GSI GROUP INC
Form 10-Q
April 13, 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 September 26, 2008

Or

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

Commission File No. 000-25705

GSI Group Inc.

(Exact name of registrant as specified in its charter)

New Brunswick, Canada	**98-0110412**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
125 Middlesex Turnpike	
Bedford, Massachusetts, USA	**01730**
(Address of principal executive offices)	**(Zip Code)**

(781) 266-5700

(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 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 x

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 x
Non-accelerated filer ¨	Smaller reporting company ¨

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

As of March 23, 2010, there were 47,901,978 of the Registrant s common shares, no par value, issued and outstanding.

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GSI GROUP INC.

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EXPLANATORY NOTE

In August 2008, GSI Group Inc. (the Company) closed its acquisition of Excel Technology, Inc. (Excel). Delays in the integration of the financial accounting systems of the Company and Excel following the acquisition initially led to a delay of several weeks in the preparation of the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 26, 2008 (the 2008 Q3 Report). Shortly thereafter and prior to filing the 2008 Q3 Report, the Company initiated an internal review of certain potential errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Company s Semiconductor Systems Segment, which were brought to the attention of the Audit Committee of the Company s Board of Directors (the Audit Committee) by Company management. Following this initial internal review, the Audit Committee, in consultation with the Company s outside legal counsel determined that it was appropriate to undertake an independent review of the potential revenue recognition issues brought to its attention.

On or about November 25, 2008, the Audit Committee initiated a broader independent review of sales transactions in the Semiconductor Systems Segment that contain arrangements with multiple deliverables for fiscal years 2007 and 2008. The review was subsequently expanded to include sales transactions in the Semiconductor Systems Segment, along with certain other sales transactions for fiscal years 2006, 2007 and 2008. To assist in its review, the Audit Committee retained independent legal counsel and forensic accounting experts.

On December 4, 2008, the Company announced that it identified errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Semiconductor Systems Segment and that the previously issued financial statements contained in the Company s Quarterly Reports on Form 10-Q for the periods ended March 28, 2008 and June 27, 2008 should no longer be relied upon.

Subsequently, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems Segment customers during fiscal year 2007. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2007 should no longer be relied upon. The Audit Committee thereafter expanded the scope of its investigation to include fiscal year 2006.

On March 30, 2009, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems Segment customers during fiscal year 2006. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2006 should no longer be relied upon.

The Audit Committee s advisors reported the results of the investigation to the Audit Committee on April 24, 2009. The Company voluntarily reported the investigation results to the Securities and Exchange Commission (SEC) on April 30, 2009. The Company later announced in May 2009 that it was reviewing sales transactions of its Semiconductor Systems Segment during fiscal years 2004 and 2005 to determine if adjustments needed to be made to those periods. Thereafter, on June 30, 2009, the Company announced that it was undertaking a preliminary review of the timing of revenue recognized in connection with multiple element arrangements in its Precision Technology Segment from 2004 through 2008 to determine if adjustments need to be made to those periods (collectively with the Audit Committee s review of transactions in the Semiconductor Systems Segment and any other related Company reviews of transactions in the Semiconductor Systems Segment and Precision Technology Segment, the Revenue Review). As is further explained in Note 2 of the Notes to Consolidated Financial Statements, in connection with the Revenue Review, the Company concluded that there were a number of adjustments required that primarily relate to revenue recognition and the corresponding adjustments to deferred revenue, cost of goods sold and other assets. Adjustments to revenue resulted in revenue and their related costs being deferred and recognized in subsequent periods once all revenue recognition criteria have been met. In addition, these adjustments did not affect the Company s cash balances. The transactions that are being restated as a result of the Revenue Review include transactions for which the complete facts required to make the appropriate assessment with respect to the timing of the revenue recognition were not communicated to the finance department at the time the initial revenue was booked. As of September 26, 2008, a substantial portion of the revenue deferred through the restatement remains deferred, pending the finalization of all deliverables under the terms of the arrangements with customers. The revenue adjustments, in aggregate for both the Semiconductor Systems and the Precision Technology Segments, primarily relate to:

- multiple-element arrangements for which objective and reliable evidence of fair value does not exist for one or more of the undelivered elements;

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- for those arrangements whereby it was determined that customer acceptance was required in order to record revenue in accordance with the Company s policy, the correction of the timing of revenue for instances where customer acceptance could not be demonstrated until a period subsequent to the period of original revenue recognition;

- contractual terms that resulted in arrangements being deemed to not be fixed or determinable at the outset of the arrangement (including extended payment terms and contracts whereby product quantity mix was subject to adjustment during the term of the arrangement); and

- certain other revenue adjustments which were not individually, or in the aggregate, significant. These adjustments have been reflected in the restated consolidated financial statements and primarily relate to the accounting for separately priced extended warranty contracts.

In addition to adjustments from the Revenue Review, the Company has also identified and recorded the impact of certain adjustments which, due to their materiality, were not previously recorded. Certain of these adjustments affect revenue, cost of goods sold and operating expenses, as well as offsetting balance sheet accounts. These adjustments have been reflected in the accompanying consolidated financial statements.

In connection with its restatement, the Company and Ernst & Young LLP, its independent auditors, identified and reported to the Company s Audit Committee significant internal control matters that collectively constitute material weaknesses . Please see Item 4. Controls and Procedures below for a description of these matters, and of certain of the measures that have been implemented during 2009, to date, as well as additional steps the Company plans to take to strengthen its controls.

The Company does not anticipate amending its previously filed annual reports on Form 10-K or any quarterly reports on Form 10-Q. The consolidated financial statements and related consolidated financial information contained in previously filed reports, including for the years ended December 31, 2007 and 2006 and for the first two quarterly reports during 2008 and the first three quarters of 2007, should no longer be relied upon.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

GSI GROUP INC.

CONSOLIDATED BALANCE SHEETS

(In thousands of U.S. dollars, except share data)

	September 26, 2008 (Unaudited)	December 31, 2007 (As Restated)
ASSETS		
Current Assets		
Cash and cash equivalents	$ 52,141	$ 172,387
Accounts receivable, net	64,462	71,631
Income taxes receivable	37,180	21,790
Inventories	87,892	64,139
Deferred tax assets	11,041	8,541
Deferred cost of goods sold	35,285	37,194
Deferred debt financing costs	6,340	
Other current assets	6,267	7,120
Current assets of discontinued business held for sale	4,317	3,864
Total current assets	304,925	386,666
Property, plant and equipment, net of accumulated depreciation and amortization	70,794	28,382
Deferred tax assets	21,214	16,589
Deferred cost of goods sold	23,133	12,758
Investments in auction rate securities	25,860	
Other assets	2,253	1,566
Intangible assets, net	156,299	29,775
Goodwill	176,232	26,291
Noncurrent assets of discontinued business held for sale	4,649	5,618
Total Assets	$ 785,359	$ 507,645
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Debt (Note 8)	$ 183,840	$
Accounts payable	33,413	17,905
Income taxes payable	1,186	1,546
Accrued compensation and benefits	11,524	9,848
Deferred revenue	69,458	79,462
Deferred tax liabilities	798	286
Other accrued expenses	17,239	8,980
Current liabilities of discontinued business held for sale	1,568	1,577
Total current liabilities	319,026	119,604
Deferred revenue	39,133	22,101
Deferred tax liabilities	60,458	10,124

Accrued restructuring, net of current portion	1,106	1,015
Income taxes payable	4,050	3,966
Accrued pension liability	4,316	4,481
Other liabilities	5,044	676
Minority interest	164	
Total liabilities	433,297	161,967
Commitments and contingencies (Note 14)		
Stockholders equity:		
Common shares, no par value; Authorized shares: unlimited; Issued and outstanding: 41,709,379 and 42,161,592, respectively	304,595	310,970
Additional paid-in capital	36,858	8,191
Retained earnings	4,995	19,131
Accumulated other comprehensive income	5,614	7,386
Total stockholders equity	352,062	345,678
Total Liabilities and Stockholders Equity	$ 785,359	$ 507,645

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

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GSI GROUP INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands of U.S. dollars, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 26, 2008 (Unaudited)	September 28, 2007 (Unaudited, As Restated)	September 26, 2008 (Unaudited)	September 28, 2007 (Unaudited, As Restated)
Sales	$ 71,443	$ 84,077	$ 192,137	$ 223,699
Cost of goods sold	48,557	51,376	124,086	134,938
Gross profit	22,886	32,701	68,051	88,761
Operating expenses:				
Research and development and engineering	8,874	7,390	23,829	22,494
Selling, general and administrative	16,674	15,120	46,911	44,010
Amortization of purchased intangible assets	1,646	554	2,749	1,654
Restructuring	3,073	1,939	4,206	5,868
Acquisition-related in-process research and development charge	12,142		12,142	
Total operating expenses	42,409	25,003	89,837	74,026
Income (loss) from operations	(19,523)	7,698	(21,786)	14,735
Interest income	595	1,708	2,763	4,921
Interest expense	(2,892)	(26)	(2,927)	(107)
Foreign exchange transaction gains (losses)	(2)	682	269	463
Other income	12	19	154	176
Income (loss) from continuing operations before income taxes	(21,810)	10,081	(21,527)	20,188
Income tax provision (benefit)	(7,600)	3,438	(7,081)	6,858
Income (loss) from continuing operations	(14,210)	6,643	(14,446)	13,330
Income (loss) from discontinued operations, net of tax	(19)	12	310	266
Net income (loss)	$ (14,229)	$ 6,655	$ (14,136)	$ 13,596
Net income (loss) from continuing operations per common share:				
Basic	$ (0.34)	$ 0.16	$ (0.35)	$ 0.31
Diluted	$ (0.34)	$ 0.15	$ (0.35)	$ 0.31
Net income from discontinued operations per common share:				
Basic	$	$	$ 0.01	$ 0.01
Diluted	$	$	$ 0.01	$ 0.01
Net income (loss) per common share:				
Basic	$ (0.34)	$ 0.16	$ (0.34)	$ 0.32
Diluted	$ (0.34)	$ 0.15	$ (0.34)	$ 0.32
Weighted average common shares outstanding Basic	41,677	42,654	41,792	42,344
Weighted average common shares outstanding Diluted	41,677	42,936	41,792	42,578

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

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GSI GROUP INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of U.S. dollars)

	Nine Months Ended	
	September 26, 2008 (Unaudited)	September 28, 2007 (Unaudited, As Restated)
Cash flows from operating activities:		
Net income (loss)	$ (14,136)	$ 13,596
Adjustments to reconcile net income (loss) to net cash from operating activities:		
Income from discontinued operations	(310)	(266)
Depreciation and amortization	11,656	11,038
Acquisition-related in-process research and development charge	12,142	
Step-up value of acquired inventory sold	366	
Share based compensation	2,342	1,830
Deferred income taxes	(378)	2,700
Earnings from equity investments	(87)	(117)
Unrealized loss on derivatives		18
Gain on sale of property and assets	(1,162)	
Non-cash interest expense	274	
Changes in current assets and liabilities, net of effects from business acquired:		
Accounts receivable	26,444	(17,218)
Inventories	12,986	5,967
Deferred costs	(8,110)	(99)
Other current assets	(4,998)	5,730
Deferred revenue	6,511	(1,530)
Accounts payable, accruals and taxes receivable and payable	(615)	1,699
Cash used in operating activities of discontinued operations	(153)	(1,034)
Cash provided by operating activities	42,772	22,314
Cash flows from investing activities:		
Acquisition of businesses	(368,711)	(3,006)
Cash received in acquisition of businesses	10,430	
Purchases of property, plant and equipment	(16,404)	(3,861)
Proceeds from the sale of property, plant and equipment	3,211	
Changes in other assets and liabilities	10,229	381
Cash provided by (used in) investing activities of discontinued operations	969	(250)
Cash used in investing activities	(360,276)	(6,736)
Cash flows from financing activities:		
Proceeds from issuance of debt	210,000	
Payments for debt issuance costs	(6,472)	
Purchases of the Company s common shares	(6,439)	(2,414)
Net proceeds from the issuance of share capital	63	7,334
Excess tax benefit of stock options	23	345
Cash provided by financing activities	197,175	5,265
Effect of exchange rates on cash and cash equivalents	83	2,587
Increase (decrease) in cash and cash equivalents	(120,246)	23,430

Cash and cash equivalents, beginning of period (1)		172,387		138,315
Cash and cash equivalents, end of period (1)	$	52,141	$	161,745
Supplemental disclosure of non cash financing activity:				
Issuance of warrants	$	26,302		

(1) The Consolidated Statements of Cash Flows include cash and cash equivalent balances (in thousands) of $2, and $530 of the discontinued business held for sale for the nine months ended September 26, 2008, and September 28, 2007, respectively.

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

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization, Presentation and Significant Events

GSI Group Inc. (GSIG) and its subsidiaries (collectively the Company) designs, develops, manufactures and sells photonics-based solutions (consisting of lasers, laser systems and electro-optical components), precision motion devices, associated precision motion control technology and systems. Its customers incorporate its technology into their products or manufacturing processes, for a wide range of applications in a variety of markets, including: industrial, scientific, electronics, semiconductor, medical and aerospace. The Company operates in three segments: Precision Technology, Semiconductor Systems and Excel Technology, Inc. (Excel). The Company s principal markets are in North America, Europe, Japan and Asia-Pacific. The Company exists under the laws of New Brunswick, Canada.

Acquisition of Excel Technology, Inc.

In August 2008, the Company acquired Excel, a designer, manufacturer and marketer of photonics-based solutions consisting of lasers, laser-based systems, precision motion devices and electro-optical components, primarily for industrial and scientific applications. Excel, which was headquartered in East Setauket, New York, manufactures its products in plants located in the United States and Germany, and sells its products to customers worldwide, both directly and indirectly through resellers and distributors. The Company acquired Excel in exchange for a cash payment of $368.7 million, including transaction costs, a portion of which was financed by entering into a loan agreement for $210.0 million. This loan is further discussed in the section below titled Chapter 11 Bankruptcy Filing , and in Note 8 of Notes to Consolidated Financial Statements. Subsequent to the acquisition of Excel, the Company established a third segment which is comprised solely of the operations of the newly acquired entity. See Note 4 of Notes to Consolidated Financial Statements for further details regarding the Excel transaction.

Divestiture of U.S. General Optics Business

On October 8, 2008, the Company completed the sale of its General Optics business, located in Moorpark, California, (the U.S. Optics Business) for a sale price of $21.6 million, which represented a gain of $8.7 million, net of tax. The sale of the U.S. Optics Business is reported as Gain on Disposal of Discontinued Operations in our consolidated statements of operations for the year ended December 31, 2008. This business was part of the Company s Precision Technology Segment. The results of operations of the U.S. Optics Business have been reclassified and reported as income from discontinued operations in our consolidated statements of operations. See Note 5 of Notes to Consolidated Financial Statements for further details regarding the sale of the U.S. Optics Business.

NASDAQ Delisting Determination

On November 3, 2009, the NASDAQ Hearing Panel (the Panel) of the NASDAQ Stock Market (NASDAQ) notified the Company that it had determined to delist the Company s common shares from the NASDAQ Global Select Market and to suspend trading in the Company s common shares effective at the open of market on November 5, 2009. The Panel s determination was made in connection with the Company s non-compliance with the filing requirements set forth in Listing Rule 5250(c)(1) due to the delayed filing of certain of our periodic reports. As permitted by NASDAQ rules, the Company timely appealed the Panel s determination to the NASDAQ Listing and Hearing Review Council (the Listing Council). On January 15, 2010, the Listing Council notified the Company that it affirmed the Panel s decision to delist the Company s securities. On March 15, 2010, the Company received notification from the NASDAQ Stock Market, LLC Board of Directors (the NASDAQ Board) that the NASDAQ Board has declined to call for review the January 15, 2010 decision of the Listing Council. Accordingly, pursuant to Listing Rule 5825, the Listing Council s decision represents the final decision of NASDAQ. In accordance with Listing Rule 5830 and Rule 12d2-2 under the Securities Exchange Act of 1934, NASDAQ filed an application on Form 25 with the SEC on April 5, 2010, to delist the Company s securities from NASDAQ. The application will become effective ten days after filing.

The Company s common shares are currently quoted on the Pink OTC Markets Inc., continuing under the trading symbol GSIGQ. The Company intends to seek relisting of its common shares on a national exchange as soon as possible once it becomes current in its reporting obligations.

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Chapter 11 Bankruptcy Filing

In connection with the Company s failure to file the 2008 Q3 Report, as described in the Explanatory Note, on December 12, 2008, the Company announced that it had received four letters from certain noteholders of the 11% Senior Notes due in 2013, in the principal amount of $210.0 million (the Senior Notes), issued by GSI Group Corporation (GSI US), alleging that the Company had failed to comply with a covenant in the Senior Note Indenture (the Indenture), relating to the Senior Notes, as a result of the Company s failure to file its 2008 Q3 Report within the time period specified by the rules and regulations of the SEC. These noteholders further alleged that, if such failure continued for 60 days from the date that the Company received notices of failure from holders comprising at least 25% of the aggregate principal amount of Senior Notes then outstanding, then such failure would constitute an event of default. Although the Company asserted that the letters did not constitute proper notice as required pursuant to the terms of the Indenture, and notified the trustee under the Indenture as such, the Company continued to work diligently to complete the review by its Audit Committee and to file its 2008 Q3 Report to avoid any claim of an Event of Default from occurring under the Indenture. Upon receipt of the letters from the noteholders, the Company commenced discussions with certain of the noteholders. On February 11, 2009, the Company announced that it entered into forbearance agreements with certain noteholders holding greater than 75% of the outstanding aggregate principal amount of the Senior Notes, pursuant to which such noteholders agreed to forbear from taking any action or exercising any remedies under the Indenture as a result of the Company s delayed periodic reports until February 27, 2009, pursuant to other terms and conditions more specifically set forth therein. On June 30, 2009, the Company announced that it reached an agreement on a non-binding term sheet with certain noteholders to consensually restructure the Company s outstanding obligations under the Senior Notes.

Following negotiations between the Company and certain noteholders about the restructuring, on November 20, 2009 (the Petition Date), GSIG and two of its United States subsidiaries, GSI US and MES International, Inc. (MES and, collectively with GSIG and GSI US, the Debtors), filed voluntary petitions for relief (the Chapter 11 Petitions) under Chapter 11 of the United States Bankruptcy Code (the Bankruptcy Code) in the United States Bankruptcy Court for the District of Delaware (the Court) (the Chapter 11 Cases). Following the Petition Date, the Debtors continue to operate their business as debtors-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Court.

On November 19, 2009, in anticipation of filing the Chapter 11 Petitions, the Debtors entered into a Noteholder Restructuring Support Agreement with eight of ten of the beneficial holders (the Consenting Noteholders) of the Senior Notes, representing Consenting Noteholders holding approximately 88.1% of the outstanding principal amount of the Senior Notes. Pursuant to the Noteholder Restructuring Support Agreement, the Consenting Noteholders agreed, subject to certain conditions, to support the Joint Chapter 11 Plan of Reorganization proposed by the Debtors, which was filed with the Chapter 11 Petitions.

On March 16, 2010, the Debtors entered into an Amended and Restated Plan Noteholder Restructuring Support Agreement (as amended, the Plan Support Agreement) with Consenting Noteholders holding approximately 88.1% of the outstanding principal amount of the Senior Notes. Pursuant to the Plan Support Agreement, the Consenting Noteholders have agreed to support a modified plan, in substantially the form of the Second Modified Joint Chapter 11 Plan of Reorganization for the Debtors as filed with the Court on March 16, 2010, and attached as Exhibit A to the Amended Plan Support Agreement (the Second Modified Plan).

On April 9, 2010, the Debtors filed their Third Modified Joint Chapter 11 Plan of Reorganization (as modified, the Plan) with the Court, which reflected further modifications to the Second Modified Plan. The terms of the Plan are hereafter described under the heading The Third Modified Joint Chapter 11 Plan of Reorganization.

The Third Modified Joint Chapter 11 Plan of Reorganization

Pursuant to the Plan, which is subject to Court approval, the holders of claims under the Senior Notes (the Senior Note Claims) would, in exchange for the Senior Note Claims, receive their pro rata share of (i) shares of new convertible preferred stock of GSIG (the Preferred Shares), which, on an as-converted basis, would represent approximately 53.8% of GSIG s post-consummation outstanding shares, (ii) new secured notes in the aggregate amount of $110 million, (iii) excess cash available under the Plan to the extent certain allowed claims exceed $22.5 million and (iv) a cash payment (the Cash Payment) in an amount of $69,315 for each day from and including the Petition Date until the plan distribution

date. Under the terms of the Plan and because the Debtors commenced the Chapter 11 Cases by November 20, 2009, this Cash Payment would be reduced by $2.1 million. On the effective date of the Plan, GSIG would also pay any and all interest accrued on the Senior Note Claims until the Petition Date. As of the Petition Date, there is approximately $6.03 million in accrued and unpaid interest with respect to the Senior Notes. The Preferred Shares would have a 1x liquidation preference and be

GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

mandatorily redeemable after 8 years for cash or, if certain circumstances are met, common shares of GSIG. The Preferred Shares would be voted on an as-converted basis together with GSIG s common shares and share *pari passu* in any dividend declared on common shares, but not have any guaranteed fixed dividend rights. The interest rate on the new secured notes would be 12.25% and, at GSI US s option, subject to GSIG s compliance with a fixed charge coverage ratio defined in the indenture for the new secured notes to be entered into upon the effective date of the Plan, would be payable in kind at a compounded rate of 13%. The new secured notes would be issued by GSI US, guaranteed by GSIG, ten of GSI US s United States subsidiaries, and two of GSIG s Canadian subsidiaries and secured by substantially all the assets of GSI US and the guarantors.

As part of the Plan, GSIG s wholly owned subsidiary, GSI Group Limited, would, in exchange for claims under an unsecured note in the principal amount (as fixed pursuant to the Plan) of $20 million, payable by GSI US to GSI Group Limited (the GSI UK Note Claim), receive (i) Preferred Shares, which, on an as-converted basis, would represent approximately 5.1% of GSIG s post-consummation outstanding shares, (ii) approximately $10.5 million of the new secured notes, (iii) its pro rata share of the excess cash available under the Plan to the extent certain allowed claims exceed $22.5 million and (iv) its pro rata share of the Cash Payment, as adjusted. On the effective date of the Plan, GSIG would also pay interest accrued on the GSI UK Note Claim until the Petition Date.

As contemplated by the Plan, existing shareholders would (i) retain 41.1% of GSIG s post-consummation outstanding shares, which would be issued in common shares and (ii) receive one series of three-year warrants to purchase a number of common shares equal to 10% of 111% of the post consummation outstanding shares of GSIG (that is, the number of shares of GSIG that would equal 10% of the shares of GSIG, including the Preferred Shares on an as-converted basis, before taking into account the number of shares represented by such warrants) at a strike price of $2.50 per share.

Under the proposed Plan, all classes of claims, including all claims by vendors and suppliers, would be unimpaired and paid in full, except for the Senior Note Claims, the GSI UK Note Claim and the equity interest in GSIG.

The Plan provides that its effectiveness is subject to customary conditions, including, without limitation, that the effective date occurs on or before May 20, 2010, unless such date is extended pursuant to the Plan Support Agreement.

The Plan contemplates that the Debtors will continue to operate their businesses in substantially their current form. On November 23, 2009, the Debtors obtained the Court s approval of so-called first day motions providing for the continued payment of vendors and suppliers under normal terms in the ordinary course of business for goods and services provided to the Debtors prior to and after the Petition Date. On December 18, 2009, the Court approved the Plan Support Agreement. The Court further approved the Debtors Disclosure Statement with respect to the Plan on January 8, 2010, and set a date for consideration of confirmation of the Plan for April 16, 2010**.**

The Plan provides that, following the effective date of the Plan, GSIG s Board of Directors would be comprised of seven directors, to include its Chief Executive Officer, three members to be appointed by the beneficial holders of the Senior Notes, two members to be appointed by the current shareholders of GSIG and one member to be appointed by the current board of directors of GSIG, which member will be selected from the members of GSIG s current board of directors as of the date of the Plan. The Plan anticipates that the current officers of GSIG would continue as officers of GSIG following the effective date of the Plan.

The recoveries summarized above and the other terms of GSIG s restructuring are more fully described in the Plan, which forms a part of the Plan Support Agreement.

The Plan Support Agreement

The Debtors proposed financial restructuring, as set forth in the Plan, has the support of Consenting Noteholders holding approximately 88.1% of the principal amount of the outstanding Senior Notes, representing 80% of all holders of the Senior Notes. The Plan Support Agreement was approved by the Court on December 18, 2009, and, as noted above, was amended and restated on March 16, 2010.

The Plan Support Agreement requires the Consenting Noteholders, and their successors and assigns, (i) to timely file a notice with the Court indicating that the votes previously submitted by the Consenting Noteholders with respect to the Plan shall constitute and be deemed votes accepting and in favor of the Plan, (ii) not to object to confirmation of the Plan and not

GSI GROUP INC.

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to object to, or otherwise commence, any proceeding to oppose or alter the Plan or support an alternative restructuring, (iii) not to withdraw, change or revoke their votes with respect to the Plan, except as otherwise permitted in the Plan Support Agreement, and (iv) except as otherwise permitted in the Plan Support Agreement, not to take any other action, including commencing any legal proceeding, that is inconsistent with, or that would materially prevent, hinder or delay the consummation of, the restructuring.

The support of the Consenting Noteholders under the Plan Support Agreement will terminate under certain circumstances, including, without limitation, if (i) the Debtors are in material breach of any obligations under the Plan Support Agreement, (ii) the Debtors file any motion or pleading with the Court that is inconsistent in a material respect with the Plan Support Agreement or the Plan, (iii) the Court grants relief that is materially inconsistent with the Plan Support Agreement or the Plan, (iv) the Debtors fail to achieve certain deadlines with respect to the approval of the Plan Support Agreement or the disclosure statement or confirmation or effectiveness of the Plan, (v) a trustee is appointed in the Chapter 11 Cases or any of the Chapter 11 Cases is dismissed or converted to a case under Chapter 7 of the Bankruptcy Code or if the Debtors make a motion for such appointment, dismissal or conversion, (vi) the Court enters an order invalidating, disallowing, subordinating, recharacterizing or limiting the principal and interest components of the Senior Note Claims or disgorging any amounts paid prior to the Petition Date from any holder of the Senior Note Claims or (vii) there is a Material Adverse Change to GSIG (as defined in the Plan Support Agreement).

The Plan Support Agreement provides that GSIG shall use its best efforts to (i) support and complete the restructuring and all transactions contemplated by the Plan, (ii) take any and all necessary and appropriate actions in furtherance of the restructuring, (iii) complete the restructuring and all transactions contemplated under the Plan within set time-frames, (iv) obtain any and all required regulatory and/or third-party approvals for the restructuring, and (v) not directly or indirectly seek, solicit, support, consent to, or participate in the negotiation or formulation of alternate plans of reorganization, certain other corporate transactions, such as mergers, dissolutions, or a sale of substantially all of GSIG s assets or any other action that is inconsistent with the reorganization as contemplated by the Plan Support Agreement.

Subsequent to the Petition Date, the provisions in Financial Accounting Standards Board (FASB) Staff Position (FSP) 90-7-1, Financial Reporting by Entities in Reorganization under the Bankruptcy Code, apply to the Debtors financial statements while the Debtors operate under the provisions of Chapter 11. FSP 90-7-1 does not change the application of generally accepted accounting principles in the preparation of financial statements. However, FSP 90-7-1 does require that the financial statements, for periods including and subsequent to the filing of the Chapter 11 petition, distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

Companies Creditors Arrangement Act

On April 8, 2010, the Debtors commenced certain parallel proceedings to the Chapter 11 Cases before the Court of Queen s Bench of New Brunswick (the NB Court), pursuant to section 46 of the Companies Creditors Arrangement Act, for an order of the NB Court recognizing the foreign main proceeding constituting the Chapter 11 Cases and seeking relief from certain actions by the NB Court.

Going Concern

Operating in bankruptcy imposes significant risks and uncertainties on our business. See Item 1A Risk Factors Risks Relating to Bankruptcy for a discussion of the risks and uncertainties relating to our business and investing in the Company s securities as a result of the Chapter 11 Cases.

The Company believes that when it emerges from bankruptcy, it will be sufficiently capitalized. The Company expects that it will have assets that exceed its liabilities, and that those assets, as well as the net assets derived from its continuing operations, will be sufficient to meet the Company s obligations, including the obligations with respect to the payment of interest, and repayment of principal under the New Term Loan. Notwithstanding the Company s expectation upon its emergence from bankruptcy, uncertainties inherent in the bankruptcy process raise substantial doubt about the Company s ability to continue as a going concern. In particular, until the terms of the Plan are confirmed by the Court, the Company may be required to pay the Senior Note Claims under the original terms of the Senior Notes. The consolidated financial

statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

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2. Restatement of Previously Issued Financial Statements

In August 2008, the Company completed its acquisition of Excel. Delays in the integration of the financial accounting systems of the Company and Excel following the acquisition initially led to a delay of several weeks in the preparation of the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 26, 2008 (the 2008 Q3 Report). Shortly thereafter and prior to filing the 2008 Q3 Report, the Company initiated an internal review of certain potential errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Company s Semiconductor Systems Segment, which were brought to the attention of the Audit Committee of the Company s Board of Directors (the Audit Committee) by Company management. Following this initial internal review, the Audit Committee, in consultation with the Company s outside legal counsel, determined that it was appropriate to undertake an independent review of the potential revenue recognition issues brought to its attention.

On or about November 25, 2008, the Audit Committee initiated a broader independent review of sales transactions in the Semiconductor Systems Segment, along with certain other sales transactions that contain arrangements with multiple deliverables for fiscal years 2007 and 2008. The review was subsequently expanded to include fiscal year 2006. To assist in its review, the Audit Committee retained independent legal counsel and forensic accounting experts.

On December 4, 2008, the Company announced that it identified errors in the recognition of revenue related to sales to a customer in the first and second fiscal quarters of 2008 in the Semiconductor Systems Segment and that the previously issued financial statements contained in the Company s Quarterly Reports on Form 10-Q for the periods ended March 28, 2008 and June 27, 2008 should no longer be relied upon.

Subsequently, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems Segment customers during fiscal year 2007. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2007 should no longer be relied upon. The Audit Committee thereafter expanded the scope of its investigation to include fiscal year 2006.

On March 30, 2009, the Company announced that it had identified additional revenue recognition errors related to the timing of revenue recognition from sales to certain Semiconductor Systems Segment customers during fiscal year 2006. The Audit Committee concluded, upon the recommendation of Company management, that the range of potential adjustments resulting from the identified errors is material to the financial statements of the Company for the periods indicated and as a result, the Audit Committee determined that the previously issued interim and annual historical financial statements for 2006 should no longer be relied upon.

The Audit Committee s advisors reported the results of the investigation to the Audit Committee on April 24, 2009. The Company voluntarily reported the investigation results to the SEC on April 30, 2009. Thereafter, on June 30, 2009, the Company announced that it was undertaking a preliminary review of the timing of revenue recognized in connection with multiple element arrangements in its Precision Technology Segment from 2004 through 2008 to determine if adjustments need to be made to those periods (collectively with the Audit Committee s review of transactions in the Semiconductor Systems Segment and any other related Company reviews of transactions in the Semiconductor Systems Segment and Precision Technology Segment, the Revenue Review).

As part of its Revenue Review procedures, the Company assessed historic revenue transactions back to 2002. Transactions prior to 2004 were reviewed to the extent that the Company had reason to believe such transactions could materially affect the consolidated financial statements for 2004, or any period after 2004. The restated consolidated financial statements include a number of adjustments primarily related to the timing of revenue recognition which impacts revenue, cost of goods sold, deferred revenue, and deferred cost of goods sold.

Adjustments arising from the Revenue Review resulted in sales and their related costs being deferred and recognized in subsequent periods, once all revenue recognition criteria have been met. In addition, these adjustments did not affect the Company s cash balances. As of September 26, 2008, a substantial portion of the revenue identified in the Revenue Review remains deferred, pending the finalization of all deliverables under

the terms of the customer arrangements. The corresponding costs have also been deferred and are included as deferred cost of goods sold as a component of other deferred

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assets in the accompanying financial statements. All the deferred revenue and the deferred cost of goods sold have been classified as current or long-term, based on the Company s assessment of when each particular transaction is anticipated to be recognized into revenue.

As discussed further below, the majority of adjustments from the Revenue Review were derived from the Company s incorrect accounting for multiple element arrangements, the determination of fixed and determinable consideration, and the determination of customer acceptance. The Company found inconsistent and incorrect application of its policies. The transactions that are being restated as a result of the Revenue Review include transactions for which the complete facts required to make the appropriate assessment with respect to the timing of the revenue recognition were not communicated to the finance department at the time the initial revenue was booked. Refer to Note 3 of Notes to Consolidated Financial Statements for discussion of the Company s revenue recognition policy.

In addition to adjustments from the Revenue Review, the Company has also recorded the impact of certain adjustments which, due to their materiality, were not previously recorded. Certain of these adjustments affect revenue, cost of goods sold, the provision for income taxes, and, to a lesser extent, operating expenses.

The net effects of all of the restatement adjustments on the statement of operations for the nine months ended September 28, 2007 are as follows (in thousands, except per share data):

	Nine Month Period Ended September 28, 2007		
	As Reported	**Adjustments**	**As Restated**
Sales	$ 222,614	$ 1,085	$ 223,699
Cost of goods sold	131,073	3,865	134,938
Gross profit	91,541	(2,780)	88,761
Operating expenses	76,229	(2,203)	74,026
Income (loss) from operations	15,312	(577)	14,735
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	5,174	279	5,453
Income from continuing operations, before income taxes	20,486	(298)	20,188
Income tax provision (benefit)	6,468	390	6,858
Income from continuing operations	14,018	(688)	13,330
Income from discontinued operations, net of tax	277	(11)	266
Net income (loss)	$ 14,295	$ (699)	$ 13,596
Net income per share - basic	$ 0.34	$ (0.02)	$ 0.32
Net income per share - diluted	$ 0.34	$ (0.02)	$ 0.32

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The net effects of all of the restatement adjustments on the statement of operations for the three months ended September 28, 2007 are as follows (in thousands, except per share data):

	Three Month Period Ended September 28, 2007		
	As Reported	**Adjustments**	**As Restated**
Sales	$ 81,076	$ 3,001	$ 84,077
Cost of goods sold	47,194	4,182	51,376
Gross profit	33,882	(1,181)	32,701
Operating expenses	25,889	(886)	25,003
Income (loss) from operations	7,993	(295)	7,698
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	2,383		2,383
Income from continuing operations, before income taxes	10,376	(295)	10,081
Income tax provision (benefit)	2,713	725	3,438
Income from continuing operations	7,663	(1,020)	6,643
Income from discontinued operations, net of tax	109	(97)	12
Net income (loss)	$ 7,772	$ (1,117)	$ 6,655
Net income per share - basic	$ 0.18	$ (0.03)	$ 0.16
Net income per share - diluted	$ 0.18	$ (0.03)	$ 0.15

The net effects of all of the restatement adjustments on the statements of operations for the six months ended June 27, 2008 and June 29, 2007 are as follows (in thousands, except per share data):

	Six Month Period Ended June 27, 2008			Six Month Period Ended June 29, 2007		
	As Reported	**Adjustments**	**As Restated**	**As Reported**	**Adjustments**	**As Restated**
Sales	$ 131,800	$ (11,106)	$ 120,694	$ 141,538	$ (1,916)	$ 139,622
Cost of goods sold	80,796	(5,267)	75,529	83,879	(317)	83,562
Gross profit	51,004	(5,839)	45,165	57,659	(1,599)	56,060
Operating expenses	49,315	(1,887)	47,428	50,340	(1,317)	49,023
Income (loss) from operations	1,689	(3,952)	(2,263)	7,319	(282)	7,037
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	2,467	79	2,546	2,791	279	3,070

Income from continuing operations, before income taxes		4,156		(3,873)		283		10,110		(3)		10,107
Income tax provision (benefit)		1,091		(572)		519		3,755		(335)		3,420
Income (loss) from continuing operations		3,065		(3,301)		(236)		6,355		332		6,687
Income from discontinued operations, net of tax		136		193		329		168		86		254
Net income (loss)	$	3,201	$	(3,108)	$	93	$	6,523	$	418	$	6,941
Net income per share - basic	$	0.08	$	(0.07)	$	0.00	$	0.15	$	0.01	$	0.16
Net income per share - diluted	$	0.08	$	(0.07)	$	0.00	$	0.15	$	0.01	$	0.16

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The net effects of all of the restatement adjustments on the statements of operations for the three months ended June 27, 2008 and June 29, 2007 are as follows (in thousands, except per share data):

	Three Month Period Ended June 27, 2008			Three Month Period Ended June 29, 2007		
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Sales	$ 62,772	$ (3,303)	$ 59,469	$ 70,266	$ 3,634	$ 73,900
Cost of goods sold	38,340	(1,479)	36,861	41,271	1,992	43,263
Gross profit	24,432	(1,824)	22,608	28,995	1,642	30,637
Operating expenses	24,520	(983)	23,537	25,294	(919)	24,375
Income (loss) from operations	(88)	(841)	(929)	3,701	2,561	6,262
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	1,138		1,138	1,627		1,627
Income from continuing operations, before income taxes	1,050	(841)	209	5,328	2,561	7,889
Income tax provision (benefit)	94	165	259	2,088	389	2,477
Income (loss) from continuing operations	956	(1,006)	(50)	3,240	2,172	5,412
Income from discontinued operations, net of tax	138	(28)	110	83	24	107
Net income (loss)	$ 1,094	$ (1,034)	$ 60	$ 3,323	$ 2,196	$ 5,519
Net income per share - basic	$ 0.03	$ (0.02)	$ 0.01	$ 0.08	$ 0.05	$ 0.13
Net income per share - diluted	$ 0.03	$ (0.02)	$ 0.01	$ 0.08	$ 0.05	$ 0.13

The net effects of all of the restatement adjustments on the statements of operations for the three months ended March 28, 2008 and March 30, 2007 are as follows (in thousands, except per share data):

	Three Month Period Ended March 28, 2008			Three Month Period Ended March 30, 2007		
	As Reported	Adjustments	As Restated	As Reported	Adjustments	As Restated
Sales	$ 69,028	$ (7,803)	$ 61,225	$ 71,272	$ (5,550)	$ 65,722
Cost of goods sold	42,456	(3,788)	38,668	42,608	(2,309)	40,299
Gross profit	26,572	(4,015)	22,557	28,664	(3,241)	25,423
Operating expenses	24,795	(904)	23,891	25,046	(398)	24,648
Income (loss) from operations	1,777	(3,111)	(1,334)	3,618	(2,843)	775
Interest income (expense), other income (expense), and foreign exchange transaction gains (losses), net	1,329	79	1,408	1,164	279	1,443

Income from continuing operations, before income taxes	3,106	(3,032)	74	4,782	(2,564)	2,218
Income tax provision (benefit)	997	(737)	260	1,667	(724)	943
Income (loss) from continuing operations	2,109	(2,295)	(186)	3,115	(1,840)	1,275
Income from discontinued operations, net of tax	(2)	221	219	85	62	147
Net income (loss)	$ 2,107	$ (2,074)	$ 33	$ 3,200	$ (1,778)	$ 1,422
Net income per share - basic	$ 0.05	$ (0.05)		$ 0.08	$ (0.05)	$ 0.03
Net income per share - diluted	$ 0.05	$ (0.05)		$ 0.08	$ (0.05)	$ 0.03

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The net effects of all of the restatement adjustments on selected balance sheet accounts as of December 31, 2007, and on the statement of stockholders equity as of December 31, 2006 are as follows (in thousands):

	Year Ended December 31, 2007		
	As Reported	Adjustments	As Restated
Assets:			
Cash and cash equivalents	$ 171,713	$ 674	$ 172,387
Accounts receivable, net	71,403	228	71,631
Inventories	64,002	137	64,139
Deferred cost of goods sold:			
Current	429	36,765	37,194
Long-term		12,758	12,758
Total deferred cost of goods sold	429	49,523	49,952
Income tax receivable and deferred tax assets	30,378	16,542	46,920
All other assets not listed above	102,286	330	102,616
Total assets	$ 440,211	$ 67,434	$ 507,645
Liabilities and Stockholders Equity:			
Deferred revenue:			
Current	$ 9,949	$ 69,513	$ 79,462
Long-term		22,101	22,101
Total deferred revenue	9,949	91,614	101,563
Income taxes payable and deferred tax liabilities	12,846	3,076	15,922
All other liabilities not listed above	43,298	1,184	44,482
Total liabilities	66,093	95,874	161,967
Stockholders equity	374,118	(28,440)	345,678
Liabilities and stockholders equity	$ 440,211	$ 67,434	$ 507,645

	Year Ended December 31, 2006		
	As Reported	Adjustments	As Restated
Decrease in stockholders equity	$ 343,073	$ (25,397)	$ 317,676

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(Unaudited)

The following table presents the impact of the restatement adjustments to the Company s beginning retained earnings (accumulated deficit) balance, cumulatively to reflect adjustments booked to all periods prior to January 1, 2007 (in thousands):

	Amount
Retained earnings, December 31, 2006 (as previously reported)	$ 29,431
Adjustments from:	
Semiconductor Systems Segment Revenue Review, before income tax effect	(28,402)
Precision Technology Segment Revenue Review, before income tax effect	(7,566)
All other non-income tax adjustments	241
Income tax adjustments	10,418
Total adjustments	(25,309)
Retained earnings, December 31, 2006 (as restated)	$ 4,122

The net effects of all of the restatement adjustments on the condensed cash flow statements for the nine months ended September 28, 2007 are as follows (in thousands):

	Nine Months Ended September 28, 2007		
	As Reported(1)	Adjustments	As Restated
Net income (loss)	$ 14,295	$ (699)	$ 13,596
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	12,940	2,263	15,203
Changes in assets and liabilities	(5,049)	(1,436)	(6,485)
Cash flows from operating activities	22,186	128	22,314
Cash flows from investing activities	(6,524)	(212)	(6,736)
Cash flows from financing activities	5,265		5,265
Effect of exchange rates on cash and cash equivalents	2,503	84	2,587
Net increase (decrease) to cash and cash equivalents	23,430		23,430
Cash and cash equivalents, beginning of year (2)	138,315		138,315
Cash and cash equivalents, end of year (2)	$ 161,745		$ 161,745

(1) Amounts as reported reflect operating activities associated with discontinued operations as changes in assets and liabilities.

(2)

The Consolidated Statements of Cash Flows include cash and cash equivalent balances (in thousands) of $1,814 and $530 of the discontinued operations as of December 31, 2006 and the nine months ended September 28, 2007, respectively.

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The net effects of all of the restatement adjustments on the condensed cash flow statements for the six months ended June 27, 2008 are as follows (in thousands):

		Six Months Ended June 27, 2008	
	As Reported(1)	Adjustments	As Restated
Net income (loss)	$ 3,201	$ (3,108)	$ 93
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	6,304	(185)	6,119
Changes in assets and liabilities	16,753	6,106	22,859
Cash flows from operating activities	26,258	2,813	29,071
Cash flows from investing activities	(9,924)	(2,517)	(12,441)
Cash flows from financing activities	(6,378)	130	(6,248)
Effect of exchange rates on cash and cash equivalents	1,602	(1,100)	502
Net increase (decrease) to cash and cash equivalents	11,558	(674)	10,884
Cash and cash equivalents, beginning of year (2)	171,713	674	172,387
Cash and cash equivalents, end of year (2)	$ 183,271		$ 183,271

(1) Amounts as reported reflect operating activities associated with discontinued operations as changes in assets and liabilities.

(2) The Consolidated Statements of Cash Flows include cash and cash equivalent balances (in thousands) of $1 and $1 of the discontinued operations for the year ended December 31, 2007 and the six months ended June 27, 2008, respectively.

The following discussion provides additional information regarding the adjustments that were identified during the Revenue Review. Certain transactions may have been restated for multiple reasons but have been included in the most applicable category.

Semiconductor Systems Segment

The Company s product sales to customers of its Semiconductor Systems segment are typically multiple element arrangements. These arrangements generally include: hardware components, software components, installation services, an initial warranty period and training on the use of the product. Certain of these arrangements may also include other elements including specified product or software upgrades, product performance commitments and may also include separately priced extended warranty services.

Multiple Element Arrangements without Objective and Reliable Evidence of Fair Value for Undelivered Elements

The Revenue Review identified certain arrangements whereby there were undelivered elements for which objective and reliable evidence of fair value did not exist at the time that the revenue was initially recorded. The Company has deferred the revenue under these arrangements, and recognizes the revenue at the point in time when such undelivered elements are resolved. These undelivered elements include undelivered hardware, delivered hardware not functioning to specifications, and undelivered future software features or functionality committed as part of

the arrangement. Additionally, the Company evaluated the unit of accounting for certain transactions based on the guidance in AICPA s Technical Practice Aid (TPA) 5100.39, Software Revenue Recognition for Multiple Element Arrangements. As a result, certain multiple customer orders that were originally accounted for as separate transactions are accounted for as one transaction in the restatement.

The Determination of Customer Acceptance

Under the Company s policy, sales to customers in Japan, sales to new customers, and sales of new products to existing customers, as defined in its policy, are required to be recorded upon the customer having installed, tested and accepted the product at the customer s site. Without acceptance for these types of sales, the Company is unable to conclude

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that the delivery has been achieved in accordance with the criteria in the SEC s Staff Accounting Bulletin (SAB) 104, Revenue Recognition. The Revenue Review noted instances whereby the criteria required under its policy to record revenue at the time of shipment had not be achieved; therefore revenue was improperly recognized in an earlier period. In such cases, the Company has deferred revenue recognition until the appropriate customer acceptance was received. Additionally, the Company noted instances where there were two documents representing customer acceptance; one form on a format provided by the Company, and another on a customer-specific form. Often these forms were provided from the customer on separate dates. In these cases of dual acceptance , the Company has performed procedures to assess when all deliverables were made, and then reviewed that against the multiple customer acceptance forms. As a result of these procedures, revenue has been generally recorded on the later of the two acceptance forms dates.

Determination that the Fees are not Fixed or Determinable

Under the Company s policy, arrangements with extended payment terms are not considered to be fixed or determinable. Accordingly, revenue is recognized as the payments become due. The Revenue Review noted instances whereby the arrangements with extended payment terms were not properly identified and revenue was improperly recognized in an earlier period. The revenue, as restated, reflects revenue being recorded as the payments have become due.

Other

The Revenue Review also identified certain other revenue adjustments which were not individually, nor in the aggregate, significant. These adjustments have been reflected in the restated consolidated financial statements and primarily relate to the accounting for separately priced extended warranty contracts. In certain arrangements, the amount deferred for extended warranty contracts differed from the stated price of the extended warranty contracts. In such cases, the Company has adjusted the amount of deferred revenue to equal the stated price of the extended warranty contracts, with the recognition of the adjusted amount recorded over the appropriate period of the extended warranty.

Precision Technology Segment

The Company s product sales to customers of its Precision Technology segment generally represent customer orders for a large volume of one or more types of components and occasionally include services such as installation, training and preventative maintenance plans. In order to meet customer production and inventory requirements, these arrangements frequently provide for the delivery of the components over several quarters.

Multiple Element Arrangements without Objective and Reliable Evidence of Fair Value for Undelivered Elements

The Revenue Review identified certain arrangements whereby there were undelivered elements for which objective and reliable evidence of fair value did not exist at the time that the revenue was initially recorded. Additionally, the Company evaluated the unit of accounting for certain transactions based on the guidance in TPA 5100.39. As a result, certain multiple customer orders that were originally accounted for as separate transactions are accounted for as one transaction in the restatement.

A typical order includes a variety of products shipped over several reporting periods. These transactions were historically recognized based on the invoice price of each product shipped. The restated revenue is recognized under the multiple units shipped methodology, whereby revenue is recognized in each period based upon the lowest common percentage of the products shipped in the period. This approximates a proportional performance model of revenue recognition. This generally results in a partial deferral of revenue to a later reporting period. No revenue is recognized unless one unit of each product has been delivered.

Determination that the Fees are not Fixed or Determinable

The Revenue Review identified certain customer arrangements that included customer rights to adjust the product quantity mix or otherwise involved uncertainty regarding the terms of the arrangement. In such cases, the Company has determined that the arrangement fees are not fixed or determinable and revenue is recognized when the order is completely fulfilled.

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Summary of Sales Adjustments

The following tables reflect the adjustments identified during the Company s Revenue Review, as well as from the recording of previously unrecorded immaterial adjustments. The tables present a reconciliation of sales as previously reported to amounts as restated for the periods indicated (in thousands):

	Three Months Ended September 28, 2007	Nine Months Ended September 28, 2007
Sales, as previously reported	$ 81,076	$ 222,614
Revenue Restatement Adjustments:		
Semiconductor Systems Segment:		
Multiple element arrangements	(4,517)	(8,719)
Customer acceptance not assured	289	3,584
Price not fixed or determinable		(654)
Other	(296)	(615)
Subtotal Semiconductor Systems Segment	(4,524)	(6,404)
Precision Technology Segment:		
Multiple element arrangements	(753)	(713)
Price not fixed or determinable	8,488	8,332
Other	(210)	(130)
Subtotal Precision Technology Segment	7,525	7,489
Total revenue restatement adjustments	3,001	1,085
Sales, as restated	$ 84,077	$ 223,699

	Three Months Ended		Three Months Ended		Six Months Ended	
	March 28, 2008	March 30, 2007	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Sales, as previously reported	$ 69,028	$ 71,272	$ 62,772	$ 70,266	$ 131,800	$ 141,538
Revenue Restatement Adjustments:						
Semiconductor Systems Segment:						
Multiple element arrangements	(5,981)	(7,182)	(6,078)	2,980	(12,059)	(4,202)
Customer acceptance not assured	1,108	1,685	325	1,611	1,433	3,296

Price not fixed or determinable	(691)			(654)	(691)	(654)
Other	(351)	(221)	(215)	(99)	(566)	(320)
Subtotal Semiconductor Systems Segment	(5,915)	(5,718)	(5,968)	3,838	(11,883)	(1,880)
Precision Technology Segment:						
Multiple element arrangements	(2,121)	126	197	(86)	(1,924)	40
Price not fixed or determinable	224	42	2,388	(198)	2,612	(156)
Other	9		80	80	89	80
Subtotal Precision Technology Segment	(1,888)	168	2,665	(204)	777	(36)
Total revenue restatement adjustments	(7,803)	(5,550)	(3,303)	3,634	(11,106)	(1,916)
Sales, as restated	$ 61,225	$ 65,722	$ 59,469	$ 73,900	$ 120,694	$ 139,622

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GSI GROUP INC.

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(Unaudited)

Expense Adjustments

In connection with its Revenue Review, the Company has deferred the corresponding direct costs associated with the deferred revenue. These deferred costs have been recorded as deferred cost of goods sold, in the current and long-term sections of the accompanying balance sheets, as appropriate, and are reflected in the statements of operations as cost of goods sold when the related revenue is recognized. These costs represent the direct and incremental costs that are attributable to the product whose revenue is being deferred.

The following tables reflect the adjustments to cost of goods sold and operating expenses that were identified as a result of the Company s Revenue Review, as well as from the recording of previously unrecorded immaterial adjustments. The tables present a reconciliation of previously reported amounts to amounts as restated for the periods indicated (in thousands):

	Three Months Ended September 28, 2007	Nine Months Ended September 28, 2007
Cost of goods sold, as previously reported	$ 47,194	$ 131,073
Semiconductor Systems segment adjustments	(969)	(2,981)
Precision Technology segment adjustments	4,265	4,146
Reclassification of amortization of intangible assets (core technology)	886	2,700
Cost of goods sold, as restated	$ 51,376	$ 134,938
Operating expenses, as previously reported	$ 25,889	$ 76,229
Reclassification of amortization of intangible assets (core technology)	(886)	(2,700)
All other operating expense adjustments		497
Operating expenses, as restated	$ 25,003	$ 74,026

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

	Three Months Ended		Three Months Ended		Six Months Ended	
	March 28, 2008	March 30, 2007	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Cost of goods sold, as previously reported	$ 42,456	$ 42,608	$ 38,340	$ 41,271	$ 80,796	$ 83,879
Semiconductor Systems segment adjustments	(3,507)	(3,298)	(3,815)	1,286	(7,322)	(2,012)
Precision Technology segment adjustments	(1,155)	38	1,538	(157)	383	(119)
Reclassification of amortization of intangible assets (core technology)	874	951	798	863	1,672	1,814
Cost of goods sold, as restated	$ 38,668	$ 40,299	$ 36,861	$ 43,263	$ 75,529	$ 83,562
Operating expenses, as previously reported	$ 24,795	$ 25,046	$ 24,520	$ 25,294	$ 49,315	$ 50,340
Reclassification of amortization of intangible assets (core technology)	(874)	(951)	(798)	(863)	(1,672)	(1,814)
All other operating expense adjustments	(30)	553	(185)	(56)	(215)	497
Operating expenses, as restated	$ 23,891	$ 24,648	$ 23,537	$ 24,375	$ 47,428	$ 49,023

Income Taxes

In connection with its Revenue Review, the Company has reassessed it provision for income taxes. As part of its assessment of its provision for income taxes, the Company has recorded two primary adjustments.

In connection with the Revenue Review, the Company reassessed the probability of realization of deferred tax assets in certain jurisdictions taking into account the effect of the restatement. This assessment, while conducted currently in connection with the restatement activities, was performed using only those facts that were known or expected to be knowable at the time in which each accounting period would have been initially closed. Pursuant to SFAS 109 the Company only recognizes a deferred tax asset when it is more likely than not of recovery, considering future reversal of deferred tax liabilities, available taxable income in carryback periods, the probability of future taxable income after a pattern of generating income in the jurisdiction or tax planning strategies that the Company can implement. Accordingly, adjustments have been reflected to the beginning balance sheet to reduce the deferred tax assets, and the corresponding beginning retained earnings balance.

The provision for income taxes has been further adjusted to reflect the statutory rate, adjusted by timing items and other appropriate current period tax credits, as applied against the as adjusted income and loss of the Company in various periods. See Note 12 of the Notes to Consolidated Financial Statements for further disclosure.

3. Summary of Significant Accounting Policies

Basis of presentation

These consolidated financial statements have been prepared by the Company in U.S. dollars and in accordance with U.S. generally accepted accounting principles, applied on a consistent basis.

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC), and the instructions to Form 10-Q and the provisions of Regulation S-X pertaining to interim financial statements. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations.

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The interim consolidated financial statements include the accounts of the Company. Intercompany transactions and balances have been eliminated. In the opinion of management, all adjustments and accruals necessary for a fair presentation have been made and include only normal recurring adjustments and accruals. The results for interim periods are not necessarily indicative of results to be expected for the year or for any future periods.

Basis of consolidation

The consolidated financial statements include the accounts of GSI Group Inc. and its wholly owned subsidiaries, including the accounts of Excel since August 20, 2008. The accounts of Excel include its 50% owned joint venture, Excel Laser Technology Private Limited (Excel SouthAsia JV), since it is a variable interest entity and the Company is the primary beneficiary of the joint venture. Financial information related to the joint venture is not considered material to the consolidated financial statements. Intercompany accounts and transactions have been eliminated.

Comparative amounts

In addition to the adjustments from the restatement, certain prior quarter amounts have been reclassified to conform to the current quarter presentation in the financial statements and notes as of and for the quarter ended September 26, 2008. These reclassifications primarily relate to the Company s discontinued operations, which have been presented separately in the accompanying consolidated financial statements, as further described in Note 5. These reclassifications also include an adjustment to reflect the amortization of core technology in cost of goods sold. Since these costs had previously been included in selling, general and administrative expenses, the adjustment for this reclassification is included as a separate line in the restatement schedules in Note 2 that present the nature of the changes to the cost of goods sold and operating expenses. These reclassifications had no effect on the Company s previously reported results of operations, or financial position.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 sales and expenses during the reporting periods. On an ongoing basis, the Company evaluates its estimates, assumptions and judgments, including those related to revenue recognition; allowance for doubtful accounts; inventory costing and reserves; the assessment of warranty reserves; the valuation of goodwill, intangible assets and other long-lived assets; accounting for business combinations; share-based payments; employee benefit plans; accounting for restructuring activities; accounting for income taxes and related valuation allowances; and, accounting for loss contingencies. Actual results could differ significantly from those estimates.

Cash and cash equivalents

Cash equivalents consist principally of money market funds invested in U.S. Treasury Securities and repurchase agreements of U.S. Treasury Securities that have original maturities of 90 days or less. The Company does not believe it is exposed to any significant credit risk related to its cash equivalents.

Financial instruments and fair value measurements

Financial instruments with remaining maturities that are payable within one year from the balance sheet date are classified as current. Financial instruments with remaining maturities that are payable more than one year from the balance sheet date are classified as long-term.

Long-term Investments

As of September 26, 2008, the Company held auction rate securities, recorded at a fair value of $25.9 million, and with a par value of $32.3 million. These securities were acquired as part of the Company s purchase of Excel in 2008. These auction rate notes are student loans backed by

the federal government and are privately insured. Current capital market conditions have impacted the Company s ability to liquidate certain auction rate securities. Liquidity for these auction rate securities is typically provided by an auction process that resets the applicable interest rate at pre-determined intervals, usually every 7, 28, 35 or 90 days. In the past, the auction process has allowed investors to roll over their holdings or obtain immediate liquidity by selling the securities at par. Due to the current capital market conditions, auctions have not had

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

sufficient bidders to allow investors to complete a sale of some auction rate securities. Due to the uncertainty in the market as to when these auction rate notes will be refinanced or the auctions will resume, the Company has classified these instruments as long-term assets available for sale. If the credit ratings of the issuer, the bond insurers or the collateral deteriorates further, or if the issuers of these auction rate securities are unable to successfully close further auctions, the Company may further reduce the carrying value of these investments and may in the future be required to record impairment charges against these investments, some of which may be considered other-than-temporary impairment charges. From the date of the Company s acquisition of Excel, through September 26, 2008, the Company has recorded an unrealized gain on these investments of $0.9 million and has recorded that gain, net of tax, within other comprehensive income. See Note 17 for discussion of sales of auction rate securities after September 26, 2008.

At September 26, 2008 and December 31, 2007, the Company had a 25.1% equity investment in a privately held company located in the United Kingdom, valued at $0.9 million at September 26, 2008 and December 31, 2007, and included in Other Assets in the accompanying consolidated balance sheets. The Company uses the equity method to record the results of this entity. In relation to this investment, the Company recognized gains as other income of approximately $87,000 and approximately $117,000 for the nine months ended September 26, 2008 and September 28, 2007, respectively. In relation to this investment, the Company recognized a loss as other expense of approximately $56,000 for the three months ended September 26, 2008 and a gain as other income of approximately $23,000 for the three months ended September 28, 2007.

Fair Value Measurements

On January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements, with no impact on its consolidated results and financial position. SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances disclosures about fair value measurements. Fair value is defined as the price that would be received for an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. Valuation techniques must maximize the use of observable inputs and minimize the use of unobservable inputs.

SFAS 157 establishes a value hierarchy based on three levels of inputs, of which the first two are considered observable and the third is considered unobservable:

Level 1. Quoted prices for identical assets or liabilities in active markets which we can access.

Level 2. Observable inputs other than those described in Level 1.

Level 3. Unobservable inputs.

The following table summarizes the financial assets, as of September 26, 2008, that are measured at fair value on a recurring basis (in thousands):

	September 26, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Cash equivalents (a)	$ 38,459	$ 38,459	$	$

Auction rate securities (b)		25,860					25,860
Total	$	64,319	$	38,459	$	$	25,860

(a) Cash equivalents are valued at quoted market prices in active markets.

(b) Auction rate securities are valued based on assumptions that market participants might use in their estimates of fair value (including, among other factors, underlying collateral and lack of liquidity).

The following table summarizes the activity with respect to the auction rate securities (in thousands):

Balance at December 31, 2007	$
Added in connection with Excel acquisition	24,985
Unrealized gains	875
Balance at September 26, 2008	$ 25,860

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GSI GROUP INC.

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(Unaudited)

See Note 8 of the Notes to Consolidated Financial Statements for discussion of the estimated fair value of our Senior Notes.

Accounts receivable and allowance

Trade accounts receivable are recorded at the invoiced amount. The Company generally does not require collateral for trade accounts receivable. The Company maintains an allowance for doubtful accounts. The allowance for doubtful accounts is based on the Company s best estimate of the amount of probable credit losses resulting from the inability of the Company s customers to make required payments. The Company determines the allowance based on a variety of factors including the age of amounts outstanding relative to their contractual due date, specific customer factors, and other known risks and economic trends in industries. Charges booked to the allowance for doubtful accounts are recorded as selling, general and administrative expenses, and are recorded in the period that they are determined to be uncollectible.

Inventories

Inventories, which include materials and conversion costs, are stated at the lower of cost or market, using the first-in, first-out method. Market is defined as replacement cost for raw materials and net realizable value for other inventories. Demo inventory is recorded at the lower of cost or its net realizable value.

Property, plant and equipment

Property, plant and equipment are stated at cost and the Company uses the straight-line method to determine depreciation and amortization over estimated useful lives. Estimated useful lives for buildings and improvements range from 3 to 60 years and for machinery and equipment from 1 to 13 years. Leasehold improvements are amortized over the lesser of their useful lives or the lease term, including option periods expected to be utilized. Repairs and maintenance are expensed as incurred.

The carrying values of property, plant and equipment are reviewed for impairment whenever changes in events or circumstances indicate their carrying values may not be recoverable. The impairment analyses are conducted in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-lived Assets. No impairment charges were recorded in the third quarter or first nine months of 2008 or 2007. In the fourth quarter of 2008, the Company recorded a charge to reduce the carrying value of its goodwill, intangible assets and other long-lived assets by $215.1 million, including $5.4 million to write-down property, plant and equipment to fair value. See the section on *Impairment* below and Note 17 for additional information on this subsequent event.

Business combinations

The Company determines and allocates the purchase price of an acquired company to the tangible and intangible assets acquired and liabilities assumed as well as to in-process research and development as of the business combination date in accordance with SFAS 141, Business Combinations. The purchase price allocation process requires the Company to use significant estimates and assumptions, including fair value estimates, as of the business combination date including:

- estimated fair values of intangible assets;
- expected costs to complete any in-process research and development projects;

- estimated income tax assets and liabilities assumed from the acquiree; and,

- estimated fair value of pre-acquisition contingencies assumed from the acquiree.

While the Company uses its best estimates and assumptions as a part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the business combination date, its estimates and assumptions are inherently uncertain and subject to refinement. As a result, during the purchase price allocation period, the Company records adjustments to the assets acquired and liabilities assumed, with a corresponding offset to goodwill. Generally, with the exception of unresolved income tax matters, subsequent to the purchase price allocation period any adjustment to assets acquired or liabilities assumed is included in operating results in the period in which the adjustment is determined.

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(Unaudited)

In-process research and development costs are expensed when acquired and represent the estimated fair value as of the dates of acquisition of in-process projects acquired that have not yet reached technological feasibility and have no alternative future uses.

In fiscal 2009, the Company will adopt SFAS 141 (revised 2007), Business Combinations. Refer to Recent Accounting Pronouncements (below) for additional information.

Goodwill and intangible assets

Goodwill represents the excess of the purchase price in a business combination over the fair value of the acquired tangible and intangible net assets. In connection with its acquisition of Excel, the Company acquired certain trade names classified as intangible assets with indefinite lives. Goodwill and indefinite-lived intangibles are not amortized but they are required to be assessed for impairment at least annually. The Company also has certain intangible assets with definite lives that are amortized over their estimated useful lives. These definite-lived intangible assets were acquired in connection with the Company s historic business combinations. Their estimated useful lives are the periods over which their economic benefits are expected to be realized. The Company reviews its useful life assumptions, including the classification of certain intangible assets as indefinite-lived , on a periodic basis to determine if changes in circumstances warrant revisions to them. The Company s most significant intangible assets are acquired technology; customer relationships; and trademarks and trade names.

All of the Company s goodwill and intangible assets reside in our Precision Technology and Excel Segments.

Impairment

Our product lines generally correspond with our reporting units which is the level at which we evaluate our goodwill, intangible assets and other long-lived assets for impairment. The values of each reporting unit include assets and liabilities which relate to the reporting unit s operations. Additionally, reporting units that benefit from corporate assets or liabilities are allocated a portion of those corporate assets and liabilities on a systematic, proportional basis. Impairment analyses of goodwill and indefinite-lived intangible assets are conducted in accordance with SFAS 142, Goodwill and Other Intangible Assets. We test our goodwill balances annually in the beginning of the second quarter and more frequently if indicators are present or changes in circumstances suggest that impairment may exist. The Company s indefinite-lived intangible assets represent trade names that were acquired in the August 2008 acquisition of Excel. We will assess these indefinite-lived intangible assets for impairment on an annual basis in the beginning of the second quarter, beginning in 2009, and more frequently if indicators are present or changes in circumstances suggest that impairment may exist.

Intangible assets with definite lives are amortized over their estimated useful lives. The carrying values of definite-lived intangible assets and other long-lived assets (property, plant and equipment) are reviewed for impairment whenever changes in events or circumstances indicate their carrying values may not be recoverable. The impairment analyses are conducted in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-lived Assets.

No impairment charges were recorded in the third quarter or first nine months of 2008 or 2007. In the fourth quarter of 2008, the Company recorded a charge to reduce the carrying value of its goodwill, intangible assets and other long-lived assets by $215.1 million. The impairments of intangible assets and other long-lived assets (property, plant and equipment) were reflected as reductions in their gross carrying amounts. See Note 17 for additional information on this and other subsequent events.

Revenue recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, risk of loss has passed to the customer and collection of the resulting receivable is reasonably assured. Revenue recognition requires judgment and estimates, which may affect the amount and timing of revenue recognized in any given period.

The Company follows the provisions of Emerging Issues Task Force (EITF) 00-21, Revenue Arrangements with Multiple Deliverables for all multiple element arrangements. Under EITF 00-21, the Company assesses whether the

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(Unaudited)

deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes and whether objective and reliable evidence of fair value exists for these separate units of accounting. The Company applies the residual method when objective and reliable evidence of fair value exists for all of the undelivered elements in a multiple element arrangement. When objective and reliable evidence of fair value does not exist for all of the undelivered elements in a multiple element arrangement, the Company recognizes revenue under the multiple units shipped methodology, whereby revenue is recognized in each period based upon the lowest common percentage of the products shipped in the period. This approximates a proportional performance model of revenue recognition. This generally results in a partial deferral of revenue to a later reporting period. No revenue is recognized unless one unit of each product has been delivered.

Although certain of the Company s products contain operating and application software, the Company has determined the software element is incidental in accordance with the AICPA s Statement of Position (SOP 97-2) and EITF 03-05, Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software.

The Company determines the unit of accounting for certain transactions based on the guidance in TPA 5100.39. In particular, multiple purchase orders may be deemed to be interrelated and considered to constitute a multiple element arrangement for accounting purposes.

Semiconductor Systems transactions are generally multiple element arrangements which may include hardware, software, installation, training, an initial standard warranty, and optional extended warranty arrangements. The Company generally designs, markets and sells these products as standard configurations. For those standard configurations where acceptance criteria, if any, exist and are demonstrated prior to shipment, revenue is recorded at the time of shipment. For those cases where acceptance criteria cannot be demonstrated prior to shipment of a product or if a significant amount of fees are due upon acceptance, the Company recognizes revenue upon customer acceptance. Acceptance is generally required for sales of Semiconductor Systems segment products to Japanese customers, sales of New Products , which are considered by the Company, for purposes of revenue recognition determination, to be either (a) a product that is newly released to all customers, including a product which may have been existing previously, but which has been substantially upgraded with respect to its features or functionality; or, (b) the sale of an existing product to a customer who has not previously purchased that product. The Company follows a set of predetermined criteria when changing the classification of a New Product to a standard configuration whereby acceptance criteria are considered to be demonstrated at the time of shipment.

Precision Technology and Excel transactions include both single element and multiple element transactions. Multiple element transactions may include two or more products and occasionally also contain installation, training or preventative maintenance plans. Revenue is generally recognized under the multiple units shipped methodology described above.

The Company s Semiconductor Systems segment also sells spare parts and consumable items, which are not subject to acceptance criteria. Revenue for these spare parts and consumable items is generally recognized under the multiple units shipped methodology described above.

Installation is generally a routine process that occurs within a short period of time from delivery and the Company has concluded that this obligation is inconsequential and perfunctory. As such, for transactions that include installation, and for which customer acceptance has not been deemed necessary in order to record the revenue, the cost of installation is accrued at the time product revenue is recorded and no related revenue is deferred. Historically, the costs of installation have not been significant.

The initial standard warranty for product sales is accounted for under the provisions of SFAS 5, Accounting for Contingencies, as the Company has the ability to ascertain the probable likelihood of the liability, and can estimate the amount of the liability. A provision for the estimated cost related to warranty is recorded to cost of goods sold at the time revenue is recognized. The Company s estimate of costs to service the warranty obligations are based on historical experience and expectations of future conditions. To the extent the Company experiences increased warranty claims or increased costs associated with servicing those claims, revisions to the estimated warranty liability are recorded as increases or decreases to the accrual at that time, with an offsetting entry recorded to cost of goods sold.

The Company also sells optional extended warranty services, and preventative maintenance contracts, at the time of their product purchase. The Company accounts for these agreements in accordance with provisions of FASB Technical Bulletin (FTB) 90-1 Accounting for Separately

Priced Extended Warranty and Product Maintenance Contracts under which it recognizes the separately priced extended warranty and preventative maintenance fees over the associated period.

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(Unaudited)

The Company, at the request of its customers, may at times perform professional services for its customers, generally for the maintenance and repairs of products previously sold to those customers. These services are usually in the form of time and materials based contracts which are short in their duration. Revenue for time and material services is recorded at the completion of services requested under a customer s purchase order. Customers may, at times subsequent to the initial product sale, purchase a service contract whereby services, including preventative maintenance plans, are provided over a defined period, generally one year. Revenue for such service contracts are recorded ratably over the period of the contract.

The Company typically negotiates trade discounts and agreed terms in advance of order acceptance and records any such items as a reduction of revenue. The Company s revenue recognition policy allows for revenue to be recognized under arrangements where the payment terms are 180 days or less, presuming all other revenue recognition criteria have been met. From time to time, based on the Company s review of customer creditworthiness and other factors, the Company may provide its customers with payment terms that exceed 180 days. To the extent all other revenue recognition criteria have been met, the Company recognizes revenue for these extended payment arrangements as the payments become due.

The Company has significant deferred revenue included in its accompanying consolidated balance sheets, with balances (including both current and long-term amounts) of $108.6 million and $101.6 million as of September 26, 2008 and December 31, 2007, respectively. A significant majority of these amounts relate to arrangements whereby the entire arrangement has been accounted for as deferred revenue, as there is no fair value for the undelivered elements. Upon the final delivery of the undelivered element(s) of the arrangement, the revenue will be recorded for that arrangement. To a much lesser extent, the deferred revenue balances relate to either: (a) the unrecognized portion of a multiple element arrangements that is being recognized into revenue over a ratable basis as associated services are performed; (b) arrangements not currently recognizable due to the arrangement not being fixed and determinable at its inception; (c) the future amortization to revenue of extended warranty contracts and preventative maintenance plans; (d) revenue deferrals for product shipments with FOB destination shipping terms; and (e) deposits from customers against future orders. The classification of deferred revenue, and deferred cost of goods sold, is based on the Company s expectations relative to when the revenue will be recognizable, based on facts known to the Company as of the date its financial statements are released.

Deferred cost of goods sold

The Company defers the corresponding direct costs associated with the deferred revenue. These deferred costs have been recorded as deferred cost of goods sold, in the current and long-term sections of the accompanying balance sheets, as appropriate, and are reflected in the statements of operations as cost of goods sold when the related revenue is recognized. These costs represent the direct and incremental costs that are attributable to the product whose revenue is being deferred.

Research and development and engineering costs

Internal costs relating to research and development and engineering costs incurred for new products and enhancements to existing products are expensed as incurred.

Product warranty

The Company generally warrants its products for material and labor to repair and service the system. The standard warranty is generally a period of up to 12 months, with the exception of two product lines, DRC Encoders and JK lasers, both being product lines that are included in the Precision Technology segment, and which have a warranty period of 24 months. The accounting for warranty provisions is discussed in the Revenue Recognition section of this Note 3.

Share-based compensation

The Company has stock-based compensation plans which are more fully described in Note 10. The Company adopted SFAS 123(R) Accounting for Share-Based Payment on a modified prospective basis effective January 1, 2006.

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Shipping & handling costs

Shipping and handling costs are recorded in cost of goods sold.

Advertising costs

Advertising costs are expensed as incurred.

Foreign currency translation

The financial statements of the Company and its subsidiaries outside the United States have been translated into United States dollars in accordance with the SFAS 52, Foreign Currency Translation. Assets and liabilities of foreign operations are translated from foreign currencies into United States dollars at the exchange rates in effect on the balance sheet date. Sales and expenses are translated at the average exchange rate in effect for the period. Accordingly, gains and losses resulting from translating foreign currency financial statements are reported as a separate component of other comprehensive income in stockholders equity. Foreign currency transaction gains and losses are included in net income on the accompanying consolidated statements of operations. Foreign exchange transaction losses were $2,000 for the quarter ended September 26, 2008 and foreign exchange transaction gains were $682,000 for the quarter ended September 28, 2007. Foreign exchange transaction gains were $269,000 and $463,000 for the nine months ended September 26, 2008 and September 28, 2007, respectively.

These amounts arose primarily from transactions denominated in currencies other than the functional currency, as well as from gains or (losses) on derivative contracts.

Restructuring charges

In accounting for its restructuring activities, the Company follows the provisions of SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities. In accounting for these obligations, the Company makes assumptions related to the amounts of employee severance, benefits, and related costs and to the time period over which facilities will remain vacant, sublease terms, sublease rates and discount rates. Estimates and assumptions are based on the best information available at the time the obligation has arisen. These estimates are reviewed and revised as facts and circumstances dictate; changes in these estimates could have a material effect on the amount previously expensed against the Company s earnings, and currently accrued on the Company s consolidated balance sheet.

Accumulated other comprehensive income (loss)

The following table provides the details of accumulated other comprehensive income at:

	September 26, 2008	December 31, 2007 (As Restated)
Accumulated foreign currency translations	$ 9,046	$ 11,660
Unrealized gain on available for sale investments, net of tax of $335	540	
Accrued pension liability, net of tax of $271 (December 31, 2007 $227)	(3,972)	(4,274)
Total accumulated other comprehensive income	$ 5,614	$ 7,386

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GSI GROUP INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Comprehensive net income (loss)

The components of comprehensive income (loss) are as follows:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007 (As Restated)	September 26, 2008	September 28, 2007 (As Restated)
Net income (loss)	$ (14,229)	$ 6,655	$ (14,136)	$ 13,596
Change in foreign currency translation adjustments (1)	(3,920)	2,569	(2,615)	4,993
Unrealized gain on available for sale investments, net of tax	540		540	
Change in accrued pension liability, net of tax	297	(24)	302	(224)
Cumulative effect of adopting FIN 48				(136)
Accumulated comprehensive net income (loss)	$ (17,312)	$ 9,200	$ (15,909)	$ 18,229

(1) The foreign currency translation adjustments are primarily related to the movement in the British Pound, Japanese Yen and European Union Euro.

Derivative financial instruments

The Company s primary objective for holding derivative financial instruments is to manage currency risk. In accordance with SFAS 133, Accounting for Derivative Instruments and Hedging Activities, the Company s accounting policies for these instruments are based on whether they meet the criteria for designation as hedging transactions, including cash flow, or net investment hedges. The Company did not have any derivative instruments that qualify for hedge accounting under SFAS 133 at September 26, 2008 or December 31, 2007. In cases when the Company does have derivative contracts, it records all derivatives at fair value as assets or liabilities in the consolidated balance sheet and any changes are recognized in other income and expense.

When the Company enters into foreign currency derivative contracts, the contracts are generally for less than six months duration with the purpose of hedging foreign currency risk on sales transactions. At September 26, 2008, the Company held forward contracts to: sell Japanese yen for the equivalent of $3.7 million; buy British Pounds and European Union Euros for $7.4 million and $1.2 million, respectively. As of September 26, 2008, the Company has recorded an unrealized gain of $4,000 relating to these contracts. At December 31, 2007, the Company held forward contracts to: sell Japanese yen for the equivalent of $7.9 million; settle U.S. dollar / Japanese yen average strike option with an underlying currency amount of 400 million yen (U.S. equivalent of $3.5 million); and buy British pounds for the equivalent of $4.2 million.

Net income (loss) per common share

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. For diluted net income (loss) per common share, the denominator also includes any dilutive outstanding stock options, restricted stock and warrants determined using the treasury stock method. Common and common share equivalent disclosures are (in thousands):

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007 (As Restated)	September 26, 2008	September 28, 2007 (As Restated)
Weighted average common shares outstanding	41,677	42,654	41,792	42,344
Dilutive potential common shares (1)		282		234
Diluted common shares	41,677	42,936	41,792	42,578
Excluded from diluted common shares calculation stock options, restricted stock and warrants that are anti-dilutive (2)	7,738	388	7,534	1,065

(1) Due to the Company s net loss position for the three months ended and nine months ended September 26, 2008, all dilutive shares are excluded as their effect would also have been anti-dilutive.

(2) Subsequent to September 26, 2008, the warrants that were issued in connection with the debt were exercised and converted into shares of common stock.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Accounting for income taxes

The liability method is used to account for income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which the differences are expected to be recovered or settled. A valuation allowance is established to reduce the deferred tax assets if it is more likely than not that the related tax benefits will not be realized in the future.

Recent Accounting Pronouncements

Disclosures about Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS 161 Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB statement No. 133. SFAS 161 requires enhanced disclosures about an entity s derivative and hedging activities and thereby improves the transparency of financial reporting. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. At initial adoption, SFAS 161 encourages, but does not require, comparative disclosures for earlier periods. The Company does not expect that this new pronouncement will have a material impact on the Company s financial statements in future periods.

Business Combinations

In December 2007, the FASB issued SFAS 141 (revised 2007) Business Combinations. SFAS 141R establishes principles and requirements for the method in which the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company believes that this new pronouncement, once adopted, will have an impact on its accounting for future business combinations, however, the effect will be dependent upon the particular acquisition(s) that may be made in the future.

The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of SFAS 115. SFAS 159 provides businesses with the option to measure financial instruments and certain other items at fair market value. Unrealized gains and losses on items for which the fair market value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, provided that the entity also elects to apply the provisions of SFAS 157, Fair Value Measurements, as discussed below. The Company adopted SFAS 159 on January 1, 2008 with no impact on its consolidated results and financial position.

Fair Value Measurements

In September 2006, the FASB issued SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy to classify the source of the information. This statement is effective for the Company beginning January 1, 2008. The Company adopted SFAS 157 with no impact on its consolidated results and financial position.

In February 2008, the FASB issued FSP 157-2, Effective Date of FASB Statement No. 157, which delays the effective date of SFAS 157 for all nonrecurring fair value measurements of nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. The nonfinancial assets and nonfinancial liabilities to which SFAS 157 was not applied are included in the Company s accompanying consolidated balance sheets under the captions: property, plant and equipment, net; other assets; goodwill; and, intangible assets, net. The Company has not determined the effect on its consolidated financial statements from the application of SFAS 157 for all nonrecurring fair value measurements of nonfinancial assets and liabilities. The partial adoption of SFAS 157 for financial assets and financial liabilities did not impact the Company s consolidated results of operations or financial condition.

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(Unaudited)