Company's significant accounting policies are summarized in Note 1 of its Consolidated Financial Statements in this Quarterly Report on Form 10-Q. While all these significant accounting policies impact its financial condition and results of operations, certain of these policies require management to use a significant degree of judgement and/or make estimates, consistent with generally accepted accounting principles, that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of income and expenses during the reporting periods. Since these are judgements and estimates, they are sensitive to changes in business and economic realities, and events may cause actual operating results to differ materially from the amounts derived from management’s estimates and judgements.

The Company believes the following represent the most critical accounting judgments and estimates affecting its reported financial condition and results of operations:

Bad Debts

The Company estimates an allowance for doubtful accounts based on known factors related to the credit risk of each customer and management’s judgment about the customer’s business. Ten customers account for approximately 63% of the Company’s sales in the current fiscal year to date. At July 1, 2006, the allowance for bad debts amounted to $161,000, which represented 2.4% of receivables.

Because of the Company’s long term relationships with the majority of its customers, in most cases, the principal bad debt risk to the Company arises from the insolvency of a customer rather than its unwillingness to pay. In addition, in certain cases the Company maintains credit insurance covering up to 90% of the amount outstanding from specific customers. The Company also carries out some of its foreign trade, particularly in the Far East, using letters of credit.

The Company reviews all accounts receivable balances on a regular basis, concentrating on any balances that are more than 30 days overdue, or where there is an identified credit risk with a specific customer. A decision is taken on a customer-by-customer basis as to whether a bad debt reserve is considered necessary based on the specific facts and circumstances of each account. In general, the Company would reserve 100% of the receivable, net of any recoverable value added taxes or insurance overages, for a customer that becomes insolvent or files for bankruptcy, and lesser amounts for less imminent defaults. To a lesser degree, the Company maintains a small bad debt reserve to cover the remaining balances based on historical default percentages.

If the financial condition of any of the Company's customers is worse than estimated or were to deteriorate, resulting in an impairment of its ability to make payments, the Company’s results may be adversely affected and additional allowances may be required. With the exception of a significant loss of $562,000 in fiscal 2001 relating to one US customer, credit losses have not been significant in the past ten years.

Inventories

Inventories are valued at the lower of cost or market. Inventory costs include materials, direct labor and manufacturing overhead, and are relieved from inventory on a first-in, first-out basis. The Company carries out a significant amount of customization of standard products and also designs and manufactures special products to meet the unique requirements of its customers. This results in a significant proportion of the Company’s inventory being customer specific. The Company’s reported financial condition includes a provision for estimated slow-moving and obsolete inventory that is based on a comparison of inventory levels with forecast future demand. Such demand is estimated based on many factors, including management judgments, relating to each customer’s business and to economic conditions. The Company reviews in detail all significant inventory items with holdings in excess of estimated normal requirements. It also considers the likely impact of changing technology. It makes an estimate of the provision for slow moving and obsolete stock on an item-by-item basis based on a combination of likely usage based on forecast customer demand, potential sale or scrap value and possible alternative use. This provision represents the difference between original cost and market value at the end of the financial period. In cases where there is no estimated future use for the inventory item and there is no estimated scrap or resale value, a 100% provision is recorded. Where the Company estimates that only part of the total holding of an inventory item will not be used, or there is an estimated scrap, resale or alternate use value, then a proportionate provision is recorded. Once an item has been written down, it is not subsequently revalued upwards. The provision for slow moving and obsolete inventories at July 1, 2006 was $924,000, or 14% of the original cost of gross inventory. At September 30, 2005 the provision was $803,000, or 18% of gross inventory. If actual future demand or market conditions are less favorable than those projected by management, or if product designs change more quickly than forecast, additional inventory write-downs may be required, which may have a material adverse impact on reported results.

Warranty Costs

The Company provides for the estimated cost of product warranties at the time revenue is recognized. While the Company engages in product quality programs and processes, the Company's warranty obligation is affected by product failure rates and repair or replacement costs incurred in correcting a product failure. Accordingly, the provision for warranty costs is based upon anticipated in-warranty failure rates and estimated costs of repair or replacement. Anticipating product failure rates involves making difficult judgments about the likelihood of defects in materials, design and manufacturing errors, and other factors that are based in part on historical failure rates and trends, but also on management’s expertise in engineering and manufacturing. Estimated repair and replacement costs are affected by varying component and labor costs. Should actual product failure rates and repair or replacement costs differ from estimates, revisions to the estimated warranty liability may be required and the Company’s results may be materially adversely affected. In the event that the Company discovers a product defect that impacts the safety of its products, then a product recall may be necessary, which could involve the Company in substantial unanticipated expense significantly in excess of the reserve. There were no significant safety related product recalls during the past three fiscal years.

Goodwill Impairment