NANOMETRICS INC
Form 10-Q/A
June 13, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q /A

Amendment No. 1

(Mark One)

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended April 1, 2006

OR

¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ______ to ______

Commission file number 0-13470

NANOMETRICS INCORPORATED

(Exact name of registrant as specified in its charter)

California	**94-2276314**
(State or other jurisdiction of incorporation or organization)	**(I. R. S. Employer Identification No.)**
1550 Buckeye Drive, Milpitas, CA	**95035**

(Address of principal executive offices) **(Zip Code)**

Registrant s telephone number, including area code: (408) 435-9600

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

Indicate by check mark whether the registrant 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.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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 April 24, 2006, there were 13,085,332 shares of common stock, no par value, issued and outstanding.

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EXPLANATORY PARAGRAPH

We are filing this Form 10-Q/A, Amendment No. 1 solely for the purpose of revising the portion of footnote No. 3 of the Notes to Condensed Consolidated Financial Statements in Item I of Part I that relates to our acquisition of Soluris Inc**.** We are revising the footnote to: a) clarify the disclosure related to our management s responsibility for estimating fair values of assets acquired and liabilities assumed in the Soluris merger; and b) revise the unaudited pro forma information as if Nanometrics had acquired Soluris at the beginning of the three months ended April 1, 2006. This Form 10-Q/A, Amendment No. 1 also includes the required certifications of our principal executive officer and principal financial officer. We have made no further changes to the originally filed Form 10-Q. All other information in this Form 10-Q/A, Amendment No. 1 is as of the date the Form 10-Q was originally filed and does not reflect any subsequent information or events.

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NANOMETRICS INCORPORATED

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FOR QUARTER ENDED APRIL 1, 2006

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PART I FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts in thousands except share amounts)

(Unaudited)

	April 1, 2006	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 33,915	$ 40,445
Short-term investments		4,949
Accounts receivable, net of allowances of $657 and $592, respectively	20,570	18,983
Inventories	27,494	25,656
Prepaid expenses and other	4,183	1,259
Total current assets	86,162	91,292
Property, plant and equipment, net	42,613	42,928
Goodwill	3,030	
Intangible assets	4,760	639
Other assets	1,483	1,441
Total assets	$ 138,048	$ 136,300
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Revolving line of credit	$ 510	$ 1,186
Accounts payable	4,653	3,348
Accrued payroll and related expenses	2,086	1,540
Deferred revenue	3,818	3,448
Other current liabilities	3,920	3,869
Income taxes payable	748	770
Current portion of debt obligations	381	400
Total current liabilities	16,116	14,561
Deferred income taxes and other long-term liabilities	257	
Debt obligations	1,313	1,396
Total liabilities	17,686	15,957
Contingencies		
Shareholders Equity:		
Common stock, no par value; 50,000,000 shares authorized; 13,033,438 and 12,990,894, respectively, outstanding	107,592	107,294
Additional paid-in capital	853	
Retained earnings	10,896	12,218

Accumulated other comprehensive income	1,021	831
Total shareholders equity	120,362	120,343
Total liabilities and shareholders equity	$ 138,048	$ 136,300

See Notes to Unaudited Condensed Consolidated Financial Statements

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NANOMETRICS INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands except per share amounts)

(Unaudited)

	Three Months Ended April 1, 2006	April 2, 2005
Net revenues:		
Products	$ 15,972	$ 21,010
Service	2,996	2,340
Total net revenues	18,968	23,350
Costs and expenses:		
Cost of products	7,909	9,732
Cost of service	2,534	2,573
Research and development	2,528	3,179
Selling	3,102	3,143
General and administrative	4,550	1,998
Total costs and expenses	20,623	20,625
Income (loss) from operations	(1,655)	2,725
Other income (expense):		
Interest income	332	130
Interest expense	(13)	(18)
Other, net	35	(270)
Total other income (expense), net	354	(158)
Income (loss) before income taxes	(1,301)	2,567
Provision for income taxes	21	83
Net income (loss)	$ (1,322)	$ 2,484
Net income (loss) per share:		
Basic	$ (0.10)	$ 0.20
Diluted	$ (0.10)	$ 0.18
Shares used in per share computation:		
Basic	13,018	12,575
Diluted	13,018	13,455

See Notes to Unaudited Condensed Consolidated Financial Statements.

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NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

(Unaudited)

	Three Months Ended	
	April 1, 2006	April 2, 2005
Cash flows from operating activities:		
Net income (loss)	$ (1,322)	$ 2,484
Reconciliation of net income (loss) to net cash used in operating activities:		
Depreciation and amortization	572	626
Stock-based compensation	853	
Changes in assets and liabilities:		
Accounts receivable	(1,337)	(6,004)
Inventories, net	(630)	(34)
Prepaid expenses and other	(609)	57
Other assets	(17)	
Accounts payable, accrued and other current liabilities	333	402
Deferred revenue	(76)	1,717
Income taxes payable	(24)	(408)
Net cash used in operating activities	(2,257)	(1,160)
Cash flows from investing activities:		
Purchase of Soluris net assets, net of cash received	(6,752)	
Purchase of short-term investments		(18,933)
Sales/maturities of short-term investments	4,949	18,000
Purchases of property, plant and equipment	(48)	(27)
Deferred acquisition costs related to the proposed mergers	(1,960)	(1,130)
Net cash used in investing activities	(3,811)	(2,090)
Cash flows from financing activities:		
Repayments of debt obligations	(793)	(446)
Sale of shares under employee stock option plan and purchase plan	298	131
Net cash used in financing activities	(495)	(315)
Net decrease in cash and cash equivalents	(6,563)	(3,565)
Effect of exchange rate changes on cash and cash equivalents	33	(88)
Cash and cash equivalents, beginning of period	40,445	15,949
Cash and cash equivalents, end of period	$ 33,915	$ 12,296
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 13	$ 18
Cash paid (refunded) for income taxes	$ (151)	$ 476

See Notes to Unaudited Condensed Consolidated Financial Statements.

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NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Consolidated Financial Statements

In the opinion of management, the accompanying Unaudited Consolidated Interim Financial Statements (financial statements) of Nanometrics Incorporated and its wholly-owned subsidiaries (collectively, Nanometrics or the Company) have been prepared on a consistent basis with the December 31, 2005 audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly present the information set forth therein. The financial statements have been prepared in accordance with the regulations of the United States Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with accounting principles generally accepted in the United States of America. The operating results for interim periods are not necessarily indicative of the operating results that may be expected for the entire year. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2005, which were included in the Company s Annual Report on Form 10-K, which was filed with the SEC on March 24, 2006.

Fiscal Period Nanometrics uses a 52/53 week fiscal year ending on the Saturday nearest to December 31. All references to the quarter refer to Nanometrics fiscal quarter. The fiscal quarters presented herein include 13 weeks.

Note 2. Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 155, *Accounting for Certain Hybrid Instruments An Amendment of FASB Statements No. 133 and No. 144* (SFAS 155). SFAS 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. It also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. Furthermore, SFAS 155 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and it amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of the first fiscal year beginning after September 15, 2006. The Company s adoption of the provisions of SFAS 155 is not expected to impact its financial condition or results of operations.

In September 2005, the Emerging Issues Task Force (EITF) reached consensus on EITF Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty* (Issue No. 04-13). In certain situations, a company may enter into nonmonetary transactions to sell inventory to another company in the same line of business from which it also purchases inventory. Under Issue No. 04-13, in general, an entity is required to treat sales and purchases of inventory between the entity and the same counterparty as one transaction for purposes of applying Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions* when such transactions are entered into in contemplation of each other. When such transactions are legally contingent on each other, they are considered to have been entered into in contemplation of each other. The EITF also agreed on other factors that should be considered in determining whether transactions have been entered into in contemplation of each other. Issue No. 04-13 will be effective for all new arrangements entered into in reporting periods beginning after March 15, 2006. The Company does not anticipate any impact on its consolidated results of operations and financial condition upon adoption of the provisions of Issue No. 04-13.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154) which replaces APB 20 *Accounting Changes* and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion.* 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted in the first fiscal quarter of 2006. The adoption of SFAS 154 did not have a material impact on the Company s financial position or consolidated results of operations and financial condition.

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Note 3. Acquisitions

Accent Optical Technologies

On January 25, 2006, Nanometrics announced a definitive agreement to merge with Accent Optical Technologies, Inc. (Accent Optical), a supplier of process control and metrology systems to the global semiconductor manufacturing industry headquartered in Bend, Oregon. The Company believes the merger of Nanometrics and Accent Optical will create one of the largest independent metrology companies in the semiconductor industry and allow the combined company to expand its market position in each of its primary stand-alone metrology segments after the merger. The merger is expected to create a strong platform for the combined company to deliver metrology systems to both new and existing customers. Under the terms of the merger agreement, which was unanimously approved by the boards of directors of both companies, the Company will issue 4.9 million shares of its common stock for all outstanding Accent Optical capital stock and rights to acquire Accent Optical capital stock. Nanometrics will also issue an additional number of shares of its common stock equal to the quotient of the aggregate exercise price of all Accent Optical stock options that are assumed pursuant to the merger agreement, divided by the average closing price of Nanometrics common stock for the ten (10) trading days ending two (2) days prior to the closing date of the merger. As part of the merger agreement, Nanometrics agreed to provide Accent Optical with a working capital loan in the aggregate amount $2.5 million. As of March 31, 2006, Nanometrics advanced $750,000 to Accent Optical as part of this agreement. Subsequent to quarter-end, Nanometrics advanced an additional $1,750,000. The total estimated purchase price of $71.1 million is based on the average of Nanometrics closing stock price for the period beginning two trading days before and ending two trading days after the merger was announced in accordance with EITF 99-12, *Determination of Measurement date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*, and includes the 4.9 million shares of Nanometrics common stock valued at $68.1 million, assumed vested stock options with a fair value of $1.2 million and estimated direct transaction costs of $1.7 million. Accent Optical stockholders will own approximately 27% of the outstanding shares of Nanometrics common stock immediately after the merger, and Nanometrics shareholders will own approximately 73% of the outstanding shares of Nanometrics common stock immediately after the merger. Completion of the transaction is subject to required approvals from Nanometrics and Accent Optical shareholders. The merger is expected to be completed near the end of the second quarter of fiscal year 2006.

The merger will be accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*. Under the purchase method of accounting, the total estimated purchase price is allocated to the net tangible and identifiable intangible assets of Accent Optical acquired in connection with the merger, based on their respective estimated fair values. Pursuant to the terms of the merger agreement, either Nanometrics or Accent Optical may terminate the merger agreement upon the occurrence of certain specified circumstances or events. In connection with such termination, either Nanometrics or Accent Optical may be required to pay to the other party a termination fee of $5.0 million, plus expenses. Unless otherwise indicated, references to Nanometrics in this filing relate to Nanometrics as a stand-alone entity and do not reflect the impact of the potential business combinations transaction with Accent Optical.

Soluris, Inc.

On March 15, 2006, Nanometrics announced it had acquired Soluris Inc., (Soluris) a privately held corporation focused on overlay and CD measurement technology and headquartered in Concord, Massachusetts. The acquisition of Soluris will enhance the Company s line of overlay products and provide access to various other new customers. Its flagship product, the IVS 155, is a tool for use in the 200mm and smaller semiconductor overlay and CD measurement market. Under the terms of the merger agreement relating to the acquisition, the total consideration to purchase all the outstanding stock of Soluris was $6.6 million in an all-cash transaction. The Company also incurred $0.3 million in transaction fees, including legal, valuation and accounting fees. The merger has been accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*. Under the purchase method of accounting, the total estimated purchase price is allocated to the net tangible and identifiable intangible assets of Soluris acquired in connection with the merger, based on their respective estimated fair values. The results of operations of Soluris were included in the Company s condensed consolidated statements of operations from the date of the acquisition.

The preliminary allocation of the Soluris purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed was based on management s estimates of fair value at the date of acquisition. When estimating fair values of assets acquired and liabilities assumed, management considered a number of factors, including valuations, appraisals and assumptions which are subject to change. The primary areas of the purchase price allocation that are not yet finalized relate to the completion of audited financial statements and income tax returns, and the impact of audit adjustments, if any, on management s estimates of fair values. We expect management s valuation process to be completed during the fourth quarter of fiscal 2006

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The preliminary allocation of the Soluris purchase price is summarized below (in thousands):

Assets acquired:	
Cash	$ 67
Accounts receivable	474
Inventories	1,175
Other assets	112
Total assets acquired	1,828
Liabilities assumed:	
Accounts payable	(562)
Accrued compensation	(450)
Deferred revenue	(443)
Other accrued liabilities	(504)
Total liabilities assumed	(1,959)
Net liabilities assumed	(131)
Deferred income tax liabilities	(240)
Goodwill and other intangible assets:	
Goodwill	3,030
Customer relationships	2,900
Patented technology	700
Trademark	600
Total goodwill and other intangible assets	7,230
Net assets acquired	$ 6,859

The patented technology and customer relationships are being amortized over an estimated useful life of ten years. The amount allocated to the trademark has been determined to have an indefinite life. In accordance with SFAS No. 142, *Goodwill and other Intangible Assets,* the Company will not amortize the goodwill and trademark, but will evaluate them annually for impairment or whenever events or circumstances occur which indicate that they might be impaired.

If the Company had acquired Soluris at the beginning of the period presented, the Company s unaudited pro forma net revenues, net income (loss) and net income (loss) per share from continuing operations would have been as follows (in thousands, except per share amounts):

	Three Months Ended	
	April 1, 2006	**April 2, 2005**
Net revenues	$ 20,083	$ 26,446
Net income (loss)	(1,982)	2,413
Net income (loss) per share		
Basic	$ (0.15)	$ 0.19
Diluted	$ (0.15)	$ 0.18

Note 4. Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (collectively Employee Stock Purchases) based on estimated fair values. SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s financial statements as of and for the three months ended April 1, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s consolidated statement of operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123, *Accounting for Stock-Based Compensation* (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s consolidated statements of operations, because exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s consolidated statement of operations for the first quarter of fiscal 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). As stock-based compensation expense recognized in the consolidated statement of operations for the first quarter of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company s estimated forfeiture rate for the three months ended April 1, 2006, of 14.1% was based on historical forfeiture experience. In the Company s pro forma information, required under SFAS 123 for the periods prior to fiscal 2006, the Company estimated forfeitures at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differed from those estimates.

SFAS 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash flows. There were no such tax benefits during the three months ended April 1, 2006. Prior to the adoption of Statement SFAS 123(R) those benefits would have been reported as operating cash flows had the Company received any tax benefits related to stock option exercises.

Valuation and Expense Information under SFAS 123(R)

The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company s stock options. The Black-Scholes model requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term of options granted was calculated using the simplified method allowed by SAB 107. The risk-free rate is based on the U.S Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of Nanometrics stock price. These factors could change in the future, which would affect the stock-based compensation expense in future periods.

The weighted-average fair value of stock-based compensation to employees is based on the single option valuation approach. Forfeitures are estimated and it is assumed no dividends will be declared. The estimated fair value of stock-based compensation awards to employees is amortized using the straight-line method over the vesting period of the options. The weighted-average fair value calculations are based on the following average assumptions:

	Three Months Ended April 1, 2006
Stock Options:	
Expected life	4.3 years
Volatility	73.6%
Risk free interest rate	4.55%
Dividends	
Employee Stock Purchase Plan:	
Expected life	0.5 years
Volatility	37.5%
Risk free interest rate	1.7%
Dividends	

The weighted average fair values per share of the stock options awarded in the three months ended April 1, 2006 was $14.00 based on the fair market value of the Company s common stock on the grant dates.

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The following table summarizes stock-based compensation expense for all share-based payment awards made to the Company s employees and directors pursuant to the Employee Stock Purchases under SFAS 123(R) for the three months ended April 1, 2006 which was allocated as follows (in thousands):

	Three Months Ended April 1, 2006
Cost of products	$ 67
Cost of service	38
Research and development	260
Selling	147
General and administrative	341
Stock-based compensation expense included in costs and expenses	853
Total stock-based compensation expense related to employee stock options and employee stock purchases	$ 853

The table below reflects net income (loss) and basic and diluted net income (loss) per share for the three months ended April 1, 2006 compared with the pro forma information for the three months ended April 2, 2005 as follows (in thousands except per-share amounts):

	Three Months Ended April 1, 2006	Three Months Ended April 2, 2005
Net income (loss) as reported for the prior period[1]	N/A	$ 2,484
Stock-based compensation expense related to employee stock options [2]	(853)	(955)
Net income (loss), including the effect of stock-based compensation expense [3]	$ (1,322)	$ 1,529
Net income (loss) per share as reported for the prior period[1]		
Basic		$ 0.20
Diluted		$ 0.18
Net income (loss) per share, including the effect of stock-based compensation expense [3]		
Basic	$ (0.10)	$ 0.12
Diluted	$ (0.10)	$ 0.11
Shares used to compute income per share		
Basic	13,018	12,575
Diluted	13,018	13,455

(1) Net loss and net loss per share prior to fiscal 2006 did not include stock-based compensation expense for employee stock options under SFAS 123 because the Company did not adopt the recognition provisions of SFAS 123.

(2) Stock-based compensation expense prior to fiscal 2006 is calculated based on the pro forma application of SFAS 123.

(3) Net income and net income per share prior to fiscal 2006 represents pro forma information based on SFAS 123.

A summary of option activity under the Company s stock option plans during the three months ended April 1, 2006 is as follows:

	Shares Available	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in Thousands)
Options					
Outstanding at December 31, 2005	1,979,761	2,570,758	$ 10.01		
Exercised		(42,544)	6.99		
Granted	(263,200)	263,200	14.00		
Canceled	39,805	(59,805)	13.12		
Outstanding at April 1, 2006	1,756,366	2,731,609	$ 10.38	4.85	$ 10,955
Exercisable at April 1, 2006		1,503,657	$ 8.77	3.98	$ 8,758

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $13.85 as of April 1, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total intrinsic value of options exercised during the three months ended April 1, 2006 was $0.3 million. The fair value of options vested was $0.9 million for the three months ended April 1, 2006.

The following table summarizes significant ranges of outstanding and exercisable options as of April 1, 2006.

	Options Outstanding			Options Exercisable	
		Weighted Average	Weighted		Weighted
		Remaining	Average		Average
	Number	Contractual Life	Exercise	Number	Exercise
Range of Exercise Prices	Outstanding	(Years)	Price	Exercisable	Price
$3.14 $ 5.54	69,175	3.15	$ 4.58	69,175	$ 4.58
$5.70 $ 5.70	813,771	4.21	$ 5.70	813,771	$ 5.70
$6.33 $ 8.51	286,703	4.29	$ 7.49	196,071	$ 7.45
$9.90 $11.77	342,435	5.94	$ 11.25	37,386	$ 10.45
$12.02 $12.02	100,000	5.15	$ 12.02	33,333	$ 12.02
$12.03 $12.03	279,300	6.45	$ 12.03	0	$ 0.00
$12.29 $13.57	296,600	6.10	$ 12.94	35,790	$ 12.88
$13.75 $15.25	298,632	5.06	$ 14.74	110,381	$ 14.21
$15.81 $25.24	241,493	2.93	$ 18.57	204,250	$ 18.88
$29.20 $29.20	3,500	2.38	$ 29.20	3,500	$ 29.20
$3.14 $29.20	2,731,609	4.85	$ 10.38	1,503,657	$ 8.77

As of April 1, 2006, total unrecognized compensation costs related to unvested stock options was $5.4 million, which is expected to be recognized as expense over a weighted average period of approximately 2.07 years.

Pro Forma Information Under SFAS 123 for Periods Prior to Fiscal 2006

Prior to fiscal 2006, the weighted-average fair value of stock-based compensation to employees was based on the single option valuation approach. Forfeitures were estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differed from those estimates. It was assumed no dividends would be declared. The estimated fair value of stock-based compensation awards to employees was amortized using the straight-line method over the vesting period of the options. The weighted-average fair value calculations were based on the following weighted-average assumptions:

	Three Months Ended
	April 2, 2005
Stock Options:	
Expected life	3.3 years
Volatility	80.0%
Risk free interest rate	3.38%
Dividends	
Employee Stock Purchase Plan:	
Expected life	0.5 years
Volatility	66.0%
Risk free interest rate	1.1%

Dividends

Note 5. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following (in thousands):

	April 1, 2006	December 31, 2005
Raw materials and subassemblies	$ 13,211	$ 14,175
Work in process	7,671	5,021
Finished goods	6,612	6,460
Total inventories	$ 27,494	$ 25,656

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Note 6. Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price paid over the fair value of tangible and identifiable intangible net assets acquired in the acquisition of Soluris. In accordance with SFAS No. 142, goodwill is reviewed annually or whenever events or circumstances occur which indicate that goodwill might be impaired. During the first quarter of 2006, the Company recorded goodwill of $3.0 million as a result of the Company s acquisition of Soluris.

Intangible assets with an indefinite life are evaluated annually for impairment or whenever events or circumstances occur which indicate that those assets might be impaired. During the first quarter of 2006, the Company recorded a trademark of $0.6 million with an indefinite life as a result of the Company s acquisition of Soluris.

Finite-lived intangible assets are recorded at cost, less accumulated amortization. Finite-lived intangible assets as of April 1, 2006 and December 31, 2005 consist of the following (in thousands):

April 1, 2006	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Intangible Assets**
Patented technology acquired in business combinations	$ 700	$ 3	$ 697
Customer relationships	2,900	12	2,888
Patented technology	1,790	1,215	575
Other	250	250	
Total	$ 5,640	$ 1,480	$ 4,160

December 31, 2005	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Intangible Assets**
Patented technology	$ 1,790	$ 1,151	$ 639
Other	250	250	
Total	$ 2,040	$ 1,401	$ 639

The amortization of finite-lived intangibles purchased in the Soluris acquisition is computed using the straight-line method over a period of ten years. Total amortization expense was $0.1 million for each of the quarters ended April 1, 2006 and April 2, 2005.

The estimated future amortization expense as of April 1, 2006 is as follows (in thousands):

Fiscal Years	
2006 (remaining nine months)	$ 462
2007	616
2008	488
2009	360
2010	360
2011 and after	1,874

Total amortization	$ 4,160

Note 7. Other Current Liabilities

Other current liabilities consist of the following (in thousands):

	April 1, 2006	December 31, 2005
Accrued warranty	$ 1,540	$ 1,440
Accrued professional services	1,687	1,518
Other	693	911
Total other current liabilities	$ 3.920	$ 3,869

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Note 8. Shareholders Equity

Net Income (Loss) Per Share - Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income per share gives effect to all potentially dilutive common shares outstanding during the period, which include certain stock options, calculated using the treasury stock method. A reconciliation of the share denominator of the basic and diluted net income (loss) per share computations is as follows (in thousands):

	Three Months Ended	
	April 1, 2006	**April 2, 2005**
Weighted average common shares outstanding-shares used in basic net income (loss) per share computation	13,018	12,575
Potentially dilutive common stock equivalents, using the treasury stock method		880
Shares used in diluted net income (loss) per share computation	13,018	13,455

For the quarter ended April 1, 2006, the Company had securities outstanding which could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted net loss per share in the periods presented as their impact would have been antidilutive. Weighted average common share equivalents, consisting of stock options excluded from the calculation of diluted net loss per share were 1.2 million in the quarter ended April 1, 2006.

At April 2, 2005, diluted net income per share excludes common equivalent shares outstanding of 0.8 million, as their effect was anti-dilutive.

Note 9. Comprehensive Income (Loss)

The Company s comprehensive income (loss) was as follows (in thousands):

	Three Months Ended	
	April 1, 2006	**April 2, 2005**
Net income (loss)	$ (1,322)	$ 2,484
Foreign currency translation adjustment, net of tax	190	(260)
Total comprehensive income (loss)	$ (1,132)	$ 2,224

Substantially all of the accumulated other comprehensive income reflected as a separate component of shareholders equity consists of accumulated foreign currency translation adjustment for all periods presented.

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Note 10. Warranties

Product Warranty- The Company sells the majority of its products with a 12 month repair or replacement warranty from the date of acceptance which generally represents the date of shipment. The Company provides an accrual for estimated future warranty costs based upon the historical relationship of warranty costs to the cost of products sold. The estimated future warranty obligations related to product sales are recorded in the period in which the related revenue is recognized. The estimated future warranty obligations are affected by the warranty periods, sales volumes, product failure rates, material usage, labor and replacement costs incurred in correcting a product failure. If actual product failure rates, material usage, labor or replacement costs differ from the Company s estimates, revisions to the estimated warranty obligations would be required. For new product introductions where limited or no historical information exists, the Company may use warranty information from other previous product introductions to guide it in estimating its warranty accrual. The warranty accrual represents the best estimate of the amount necessary to settle future and existing claims on products sold as of the balance sheet date. The Company periodically assesses the adequacy of its reported warranty reserve and adjusts the amounts in accordance with changes in these factors. Components of the warranty accrual, which was included in the accompanying consolidated balance sheets with other current liabilities, were as follows (in thousands):

	Three Months Ended	
	April 1, 2006	**April 2, 2005**
Balance as of beginning of period	$ 1,440	$ 1,055
Actual warranty costs	(235)	(327)
Provision for warranty	205	423
Balance as of end of period	$ 1,410	$ 1,151

Intellectual Property Indemnification Obligations- In addition to product warranties, the Company will, from time to time, in the normal course of business, indemnify certain customers with whom it enters into contractual relationships. The Company has agreed to hold these customers harmless against third party claims that Nanometrics products, when used for their intended purpose(s), infringe the intellectual property rights of such third parties or other claims made against the customer. It is not possible to determine the maximum potential amount of liability under these indemnification obligations due to the limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in each particular claim. Historically, the Company has not made payments under these obligations and believes that the estimated fair value of these agreements is minimal. Accordingly, no liabilities have been recorded for these obligations on the consolidated balance sheets as of April 1, 2006 and December 31, 2005.

Note 11. Income Taxes

Income tax provisions for interim periods are based on the Company s estimated annual income tax rate. In the first quarter of fiscal 2006, the Company s income tax provision is a result of foreign taxes. In the first quarter of fiscal 2005, the Company recorded an income tax provision of $0.1 million on pre-tax income of $2.6 million. The estimated annual tax rate differs from the combined United States federal and state statutory income tax rate of 40% primarily due to estimated utilization of the Company s net operating losses and various tax credits and reduction of the associated deferred tax valuation allowance.

Note 12. Contingencies

On March 9, 2005, Nova Measuring Instruments Ltd. (Nova) filed suit against us in the United States District Court for the Northern District of California. The complaint alleges that certain of the Company s products infringe a Nova patent and seeks a preliminary and permanent injunction against their sale and unspecified damages. The Company does not believe any of its products infringe any valid claim of the Nova patent and intends to vigorously and aggressively defend itself in the litigation. While the results of such litigation matters and claims cannot be predicted with certainty, the Company believes the final outcome of such matters will not have a material adverse impact on its financial position or results operations.

In August 2005, KLA-Tencor Corporation, (KLA), filed a complaint against us in the United States District Court for the Northern District of California. The complaint alleges that certain of the Company s products infringe two of KLA s patents. On January 30, 2006, KLA added a third patent to their claim. The complaint seeks a preliminary and permanent injunction against the sale of these products as well as the recovery of monetary damages and attorneys fees. The Company does not believe that any of its products infringe the intellectual property of any third party and it intends to vigorously and aggressively defend itself in the litigation. As part of such defense, the Company has filed a request for re-examination of the three allegedly infringed KLA patents with the U.S. Patent & Trademark Office (PTO). These requests for re-examination were recently accepted for review by the PTO. In March 2006, the Company filed a motion for and was granted a stay in the patent litigation case until such re-examination is completed.

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Note 13. Geographic and Significant Customer Information

Nanometrics has operations in four primary geographic operating locations: the United States, Japan, South Korea and Taiwan. All such operating locations have similar economic characteristics, as defined in SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, and accordingly, Nanometrics operates in one reportable segment: the sale, design, manufacture, marketing and support of thin film, optical critical dimension and overlay dimension metrology systems. The following table summarizes total net revenues and long-lived assets attributed to significant countries (in thousands):

	Three Months Ended	
	April 1, 2006	April 2, 2005
Total net revenues:		
United States	$ 12,188	$ 5,411
Japan	4,386	5,167
South Korea	1,371	10,174